Restoring Trust in Financial Markets.

A. Introduction

The task, we are told, is to restore trust in financial markets after the damage done by Enron and its cohorts, the "tech bubble", and earlier by the Asian crisis. Confucius said that a ruler needs three things – weapons, food, and trust; if he has to give up any of these, weapons go first, then food. "Without trust we cannot stand". (quoted in O'Neil 2002). But how do we strengthen trust? We are now in the phase of the economic cycle when we hear increasingly-strident cries that "the government ought to do something about it". So there will be pressures to re-write, formalise, strengthen and centralise the rules of prudential supervision, governance and corporate behaviour, making them more intrusive and prescriptive.

Of course formal legally-enforceable rules and regulation are part of the environment which provides incentives for good corporate behaviour. But there are two broad constraints on what can be done with formal rules:

- They are costly to administer and introduce distortions – "the law of unintended consequences"
- The more comprehensive the rules are, the more the rule-makers will be blamed when things go wrong, as they will.

Governance is about behaviour, which stems from a wider system of incentives than simply those set down in the formal rules. We need to put maximum reliance on market discipline, and making markets work better may pay higher dividends than overly-refined governance rules, or lumbering directors with new (and often unattainable) responsibilities.

"Restoring trust in markets" may be the wrong starting-point: maybe people have had too much trust in the efficiency of markets, and in the universal presence of honest and competent managers (recall Warren Buffett's advice: "only invest in companies that can be run by a fool, because one day they will be"). What we should restore is *reality, caution and scepticism.* By all means we should endeavour to improve company governance, but what also needs to change is the public's perception of how much (and how little) the formal legally-enforceable rules of good governance can deliver, to encourage them to make their own decisions about who to trust and who to shun.

In this paper, I argue that business has become more complex, and so the problems of corporate governance have become more difficult. There may be a need for new legally-enforceable rules (or a re-jigging of the old ones), but we should be looking elsewhere for less formal rules and norms of behaviour, and for ways of making self-regulation work better than it has in the past. We should also harness the power of market discipline, but this means we should also look at ways of making markets work better. Then, having done what we can to improve the rules and to use markets in order to reinforce incentives for good governance, we need to remind investors that they are responsible for their decisions, both good and bad.

Changes in Market Behaviour

The problems that give rise to the calls for more government action may be getting worse, for a variety of reasons. First, the "culture" of business may be changing. Whatever it faults, the elitist and patrician culture associated with the traditional business clubs did carry with it a set of codes of behaviour which, while not always honoured, provided an element of *nobless oblige* and some constraints on behaviour. This has been replaced by a more amoral and sharp-edged *shareholder value* mind-set. For many businesses, the notion of "stakeholder" and "shareholder" are synonymous. Questionable behaviour has, on occasion, been justified in terms of a narrow and short-term view of maximising shareholder value.

At the same time, as financial markets get more efficient, they probably become more volatile. Short-termism by managers is encouraged by continuous reporting and the configuration of salary incentives. More efficient markets may be riskier markets. Many of the sophisticated "financial engineering" products are just ways of unloading risk to the ignorant. Derivatives are claimed to shift risk to those who can bear it, but there is little evidence of this – e.g. banks shift credit risk to insurance companies, but there are no indications that insurance companies are either more able to assess credit risk or more able to withstand mis-assessments. Securitisation takes the safest assets off the balance sheets of traditional core financial institutions – the safe and conservative managers. Now, credit securitisation means no-one is on credit watch.

Information technology means that all market players have instant access to the same market-shifting news, and this tends to trigger discontinuous ("jerky") shifts in market sentiment, through correlated expectations. Globalisation reduces the detailed knowledge of investments and encourages herding, so even the most diligent funds manager will be caught when the herd turns.

Meanwhile, the fat and slack which provided some cushioning of volatility in the past has gone. Prudential regulators used to talk approvingly about “healthy profits” in the banking sector, which the economists took as proof of inefficient “excess profits/rents”. As these rents disappear, the system becomes more efficient but also more fragile.

The future probably won’t have a bull market to hide the mistakes and the fluctuations in returns: the abnormally high tide lifted all boats. The two decades of fabulous returns now leave a legacy of unrealistic expectations, which some companies will promise to meet (and will disappoint investors), while others will try to repeat the high returns through excessive risk-taking. In this more volatile environment, there will be more personal (i.e. household) money (including that of the most vulnerable groups), especially as private pensions/superannuation become more widespread. Because of the complexity of the rules surrounding pensions, these investments will often be managed by professionals, so principal/agent problems arise which did not exist in a simpler world. The gross conflicts and dereliction of duty by investment advisors in America are currently coming to light, but there is no reason to think that they are confined to the USA.

One further problem. Business has become more complex, and the accounting system has not found ways of keeping up with and recording the full extent of this complexity. It may be a simplification of the “Good Old Days” to see that world as being populated by businesses with mainly tangible assets, whose presence could be verified by the accountants and auditors, and a valuation given within reasonable bounds. Now many companies have almost no tangible assets, and their worth lies in the way the various resources (staff, marketing machine, customer lists, brand names) have been brought together. Streams of future earnings are given value, even though the associated work has not yet been done. There is no dispute that these intangibles have value – we see this when such companies are sold. But we also see that this value can disappear quickly as markets change and evaluations shift. Of course this was always true with assets – even physical assets. But the potential for re-writing the accounting script seems much greater today than before, and the accountants have gone from being humble servants of the business to partners in the promotion of the stock. In September, the Chicago Tribune analysed the sad demise in the standards at Andersen. Even when the spirit is willing, the flesh is weak, as illustrated by the failure of the FASB (the US accounting standards board) to impose its view on the expensing of equity options. When, under lobby-inspired political pressure, they soften their stance to make this “recommended” rather than mandatory, 498 of the top 500 companies chose to ignore the recommendation (Buffet 2002).

