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## The global financial crisis and the governance of financial institutions

Professor John H Farrar\*

*The global financial crisis has presented many regulatory challenges as jurisdictions struggle to effectively address systemic risk. This article, which constituted a plenary address at the Corporate Law Teachers Association Conference, 2010, traverses the range of regulatory measures that have been implemented in the corporate governance and prudential risk management fields with a focus upon developments in Australia, New Zealand and the United Kingdom.*

The global financial crisis has challenged many of our assumptions about the financial system.<sup>1</sup> In the last decade or so we have seen the re-organisation and transformation of the financial services sector<sup>2</sup> and the rise of the so-called masters of the universe<sup>3</sup> who have commanded enormous rewards for exposing others to great risks.<sup>4</sup> We had assumed that in spite of market fluctuations, management basically understood their businesses, lines of authority were clear and followed, and adequate risk management systems and other internal controls were in place. The present crisis has shown that on the contrary this was not necessarily so. Banking is an industry which has failed

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1 See H Paulson Jr, *On the Brink — Inside the Race to Stop the Collapse of the Global Financial System*, Business Plus, New York, 2010; R Barbera, *The Cost of Capitalism*, McGraw Hill, New York, 2009; P Mason, *Meltdown The End of the Age of Greed*, Verso, London, 2009; W Munchau, *The Meltdown Years — The Unfolding of the Global Economic Crisis*, McGraw Hill, New York, 2010; J Stiglitz, *Freefall — Free Markets and the Sinking of the Global Economy*, Allen Lane, London, 2010; S Schwarcz, 'Regulating Complexity in Financial Markets' (2009) 87 *Wash UL Rev* 211; 'Understanding the Subprime Financial Crisis' (2008–2009) 60 *SCL Rev* 549; 'Protecting Financial Markets: Lessons from the Subprime Mortgage Meltdown' (2008–2009) 93 *Minn L Rev* 373; J Farrar, L Parsons and P Joubert, 'The Development of an Appropriate Regulatory Response to the Global Financial Crisis' (2009) 21 *Bond L Rev* 1; the Special Issue of the *University of New South Wales Law Journal* 2009, Vol 32, No 2, especially M Legg and J Harris, 'How the American Dream Became a Global Nightmare: An Analysis of the Causes of the Global Financial Crisis' (2009) 32 *UNSWLJ* 350; P Vasudev, 'Credit Derivatives and Risk Management: Corporate Governance in the Sarbanes-Oxley World' [2009] *JBL* 331.

2 See R Baxt, A Black and P Hanrahan, *Securities and Financial Services Law*, 7th ed, LexisNexis Butterworths, Chatswood, 2008, Ch 1; G Pearson, *Financial Services Law and Compliance in Australia*, Cambridge University Press, Melbourne, 2009, 2.2.

3 Based on the TV series and film. A more phallic expression was used in the industry and by M Lewis, *Liars' Poker — Two Cities, True Greed*, Hodder & Stoughton, London, 1989.

4 See R Garnaut, *The Great Crash of 2008*, Melbourne University Press, Carlton, 2009.

the global economy.<sup>5</sup> Banks have given credit to anyone who wanted it. They have failed to handle risk effectively. Instead of expediting the flow of capital to industry they have frozen it. As *The Economist's* special report on international banking of 16 May 2009 said:

the costs of this failure are massive. Frantic efforts by governments to save their financial systems and buoy their economies will do long-term damage to public finances. The IMF reckons that average government debt for the richer G20 countries will exceed 100% of GDP in 2014, up from 70% in 2000 and just 40% in 1980.<sup>6</sup>

The market capitalisation of banks fell substantially, precipitating a significant decline in stock markets around the world,<sup>7</sup> and we are still picking up the wreckage.

### **The governance of financial institutions**

Light-handed regulation of the financial sector in the United States and United Kingdom and its intellectual underpinnings have come in for strong criticism,<sup>8</sup> and we are likely to see an international move for stronger regulation of the sector. It is arguable that in Australia we have had a stronger system of regulation since the Australian Prudential Regulation Authority (APRA) found its feet after the HIH collapse. Australia certainly has on paper the toughest company and securities law, tempered in the past by erratic enforcement.

Included in the current debates over the global financial crisis is a discussion of the role of governance and particularly the corporate governance of financial institutions. The following is a diagram showing the role of key players in the governance of financial institutions:

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<sup>5</sup> 'Rebuilding the banks', *The Economist*, 16 May 2009, A Special Report on International Banking, p 3. Australia and Canada were spared catastrophe for reasons which we will consider later.

<sup>6</sup> *Ibid.*

<sup>7</sup> Garnaut, above n 4, p 98.

<sup>8</sup> See, for instance, Garnaut, above n 4, pp 75ff.

Table 1: The Governance of Financial Institutions – The role of key players

Financial and Other Risk Management Areas	Balance Sheet Structure	Income Statement Structure & Profitability	Solvency Risk & Capital Adequacy	Credit Risk	Liquidity Risk	Market Risk	Interest Rate Risk	Currency Risk	Operational Risk
Key Players and Responsibilities									
Systemic (key players):	Accountability (dimension of risk for which key player is responsible)								
Legal and Regulatory Authorities	Set regulatory framework, including risk exposure limits and other risk management parameters, which will optimize risk management in the banking sector								
Supervisory Authorities	Monitor financial viability and effectiveness of risk management. Check compliance with regulations								
Institutional (key players):									
Shareholders	Appoint "fit and proper" boards, management, and auditors								
Board of Directors	Set risk management and other bank policies. Ultimate responsibility for the entity								
Executive Management	Create systems to implement board policies, including risk management, in day-to-day operations								
Audit Committee/Internal Audit	Test compliance with board policies and provide assurance regarding corporate governance, control systems, and risk management processes								
External Auditors	Express opinion and evaluate risk management policies								
Public/Consumer (key players)	Should demand transparency and full disclosure								
Investors/Depositors	Understand responsibility and insist on full disclosure. Take responsibility for own decisions								
Rating Agencies and Media	Insist on transparency and full disclosure. Inform the public and emphasize ability to service debt								
Analysts	Analyze quantitative and non-quantitative risk-based information and advise clients								

Taken from Table 1.2, 'Partnership in Corporate Governance of Banks' in H van Greuning and S Brajovic Bratanovic, *Analyzing Bank Risk — A Framework for Assessing Corporate Governance and Risk Management*, 3rd ed, the World Bank, Washington, DC, 2009.

