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# Providing a Sound Basis for Financial Sector Development through Good Corporate Governance

Remarks by

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It is both an honour and a pleasure for me to be invited to speak to you today and exchange ideas on a subject which is fundamental to economic growth and hence a central policy concern of my organisation, the OECD, and, indeed, of governments around the globe. That subject is the need to achieve good corporate governance in order to strengthen investor confidence and the stability and integrity of financial markets. But first let me express my thanks to the People's Government of Beijing Municipality, the Peoples Bank of China, the China Banking Regulatory Commission, the China Securities Regulatory Commission and the China Insurance Regulatory Commission for hosting this forum. I am particularly pleased to note that the four Chinese institutions represented on this panel are our direct counterparts in the on-going policy dialogue between China and the OECD on financial issues. As you may know, the OECD has a major commitment to work in close cooperation with China through a process of policy dialogue across a broad range of issues. We are already well advanced in this process and look forward to the further strengthening of this relationship.

Turning to the subject of this forum, inadequacies in corporate and financial governance have emerged as a major problem for the world economy. The scandals we have witnessed in a number of countries in the past few years have highlighted the need to develop a better framework for financial market integrity and transparency -- without, however, falling into the pitfalls of over-regulation. In this context, reliance on effective surveillance by regulatory authorities – indeed an essential requirement - needs to be supplemented by more sound incentive structures that result in better governance of companies and financial institutions, increased attention to risk management, improved disclosure and the development of programs for financial education. The promotion of confidence in financial markets will certainly benefit from higher standards of governance as well as from improvements in financial education and awareness. These are key tools for the development of sound and efficient markets. The OECD has been mandated to give high priority to addressing all of these issues.

While the focus of our discussions today will be on the financial sector, economy-wide efforts to improve corporate governance in all companies are relevant for financial markets and financial institutions. Healthy financial markets require participants – borrowers, lenders and investors, and financial intermediaries – that are viewed as being credible and reliable. The governance of financial firms raises some specific issues I will discuss later, but it is also very important that they meet the standards of good corporate governance expected of all companies. OECD's efforts to promote good corporate governance are centred on the development and use of the *OECD Principles of Corporate Governance.* Since they were issued in 1999, the OECD *Principles* have attained worldwide recognition as a benchmark through their endorsement by the Financial Stability Forum as one of their *12 Key Standards for Sound Financial Systems*. They underpin the corporate governance component of World Bank/IMF Reports on the Observance of Standards and Codes, and provide the basis for an extensive program of cooperation between the OECD and countries throughout the world. And significantly, they have been used as a basis for the development of regulatory frameworks in many countries, including China.

The recent corporate scandals in a number of countries led the OECD governments to ask us to review the Principles with an eye to developing an even stronger framework for financial market integrity and transparency. Just last week Ministers from our 30 Members endorsed the main result of this review, the *Revised OECD Principles of Corporate Governance*. I am confident these *Revised Principles* will further reinforce the OECD's contribution and commitment to collective efforts to strengthen the fabric of governance. In particular, they should be of value to our cooperative activities with China. I will summarise some of the ways in which the Principles have been strengthened.

First, a completely new chapter has been added, presenting principles for the development of the regulatory framework necessary for underpinning good corporate governance. The framework should lead to more transparent and efficient markets. Broad principles covering implementation and enforcement specify that supervisory, regulatory and enforcement authorities should have the clear and well defined authority as well as the legal and material resources to fulfil their duties.

Other important revisions are designed to improve the possibilities for the effective exercise of informed ownership by shareholders with respect to such issues as the nomination and election of board members and proposing resolutions. The *Revised Principles*, recognising that the governance tone in a company should be set at the top by the directors and senior management, call on boards to define clear ethical standards. Other provisions provide for the protection of "whistleblowers", who uncover breaches of those standards. The *Revised Principles* tighten the responsibilities of the board, emphasising to the obligation to oversee the integrity and effectiveness of the accounting, compliance, risk management and financial reporting systems. They strengthen disclosure requirements, especially regarding conflicts of interest, related party transactions and material risks, and underline the duties of the external auditors, who are accountable to shareholders and have a duty to the company to exercise due professional care. The protection of the rights of minority shareholders is also given increased attention.