B. <u>What to do about it</u>

When markets go sour, there are increasing calls for the government to “do something” about it. The first reaction is to get the government to compensate the losers. The political pressures to widen the net of government protection, *ex post facto*, is strong (we never contemplated rescuing any of the policy-holders of the failed Australian insurance company HIH, but here we are, innocent bystanders/taxpayers, reluctantly picking up some of the costs). The second reaction is to put in place regulations purporting to prevent recurrence. What is the right response to this problem?

There are two closely-related and sometimes-overlapping approaches that are relevant. The first is to re-examine the existing *rules and codes of conduct*, with a view to making them more effective (but without starting from the view- point that this means *more* of them). The second is greater reliance on *market discipline*, but with the recognition that markets don’t work particularly well, so we need to see what can be done to make them work better. Then, having done what we can to re-jig the rules and markets to make them work better, we need a third element: to put up a *caveat emptor* sign, so that the authorities are not blamed when markets and rules fail to protect investors (and the taxpayers are not lumbered with the losers’ losses)

Rules and Codes of Conduct

There will be much discussion at this meeting on the specifics of how the rules should be re-jigged. I will leave that to the experts in the specific fields, and try to set down some broader principles of rule-making:

- Parsimony and simplicity
- Widespread involvement (“collective guilt”)
- Subsidiarity – devolve as far as possible
- Caveat emptor

<u>Parsimony</u>
The general case against overreach with rules is clear enough. Excessive rule-making:

- Stops businesses from working efficiently by distorting their decisions: Rule to enforce prudence inhibit risk-taking and entrepreneurship: they stop the managers from managing. They create moral hazard.
- Introduces expensive "sand in the wheels" of enterprise through compliance costs:
- Inhibits market discipline – the more the regulators do, the more they distort of emasculate market controls.
- Some rules make things worse because they are not congruent with the markets view – e.g. hedging for mining companies.
- Worst of all, if you set the rules, you will get he blame, even when it is inevitable that things will go wrong.

For my taste, the case can be made in a single sentence: "Beware the Nanny State: it will be run by lawyers".

Let me go from the general to a specific example of over-reach. There seems a strong tendency to react to perceived deficiencies in governance by requiring directors to get more involved in the job of *managing* the company, and to take responsibility for it. Let me quote from the Commonwealth Secretariat's Checklist for financial sector governance (Commonwealth Secretariat 2001): "the supervisory authority (should) require bank *directors* and senior management to sign regular statements attesting to the effectiveness of risk management systems and *to hold them responsible* if it transpires that these attestations were misleading or false" (my italics). The distinction between the management role and the directors' role may be tricky to define in practice, but to confound the two roles and treat them as equally responsible seems an unhelpful way to go, if we are at least as interested in the *efficient running* of the company in normal times, as we are in finding scapegoats when things go wrong. The manager's job is to manage, and the director's job is to discipline them (in extremis, by sacking) if they are not doing this properly, standing at one remove from the daily tasks. To expect the Directors to be on top of the complexity of a risk management system in a complex financial institution, to the stage where they can attest its effectiveness, is a case of over-reach.

If this distinction seems too subtle, let me give an example at the other end of the spectrum, where there the Directors should be exercising a strong control, but often are not. "Growing" companies seems to the fashionable jargon to include high on the list of a manager's priorities, but it raises questions. From the shareholders' viewpoint, growth of an enterprise should not, in itself, be a high priority – if an investor wants a bigger portfolio, purchase of additional shares is the way to go. It may well be that the opportunities for the highest return lie with another company. A company which has a highly-profitable niche market (lets call it Golden Goose Ltd) should not grow unless this market can be profitably expanded (if more golden geese can be bred in a cost-efficient way): to invest in lesser assets, just to get growth, would be a misallocation of shareholders' funds. So growth in itself should not be an attraction for shareholders (unless it is shorthand for a whole lot of other more complex attributes, such as being in an industry whose growth will make it more profitable than average). But growth may well be a *personal* priority for management, even as an end in itself. Growth means a larger salary, more prestige, more experience, a better CV, a bigger office and a more luxurious car.

This is the sort of issue – where differences of viewpoint between shareholders and management may arise – that require the directors' attention – not double-guessing the operations of the firm and constantly look over management's shoulder. My impression is that directors can never know enough to effectively second-guess an active CEO (who, after all, controls most of the flow of information to the directors), and that governance rules which depend on them being able to do this will disappoint when things go wrong. If you accept this argument, then it seems quite wrong-headed to force this sort of role-confusion through overly-prescriptive codes which raise unrealistic expectations of what directors can achieve.

The other related criterion which goes hand in hand with *parsimony* is *simplicity*. The enormous complexity which has now been built into Basle II – the international rules for the prudential supervision of banks – does not seem to be the answer for global supervision. A further point related to simplicity, which may be blindingly obvious, but just might be forgotten in the rush to make rules. Legally enforceable rules need to be simple and clear-cut: most governance issues are not, so lend themselves more to enforcement through moral suasion, publicity ("name and shame") and peer pressure, rather than prosecution[1].

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[1] The HIH Royal Commissioner puzzled why none of those involved had asked themselves the question –"is this right?" and suggested that "those who participate in the direction and management of public companies need to identify and examine what they regard as the basic moral underpinnings of their system of values", but did not suggest that there was a case for prosecuting, for example, the Chairman of HIH.