Lord Myners, the former UK Minister for the City, said in an interview in the *Sunday Times*:

I think regulation is one aspect of enhancing confidence in financial institutions. Others include self-healing through improved governance, more effective boards, more considered analysis of incentive plans and the behaviours they will produce, and stronger capital. There isn't a single silver bullet here, regulation in itself

without support of those other features will lead to a potential frustration of innovation and probably higher cost of funding.<sup>9</sup>

Major financial institutions are usually, although not necessarily, listed companies which are subject to the normal rules of corporate governance.

The Australian Securities Exchange Corporate Governance Council's *Corporate Governance Principles and Recommendations* recommend that:

- a majority of the board should consist of independent directors, with an independent chair;
- the board should implement risk management policies and systems, which can be through an audit committee, a risk management committee or another relevant committee; and
- there should be a remuneration committee with appropriate policies.

APRA adopted Prudential Standard APS 510 for the governance of authorised deposit-taking institutions and Prudential Standard GPS 510 for the governance of general insurers in May 2006. These have been amended with effect from 1 April 2010. APRA will also be updating Prudential Standard LPS 510 for the governance of life insurers, with effect from July 2010. The New Zealand *Principles of Corporate Governance and Guidelines* adopt a more principle-based approach with accompanying guidelines. These are less detailed.

The governance of financial institutions follows the general approach but also has some distinctive characteristics,<sup>10</sup> and as we shall see there are now arguments being made internationally for a stricter regime as a result of the global financial crisis — some of which are being implemented in Australia. Regulators cannot prevent failures, but maintain a crucial role as facilitators. They also act by enhancing and monitoring governance systems, particularly with regard to risk management. Shareholders appoint the directors who set the strategic direction and monitor management. Management must be fit and proper people in the sense of ethics and competence. Audit committees, risk management processes and internal audit are important elements as are external auditors.

The modern approach to corporate governance has been a symbiosis of law and self-regulation with increased emphasis on the latter in the last 20 years.<sup>11</sup> In spite of this we have had major corporate collapses like Enron, WorldCom and HIH, which had all the bells and whistles of corporate governance, and now the global financial crisis. Does this mean that the system of corporate

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9 Interview with A Davidson, 'Paul Myners, The City's middle man', *The Sunday Times*, 12 October 2008.

10 See M Ariff and M Hoque, 'Corporate Governance: the Case of Australian Banks' in B E Gup (Ed), *Corporate Governance in Banking: A Global Perspective*, Edward Elgar, Cheltenham 2007, p 210; H Van Greuning and S Bratanovic, *Analyzing Bank Risk — A Framework for Assessing Corporate Governance and Risk Management*, 3rd ed, the World Bank, Washington, DC, 2009.

11 See J Farrar, *Corporate Governance: Theories, Principles and Policies*, 3rd ed, Oxford University Press, Melbourne, 2008, Ch 1 and J du Plessis, J McConvill and M Bagaric, *Principles of Contemporary Corporate Governance*, Cambridge University Press, Melbourne, 2005, Ch 6.

governance has also failed?<sup>12</sup> A key element in the system of corporate governance is the use of independent directors and most systems require a majority of independent directors for listed companies.<sup>13</sup> Now as a result of the global financial crisis people are beginning to question this and to argue that inexperienced non-executive directors facilitated bank failure.<sup>14</sup> Another important element in modern corporate governance is the use of specialist board committees. Key committees are the Audit and Risk Management committees. People have begun to question what use these committees have been in the present crisis.

A threshold definitional question is whether ‘financial institution’ and ‘institutional investor’<sup>15</sup> mean the same thing. Financial institutions are of three major types — deposit-taking institutions, insurance companies and pension funds, and brokers, underwriters and investment funds. Institutional investors normally refer to banks, insurance companies, pension funds, mutual funds and hedge funds. It can be seen from this that there is substantial overlap between the two categories. In the past, the emphasis has been more on the role of institutional investors in the scheme of corporate governance of listed companies.<sup>16</sup> Only recently have people begun to question the governance of the financial institutions themselves and their organisation and relationships.<sup>17</sup> Such a debate has been long overdue.

An important question in corporate governance is whether one size fits all? It can be argued that one size does not fit all and that financial institutions are *sui generis* and require distinctive corporate governance quite apart from the issue of prudential regulation. It is obvious that there are differences between listed and unlisted companies<sup>18</sup> and that most systems have concentrated on listed companies. Only recently has some attention been given to the governance of small and medium-sized enterprises.<sup>19</sup> In the past, people have emphasised the differences between financial and non-financial companies, although at the time of the American Law Institute’s corporate governance project this distinction was rejected.<sup>20</sup> One of the reasons to disagree with that approach is the rise of financial conglomerates,<sup>21</sup> which has been marked by the emphasis on contract and the decline of the fiduciary concept with the

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12 See D Branson, ‘Enron — When All Systems Fail: Creative Destruction or Roadmap to Corporate Governance Reform’ (2003) 48 *Villanova L Rev* 989.

13 See Farrar, above n 11, pp 391ff.

14 See D Kershaw, ‘Rebuilding Confidence in the Governance of Financial Institutions’, LSE Powerpoints, at <<http://www.lse.ac.uk/collections/law/projects/lfm/Kershaw%20-%20Rebuilding%20Confidence%20in%20Governance%20of%20Financial%20Institutions.pdf>> (accessed 30 June 2010).

