



Asia-Pacific
Economic Cooperation

Workshop on Strengthening Corporate Governance within Financial Institutions

**19-22 May 2004
Shanghai, China**

Organized by:

APEC Finance and Development Program (AFDP)

APEC Business Advisory Council (ABAC)

Pacific Economic Cooperation Council (PECC) Finance Forum

China National Committee for Pacific Economic Cooperation (CNCPEC)

Published in July 2004

Copyright © 2004 APEC Secretariat
APEC Secretariat
35 Heng Mui Keng Terrace
Singapore 119616
Tel: (65) 6775 6012
Fax: (65) 6775 6013
E-mail: info@apec.org
Website: www.apec.org

APEC Publication Number: APEC# 204-OT-04.1



APEC FINANCE and DEVELOPMENT PROGRAM

Workshop on Strengthening Corporate Governance within Financial Institutions

May 19-22, 2004

Shanghai National Accounting Institute

Shanghai, P.R.China

Document No.	Contents	Document Titles
Business Arrangements		
1-(01)		Program
1-(02)		Delegation List
Theme Sessions		
2-(01)	Presentation and Bio of John Thompson	OECD Corporate Governance Principles and Governance of Banks
2-(02)-a	Presentation and Bio of Jesus Estanislao	The Regulatory Framework and Government's Role in Improving Corporate Governance within Banking Sector
2-(02)-b	Presentation and Bio of Yongxiang Bu	The Regulatory Framework and Government's Role in Improving Corporate Governance within Banking Sector
2-(03)	Presentation and Bio of Jevons Lee	Financial Disclosure and Information Transparency in Banks
2-(04)-a	Presentation and Bio of Stefan Hohl	Panel Discussion: Sound Corporate Governance Practices in Banks: Basel 2
2-(04)-b	Presentation and Bio of Jesus Estanislao	Panel Discussion: Sound Corporate Governance Practices in Banks: Basel 2
2-(04)-c	Presentation and Bio of John Hatton	Panel Discussion: Sound Corporate Governance Practices in Banks: Basel 2
2-(05)	Presentation and Bio of Kwang S. Chung	Case Study: Corporate Governance in the APEC Economies: Korea's Experiences and Lessons Learned
2-(06)	Presentation and Bio of Angus Chan	Case Study: Corporate Governance in the APEC Economies: Hong Kong's Experiences and Lessons Learned
2-(07)-a	Presentation and Bio of Simon Glass	Case Study: Internal Control Systems in HSBC



APEC FINANCE and DEVELOPMENT PROGRAM

Document No.	Contents	Document Titles
2-(07)-b	Presentation and Bio of Xing Xiao	Case Study: Internal Control Systems in HSBC
2-(08)	Presentation and Bio of Jeffrey Coles	Corporate Governance and Control: What is Different about Financial Institutions
2-(09)-a	Presentation and Bio of Yasuo Kanzaki	Key Developments Arising, including corporate governance issues
2-(09)-b	Presentation and Bio of Brant Free	Key Developments Arising, including corporate governance issues
2-(10)-a	Presentation and Bio of Bruce Cameron	International Accounting Standards for Insurance Contracts
2-(10)-b	Presentation and Bio of David Knox	International Accounting Standards for Insurance Contracts
2-(11)	Presentation and Bio of Nigel Hazell	Issues in Implementation - an industry perspective
2-(12)	Presentation and Bio of Juliet McKee	Compliance, Business Ethics and Corporate Governance in Financial Institutions
2-(13)	Presentation and Bio of Zhichao Wang	Case Study: Corporate Governance in the APEC Economies: China's Experiences and Lessons Learned
2-(14)	Presentation and Bio of David Campbell	International Trends in Financial Reporting



APEC FINANCE and DEVELOPMENT PROGRAM

DOC.NO.1-(01)

Program



APEC FINANCE and DEVELOPMENT PROGRAM

Workshop on Strengthening Corporate Governance within Financial Institutions

May 19-22, 2004
Shanghai National Accounting Institute
Shanghai, P.R.China

Program

Tuesday, May 18

18:00 – 20:00 Welcoming Reception/Dinner
Venue: 2nd Floor, Cafeteria

Host: Mr. Kouqing Li, Deputy Secretary-General, AFDP Secretariat

Wednesday, May 19

08:30 – 08:45 Opening Ceremony
Venue: Classroom 206#207#, AB Area

Presenters:

- Mr. Kouqing Li, Deputy Secretary-General, AFDP Secretariat
- Mr. Ken Waller, Group Economic Advisor, Commonwealth Bank of Australia, Australia

08:45 - 09:00 Photo Taking

09:00 – 10:15 OECD Corporate Governance Principles and Governance of Banks

Venue: Classroom 206#207#, AB Area

Presenter:

- Mr. John Thompson, Financial Counsellor, DAFPE, OECD

10:15 – 10:30 Coffee Break

10:30– 11:45 The Regulatory Framework and Government's Role in Improving Corporate Governance within Banking Sector

Workshop Program

Venue: Classroom 206#207#, AB Area

Presenters:

- Mr. Jesus Estanislao, President, Institute of Corporate Directors, the Philippines
- Mr. Yongxiang Bu, Deputy Director, Research Department, People's Bank Of China, P.R.China

11:45 – 13:30

Lunch

Venue: 2nd Floor, Cafeteria

13:30 – 14:45

Financial Disclosure and Information Transparency in Banks

Venue: Classroom 206#207#, AB Area

Presenter:

- Mr. CHI-WEN Jevons Lee, Associate Dean for Asian Programs, Freeman College of Business, Tulane University, U.S.A

14:45 – 15:00

Coffee Break

15:00 – 17: 00

Panel Discussion: Sound Corporate Governance Practices in Banks: Basel 2

Venue: Classroom 206#207#, AB Area

Moderator: Mr. Ken Waller, Group Economic Advisor,
Commonwealth Bank of Australia, Australia

Panelists:

- Mr. Stefan Hohl, BIS, Representative Office for Asia and the Pacific
- Mr. Jesus Estanislao, President, Institute of Corporate Directors, the Philippines
- Mr. John Hatton, Company Secretary, Commonwealth Bank of Australia, Australia

Thursday, May 20

09:00 – 10:15

Case Study: Corporate Governance in the APEC Economies: Korea's Experiences and Lessons Learned

Venue: Classroom 206#207#, AB Area

Presenter:

- Mr. Kwang S. Chung, President, the Korea Corporate Governance Service, & Professor of Finance, Chung-Ang University Korea, Korea

10:15 – 10:30 **Coffee Break**

**10:30 – 11:45 Case Study: Corporate Governance in the APEC Economies:
Hong Kong's Experiences and Lessons Learned**

Venue: Classroom 206#207#, AB Area

Presenter:

- Mr. Angus Chan, Senior Manager of Banking Policy
Department, Hong Kong Monetary Authority, Hong Kong,
China

11:45– 13:00 **Lunch**

Venue: 2nd Floor, Cafeteria

13:00 – 14:15 Case Study: Internal Control Systems in A Commercial Bank

Venue: Classroom 206#207#, AB Area

Presenter:

- Mr. Simon Glass, Chief Financial Officer, HSBC

Commentator:

- Ms. Xing Xiao, Assistant Professor, School of Economics and
Management, Tsinghua University, P.R.China

14:15 – 14:30 **Coffee Break**

**14:30 – 15:45 Corporate Governance and Control: What is Different about
Financial Institutions?**

Venue: Classroom 206#207#, AB Area

Presenter:

- Mr. Jeffrey Coles, Professor of Finance, Arizona State
University, U.S.A.

15:45 – 16:00 **Coffee Break**

16:00 – 17:30 Group Discussion

Venue: 208# 209#, AB Area

Moderator: Mr. Kouqing Li, Deputy Secretary-General, AFDP
Secretariat

Presenters: All participants

Friday, May 21

09:00 – 10:30 International Accounting Standards for Insurance Contracts

Venue: Classroom 206#207#, AB Area

Presenters:

- Mr. Bruce Cameron, Director, PricewaterhouseCoopers, China
- Mr. David Knox, Director, PricewaterhouseCoopers Actuarial

10:30 – 10:45 Coffee Break

10:45 – 11:30 Case Study: Corporate Governance in the APEC Economies: China's Experiences and Lessons Learned

Venue: Classroom 206#207#, AB Area

Presenter:

- Mr. Zhichao WANG, Director, Life Insurance Department, China Insurance Regulatory Commission

11:30– 13:00 Lunch

Venue: 2nd Floor, Cafeteria

13:00 – 14:15 Key Developments Arising, including corporate governance issues

Venue: Classroom 206#207#, AB Area

Presenter:

- Mr. Yasuo Kanzaki, Special Advisor, Nikko Citigroup Ltd.

Commentator:

- Mr. John Thompson, Financial Counsellor, DAFPE, OECD

14:15 – 15:15 International Accounting Standards Implications for the Life Insurance Businesses of the Commonwealth Bank Group

Venue: Classroom 206#207#, AB Area

Presenter:

- Mr. Nigel Hazell, Regional Director, Finance and Operations, CMG Asia

Commentator:

- Ms. Juliet McKee, NZPECC Finance Forum Convenor

15:15 – 15:30 Coffee Break

15:30 – 16:30 Panel Discussion: Strategic Developments Going Forward

Venue: Classroom 206#207#, AB Area

Workshop Program

Moderator: Mr. Ken Waller, Group Economic Advisor,
Commonwealth Bank of Australia, Australia

Panelists:

Yasuo Kanzaki; Brant Free; Bruce Cameron;
David Knox; Nigel Hazell

**16:30 – 16:50 Brief Conclusion on Challenges for the Asian Insurance Industry
Arising from International Accounting Standards**

Saturday, May 22

09:00 – 09:30 International Trends in Financial Reporting

Venue: Classroom 206#207#, AB Area

Presenter:

- Mr. David Campbell, Asia Pacific Insurance Practice Leader,
PricewaterhouseCoopers

**09:30 – 10:45 Compliance, Business Ethics and Corporate Governance in
Financial Institutions**

Venue: Classroom 206#207#, AB Area

Presenter:

- Ms. Juliet McKee, NZPECC Finance Forum Convenor

10:45 – 11:00 Coffee Break

11:00 – 11:45 Group Report

Presentation of Findings from Group Discussions

Venue: Classroom 206#207#, AB Area

Moderator: Mr. Kouqing Li, Deputy Secretary-General, AFDP
Secretariat

11:45– 13:00 Farewell Lunch

Venue: Shu You Seafood Restaurant

**13:00- 18:00 Visiting Shanghai City Planning Exhibition Center &
Shanghai Museum**



DOC.NO.1-(02)

Delegation List

**WORKSHOP ON STRENGTHENING CORPORATE GOVERNANCE
WITHIN FINANCIAL INSTITUTIONS**

**May 19-22, 2004
Shanghai National Accounting Institute
Shanghai, P.R.China**

DELEGATION LIST

Official Delegates:

AUSTRALIA

1. Mr. John Hatton
Company Secretary
Commonwealth Bank of Australia
Tel: 612-9378 3546
Fax: 612-9378 3317
Email: hattonjd@cba.com.au

CANADA

1. Mr. Aaron Low
Public Diplomacy Assistant
Public Diplomacy
Canadian Consulate General in Shanghai
Tel: 8621-6279 8400 ext.5597
Fax: 8621-6279 8401
Email: Aaron.low@dfait-maeci.gc.ca

PEOPLE'S REPUBLIC OF CHINA

1. Mr. DU Yan
Finance Department
Ministry of Finance
Tel: 8610-6855 1220
Fax: 8610-68551270
Email: du-yan@263.net
2. Mr. JIANG Huadong
Finance Department
Ministry of Finance

Tel: 8610-6855 1215
Fax: 8610-6855 1215
Email: jianghuadong@sina.com

3. Mr. BU Yongxiang
Deputy Director
Research Department
People's Bank Of China

4. Mr. LE Jiandong
Research Department
People's Bank of China
Tel: 8610-6619 4759
Email: yjiandong@pbc.gov.cn

5. Mr. LIU Ye
People's Bank of China
Tel: 8610-6619 5457

6. Mr. WEI Jianbo
Department of Fund Supervision
China Securities Regulatory Commission
Tel: 8610-8806 1704
Fax: 8610-8806 1446
Email: weijb@csrc.gov.cn

7. Mr. LI Xiaogang
Department of Futures Supervision
China Securities Regulatory Commission
Tel: 8610-8806 1729
Fax: 8610-8806 1111
Email: lixg@csrc.gov.cn

8. Mr. SU Huchao
Department of Intermediary Supervision
China Securities Regulatory Commission
Tel: 8610-8806 1697
Fax: 8610-8806 1014
Email: suhc@csrc.gov.cn

9. Mr. XI Yongchun
Treasury and Accounting Department
China Banking Regulatory Commission
Tel: 8610-6551 7452

Fax: 8610-6551 7422
Email: xiyongchun@cbr.gov.cn

10. Ms. ZHOU Xiaping
Treasury and Accounting Department
China Banking Regulatory Commission
11. Mr. ZHANG Jian
Human Resources Department
China Banking Regulatory Commission
12. Mr. WANG Zhichao
Director
Life Insurance Department
China Insurance Regulatory Commission
Tel: 8610-6650 6171
Fax: 8610-6650 6471
13. Ms. JIANG Tao
Director
Property Insurance Department
China Insurance Regulatory Commission
Tel: 8610-6601 1889
Fax: 8610-6650 6139
14. Mr. JIANG Bo
International Department
China Insurance Regulatory Commission
Tel: 8610-6650 6238
Fax: 8610-6601 1869
Email: circ-cooperation@tom.com
15. Mr. CHEN Dongling
Deputy Director
Economic Commission
Shanghai Municipal People's Government
Tel: 8621-6321 2810*2690
Fax: 8621-6327 8073
Email: dchen@sh.gov.cn

HONG KONG, CHINA

1. Mr. Angus Chan
Senior Manager of Banking Policy Department

Hong Kong Monetary Authority
Email: Angus_SH_Chan@hkma.gov.hk

INDONESIA

1. Mr. Mulia Simatupang
Analyst
Bank Indonesia
Tel: 6221-381 8392
Fax: 6221-380 1766
Email: mulia_r@bi.go.id
2. Mr. Ashal Badri
Vice President
Risk Management Division
Bank BNI Indonesia
Tel: 6221-2601 177*9401 or 9402
Fax: 6221-6983 7031

MALAYSIA

1. Ms. Azlina Shahrin
Associate/ Law Reform & Regulatory Policy Department
Securities Commission
Tel: 603-6204 8271
Fax: 603-6201 5101
Email: azlina@seccom.com.my

MEXICA

1. Ms. Cristina Rohde Faraudo
General Director for Financial Supervision
Ministry of Finance and Public Credit/ Insurance and Securities National
Commission
Tel: 5255-5724 7598 or 5724 7437
Fax: 5255-5661 6800
Email: crohde@cnsf.gob.mx

PHILIPINES

1. Mr. Gerardo Tison
Deputy Director, Monetary Board
Bangko Sentral ng Pilipinas
Tel: 632-5253 460

Fax: 632-5214 048
Email: gtison@bsp.gov.ph

THAILAND

1. Mr. Saengchart Wanichwatphibun
Senior Analyst
Financial Institutions Policy Group
Bank of Thailand
Tel: 662-283 6828
Fax: 662-283 5938
Email: Saengchw@bot.or.th

International Organizations:

APEC FINANCE AND DEVELOPMENT PROGRAM

1. Mr. LI Kouqing
Deputy Secretary-General
APEC Finance and Development Program Secretariat
Tel: 8621-6976 8006
Fax: 8621-6976 8016
Email: likouqing@afdp.org

ASIAN CORPORATE GOVERNANCE ASSOCIATION

1. Mr. Francois Roy
Chief Analyst
Phone: 852-2878 7788
Fax: 852-2878 7288
Email: francois@acga-asia.org

BANK OF INTERNATIONAL SETTLEMENT

1. Mr. Stefan Hohl
BIS Asia Regional Office
Email: Stefan.Hohl@bis.org

ORGANIZATION FOR ECONOMIC COOPERATION AND DEVELOPMENT

1. Mr. John Thompson
Financial Counsellor
Email: John.Thompson@oecd.org

PECIFIC ECONOMIC COOPERATION COUNCIL

1. Ms. CHEN xiaoshuang
China National Committee for Pacific Economic Cooperation
Tel: 8610-8511 9648
Fax: 8610-6523 5135
Email: cncpec@netchina.com.cn
2. Ms. Juliet McKee
NZPECC Finance Forum Convenor
Tel: 644- 4762 900
Email: juliet@mckee.co.nz
3. Ms. Mari Elka Pangestu
Tel: 8621- 5833 9086
Fax: 8621-5833 9076
Email: mpangestu@ssafara.net

Private Institutions:

1. Mr. Kenneth Waller
Group Economic Advisor, Commonwealth Bank of Australia, Australia
Tel: 613-9675 7651
Fax: 613-9675 6464
Email: wallk@cba.com.au
2. Mr. Simon Glass
Chief Financial Officer
HSBC
3. Mr. Brant Free
Senior Vice President
International External Affairs
The Chubb Corporation
Email: bfree@chubb.com
4. Mr. Nigel Hazell
Regional Director, Finance Operation
CMG Asia Ltd
Tel: 852-2861 4922
Fax: 852-2520 1119
Email: nrh@cmgasia.com.hk

5. Mr. Yasuo Kanzaki
Special Advisor
Nikko Citigroup Limited
Tel: 813-5562 2405
Fax: 813-5562 2510
Email: kanzaki_yasuo@mail.nikko.co.jp

6. Ms Ikuko Hirano
Deputy General Manager
Management Planning and Administration Division
Nikko Cordial Corporation
Tel: 813-5644 4389
Fax: 813-5644 4397
Email: hirano_ikuko@mail.nikko.co.jp

7. Mr. Keith Weaver
Vice President and CFO
Manulife Financial, Asia
Tel: 852-2510 5802
Fax: 852-2510 7376
Email: keith_weaver@manulife.com

8. Mr. David Knox
Director
PricewaterhouseCoopers Actuarial
Tel: 613-8603 3919
Fax: 613-8613 2214
Email: david.knox@au.pwc.com

9. Mr. David Campbell
Asia Pacific Insurance Practice Leader
PricewaterhouseCoopers

10. Mr. Bruce Cameron
Director
PricewaterhouseCoopers, China

11. Mr. Alex Wong
Partner
Pricewaterhouse Coopers, Shanghai
Tel: 8621-6386 3388*3690
Fax: 8621-6386 3300

12. Mr. ZHANG Weidong
Senior Researcher
Research Center
Shanghai Stock Exchange
Tel: 8621-6880 0094
Fax: 8621-6881 3828
Email: wdzhang@sse.com.cn

13. Mr. WANG Jinyong
Vice President
Industrial Securities Co., Ltd
Tel: 8621-6841 9393
Fax: 8621-6841 9764
Email: jywang@xyzq.com.cn

14. Ms. Isabella Lea
Investment Banking Division
Industrial Securities
Tel: 8621-6841 9126
Fax: 8621-6841 9764
Email: Isabella_lea@hotmail.com

15. Mr. YUAN Jin
Vice General Manager
China Merchants Bank
Tel: 8621-5879 1227
Fax: 8621-5879 1235
Email: 042572@cmbchina.com

16. Ms. YIN Qinghong
China Merchants Bank, Shanghai Branch
Tel: 8621-5879 2228*8910
Fax: 8621-5879 0442
Email: yinqh@cmbchina.com

17. Mr. YE Cong
President
Shanghai Sinowave Chemical Co., Ltd
Tel: 8621-6204 3229
Fax: 8621-5290 3311
Email: yecong@public7.sta.net.cn

18. Mr. YANG Shaohua
Financing Manager

Shanghai Sinowave Chemical Co., Ltd
Tel: 8621-5290 1339
Fax: 8621-5290 3311
Email: yang_shaohua2003@163.com

19. Mr. SHI Lei

Director & General Manager
Shanghai Commercial Investment (Group) Co., Ltd
Tel: 8621-6282 5518
Fax: 8621-6282 6297
Email: shilei@scig.com.cn

20. Mr. XU Jie

China Minsheng Bank Corp.
Tel: 8621-5385 7700*384
Fax: 8621-5385 7513

21. Ms. TONG Jinyu

China Minsheng Bank Corp.
Tel: 8621-5385 7700*276
Fax: 8621-5385 7513
Email: tongjinyu@cmbc.com.cn

22. Mr. LIN Caiyi

Department of Strategy and Development
China UnionPay
Tel: 8621-6840 1888*6805
Fax: 8621-6840 0739
Email: cylin@chinaunionpay.com

23. Mr. SHAO Xiaohua

Department of Strategy and Development
China UnionPay
Tel: 8621-6840 1888*6859
Fax: 8621-6840 0739
Email: xhshao@chinaunionpay.com

24. Ms. XIAO Xue

President Assistant
China Thai International Finance Co., Ltd
Tel: 8621-6335 2788*228
Fax: 8621-6335 1986
Email: xiaox@ctif.com.cn

25. Ms. LI Guo
Finance Department
China Thai International Finance Co., Ltd
Tel: 8621-6335 2788*265
Fax: 8621-6335 1986
Email: lig@ctif.com.cn
26. Mr. SHEN Yongqing
Chief Manager, Market Development
China Construction Bank, Shanghai Branch
Tel: 8621-6849 1583
Fax: 8621-5888 0000*1766
Email: shenyongqing/sh/ccb@ccb.com.cn
27. Mr. SHI Qi
Director
Administration Department
Bank of Communication, Shanghai Branch
Tel: 8621-6311 1000*3501
Fax: 8621-6374 4799
Email: shiqish@21cn.com
28. Mr. LUO Rijun
Deputy General Manager
R&D Department
Bank of Communication, Shanghai Branch
Tel: 8621-5385 6220
Fax: 8621-5385 6036
Email: luorj@95559.sh.cn
29. Mr. TAO Ruli
China Construction Bank, Shanghai Branch
Tel: 8621-5888 0000
Fax: 8621-6849 0311
30. ZENG Tong
Operation Support Department
Chang Xin Asset Management Co., Ltd
Tel: 8621-5058 8077
Fax: 8621-5058 8077
Email: qinbo@cxfund.com.cn
31. QIN Bo
Operation Support Department

Chang Xin Asset Management Co., Ltd
Tel: 8621-5058 8077
Fax: 8621-5058 8077
Email: qinbo@cxfund.com.cn

32. Ms. HONG Qin
Board of Directors Office
Bank of Shanghai
Tel: 8621-6337 0010
Fax: 8621-6337 0005
Email: hongqin@bankofshanghai.com
33. Mr. LUO Deming
Treasury and Finance Department
Bank of Shanghai
Tel: 8621-6337 1206
Fax: 8621-6337 1279
Email: luodm@bankofshanghai.com
34. XING Huan
Department of Finance and Accounting
PICC Property and Casualty Company Limited
Tel: 8610-6315 6688*8595
Fax: 8610-6317 2704
Email: xingh@piccnet.com.cn
35. WANG Yan
Department of Finance and Accounting
PICC Property and Casualty Company Limited
Tel: 8610-6315 6688*8702
Fax: 8610-6315 2061
Email: xingh@piccnet.com.cn
36. Mr. LI Chunyan
President Assistant
Ping An Bank
Tel: 86591-333 0847
37. Mr. WANG Chao
President Assistant
Xizang Securities Company
Tel: 8621-5554 0968
38. Mr. HUANG Qiang

Xizang Securities Company

Academic Delegates:

1. Mr. Jesus Estanislao
President and CEO
Institute of Corporate Directors
Tel: 632-8841 4014
Fax: 632-8841 1493
Email: jestanislao@icdcenter.org

2. Mr. Jeffrey Coles
Professor of Finance
Arizona State University

3. Mr. CHI-WEN Jevons Lee
Associate Dean for Asian Programs, Freeman College of Business
Tulane University

4. Mr. Kwang S. Chung
Professor of Finance
Chung-Ang University Korea

5. Mr. XIE Rong
Vice President
Shanghai National Accounting Institute
Email: xierong@snai.edu

6. Mr. CAO Shengrong
Research Fellow
Shanghai National Accounting Institute
Email: johnson@snai.edu

7. Mr. ZHAO Chunguang
Research Fellow
Shanghai National Accounting Institute
Email: chunguang@snai.edu

8. Mr. YAN Yan
Research Fellow
Shanghai National Accounting Institute
Email: yanyan@snai.edu

9. Mr. WU Jianyou
Research Fellow
Shanghai National Accounting Institute
Email: wujy@snai.edu

10. Ms. XING Xiao
Assistant Professor
School of Economics and Management,
Tsinghua University

11. Mr. Zhang Bin
Assistant Research Fellow, Division of World Economy
China Institute of International Studies
Tel: 8610- 8511 9579
Email: zhangbin62@sina.com.cn

12. Mr. LIU Tianming
Financial Management School
Shanghai Institute of Foreign Trade
Email: tomleo@vip.sina.com

13. Mr. QIN Haiying
Research Center for Corporate Governance
International Business School
Nankai University

14. Mr. CAO Tingqiu
Research Center for Corporate Governance
International Business School
Nankai University



DOC.NO.2-(01)

**OECD Corporate Governance Principles and
Governance of Banks**

John Thompson

Financial Counsellor, DAFFE, OECD



**APEC Finance and Development Program
Workshop 2004**

**OECD Corporate Governance Principles and
Governance of Banks**

18-19 May 2004
Shanghai National Accounting Institute
Shanghai, China

John K. Thompson
Financial Counselor
Directorate for Financial and Enterprise Affairs, OECD

OECD  1 OCDE



Historical Background

- Growing Interest in Corporate Governance in OECD Countries in 1980s-1990s
 - Institutionalization of Equity Ownership.
 - Increasing Reliance on Capital Markets, Convergence in Governance Regimes.
 - Cross Border Equity Investment.
- Rise of Shareholder Value as the International Norm in Governance.
- Asian Crisis of 1997:
 - Existing Asian Growth Model: Passive finance, protectionist, export led, government directed.
 - Consensus to align National Policies with International Practice.