Wide involvement in rule-making and enforcement

If all the market disciplines are provided by government fiat (laws or regulations), then the government will be in the main firing line when things go wrong. If, on the other hand, ways of doing business, mores, codes, rules and laws comes from a variety of sources, with a wide measure of cross-involvement in their formulation and enforcement, then there is a greater degree of “ownership”, “collective guilt”, or collective protection, when things go wrong.

A powerful argument can be made for heavy reliance on self regulation via industry associations. Not only do they know the industry best, but they have some capacity to enforce at low cost. Self regulation has a bad name because it usually mean blatant self-interest in rule-making and leniency in enforcement. Rather than taking the rule-making/enforcing elsewhere, these weaknesses could be addressed. Industry groups need to be made to realise that if they can’t strike a good balance with societal interest, then they will be lumbered with much less sympathetic rules, less appropriate for their interests[2].

While making this point, it need to be acknowledged that most of the industry associations see themselves as lobbyist, to push their particular interests. This can be justified in that the melding of the opinions of these self-interested groups which takes place in the political process will produce a balanced outcome. Generally this may be rue, but in the specific case here the association is used to develop the “rules of the game” to be applied to their industry, somehow they have to put aside their narrow interests and aim for rules which are fair to all. This is a “big ask” of groups who have often seen their role as an advocate. But if they insist on the pursuit of their own narrow interests – and see themselves as a lobby group rather than an expert group – then this approach will not work and will be replaced by centralised rule-making. There must be a better way. To give a specific example: perhaps the introduction of a genuinely independent arbitrator can add sharper teeth to self-regulation. Complaints made to self-regulatory bodies shouldn’t be “like complaining about your spouse to your mother in law”.

It seems both too pessimistic a view, and conceptually incorrect, to argue that a rule-making/enforcing body representing the players in an industry must inevitably produce ineffectual rules because of some intrinsic

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[2] I might note a small but specific example, where the IFSA (investors’ association) requires its members to vote at company meetings on all governance issues and report their voting.

conflict of interest. It will often be in the interests of a group as a whole to exercise discipline over individual members, when their overall reputation depends on the actions of individuals. This point could be put more strongly: some rules are in everyone's self-interest and will be almost self-enforcing – for example, getting everyone to drive on the same side of the road. So we should search for such consensual rules which need little enforcement. This also suggests the benefits of voluntary codes (with, at most, "if not, why not" to back them up, rather than legal prosecutions).

Reputation is a powerful motivation in self-regulation. How can reputational issues be harnessed and sharpened for more effective action by directors? The may be opportunities to build on this through peer pressure: maybe the Business Club does have a role after all. Note, however, that peer pressure works both for the good and the bad – one of the reasons executive salaries and returns have been bid up so high is peer pressure/competition. What about governance competitions, along the lines of beauty pageants (who has the best Governance Statement in their Annual Report and on their web-site?). This is what Warren Buffett (Buffett 2002) has to say: "In our 1992 annual report, discussing the unseemly and self-serving behavior of so many CEOs, I said "the business elite risks losing its credibility on issues of significance to society – about which it may have much of value to say – when it advocates the incredible on issues of significance to itself." That loss of credibility has occurred. The job of CEOs is now to regain America's trust – and for the country's sake it's important that they do so. They will not succeed in this endeavor, however, by way of fatuous ads, meaningless policy statements, or structural changes of boards and committees. Instead, CEOs must embrace stewardship as a way of life and treat their owners as partners, not patsies. It's time for CEOs to walk the walk."

The greatest hope for a change in attitude may be from a knowledgeable and bold (even aggressive) group of business commentators and analysts. Would it be too much to expect analysts to provide as many "sell" recommendations as "buy"? While good financial journalism exists, much of it is just an extension of the PR effort of the company in question, and business magazine awards for excellence are so flawed that they might be used by regulators as "red flags" of impending problems. One of the main virtues of disclosure is to provide analysts and commentators with the material for them to exercise their "frank and fearless" opinions.

Let me give an example of an issue which seems best handled without government intervention. In the current debate (at least as viewed from Australia), there would be no more contentious or confidence-sapping issue than the remuneration of CEOs and Directors, with the general public view being that directors have conspired among themselves to pay themselves excessively, and the worse the performance, the higher the reward. This is clearly not good for restoring faith in capital markets, and a higher level of transparency might promote both trust and economic efficiency over time, by reducing the incidence of what someone recently describes as " a process whereby twenty brilliant years is rewarded with a gold watch and six disastrous months is paid out with ten million dollars". But it seems to be something that should be fixed by the directors themselves (setting the terms of contracts, for example, so that bonuses are paid only for demonstrably-outstanding performance against a relevant market benchmark, sustained over a period of time, and that failure is not rewarded). This should be done under the active and vocal supervision of institutional investors, who should be ready to voice an opinion (backed up by the ultimate threat of exit from shareholdings) when directors do not exercise appropriate self-restraint. Institutional investors should be a more effective method of bringing pressure to bear here, provided that they themselves are not *de facto* members of the same club. This is an example of where their voice, rather than their exit from shareholding, would be helpful.

What is the test of an independent director? This issue is centre-stage in the governance debate at the moment (and was the focus of comments in the recently released Australian Stock Exchange governance code). It was not so long ago that this mean nothing more than a non-executive, and the independent director could have played golf with the chairman every weekend for the past twenty years: or the director might just be part of the marketing effort of the company, owing his or her position to their contacts, either commercial or political. The central issue for independence should be: "will this person stand up and argue with the CEO when necessary?" When we look back on the history of governance failures in Australia (anyone wanting a quick introduction could read Trevor Sykes' *Bold Riders*), in just about every case there has been an ego-driven CEO. This solution is offered, only half in jest: it might be made compulsory for CEOs to spend three months in a Buddhist monastery and Directors to do a course in assertiveness-training, just to balance things up[3].