15 Compare Farrar, above n 11, Ch 26.

16 Farrar, above n 11, pp 369ff.

17 See, eg, J Farrar and K Levy, ‘The Governance of Superannuation Funds’ in J Farrar and S Watson (Eds), *Contemporary Issues in Corporate Governance*, Centre for Commercial and Corporate Law, University of Canterbury, 2010.

18 See H Manne, ‘Our Two Corporation Law Systems: Law and Economics’ (1967) 53 *Virginia L Rev* 53.

19 See J Farrar, ‘The Governance of SMEs and Unlisted Companies’ (2008) 4 *NZBLQ* 213.

20 American Law Institute (ALI), *Principles of Corporate Governance: Analysis and Recommendations*, Philadelphia, 1992, pp 180, 211.

21 *Ibid*, p 211. See APRA Discussion Paper, *Supervision of Conglomerate Groups*, 18 March 2010.

demise of relationship banking. On the other hand, in Australia the approach in relation to superannuation has been a mandatory trust regime coupled with financial services disclosure. This looks good on paper, and in fact gives rise to a lot of paper, but arguably ultimately represents a paper tiger and rewards a financial oligopoly which has captured the process and achieves generous remuneration irrespective of performance.<sup>22</sup> A second reason is that the boards of financial institutions face more pressure to satisfy non-shareholder stakeholders than the boards of non-financial firms. Third, financial institutions are regulated by several different regulators. The second and third points have been made by Professor Renée Adams of the University of Queensland in a very useful paper, *Governance and the Financial Crisis*.<sup>23</sup> Her overall conclusions using US data are that the governance of financial institutions is on average not obviously worse than non-financial firms, and that bank directors earned significantly less compensation than their counterparts in non-financial firms. Her data is complex but perhaps indicates that it is difficult to speak in general terms and that one needs to make specific comparisons. Firm size is a very relevant factor. Also, executive remuneration is a more significant matter on which to concentrate rather than director compensation. Her paper is to be welcomed and demonstrates the need for more detailed research in this area.

### The role and composition of the board of directors

One of the perennial problems of corporate governance for any kind of company is the ambiguous role of the board of directors.<sup>24</sup> The original role was to manage the company but the modern tendency is to refer to the role as being to manage, supervise or monitor management.<sup>25</sup> The term monitoring was first used in relation to financial institutions in the United States but it has been extended to companies generally.<sup>26</sup> A key element in the monitoring is the role of independent directors and board committees.

The first requirement of independent directors came in Section 10 of the US Investment Company Act 1940 which provides that not more than 60% of the directors of a registered investment company may be interested persons. In the same year the SEC recommended that corporations form committees composed of independent directors, but no regulatory action was taken until 1972 with a release in respect of audit committees composed of outside directors.<sup>27</sup>

The definition of independent directors has tended to exclude people with

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22 See Farrar and Levy, above n 17.

23 ECGI Finance, Working Paper No 248/2009.

24 See Farrar, above n 11, Ch 8; du Plessis, McConvill and Bagaric, above n 11, pp 54ff.

25 Du Plessis, McConvill and Bagaric, above n 11, at 94.

26 See M Eisenberg, *The Structure of the Corporation — A Legal Analysis*, Little Brown & Co, Boston, 1976, pp 140ff, 162ff; the ALI, above n 20, p 111.

27 See R Karmel, 'The Independent Corporate Board: A Means to What End?' in G Birrell et al (Eds), *The American Law Institute and Corporate Governance: An Analysis and Critique*, National Centre for the Public Interest, 1987, p 193. For the effect of this in the United States, see J Gordon, 'The Rise of Independent Directors in the United States, 1950–2005: of Shareholder Value and Stock Market Prices' (2007) 59 *Stanford L Rev* 1465. For Australia, see Farrar, above n 11, pp 391–6.

specialist knowledge of the companies' affairs and some argue as a consequence against having a majority of independent directors on a listed company board.<sup>28</sup> Recent UK research has examined the question of whether inexperienced non-executive directors facilitated bank failure and the necessity for government bail-outs.<sup>29</sup>

APRA's Prudential Standard APS 510 for the governance of authorised deposit-taking institutions and Prudential Standard GPS 510 for the governance of general insurers provide detailed requirements regarding boards and senior management. The board must have a majority of independent directors at all times and the chairperson must be an independent director. A majority of directors present and eligible to vote at all board meetings must be non-executive. The chairperson must not have been the Chief Executive Officer of the institution at any time during the previous 3 years. Rule 7 of APS 510 and Rule 8 of GPS 510 provide that the board must ensure that directors and senior management of the regulated institution, collectively, have the full range of skills needed for the effective and prudent operation of the regulated institution, and that each director has skills that allow them to make an effective contribution to board deliberations and processes. This includes the requirement for directors, collectively, to have the necessary skills, knowledge and experience to understand the risks of the regulated institution, including its legal and prudential obligations, and to ensure that the regulated institution is managed in an appropriate way taking into account these risks. This does not preclude the board from supplementing its skills and knowledge through the use of external consultants and experts.

The UK *Review of Corporate Governance in UK Banks And Other Financial Industry Entities* of 16 July 2009<sup>30</sup> makes useful recommendations with regard to board size, composition and compensation. It recommends that non-executive directors should have the knowledge and understanding of the business to enable them to contribute effectively.<sup>31</sup> To this end they should be provided with a personalised approach to induction, training and development which is kept under review.<sup>32</sup> Non-executive directors should have access to dedicated support.<sup>33</sup> It should be expected that they will give greater time commitment than has been normal in the past.<sup>34</sup> The Financial Services Authority has ongoing supervisory responsibilities and the review suggests that they should give closer attention to both the overall balance of the board in relation to risk strategy and the extent of training provided for them.<sup>35</sup>

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28 See, eg, N Wolfson, *The Modern Corporation — Free Markets Versus Regulation*, The Free Press, NY, 1984, p 83; the authors in Birrell et al, above n 27, and the arguments in Farrar, above n 11, pp 391–6. See also du Plessis, McConvill and Bagaric, above n 11, at 323ff.