OECD  2 OCDE



Decision to Develop Core Principles

- Governance systems vary widely:
 - No single model of good corporate governance: but need for **a high-level global benchmark**
- Detailed codes, should be established at national and regional levels.
- OECD Task Force objective: identify common elements underlying good corporate governance across the different systems.



Intended Uses of the Principles

- Primarily aimed at governments.
- Guidance also for stock exchanges, investors, corporations, regulations:
- Views primarily listed companies.
- *BUT* also relevant for other companies:
 - Closely held
 - State-owned



Overview of Principles

- Rights of Shareholders.
- The Equitable Treatment of Shareholders.
- The Role of Stakeholders.
- Disclosure and Transparency.
- The Role of the Board.



Rights of Shareholders

- *Protection of shareholders' rights and the capacity of shareholders to influence the behaviour of the corporation are pillars of good corporate governance.*



Rights of Shareholders

- Secure ownership and registration
- Participation in basic decisions (pre-emption and appraisal)
- General shareholder meetings: *in absentia* voting, proxy rules: the IT impact
- Disclosure of capital and control structures: corporate groups and block-holders
- Fair and transparent transfers of control
- Institutional voting: pointing to the trend



Equitable Treatment of Shareholders

- All shareholders - including foreign shareholders - should be treated fairly by controlling shareholders, boards and management.

Equitable Treatment of Shareholders

- **Insider trading** prohibition: a cornerstone of market integrity in developed economies
- **Self-dealing** and the disclosure of potential conflicting interests: the curse of emerging markets
- Effective redress: the possibility to seek remedies in courts for all shareholders: a key implementation aspect
- Ex ante transparency with respect to **distribution of voting rights** and ways voting rights are exercised
- **Beneficial ownership** and the role of custodians: OECD trends and ADR issue

OECD  9 OCDE

The Role of Stakeholders

- Most Stakeholders' rights are protected by **other laws** (labour law, environmental law, etc.)
- In some countries the **Board** is accountable to some stakeholders, particularly the employees
- The Principles are **agnostic on formal stakeholder participation**
- The Principles urge **transparency**, including o stakeholders
- They urge incentives for stakeholder participation as a **value enhancing mechanism driven by the corporations themselves**: i.e. encourage firm-specific investment

OECD  10 OCDE



Disclosure and Transparency

- *A strong financial and non financial disclosure regime is the heart of corporate governance.*



Disclosure and Transparency

- Financial and operating results
- Company objectives
- Ownership and control structure
- Board and executive information and recommendation
- Foreseeable risk factors
- Stakeholder information
- Governance information
- Independent audit and high quality dissemination channels



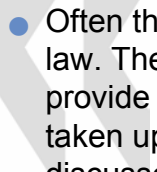
The Role of the Board

- *The Board is the main mechanism for monitoring management and developing strategy.*




The role of the Board

- The key issue: independence from management
 - Target: non-executive participation (but “ the boards should consider ... ”) with specific tasks: audit, remuneration, nomination
- Act fairly with respect to various groups of shareholders, deal fairly with stakeholders, assure compliance with laws;
- Review strategy and planning, manage potential conflicts of interest, assure integrity of accounting, reporting and communications;
- Board members need to spend enough time and have good information.

- 
- Often there is a tension between markets vs.. the law. The Principles do not address this issue. They provide a conceptual framework of issues. These are taken up in the OECD/World Bank Round tables and discussed in all the regions of the world. So these regions can provide their own agenda for reform and improvement of corporate governance.

Dissemination of the OECD Principles

International Level

- 
- FSF: 12 core international standards
 - IFIs including IMF and World Bank: country assessment

Regional Level

- APEC / PECC : Guideline for Good Corporate Governance

National Level


- Many Asian countries have adopted their own codes of corporate governance
ex. Singapore, Korea, China . . .

Regional Corporate Governance Roundtables

- Organized by the OECD in close cooperation with the World Bank, the IFC, the Global Corporate Governance Forum and key regional partners.
- Five RTs established: Asia, Latin America, Eurasia, Russian and South East Europe.
- OECD Principles are a framework for discussion
- White Paper as a final product, which formulates common policy objectives, reform priorities and recommendations.

Asian Corporate Governance Outreach

- 4 meetings in the past
 - Seoul, March 1999: Overview of Asian Corporate Governance
 - Hong Kong, May 2000: Transparency and Disclosure
 - Singapore, April 2001: The Role of Stakeholders and the Responsibilities of Board
- White Paper adopted in 2003
- China Corporate Governance Roundtable Shanghai Feb 2004
- Information available on www.oecd.org



Characteristics of Asian Corporate Governance

- Deficiencies in the corporate governance regimes of Asian economies may have aggravated the 1997-98 Asian crisis, while they may have not been a cause of the crisis
- The Asian corporate governance and finance landscape
 - Concentrated corporate ownership
 - High leverage ratio with dominance of bank finance



Major issues of concern

- The need to strengthen disclosure requirements, particularly related-party transactions and insider trading
- The need to clarify and strengthen the fiduciary duty of directors to act in the interest of all shareholders
- The need to provide shareholders who suffer financial losses with a private right of action against the controlling shareholders and directors
- The need to ensure that regulators have the capacity to enforce regulations and monitor companies with the respective requirements
- The need to establish effective mechanism for corporate restructuring including insolvency framework

POST-2000 REVELATIONS SHAKE CONFIDENCE IN CAPITAL MARKETS

- **Corporate Governance: Enron, Ahold, Parmalat**
 - Management Could Manipulate Boards
 - Executive Remuneration not Linked to Results
 - False or Misleading Data
 - Auditors and Boards did not Exercise Oversight
- **Intermediaries**
 - Research supported Investment Banking
 - Conflicts of Interest between Commercial Banking and Investment Banking
- **Rating Agencies** followed rather than led markets
- **Institutional Investors** accepted deceptive information, did not demand reform

Abuses often discovered by parties other than the securities regulators

How seriously will these revelations undermine confidence in the markets?

OECD  21 OCDE

A Need for Stronger Principles

- OECD launches new review in 2002
- Wide Consultation industry Business, Unions, Civil Society
- Non Member Country involvement (Round Tables and Consultations)
- Revised Principles Approved in May 2004

OECD  22 OCDE

Key Features of the Revised Principles

Shareholder and investors

- Institutional investors should disclose their corporate governance policies, how they decide on the use of their voting rights and how they manage conflicts of interest that may compromise their voting.
- Restrictions on consultations between shareholders about their voting intentions should be eased to reduce the cost of informed ownership.
- Shareholders should be able to remove board members and participate effectively in the nomination and election processes.
- They should be able to make their views known about executive and board remuneration policy and any equity component should be subject to their approval.

Key Features of the Revised Principles

Conflicts of interest and auditor responsibility

- Rating agencies and analysts are exhorted to avoid conflicts of interest which could compromise their advice;
- The duties of the auditor must be strengthened and include accountability to shareholders and a duty to the company to exercise due professional care when conducting an audit;
- Auditors should be wholly independent and not be compromised by other relations with the company.
- A new principle advocates protection for whistleblowers, including institutions through which their complaints or allegations can be addressed and provides for confidential access to a board member.

Key Features of the Revised Principles

Board responsibilities

- The duties and responsibilities of the board have been clarified as fiduciary in nature, particularly important where company groups are concerned;
- The principle covering board independence and objectivity has been extended to avoid conflicts of interest and to cover situations characterized by block and controlling shareholders
- The board's responsibility for oversight of internal control systems covering financial reporting is clarified.

Key Features of the Revised Principles

- **Greater Emphasis on Enforcement**

Regulatory agencies

- should be endowed with strong power to carry out their monitoring and enforcement functions,
- should be ensured to be able to impose credible sanctions in cases of non-compliance, and
- should be equipped with sufficient financial and human resources.

Shareholders awareness and activism

Judicial infrastructure

- Effective remedial measures
- Effective court system

Differences in Governance Regimes

Corporate Governance

- Mainly the private relationship between shareholder and the company
- “Optional” recognition of stakeholder rights

Additional Governance Issues in Financial Institutions

- Shareholders (as well as “optional” stakeholders)
- Other legitimate claimants
- Many institutions not organised in corporate form (Mutual, trust, contractual, etc.)
- Regulatory structure is an integral part of the governance process

Governance Regime for Financial Intermediaries

- Board of Directors accountable for performance
- Names, monitors, remunerates and replaces management
- Responsible for designing adequate systems
 - Risk management
 - Compliance
- Three highest duties
 - Adequate return (owners)
 - Prudential soundness (supervisors)
 - Fiduciary obligations (investors, pensioners, insured, etc.)

A Modern Supervisory Regime

- Independence and institutional capability of supervisors
- Transparency in accounting and disclosure
- Reliance on international supervisory standards
 - Basle Core Principles (Banking)
 - IOSCO Principles (Investment and Securities)
 - IAIS Principles (Insurance)
- Multi-tiered supervision
 - In-house governance of each institution
 - Industry standards/self-regulatory organisations
 - Discipline by the market (investors, counterparties, rating agencies)
 - Official supervision
- Prompt corrective action
 - Automatic progressive sanctions if specific indicators deteriorate

New Bank Governance Paradigm

- Internal Governance is the first line of Defense for Supervisors
- Principle: Bank must earn a competitive return
- Published accounts must be trustworthy
- Strong Credit Culture is Essential
- Capital ratios
 - Strict Loan Classification with Forward-looking criteria
 - Adequate Provisioning
 - Risk based Pricing,
 - Capital Charges
 - Profit “hurdles”
- Scrutiny by the market (investors and counterparties, rating agencies)



Foundations of Bank Governance

- Codes of Conduct and Compliance
- Clear Corporate Strategy
- Transparent decision making hierarchy
- Mechanisms for cooperation among board, auditors, senior management
- Internal Controls, Checks and balances (audit risk management)
- Monitoring large exposures and related party transaction
- Financial incentives
- Information flows, internal and external



Key Functions of Bank Boards

- Procedures for Risk Management
- Monitoring connected lending
- Audit Function
 - Audit Committee
 - Contacts with External Auditor
- Mitigating influence of management and large shareholders
- Frequent meetings (preferably monthly, at least quarterly)
- Meeting with supervisors

A Special Case: Banks Needing Rehabilitation

- Responsibility moves from central authorities to board/management of bank
- Program must differentiate between banks that adjust and those that do not
- One shot re-capitalisation using public funds
 - Common stock
 - Owners' capital is written down
- Board/management is replaced
- Ongoing monitoring
- Board agree to reach targets (ROE, ROA, BIS ratio, cost ration, NPLs/total loans etc.)
- Business improvement plans
- Sharing the upside

Finding an Appropriate Ownership Structure (a)

The challenge: find owners who put their own capital at risk and monitor management effectively who are the candidates?

- ***Incumbent management (Management buy-out)***
 - *No contribution of capital*
 - *Limited interest in change*
 - *Strong control of information*
 - *Conflicts of interest*
- ***Dispersed domestic investors***
 - *Employees, mass privatization, IPOs*
 - *Dispersed investor cannot monitor management in emerging economies*
 - *Employees and mass privatization provide no capital*
 - *Vulnerability to capture*
- ***Government***
 - *Commitment of new capital?*
 - *Limited ability to monitor/ Representation of state interest?*
 - *Moral hazard*
 - *Conflict of interest*

Finding an Appropriate Ownership Structure (b)

Who are the other candidates?

- *Domestic industry*
 - *Conflicts of interest*
 - *Lack of transparency*
- *Foreign strategic investors*
 - *Skills*
 - *Capital*
 - *Monitoring*
 - *Global practices*
 - *Management contracts*
- *Foreign Portfolio Investors*
 - *Institutional investors*
 - *Capital*
 - *Monitoring*
 - *Global benchmarks*

Finding an Appropriate Ownership Structure (c)

What is the answer?

- *Significant foreign ownership in the banking sector*
 - *Direct establishment of branches/subsidiaries*
 - *Acquisition of domestic banks*
 - *Overseas equity issuance, including GDRs*
- *Mixed ownership structures*
- *Counterweight to government influence*
- *Foreign strategic and portfolio investors, plus dispersed domestic investors*
- *Limit influence of incumbent management, domestic industry and mass privatization funds*
- *Possibility for re-sale to domestic investors*

Biography of John K. Thompson Nationality: American

Since 2000. Financial Counselor. Directorate for Financial Fiscal and Enterprise Affairs. OECD. Work on interdisciplinary Projects and Policy issues to promote stability of the financial system and assist non-members in development of financial systems. Support of the Financial Stability Forum.

1999. Seconded to Asian Development Bank office in Seoul, Korea. Monitored compliance with financial sector reform loan and advised Korean authorities on financial issues.

1997-98 Coordinator of drafting Group that produced OECD Principles of Corporate Governance.

1994-98. Head of Financial Affairs Division.

1983-1994. Senior Financial Economist. Financial Affairs Division.

During his time at OECD, John K. Thompson has worked on analysis of issues related to banking, securities markets, trade and in financial services, systemic risk, emerging markets, market supervision and other questions related to international finance. Topics on the structure of financial systems has included securitization, collective investment schemes, venture capital, corporate governance and European financial union. While most work has involved OECD Countries, he has also been active in outreach activities with non-Member Economies in Asia, Latin America and Economies in Transition. He has produced and published analytic and policy-oriented work on all these issues.

Previous experience

1977-83. Chief International Economist. Mellon Bank. Pittsburgh.
Adjunct professor of Economics at University of Pittsburgh and Carnegie Mellon University.

1968-77. Economist Federal Reserve Bank of New York

Education:

Ph.D. in Economics New York University (1976)
Institut d'Etudes Politiques (Paris) 1964-65. Graduate Studies in Political Science and Economics.
M.A. in International Relations. in Economics New York University (1966)

Languages: English, French, German and Spanish.



DOC.NO.2-(02)-a

**The Regulatory Framework and Government's
Role in Improving Corporate Governance
within Banking Sector**

Jesus Estanislao

President, Institute of Directors of the Philippines

THE REGULATORY FRAMEWORK & GOVERNMENT'S ROLE IN IMPROVING CORPORATE GOVERNANCE WITHIIN THE BANKING SECTOR



Jesus P. Estanislao
Institute of Corporate Directors (Philippines)

Road Map of the Presentation

- I. Introduction*
- II. Spreading General Awareness*
- III. Moving on to the Next Practical Steps*

Road Map of the Presentation

IV. Forging a Tool for Assessing CG Improvement

V. Securing the Independence of Bank Directors

VI. Continuing Advocacy for CG Reforms

VII. Concluding Comments

I. INTRODUCTION

High profile bad governance cases
and
1997-98 Asian Financial Crisis

are of great instructive and stimulative value
to heighten awareness and
clean up our CG act.

The environment is CG-conducive.

- *Regulatory framework is there.*
- *Codes of CG, consistent with OECD, have been issued and now being refined and enhanced.*
- *Laws empowering CB and regulators have been passed.*

Central Banks are called upon to play a leading role in promoting CG reforms,

given minor role of capital markets in developing economies vis a vis banking sector.

How might Central Banks play their critical role in promoting corporate governance reforms?

A possible conceptual frame of reference is rolled out for further enrichment from others.

II. Spreading General Awareness



In the Philippines

Going beyond issuances.

The Central Bank REQUIRED
Bank Directors' Training

Formulation of proper corporate governance practices:

- *Under APEC auspices, and led by East Asian economies;*
- *endorsed by the APEC Leaders in Shanghai in 2001.*

OECD Principles + APEC-endorsed practices

Became source of orientation seminars conducted all over East Asia

Positive side of CB Mandate

- *Gave broad overview of demands and best practices of CG*
- *Made directors assess their practices*
- *Appreciated Central Bank's motives*

Negative side of CB Mandate

- *Became part of "fit and proper" test*
 - *Some directors viewed it more from the compliance side*
- *After compliance, complacency*

III. Moving to the Next Practical Steps



Central Banks have required the
Setting up of:

- *Audit Committee*
- *Risk Oversight Committee*
- *Governance Committee (includes nomination, continuing education, compensation, performance evaluation)*

Raising the Profile of Independent Directors

- *Requiring banks to have more of them;*
- *Demanding from them a high degree of "independence" and consistency with modern CG principles;*
- *Having a majority of them in board committees*

Two Questions

- *How do we educate and form independent directors?*
- *Where do we get them?*

*IV. Forging a Tool for Assessing
Corporate Governance Improvement*



Interest of the Central Bank

A Benchmarking instrument



*To assess boards and board
committees and their
current practices*

A Self-Assessment instrument

The orientation seminar and specialized courses highlight specific best practices.

Directors should be allowed to reflect and rate their current practices vis-à-vis the best practices.

With the help of IODs, weights can be pre-determined and a total score made.



A Self-Assessment instrument

Useful to independent and other directors at any given time in:

- *Prioritizing actions*
- *Specifying time lines*
- *Tracking progress*



A Self-Assessment instrument

A useful tool for CB examiners

-inquiring on actual improvement

-making an independent check



**Later, a higher level of objectivity
and scoring via Independent Assessors.**

V. Securing the Independence of Corporate Directors



Where do we get Independent Directors?

Literal compliance with the definition of independent bank directors is no guarantee.

Central Banks are now putting weight on the

PROFESSIONALIZATION of the practice of corporate directorship.

Nurturing a spirit of service and Professionalizing

- **attitudes**
- **frame of mind**
- **knowledge**
- **skills**

Making of a professional corporate director

1. Fully aware of his/her duty of loyalty to the bank as a corporation, with separate and autonomous legal personality
2. Committed to all stakeholders, starting with the shareholders
3. Seeks to add value in meetings

Making of a professional corporate director

4. Performs the functions of monitoring, supervision and oversight, policy and strategy formulation
5. Nurtures a culture of compliance, ethics and social responsibility

Need for a well-structured, practice-oriented program specifically designed for professional directors.

Such **professional development programs** have already been developed and can be replicated.

Professionalizing directors is not enough.

The environment must be made conducive to full observance and enforcement of CG reforms, i.e.

- *business,*
- *economic,*
- *legal,*
- *social environment.*

*VI. Continuing Advocacy for
Governance Reforms*



**No sector in any economy and society can
stand alone.**

It is necessarily inter-connected with others in the
economic and social system.

The Central Bank is no exception.

1st the Central Bank can use the banking sector to spur CG reforms in non-bank corporations.

Making the new BIS rules work, specifically on meeting the capital adequacy ratio.



Bringing the borrowing corporations in the CG reform loop.

2nd the Central Bank can work closely with other regulators, i.e.

- *Ministry of Finance*
- *Securities and Exchange Commission*
- *Insurance Commission*



Putting together those who have a stake in the development of the capital market under an umbrella coordinating council and the leadership of

The Central Bank and Ministry of Finance

Together with

- ***Bankers' association;***
- ***Associations of financial executives, investment houses, pre-need and insurance companies, external auditors, etc.***

A Coordinating Council

- *A review process of CG standards and codes*
- *A 3-5 year action program can be formulated*
- *An annual review and update can be undertaken with all key players*

VI. role of the public and private sectors

Reputational Agents

- *Auditors*
- *Media*
- *Lawyers*
- *Judges*

VI. role of the public and private sectors

Concluding Comments

A menu for Central Bankers which
can be approached:

- *either systematically
(following in reverse order);*
- *or pragmatically (based on priorities).*

1. CG reforms is linked to the broader public governance reforms.

2. The role of reputational agents must be actively sought.

3. Central Banks can deftly and smartly
get non-bank corporations to
adopt CG reforms

4. Central Banks to help promote
nomination of Independent Directors via
a Professional Development Program track
to deepen professionalization of bank directors.

5. Central Banks to spur banks to use CG scorecard, leading to eventual public disclosure of objectively processed scoring.

6. Central Banks to push banks to set up audit, risk oversight and governance committees in which independent directors constitute the majority.

7. Central Banks to initiate the process by requiring bank directors to go through a supervised orientation course on corporate governance.

This follows CB issuances calling the attention of bank directors to their serious fiduciary duties.

THANK YOU



Jesus P. Estanislao
Institute of Corporate Directors (Philippines)



THE REGULATORY FRAMEWORK & GOVERNMENT'S ROLE IN IMPROVING CORPORATE GOVERNANCE WITHIN THE BANKING SECTOR

Jesus P. Estanislao
Institute of Corporate Directors (Philippines)

Introduction

There has now been enough coverage of corporate governance failures in both developed and developing economies to ensure greater consciousness on the part of regulators of the imperative for promoting corporate governance reforms. The spate of corporate governance cases in the past few years in the United States alone (and certainly not limited to it) has been of great instructive and stimulative value for the institutions and individuals with a deep commitment to proper corporate governance

practices. Those of us in the developing world, and particularly those in the East Asian region, can not forget the key lessons of the East Asian financial crisis of 1997-1998: and among those lessons is the need for us to clean up our act in the corporate governance field.

It should therefore come as no surprise that the regulatory framework has perhaps never been as conducive as now for improving corporate governance. Codes of corporate governance, in full consistency with the core principles that OECD has been promoting and is now in the process of refining, have already been issued in virtually all economies that matter. Laws have been passed in many jurisdictions that empower the regulatory authorities, and more specifically the Central Bank, to issue the needed regulations that foster and safeguard proper corporate governance practices, that take sensitive account of local realities, but pretty much in line with globally accepted principles.

Precisely in view of local realities in developing economies, where capital markets play a small role relative to the banking sector in the provision of corporate external finance, Central Banks are called upon to play a leading role in promoting corporate governance reforms. To be sure, the long-term goal for all economies is the strengthening and development of capital markets. But even as this goal should continue to be vigorously pursued, in both the short and medium term, in developing economies, given the preponderance of bank finance to meet the needs of corporations for external finance, it is in and through the banking sector where corporate governance improvement should be promoted as an immediate top priority.

Thus, in the corporate governance field, the importance of the Central Bank in improving corporate governance practices in the banking sector as well as through the banking sector in corporations that borrow

heavily from the banking system cannot be overemphasized.

How might Central Banks play their critical role in promoting corporate governance reforms? To be sure, each Central Bank would have to take into account the real possibilities open to it in view of the priorities it must follow within the circumstances where it operates. It is foolhardy to suggest general approaches that would fit all circumstances. So what anyone can suggest is only a conceptual frame of reference that can be improved on and enriched as more successful experiences get exchanged and held up as concrete cases to learn from and for others to consider adapting.

Spreading General Awareness

Central Banks can issue---as many have already done---circulars calling the attention of bank directors

about the duties and responsibilities that the law and modern corporate governance principles vest upon them. This often is not enough because the tendency is for circulars to be noted and eventually filed away, relegated to the back of the mind of bank directors.

Thus, to deepen awareness of the duties and responsibilities of corporate directors who serve in bank boards, Central Banks have moved one step further by requiring all of them to go through a formal Orientation Seminar that duly accredited training providers offer. The key word is “require”, which can mean that for a bank director to be able to continue to serve in any bank board, he or she must show a certificate of attendance in an Orientation Seminar, whose content the Central Bank had previously vetted and approved.

In this regard, the OECD core principles provide useful guidelines. In East Asia, the PECC-formulated set of proper corporate governance practices that

APEC endorsed also served as a useful reference. In some specific economies, the Code of Corporate Governance, which the appropriate regulatory issued, gave an officially-sanctioned framework for the content of the required Orientation Seminar.

There has been at least one good point about requiring bank directors to take an Orientation Seminar: The two-day seminar gives enough opportunity for all directors in the banking system to have a comprehensive overview of what modern corporate governance expects of them. It also gives sufficient exposure to proper practices that bank boards should consider adopting. It gives them a much fuller appreciation of the reasons why the Central Bank is insisting on compliance with the circulars covering corporate governance reforms. From all these aspects, it is clear that a much wider awareness of the need for improving corporate governance practices has been secured in the banking sector.

But there is a bad side as well to the required Orientation Seminar constituting a critical and most visible component of the “fit and proper” test for bank directors. It has led to several bank directors equating corporate governance with a requirement imposed from on top. This is a short step from thinking that attendance at an Orientation Seminar on corporate governance is all that bank directors have to do in order to pass the “corporate governance test”. Compliance with the formal attendance requirement has led to complacency on the part of many bank directors who now presume that they need not take any further action in the corporate governance field.

Moving on to the Next Practical Steps

To get at least some bank directors to go beyond mere formal compliance with the attendance requirement, Central Banks have given priority to a

few board committees being constituted up in bank boards. In the process, they have able to give teeth to the additional requirement they have imposed, often with a mandate that the law itself has given, on banks having at least a few independent directors in their board.

In particular, Central Banks have asked that bank boards set up an Audit Committee, a Risk Oversight Committee, and a Governance Committee (this latter to handle specified functions concerning directors such as nomination, continuing professional education, performance evaluation, and compensation). They have also made clear that the majority of the members of these critical board committees should be independent directors.

This further move on the part of the Central Bank has raised the profile of independent directors. Banks have been put on notice that they have to elect more independent directors to their boards than in the past.

Moreover, these independent directors are expected to play a critical and important role in some key aspects of board operations, which are demanding of time, appropriate background and expertise.