[3] Given the current emphasis on increasing the numbers of independent directors, it is interesting to note that Buffett's company Berkshire Hathaway has only two independent directors and the Chairman is also the CEO, but few would see it as being badly run.

Subsidiarity

I put this forward more as a point for discussion rather than as a well-developed argument. It basis is little more than the idea that important rule-making knowledge rests with those who are close to the detail, because rules have to be *operational*. But it is motivated, as well, by the feeling that there are strong centripetal forces in rule-making (sometimes driven as much by a desire for uniform tidiness as intrinsic need), and there should be some counter to this tendency.

Maybe an analogy is another way of making the point. For the most part, discipline is exercised over the young people in our communities largely by parental and family influences and peer groups, assisted by the wide range of guiding and disciplining institutions our children operate with, such as school, leisure and religious groupings. It is rare, (we hope never) that the full force of the law, with police, courts and formal punishment, is needed to make things work. When something goes wrong, our automatic reaction is not to introduce a law (to enforce, for example, a universal Saturday night curfew). So it should be for corporate behaviour – we sort it out at the most-disaggregated level.

There may be another relevant analogy here: we believe that one of the virtues of having a variety of tax schemes is to “pluck the goose with a minimum of squawking”: similarly, spreading the methods of disciplining the market may be more effective.

Caveat Emptor

Trust, as Confucius noted above, is a fine quality. But we need to think of this as a balancing-act. Trust obviously enhances and lubricates commerce, so some rules are needed to enhance trust: you need rules and standards (we don’t want to have to check the quality of the water supply before we have a drink, or the safety of the aeroplane before we fly). But if trust relies on a third party facilitating or guaranteeing the transaction, then we are into the territory of confused responsibility and moral hazard. To try to operationalise this, trust must be something organic between the principal parties to the transaction, rather than something imposed on top through rules and regulations. So let the buyer decide how much trust exists in the transaction, and wear the consequences. Putting cancer warnings on cigarette packets has not stopped people smoking, but it may, at least, stop them from blaming the government (and hence the taxpayer) when things go wrong. Markets are like salesmen, who are congenitally unable to emphasise (or even mention) the down-side. The task of aligning expectations with the realities has no natural advocate.

Investors need to be made aware of this, but without taking away from them the responsibility for their actions.

One additional point which seems particularly important for prudential supervisors. Don't give apparent or implicit protection to a wider group than you have to, or intend to. The corollary of this is make it clear who *is* protected, so that the group doesn't expand through self-selection when things go wrong.

<u>The "Golden Straitjacket"</u>
What about the internationally-devised rules, procedures and standards (which Tom Friedman, in his book "The Lotus and the Olive Tree", described as the "Golden Straitjacket"), which globalisation imposes on countries that participate in international trade and capital flows? This meeting is, in fact, part of the process of devising these rules, in the sense that each of you will take back to your countries a deeper understanding of the way rule-making is being done elsewhere, and probably a recognition that uniformity of rules across nations fosters simplicity and certainty in transactions. Should this sort of universal rule-making become the central source? I find this a fascinating and unresolved issue. Clearly there are great benefits from international uniformity in rules, codes and standards. But just as clearly, this process can be taken too far, and just as important, it leaves open the awkward question of whose set of rules should prevail? There will be a tendency for the dominant power to make the rules for its own circumstances and in its own interests: patents and copyright are an example of this. International rules aren't the obvious or logical starting point for rules of governance to handle diverse circumstances (to handle, e.g., poor legal and accounting infrastructure and family control of companies). We noted earlier the degree of complexity which has now been embodied in the Basle II rules for banking supervision – appropriate to the complexity of financial institutions in major financial centres, but less relevant to the problems of developing country banks doing the bulk of their business in the region. It may be that there is something analogous with the Theory of Optimal Currency Areas – that a set of criteria can be developed to guide the choices of coverage, with different golden straitjackets applying in different geographical areas or complexity-levels of enterprise.

Two valid starting points might be put forward. One is to repeat the parsimony point: international rules shouldn't be too all-encompassing, detailed and prescriptive. Second (again drawing on the idea of widespread involvement), there should be a major effort at democratising the development of the Golden Straitjacket. Specifically, those of us from small or medium-sized countries should fight hard, perhaps in concert, to have a louder voice at the table when the rules are made.

Remembering that the most effective rules are often those that are applied through behavioural norms rather than legislative edict, it may be that foreign investment is one of the most effective ways of harnessing aspects (particularly the governance aspects) of the Golden Straitjacket, without actually enacting it in domestic law. Note, for example, the effect of foreign financial institutions on Japan. The more extreme possibility is to directly harness the power of foreign regulators, by allowing the bulk of the financial sector to be sold to foreigners (c.f. Argentina, Mexico). In a similar vein, encouraging foreign investment in equity markets is a powerful “vector of influence” on governance and transparency – as well as its usual beneficial role in providing a source of funding whose general risk characteristics are understood by the investors.