29 See Kershaw, above n 14.

30 United Kingdom, *A Review of Corporate Governance in UK Banks and Other Financial Industry Entities: Final Recommendations*, November 2009, Ch 3. As to board size in Australia and the split between executive and independent directors, see Ariff and Hoque, above n 10, pp 224–5.

31 *A Review of Corporate Governance in UK Banks and Other Financial Industry Entities: Final Recommendations*, p 43.

32 *Ibid*, p 43.

33 *Ibid*, p 44.

34 *Ibid*, p 45.

35 *Ibid*, p 47.



Non-executive directors should be ready, able and encouraged to challenge proposals on strategy put forward by the executives.<sup>36</sup> The chair should be expected to commit a substantial proportion of time, probably not less than two thirds, to the business of the institution.<sup>37</sup> The chair should have a combination of financial industry experience and a proven track record of leadership.<sup>38</sup> The chair should be elected on an annual basis.<sup>39</sup> The review also considers the role of the senior independent director as a sounding board for the chair.<sup>40</sup> The board should undertake regular evaluation of its performance.<sup>41</sup>

### The duty of care, liquidity and risk management

From time to time there has been an argument for an increased duty and standard of care on directors of financial institutions.<sup>42</sup> This kind of argument was raised in the United States in the early twentieth century but was rejected.<sup>43</sup> As long ago as 1946 Professor H Ballantine thought that a distinction based solely on the label 'financial' as opposed to 'industrial' corporation was unjustified and anachronistic,<sup>44</sup> and the American Law Institute took the same view in 1992.<sup>45</sup> It said that 'in general, today banks and other financial institutions are often complex economic entities with activities far wider than the holding of deposits. Industrial corporations often are, at least in part, financial institutions.'<sup>46</sup> Nevertheless the argument has recently been restated.<sup>47</sup>

The two main arguments for stricter rules for bank directors are first the role of banks in providing access to credit and its importance in the economy<sup>48</sup> and, second, the special vulnerability of the banking industry and the significance of banking failure for the economy as a whole.<sup>49</sup> Banks have a special role in respect of liquidity. By holding illiquid assets and issuing liquid liabilities they create liquidity for the economy and are peculiarly susceptible to a bank run.<sup>50</sup> This extreme behaviour, which represents a classic prisoner's dilemma,<sup>51</sup> can cause the failure of even a solvent bank. As J M Keynes wrote:

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36 Ibid, p 51.

37 Ibid, p 58.

38 Ibid, p 54.

39 Ibid, p 55.

40 Ibid, p 56.

41 Ibid, p 57.

42 See M Eisenberg, *Cases and Materials on Corporations and other Business Organizations*, 8th ed, Foundation Press, New York, 2000, pp 535–6.

43 See ALL, above n 20, p 211. See also *Atherton v FDIC* 519 US 213 (1997).

44 *Law of Corporations*, rev ed, Callaghan, Chicago, 1946, para 63a.

45 Above n 43.

46 Ibid.

47 J Macey and M O'Hara, *The Corporate Governance of Banks*, FRBNY Economic Policy Review, April 2003, p 91.

48 A Busch, *Banking Regulation and Globalization*, Oxford University Press, Oxford, 2009, p 23. For other arguments based on asymmetric information, unsophisticated asset holders, dynamic instability and contagion, see J Stanford and T Beale, *The Law and Economics of Financial Institutions in Australia*, Butterworths, Sydney, 1995, pp 269ff.

49 Busch, *ibid*, pp 23–4.

50 Macey and O'Hara, above n 47, p 97.

51 Ibid.

'Of the maxims of orthodox finance none, surely, is more antisocial than the fetish of liquidity.'<sup>52</sup> Added to these is a third argument that banks and other financial institutions are often elaborate financial conglomerates which are now different from industrial corporations in the western world. The old argument is no longer true if it ever was.

Jonathan Macey and Maureen O'Hara argued in 2003 that financial institution directors should be obliged to inform themselves of whether a particular decision will: (1) impact the ability of the institution to pay its debts as they fall due; (2) materially increase the riskiness of the institution; or (3) materially reduce its capital position as measured both by a risk-based calculation and the leverage test. This links care with liquidity and risk management. This is in the context of what is often a complex or opaque corporate structure.<sup>53</sup> The current case law test is not that of a competent operator in financial products and is of a more general nature but taking account of the nature of the company's business and its circumstances.<sup>54</sup> This falls short of the specifics of the proposed test. Financial institutions face financial, market, human resources and other risks. It is the role of the board and, in particular, the audit and risk management committees to monitor these risks.

The Banking Risk Spectrum is shown below:

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52 *The General Theory of Employment, Interest and Money*, Macmillan St Martins Press, London, 1936, p 155.

53 Macey and O'Hara, above n 47, p 102. Cf Eisenberg, above n 42, p 536. Cf *Re Barings Plc (No 5)*, *Secretary of State for Trade and Industry v Baker (No 5)* [2000] 1 BCLC 523. See also Dr John Laker, *Corporate Governance in Financial Institutions — Some Remarks*, ABAC/ABA/PECC Symposium on Good Corporate Governance, Melbourne, 19 October 2005. This topic links with 'fit and proper' requirements and also unfitness under the UK disqualification of director provisions. See also Bank for International Settlements, Basel Committee on Banking Supervision, Consultative Document, *Principles for Enhancing Corporate Governance*, March 2010, Principles 2 and 12.