Moreover, their role in these board committees requires a high degree of “independence” so it can be discharged properly and in consistency with the principles of modern corporate governance.

Two questions necessarily arise from the importance given to the role of independent directors. First, how do you get independent directors to learn the globally accepted benchmarks for proper practice in the board committees they serve. Second, where do you get independent directors with the skills demanded not only by the board committees where they have to constitute the majority, but also in the full board itself?

Forging a Tool for Assessing Corporate Governance Improvement

To help answer the first question, Central Banks have an interest in disseminating proper practices, which can serve as benchmarks for boards and board committees in assessing their current practices. They may or may not work with independent institutes of directors in this regard. But it would be useful for them to do so, since these institutes of directors focus precisely on learning of proper practices elsewhere and determining how they may be adapted to the circumstances of the local economy.

Thus, even in the introductory Orientation Seminar, proper practices for corporate boards are presented. And in specialized courses for Board Committees--- such as Audit, Risk Oversight, and Governance--- more particular proper practices, specific to these committees are also highlighted. If these are to serve as useful benchmarks, then bank directors can be made to reflect on where their current practices stand in relation to them (i.e. the global benchmarks that

may be adapted to local circumstances). In other words, bank directors can rate the current practices in their respective bank board or board committee relative to proper corporate governance practices. They can determine in what specific points they are already close to the appropriate benchmarks, or in which other points their current practices are still very far behind. Thus, they can give themselves a “score” on each important point. These different scores can be given a pre-determined weight. In this regard, the institute of directors can play an indispensable role by providing an appropriate set of weights by which to combine the different scores and arrive at a total scorecard (with appropriate sub-totals as may be required).

The corporate governance scorecard---with appropriate sub-total scores and scores down to individual points---can be extremely useful for independent and other directors in determining at any given time where they are, with their current practices,

in relation to the benchmarks. This can guide them in prioritizing the actions they may need to implement so as to improve their corporate governance practices and bring them much closer to the benchmarks. They can specify the time period they think they would need to pursue those priority actions. And at the end of that specified time period, they can go through the scorecard exercise once again to determine actual progress that has in fact been made.

The scorecard may apply at first only to the over-all corporate governance regime prevailing in a bank board. It may then drill down into the more specialized areas that board committees cover, such as audit, risk oversight, and governance. It may also include the over-all culture of compliance, ethics, and social responsibility that boards must ensure as an operative overhang influencing all decisions and actions of the board, its different board committees, and top management (cascading down to the last operating unit within the bank). The coverage can be flexible. It

can be as specific in its focus (e.g. trained only on the board Audit Committee) or as comprehensive as desired or deemed necessary.

Over time, Central Banks could inquire into the different scorecards and into the actual improvement in corporate governance practices that those scorecards track. Moreover, instead of relying on self-assessment that bank directors make of corporate governance practices in the bank, Central Bank examiners may make an independent check on the objectivity of the self-assessment scores. The cross-check that independent assessors may make of such corporate governance practices could in time ensure a higher level of objectivity of the scores that enter into a bank's corporate governance scorecard.

Securing the Independence of Bank Directors

The second question, which asks where to get independent directors, needs to be faced. And Central Banks have a great stake in the manner in which this question is answered.

A literal compliance with the definition of independent bank directors (no relation by blood or marriage, no major business connection and no previous employment in the immediate past with the bank) would not necessarily lead to the nomination of bank directors who would think and act with the desired independence of mind. Thus, rather than focusing only on the literal definition of an independent bank director, Central Banks are beginning to give more weight to the professionalization of the practice of corporate directorship. This would give much more weight to the attitudes and frame of mind, the knowledge, skills and concerns of bank directors who act professionally in the boardroom and while serving in board committees.

Taking into account the heavy duties and responsibilities that the law and Central Bank regulations vest on them, bank directors need to be more fully aware of their duty of loyalty to the bank as a corporation with its separate and autonomous legal personality, which has clear commitments to several stakeholders, beginning with all the shareholders. In the discharge of such duty of loyalty, bank directors seek to add independent value to board deliberations and decisions. And they have to be prepared for the multiple demands imposed on bank boards, such as the different board functions of monitoring, supervision and oversight, policy and strategy formulation. Each of these board functions requires different skills and orientation. Moreover, the basic orientation in undertaking them needs to be pervaded with a culture of compliance, ethics, and social responsibility.

It is not easy to find many individual bank directors already in possession of all the knowledge and skills,

the orientation and culture that a bank directorship demands. Thus, for truly dedicated and committed bank directors, it is necessary for them to go through a well-structured, practice-oriented program specifically designed for professional directors. Happily, such professional development programs have been developed in some jurisdictions, and these can be adapted to the specific circumstances of any economy. Central Banks would do well to encourage and support the efforts towards making local adaptations of these professional development programs. And these programs should be on offer not only to the designated “independent directors”, but for as many bank directors as possible (indeed, for all bank directors).

But even as many more professionally trained directors serve in bank boards, the standards of actual corporate governance practice would still fall short of globally accepted proper practices if the broader business, economic, legal, and social

environment were far from conducive to the full observance and strong enforcement of corporate and related governance principles. Thus, a significant start may be made in the banking sector, particularly through increasing the number of professional directors actually serving in bank boards. This start, however, has to be reinforced by other initiatives, which the Central Bank may seek to promote in close cooperation with other government agencies and other sectors of society.

Continuing Advocacy for Governance Reforms

No sector in any economy and society can stand alone. It is necessarily inter-connected with others in the economic and social system. Thus, even if the banking sector occupies a central position in the financial and economic system, it cannot be isolated from the other components of the economy and polity. More specifically, even if the Central Bank were to go

very far in promoting corporate governance in the banking system, it still would need to reach out to other agencies of government and other sectors of society in order to reinforce the corporate governance gains made in the banking sector.

First, before going too far out, the Central Bank may use the changes in the banking sector to spur corporate governance improvement in non-bank corporations, which depend heavily on bank financing for their external finance requirements. The changes in BIS rules, and specifically the monthly reporting of capital adequacy ratios of banks can be smartly used to put pressure for improving the basic corporate governance regime in borrowing corporations. The risk weights that banks have to apply to the different components of their loan portfolio can be calibrated so as to reflect the risks associated with corporate governance regimes: the better the regime, the lower the risks. This would lead to giving a premium for an improved corporate governance regime, rewarding

borrowing corporations with such an improved regime with lower interest rates and better loan terms.

Second, the Central Bank would need to work closely with other regulatory agencies, which in several jurisdictions may operate separately from the Central Bank. Close working relationships need to be forged with the Securities & Exchange Commission, the Insurance Commission, let alone the Department (Ministry of Finance). Often, all these government agencies already have formed a coordinating council, which may include representation from relevant business sectors as well. The bankers' association, the stock exchange, the association of pre-need and insurance companies, the association of investment houses, the association of financial executives and of external auditors, etc. represent sectors with immediate and direct interest in the corporate governance regime in the economy. With their representatives in the coordinating council, where the Central Bank and other relevant government agencies

play an active role in further strengthening the financial system, they can be co-opted for the cause of promoting corporate governance reforms in the economy. For instance, they can participate actively in the review of standards and codes related to corporate governance practice. As a result of such a review, they can formulate a program of action to improve the corporate governance regime in the economy. After a period of 3 to 5 years, that program of action can be assessed in terms of progress made and of gaps still unfilled. The program of action would then be updated with a view to ensuring that progress is made and speeded up. In all of this coordinating work, it is difficult to imagine a less than central role for the Central Bank, taking into account the often preponderant importance of the banking sector.

Third, other reputational agents also have a role in corporate governance. Auditors, the media, and judges have significant influence in shaping the environment for proper practices of corporate

governance. Often, internal reforms in these professions are essential pre-conditions for raising the corporate governance standards that are actually observed. It is not surprising for Central Banks, therefore, to show interest and encouragement, albeit from some distance, for these reforms to be undertaken. At an even farther distance on the part of the Central Bank, but with no less interest and support, the broader governance reforms undertaken in society as a whole, such as those dealing directly with public governance, should reinforce any gains made in improving corporate governance.

Concluding Comments

From the broad conceptual framework presented above, which has been taken out of a limited experience in promoting corporate governance reforms in a developing economy, the following key points bear highlighting:

- a) Corporate governance reform is closely linked with broader governance reform, including reforms to improve public governance.
- b) The role of reputational agents and of other key players in the financial and economic system, starting from auditors, media, and judges, and ending with Securities & Exchange Commissions and Departments (Ministries) of Finance, cannot be underestimated. Their cooperation needs to be actively sought.
- c) Central Banks through deft and smart use of regulations in applying new rules such as those concerning the monthly reporting of capital adequacy ratio can use the banking sector to stimulate improvement in the corporate governance regime of non-bank corporations that borrow heavily from banks.
- d) Central Banks in promoting the nomination of more independent directors to bank boards can give significant support to the initiatives---such as the professional development program for

corporate directors---that aim at professionalizing the practice of corporate directorship.

- e) Central Banks can spur banks to use the corporate governance scorecard as a regular tool for tracking actual improvement in their corporate governance regime. Eventual public disclosure of the scores that banks obtain from an objectively formulated scorecard could put enormous pressure on banks to take their corporate governance improvement program seriously.
- f) Central Banks can push the reform envelope in the corporate governance field by requiring that bank boards set up specialized board committees---such as Audit, Risk Oversight, and Governance---in which independent directors constitute the majority.
- g) Central Banks often initiate corporate governance reforms in the banking sector by requiring all bank directors to undergo a

serious and properly supervised Orientation Seminar on corporate governance. This follows immediately after the initial issuances of circulars calling the attention of bank directors to their serious fiduciary duties arising from their being in a bank board.

These 7 points present a menu of options that Central Banks may decide to take, systematically (one after the other, in reverse order as they are listed immediately above) or pragmatically (depending on which opportunity may be open at any given time). They may be reinforced or replaced by alternative initiatives that Central Banks may find more realistic and relevant in the circumstances where they operate.

The menu of options presented above should therefore be expanded and enriched based on the successful undertakings other Central Banks may have initiated in promoting and speeding up corporate

governance reforms in the banking sector, particularly in a developing economy context.

Manila, May 19, 2004

JESUS P. ESTANISLAO



Dr. Jesus P. Estanislao currently heads two Institutes committed to governance reforms: the Institute of Corporate Directors, focused on corporate governance, and the Institute for Solidarity in Asia, with focus on national governance. He served as Chair of the President's Governance Advisory Council. He also holds the title of University Professor at the University of Asia and the Pacific.

Dr. Estanislao has spent much of his career founding or rehabilitating institutions.

He was the founding Dean of the Asian Development Bank Institute in Tokyo (1998). He also served as the founding President (1992-1997) of the University of Asia and the Pacific, which grew out of the Center for Research and Communication, of which he was the founding Executive Director (1969-1981).

After the 1986 People Power revolution in the Philippines, he was given the responsibility of rehabilitating the Development Bank of the Philippines, a task he completed in 3 years. He was appointed in 1989 to the Cabinet of President Aquino, whom he served as Secretary of Economic Planning and Director General of the National and Economic Development Authority, and subsequently as Secretary of Finance, 1990-1992. As the Republic's chief economic officer, he oversaw the economic recovery and reform program of a newly reinstalled democracy.

After he left government, Dr. Estanislao was asked to become the Philippine representative in APEC's Eminent Persons Group by President Ramos, whom he served as Adviser during the Philippine chairmanship of APEC in 1996. He also served as Philippine representative in the ASEAN Eminent Persons Group.

Dr. Estanislao holds a Ph.D. in Economics from Harvard University, where he was also a Teaching Fellow and Research Fellow. He obtained his MA in Economics from Fordham University, and his AB in Economics and Ph.B. (summa cum laude) from the University of San Carlos.

He holds four honorary doctoral degrees from Xavier University, St. Paul University, Manila Central University, and the University of San Carlos. Dr. Estanislao was awarded the Philippine Legion of Honor in 1992, the Laureate Award of the International Corporate Governance Network in 2002 and the Distinguished Person of the Year Award of the Association of Development Financing Institutions in Asia and the Pacific for 2003.

Manila, January 2004



DOC.NO.2-(02)-b

**The Regulatory Framework and Government's Role in
Improving Corporate Governance within Banking Sector**

BU Yongxiang

Deputy Director, Research Department, People's Bank Of China

Government's Role in Enhancing China's SoCBs Corporate Governance

Here SoCBs refer to 4 wholly state-owned commercial banks, Bank of China (BOC), Industrial and Commercial Bank of China (ICBC), China Construction Bank (CCB) and Agricultural Bank of China (ABC). By the end of 2003, four SoCBs account for 55 percent of total assets in banking sector (15 trillion yuan), 57 percent of deposits and 55 percent of bank lending and 80 percent of banking payments and settlements.

I. The Challenges Faced By China's SOCBs in Implementing Corporate Governance.

China's government has recently reinforced its commitment to implement significant financial sector reform in order to deepen the market-oriented modern enterprise system and address increased competition in financial services industry after China's WTO accession. There now exists both the will to strengthen the corporate governance of China's State-owned Commercial Banks (SOCBs) and strong awareness of the need to improve governance in both government agencies and SOCBs themselves. The SOCBs however face a number of challenges in implementing reform. Among these challenges are:

1. The SOCBs at present have a "principal-agent" problem with little formal definition of the state's role as owner. Although the SOCBs formally have a profit-making objective, in practice the influence of government stakeholders lead to the pursuit of multiple state objectives that may compromise the commercial goals of SOCBs. The absence of formal mechanism such as a Board of Directors for synthesizing state interests into a coherent set of objectives for management is the SOCBs primary corporate governance challenge.

2. Accountability Problems or equally Soft – Budget Constraints - Under government ownership the state has ultimate and unlimited liability. Bureaucrats may intervene simply because they do not bear personal financial risk if their intervention goes wrong. Management too cannot be held personally accountable for their actions for government policy lending decisions. For example, 'loans' often may not be commercial loans but capital disbursements to local SOEs and other government agencies. When lending decisions not based on commercial criteria, not based on expected risk and return, then repayment becomes problematic.

3. SOCB senior management faces difficulties in establishing bank-wide performance management and evaluation systems that can align the bank toward desired performance, and allow for the linkage of compensation systems to performance evaluation. To some extent we can say that there is no formal, bank-wide performance management and evaluation framework in place that serves to align the interests of shareholders or stakeholders and senior management around the bank's performance objectives and provide stakeholders with critical information on

the bank's performance. Current SOCBs Compensation Systems are not effective in aligning the interests of the state stakeholders and senior management around performance or promoting risk reduction through the rewarding staff with critical technical skills and expertise.

4.The SOCBs face a number of challenges with respect to developing a sound internal control environment.These include the size and complexity of the SOCB organizations, the branch focused organizational structure, information systems geared toward administrative purposes. Survey results revealed significant unfavorable gaps between the risk management and internal control environment in SOCBs against the average benchmarks for international financial institutions.

5.We know that the transformation of shareholder structure will gradually introduce key elements of the corporate governance system for SOCBs, experience has shown that this alone will not necessarily improve the quality of governance. However, the wholly state owned ownership does play vital role that trigger moral hazard problems with SOCBs.

6.SOCBs financial reporting practices do not fully support the good governance principles of transparency and accountability to shareholders/stakeholders. The quality of governance will improve with the adoption and internalization of the concepts of accountability to shareholders, transparency and timely disclosure of accountant information by SOCBs.

7.Organizational problem. The SoCBs structure traditionally tracked with the administrative structure of government. Although each SoCBs is actively pursuing organizational restructuring, the organizations are still driven at the branch level along four or five organizational layers: headquarters to provincial branches, to Municipal Branches, to County and Sub-County Branches, to Banking offices and Deposit Taking Units.

Functional units within each level replicate the organizational structure of the above layer and report upward in a “duplicated parenting” fashion. This structure creates numerous organizational problems including:

Poor information flows: which make management difficult and allow opportunities for inappropriate behavior at branch levels

Duplication of functions: under this kind of structure administrative and support units are often duplicated at each level.

Inconsistency with market: same number of branches to different regions with different market volumes. (less developed economy)

II. Reform Strategies of China's SoCB Corporate Governance

China's government had committed to a timetable to move each of the SOCBs

through the shareholder diversification process within next 3 years and particularly, committed to taking the first step of reform, that is reorganizing BOC and CCB by end 2007. the reform principle is moving SoCBs into Joint-stock banks and implementing “one policy for one bank”, moving from a system based on control of people and appointments to control through a system of corporate governance appropriate to commercial enterprises and implement appropriate changes in the process of appointment, promotion and dismissal of SOCB managers.

1. Government’s determination and Commitments: Premier Wen’s can-only-win-battles and the government has realized that

(1) **only through Corporate Governance reform can SOCBs compete in domestic and global financial services marketplace.**

(2) only through shareholder diversification can SOCB be fully commercialized.

(3) SOCB’S objectives need be clarified, government’s role can not exceed the function of one shareholder and one director of SOCB’s Board of director, even though this shareholder is a big shareholder, and Board of Directors is the sole authority empowered to direct SOCB Management.

2. Reform Agency. China government has demonstrated the highest-level political commitment necessary to enforce governance model and processes through the establishing an independent banking regulation entity(CBRC) in April 2003.

CBRC acts as **the banking supervision entity as well as a SOCB reform agency to drive reform forward and outline the principles of** related decrees and regulations needed to implement reform (**Under the strong engagement of central bank**). The state council has established a working team of SoCB reform and governor Zhou acts as chairman and Mr Liu as vice chairman of this team.

The CBRC has promulgated “Corporate Governance reform and supervision guideline on BOC and CCB” in March 11 this year. Chapter 2 of this guide covers corporate governance, it requires

(1) article 4, establish a shareholders meeting, board of directors and supervisors, and management.

(2) article 5, absorb domestic and international strategic investors to diversify ownership. In particular, attracting foreign strategic investors is strengthened for purpose of importing world standard management skills.

(3) article 6 clarifies the objective of SoCBs, banks shall have in place clear-cut development strategies with an aim at maximum profitability.

bank shall identify its core and market competitive advantages in light of its own profile and market situations, and on this basis, adopt a comprehensive package of development strategies consistent with its development goals. The implementation of the strategies shall be rolled out and assessed on an annual basis.

(4) article 7 on internal control system, to establish a risk management systems dealing with credit risks, market risks and operation risks.

banks shall have in place sound mechanisms for decision-making, internal controls and risk management.

bank shall be effective in identifying, measuring, monitoring and controlling risks.

(5) article 8 on organizational reform, two banks shall optimize their organizational set-up, improve the allocation of resources and conduct their business in an efficient and cost-effective manner by way of reducing the layers of hierarchy, adopting a line management structure and streamlining their business and management procedures.

(6) article 9 on human resource management, establish a market oriented human resource management system and effective incentive mechanism.

(7) article 10 on financial information disclosure and enhancing transparency.

The two banks shall, with reference to the requirements for a modern financial corporation and a listed commercial bank, have in place policies and procedures for both prudent accounting practices and stringent information disclosure, and shall enforce these policies and procedures to improve their financial management and information disclosure activities.

3. Government objectives stand out of SoCBs' businesses.

the best way to improve SOCB performance and commercial culture is to push each SOCB into a commercial mode by placing SOCB fully under the company law and quickly into a situation where multiple shareholders are able to bring capital, expertise and commercial culture to further restructuring and growth initiatives. During this transition some critical state objectives can be met through the establishment of state stakeholder performance objectives against which management will be held accountable. Other state objectives that are pursued by SOCBs will have to be restructured or converted into other market-based programs. If the SOCBs continue to fail to make this transition, they will lose market share and China's consumers and fast growing small businesses that create employment and future high-paying jobs will suffer.

You can not ask the SOCBs to offer social stability loans any more.

4. Commit to a timetable to move each of the SOCBs through the shareholder diversification process and particularly, commit to transform BOC AND CCB in to public listed banks.

Initially, experts had recommended to go through three phases of the shareholder transformation process, namely:

- Phase 1: Wholly-owned state bank
- Phase 2: Joint-stock bank
- Phase 3: Publicly-listed bank

These are not necessarily consecutive. If accompanied by appropriate restructuring,

SOCBs or components of their businesses could move directly from the current state to joint stock or publicly listed corporate form. This would be an appropriate way to accelerate the commercialization of certain SOCB business activities.

Overview of Shareholder Structure Transformation

At present, there is no shareholders representative, there is external government sent board of supervisors, no board of directors and management only accountable to central government(MOF Or CBRC).

AT wholly state owned company phase, there is identified shareholders, but no meetings or voting, also exists board of supervisors, there is board of directors representing government, and the management accountable to the board of directors.

At joint stock phase, not only exists identified shareholders, but also meetings and votings, there is joint stock board of supervisors, and the board of directors represents multiple shareholders.

At public listed phase, shareholders become more diversified, and board of supervisors and directors more diverse too. The bank becomes more self-disciplined and is scrutinized by investors, analysts and external auditors.

There are various critical tasks need to be done, include:

- Clarification of the State’s Objectives as Owner
- Formal Separation of Principal from Agent
- Establishment of a Board of Directors to Oversee Management
- Making Decisions related to SOCBs Reform, and Reform of Shareholder Structure.
- Election of Board of Directors and Supervisors for each SOCB

Critical Tasks	Key Subtasks
Clarification of the State’s Objectives as Owner	<ul style="list-style-type: none"> • Identify Objectives • Synthesize Various Objectives Formalize State’s Objectives for Each SOCB
Formal Separation of Principal from Agent	Complete Transition to Corporate Form, need to dispose historical losses
Establishment of a Board of Directors to Oversee Management	<ul style="list-style-type: none"> • Define Board Qualifications • Define Board Balance • Finalize Legal and Institutional Processes • Screen Board Members • Select Board Members

Decisions related to SOCBs Reform, and Reform of Shareholder Structure.	Review and Decide on the major restructuring issues, mergers, acquisitions, and shareholder diversification plans requiring shareholder approval
Election of Board of Directors and Supervisors for each SOCB	Senior Officials to represent state as owner in reviewing major Board proposals and making decisions required of shareholder.

Mechanism for the government acts as the owner of SoCBs:

It is important that the **mechanism ultimately selected for this task** be the one best able to ensure success. The government has various options for implementing these reforms. In many ways, ensuring commitment to implementing the critical tasks outlined above and backing them with political will and adequate resources is more important than the form or vehicle selected to carry these tasks out. There are however, advantages and disadvantages inherent in each of the options. These are compared in the table below:

Mechanism	Advantages	Disadvantages
State Assets Holding Company (I)	<ol style="list-style-type: none"> 1. Shareholding and shareholder rights assigned to Holding Company 2. Responsible for Portfolio of SOCBs - Cost savings and Managerial Expertise 3. May improve speed of decision making on restructuring decisions 	<ol style="list-style-type: none"> 1. Loss of state control to holding company 2. May become independent power base....too much power 3. Adds another layer of bureaucracy 4. Adds costs of institutional development including staff, etc. 5. May become a block to reform and further shareholder diversification 6. Given power may manipulate /interfere in management decision-making
Committee under State Council headed by Vice	<ol style="list-style-type: none"> 1. Does not result in extra layer of bureaucracy 2. Political support for reform 	<ol style="list-style-type: none"> 1.Lack of institutional resources threaten speed of reform 2.Lack of institutional resources

Premier (II)	ensured 3. State control ensured 4. Less costly in terms of new staff and resources	and expertise may result in less than optimal decision-making
CBRC assuming responsibilities of Owner (III)	1. No new organization needed 2. Supervisors are familiar with Strengths and Weaknesses in each SOCB 3. Less Costly in terms of new staff and resources	1. Requires major reform of existing regulation 2. Lack of institutional resources threaten speed of reform 3. Lack of institutional resources and expertise may result in less than optimal decision-making 4. Would require expansion of role 5. Does not provide for easy evolution as shareholder diversification continues
SOCB Reform Agency (IV)	1. Established solely to drive SOCB reform process – clear responsibility and accountability related to SOCB reform and commercialization 2. Limited lifespan as defined in regulation and little risk of creating permanent bureaucracy 3. Full time staff and resources necessary to drive reform 4. Led by Senior Government Official able to facilitate consensus between stakeholders and isolate SOCBs from interference in commercial operations during transition	1. Requires regulation to establish Agency 2. Costs of Staff to carry out responsibilities

The biggest problem in implementing corporate governance reform is the existing of huge amount of bad loans and the shortage of banking capital to each SOCBs.

Due to historical reason, The level of bad debts and non-performing loans at four State-owned commercial banks are pretty high. Using official estimates, the combined NPL ratio of the four banks was 20.36 per cent or an equivalent 1.92 trillion yuan (US\$232 billion), at the end of 2003. But overseas analysts put the real figure at nearly 40 per cent, or nearly half a trillion US dollars.

The central government has taken steps to clean up balance sheets by pumping US\$45 billion in foreign exchange reserve into the CCB and the BOC at the end of last year.

Also in December 2003, china has set up a state owned company---HUIJIN, or foreign exchange financial company, the owner of this company is state council, and the capital is 45 billion US dollar or equally 372.465 billion Chinese Yuan. Directors ,supervisors are from PboC, MOF and SAFE. Mr Guoshuoqing acts as president and Ms Hu Xiaolian as general manager.

HUIJIN can be regarded as state-owned asset administration committee at banking sector. Huijin presumably will act as **State Assets Holding Company, it will act as the shareholder of state asset in SoCBs and send directors to SoCBs** and choose manager from market.