Market Discipline

These powerful arguments against overly intrusive and prescriptive rule-making would take us towards reliance on the discipline of the market – epitomised by the “disclosure model” that might be associated with New Zealand, but which ought to be seen as being much wider than simple disclosure. We used to joke about the idea that depositors, on entering a New Zealand bank, would pause at the counter to peruse the bank’s balance sheet before depositing their money, and return at regular intervals (how often? In this fast-moving world, every few minutes!) to check that things were still OK. This view seemed to depend so heavily on the “efficient markets” view of the world (which abstracts from all the real world problems that make markets less than efficient, such as the costless availability of perfect information), and some of us have been long-standing cynics about the “magic of the market” (thanks, Al Gore, for another memorable phrase). It is now pretty clear that the “efficient markets” view of the world is a theoretical construct, inadequately capturing reality. If this “efficient markets” view of the world were correct, we would not see:

- Sharp movements in asset prices not associated with any new “news”
- Regular medium-term swings in asset prices over the course of the cycle
- The sort of “irrational exuberance” seen during the Tech Bubble
- Failure of uncovered arbitrate conditions to hold in the foreign exchange markets

- Large amounts of money "left on the table" at IPOs

Perhaps most damaging for the system as a whole is the market's tendency to foster asset bubbles – bull and bear markets. This behaviour is so far from the text-book model, that some economists simply deny that these price movements are irrational. But any observer of the real world will have to acknowledge that when asset prices rise, demand for the asset often rises (demand curves slope upwards, not downwards!) When prices move down, forces are unleashed that make them move down even more. So markets have great potential for instability, and Milton Friedman's stabilising speculators are a very rare breed. This is not the place to enter into the debate on what central banks should do to try to smooth the asset cycle, but the case for a more active role might be noted: if the authorities were able to do more to rein in the "bull" phase of the market, we would spend less time wondering how to handle the "bear" phase. One constraint is that bull phases are much more popular than bear, and one of the first lessons central bankers learn is that it is hard to "take away the punch bowl just when the party is starting to be fun".

Where does that leave us with market discipline?[4] Churchill said that democracy was the worst system of government, except for all the others. The same may apply to markets. Weak though it is, it is the best discipline we have. So we need to turn our energy in two directions – first, to figure out ways to make markets work better and more openly: and second, to make sure the users of the market know its short-comings.

Economists are much more interested in rules which enhance the operation of markets as a whole and prevent systemic problems, than in ensuring that every enterprise stays afloat. If you believe in the Schumpeterian "cold winds of creative destruction", then you should allow them to blow. Just as there can't be religion without hell, there can't be well-functioning markets without bankruptcies. The objective should not be to preserve the enterprise, but to ensure that the system can "move on" quickly and with a minimum of collateral damage. So we might put our main effort into clear bankruptcy rules, rather than refine governance to the "n"th degree. This would also suggest that the present requirement on Directors to ensure that a company does not trade while it is insolvent should remain a central element of discipline, to ensure that a "zombie companies" – which are dead but do not acknowledge this - do not continue to operate

[4] For an excellent analysis of some of these issues, see Crockett (2001)

Here are some suggested elements that might help:

- Disclosure
- Encourage and facilitate diversity of financial institutions, with differential rules
- Encourage and facilitate diversity of investors, with differential roles and different expectations
- Reducing vulnerability to catastrophic failure
- Caveat emptor again

<u>Disclosure</u>

One of the great attractions of disclosure is that it clearly serves the cause of economic efficiency, as well as governance. All this seems clear in principle – that more disclosure is always better, and that disclosure should be continuous (i.e. equity-price-shifting news should be communicated as soon as it is known) and that it should be general – to the whole of the market, not just in dialogue with some selected analysts. The problems come in practice: a project goes sour over time, and the full enormity of the problems is only clear (or is only certain) over time. At what point does the management "press the panic button" and say that they think things may be going wrong? Why not wait a bit ("don't startle the horses") in the hope that things will start to go right again? Given market's proclivity to over-react to news, the temptations to under-disclosure are great.

<u>Diversity of institutions</u>

Even though the brief of this group runs more widely, I focus here on financial institutions, because if these are working well, they will discipline the rest of the corporate sector, help to provide a "guardian on the gateway to investment", and provide a safe place for investment funds. When it comes to the institutional structure of the financial sector, there is application of the old adage about not putting all your eggs in the one basket. There should be a variety of financial institutions, clearly differentiated, especially as regards risk.

We need a financial sector engineered along the lines of an onion. At the heart are financial institutions of undoubted safely, where the widows and orphans can leave their funds and sleep in peace. The outer layer are institutions clearly intended for those who can afford to take risks and lose: this is real caveat emptor territory. The intermediate layers are always going to be more ambiguous, but the job of the authorities is to try to keep them as distinct as possible.

Some of you will think of this as very old fashioned. Indeed it is. It is the model put forward many years ago (when deregulation was in its infancy) by Al Wojnilower (Wojnilower 1991). He likened the financial sector to a zoo (he had relevant experience – he worked on Wall Street). If deregulation opened the cages, on the argument that competition and market forces would work out who were the most efficient players, we would end up with fat lions and no deer. We now know that the cages *were* opened, and there was a strongly-held view that conglomeration would result. We would see bankassurance, and this would be combined with asset management so that one institution would seamlessly deliver the full range of financial products to a customer. Indeed this looked like it was happening for a while, but it is now less clear. Managers are finding that banks business and insurance business are very different, with very different risk characteristics, and they require very different balance sheet management. So some of the bank/insurance links seem to be fraying apart. As for funds management, many are now seeing this as three (perhaps more) separate businesses – distribution to investors, asset management (probably including new-product formulation) and back office (the accounting and compliance issues) – with at least some people thinking that these each require quite different skills and cultures, which are hard to manage within one institution.