54 Laker, above n 53, pp 4ff. See also Corporations Act 2001 (Cth) s 180(1) and Companies Act 1993 (NZ) s 137. As to the relationship of liquidity to insolvency *Sandell v Porter* (1966) 115 CLR 666 at 670; 40 ALJR 71; BC6600670; *Sandell, Pengulan Floor Coverings Pty Ltd v Carter* (1997) 24 ACSR 651; 193 LSJS 243; 15 ACLC 1293; BC9703643; *Powell Duncan (Nolex Yachts Aust) v Fryer* (2001) 159 FLR 433; 37 ACSR 589; [2001] SASC (FC) 59; BC200100756 and *ASIC v Plymin (No 1)* (2003) 175 FLR 124; 46 ACSR 126; [2003] VSC 123; BC200302080. The distinction seems to be drawn between temporary and endemic lack of liquidity. In banking, liquidity means the ability to meet obligations when they become due without incurring unacceptable losses. An important factor is the cost of liquidity. Banks normally have more options available for maintaining liquidity unless there is a banking crisis such as we have recently experienced.

**Table 2: The Banking Risk Spectrum**

<b>Financial Risks</b>	<b>Operational Risks</b>	<b>Environmental Risks</b>
Balance sheet structure	Internal fraud	Country and political risks
Earnings and income statement structure	External fraud	Macroeconomic policy
Capital adequacy	Employment practices and workplace safety	Financial infrastructure
Credit	Clients, products, and business services	Legal infrastructure
Liquidity	Damage to physical assets	Banking crisis and contagion
Market	Business disruption and system failures (technology risks)	
Interest rate	Execution, delivery, and process management	
Currency		

Taken from Table 1.1 'The Banking Risk Spectrum' in H van Greuning and S Brajovic Bratanovic, *Analyzing Bank Risk — A Framework for Assessing Corporate Governance and Risk Management*, 3rd ed, the World Bank, Washington, DC, 2009.

It is remarkable how little attention was paid to risk management in the past. This may have been due to ownership patterns. Joint stock banks and insurance companies were subject to some system of regulation but City of London stock brokers had no real experience of risk management prior to Big Bang.<sup>55</sup> The Council of Lloyds also significantly failed to monitor insurance risk.<sup>56</sup> Merchant banks were complacent.

Barings was undone by a rogue trader, weak management and a lax regulatory regime in the 1990s.<sup>57</sup> Barings' collapse caused most City of London firms to formalise their risk management. Nevertheless it was the beginning of the end of Gentlemanly Capitalism.<sup>58</sup>

*The Final Report of the Royal Commission into the Tricontinental Group of*

<sup>55</sup> See P Augar, *The Death of Gentlemanly Capitalism*, Penguin Books, London, 2000, pp 96ff.

<sup>56</sup> A Raphael, *Ultimate Risk*, Corgi Books, London, 1995, p 240.

<sup>57</sup> Augar, above n 55, p 229.

<sup>58</sup> Augar, above n 55.

*Companies* in Victoria on 31 August, 1962,<sup>59</sup> made strong criticism of Tricontinental's management of credit risk and the Reserve Bank's voluntary prudential supervision.

Risk management was referred to by the Cadbury Report and in Australia it was mainly thought of in relation to the Audit Committee.<sup>60</sup> It received more attention in the Australian Securities Exchange's Corporate Governance Council's *Principles of Good Corporate Governance and Best Practice Recommendations*, particularly in the revised version. The Australia/New Zealand risk management standard was originally adopted in 1995 and was revised in 2009 (AS/NZS ISO 31000:2009). APRA initially found it difficult to deal with its insurance responsibilities and was slow off the mark in responding to HIH's difficulties. APRA was reformed with a full time Executive Group in place of its previous board. In 2002 it introduced a risk-based framework with two components — a Probability and Impact Rating System (PAIRS) and a Supervisory Oversight and Response System (SOARS). PAIRS deals with the riskiness of an institution, while SOARS deals with how APRA officials respond to that risk. PAIRS deals with probability and impact of failure and is based on qualitative data which results in a risk score.<sup>61</sup> Some concerns have been raised about the subjective aspects of some of this process.<sup>62</sup> This is where SOARS comes in and the actual level of intervention is set by the Executive Group together with senior management. APRA now tends to earlier and more interventionist action.<sup>63</sup>

The topic of risk management in banking was usefully discussed by Dr John Laker, the Chair of APRA in 2006.<sup>64</sup> He analysed the financial system risks in two main categories — systemic risk which affects the financial system as a whole, and non-systemic or diversifiable risk which is peculiar to a specific institution.<sup>65</sup>

The challenge for prudential regulators such as APRA is to strike a balance between financial safety and other public policy objectives such as efficiency and competition.<sup>66</sup> In the case of banking, APRA's prudential framework is based on the Basel accords which are currently undergoing revision. The first accord in 1988 was a risk-based capital adequacy regime. In 2004, Basel II

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<sup>59</sup> Vol 1, p 281.

<sup>60</sup> Philomena Leung et al, *The Role of Internal Audit in Corporate Governance & Management*, RMIT Publishing, Melbourne, 2003, p 23 — explaining that 74% of internal auditors regarded risk management as one of their most important functions.

<sup>61</sup> See G Pearson, *Financial Services Law and Compliance in Australia*, Cambridge University Press, Melbourne, 2009, at 2.3.2.4.

<sup>62</sup> J Black, 'Managing Regulatory Risks and Defining the Parameters of Blame: A Focus on the Australian Prudential Regulatory Authority' (2006) 28 *Law and Policy* 8.

<sup>63</sup> Pearson, above n 61, at 35.

<sup>64</sup> *Risk Management in Banking — A Prudential Perspective*, 59 International Banking Summer School, Melbourne, 6 September 2006. See also IMF, Financial Sector Assessment Program, Australia. *Detailed Assessment of Observance of Standards and Codes*, October 2006, pp 26–7; APRA, *Implementation of the Basel II Capital Framework Supervisory Review Process*, 21 December 2007; Basel Committee on Banking Supervision, *Principles for Sound Liquidity Risk Management and Supervision*, September 2008; Consultative Document, *Principles for Enhancing Corporate Governance*, Principles 6–8. See Pearson, above n 61, at 2.3.24 and 7.5.

