

“Whose Money is it Anyway?”¹

Some Thoughts on Corporate Governance in the Financial Sector.

M. John Phillips²

*As much freedom as possible;
As much authority as necessary.³*

Thank you.

A couple of weeks ago, I received in my e-mail, some revised definitions of well-known accounting acronyms. To quote just a few:

EBITDA = Earnings Before I Tricked the Dumb Auditor.

EBIT = Earnings Before Irregularities and Tampering.

EPS = Eventual Prison Sentence.

That such things are circulating in cyber-space is just another indication of the effects of events like Enron, Andersen, HIH, and all the others.

Underlying the humour is a deep concern that something is rotten in the state of Denmark.

Which is interesting, but not the point at which I intended to start this talk.

¹ Luncheon address to Australian Business Economists, Wentworth Hotel, Sydney, 8 October 2002.

² Chairman, The Australian Gas Light Company; Chairman, Foreign Investment Review Board; Chancellor, University of Western Sydney.

³ Seen on a bumper sticker. Origin unknown.

So, with your indulgence, let me get back on track.

Why is the financial sector so heavily regulated? And why are the lobbyists baying for even more controls?

After all, we went through a wide-ranging process of deregulation during the late 1970s and early 1980s. But new regulations have been introduced, so the regulatory requirements now are at least as intrusive and time consuming as they have ever been.

But more is being sought.

As Professor Julius Sumner Miller might have said: “Why is it so?”

The provocative answer is because financial institutions are not to be trusted.

You might think that an unfair statement; I’m sure that senior executives in the financial sector would think so.

But, that’s the way the evidence points. It suggests that the community expects a great deal of its financial institutions- its banks, its insurance companies, its funds managers- in terms of prudence, in terms of integrity, in terms of transparency, in terms of service.

It is not convinced that, left to their own devices, financial institutions would live up to those expectations.

So, why is the general populace getting its collective knickers in a knot? Why does it regard the financial system as so important, so sensitive, and why does it expect the authorities to take a relatively intrusive role in its operations?

Why is the financial system special?

Let me start with an “idiot’s guide” to the financial system and what it does, a kind of “Finance for Dummies”.

At bottom, there are three distinguishable segments of the financial system, each essential to the workings of a modern economy and to the capacity of individuals and groups to manage their affairs in that economy.

Regrettably, the differences are sometimes overlooked as the tendency to believe that all financial institutions are the same, has gained currency. This is not a belief I share, despite some blurring of the differences as institutions involve themselves in all three segments.

The first segment to recognise is **financial intermediation**.

The financial system is expected to provide a haven for the nation’s liquid savings, an efficient source of credit and a reliable structure for facilitating payments and money transfers.

These things are very important.

If citizens lose their savings, a first port of call for redress tends to be the government. And governments recognize this and react swiftly, sometimes impetuously, when savings institutions show signs of being in trouble.

I well remember when a former state premier took up a megaphone to try to stop the run on a financial institution in his state. The secondary banking crisis in the United Kingdom, the Savings & Loan debacle in the United States and similar problems in many other countries provide additional illustrations of community and government reactions.

And if the central payments system fails to operate effectively, the outcome can be very serious.

A good example was the Bank Herstatt problem in 1974. Another was the break down in the computer system in the Bank of New York in 1985. Others will undoubtedly come to your minds.

Without going into detail, such occurrences demonstrate just how important is confidence that the payments system is as dependable and as secure as possible.

The second segment to recognize is **risk management**.

This relates mainly to general insurance and reinsurance, but can also be held to include the financial derivatives markets, designed to permit the hedging of risks but increasingly used to generate risks in the interests of pursuing profit.

Recently, it has been very difficult, and expensive, to obtain some types of insurance. Partly this reflects the problems following September 11 last year, but it has also been an outcome of the collapse of certain insurance providers because of poor corporate management.

The failure of these companies and the escalation in premiums have focused community and government concerns on the regulation of the insurance industry and the legal framework within which the industry operates.

The third segment is what might be categorized as **funds management**.

Australia has witnessed an exponential growth in the amount of funds under management, reflecting the big lift in pension funds as a result of government policies.

Community concerns in this area cover a number of aspects.

The level of fees charged is one, as is the remuneration paid to funds management employees.

The generally poor performance of the managers compared to benchmarks, and to the promises they make, is another.

The collapse, or near collapse, of some managers and the warnings sounded by the regulator, APRA, have added to concerns.

Each of these three segments calls for a different approach to management and to regulation.

If I were looking for someone to fix the drains in my house, my first choice would not normally be an electrician.

In recent times, I fear, on both the management and the regulatory front, we have had too many electricians seeking to fix financial system drains. Some of the problems that have emerged have stemmed from a failure to understand the special features and the particular risk profiles of different types of financial activity.