All this has strong messages for regulators. When we thought that convergence was the name of the game, we thought it was inevitable that supervision would have to go outside the core institutions (the banks) to look at the overall balance sheets of the conglomerates, and that prudential supervision would have to be re-jigged to do this. Various models emerged. But the common feature was that as regulators ventured further outside the core financial institutions, they were, like it or not, taking responsibility for institutions beyond the original core of the onion. Whereas we used to try to tell the bank depositors that they should not rely on the government to save them in the event of a bank melt-down, we now seem to be ready, in concept at least, to put taxpayers funds into just about any financial institution (again, HIH is the example).

I should try to demonstrate here the extra point – that even as the protective net is thrown wider, the risks that the regulators are trying to tie down have a tendency to slip out. We thought that regulators would have to look at the overall balance sheets of financial institutions because of the financial linkages with the non-bank parts of the conglomerate, but now we find that banks are unloading various risk from their balance sheets (via derivatives) so that if the regulator needs to be satisfied that the risk is held by an institution capable of bearing it, the regulator will have to check out the balance sheet where the derivative resides – which could well be a non-financial institution, outside the regulator's scope.

For those countries where the cages in the zoo have not yet been fully opened, we might acknowledge that encouraging the opening does not, after all, seem such a great idea, and the efficiency cost of keeping the animals separate may not be so great.

Within each type of financial institution, there will be substantial differentiation as to modus operandi, risk and, it would have to be said, trustworthiness. This is not just natural: it is desirable. So rules should not aim at making every entity within an institutional class a clone of the others, but should help the market distinguish between the individuals fully and accurately. Regulators can help in this process, although they need common sense and courage: many years ago, when the Reserve Bank of Australia was involved in these prudential matters, we made the Blood Bank seek special dispensation for using the work "bank", and yet we made no protest when Estate Mortgage (later to go broke with lots of household funds in their care) claimed that it was "safer than a bank". Rating agencies and analysts will play a central role here, and efforts at transparency should be aimed at them and their needs, and they should be encouraged to perform better, not be rules, but by public discussion and commentary. Perhaps one of the saddest commentaries of the Tech Boom is that it took formal legal prosecutions in the US to rein in the hucksterism and snake-oil promotion methods that passed for equity analysis in the great financial houses, and that neither the financial press, nor the market nor management exercised the sort of discipline that common sense (or, indeed, a feeling of proper professionalism) would have suggested[5].

Let me conclude this section with a specific example of where differentiation of institutions seemed to help. In the early days of the Asian crisis, the Bangkok authorities closed all the finance companies. Because these were clearly differentiated from banks, and carried out their business at the riskier end of the market, it was possible to close all this class if institution without this setting off a run on banks – a differentiated set of institutions

Diversity of investors

So we need to view institutions and those who make the rules, each, in terms of different layers or a hierarchy. The other area where the idea of a

[5] It might we worth noting that it was the New York state authorities, rather than the SEC, that took on the egregious behaviour of investment analysts.

hierarchy is relevant is with investors. I have already suggested an illustrative starting point: that widows and orphans have a "natural fit" (in the market research jargon, they would be an 'affinity group") with banks – the safest institutions. If, at the other end of the spectrum, we see fund managers and institutional investors as being most capable of spreading risk and interpreting the market signals, then we should aim the bulk of our transparency and accounting information at them. We need to encourage institutional holdings, and for institutions to be interested in control rather then liquidity – i.e. "voice" rather than "exit". The accounting, auditing and general governance rules should be formulated with an audience in mind, and I don't think it is sensible to think of this as the New Zealand retail depositor entering a bank and checking the balance sheet on display. We need a sharper focus than this. Common sense tells us that it will be principally the institutional investors, and secondarily, analysts and the financial press, that can use this transparency. Market discipline will come from institutions which have the clear need, responsibility and capability to put in the big effort to understand and interpret the information. So when the hierarchy of rule-making groups sets the rules, institutional investors are probably the main voice they should listen to.

While on the subject of institutional investors, those who are interested in governance might usefully spend time pondering the way that institutional investors may develop over time. As a fund-managing institution gets relatively large in its markets, it becomes more difficult to be active fund managers (i.e. holding favourite shares and being short in shares they consider to be "dogs") rather than index-managers – this is forced on them both by their dominance in the market and the incentives on the managers. The institutional investors who go out on a limb *and stay there* (because it takes time for the economic fundamentals to reassert themselves), with clear positions on individual shares, are important both in an *economic* sense (they are swinging funds into new areas, fanning Schumpeter's cold winds of creative destruction), and also for governance – we want them to support governance virtue and punish governance weakness. For both reasons we should be happy to see active fund management, and be just a little disparaging of the indexers – after all, this is not much value added that can't be done by a mindless computer. If government pension arrangements (in Australia's case, compulsory superannuation) are encouraging a huge amorphous mass of indexed investment funds directed by a mindless market-indexing computer, we will have achieved little in terms of directing investment into the highest return uses.

The point could be illustrated by some recent press commentary comparing two of our media companies (Terry McCrann, The Australian 12 April 2003), one of which (Fairfax) began with a rich legacy of market position and was (for the main part) carefully and conservatively managed, and the other was of course, Murdoch's News Limited, the archetypical risk-taking entrepreneur. The first is much the same size as it was, and is contemplating expanding into New Zealand: the second now has world-wide reach. Of course, we need both, and we need financial markets which steer the right kind of investors into the appropriate place on the spectrum of risk. So when we devise new rules, we should ask ourselves if we are hindering or fostering this differentiating, sorting and matching process.

This sentiment could be put more briefly in the form of a question: "Why are there so few Warren Buffetts managing our money?"