<sup>65</sup> Laker, above n 53, p 2. See also S Schwarcz, 'Systemic Risk' (2008) 97 *Georgetown LJ* 193.

<sup>66</sup> Laker, *ibid*, p 2.

introduced new and more granular capital requirements which were more sensitive to the actual risks within the bank's business. Basically the greater the risk to which the bank is exposed, the greater the amount of capital needed to safeguard solvency and economic stability. The main problem in the present crisis is to quantify exposure to derivative and credit default swap liability. As Hank Paulson has written, 'the devil was in the details — and the details were murky'.<sup>67</sup>

Dr Laker emphasised that prudential regulators work on the fundamental premise that the primary responsibility for financial soundness and prudential risk management lies with the board of directors and senior management.<sup>68</sup> This involves risk identification and risk mitigation and management. The latter involves a variety of options including limiting the risks, pooling of risks, diversification, hedging divestment of risk and insurance cover.<sup>69</sup> Dr Laker discussed financial risk in terms of credit risk, traded market risk and operational risk.<sup>70</sup>

An effective risk management regime must have the following characteristics:

- Clearly defined management responsibilities and accountability;
- Avoidance of conflicts of interest;
- A system of approvals, limits and authorisation;
- An audit committee or risk management committee to maintain internal control;
- Detailed risk controls for each business line;
- An effective system of internal audit or compliance process; and
- A cushion of unencumbered high quality liquid assets to withstand high stress events, commensurate with the complexity of on-and off-balance sheet activities.<sup>71</sup> This needs to be under constant review to keep pace with changes in the risk profile and the external risk landscape. This is the subject of increasing prudential regulation.

APRA adopted Prudential Standard APS 110 on Capital Adequacy in January 2008. This standard aims to ensure that authorised deposit-taking institutions maintain adequate capital on both an individual and group basis to act as a buffer against the risks involved in their activities. The key requirements are that the institution must have Internal Capital Adequacy Assessment Process; maintain minimum levels of capital; and inform APRA of any significant adverse changes in capital. In addition, *Prudential Standard APS 111* deals with *Capital Adequacy: Measurement of Capital*. The key requirements of this standard are that authorised deposit-taking institutions must only include eligible capital as a component of capital for regulatory capital purposes; deduct certain items from capital; and meet certain limitations with regards to Tier 1 capital and Tier 2 capital. *Guidance Note AGN 210.1* deals with liquidity management strategy. These are being revised

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<sup>67</sup> Paulson, above n 1, p 46.

<sup>68</sup> Laker, above n 53, p 3.

<sup>69</sup> *Ibid*, p 5.

<sup>70</sup> *Ibid*, pp 6–8.

<sup>71</sup> *Ibid*, p 8. See the materials cited at n 64 above. See too Basel Committee on Banking Supervision, *Principles for Sound Stress Testing Practices and Supervision*, May 2009.

in light of enhancements to the Basel II Framework. APRA recognises that the scope of the liquidity management strategy may vary among institutions depending on the nature and complexity of their operations. *Prudential Standard APS 116*, also implemented in January 2008, deals with *Capital Adequacy: Market Risk* and requires a framework to manage, measure and monitor market risk commensurate with the nature, scale and complexity of operations of the institutions.

In a recent IMF Working Paper, *Basel Core Principles and Bank Risk: Does Compliance Matter?* of March 2010, Asli Demirguc-Kunt and Enrica Detragiache consider whether compliance with Basel Core principles for effective banking supervision is associated with lower bank risk, as measured by Z-Scores. They find no evidence linking better compliance with improved bank soundness. This is a worrying finding which may reflect the difficulty of capturing bank risk using accounting measures.

Keynes distinguished between risk, to which numerical probability can be assigned, and uncertainty.<sup>72</sup> Uncertainty is the risk which cannot be calculated with any degree of confidence. This relationship is less a dichotomy than a spectrum. The topics of risk, uncertainty and regulation are the subject of an interesting paper by Simeon Moore<sup>73</sup> which is not yet published and are also discussed by Judge Richard Posner in Ch 9 of his recent book, *The Crisis of Capitalist Democracy*.<sup>74</sup>

US banks mispriced and misjudged risk, effectively outsourcing risk assessment to credit rating agencies and gambling on a government bailout. The regulators stood back and let it happen. It has been argued that Australian banks have been better regulated.<sup>75</sup> Certainly the sector has been subject to a lot of regulation, but the fact that it has emerged from the current financial crisis relatively unscathed may be due at least in part to timing and the fact that Australian banks were less of an international player at the time than their US, UK and European counterparts. This is a matter which needs further detailed research before the above claim can be substantiated. One must guard against the fallacy of post hoc propter hoc.

## Remuneration issues

Even before the current crisis there has been growing investor dissatisfaction with remuneration levels, particularly in the financial sector, and the lack of correlation between pay and performance.<sup>76</sup>

APRA released its prudential requirements on the remuneration for authorised deposit-taking institutions and general and life insurance

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72 J Maynard Keynes, *A Treatise on Probability*, MacMillan, London; St Martin's Press, New York, 1921, Ch XXIV.

73 'Round and round the merry-go round: Shall the subprime mortgage crisis and consequential credit crunch provide the economic stimulus required to finally cause the demise of the "invisible hand approach" to market and market participant regulation', Banking and Finance Paper, Bond University 2009.

74 Harvard University Press, Cambridge, Mass, 2010.

75 See T D'Aloisio, *Regulatory Response to the Financial Crisis*, Asia Securities Forum, Sydney, 12 October 2009, pp 13–14.

76 See L Bebchuk and J Fried, *Pay Without Performance — The Unfulfilled Promise of Executive Performance*, Harvard University Press, Cambridge, 2004.

companies on 30 November 2009. The revised governance standards will come into effect between April and July 2010. By this date APRA requires that a Capital Board Remuneration Committee with appropriate composition and charter will be established and a suitable remuneration policy will be in place. APRA's requirements take as their starting point the Financial Stability Board's *Principles for Sound Compensation Practices* of April 2009. These principles have been endorsed by the G20 leaders.