China's choice is something of the combination of MECHANISM ONE and mechanism two. While mechanism one is most relevant to China's situation. However, this mechanism as well as HUIJIN should have several prerequisites:

- **Ability to Drive Reform:** A share holding company established by decree with specific responsibility for these issues will be best able to drive reform forward given the importance and complexity of the tasks involved.
- **Accountability:** Launching reform is a complex and difficult task best undertaken by a dedicated team with managerial accountability for driving reform.
- **Authority:** It is important that the entity have the institutional strength and capacity necessary to fulfill its duties and to isolate SOCBs from interference by state stakeholders during transition.
- **Independence:** The entity has the difficult task of integrating all stakeholder interests. It should therefore be independent of any particular stakeholder.

III. Conclusions

we believe China can significantly increase the probability of success by implementing the preconditions described above to ensure that reforms are launched in a supportive environment. Without these supporting elements the benefits of corporate governance reform is likely to be minimal, at least in the short term. As stated above corporate governance mechanisms have evolved over decades in developed market economies and China can learn from the experience of your countries in building effective corporate governance regimes. China has unique challenges that must be overcome in implementing reform that make careful design, implementation, orientation and enforcement of the “details” even more important.

International experience has shown that there is no “one size fits all” solution to corporate governance mechanisms, and lasting sustainable improvements only work

when the solutions take into account various environmental and societal factors such as the legal and regulatory framework, primary financing arrangements and shareholder composition, as well as the specific needs and style of the company in question.



DOC.NO.2-(03)

Financial Disclosure and Information Transparency in Banks

CHI-WEN Jevons Lee

Associate Dean for Asian Programs

Freeman College of Business, Tulane University

DOC.NO.2-(04) -a

Financial Disclosure in Bank Governance

Jevons Lee
Tulane University
Tsinghua University

Reasons for Risk in Banking

- Moral hazard
 - Debtors
 - Internal experts
- Ponzi Scheme
 - Fail to recognize P/L of different businesses separately
- Adverse selection
 - Only bad clients come

Reasons for Risk in Banking

- The winner's curse
 - The winner provides the most favorable condition to customers

2004-6-28

APEC

3

Disclosure Related Risks

- Type I error
 - Misjudge a good client
- Type II error
 - Misjudge fraud, earnings management

2004-6-28

APEC

4

Cases

Enron

- Sales: \$13B in 1996 ⇒ \$100B in 2000
- Market value: \$70B
- Ranked 16th in Fortune 500
- Chosen as America's most innovative company by Fortune Magazine in 6 years
- Bankrupt on Dec. 2, 2001

2004-6-28

APEC

5

Cases

Arthur Anderson

- The most influencing financial consulting firm
- Sales in 2001: \$9.3B
- More than 480 branches
- Approximately 85 thousand employees
- Convicted by the Federal Grand Jury on Jun. 15, 2002
- Ceased auditing public companies on Aug. 31, 2002, effectively ended the life of the 89-year-old firm.

2004-6-28

APEC

6

Cases

● Lantian

- Total assets: ¥ 260M in 1995 ⇒ ¥ 2.8B in 2000
- ROE in 1998-2000: 29.43%, 29.28%, and 21.99%
- Ranked 20th of China's most value created listed firms
- Punished by CSRC for fraud
- Off-balance-sheet loans: more than ¥ 0.3B

2004-6-28

APEC

7

Cases

● Zhong Guancun

- Punished by CSRC for unfaithful disclosure on Sep. 30, 2001 and Dec. 16, 2003 respectively
- Investigated by CSRC in Apr. 2004
- Potential loss of ¥ 5B from loan assurance to other companies, which is 3.8 times of its net asset

2004-6-28

APEC

8

An Important Modern Development of Risk Analysis

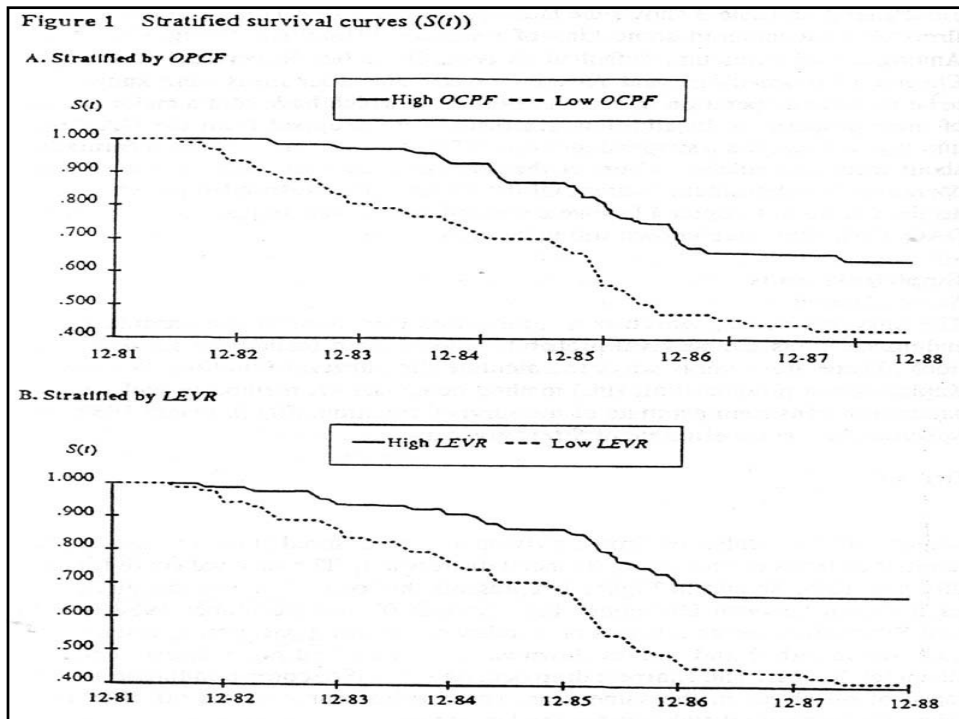
Chen and Lee (1993)

- Financial ratios and corporate endurance: A case of the oil and gas industry
- Endurance to business adversity (Drastic oil price decline)
 - Methodology: Survival analysis
 - Sample: Oil and gas industry in early 1980s
 - Result: Several ratios can be used to predict corporate endurance

2004-6-28

APEC

9



Proxy variable	Expected sign	Model 1 (all variables)	Model 2 (without SIZE)	Model 3 (stepwise reduction)
LIQU	-	-4.53 (-3.01)*	-4.63 (-2.81)*	-4.38 (-3.14)*
LEVR	-	-6.02 (-6.34)*	-3.90 (-4.98)*	-5.72 (-6.37)*
OPCF	-	-1.84 (-0.94)	-5.00 (-2.14)†	
AGGR	+	-0.11 (-1.33)	-0.00 (-0.00)	
FINDFC	-	-2.85 (-2.51)*	-2.39 (-2.15)*	-2.55 (2.36)*
FINDSE	-	-1.50 † (-2.00)†	-1.52 (-1.88)†	-1.51 (2.05)†
OIOG	+	0.99 (1.66)†	1.00 (1.63)	0.96 (1.64)†
OWN	-	-0.25 (-0.32)	0.80 (1.19)	
AGE	-	-0.04 (-1.56)	-0.06 (-2.45)*	
SIZE	-	-0.34 (-3.67)*		0.34 (-4.89)*
Likelihood ratio test		64.72*	50.60*	59.52*

Notes:
See Table 1 for definition of determinant variables. The dependent variable is the hazard rate.
Each entry is the parameter estimate and the bracketed number below each entry is the asymptotic t-statistic.
Sample size: 175. Merged firms are included as censored observations. There are 67 firms encountering financial distress (i.e., uncensored).
* Indicates significance (one-tailed test) at the 0.01 level.
† Indicates significance (one-tailed test) at the 0.05 level.

The use of Financial Disclosure in Risk Analysis

Theory	Result	Business application
Beaver (1966) Altman (1968)	Yes or No	Z-Score
Ohlson (1980)	Probability of default	Rating
Chen & Lee (1993)	Endurance	Rating

A comparison of survival analysis and logit analysis

TABLE 6
Application of logit and proportional hazard models in prediction

Company names (1)	Binomial prediction		Prediction of corporate survival time							
	Actual failure/ survival (2)	Estimated prob. of surviving (3)	Actual months of survival (4)	Probability of surviving after month <i>t</i> (percentage)						
				12 (5)	24 (6)	36 (7)	48 (8)	60 (9)	72 (10)	84 (11)
Ike Lovelady	F	4	10	78	43	24	10	0	0	0
Page Petroleum	F	2	12	65	23	8	2	0	0	0
Buttes Gas & Oil	F	12	41	91	71	57	40	9	7	6
Monogram Oil	F	1	47	75	38	20	7	0	0	0
Texas American	F	15	55	91	71	57	40	9	6	5
Arapaho Petroleum	F	48	67	96	88	81	71	42	37	34
Texas Internat'l	F	50	74	98	94	90	84	64	60	58
Apache Corp.	S	76	>84	99	96	94	90	77	74	73
Kerr-McGee	S	85	>84	99	98	96	93	83	81	80
Mesa Petroleum	S	57	>84	98	95	91	86	68	67	64

Notes:

F indicates that the firm encountered financial distress between December 1981 and December 1988; S indicates otherwise. The estimated probabilities of surviving, conditional on a vector of four independent variables, are derived from model 3 of Table 5. The estimated probabilities of surviving longer than time *t*, conditional on a vector of six independent variables, are derived from model 3 of Table 4.

New Development of Risk Analysis and Their Implementation in China

- Option pricing and KMV model
 - Need market price
- VaR
 - Need historical rating



Panel Discussion: Sound Corporate Governance Practices in

Banks: Basel 2

Stefan Hohl

BIS, Representative office for Asia and the Pacific



BIS Asian Office

BANK FOR INTERNATIONAL SETTLEMENTS

Corporate Governance and Basel 2

APEC Finance and Development Program
Shanghai, 19-22 May 2004

Stefan Hohl, BIS*

Representative Office for Asia and the Pacific, Hong Kong



Special role of banks

- Banks merit special attention
 - “Liquidity production” role for the economy
 - Capital structure (highly leveraged)
 - Funded largely by deposits
 - Maturity mismatch (assets vs liabilities)
- Bank’s failure may have systemic impact
- Facing strategic challenges (e.g. IT, globalization, ...)
- Governmental safety nets
 - Deposit insurance
 - Moral hazard
- Banks need to have strong corporate governance



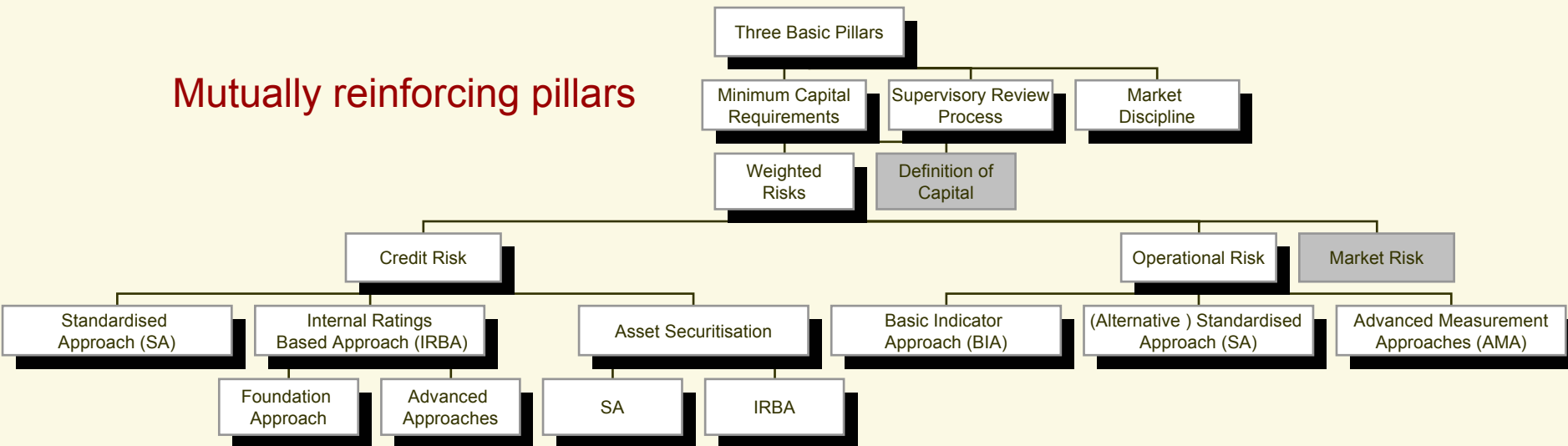
Basel Capital Accord - Process

- 1988 Accord (Basel 1)
- Market Risk Amendment 1996
- Basel 2 process (New Capital Accord)
 - First Consultative Document CP1, (June 1999)
 - Second Consultative Document CP2, (January 01)
 - Quantitative Impact Study 2 (QIS 2) (Summer 01)
 - Quantitative Impact Study 3 (QIS 3) (Autumn 02)
 - Third Consultative Document (May 2003)
 - Press Releases (11 October 2003, 15 January 04)
 - Three BCBS technical papers (30 January 04)
 - Implementation framework to be published (Summer 04)
 - Basel 2 Accord to be implemented late 2006
 - Comparison with Basel 1 in 07/08 for IRB and AMA banks



The New Capital Accord – Basel 2

Mutually reinforcing pillars





Key aspects of Basel 2 -1

- Improving Risk Management
- Risk based regulatory capital regime
 - But, one size does not fit all
- More economic view on regulatory capital charge
 - Quantification of risk important
 - Credit, Market and Operational risk under Pillar 1
 - All other risks under Pillar 2
- Adequate risk management structures necessary,
 - Quantitative requirements, and
 - Qualitative requirements (Minimum requirements to be met for Credit, Market and Operational risk)



Key aspects of Basel 2 -2

- Features of Basel II - Encourages better
 - Consolidation across the banking group
 - Risk management
 - Treatment including measurement of
 - Credit Risk
 - Market Risk
 - Operational Risk
 - Capital management – Pillar 2
 - Disclosure – Pillar 3



Cyclicality in minimum capital requirements

- Economic cycles are inevitable – but no aggravation
- Basel II measures to correct short-term volatility in capital at the date of implementation are
 - Parallel running of the advanced approaches
 - Several floors
- More durable measures to moderate the effects of the cycle
 - Slope of risk weight curves
 - Bank's own estimates of PDs (LGDs)
 - Stress-testing
 - Recognition of provisions
 - Basel II itself promotes more educated credit decisions



Basel 2 and CG –1

- Standardized Approach for Credit Risk
 - Risk assessment by third parties
 - Use the appropriate risk weight
 - Increase the risk weight for unrated claims when appropriate
 - Past-due loans even higher weighted
 - Credit Risk Mitigation and On-Balance sheet netting
 - Legal certainty overarching principle
 - Legal mechanism by which collateral is pledged or transferred must ensure that the bank has the right to liquidate or take legal possession of the collateral



Basel 2 and CG –2

- Internal Ratings Based Approach (IRBA)
 - Board must approve all material aspects related to IRBA
 - Senior management must ensure that the rating system is operating properly on an ongoing basis
 - Internal Ratings must be essential part of reporting
 - Independent credit risk control unit crucial
 - Annual review by internal audit required



IRB Approach - Minimum Requirements

- IRB bank must demonstrate to its supervisor that it meets the IRB requirements on an ongoing basis
- Generic overarching principles aimed to achieve that
 - Banks' rating systems should provide for a meaningful differentiation of risk,
 - Data sources used by banks should be suitably rich and robust,
 - Ratings should be subject to some independent review, and
 - Ratings should be an integral part of the culture and management of the banks, bank's "use test"



Minimum requirements (a bit more in detail) -1

- Corporate governance and oversight
 - All material aspects of the rating and estimation processes must be approved by the bank's board of directors or a designated committee thereof and senior management
 - These parties must possess a general understanding of the bank's risk rating system and detailed comprehension of its associated management reports



Minimum requirements (a bit more in detail) -2

- Corporate governance and oversight
 - Senior management also must have a good understanding of the rating system's design and operation, and must approve material differences between established procedure and actual practice
 - Internal ratings must be an essential part of the reporting to these parties



Minimum requirements (a bit more in detail) -3

- Credit risk control
 - Ratings should be subject to some **independent review**
 - Banks must have independent units that are responsible for the design or selection, implementation and performance of their internal rating systems
 - This unit must actively participate in the development, selection, implementation and validation of rating models
- Internal and external audit
 - Internal audit or an equally independent function must review at least annually the bank's rating system and its operations



Another aspect - Role of Validation of IRB

- Validation is a process to check whether a rating system can accurately measure credit risk
- Combination of various elements to ensure that the calculation of an IRB system have sufficient integrity to be relied on for regulatory capital assessments
 - Examples of various elements are rating system design, rating system review, oversight and control, database controls, use and experience tests
- Validation refers to all activities undertaken by a bank to assess the performance of its IRB system in quantifying and assigning PD, LGD and EAD values



Complete IRB validation process for banks

- A complete validation process includes at least
 - Timetable for validation activities
 - Responsibility assignments
 - Tasks to be performed
 - Reporting of findings
 - Actions to be taken in response to findings
- Existence of a validation policy signed by the Board
- Banks should develop all tools and processes needed for a broad IRB validation



Basel 2 and CG –3

- Asset Securitization
 - Capital charge based on economic substance rather legal form
 - Transferor of assets has no (even indirect) control over the transferred exposures
 - Banks must transfer significant credit risk to 3rd parties



OpRisk: AMA – Capital Allocation -1

- Key issue: Capital allocation for operational risk
- “Principles for the home-host recognition of AMA operational risk capital”
 - BCBS paper, 30 January 2004
- Global AMA capital calculation for a banking group
- Hybrid Approach
 - Combination of stand-alone AMA calculations for significant internationally active banking subsidiaries and an allocated portion of the group-wide AMA capital requirement for its other internationally active subsidiaries



OpRisk: AMA – Capital Allocation -2

- Significant Subsidiaries – further clarification
 - AMA capital requirements on a stand-alone basis
 - May incorporate an estimate of diversification benefits of its own operations, but not group-wide
 - Can utilise resources of other group entities
 - Could rely on these data and parameters, provided adjustments are made if necessary
- Non-Significant Subsidiaries
 - Pillar 1 capital charge for operational risk allocated from the group-wide AMA calculation however subject to supervisory approval



OpRisk: AMA – Capital Allocation -3

- Principle 1 – Scope of AMA
 - AMA capital requirements should be consistent with the scope of application of the New Accord
 - Scope of application, each internationally active bank needs to calculate its own capital requirements
 - Home and host country must be satisfied with the requirements established
 - Approval of both home and host country supervisors
 - Early cooperation between banks, home and host supervisors is encouraged, i.e. early submission of implementation plan
 - Host country supervisors would retain the right to impose additional capital requirements under Pillar 2



OpRisk: AMA – Capital Allocation -4

- Principle 2 – Corporate Governance
 - Board of directors and senior management at each level of a banking organisation must understand their operational risk profile and ensure proper risk management and that the capital is adequate
 - Primary responsibility for overall risk management rests with board of directors and senior management
 - Even for wholly-owned subsidiaries of a banking group, the board and senior management of that subsidiary bank are responsible for its risks and operational controls and must ensure that the subsidiary is adequately capitalised



OpRisk: AMA – Capital Allocation -5

- Principle 3 – Legal entities
 - Each bank subsidiary must be sufficiently capitalised on a stand-alone basis at legal entity level
 - Problem of freely transferable capital in times of stress, based on legal and practical impediments
 - Benefits of diversification at the overall group level must be excluded for significant banking subsidiaries
 - Diversification benefits may be limited – (host) national discretion - for non-significant banking subsidiaries
 - With allocation under Pillar 1, impact of group-wide diversification benefits must be assessed for having an appropriate level of minimum regulatory capital



Required Disclosures - Overarching Principles

- *Qualitative* disclosures just as important as *quantitative*
- For each risk area (e.g. credit, market, etc.) banks must disclose their risk management objectives and policies:
 - strategies and processes
 - structure and organisation of the relevant RM function
 - scope and nature of risk reporting/measurement system
 - policies for hedging/mitigating risk (as well as follow-up)
- Banks must have formal disclosure policy including implementation of a process assessing its appropriateness



The Basel Guidelines on Bank's Governance

- Issued in 1999
- Sets out the key elements of corporate governance
- Draws on supervisory experience
- Focused on the unique issues related to corporate governance of banks
- Intended as a supplement and to reinforce the OECD principles
- Document does not promote a particular governance structure (e.g., Anglo-Saxon vs. German models)



The Basel Guidelines

Objectives:

- To encourage practices which can strengthen corporate governance under diverse structures (e.g. as regards the relative role of the board of directors and management)
- To assist supervisors in promoting the adoption of sound corporate governance practices by banking organisations in their countries



Important forms of oversight

- Oversight by
 - Board of Directors (or supervisory board)
 - Individuals not involved in the day-to-day running in various business areas
 - Direct line management
 - Independent risk management
 - Independent audit function
- Fit-and-proper test for key personnel



Public disclosure is recommended in the following areas

- Ownership structure
- Board membership and responsibilities
- Compensation and equity interests of owners and managers
- Role and activities of the bank
- Responsibility for strategic direction
- Audit procedures (internal and external)



What is the role of supervisors in CG?

- Supervisors should:
 - expect banks to implement organisational structures that include appropriate checks and balances
 - ensure that boards and senior management have in place processes to fulfil their responsibilities
 - hold the board accountable for any problems detected and require timely corrective measures
 - be attentive to any signs of deterioration in management quality
 - consider issuing guidance to banks on sound corporate governance



Concluding Thoughts

- Special role of banks may call for broader fiduciary duties (care and loyalty) for bank directors
- Basel Committee recommendations for banks reinforce OECD guidelines
 - Agreement on principles is crucial however national and cultural differences important
 - Implementation is key, but enforcement is a precondition
 - Be clear: Supervisors don't run a bank
- Basel II supports a good structure of bank governance



DOC.NO.2-(04) -c

**Panel Discussion: Sound Corporate Governance Practices in
Banks: Basel 2**

John Hatton

Company Secretary, Commonwealth Bank of Australia

APEC Finance & Development Program Strengthening Corporate Governance Within Financial Institutions

Sound Corporate Governance Practices in Banks : Basel 2

Presented by

John Hatton

Company Secretary

Commonwealth Bank of Australia

Commonwealth Bank



Board Criteria

- Independence
- Knowledge and experience
- Ability to think strategically and exercise sound business judgement
- High levels of professional skill and appropriate personal qualities

Commonwealth Bank



Relationship between Board and Management

- Appropriate and effective delegations to Management.
- Honest flow of information from Management to Board.
- Board and senior management to gain a deeper understanding of the concepts and operations of the risk management systems.
- A structured and continuing educational program.
- Flow of information needs to be supported by a culture of honesty and integrity.

Credit Ratings Approach

- Risk Ratings requires an initial assessment by Management of factors including -
 - market and regulator expectations
 - reputation implications
 - cost
 - benefits
 - capital implications

Credit Ratings Approach (cont'd)

- Human Resources framework of –
 - appropriate training; and
 - motivated through performance measurement and reward system

Market Disclosure

- Transparency.
- Enhance market discipline.

Disclosure Requirements

- What should be disclosed?
- How and to whom should it be disclosed?
- What are the existing disclosure processes and do they need to be enhanced?

Disclosure Requirements (cont'd)

- Ensure meaningful information is presented to those persons who require it in a way in which it is comprehensible.
- It is not necessary or desirable for all detailed information to be released to all investors as part of the normal periodic reporting.

Disclosure Requirements (cont'd)

- Timely disclosure.
- The market can operate in an environment where all relevant information is known by all participants and trading can be done on a fully informed basis.
- Market sensitive information is identified, assessed and released to the market.

Disclosure Requirements (cont'd)

- Boards need to assess both the disclosure processes and the quality of information being reported so that they can take comfort that –
 - the entity is properly discharging its obligations under regulatory obligations; and
 - the quality of the information is of a sufficient standard so that disclosures to the market are appropriate to show the entity's position.

Summary

- Benefits of disclosure –
 - Strong share price;
 - appropriate debt raisings;
 - positive standing in the community;
 - good relationship with regulators; and
 - a positive business environment

Sound Corporate Governance Practices in Banks : Basel 2

Presented by

John Hatton

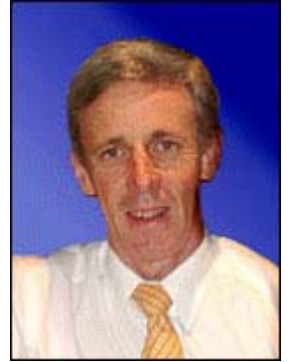
Company Secretary

Commonwealth Bank of Australia

19 May 2004

JOHN DAMIEN HATTON

BIOGRAPHY



John has been Company Secretary of Commonwealth Bank of Australia since 1994, leading a team of 24 responsible for the operations of the Bank and the Group of approximately 350 companies in Australia and various off-shore jurisdictions. During this period, John has been involved in many significant steps in the development of the Bank, including the various stages of the privatisation of the Bank and the merger with Colonial Limited.

From 1985-1994, John was a solicitor with the Bank's Legal Department and was involved in large commercial transactions, including aircraft leveraged leasing, project financing and infrastructure projects.

John has a law degree from Sydney University and was admitted as a solicitor in New South Wales. In addition, John is a Fellow of the Chartered Secretaries Australia and a Member of the Australian Institute of Company Directors.