You might (correctly) conclude that I hold no particular brief for the "small investor" with a self-managed portfolio, or a belief that governance and market-conduct rules should be directed mainly at protecting small investors. If ever there was an old-fashioned idea whose time had come and gone, it is that we need an army of small shareholders to reconcile us with capitalism and keep socialism at bay. Do we really benefit from having everyone watching the stock-market ticker all day and spending their spare time sucking their pencils over their next stock-pick? This is not to suggest that individual direct ownership should be discouraged, but rather to argue that widespread direct ownership does nothing for good governance, other than breeding calls to the political system for more efficiency-sapping rules[6]. The operational point here is that the important efforts at greater corporate transparency should be made with institutional investors in mind, not to humour or placate the amateurs.

You will have to make your own judgements about just how much protection the small shareholder is offered. If we insist on special representatives on boards for minority shareholders, and rules to stop over-hyped property salespeople from exploiting the gullible, what will we do to protect people from Nigerian money-transfer scams and the sale of $2 gold watches in the pub on Friday nights?

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[6] Perhaps my concerns here are exaggerated: after all, much more has been lost by small shareholders in the Telstra II privatisation float than was lost in by HIH policy-holders, and the Telstra victims have remained stoically silent.

Re-jigging the rules

This section returns to the issue of rules, but with the extra focus of rules which might make markets work better.

Let me give an example of a case where better arrangements between the players (without changing the legal rules) might be achievable. We know that large amounts of money are "left on the table" after IPOs (Ghon Rhee 2002). This creates various opportunities for mischief and trust-sapping actions: allotment to favoured customers, kick-backs in the form of access to lucrative work. Why not examine, with an open mind, why a more auctioned-based system would not remove this temptation?

As balance sheets become more complex (particularly with sophisticated "financial engineering"), the ability of ordinary observers to draw judgements based on the accounts is limited. This is compounded by problems of valuations – not just of nebulous concepts like "goodwill", but even of assets where there can legitimately be a wide range of opinion. Its hard to be critical of he concept of "pro-forma" accounts if these give insights into the underlying position of the company, but they have obviously also raised rich opportunities for puffery in the accounts. Of course there are some improvements which could be made – the expensing of salary options seems an obvious example, where once again Warren Buffett seems to get it right: "If these are not expenses, what are they?" We are coming to recognise the critical role of auditors, but only if auditors can "step up to the plate" and deliver expert (if necessarily subjective) judgements about matters of approach, valuations and principle – not just report that the figures added up. Prudential regulators in Australia learned a bitter lesson in relying on auditors during the early 1990s, when auditors had a very restricted view of their own obligations and responsibilities. Once again this doesn't seem a prime case for government decree – professionalism, common sense and frankness are hard to legislate. But this should not stop institutional investors, analysts the press and, above all, the professional bodies, from demanding these qualities in our auditors.

One reason why accounts have become more complex is that businesses are more complex. But some, at least, seems to be contrived complexity to either obscure financial relationships or avoid taxes. When the tax system allows a loophole of special privilege, then there will be all sorts of complex manoeuvring to exploit it: some would even argue that tax arbitrage ensures that the cost of exploiting the arbitrage equals the value of the tax concession. The point here is that the system would work better, accounts would be simpler and clearer, and lots of accountants and lawyers would be freed to do more useful things, if we could ever make the tax system simple. In Australia at least, the courts have been unhelpful to the cause of simplicity, but this does not relieve the politicians from their responsibility to legislate for a system which requires the courts to enforce simple notions, such as that if you have a lot of income, you should pay a lot of tax. This might seem a bit radical, but could we envisage a world in which simplicity is highly valued (KISS), and if companies have made elaborate arrangements through obscure jurisdictions ("shady deals in sunny places"), these would not be recognised if, later, a company wants to use our courts to enforce a deal?

While we are in the "radical idea" mode, we could do more to prevent the poor governance once summarised as the business practice of "privatising the profits and socialising the losses". We saw a fair bit of this during the Asian crisis, with creditors who had been happy enough to accept the risk-adjusted rewards in the good times (and were ready to tell governments to keep out of the way), but who pressed for government help when things went wrong. I note with some astonishment the efforts put in by the Canadian government on behalf of Manulife in Indonesia, whereas the Canadian taxpayer might well have seen this as a case of "consenting adults": Manulife can hardly have had any illusions about the state of Indonesian justice when they formed their partnership. In a similar vein, I note the recent meeting of the Indonesian authorities with eleven ambassadors to try to sort out the Asian Pulp and Paper problems. What were they doing? Isn't this another case of "consenting adults? The short answer is that readily-provided government trade and investment promotion provides the vehicle that allows the private sector to "socialise the losses". Good governance requires a clear understanding of where responsibility rests, and it is not clear that the foreign taxpayers were sufficiently informed of the risks that they ran.

What might be said specifically on the lessons from the Asian crisis? In the narrow Washington Consensus view, the lesson of the crisis was that if countries had just been a bit more transparent, had some better accounting and bankruptcy rules, and had less government interference in the foreign exchange market, then all would have been well [for a recent exposition of this unreconstructed view, see Frenkel at the BoE conference]. The corollary is that if these conditions can be created, then the system will work well next time round. For me, the true lessons of the Asian crisis is that we should, of course, try to reform and improve the financial infrastructure, but that we will be working in a very imperfect world for many years to come (perhaps forever), and the vital extra ingredient is to have players/actors who understand this imperfect world, and have fallback positions (“Plan B”) ready to soften the damage. At the same time we want to encourage financial systems with enough resilience to cope with a fair amount of damage, without catastrophic meltdown. The IMF gets half the story right: “Increasingly, it has been realised that there is no good way to deal with the consequences of a capital account crisis – only more or less bad ways. Increasing attention had therefore turned to the need for prevention.” [Boorman et al, p60]. Here follows a long list of what countries should do to bring themselves to governance nirvana. All worthy stuff, and well worth striving for. But the point to be made here is that diligent striving will take us only so far, and that things will go wrong again. So we want to give lots of thought to how to make the financial system as a whole more resilient. So Sovereign Debt Restructuring Management and Collective Action Clauses seem like good ideas to me. What is needed is quick resolution of the issues (analogous to domestic bankruptcy), so that they don’t hang around sapping confidence.