It was a recognition of these differences that led the US to introduce the Glass Steagall regulations following the financial debacles of the 1920s and 1930s, effectively keeping the different types of financial activity separate for half a century, to simplify regulation and prevent cross-contamination.

I certainly would not wish to turn the clock back to that period or to those types of restriction.

However, we need to recognize that the system is not perfect, and recent events have made the community very reluctant to accept self-regulation as the way to go.

And it is hard, on the record, to argue that the community's reluctance is unjustified.

After all, if you can't have confidence in the AMP, whom can you trust?

In the first century B.C., it was written that, "*Money alone sets all the world in motion*"⁴. That may be an overstatement but money is certainly the centerpiece of much that happens in our lives and in the lives of our governments and communities.

So the activities of those organizations that handle the nation's financial transactions are of central importance.

And all through history, there have been concerns with the ethical standards adopted by those institutions.

The ancient Greeks, noted for their "civilized" approach to life, apparently preferred slaves to freemen as their financial record keepers (their accountants). Slaves could be tortured to get at the truth, which presumably was seen as a more effective means of handling continuous disclosure and achieving a true statement of financial affairs.

⁴ Publilius Syrus, *Moral Sayings*, translated by Darius Lyman.

Despite its irritation with the finance industry, I think the public today, perhaps even the Chairman of the ACCC, would see that as a slight over-reaction.

Nonetheless, each example of financial imprudence or malfeasance produces new pressures for additional official intervention.

It is probably not unfair to say that the finance industry is more open to abuse than most other industries. Let me explain!

In most parts of the economy, money is the measuring rod for the capital supporting a business and the means of payment for goods and services produced or acquired in the course of operations.

In the financial sector, however, money is also the stock-in-trade. And markets have developed to permit that stock to be traded or transformed in an endless variety of ways.⁵

At little or no notice, a monetary obligation may be transformed from long-term to short-term, from variable to fixed rate, from one currency to another.

Derivatives markets may be used to create obligations on a highly leveraged basis, not just to hedge an underlying transaction but, sometimes, purely to speculate.

⁵ As an aside, I don't believe those who set accounting standards have fully come to grips with this essential difference between financial institutions and other trading enterprises.

The markets themselves are complex, short-term in nature, potentially volatile and often open to exploitation by larger players or players with privileged access to information.

Money has become a commodity, but a commodity with rather special characteristics.

These things add immeasurably both to the dangers facing unwary or excessively “courageous” players and to the temptations facing the less virtuous.

For instance, we have institutions, some undoubtedly represented among the audience today, which, as part of their day-to-day activities:

- Comment publicly on market developments and issue forecasts of trends and rates;
- Carry out market transactions on the institution’s own account;
- Carry out market transactions on behalf of customers; and
- Manage funds on behalf of customers:

That is only a partial list, of course.

However, it should be sufficient to illustrate the potential for conflict of interest and for temptation to act *at the edge of ethics*.

The nature of analysts' reports, to which President Bush has referred; the timing of transactions relative to the release of forecasts; the order in which customer and house transactions are placed in the market; the list of practices which may not be strictly illegal but which are clearly out of step with morality can be quite long.

I am not suggesting that these practices are universal but they have occurred, and they do occur, despite the existence of *Chinese Walls*.

This reliance on *Chinese Walls* is an interesting phenomenon, isn't it? I'd love an options package for every time I have heard it used as a defence against claims of conflict of interest.

I understand that the origin of the concept concerns a newly married couple in a Chinese household. Space is at a premium so the family divides a room by stringing a rope across it and draping a blanket, or blankets, over the rope. That is the *Chinese Wall*.

On one side of the *Wall* is the young couple, doing whatever newly married young couples do. On the other is the family. They, of course, can hear everything happening on the other side but are expected to ignore it.

That is roughly the way many people believe *Chinese Walls* operate in financial corporations, with the added concern that the activity on the other side of the wall is not always ignored.

I have spoken, on previous occasions, of the three Capital As of human behaviour, *Avarice, Ambition and Apathy*.⁶

The first two, understandably, tend to be more prevalent in areas where cash flows and financial incentives are high.

Regrettably, the third, *Apathy*, is still a feature of some senior managements and boards of directors, which are more concerned with the *bottom line*, provided the law is not obviously being broken.

Dealing with the grey area between the illegal and the unethical is one of the major challenges facing corporate governance.

Remuneration

One particular area of challenge concerns the remuneration of executives and directors.

Financial institutions usually play with two pots of money, the capital provided by shareholders and the funds contributed by depositors, other lenders, policy-holders, investors etc.

In exercising their fiscal responsibilities, boards need to be conscious of this. Sometimes, one gets the impression that they lose sight of this reality and see the funds as their own, to use and disburse as they see fit.

⁶ I hope we don't now have to add a fourth "A" – lax Auditing.

There has developed an attitude that fees and margins should be set at whatever level the market will bear, so the only issue is how much of the profit pool should be available to the staff as “incentives” and how much should be paid out in dividends to shareholders.