DOC.NO.2-(05)

**Case Study: Corporate Governance in the APEC Economies:
Korea's Experiences and Lessons Learned**

Kwang S. Chung

President, the Korea Corporate Governance Service, &

Professor of Finance, Chung-Ang University Korea

AFDP Workshop on Strengthening Corporate Governance
within Financial Institutions



Corporate Governance in the APEC Economies: Korea's Experience and Lessons Learned

May 19–22, 2004
Shanghai, China

Kwang S. Chung
Korea Corporate Governance Service
and
Chung-Ang University



Contents and first topic

1. Corporate governance and finance in the pre-crisis period
2. Reform and global convergence
3. Shareholder activism and institutional investors
4. Controversies over regulation of banks and *chaebols* (Korean large business groups)
5. Lessons learned



Corporate governance-related causes of the 1997 financial crisis

- Over-investment in the private sector led to a “high cost, low efficiency” economy
 - Entrenched management and failures in corporate governance
 - Myth of “too big to fail” and empire building motives
 - Expansionary economic policies
 - Poor corporate governance of banks
- Over-leveraging resulted in large scale bankruptcies and mounting NPLs of banks
 - Controlling shareholders tried to maintain voting control
 - Unsound lending practices of banks and NBFIs
 - Cross-guarantees among *chaebols* (Korean conglomerates)

2

Corporate governance problems in the pre-crisis period

- Entrenched management
 - Boards of directors not functioning
 - Weak market discipline; takeover market nonexistent
 - underdeveloped institutional mechanism
 - Inadequate market competition
 - Entry barriers
 - Exit barriers (bankruptcy rules not efficient; myth of “too big to fail”)
- Lack of accounting and other transparencies
 - Prevalent self-dealings by controlling shareholders
 - Unfair internal transactions within business groups
 - Weak legal protection of investors
 - Exit barriers (bankruptcy rules not efficient; myth of “too big to fail”)
 - Entry barriers

3



Factors contributing to managerial entrenchment in the pre-crisis period

- Government policies to protect incumbent management
 - Prohibited share accumulation above 10 percent (repealed in 1994)
 - Shadow voting by investment trusts, bank trust accounts, etc.
- Limited concept of fiduciary duty-- duty of care only
- Concentrated ownership due to pyramids and indirect cross-shareholdings
- Control of nonbank financial institutions by *chaebols*
- Bank management influenced by government intervention resulting in an “administered-finance” system

4



Factors contributing to lack of accounting and other transparencies in the pre-crisis period

- Problems in accounting rules
- Non-independent statutory (internal) auditors
- External auditors lacking professionalism and independence
- Weak penalties on accounting manipulations and violations of disclosure rules by corporations and misconduct of auditors
- Rights of minority shareholders restricted
- Fiduciary duty not strictly enforced
- Weak protective covenants in bond indentures—no role of trustees

5



Features of credit-based and administered-finance system

- Major funding sources of corporations were credits from banks and NBFIs
- The pricing mechanism in the credit market was influenced more by administrative guidance than by competitive market forces
 - regulation of interest rates
- An important objective of monetary policy was resource allocation rather than stability of the financial system
 - government intervention to allocate funds to select industries and firms
- Major tools of monetary policy were financial regulation and administrative guidance instead of monetary aggregates
- Industrial adjustments were often government-led rather than company-led
- Relationships among government, banks, and firms were not arms' length ones
- Major suppliers of long-term funds were specialized banks instead of investment institutions
 - Entry barriers in investment trust and asset management industries

6



Effects of administered-finance practices on corporate governance of banks

- Stifled entrepreneurial spirit of bank managers
- Caused banks to neglect performance measurement and evaluation (because government influenced appointments of bank executives)
- Loans were often linked to bribes and political contributions
- Discouraged monitoring of banks by shareholders (bank ownership limited to 4%)
- Caused governance vacuum in banks allowing further room for government interference

7



Effects of administered–finance system and poor bank governance on corporate management

- Caused market mechanisms operate inefficiently (with respect to exits of nonviable firms, market competition, pricing, etc.)
- Caused banks (both as creditors and shareholders) uninterested in corporate governance and monitoring borrowers
- Allowed firms to engage in over–investment and over–leveraging
- Allowed *chaebols* to engage in cross–subsidiaries and cross–guarantees without causing troubles with lenders
 - Cross–guarantees and subsidies hindered efficient functioning of market forces (making credit evaluation of group firms difficult and deterring exits of nonviable firms)


8



Next topic

1. Corporate governance and finance in the pre–crisis period
2. Reform and global convergence
3. Shareholder activism and institutional investors
4. Controversies over regulation of banks and *chaebols*
5. Lessons learned



9



Corporate governance reform during and after the crisis

- Shadow voting eliminated
- Abolished limits on accumulation of shares of a listed firm by an outsider
- Required to appoint independent directors
 - Large firms: one-half of the board (minimum of three independents)
 - Small firms: one quarter (minimum of one independent)
- Introduced cumulative voting (not mandatory)
- Audit committee and nominating committee mandatory for large firms
- Code of Best Practice for CG published in 1999

10




Corporate governance reform during and after the crisis (continued)

- Threshold shareholding requirement for derivative suits relaxed to 0.01 percent
- Bankruptcy laws revised to facilitate reorganization/liquidation
 - Speeding up of bankruptcy proceedings
 - Provision for creditor committee
 - Heavier penalties on controlling shareholders
 - Limits on extension of debt
- Accounting rules changed to conform to international standards
- Liberalization of equity investment and (hostile) takeovers by foreigners
- Investment companies introduced (closed end in 1998; mutual funds in 2001)

11






Reforms on banking, financing, and pyramiding

- For banks and NBFIs: Threshold shareholding requirement for derivative suits lowered to one half of that of listed firms (to 0.005 percent)
- Banks and NBFIs required to appoint a compliance officer
- Civil and criminal penalties sought on directors of failed institutions for misconduct and fiduciary duty violations
- Controlling shareholders can be liable even without holding any official position
- Imposed (restored) a ceiling on investment in other firms by a *chaebol* affiliated firm (25% of net worth)
- Cross debt guarantees prohibited for *chaebol* firms
- Tax deduction denied for interest payments on excessive borrowings
- Mandated to sign agreements with banks to improve capital structure

12



Driving forces for reform and convergence

- Efficiency considerations
 - Realization that poor CG was an important cause of 1997 crisis
 - Consensus that global standards in CG facilitate economic growth
- Influence of international soft law rules
 - OECD Principles as a reference for Korean Code of Best Practice
 - Legacy of the Korea-IMF Memorandum on the Economic Program
 - Participation in international consultations (e.g., IOSCO)
- Internationalization of the securities market
 - Many firms issued ADRs or GDRs
 - Foreign investors own more than 40% of Korean listed shares

13






Driving forces for reform and convergence: activities of NGOs

- File shareholder derivative suits (e.g., Korea First Bank on neglecting duty of care)
- File complaints against *chaebol* firms to prosecution
- Make public statements on CG issues, often denouncing illegitimate managerial behavior
- Contact corporate management and negotiate measures to protect shareholders
- Cooperation with foreign funds to force changes in corporate governance
- Petition legislation to improve investor protection

14



Driving forces for reform and convergence: activities of related organizations

- **Korea Corporate Governance Service**
 - Corporate governance ratings (could be used, for instance, by banks)
 - Annual awards for good corporate governance (by Korea Stock Exchange)
 - Korea Corporate Governance Stock Price Index (“KOGI 50”)
 - Committee on CG (updates Korean Code, rating criteria, oversight of ratings)
- **Korea Institute of Directors**
 - Director education (plans director certification program)
- **Center for Good Corporate Governance**
 - Proxy analysis and CG alert service
- **Asian Institute of Corporate Governance at Korea Univ.**
 - Research, academic conferences, executive education
- **Hills Governance Center at Yonsei Univ.**
 - Focus on public governance


15



Next topic

1. Corporate governance and finance in the pre-crisis period
2. Reform and global convergence
3. Shareholder activism and institutional investors
4. Controversies over regulation of banks and *chaebols*
5. Lessons learned


16



Shareholder activism: overview

- Increasing investor sensitivity to corporate scandals
 - Stock price reaction
 - Internet based communication and coordination among small shareholders in special situations (nontrivial powershifts from large to small shareholders)
- Activism by institutional investors
 - Still in its infancy
 - New rules introduced to encourage voting (e.g., disclosure on how it voted or why it did not vote on certain control-related items)
 - Duty of care and loyalty imposed on voting by asset management companies and public funds
 - Asset management companies required to adopt and disclose “Internal Guidelines on Voting”
- Corporate governance funds
 - Some foreign funds hold large positions in firms with disputes
 - Local CG funds are in the making

17




Institutional investors as shareholders

Ownership Composition of Listed Firms by Country Based on Market Cap

	Korea (December 2002)	Japan (March 2003)	U.S. (September 2001)
Institutional Investors	15.9	40.0	46.7
Commercial Banks	5.5	19.3 ¹⁾	1.5 ²⁾
Investment Companies	6.0	4.0	18.1
Insurance Companies	2.3	9.3	7.3
Private and Public Pension Funds	0.7	5.8 ³⁾	19.8
Other Financial Institutions	1.4	1.6	-
Other Corporations	20.2	21.5	0.2
Government	5.7	0.2	-
Foreign Investors	36.0	20.6	11.2
Households	22.3	17.7	40.2 ⁴⁾


18



Regulations on shareholdings by institutions

- Banks
 - Stocks and bonds to 60% of bank's equity
 - Maximum of 15 % of one company
- Insurance companies
 - Stocks limited to 30% of total assets
 - Maximum of 5% of one company
 - Investments in affiliated group firms to 3% of total assets
- Mutual funds and investment trusts
 - Maximum of 10% of fund's trust asset in one company
 - Maximum of 20% and 10% of one company, respectively for contractual-type and corporate-type funds
 - Maximum of 5% of fund's trust property in an affiliated company
 - Maximum of 10% of fund's trust property in affiliated group companies
- Pension funds
 - Prohibited in principle from investing in stock
 - Permitted by the annual fund operation plan that requires prior approval

19



Stock investments by public pension funds: Korea vs. selected countries

Equity Investments to Total Investment Assets (as of the end of 2002)

Public Pension Funds (Korea)	3.7 %
California State Pension Fund (U.S.)	64.5
Canada Pension Plan (Canada)	26.7
Quebec Pension Plan (Canada)	45.9
Japan Welfare Pension (Canada)	39.9
Sweden National Pension Fund (Sweden)	57.7

20



Factors contributing to inactivity of institutional Investors

- Many financial institutions are affiliated with business groups
 - Poor governance give rise to unfair practices favoring the controlling shareholder
 - Activism refrained in fear of retaliation from institutions of other groups
 - Tacit collusion among group-controlled institutions?
- Institutions' business relationship with portfolio companies
- Most institutions acted as short-term traders
 - Instability of the stock market
 - Low transparency and high governance risk of listed firms
 - Mostly short-term funds invested by business firms; reluctance of individuals to invest in stocks
- Concentration of voting rights in listed firms discouraged activism
- Low level of equity ownership
 - Lack of consultation among institutions and of infrastructure for activism
- Cultural tradition inclined to avoid confrontation

21





Recent developments on shareholder activism

- Announcements of voting intentions required
- Opposing votes to management proposals not rare
- Public pension funds often joined minority shareholders in voting
- Increased visibility of foreign funds
 - **Sovereign Asset Management** accumulated 14.99 percent of SK Corp shares
 - Announced its own slate of director candidates to control one half of SK board
- Two investment trust management companies prepared focus lists for the 2004 AGM season



Activism by foreign corporate governance funds

Foreign Investment Funds Aiming at Improved Corporate Governance in Korea
As of May 30, 2003

Investment Fund	Firms in Portfolio	Ownership Fraction (%)
Hermes	Hyundai Development Co.	7.01
	Hansol Paper	8.64
	Daewoo Securities	2.07
	SK Corp.	0.69
Sovereign Asset Management	SK Corp.	14.99
Oppenheimer	LG Home Shopping	12.45
	PKL	7.01



Prospect for the role of outside shareholders as monitors of large corporations

- Engagement of SK Corp. by Sovereign may signal the beginning of a new era
 - Proved that even large *chaebol* firms are not immune from the market discipline
 - Except for Samsung Electronics? (will critically depend on the regulation on *chaebol*-affiliated financial institutions)
- Possibility of coordinated activity by foreign institutional investors looming
- Internet helps reduce the free-rider problem
 - Federated small shareholders may swing the balance in firms that are in dispute or “in play”
- Activism by public funds and other institutions to increase as their stock investment increases

24



Policy recommendations for institutional activism

- Ease restrictions on equity investment by public pension funds
 - Eliminate “prohibition in principle” clause in the law
 - Evaluate investment performance on a pre-specified long-term basis
 - Reduce room for government intervention in fund management
- Establish voting as a fiduciary obligation of institutional investors
 - Extend obligation to vote to other public funds
 - Require institutions to adopt and disclose a detailed voting guideline
 - (a model guideline is being prepared for adoption by institutions)

25



Policy recommendations for institutional activism (continued)

- Build an infrastructure for shareholder activism
 - NPF may consider outsourcing of voting services to nurture advisory organizations
 - Willing institutions may form “Korean Council of Institutional Investors” to aid and coordinate activism
 - Promote institutions to cooperate and coordinate their actions in director nomination and election, shareholder proposals, and communications with a company (cf. draft of revised OECD Principles)
- Lessen conflicts of interest
 - Strive to achieve the “long-term objective of separating financial capital from industrial capital”(MOFE’s Roadmap)
 - Require to disclose how to manage material conflicts that may affect exercise of shareholder rights(cf. draft revised OECD Principles)

26



Policy recommendations for institutional activism (continued)

- Facilitate activities of corporate governance funds
- Improve corporate governance of institutional investors
 - To lessen conflicts, to motivate faithful discharge of fiduciary duty, and to eliminate concern over government intervention in corporate management(in the case of public funds)
- Introduce electronic voting
 - Introduce a system to handle electronic voting
 - Develop rules on voting by proxy, by mail or by electronic means
 - For transparency, require to hire independent professionals to collect votes and organize such procedures
- Motivate banks to discharge monitoring responsibilities



27



Next topic

1. Corporate governance and finance in the pre-crisis period
2. Reform and global convergence
3. Shareholder activism and institutional investors
4. Controversies over regulation of banks and *chaebols*
5. Lessons learned


28



Bank ownership structure

- Ownership regulation
 - Rationale: prevent conflicts of interest arising from business groups' control of banks
 - Free to own up to 10% except for industrial capital to which the 4% limit applies
 - Fit and proper test to exceed 10, 25, and 33 percent
 - 15 percent for regional banks
 - Debate over ownership regulation discussed below
- Co-existence of banks with
 - diffuse ownership
 - a controlling shareholder
 - major shareholders without a controlling one

29





Governance structure of banks

- A majority of independent directors (IDs)
 - Nominating committee (Kookmin Bank has a separate committee of governance experts to search and recommend candidates)
- Audit committee required
 - Consist of three or more members
 - IDs no less than two-thirds
 - To elect **IDs to become audit committee members**, each shareholder is subject to a maximum of 3% of total outstanding votes
 - Special qualification requirements for **executive-director member**: the **largest shareholder group** can exercise no more than 3% of total votes
- Must establish internal control standards for officers and employees to
 - Observe laws and regulations
 - Operate assets in a sound manner
 - Protect customers
- Compliance officer mandatory
 - Ensure internal control standards to be observed
 - Investigate violations; report to audit committee
 - Incentive compensation schemes

30



Investigation of insolvent banks and debtors

- Investigation of insolvent and financially distressed banks by Korea Deposit Insurance Corporation
 - KDIC investigates major shareholders, directors, officers and employees for wrongdoings
 - Requires the bank to sue responsible persons for indemnity, to seek criminal penalties, or to impose personnel disadvantages within the bank
- Investigation of insolvent individuals and controlling shareholders, directors, officers, and employees of insolvent firms by KDIC
 - KDIC requires creditor banks to bring an action against responsible persons for compensation of damages done by their wrongdoings

31

Debate over exercise of voting rights by chaebol-affiliated financial institutions

- Institutions affiliated with large business groups
 - Forbidden from exercise of voting rights with respect to affiliates of the same group
 - Permitted to vote for items on control change and charter amendments up to a voting limit of **30% minus the votes cast by others in the group**
 - Korea's FTC proposes to reduce the current voting limit to 15%; fiercely opposed by *chaebols*
- Rationale is to prevent
 - Managerial entrenchment by weakening capital market discipline
 - Use of investor money to acquire/maintain control of business firms and build business empires
- Opposing views from the business community
 - Emphasize stability of management
 - Cite takeover threats by foreign capital
 - Concerned with reverse discrimination in favor of foreign capital

32

Debate over regulatory limits on inter-firm equity investments by chaebol affiliates

- Regulation: an affiliate of a designated large business group should limit equity investments in other firms to 25% of its net worth
- Rationale
 - Limit excessive pyramiding, indirect cross shareholding
 - Prevent excessive concentration of economic power
 - Improve transparency: prevent unfair internal transactions (tunneling)
 - Increase capital market discipline
- Demand for repeal from the business community
 - Hinders investment activity
 - Constitutes reverse discrimination in control contests between domestic and foreign firms

33

Debate over separation of financial institutions from industrial capital

- Ownership of financial institutions
 - Most large NBFIs are affiliated with *chaebols* (relationship with restriction on bank ownership)
 - As of yearend 2002, 24 *chaebols* controlled a total of 79 NBFIs
 - For example, in 2002, 54% of life insurance companies are controlled by *chaebols* (an increase from 42% in 1998)

- The conflict of interest problem
 - Favor affiliated firms in fund allocation
 - Subsidization of underperforming group members
 - Acts as a vehicle for conducting improper intra group transactions
 - Refrain from practicing institutional shareholder activism (collusion or fear of retaliations)
 - Controlling shareholders of business groups use affiliated NBFIs to maintain control of group firms (even with voting restrictions)

34



Non-bank financial institutions controlled by *chaebols*

As of July 1999

	Commercial Banks	Investment Trusts	Mutual Funds	Life Insurance	Securities	Merchant Banks
Number of Institutions Under Control(A)	7	11	7	14	16	6
Total Institutions (B)	18	24	12	29	30	11
A/B(in percentage)	38.9	45.8	58.3	48.3	58.3	54.5

35





Industrial concentration in the life insurance business

Major Life Insurance Companies in Korea
As of March 31, 2003

Firm	Total Assets (in billion won)	Percentage out of All Firms
Samsung Life	72,998	44.45
Kyobo Life	29,812	18.15
Daehan Life	29,458	17.93
Allianz	6,250	3.81
Others	25,704	15.65
All 23 Firms	164,222	100.00

36



Using financial institutions to keep control of a group: An Example

Shareholdings in Affiliated Group Firms by Samsung Life Insurance
As of March 31, 2003

<i>Firm Name</i>	<i>Equity Ownership (percent)</i>
Samsung Corporation	4.8
Samsung Electronics	6.9 ¹⁾
Samsung Heavy Industries	3.9
Samsung Techwin	1.2
Samsung Securities	11.4
Samsung Futures	80.0
Life Insurance Real Estate Trust	50.0
Samsung Investment Trust Mngt.	5.5
Samsung Fire & Marine Insurance Corp.	9.9
Hotel Shilla	7.3
Samsung Economic Research Institute	14.8

37





Relationship between poor corporate governance and economic crisis

- Unchecked agency problems of corporations can lead to economic crisis
 - One of the most important agency problems is overinvestment or empire building
 - Poor bank governance contributes to overleveraging and overinvestment
 - Demand for higher dividends is one way of checking managerial motives
- Unresolved agency problems produce high control premiums which in turn:
 - Hinder corporate restructuring and efficiency, and
 - Provide incentives to build business groups for tunneling opportunities
- Important factors contributing to managerial entrenchment and agency problems in Korea
 - Policies to protect incumbent managers rather than investors
 - Pyramiding and cross shareholding
 - Control of financial institutions by industrial capital

40



Effectiveness of reform measures

- Reform measures contributed to improvements in CG
 - Surveys by McKinsey and CLSA indicate significant improvements
 - Ratings by KCGS show the same
 - Implication: government policy is important in reforming CG practice
- However, continued “Korea discount” calls for further reform
- Areas where further improvement is needed
 - Independence of outside directors and the board (some leading firms adopted innovative methods to nominate independent directors)
 - Public confidence in transparency (cf. recent accounting scandals; earnings smoothing)
 - Business executives’ attitudes toward CG and awareness of fiduciary duty

41



Reform should continue

- Latest reform measures
 - A class action lawsuit regime (limited to securities and disclosure related frauds)
 - CEO/CFO certification
 - mandatory rotation of external auditors in every 6 years
 - Prohibition of loans to executives and major shareholders
 - Restriction on consulting by independent auditors
 - Revision of Code of Best Practice to reflect latest developments
- Further reform efforts required
 - Recognition that laws and regulations only are not sufficient
 - Improve market discipline
 - Shareholder activism
 - Public announcement of CG ratings and promotion of wider usage
 - Expand disclosure on CG (apply the “comply or explain” principle)
 - Strengthen legal enforcement (a visible change is being made by the prosecution)
 - Mandatory cumulative voting?

42



Prevention of intra-group contagion risk and promotion of independence of each board

- Efficiency of firms with a controlling shareholder vs. firms without
 - One half of the large business groups disappeared since the crisis
 - Many NBFIs with a controlling shareholder also failed
 - Frequently the cause of failure was illegitimate subsidization of nonviable member firms of the group
- Policies implemented to prevent cross subsidization
 - Corporate governance reform in general; strengthening of independence and accountability of each board within the group
 - Stronger regulatory activities of the Fair Trade Commission and the Financial Supervisory Commission
 - Prohibition of cross debt guarantees
 - Encouraging *chaebols* to transform into a holding company structure
- Changes in lending and credit rating practices required
 - Tended to look to the creditworthiness of the group as a whole
 - For failed firms, banks still seem to seek help from others in the group

43



Implications of bank performance and failures on ownership structure

- Bank performance and failures appear to indicate:
 - Successful banks have a common trait: existence of major outside shareholders and their close monitoring of bank management
 - Banks without major shareholders easily succumbed to influence from government, politicians, and labor and many of them failed
 - Banks without major shareholders may prove successful if they have good corporate governance
- Debate over 4% ownership limit for industrial capital
 - Business community: Eliminate the limit to allow effective monitoring by shareholders
 - Regulators and NGOs: Keep the limit to avoid using banks as private treasury
 - Compromise might be a solution (8 percent was the limit once in the past)
 - The debate may lose steam as more domestic and foreign financial investors come to hold major positions in the bank



Implications of experience with NBFIs

- Many NBFIs failed:
 - One type of failures: self dealings by the controlling shareholder was a major cause (savings banks)
 - Another type of failures: moral hazard by the managers (credit unions)
 - Third type of failures: excessive competition plus self dealings by the controlling shareholder (life insurance companies)
 - Implications: both good governance and regulatory supervision necessary
- Some *chaebols* still use affiliated NBFIs (especially life insurance cos.):
 - To maintain control of firms in the group
 - To subsidize firms of the group (to use NBFIs as a "private treasury"): 87% of unfair internal transactions involved an NBF
- Effects of *chaebol*-controlled NBFIs on corporate governance
 - Hinders activities in the market for corporate control
 - Weakens institutional shareholder activism



Roadmap on the separation of financial from industrial capital

- The government announced a “Roadmap to prevent negative effects of industrial capital's control of financial institutions” in January 2004
- Short run approach is to lessen negative effects
 - Strengthen requirements for board approval and disclosure of related party transactions
 - Strengthen financial supervision of the controlling shareholder and affiliates to prevent contagion of insolvency
 - Improve transparency of privately held NBFIs by strengthening rules on disclosure and board independence
 - Strengthen the fit and proper test of the largest and major shareholders
 - Weaken institutional shareholder activism; and
 - Lower loan limits to related parties
 - Gradually tighten the voting restriction with respect to affiliates
- Long term approach
 - Objective: separation of financial capital from industrial capital
 - Introduce measures to decrease private benefits and increase costs of control of financial institutions by industrial companies
 - Continue to study a system where the government can seek a court order for separation



Roadmap on the separation of financial from industrial capital

- The government announced a “Roadmap to prevent negative effects of industrial capital's control of financial institutions” in January 2004
- Short run approach is to lessen negative effects
 - Strengthen requirements for board approval and disclosure of related party transactions
 - Strengthen financial supervision of the controlling shareholder and affiliates to prevent contagion of insolvency
 - Improve transparency of privately held NBFIs by strengthening rules on disclosure and board independence
 - Strengthen the fit and proper test of the largest and major shareholders
 - Weaken institutional shareholder activism; and
 - Lower loan limits to related parties
 - Gradually tighten the voting restriction with respect to affiliates
- Long term approach
 - Objective: separation of financial capital from industrial capital
 - Introduce measures to decrease private benefits and increase costs of control of financial institutions by industrial companies
 - Continue to study a system where the government can seek a court order for separation



Kwang S. Chung

President, the Korea Corporate Governance Service
&
Professor of Finance, Chung-Ang University Korea

Kwang S. Chung is a professor of finance at Chung-Ang University. Concurrently serving as the president of the Korea Corporate Governance Service and the chair of the Corporate Governance Committee, he has been actively involved in promoting good corporate governance in Korea. He also is a member of the Public Fund Oversight Committee of the Korean government and chairs its Asset Sales Subcommittee which oversees and approves the sale of state-owned companies and debt and equity securities acquired in the process of government bailouts of financial institutions.