Caveat Emptor Again: Being realistic about the market’s weaknesses.

Relying on market discipline while being fully aware of its deficiencies seems a far superior position to the “efficient markets” (or even the Washington Consensus) view of the world.

So the New Zealand experience has another element which seems relevant. We used to joke among ourselves that New Zealand prudential supervision comprised one person with a loud-hailer, who went out every morning and announced: “Your deposits are not safe anywhere!” We thought this was a good joke, but I now think it might be a good idea, at least in concept. We need to do all we can to prevent problems and crises, but we don’t want to take responsibility for them. What did they say, yesteryear, at the dry cleaning shops? “All care but no responsibility.” In today’s litigious world, you probably can’t get away with things like that any more. So we need a new formulation, but the public’s understanding of investment markets should be clear-eyed: these are dangerous places, where “caveat emptor” should rule – and be acknowledged as the ruler. So every step we take to make markets work better and to protect investors should be accompanied by a disclaimer.

C. <u>Conclusions</u>

Corporate regulators are interested in investor protection, efficient and fair markets and reduction in systemic risk. The economist’s perspective may be a bit narrower: governance is principally about making the economy work better. This makes it more explicit that there will be failures and that investors will lose their money. It means that investment opportunities should range across the risk spectrum, not be homogenised by regulation. It put the emphasis on transparency, not just because this forces managers to be more honest, but because information is the lifeblood of an efficient economy. It accepts that coercive compliance is expensive to administer and will favour even imperfect voluntary compliance. The institutional structure should permit Schumpeter's "cold winds of creative destruction" to blow, not temper them. Legislation should be empowering, not inhibiting and limiting. We want good governance so that it improves outcomes, not for the accounting neatness or to clock up successful prosecutions. We should accept that in financial markets there are elements of *uncertainty*, as well as risk. You can't predict, even in a statistical sense, what is going to go wrong and when. So we need to foster systems that are resilient rather than aim for a specious and unattainable invulnerability.

We should resist the reflex reactions of the political process to corporate misadventure, which too often takes the form of compensating losers, and regulating surviving institutions more strongly. In defence of this argument for "Governance Lite", we might ask whether the greater emphasis of governance in recent years has contributed much to better growth. In Australia's case, the productivity improvement of the past ten years came from other factors (principally from privatisation and corperatisation of public companies). We would ask, too, whether tighter governance would have made much difference to the cases of corporate failure, recalling that the big dollars are usually lost through poor decision-making rather than by outright fraud [reference HIH, Sonnenberg)]. In any case, it would be wrong to focus mainly on corporate failure and its prevention: the main game is making the economy work better. Most of the major wealth-diminishing decisions made by Australian companies (and there have been quite a few of them: Telstra, AMP, BHP, just to give a few examples) have been management mistakes rather than fraud or issues that could have been corrected through tighter governance legislation.

Perhaps the most positive point that could be made about the current efforts to "do something" is that (as our Treasurer noted recently) (Costello 2003), in attempting to get the right combination of legislation, codes of behaviour and peer pressures, this is a "race for the top" –i.e. countries are competing to put in place the most effective systems, rather than (as happens with taxation and some forms of prudential regulation), a race for the bottom – who will do least. The reward for getting it right is a more vibrant, efficient economy.

In conclusion, let me quote Alan Greenspan (Greenspan 2003), who sees the same kind of counterpoint between addressing the problems of corporate governance through rules, on the one hand, or the building up of personal reputation, on the other. He, as an active advocate for using "the magic of the market", sees the decline in personal responsibility and morality as a direct consequence of the state's interference in these matters. The argument I have made here is a softer one: that rules are needed, but they will be imperfect and we need to put our main effort into raising the ethical standards and harnessing the discipline that comes when people are held responsible for their own actions.

> "The Granger laws of the 1870s began the process of regulating the marketing practices of the railroads. But they were not very effective and were followed by the much broader Interstate Commerce Act of 1887. The Federal Trade Commission Act of 1914 backed up the Sherman Antitrust Act of 1890 by specifying illegal trading practices. *Caveat emptor* was in retreat as federal enforcement of appropriate business practice had the collateral effect of diminishing the value of hard-earned private reputation.
>
> Over the past half century, the American public has embraced the protections of the Securities and Exchange Commission, the Federal Deposit Insurance Corporation, and the myriad other federal agencies that have largely substituted government financial guarantees and implied certifications of integrity for business reputation. As a consequence, the market value of trust so prominent in the nineteenth century seemed, by the 1990s, to have faded to a fraction of its earlier level.
>
> Perhaps we are better protected and, accordingly, better off as a consequence. But corporate scandals of recent years have affirmed the view that the plethora of laws of the past century had not eliminated the less-savory side of human nature. I anticipate that recent legislation holding chief executive officers more responsible for the integrity of their companies will help.
>
> But I am pleased to see a re-emergence of market value placed on trust and personal reputation governing business practice. Moreover, after the revelations of corporate malfeasance, the

market punished the stock prices of those corporations whose past behaviors cast doubt on the reliability of their reputations. I hope and anticipate that trust and integrity again will be amply rewarded in the marketplace as they were in earlier generations."

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