Financial executives have been very inventive in boosting their share of the pool through options and other complicated leveraging devices, not always with the full knowledge of the shareholders they are supposed to be serving.

These arrangements need to be questioned, particularly where the financial implications are not adequately measured and clearly recorded in the institution’s accounts, where executives constitute a substantial part of the Board of Directors, or where directors also share in the incentive arrangements.

Ten years ago, I wrote: *“We need to remember that the financial system exists to perform a vital community service. It is not there to stimulate the egos or libidos of market traders –or to maximize the wealth of successful practitioners. The basic purposes are to help mobilize the nation’s savings and direct them efficiently to those who can employ them productively; and to permit people in different parts of the country or of the world to make payments to each other safely and efficiently.”*⁷

⁷ M.J.Phillips, *A Question of Stability*, Response to Presentation of Vocational Service Award, Sydney, 10 March 1992.

Government Intervention

As I have said, the natural community reaction to examples of unethical or illegal conduct, or corporate collapse, is to call on the authorities for more legislation or regulation. But is that always the most appropriate reaction?

I noticed that a visiting academic from the US was critical recently of the Australian approach, arguing that we needed more black letter law, bolstered by heavier criminal penalties.

That seems to me to be a case of the pot calling the kettle “sooty”.

The basic principles on which the legal systems are built in the US and Australia, are not the same. Nor is the framework on which our respective corporate management structures are built.

Without being unkind, perhaps, if the US spent more time looking critically at their structure of corporate management, they might not need as much black letter law and litigation.

Nevertheless, there is no doubt that Government regulation has an important part to play in setting the ground rules for the operations of financial institutions.

As Charles Handy expressed it, “*The market is a mechanism for sorting the efficient from the inefficient, it is not a substitute for responsibility.*”⁸

I am not by nature an interventionist. However, I believe there are three important areas where government intervention in the finance industry is justified:

- To protect those in the community who are not well placed to protect themselves;
- To prevent the development of restrictive monopolies or cartels; and
- To prevent major abuses of the system, in which I would include misinformation and insider trading as well as other more obvious forms of malfeasance.

Just how much intervention this might involve is a moot point. My view has changed a little over the past couple of decades. Self control seems to be a difficult ideal to make work in the hot house of market trading or in the middle of a drive for market share, particularly if the culture of “payment by results” has a strong hold and the “results” are measured in the short rather than the long term.

I am reminded of the views of Ben Chifley, in his Minority Report of the 1936 Royal Commission in to Banking. He felt that the concept of profit was incompatible with the role banks should play in society. And he didn’t think that privately owned banks were to be trusted with that role.

⁸ Charles Handy, *The Empty Raincoat*, Hutchinson, London, 1994.

It is quite possible that Chifley , wherever he is, is sucking his pipe and saying “There, I told you so!”

I don't share the Chifley view on banks. But, having been a small contributor to the deregulation and internationalization of our financial markets, I confess to considerable disappointment at the average standard of financial ethics, and the attitude, “*If it's legal, it's OK*”, which has become all too common.

And we seem to be forgetting some of the lessons of the 1980s a bit too quickly for my liking.

Nonetheless, I am not a proponent of masses of regulation and black letter law. I have seen, at first hand, how ineffective that can be. Any proposal to increase regulation needs to be examined very carefully. Each will involve costs, actual monetary costs as well as, usually, costs to overall efficiency.

Since these costs, in the end, will be borne by the users of the financial system and by the community as a whole, we need to be sure they are at least balanced by the results. And we know from experience that there will be unintended consequences, which may be quite damaging.

So, we should be economical in espousing new laws and should be careful of those who argue that legislation or regulation is the answer to **all** our problems, including a deficient set of ethical standards.

We certainly should not delude ourselves that we can create a higher standard of ethics simply by Act of Parliament.

But we should come down “*like a ton of bricks*”, as the saying goes, on those who wilfully transgress to the detriment of their customers or the community in general.

As Martin Luther King put it: “*Morality cannot be legislated, but behaviour can be regulated. Judicial decrees may not change the heart, but they can restrain the heartless.*”⁹

Conclusions

Let me now try to draw these thoughts to an end, if not to a conclusion.

The financial system is not well regarded by the general community. It is widely seen as rapacious and not particularly ethical. Its previous image of dependability has been damaged by a series of incidents over the past twenty years. To a substantial extent, the community has associated these with greed and insufficient regulation.

In the circumstances, there has developed a strong push for more government intervention and less reliance on self-regulation.

⁹ Rev Martin Luther King Jr, “Strength to Love”, 1963

Governments need to respond to these pressures with caution. There is a limit to the curative properties of Government action.

Confidence will only be restored when the corporate governance practices of financial institutions, and the manner in which executives and boards are remunerated are fully consonant with the ethical standards the community expects, in other words, when the institutions realize it is other people's money, not their own, that they are playing with.

Thank you