The Basel Committee on Banking Supervision Consultative Document, *Principles for Enhancing Corporate Governance*, March 2010, Principle 11 provides:

An employee's compensation should be effectively aligned with prudent risk taking; compensation should be adjusted for all types of risk; compensation outcomes should be symmetric with risk outcomes; compensation payout schedules should be sensitive to the time horizon of risks; and the mix of cash, equity and other forms of compensation should be consistent with risk alignment.

The UK review recommended that the remuneration committee of a financial institution should have a remit extended to all aspects of remuneration policy, with particular emphasis on risk.<sup>77</sup> The report makes detailed recommendations in respect of disclosure and provision for the deferral of incentive payments to align rewards with sustainable performance.<sup>78</sup> There should be a dialogue between the remuneration committee and the board risk management committee on an arm's length basis on specific risk adjustments applied to incentive packages.<sup>79</sup> It also recommends that if the non-binding resolution on a remuneration committee report attracts less than 75% of the total votes cast, the chair of the committee should stand for re-election in the following year.<sup>80</sup>

The matter has received some general attention by the recent report of the Australian Productivity Commission.<sup>81</sup> It recommends that the matter should remain with boards and does not favour capping pay or introducing a binding shareholder vote.<sup>82</sup> Instead it favours independent remuneration committees and improved processes for using outside consultants. It favours enhanced disclosure and strengthening the consequences for boards that are unresponsive to shareholder views.<sup>83</sup> These are much tamer recommendations than the UK report and APRA's new standards.

In the United States and United Kingdom there are controversial moves to tax bonuses, which are politically justifiable but may drive business away.

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<sup>77</sup> See above n 30, p 93.

<sup>78</sup> *Ibid*, p 98.

<sup>79</sup> *Ibid*, p 99.

<sup>80</sup> *Ibid*, p 100.

<sup>81</sup> *Executive Remuneration in Australia*, 19 December 2009.

<sup>82</sup> *Ibid*, p xiv.

<sup>83</sup> *Ibid*.

## Investor litigation

In the United States, United Kingdom and Germany there has already been investor litigation arising out of the global financial crisis.<sup>84</sup> Investor litigation is normally only possible for shareholders and outside the United States most national systems lack institutional incentives for such litigation. In the case of depositors and other creditors there is contractual redress against the institution but limitations on the ability to proceed against the directors. It has been suggested from time to time that the fiduciary duties of directors can extend to creditors when the company enters the zone of illiquidity and insolvency.<sup>85</sup> Sometimes this has been put in terms of a potential negligence liability.<sup>86</sup> In Canada, Singapore and Malaysia, the legislation gives some locus standi to certain creditors as well as shareholders to bring a remedy for oppression and unfairly prejudicial contact.<sup>87</sup> In New Zealand this is not possible, but in Australia, s 1324 of the Corporations Act 2001 (Cth) confers locus standi on a creditor in respect of a breach of the Act.<sup>88</sup> So far this has been relatively under-used.<sup>89</sup>

In the United States the Madoff frauds and subprime loans have given rise to litigation, with some of it being through claims on the Securities Investor Protection Corporation and others by indirect investor litigation,<sup>90</sup> although recently there has been a decline in securities fraud class actions.<sup>91</sup>

Issues before the English courts include claims by bondholders, structured investment vehicle litigation, derivative claims in respect of Northern Rock and claims for misleading and deceptive conduct in connection with issues of securities.<sup>92</sup>

Claims in Germany include investors claiming against banks and prospectus liability.<sup>93</sup> Some of these cases are collective actions under the *Capital Markets Law of 2005*.<sup>94</sup>

All of this represents increased investor activism and we are likely to see more litigation of a similar nature in Australia and New Zealand. Directors of

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84 See E Bruno (Ed), *Global Financial Crisis — Navigating and Understanding the Regulatory Aspects*, Globe Business Publishing, London, 2009, pp 431, 447, 463.

85 See R Austin, H Ford and I Ramsay, *Company Directors — Principles of Law and Corporate Governance*, LexisNexis Butterworths, Chatswood, 2005, pp 276ff.

86 *Nicholson v Permakraft (NZ) Ltd (in liq)* (1985) 3 ACLC 453; [1985] 1 NZLR 242; (1985) 2 NZCLC 99,264.

87 See K McGuinness, *Canadian Business Corporations Law*, 2nd ed, LexisNexis, 2007, at 13.79. Malaysia and Singapore adopted the Canadian provision in spite of adopting the Australian Uniform Companies Act model.

88 See R Austin and I Ramsay, *Ford's Principles of Corporations Law*, 14th ed, LexisNexis, 2010, p 750.

89 L Thai, 'Statutory Injunction — Call for amendment to s 1324 of the Corporations Act' (2006) 24 *C&SLJ* 41 at 41.

90 See A Borrasso and H Lucas, 'US securities litigation in the financial crisis' in Bruno (Ed), above n 84, p 463.

91 'Securities Suits Drop as Credit — Crunch Cases Dry Up, Study Shows', *BusinessWeek*, 5 January 2010.

92 See C Canning and R Malone, 'Securities and banking litigation arising out of the financial crisis in the United Kingdom' in Bruno (Ed), above n 84, p 447.