He was one of the founding members of the Korea CEO Forum and served as its co-chair from June 2002 through September 2003. Unlike other business organizations, the Forum has corporate governance reform in Korea as one of its agenda. Recently he completed his three-year term as a commissioner of the Securities and Futures Commission. In the past, he held the title of an advisor to many organizations including the Fair Trade Commission, Korea Deposit Insurance Corporation, the Federation of Korean Industries, Korea Listed Companies Association, and the Korea Stock Exchange. He was a non-standing editorial writer of Maeil Business Newspaper and an independent director at Hana Bank, Korea Investors Service, Woori Finance Holdings, and other corporations. He was a local consultant to the Asian Development Bank on corporate governance.

Previously, he was an assistant professor of financial economics at Rutgers University and a visiting research economist at UCLA. He served as the dean of the College of Business Administration at Chung-Ang University and the president of the Korea Finance Association. He is a coauthor with J. Fred Weston of *Takeovers, Restructuring, and Corporate Governance*, 1st and 2nd editions. He graduated from Seoul National University and received his M.S. and Ph.D. in management from UCLA.



DOC.NO.2-(06)

**Case Study: Corporate Governance in the APEC Economies:
Hong Kong's Experiences and Lessons Learned**

Angus Chan

Senior Manager of Banking Policy Department

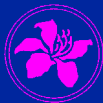
Hong Kong Monetary Authority, Hong Kong, China



Corporate Governance of Banks in Hong Kong

Angus Chan
Hong Kong Monetary Authority
20 May 2004

1



Introduction

- **Corporate governance is the system by which companies are directed and controlled**
- **It is a key issue for listed companies because of:**
 - the separation between ownership and management
 - the need to protect minority shareholders

2



Why is corporate governance important for banks?

- **Sound corporate governance is particularly important for banks because of:**
 - banks are looking after depositors' money, but risk-taking is central to their activities
 - increasing risk as a result of globalisation, deregulation and technology advancement
 - there are potentially huge systemic problems if banks get into difficulties

3



The role of bad corporate governance in the Asian crisis

- **Weak corporate governance in Asian banks was one of the key factors in the Asian crisis**
 - many banks were controlled by owner-managers and the board of directors played a little role
 - banks were often parts of wider conglomerates and were used to fund other parts of the group or the owners (i.e. connected lending)
 - management was not professional and lacked self-responsibility
 - growth was more important than return on capital
 - risk management was poor

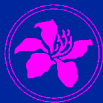
4



The role of regulation

- **The potential for banking crisis explains why banks are regulated**
- **Traditionally this has been a top-down process**
 - regulators lay down rules and try to enforce them
- **Increasingly, however, the trend is towards supervision rather than regulation**
- **This places the main emphasis on the key role of the directors and senior management in ensuring that banks are prudently managed**

5



The role of supervision

- **The above trend brings corporate governance to the fore**
 - recognises that banking is too complex to be run by regulators
 - tries to encourage self-responsibility in banks and to avoid moral hazard
- **Role of the supervisor is to put in place certain minimum standards, to monitor the performance of management and to take action if management is not doing its job properly**

6



How can good corporate governance be promoted by supervisors?

- **Issue of guidelines on corporate governance**
- **Approval of directors and chief executives of banks and removal of those that are not fit and proper**
- **Measures to encourage market discipline through disclosure and transparency**

7



Contents of the HKMA Guideline

- **Major responsibilities of the board**
 - ensure competent management
 - approve objectives, strategies and business plans
 - ensure that the bank's operations are conducted prudently and within the framework of laws and board policies
 - ensure that the bank's affairs are conducted with a high degree of integrity
- **Legal obligations of directors**
- **The use of auditors, including internal audit**
- **Specific requirements**

8



Specific Requirements (1)

- **The board should ensure that the bank establishes policies, procedures and controls to manage the various types of risk with which it is faced**
 - 8 types of risk specified by HKMA (i.e. credit, interest rate, market, liquidity, operational, reputation, legal and strategic risk)
 - board should approve relevant policies to manage these risks while senior management should put them into effect

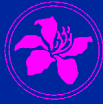
9



Specific Requirements (2)

- **The board should ensure that the bank fully understands the provisions of section 83 of the Banking Ordinance on connected lending and establishes a policy on such lending**
 - section 83 of the Ordinance limits the unsecured advances of banks to connected parties (e.g. directors and their relatives)
 - board should ensure that the bank fully understands its legal obligations and establishes a policy on connected lending according to the minimum standards specified in the Guideline

10



Specific Requirements (3)

- **The board should ensure that it receives the management letter from the external auditor without undue delay, together with the comments of management**
 - management letter should normally be received within 4 months from the financial year-end
 - board and/or audit committee should ensure appropriate action is taken to address any weaknesses identified in the management letter
 - copy of the management letter should be given to the HKMA

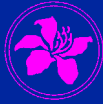
11



Specific Requirements (4)

- **The board should maintain appropriate checks and balances against the influence of management and/or shareholder controllers, in order to ensure that decisions are taken with the bank's best interests in mind**
 - board should have at least 3 independent directors to provide the necessary checks and balances and bring in outside experience
 - the role of the chairman and the chief executive of a bank are distinct. If the chairman is also the chief executive, there should be a strong independent element on the board (i.e. more than 3 independent directors)

12



Specific Requirements (5)

- **The board should establish an audit committee with written terms of reference specifying its authorities and duties**
 - audit committee should be made up of non-executive directors, the majority of whom should be independent
- **Board meetings of a bank should be held preferably on a monthly basis but in any event no less than once every quarter**
 - banks should keep full minutes of board meetings
 - HKMA will require banks to provide it with a record of the number of board meetings held each year

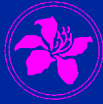
13



Specific Requirements (6)

- **Individual directors should attend at least half of board meetings held in each financial year**
 - participation of directors in board meetings can be facilitated by video or telephone conferencing
 - HKMA will monitor the attendance records of individual directors
- **The HKMA will meet the full board of directors of each bank every year**
 - HKMA's intention is not to participate in board meetings but to strengthen communication between the HKMA and the banks at the highest level

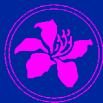
14



Industry concerns

- **Is too much burden being placed upon the board and non-executive directors, in terms of establishing policies and controls?**
- **Should there be a distinction between listed and non-listed banks?**
- **Is it a level playing field between locally incorporated banks and overseas banks?**
- **Is it going to be possible to find sufficient independent directors of the right quality?**

15



Too much burdens on directors?

- **Banks are exposed to special risks and the board needs to ensure that policies are in place to manage these risks. This does not mean that the directors should themselves formulate policies but should certainly approve such policies.**
- **Being a director of a bank does involve heavy responsibilities.**
- **The criminal sanctions in the Banking Ordinance apply to all directors, whether they are executive or non-executive.**

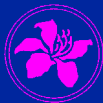
16



A distinction between listed and non-listed banks?

- **Banks are different from other companies because they are looking after other people's money.**
- **It does not matter whether the bank is listed or non-listed.**

17



A level playing field between local and foreign banks?

- **This is an interesting question.**
- **Is sound corporate governance a bad thing?**
- **Some foreign banks are a role model**
- **International standards and principles:**
 - **OECD Principles of Corporate Governance**
 - **Basel Committee Paper on “Enhancing Corporate Governance on Banking Organisations”**

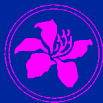
18



Sufficient independent directors?

- **“Independent directors” means non-executive directors who are independent of management and free from any business or other relationship that could materially affect their independent judgement**
- **In assessing the independence of such directors, the HKMA will take account of various factors such as their direct or indirect financial or other interest in the business of the bank and their relationship, if any, with significant shareholders of the bank**

19



Sufficient independent directors?

- **We acknowledge that it may not be easy to find independent directors with the right skills and degree of independence**
- **Flexibility:**
 - This requirement does not apply in full to deposit-taking companies and restricted licence banks
 - A 12-month transitional period is allowed

20



Compliance indicators (1) - 23 locally incorporated banks

- **Percentage of independent directors to the full board in average: almost 1/3**
- **All local banks have established audit committee (except one which relies on the parent bank's audit committee)**
- **Frequency of board meeting:**
 - 17 (Quarterly)
 - 3 (Monthly)
 - 3 (5 - 8 per annum)

21



Compliance indicators (2) - 23 locally incorporated banks

- **All directors have attended more than 50% of the board meetings**
- **Roles of Chairman and Chief Executive:**
 - 17 (Segregating these two roles)
 - 6 (No segregation but with more independent or non-executive directors)

22



Quality of people (1)

- **Key to good corporate governance is the quality and integrity of the people at the helm**
- **The appointment of directors and chief executives of banks is subject to approval by the HKMA**
- **Relevant criteria include:**
 - probity, reputation and character
 - knowledge, experience, competence, soundness of judgement
 - compliance record
 - business record and other business interests

23



Quality of people (2)

- **Senior management of a bank, under the supervision of its directors and chief executives, plays a pivotal role in ensuring the financial soundness and efficient operation of the bank**
- **In 2002, a new authorization criterion was added to require banks to have adequate systems to ensure that only fit and proper persons can be appointed as their senior managerial positions**
- **Notification of the appointment of senior executives is required**

24



Public disclosure (1)

- **Transparency or market discipline can play an important part in promoting a high standard of corporate governance**
- **This helps a bank's stakeholders and public depositors to judge the effectiveness of their board and management.**

25



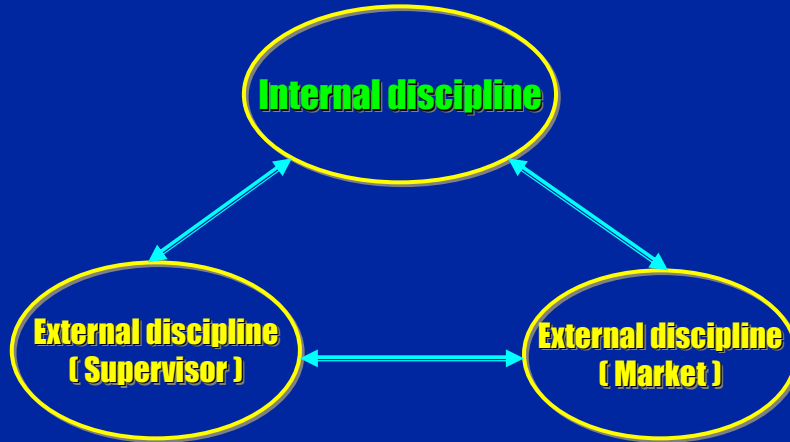
Public disclosure (2)

- **Banks in Hong Kong are required/encouraged to disclose the following additional information in their annual reports:**
 - transactions with group companies
 - a statement of compliance with the HKMA's guideline on corporate governance
 - qualitative and quantitative information on risk management
 - segmental information

26



Conclusion



27



- END -

28

Angus Chan

Senior Manager of Banking Policy Department
Hong Kong Monetary Authority, Hong Kong, China

Angus Chan joined the Banking Supervision Department of Hong Kong Monetary Authority (HKMA) in 1996. He is currently Senior Manager of Banking Policy Department, responsible for the issues relating to corporate governance, credit risk management and anti-money laundering. Prior to joining the HKMA, he was working in KPMG.

Angus Chan holds a Bachelor Degree in Accountancy from Hong Kong Polytechnic University. He is an Associate Member of the Hong Kong Society Accountants and a Fellow Member of the Association of Chartered Certified Accountants."

May 2004



DOC.NO.2-(07)

Case Study: Internal Control Systems in HSBC

Simon Glass

Chief Financial Officer, HSBC

Internal Control Systems in A Commercial Bank

Simon Glass
Chief Financial Officer
The Hongkong and Shanghai Banking Corporation Limited
on
20 May 2004

HSBC 

What Are Internal Control Systems?

‘ A process, effected by an entity’s board of directors, management and other personnel, designed to provide reasonable assurance regarding the achievement of

- Effectiveness and efficiency of operations
- Reliability of financial reporting
- Compliance with applicable laws and regulations’

Committee of Sponsoring Organisation
Of the Treadway Commission (COSO)

HSBC 

Who Is Responsible For Operation of Internal Controls?

- **Board of Directors**
 - **Senior management**
 - **Middle management**
 - **Junior management**
 - **Non-executive management**
- **Every employee of the organisation is responsible for Internal Controls!**

Why Are Internal Control Systems Important?

- **Effectiveness**
- **Efficiency**
- **Reliability**
- **Integrity**
- **Security**
- **Compliance**
- **Basel 2**

What Are the Key Ingredients of Effective Internal Control Systems?

- Culture
- Review
- Process
- Audit
- Documentation
- Resourcing
- Accountability





Simon Glass

Chief Financial Officer
The Hongkong and Shanghai Banking Corporation Limited

Mr Glass was appointed Chief Financial Officer of The Hongkong and Shanghai Banking Corporation Limited in April 2003.

Mr Glass has been with the HSBC Group for seventeen years, and has held roles in the UK, North America and Asia.

Prior to his current role, Mr Glass performed a variety of roles within the HSBC Group, including internal audit, finance, and risk management, with the most recent role prior to his recent appointment, being Chief Financial Officer, Corporate, Investment Banking and Markets.

Mr Glass is also a Managing Director of Hang Seng Bank Limited.

Mr Glass is a Member of the Institute of Chartered Accountants of England and Wales.

Mr Glass is married with two children.



DOC.NO.2-(08)

**Corporate Governance and Control: What is Different about
Financial Institutions**

Jeffrey Coles

Professor of Finance

Arizona State University, U.S.A.

Recent Evidence on Corporate Governance in Commercial Banks

Dr. Jeff Coles
Labriola Endowed Chair of Competitive Business
Professor of Finance
W. P. Carey School of Business
Arizona State University

May 20, 2004



APEC FINANCE and DEVELOPMENT PROGRAM

OUTLINE: Recent Evidence on Corporate Governance in Commercial Banks

- ◆ Corporate governance and control:
 - Definition
 - How it matters
 - How evidence typically is assembled (how to be an informed consumer of academic research on corporate governance)
 - Structure
 - Performance
 - Interesting questions

OUTLINE: Recent Evidence on Corporate Governance in Commercial Banks

- ◆ Recent Research Developments:
 - board size and composition in **banks** (new)
 - board size and composition in other firms (Coles, Daniel, and Naveen, 2004)
- ◆ Should we pressure all firms, including **banks**, to have smaller more-independent boards?

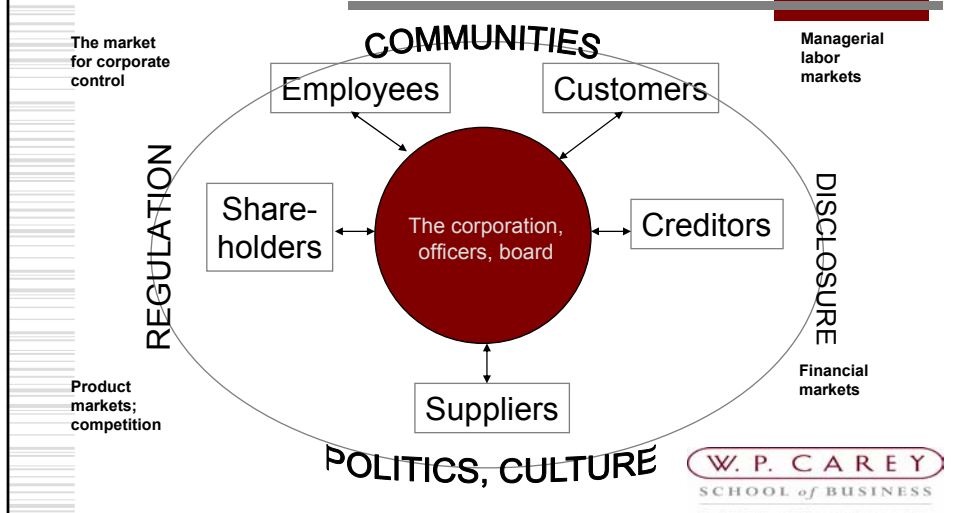
W. P. CAREY
SCHOOL of BUSINESS

Definitions

- ◆ *Corporate Governance:*
 - “The top management/board process that manages corporate value creation for, and corporate value transference among various claimants (including the society-at-large), in a context that simultaneously ensures top management accountability toward these claimants.”
- ◆ *Corporate Control:*
 - “...the monitoring, supervision, and direction of a corporation or other business organization.”

W. P. CAREY
SCHOOL of BUSINESS

How Governance Matters: The Relevant Constituencies....



ASSEMBLING EVIDENCE: CONDUCT/STRUCTURE - Many Components

- ◆ Capital structure
- ◆ Dividend policy
- ◆ Ownership structure
- ◆ Compensation policy
- ◆ Antitakeover devices
- ◆ Organized around function or product market
- ◆ Domicile
- ◆ Policy on insider trading
- ◆ Firm focus
- ◆ Etc.
- ◆ **Board of Directors**
 - Outsiders vs insiders vs. "greys"?
 - Size?
 - CEO/Chair combined?
 - Committee structure and membership?
 - Outside lead director?
 - Other director characteristics?
 - How are directors compensated?
 - Indemnification, D&O liability insurance.

ASSEMBLING EVIDENCE: PERFORMANCE

- ◆ Accounting returns
- ◆ Market returns
- ◆ P/E
- ◆ Market value
- ◆ Market to book ratio (Tobin's Q)

W. P. CAREY
SCHOOL of BUSINESS

ASSEMBLING EVIDENCE: PRIMITIVES

- ◆ State corporation law
- ◆ Federal corporation law
- ◆ Accounting rules
- ◆ Disclosure requirements
- ◆ Market for corporate control
- ◆ Market for managers
- ◆ Penalties for illegal behavior
- ◆ Production process
- ◆ Technology
- ◆ Labor market
- ◆ Monetary policy
- ◆ Nature of product market (e.g., banks vs. other)
- ◆ Etc.

W. P. CAREY
SCHOOL of BUSINESS

ASSEMBLING EVIDENCE: Governance Research?

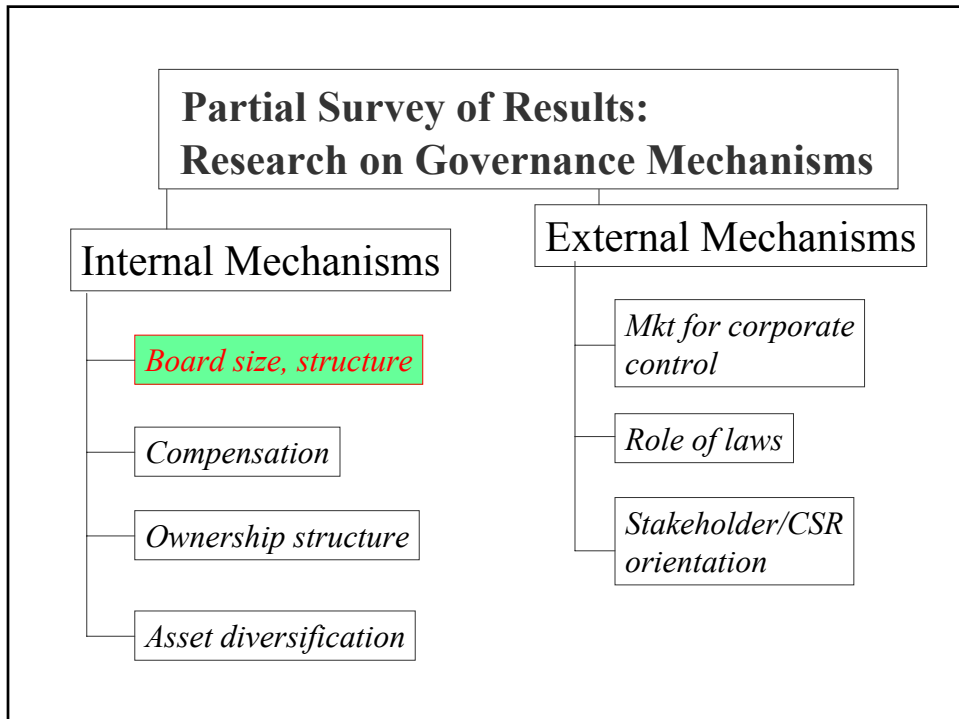
- ◆ Governance topics have been extensively researched in both the US and abroad, in such diverse fields as finance, accounting, law, and corporate strategy.
- ◆ Most of these studies attempt to link specific (sets of) governance variables to performance metrics such as shareholder value (short-run and long run) or accounting returns.
- ◆ **Performance on Structure.**
- ◆ **Structure on Structure.**

W. P. CAREY
SCHOOL of BUSINESS

ASSEMBLING EVIDENCE: Important Questions

- ◆ **Does performance depend on structure?**
 - E.g. Is Q (value) related to managerial ownership or **board size or composition**?
- ◆ **How are different pieces of the structure related (structure on structure)?**
 - E.g. If I put more outsiders on the board, do I need to give the CEO as many stock options?
- ◆ Bottom line question: how to structure the company to maximize shareholder value?

W. P. CAREY
SCHOOL of BUSINESS



Boards: Does one size fit all?

Jeff Coles, Arizona State University

Naveen Daniel, Georgia State University

Lalitha Naveen, Georgia State University

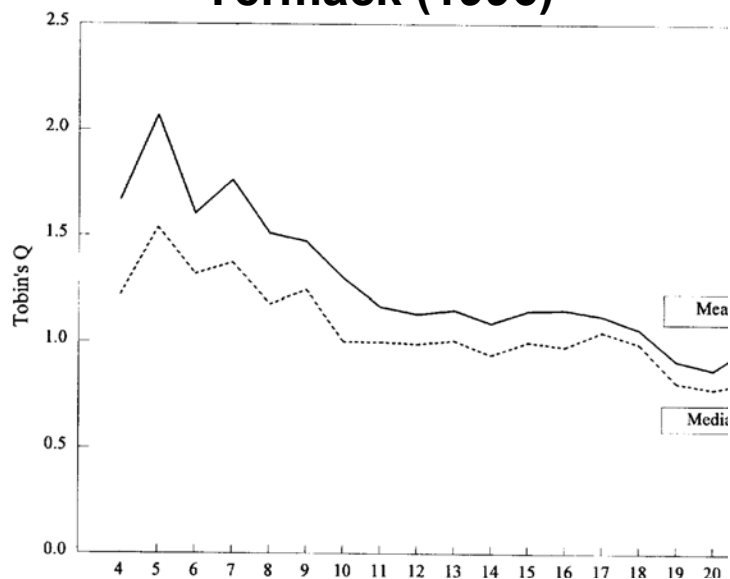
Boards: Does one size fit all?

- ◆ Impact of board structure on firm value (Tobin's Q) **for different classes of firms?**
- ◆ Board structure:
 - **Board size** (number of directors on the board)
 - **Board composition** (proportion of various types of directors on the board).

Impact of Board Size on Value?

- ◆ Conventional wisdom: **smaller boards** and **greater level of board independence** allow for more effective monitoring (Lipton & Lorsch, 1992; Jensen, 1993).
- ◆ **Most influential empirical evidence: bigger boards are associated with lower Tobin's Q (Yermack, 1996; Eisenberg et al., 1998).**
 - Interpreted to mean that smaller boards enhance firm value.

Yermack (1996)



Impact of Board Composition on Value?

- ◆ **Independent boards** (higher outsider fraction) are better at some specific tasks
 - CEO hiring (Borokhovich et al., 1996)
 - CEO firing (Weisbach, 1988)
 - Anti-takeover provisions adoption (Brickley, Coles, Terry, 1994)
 - Takeover premium negotiation (Cotter et al., 1997)
- ◆ No clear relation between board independence and firm performance
 - Negative relation: Yermack (1996)
 - Positive relation: Baysinger and Butler (1985)
 - No relation: Hermalin and Weisbach (1991); Bhagat and Black (1999, 2001)
- ◆ So why the push for more independent boards?

Board Composition and Value? The US Governance System

- ◆ Corporate accountability: Achieved through the board of directors, and the proxy voting mechanism.
- ◆ Members of the board are liable for corporate actions, and responsible for ensuring that the firm behaves in a 'legal' and 'socially responsible' manner.
- ◆ The management is accountable to the board, and the board is accountable to shareholders.
- ◆ By the way: The ruling that establishes the centrality of shareholder value maximization in the US corporation is that of the Michigan Supreme Court in 1919, in Dodge v. Ford.

W. P. CAREY
SCHOOL of BUSINESS

Characteristics/Composition of the Typical US Board (2001)

- ◆ Average board size: 11
- ◆ Average # inside directors: 2
- ◆ Average # outside directors: 9
- ◆ Of the outsiders, # grey: 4 or 5
- ◆ % boards that have as members:
 - CEOs/COOs of other companies: 83%
 - Investors: 87%
 - Women: 74%
 - Ethnic minorities: 65%
 - Former gov't official: 52%
 - Academic: 56%

Source: Korn/Ferry Int'l

W. P. CAREY
SCHOOL of BUSINESS

Directors' Views..... (cont)

- ◆ **Who appoints committee chairs/members (2001)?**
 - CEO/Chairman 45%
 - Governance/Nominating committee 30%
 - Full board 23%
- ◆ **Who will have the most influence in determining nominees for the next director?*** (2001)
 - CEO/Chairman 64%
 - Board committee 50%
 - Full board 24%
 - Chairman or lead director 33%

* Average of responses of all categories.

Source: Korn/Ferry Int'l

W. P. CAREY
SCHOOL of BUSINESS

So why the push for more independent boards?

- ◆ Reliance on outside directors, usually non-specialists, and committees to oversee board responsibilities.
- ◆ Preponderance of other company CEOs/COOs on boards; Clubiness;
- ◆ CEOs control information flows to board, and committee composition.

W. P. CAREY
SCHOOL of BUSINESS

So why the push for more independent boards?