As I summarised these revisions, you may have noted the correspondence with the issues that have characterised many of the recent cases of corporate governance failure in the OECD markets and perhaps also some areas of concern in China. The lasting value of these *Revised Principles* will rely on their active use in financial markets and by financial policy officials and regulators, together with the continued sharing of experiences among all parties concerned around the globe regarding successful implementation practices. The OECD intends to maintain such a dialogue.

Of course, within the overall context of corporate governance, there are distinctive challenges of governance for financial institutions. Typically, these institutions collect funds from the general public and distribute those funds through the banking system and the capital market. They use "other people's money" in ways that open the possibility for abuse and instability. Financial institutions are subject to a wide range of conflict of interest problems. This was vividly brought to light in the recent corporate scandals involving investment research as well as commercial and investment banking services. The ways these conflicts are addressed and managed are critical elements in the governance of these institutions and their reputations.

Financial institutions are subject to more extensive official regulation than other companies, partly because they are subject to special risks as reflected in banking crises, pension insolvency and stock market crashes. It is now the established doctrine among financial supervisors that the in-house governance regime of any financial institution represents the first line of defence in financial supervision -- and financial supervisors have an overriding concern in ensuring that governance systems of financial institutions are adequate.

Problems in achieving an appropriate balance between the various objectives of regulatory oversight of financial institutions have become more complex in the past two decades. Deregulation has given financial institutions far more scope to compete, to take risk and to innovate. In this environment, supervisors now devote fewer resources to reviewing the activity of financial institutions in detail and more resources to testing the resiliency of in-house systems for risk management and market conduct. Under this supervisory approach, each institution is expected to build state-of-the-art in-house risk management systems and to have strong internal compliance functions to ensure that standards established for the protection of depositors, investors and pensioners are respected. Clearly, these risk management aspects must be taken into account in the governance frameworks of financial institutions.

The OECD has been working on issues of financial governance for several years, addressing the specific governance issues arising for insurance companies, pension funds and collective investment schemes, such as mutual funds. This work is now feeding into our programs of policy dialogue with China and other countries. A good example is the plan for a policy dialogue with the CSRC on the governance of capital market intermediaries (investment banks and broker/dealers) as well as institutions engaged in investment management. We hope to hold a meeting in early 2005 in cooperation with the CSRC which will bring together Chinese and international experts to examine such governance issues in the context of ongoing Chinese reform efforts in the securities markets. I must also note our activities in close co-operation with the Chinese Insurance Regulatory Commission, with whom three meetings have already been held, and a similar programme of co-operation with the Ministry of Labour and Social Security on private pensions. Achieving good governance of both insurance companies and pension funds has a particular importance for capital markets as they are the major institutional investors in those markets; indeed, they typically play a dominant role.

The corporate governance of financial institutions has been a prominent issue in the discussions of the Regional Corporate Governance Roundtables the OECD has organised in close cooperation with the World Bank in Asia, Eurasia, Latin America, Russia and South East Europe. I am pleased to note that China has been an active participant in *the Asian Roundtable on Corporate Governance* from the outset. More recently, we have agreed to undertake a programme specifically adapted to the needs of China, which began with a meeting in February in Shanghai, co-organised with the Shanghai Stock Exchange and the Development Research Center of the State Council, where we discussed corporate governance and state owned enterprises.

Just before I conclude, please allow me to add that the OECD is now beginning a major initiative on financial education, which we consider to be a necessary complement to improved governance in the promotion of market integrity and confidence. With the increasing complexity of financial products and reliance on funded pensions to support retirement, our citizens are being asked to take on an ever growing responsibility for assuring their own retirement through investment of their savings. Governments need to increase efforts to help their populations to cope with this new responsibility. While the situation in China is different in some ways, there are some aspects of this work which could provide a basis for a further dialogue with the OECD. The Chinese population has demonstrated a praiseworthy capacity to save and now hold considerable assets. This suggests that China, like many countries, faces a challenge in educating its public in the effective use of increasingly complex financial products. As is the case in OECD countries, progress in this area should help to improve the quality and stability of the financial markets.

Let me conclude by saying that, as recent events in our corporate and financial sectors have shown, the markets of OECD and other countries are far from perfect. We must continually be on our guard to identify emerging problems and develop appropriate responses. There would be great mutual benefit in our sharing best practices, thereby learning from each other as we strive for the efficient and robust markets needed for sustainable economic growth and development. It is in that perspective that the OECD welcomes the opportunity for a continued exchange with China on issues of common interest in the areas of corporate governance and financial market development.

Thank you.