93 See F Herring and R Litten, 'Litigation caused by the financial crisis in Germany' in Bruno (Ed), above n 84, p 431.

94 *Ibid*, p 443.



financial institutions will need to consider carefully the scope of cover of their D&O policies and there is likely to be litigation over this as well.<sup>95</sup>

### The changing role of the state

An important question in respect of governance in general is the changing role of the State in the present global financial crisis.<sup>96</sup> In British Commonwealth systems we have an archaic concept of the State in the form of the Crown, but the reality of the modern state is multifunctional and complex. Historically the State in Australia and New Zealand provided a major source of development capital in the early history of the colonies. The State has been regulator of the financial sector and now it is thrust into the position of equity investor in the United States and United Kingdom.<sup>97</sup> This has required new classes of shares to be taken up by the State in what was intended to be a temporary measure.<sup>98</sup> Then there is the role of Reserve Banks as lenders of last resort.<sup>99</sup> In addition to a possible changing role of the State there has been increased emphasis on the international dimension and international approaches to the problems.<sup>100</sup> There has been a need for closer international cooperation. Attention has been focussed on the G20 countries and this has led to a reconstitution of the Financial Stability Board and increased action by the Basel Committee on Banking Supervision, the International Organization of Securities Commissions (IOSCO) and other global standards-setting bodies.<sup>101</sup>

The crisis is not over and debate continues about a new system of regulation. There will be a temptation to over-regulate the sector<sup>102</sup> and one needs to remember that the regulators themselves cannot escape some responsibility for the crisis, and need themselves to be monitored.<sup>103</sup> Some argue that we are undergoing a paradigm shift.<sup>104</sup> This is probably an exaggeration and in any event when one is living through a period of crisis and change it is difficult to detect whether the paradigm has shifted. As regards

95 See J McDonald Jr, 'Similarities Between The Savings and Loan Crisis and Today's Current Financial Crisis: What the Past Can Tell Us About the Future' (2009) 76 *Defence Counsel Jnl* 470; M Legg and J Harris, 'How the American Dream Became a Global Nightmare: An Analysis of the Causes of the Global Financial Crisis' (2009) 32 *UNSWLJ* 350 at 385–8.

96 See Farrar, Parsons and Joubert, above n 1, pp 12ff; P Alessandri and A Haldane, *Banking on the State*, November 2009, a paper presented at the Federal Reserve Bank of Chicago 12th Annual International Banking Conference, 25 September 2009.

97 See, for instance, P Mason, *Meltdown: The End of the Age of Greed*, Verso, London, 2009, p 46. For the US position, see A Sorkin, *Too Big to Fail — Inside the Battle to Save Wall Street*, Allen Lane, Camberwell, 2009.

98 The UK government took 57% of the Royal Bank of Scotland in return for injecting £15 billion equity and £5 billion of preference shares. It owns 43.5% of the merged HBOS and Lloyds TSB: '3 board members of RBS and 2 of Lloyds/HBOS are appointed by the government', *Daily Telegraph*, 13 October 2008. The total cost to the UK taxpayer has reached £850 billion. £107 million was paid to City advisers for advice. The latest absurdity is the objection by the board of RBS to the politicisation of the bank: *Guardian*, 15 December 2009.

99 Farrar, Parsons, Joubert, above n 1, pp 14ff.

100 Ibid, pp 12, 18ff for a detailed discussion.

101 Ibid, pp 29ff.

102 Farrar, Parsons, Joubert, above n 1, pp 40–1.

103 R Posner, *The Crisis of Capitalist Democracy*, Harvard University Press, Cambridge, Mass, 2010, pp 173ff.

104 Farrar, Parsons, Joubert, above n 1, pp 40–1.

corporate governance itself in Australia, we have the toughest but most obese company and financial services law and superannuation regulation, as well as detailed self-regulation. The problem is to make it work well without impeding innovation and corporate performance.<sup>105</sup>

The problem for New Zealand is of a different nature. For 25 years it has adopted a more libertarian regime which remarkably has survived changes of government but which needs now to adjust to a different climate. It has a Companies Act 1993 based on the North American model, an outdated Securities Act 1978 and a principle-based system of self-regulation of corporate governance. The powers of the Securities Commission are more limited than the Australian Securities and Investments Commission and there is no APRA. Prudential regulation remains with the Reserve Bank. Compared with other jurisdictions, there is little effective enforcement of company law or securities regulation,<sup>106</sup> and the system of superannuation is substantially privatised with little regulation.<sup>107</sup> In the meantime the country's GDP has recently declined but is projected to recover.<sup>108</sup> The present government faces a complex challenge.<sup>109</sup>

## Conclusion

The global financial crisis has challenged academic and conventional wisdom, and may have caused the beginning of a dramatic shift in international relations. The governance of financial institutions is part of that bigger picture. Governance in the broad sense is open for debate — the role of the state, international cooperation, the scope of prudential regulation, the role of boards of directors and in particular risk management procedures and capital adequacy requirements are all being questioned. In the past some research has been done on the link between governance and performance.<sup>110</sup> Perhaps the present emphasis should be more on the link between good governance and the avoidance of catastrophe.<sup>111</sup> This discussion would be of particular relevance to Australian financial institutions and regulators.

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<sup>105</sup> See Farrar, above n 11, p 572.

<sup>106</sup> See J Farrar, 'Enforcement: A Trans-Tasman Comparison' (2005) *NZ L Rev* 383.

<sup>107</sup> See T Keeper, 'Governance of New Zealand Superannuation Schemes: A Mixed Scorecard' in J Farrar and S Watson (Eds), *Contemporary Issues in Corporate Governance*, Centre for Commercial and Corporate Law, University of Canterbury, 2010.

<sup>108</sup> See OECD New Zealand — Economic Outlook 87 Country Summary, <[http://www.oecd.org/document/46/0,3343,en\\_2649\\_34109\\_45270062\\_1\\_1\\_1\\_1,00.html](http://www.oecd.org/document/46/0,3343,en_2649_34109_45270062_1_1_1_1,00.html)> (accessed 9 June 2010).

<sup>109</sup> *Answering the \$64,000 Question — Closing the income gap with Australia by 2025*, 1st Report and Recommendations 2025 Taskforce, 30 November 2009.

<sup>110</sup> See, for instance, R Brown and T Gorgens, *Corporate Governance and Financial Performance in an Australian Context*, Treasury Working Paper 2009-02, March 2009.

<sup>111</sup> Compare Stiglitz, above n 1, pp 153ff.