- ◆ Board members picked by/sympathetic to the CEO. The CEO is also chairman of the board 90% of the time.
- ◆ A sense that many boards asleep at the switch; CEO is “king”
- ◆ Boards afraid to ask tough questions (Issues of board competency)
- ◆ Difficult/time consuming/expensive to organize proxy battles/contests.

W. P. CAREY
SCHOOL of BUSINESS

Pressure for **Smaller, More Independent Boards**

- ◆ US Congress: Sarbanes-Oxley
- ◆ Listing requirements
 - NYSE
 - Nasdaq
- ◆ Institutional investors
 - Tiaa/Cref
 - Calpers
- ◆ Accounting
 - PCAOB
 - FASB/IASC

W. P. CAREY
SCHOOL of BUSINESS

.....has forced changes

- ◆ Boards have become smaller (Wu, 2003)
- AND
- ◆ Fraction of insiders has decreased over time (Huson, Parrino, and Starks, 2001)
- *Why then do larger boards and boards with high insider fraction exist?*

Research questions

1. When is it beneficial to have larger boards?
2. When is it beneficial to have higher fraction of insiders on the board?

Does one size fit all?

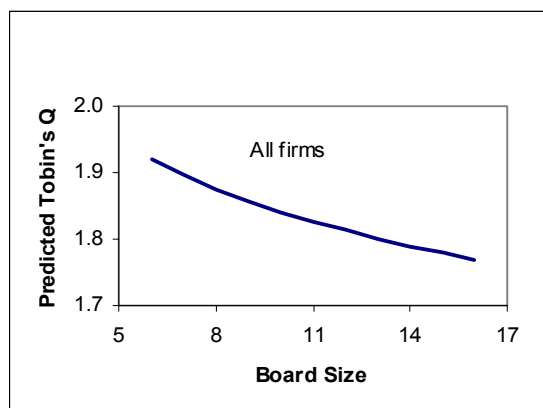
- Could there be some types of firms for whom the board size-Tobin's Q relation is zero or even positive? **BANKS?**
- Could there be some types of firms for whom the insider fraction-Tobin's Q relation is zero or even positive? **BANKS?**

Data

- ◆ Firms on Execucomp (2003)
- ◆ Board data from Compact Disclosure for 1992-1997 and from IRRC from 1998-2001
- ◆ Cross-checked Compact Disclosure data with proxy statements from Lexis-Nexis
- ◆ Financial and segment information from COMPUSTAT
- ◆ Final sample: at least 5784 firm-year observations

W. P. CAREY
SCHOOL of BUSINESS

Yermack (1996) Confirmed



W. P. CAREY
SCHOOL of BUSINESS

Univariate results

	Board size	Outsiders	Insiders	Insider fraction
Banks	13.3	10.9	2.4	0.176
Others	10.1	7.9	2.2	0.222
<i>p value</i>	(0.00)	(0.00)	(0.00)	(0.00)

Impact of board size on Q for BANKS

		Dependent variable: Tobin's Q	
		Model 1	Model 2
Log(board size)	β_1	-0.064 [†] (-1.8)	
Log(board size) * BANK dummy	β_2	0.158 ^{***} (2.8)	
Log(outsiders)	β_3		-0.072 ^{**} (-2.0)
Log(outsiders) * BANK dummy	β_4		0.153 ^{***} (3.0)
Insider fraction		0.215 ^{***} (2.7)	0.125 (1.3)
BANK dummy		-0.499 ^{***} (-2.7)	-0.450 ^{***} (-2.7)
Intercept, industry and year dummies, and additional controls		Yes	Yes
Observations		8637	8632
R ²		57%	57%
F-test		$\beta_1 + \beta_2$ = 0.094 ^{**} (<i>p</i> = 0.05)	$\beta_3 + \beta_4$ = 0.081 [*] (<i>p</i> = 0.09)

Impact of insider fraction on Q for BANKS

		Dependent variable: Tobin's Q
Log(board size)		-0.052 (-1.6)
Insider fraction	β_1	0.231*** (2.8)
Insider fraction * BANK dummy	β_2	-0.381*** (-2.6)
BANK dummy		-0.033 (-0.3)
Intercept, industry and year dummies, and additional controls		Yes
Observations		8637
R ²		57%
F-test		$\beta_1 + \beta_2$ = -0.150 ($p = 0.24$)

W. P. CAREY
SCHOOL of BUSINESS

Impact of board structure on Q for BANKS

		Dependent variable: Tobin's Q
Log(board size)	β_1	-0.063* (-1.8)
Log(board size) * BANK dummy	β_2	0.130** (2.4)
Insider fraction	β_3	0.227*** (2.8)
Insider fraction * BANK dummy	β_4	-0.248* (-1.9)
BANK dummy		-0.384** (-2.1)
Intercept, industry and year dummies, and additional controls		Yes
Observations		8637
R ²		57%
F-test		$\beta_1 + \beta_2$ = 0.067 ($p = 0.12$) $\beta_3 + \beta_4$ = -0.021 ($p = 0.84$)

W. P. CAREY
SCHOOL of BUSINESS

Do BANKS have large boards and more outsiders?

	Dependent variable:	
	Log(board size)	Log(outsiders)
BANK dummy	0.225*** (2.7)	0.272** (2.5)
Other Control variables	Sales, Debt, R&D, ROA, FCF, Intangible assets, Firm age, CEO tenure, CEO age	
Intercept, industry and year dummies	Yes	Yes
Observations	6822	6818
R ²	48%	48%

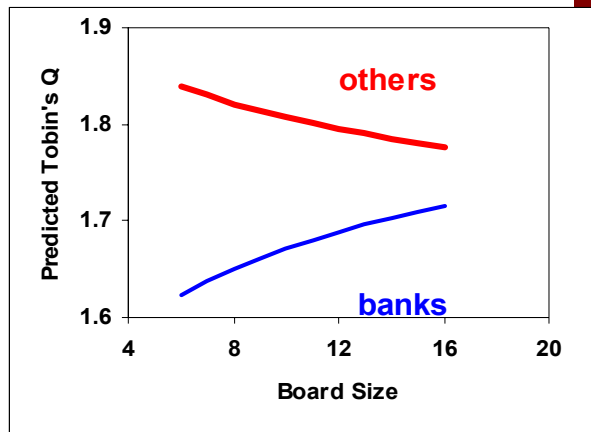
W. P. CAREY
SCHOOL of BUSINESS

Do BANKS have lower insider fraction?

	Dependent variable:	
	Insider fraction	
R&D dummy	0.004 (0.2)	
Other control variables	Sales, Debt, R&D, ROA, FCF, Intangible assets, Firm age, CEO ownership, CEO tenure, CEO age	
Intercept, industry and year dummies	Yes	
Observations	6765	
R ²	23%	

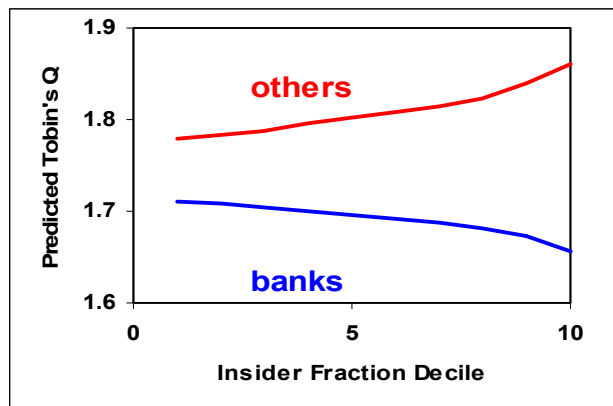
W. P. CAREY
SCHOOL of BUSINESS

Q and Board Size



W. P. CAREY
SCHOOL of BUSINESS

Q and Insider Fraction



W. P. CAREY
SCHOOL of BUSINESS

Why These Results?

- ◆ Two main functions of the board: monitoring and advising (Lorsch and MacIver, 1989)
- ◆ Directors consider their “key” normal duty to be that of advising the CEO (Lorsch and MacIver, 1989)
- ◆ Larger boardmay offer an exceptional level of high quality advice and counsel to the CEO (Dalton et al., 1999)

W. P. CAREY
SCHOOL of BUSINESS

Why?

- ◆ CEO's need for advice will increase with the complexity of the organization (Klein, 1998).
- ◆ CEO's need for advice will increase with the extent to which firm depends on external environment for resources (Pfeffer, 1972; Pfeffer and Salancik, 1978).
- ◆ Banks can be more complex and benefit from many outside contracting relationships.
- ◆ Need for advice will be greater in banks.
- ◆ Thus, the number of directors, specifically outsiders, will be greater in banks.
- ◆ For banks: in the data, Q increases in board size and outsider representation on the board.
- ◆ Also, banks should have bigger boards. They do.

W. P. CAREY
SCHOOL of BUSINESS

Conjecture

- ◆ Larger firms have more contracting relationships (Pfeffer, 1972; Booth and Deli, 1996).
- ◆ Our hypothesis: Number of directors, specifically outsiders, will be greater in larger firms, including banks.

Conjecture

- ◆ Diversified firms are more complex (Rose and Shepard, 1997).
- ◆ CEO's need for advice will be greater in diversified firms (Yermack, 1996, Hermalin and Weisbach, 1988).
- ◆ Our hypothesis: Number of directors, specifically outsiders, will be greater in diversified firms.

Conjecture

- ◆ Another proxy for a firm's dependence on external resources: Leverage (Klein, 1998; Booth and Deli, 1999).
- ◆ Our hypothesis: Number of directors, specifically outsiders, will be more in high-debt firms.

Conjecture

- ◆ Level of diversification, sales, leverage are all correlated
- ◆ We form a factor score based on above three dimensions
- ◆ Higher the factor score, higher the firm "complexity"
- ◆ Our hypothesis: Number of directors, specifically outsiders, will be greater in complex firms

Conjecture

- ◆ Inside directors
 - better at selecting strategy (Baysinger and Hoskisson, 1990)
 - provide information to outsiders (Mace, 1971; Raheja, 2002; Gillette, Noe, and Rebello, 2003)
 - possess more firm-specific knowledge (Fama and Jensen, 1983)

W. P. CAREY
SCHOOL of BUSINESS

Conjecture

- ◆ Inside directors will therefore benefit firms that have greater needs for specialized knowledge, such as R&D-intensive firms (Williamson, 1975; Raheja, 2002)
- ◆ R&D-intensive firms may be better off with less monitoring (Burkart et al., 1997)
- ◆ Our hypothesis: Fraction of insiders will be larger for R&D-intensive firms

W. P. CAREY
SCHOOL of BUSINESS

Conjectures

- ◆ Based on our discussion, we expect
 - Tobin's Q will be increasing in board size in banks, diversified firms, large firms, and high-debt firms.
 - Relation will be driven by outsiders
 - Tobin's Q will be increasing in fraction insiders in R&D-intensive firms.

Table 2: Univariate results

	Board size	Outsiders	Insiders	Insider fraction
Diversified firms	10.7	8.5	2.2	0.20
Focused firms	9.5	7.2	2.3	0.25
<i>p value</i>	(0.00)	(0.00)	(0.00)	(0.00)
Large firms	11.4	9.1	2.3	0.20
Small firms	9.3	7.1	2.2	0.24
<i>p value</i>	(0.00)	(0.00)	(0.00)	(0.00)
High-debt firms	10.6	8.4	2.2	0.21
Low-debt firms	10.1	7.8	2.3	0.23
<i>p value</i>	(0.00)	(0.00)	(0.00)	(0.00)
High-complexity firms	11.3	9.1	2.2	0.19
Low-complexity firms	9.1	6.9	2.2	0.25
<i>p value</i>	(0.00)	(0.00)	(0.85)	(0.00)
High-R&D firms	9.5	7.5	2.0	0.22
Low-R&D firms	10.6	8.3	2.3	0.22
<i>p value</i>	(0.00)	(0.00)	(0.00)	(0.37)

Table 3: Impact of board size on Q for DIVERSIFIED firms

		Dependent variable: Tobin's Q	
		Model 1	Model 3
Log(board size)	β_1	-0.108* (-1.8)	
Log(board size) * DIVERSE dummy	β_2	0.191*** (2.8)	
Log(outsiders)	β_3		-0.109** (-2.1)
Log(outsiders) * DIVERSE dummy	β_4		0.185*** (3.4)
Insider fraction		0.162* (1.9)	0.154 (1.5)
DIVERSE dummy		-0.516*** (-3.2)	-0.451*** (-3.9)
Intercept, industry and year dummies, and additional controls		Yes	Yes
Observations		6786	6783
R ² (Pseudo R ²)		58%	58%
F-test		$\beta_1 + \beta_2$ = 0.083* ($p = 0.06$)	$\beta_3 + \beta_4$ = 0.076* ($p = 0.07$)

W. P. CAREY
SCHOOL of BUSINESS

Table 4: Impact of board size on Q for LARGE firms

		Dependent variable: Tobin's Q	
		Model 1	Model 3
Log(board size)	β_1	-0.049 (-0.9)	
Log(board size) * FIRMSIZE dummy	β_2	0.153** (2.2)	
Log(outsiders)	β_3		-0.038 (-0.8)
Log(outsiders) * FIRMSIZE dummy	β_4		0.129** (2.3)
Insider fraction		0.168* (1.9)	0.196* (1.9)
FIRMSIZE dummy		-0.315* (-1.9)	-0.225* (-1.9)
Intercept, industry and year dummies, and additional controls		Yes	Yes
Observations		6794	6791
R ² (Pseudo R ²)		58%	58%
F-test		$\beta_1 + \beta_2$ = 0.104** ($p = 0.03$)	$\beta_3 + \beta_4$ = 0.090** ($p = 0.05$)

W. P. CAREY
SCHOOL of BUSINESS

Table 5: Impact of board size on Q for HIGH-DEBT firms

		Dependent variable: Tobin's Q			
		Model 1	Model 2	Model 3	Model 4
		OLS	Median	OLS	Median
Log(board size)	β_1	-0.056 (-1.0)	0.001 (0.0)		
Log(board size) * DEBT dummy	β_2	0.106 (1.6)	0.089** (2.1)		
Log(outsiders)	β_3			-0.086* (-1.7)	-0.008 (-0.3)
Log(outsiders) * DEBT dummy	β_4			0.153*** (2.8)	0.105*** (3.9)
Insider fraction		0.194** (2.2)	0.178*** (3.1)	0.178* (1.7)	0.276*** (5.1)
DEBT dummy		-0.404** (-2.6)	-0.319*** (-3.2)	-0.470*** (-4.1)	-0.328*** (-5.9)
Intercept, industry and year dummies, and additional controls		Yes	Yes	Yes	Yes
Observations		6794	6794	6791	6791
R ² (Pseudo R ²)		58%	36%	58%	36%
F-test		$\beta_1 + \beta_2$ = 0.050 ($p = 0.28$)	$\beta_1 + \beta_2$ = 0.088*** ($p = 0.01$)	$\beta_3 + \beta_4$ = 0.067 ($p = 0.13$)	$\beta_3 + \beta_4$ = 0.097*** ($p < 0.01$)

W. P. CAREY
SCHOOL of BUSINESS

Table 6: Impact of board size on Q for COMPLEX firms

		Dependent variable: Tobin's Q	
		Model 3	Model 7
Log(board size)	β_1	-0.061 (-1.1)	
Log(board size) * COMPLEXITY dummy	β_5	0.202*** (3.1)	
Log(outsiders)	β_6		-0.057 (-1.2)
Log(outsiders) * COMPLEXITY dummy	β_{10}		0.190*** (3.6)
Insider fraction		0.206*** (2.3)	0.237** (2.3)
COMPLEXITY dummy		-0.510*** (-3.3)	-0.434*** (-3.8)
Intercept, industry and year dummies, and additional controls		Yes	Yes
Observations		6794	6791
R ² (Pseudo R ²)		58%	58%
F-test		$\beta_1 + \beta_5$ = 0.141** ($p < 0.01$)	$\beta_6 + \beta_{10}$ = 0.132** ($p < 0.01$)

W. P. CAREY
SCHOOL of BUSINESS

Table 7: Impact of insider fraction on Q for R&D-INTENSIVE firms

Dependent variable: Tobin's Q		
Model 1		
Log(board size)		-0.011 (-0.3)
Insider fraction	β_1	0.024 (0.3)
Insider fraction * R&D dummy	β_2	0.559** (2.5)
R&D dummy		0.212*** (4.0)
Intercept, industry and year dummies, and additional controls		Yes
Observations		6794
R ² (Pseudo R ²)		56%
F-test		$\beta_1 + \beta_2$ = 0.583 ($p < 0.01$)

W. P. CAREY
SCHOOL of BUSINESS

Table 8: Impact of board structure on Q for COMPLEX and R&D-INTENSIVE firms

Dependent variable: Tobin's Q			
		Model 1	Model 3
Log(board size)	β_1	-0.211*** (-2.8)	-0.102* (-1.9)
Log(board size) * DIVERSE dummy	β_2	0.164** (2.4)	
Log(board size) * FIRMSIZE dummy	β_3	0.187*** (2.7)	
Log(board size) * DEBT dummy	β_4	0.081 (1.2)	
Log(board size) * COMPLEXITY dummy	β_5		0.286*** (4.3)
Insider fraction	β_6	-0.023 (-0.3)	0.052 (0.6)
Insider fraction * R&D dummy	β_7	0.524** (2.3)	0.518** (2.3)
Intercept, industry and year dummies, and additional controls		Yes	Yes
Observations		6786	6794
R ² (Pseudo R ²)		56%	55%
F-test		$\beta_1 + \beta_2 + \beta_3 + \beta_4$ = 0.221*** ($p < 0.01$)	$\beta_1 + \beta_5$ = 0.184*** ($p < 0.01$)
		$\beta_6 + \beta_7 = 0.501$ ($p = 0.02$)	$\beta_6 + \beta_7 = 0.570$ ($p = 0.01$)

W. P. CAREY
SCHOOL of BUSINESS

Table 9: Impact of COMPLEXITY on board size and outsiders

	Dependent variable: Log(board size)		Dependent variable: Log(outsiders)	
	Model 1	Model 3	Model 5	Model 7
DIVERSE dummy	0.017*** (2.7)		0.040*** (5.0)	
FIRMSIZE dummy	0.137*** (22.6)		0.172*** (22.8)	
DEBT dummy	0.026*** (4.1)		0.047*** (6.0)	
COMPLEXITY dummy		0.118*** (18.9)		0.163*** (20.9)
Control variables	Firm age, CEO age (+), CEO tenure, Risk (-), ROA, R&D, FCF, Intangible assets (~)			
Intercept, industry and year dummies	Yes	Yes	Yes	Yes
Observations	5827	5833	5824	5830
R ² (Pseudo R ²)	46%	44%	46%	44%

W. P. CAREY
SCHOOL of BUSINESS

Table 10: Impact of R&D-INTENSITY on insider fraction

	Dependent variable: Insider fraction	
	OLS: Model 1	Median: Model 2
R&D dummy	-0.015*** (-3.7)	-0.007 (-1.3)
Firm size	-0.011*** (-9.2)	-0.010*** (-6.0)
Leverage	-0.033*** (-3.2)	-0.030** (-2.3)
Log(firm age)	-0.008*** (-4.6)	-0.006** (-2.5)
Log(CEO age)	0.006*** (14.2)	0.073*** (4.7)
CEO ownership	0.006*** (14.2)	0.008*** (16.3)
Risk	0.005*** (3.5)	0.005*** (2.9)
Other control variables	ROA, CEO tenure, FCF, Intangible assets (-)	
Intercept, industry and year dummies	Yes	Yes
Observations	6510	6510
R ²	24%	14%

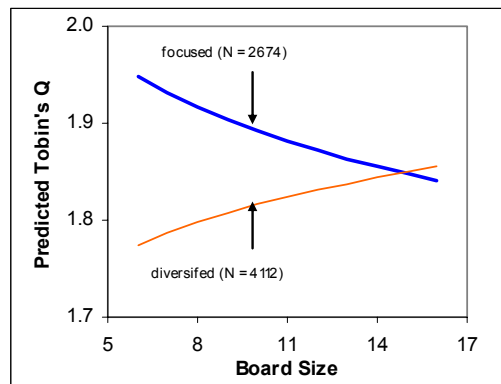
W. P. CAREY
SCHOOL of BUSINESS

Table 12: 3SLS results

	Tobin's Q	Log (board size)	Insider fraction	CEO ownership
Tobin's Q		0.459*** (16.7)	-10.952*** (-8.7)	0.440*** (2.6)
Log(board size)	β_1	-0.334 (-1.2)	0.696* (1.9)	
Log(board size) * COMPLEXITY dummy	β_2	1.280*** (5.7)		
Insider fraction	β_3	-7.988*** (-2.8)	-0.946*** (-11.4)	
Insider fraction * R&D dummy	β_4	7.860*** (3.2)		
COMPLEXITY dummy		-3.158*** (-6.0)	0.114*** (12.4)	
R&D dummy		-1.415*** (-2.6)	-0.196*** (-11.7)	4.755*** (8.4)
CEO ownership		0.120*** (3.8)		1.186*** (7.8)
Intercept, industry and year dummies, and other control variables	Yes	Yes	Yes	Yes
Observations	5790	5790	5790	5790
F-test for Tobin's Q regression		$\beta_1 + \beta_2 = 0.946^{***}$ ($p < 0.01$); $\beta_3 + \beta_4 = -0.128$ ($p = 0.79$)		

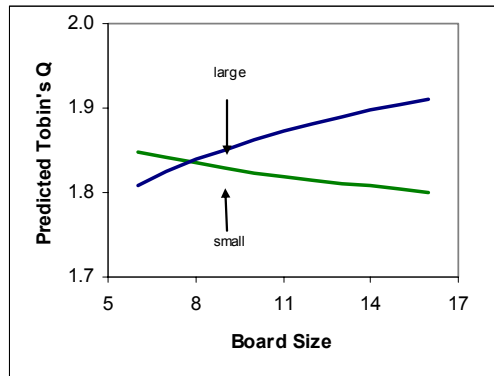
W. P. CAREY
SCHOOL of BUSINESS

In a Nutshell: Diversified Firms



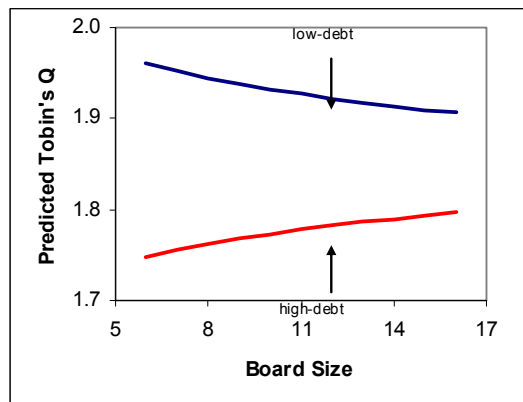
W. P. CAREY
SCHOOL of BUSINESS

Large Firms



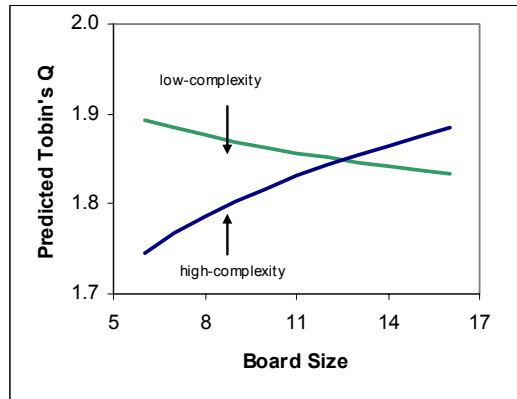
W. P. CAREY
SCHOOL of BUSINESS

Levered Firms



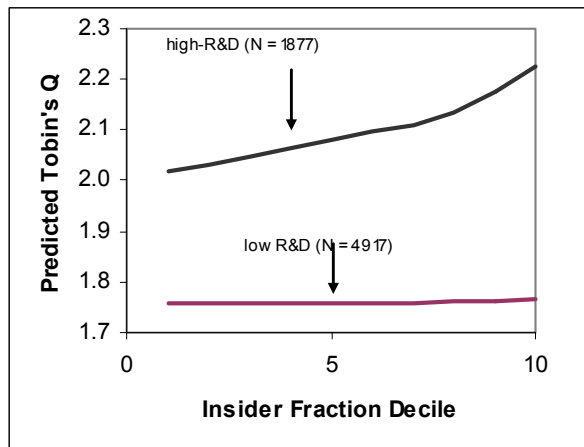
W. P. CAREY
SCHOOL of BUSINESS

Complex Firms



W. P. CAREY
SCHOOL of BUSINESS

R&D Intensive Firms



W. P. CAREY
SCHOOL of BUSINESS

Main results

- ◆ Tobin's Q increases in board size for **banks**, large, diversified, and high-debt firms and this relation is driven by outsiders
 - **Banks** and complex firms have larger boards, specifically more outsiders.
- ◆ Tobin's Q increases in insider fraction for R&D-intensive firms, but the opposite is true for **banks**.
- ◆ R&D-intensive firms have higher fraction of insiders (weaker evidence)

W. P. CAREY
SCHOOL of BUSINESS

Two Conclusions

- ◆ One size does not fit all:
 - restricting board size may hurt commercial banks;
 - requiring more outsiders on boards will hurt non-banks firms more than banks.
- ◆ Drive towards smaller, outsider-dominated boards may be misguided!

W. P. CAREY
SCHOOL of BUSINESS

Recap: Recent Evidence on Corporate Governance in Commercial Banks

- ◆ Corporate governance and control:
 - Definition
 - How it matters
 - How evidence typically is assembled (how to be an informed consumer of academic research on corporate governance)
 - Structure
 - Performance
 - Interesting questions

Recap: Recent Evidence on Corporate Governance in Commercial Banks

- ◆ Recent Research Developments:
 - board size and composition in **banks** (new)
 - board size and composition in other firms (Coles, Daniel, and Naveen, 2004)
- ◆ Should we pressure all firms, including **banks**, to have smaller more-independent boards? Probably not!



APPENDIX

Recent Evidence on Corporate Governance in Commercial Banks

Dr. Jeff Coles
Labriola Endowed Chair of Competitive Business
Professor of Finance
W. P. Carey School of Business
Arizona State University

May 20, 2004



APEC FINANCE and DEVELOPMENT PROGRAM

External Mechanisms

- ◆ The market for corporate control:
 - Extensively studied: General conclusion is that it is an important source of top management 'discipline' in the US (but perhaps one whose role is weakening);
 - Poorly performing firms are more likely to be acquired;
 - Bad bidders become good targets;

External Mechanisms

- ◆ **The market for corporate control (cont):**
 - Overall shareholder wealth effects are hugely positive; however, the gains go to target shareholders; bidder shareholders are lucky if they can break even;
 - Cash-based acquisitions do better than stock-based acquisitions both in the short run and long run;
 - Acquisitions of private targets are value-creating, public targets value-destroying;

External Mechanisms

- ◆ **The role of laws/regulation:**
 - Delaware incorporation improves firm value;
 - State-level stakeholder statutes have not amounted to much;
 - Adoption of antitakeover provisions has ambiguous shareholder wealth effects;
 - Firms in countries with less investor protection have lower value, higher cost of capital, use less external finance, are more prone to distress in situations of macroeconomic crises;

External Mechanisms

- ◆ The role of **laws/regulation** (cont):
 - Firms in civil law countries (esp. French civil law) have lower value, higher cost of capital, use less external finance, are more prone to distress in situations of macroeconomic crises;
 - There is 'convergence' in governance systems, but this convergence is one-way. Most major economies are converging to a US-styled governance system, but the the reverse is not happening (i.e., 'conversion', not convergence).

W. P. CAREY
SCHOOL of BUSINESS

External Mechanisms

- ◆ **Stakeholder/CSR orientation:**
 - Firms that 'do well' also 'do good;' there is no evidence of the reverse;
 - No credible evidence that improved corporate social responsibility adds to firm value;
 - Firms/markets in stakeholder-oriented systems of governance are not any *less* prone to corporate malfeasance, insider enrichment, or meltdowns;

W. P. CAREY
SCHOOL of BUSINESS

External Mechanisms

- ◆ **Stakeholder/CSR orientation (cont):**
 - Economies with predominantly stakeholder-oriented governance systems generally create less employment, have less-developed capital markets, have little or no market for entrepreneurial finance, and have less innovation/investment in growth industries of the future.

Internal Mechanisms of Governance

- ◆ **Top management compensation:**
 - The relationship between top management's performance-based pay and performance is essentially non-existent (although, it improved a bit in the 1990s compared to the 1980s); The evidence is similar in Germany and Japan;
 - There is no evidence, in particular, that stock options improve performance.
 - Golden parachutes have no shareholder wealth effects.

Internal Mechanisms

◆ Ownership and control:

- Evidence on impact of inside ownership is mixed: some 'reasonable' amount of inside ownership is good, but beyond a point, higher insider ownership is associated with lower firm value (i.e., suggests 'entrenchment');
- Blockholding or institutional ownership does not appear to matter much for firm performance in US;

Internal Mechanisms

◆ Ownership and control (cont):

- The evidence on blockholdings outside the US is different: the presence of blockholders and institutions leads to faster restructuring following poor performance in Japan and Germany.
- Shares with higher proportion of votes (e.g., 'A-class' shares) trade at a premium relative to inferior shares.

Internal Mechanisms

- ◆ **Ownership and control (cont):**
 - Pyramid structures and cross-holdings destroy value; Firms with such structures tend to overinvest, or tend to adopt risk-minimizing strategies;
 - However, such structures can lower the costs and time in financial distress.

Internal Mechanisms

- ◆ **Asset diversification:**
 - There is a diversification discount in the US: i.e., diversified firms are generally worth less than the sum of their parts;
 - However, there is opposite evidence outside the US, especially emerging markets.

Internal Mechanisms

◆ Board size and performance:

- Evidence on the association between proportion of outside directors and performance is ambiguous;
 - Yermack (1996) and others: Q declines in outsider fraction.
 - Outside director have a positive effect on discrete tasks:
 - ◆ Hiring/firing of CEO (Weisbach, 1988);
 - ◆ Negotiating takeover premiums (Byrd and Hickman (1992));

Internal Mechanisms

◆ Board size and performance:

- Evidence on the association between proportion of outside directors and performance is ambiguous;
 - Yermack (1996) and others: Q declines in outsider fraction.
- Board size is negatively related to firm performance and quality of decisions;
- Poor performance, CEO turnover are associated with changes in board composition;

Internal Mechanisms

- ◆ **Board composition and performance:**
 - Appointment of outsider as CEO is, on average, 'good news' for shareholders; (Similar evidence Germany and Japan);
 - Separating the role of CEO and Chairman has little impact in shareholder value in the US, but there is some contrary evidence in other countries (esp. the UK).

W. P. CAREY
SCHOOL of BUSINESS

Summary of Empirical Research on Governance

- ◆ The sum total of the evidence shows little convincing, credible, sustained relationship between specific elements of 'good' governance and improved firm performance.
- ◆ But remind me to tell you why the experiments are misguided.
- ◆ However, the evidence does indicate that poor governance practices are harmful to firms and economies.

W. P. CAREY
SCHOOL of BUSINESS

Board Composition and Value? The US Governance System

- ◆ Subsequently refined thru MBCA, and most recently, ALI principles:
 - “....corporation should have as its objective the conduct of business activities with a view to enhancing corporate profit and shareholder gain”
 - “....obliged to...act within boundaries set by law”
 -*may* take into account ethical considerations”
(*italics mine*)

W. P. CAREY
SCHOOL of BUSINESS

Key Duties/Obligations of Boards and Officers

- ◆ Fiduciary obligations set out in ALI principles
- ◆ Duty of care
 - The business judgment rule
- ◆ Duty of fair dealing (“loyalty”)
 - Disinterestedness
 - No conflicts-of-interest
 - No corporate ‘opportunity’
 - No competition with the corporation
- ◆ Special rules in takeovers, financial distress.

W. P. CAREY
SCHOOL of BUSINESS



DOC.NO.2-(09)-a

**Key Developments Arising,
including corporate governance issues**

Yasuo Kanzaki

Special Advisor, Nikko Citigroup Ltd.



Corporate Governance

To Protect Stakeholders' Interest

Yasuo Kanzaki
Nikko Citigroup Limited
May 21 2004



Management Responsibility

- Companies cannot survive unless they satisfy
 - Customers (offer goods and service)
 - The Society (be good citizen)
 - Employees (award to their work)
 - Banks (assure to service their debts)
 - Shareholders (return to their investment)
 - *Low ROE
 - *Return on Equity (Earnings/Equity)



Banks vs. Capital Markets

- Banks deal with a limited number of parties
- Secrecy
- Relationship
- Short term
- More regulated
- Capital market operate with many participants
- Transparency
- Market driven
- Long term
- Self responsibility



Governance

- Internal compliance
- Regulator and Supervisor
- Creditors
- Auditors
- Outside board members
- Shareholders
- CSR (Corporate Social Responsibility)



Revised Commercial Code

- Enhance more efficiency
(Limit number of board and divided function of directors)
- Strengthen compliance and control power
(Invite outside board member and set up audit committee)
- Respect shareholders' rights
(Improve transparency for nomination of directors)



Strengthen Accounting and Auditing System

- Converge Japanese accounting standard to International accounting standard
- Auditing system has been revised
- Auditing Oversight Board was established
- Disclosure system was strengthened



Main Objective of ASBJ

- Developing Japanese accounting standards
- Contributing to development of IFRS
- Interaction between IFRS and Japanese GAAP improves the quality of both standards
- That is the process of “Convergence”



Conflict Between IFRS & JGAAP

- Major concerns
 - Performance reporting,
 - Elimination of net income ?
 - Financial Instruments
 - Fair value option
- Substance is important but not a date



Bush's Ten Point Plan

- The duty of Corporate Leaders
- Better Information for Investors
- Making Corporate Officers Accountable
- Criminal Penalty to Abuse
- Developing a Stronger, More Independent Audit System



Sarbanes-Oxley Act of 2002

- Establishment of Public Company Accounting Oversight Board
- Board inspects accounting firms and impose appropriate sanction on misconducts
- Lead auditor must rotate off of the audit every 5 years
- CEO and CFO must certify the appropriateness of the financial statements and fairness of disclosure
- Violation of those rise to liability



US vs. Japanese Practice

■ US

- Short term oriented
- High incentive
- Efficient
- Active shareholders
- Individualism
- Lack of fairness

■ Japan

- Long term oriented
- Moderate incentive
- Inefficient
- Less active
- Conformity
- Social responsibility

Slide 2 Management Responsibility

- Companies cannot survive unless they satisfy
 - Customers (offer goods and service)
 - The Society (be good citizen)
 - Employees (award to their work)
 - Banks (assure to service their debts)
 - Shareholders (return to their investment)

Slide 3 Banks vs. Capital Markets

Banks deal with a	Capital markets
limited number of	operate with many
parties	participants
Secrecy	Transparency
Relationship	Market driven
Short-term	Long-term
More regulated	Self responsibility

Slide 4 Governance

- Internal compliance
- Outside board members
- Regulator and Supervisor
- Auditors
- Creditors
- Shareholders

Slide 5 Revised Commercial Code

- Enhance more efficiency
(Limit number of board and divided function of directors)
- Strengthen compliance and control power
(Invite outside board member and set up audit committee)
- Respect shareholders' rights
(Improve transparency for nomination of directors)

Slide 6 Strengthen Accounting and Auditing System

- Converge Japanese accounting standard to IRAS
- Auditing system has been revised
- Auditing Oversight Board was established
- Disclosure system was strengthened

Slide 7 Main Objective of ASBJ

- Developing Japanese accounting standards
- Contributing to development of IFRS
- Interaction between IFRS and Japanese GAAP improves the quality of both standards
- That is the process of “Convergence”

Slide 8 Conflict Between IFRS & JGAAP

- Major concerns

Performance reporting,

Elimination of net income ?

Financial Instruments Fair value option

- Substance is important but not a date

Slide 9 Bush’ s Ten Point Plan

- The duty of Corporate Leaders
- Better Information for Investors
- Making Corporate Officers Accountable
- Criminal Penalty to Abuse
- Developing a Stronger, More Independent Audit System
- Bush stated that CEO, in particular, has a duty to oversee the entire firm on a full-time basis. CEO’s should personally vouch for the veracity, timeliness, and fairness of their companies’ public disclosures including their financial statements. CEOs would personally attest each quarter that the financial statements and company disclosures accurately and fairly disclose the information of which the CEO is aware that a reasonable investor should have to make an informed investment decision. CEO’s typically sign only a bare-bones certification regarding the annual financial statements.

Slide 10 Sarbanes-Oxley Act of 2002

- Establishment of Public Company Accounting Oversight Board
- Board inspects accounting firms and impose appropriate sanction on misconducts
- Lead auditor must rotate off of the audit every 5 years
- CEO and CFO must certify the appropriateness of the financial statements and fairness of disclosure
- Violation of those rise to liability

Slide 11 US vs. Japanese Practice

Short term oriented

Long term oriented

High incentive

Moderate incentive

Efficient

Inefficient

Active shareholders

Less active

Individualism

Conformity

Lack of fairness

Social responsibility



Yasuo Kanzaki

Special Advisor of Nikko Citigroup Limited

Education: Graduated Waseda University in 1955,
Bachelor Degree in Political Science

Career:

He joined the Nikko Securities Co., Ltd. in 1955 and spent most of time on international finance business in Tokyo, New York and London. With the Nikko Securities Co., Ltd he was appointed as Member of the Board in 1980, Managing Director in 1982, Senior Managing Director in 1985, and Executive Vice President in 1986. He then served Chairman of the Nikko Research Center, Ltd. He is now Senior Advisor of Nikko Citigroup Limited (formerly Nikko Salomon Smith Barney Limited).

Other assignments:

Advisor of Nikko Cordial Corporation (formerly The Nikko Securities Co., Ltd.)
Trustee of KEIZAI DOYUKAI (Japan Association of Corporate Executives)
Director of Japan Fund Inc.
Advisor of Nippon GMC Commercial Mortgage
ABAC (APEC Business Advisory Council) Member



DOC.NO.2-(10)-a

International Accounting Standards for Insurance Contracts

Bruce Cameron

PricewaterhouseCoopers, China

International Financial Reporting Standards for Insurance Contracts

David Knox & Bruce Cameron



Overview

IFRS 4 – the background



- The International Accounting Standards Board began the insurance contracts project in 1997, resulting in the release of a Draft Statement of Position (DSOP) in 1999.
- In May 2002, the IASB split the Insurance Contracts Project into two phases due to the complexity of recognition and measurement issues.
- IFRS 4, the result of Phase I, is a “bridge” that provides a standard for insurance contracts until Phase II is completed.
- Insurance contracts does NOT equal products from insurance companies

IFRS 4 – overview



- Key elements of IFRS 4:
 - provides a definition for insurance contracts - intended to survive Phase II;
 - requires new disclosure
 - allows companies to apply current local accounting principles for insurance contracts;
 - non-insurance contracts will primarily be accounted for as investment contracts or contingencies;
 - eliminates certain accounting practices that are deemed to be inappropriate;
 - requires loss recognition testing and the establishment of loss recognition reserves.

The Longer Term Picture



- Insurance contracts are different, even exempt from the rest of the IFRS hierarchy
- IFRS 4 – Phase 1
 - Phase 1 is the initial phase with limited improvements, but
 - New definitions and new disclosure requirements
- Phase 2 work will commence in May 2004 for 2 years
 - The new standards may be seen in 2008 or 2009
 - They will be very significant

Definition of insurance contract



IFRS 4 defines an insurance contract as *'contract under which one party (the **insurer**) accepts significant insurance risk from another party (the **policyholder**) by agreeing to compensate the policyholder if a specified uncertain future event (the **insured event**) adversely affects the policyholder.'*

- Most insurance contracts under US GAAP are expected to fall within this definition.

What is significant insurance risk?



*'Insurance risk is significant if, and only if, an insured event could cause an insurer to pay **significant additional benefits** in any scenario, other than a scenario that lacks commercial substance. This condition may be met even if the insured event is extremely unlikely or if the present value of the contingent cash flows is a small proportion of the expected (i.e. probability-weighted) present value of all the contractual cash flows.'*

This definition is not necessarily consistent with the measure of "significant" applied in practice in the US.

What is significant insurance risk?



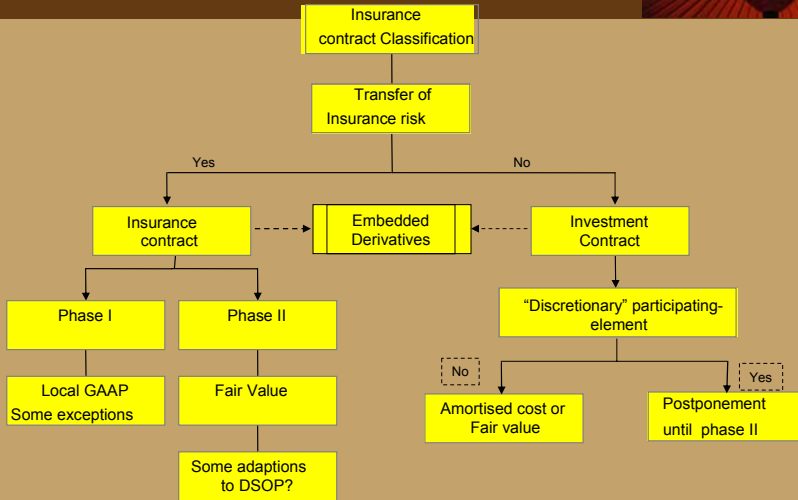
- Additional benefits include:
 - claims handling and
 - claims assessment costs.
- Exclude:
 - loss of the ability to charge future fees;
 - surrender penalties and market value adjusters;
 - possible reinsurance recoveries e.g. financial reinsurance.
 - ??contracts with high deductibles – primarily a claims admin
- Commercial substance:
 - pricing;
 - marketing.
- No guidance on amount of insurance risk provided.

What is significant insurance risk?

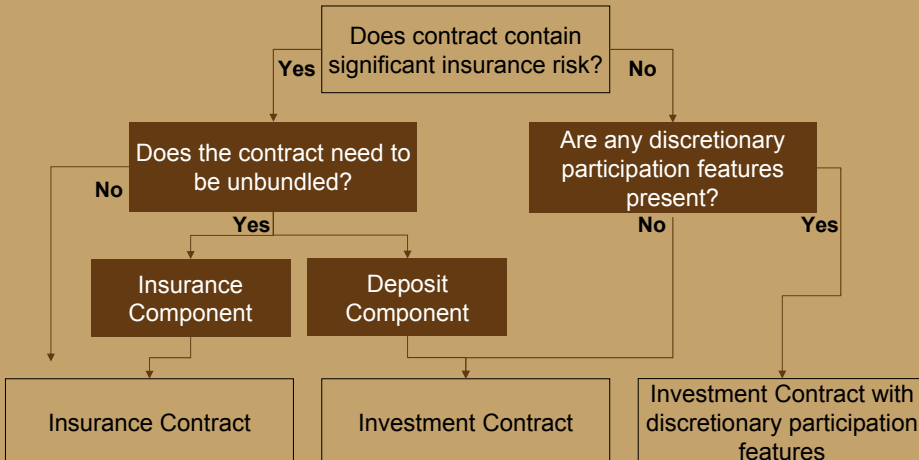


- Insurance risk evaluated at inception of contract.
- Changes in level of risk e.g., Universal life contracts.
- Survival risk is an insured risk.
- Annuity options:
 - not insurance contract if issue price at annuity current rates when option is exercised;
 - insurance if annuity rates guaranteed at inception if there is a reasonable expectation that the option will be exercised.
- Once insurance always insurance.

Product classification



Investment Contracts



Unbundling of deposit components



IFRS 4 states:

- Unbundling is required if both the following conditions are met:
 - i. the insurer can measure the deposit component separately;
 - ii. the insurer's accounting policies do not otherwise require it to recognize all obligations and rights arising from the deposit component.
- Unbundling is permitted, but not required, if insurers can measure deposit component separately but accounting policy require recognition of an obligation and rights of deposit component.
- Unbundling prohibited if cannot measure deposit component separately.

Examples of insurance contracts



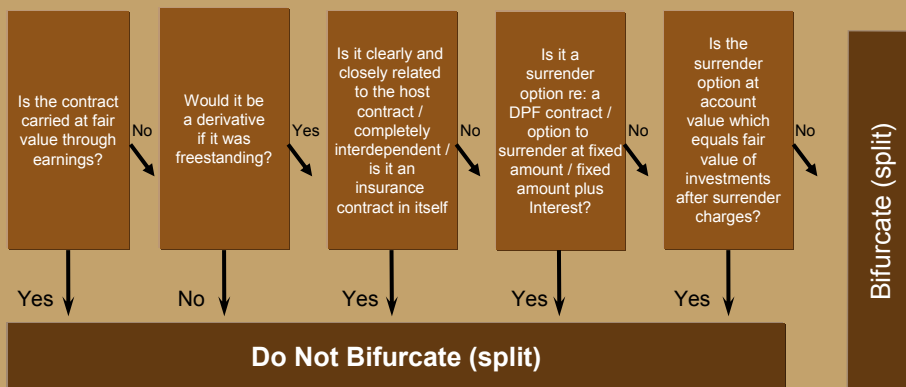
- General insurance contracts such as insurance against theft, product liability.
- Life insurance and prepaid funeral plans.
- Life-contingent annuities and pensions.
- Disability and medical cover.
- Credit insurance (pending exposure draft).
- Deferred annuity: policyholder will receive, or can elect to receive, a life contingent annuity at rates guaranteed at inception.
- Reinsurance policy with regards to lapse risk on life insurance policies/ investment policies.

Examples of contracts that are not insurance



- Investment contracts that have the legal form of an insurance contract but do not expose the insurer to significant insurance risk.
- Contracts that have the legal form of insurance, but pass all significant insurance risk back to the policyholder through mechanisms that adjust future payments by the policyholder as a direct result of insured losses.
- Self-insurance, such as captive reinsurance.
- Financial guarantee providing for payments in response to changes in specified interest rate, security price etc.

Embedded derivatives – overview of identification



Embedded derivatives



- Must be an embedded derivative.
- Must not be an insurance contract in itself.
- Separate if surrender option varies in response to change in equity or commodity price or index and entire contract is not at fair value with changes in fair value recorded in profit & loss.

Some exceptions:

- Is the option to surrender at a fixed amount / fixed amount plus interest?
- Embedded derivative and insurance contract completely interdependent.

Embedded derivatives



Summary:

- Separate if surrender option varies in response to change in equity or commodity price or index and entire contract is not at fair value with changes in fair value recorded in profit & loss.

Examples from implementation guidance



- Death benefit linked to equity prices or equity index, payable only on death or annuitisation and not on surrender or maturity. (no split – insurance)
- Embedded guarantee of minimum interest rates in determining surrender or maturity values: in the money on issue:
 - no leverage (no split);
 - leverage (split).

Examples from implementation guidance



- Embedded guarantee of minimum equity returns on surrender or maturity (split).
- Equity-linked return available on surrender or maturity (split).
- Embedded guarantee of minimum equity returns that is available only if the policyholder elects to take a life-contingent annuity (no split).

Discretionary participating features



Discretionary participation features arise where a contract can receive (in addition to guaranteed minimum payments) additional payments:

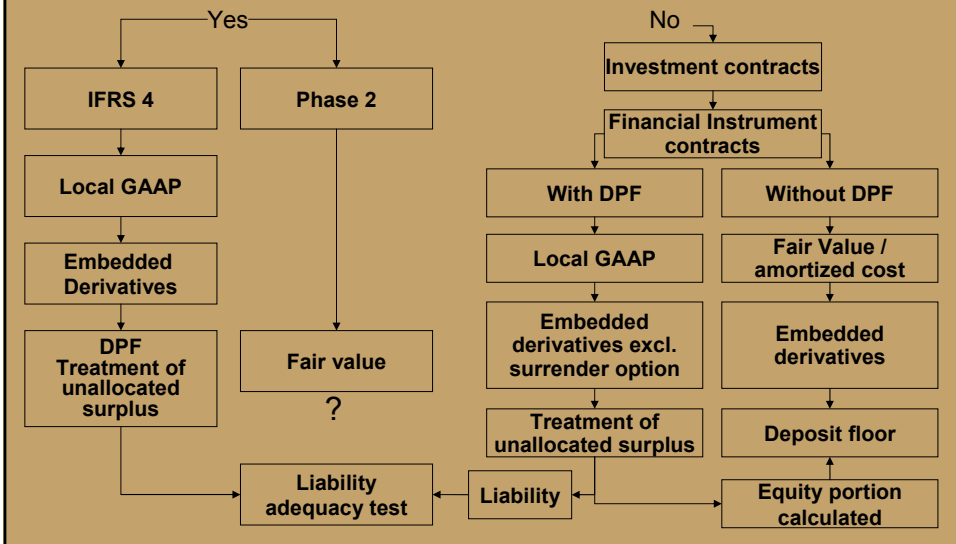
- likely to be a significant proportion of total contractual payments;
- amount and timing is contractually at the discretion of the issuer;
- contractually based on:
 - profit/loss of the issuer;
 - performance of a specified pool of contracts;
 - realized or unrealized gains/losses on a specified pool of assets.

Consequences



- Insurers will need to set clear, consistent and justifiable approaches to classify products
- Systems and company wide accounting procedures will need to accommodate them
- Never too early to consider classification

Product classification – significant risk?



Accounting for insurance contracts



- Continue local GAAP.
- Provides exemption from IASB Framework with respect to accounting changes.
- Carry out liability adequacy test, including the impact of any options or guarantees – next slide
- No liability for possible future claims with regards to future contracts.
- No offsetting or de-recognition prior to discharge, cancellation or expiration of contracts.

Accounting for insurance contracts



- Liability adequacy test:
 - current estimates of future (contractual) cash flows;
 - compare to liability less related DAC;
 - if current policy meets requirements – no additional test;
 - if not use Contingency and Provisions standard (IAS 37).

Change in accounting policies



- Changes in accounting policies:
 - only if financial statements will be more relevant and reliable (IAS 8 criteria).
- Permitted but not required, to move interest rates used to calculate p/h liabilities on insurance contracts to current rates:
 - not required for all liabilities: key concession from IAS 8;
 - no guidance on what are 'current interest rates;'
 - will allow estimation techniques.

Change in accounting policies



- May continue but not introduce:
 - measuring liabilities on undiscounted basis;
 - measuring contracted rights to future investment management fees at value > fair value;
 - using non-uniform accounting policies for the insurance liabilities of subsidiaries;
 - excessive prudence.

Asset-liability mismatch



Problem in Phase 1

- Assets – at market or fair value
- Liabilities – local GAAP

Issue:

- Insurers find Held-To-Maturity too restrictive and therefore will use either Trading or Available-for-Sale ('AFS').
- However, many insurance liabilities on a local basis are on a form of amortized cost.
- The use of AFS solves P/L mismatch; however, the mismatch still exists in equity.

Asset-liability mismatch



IFRS 4 options - Likely Impact:

- **Unlocking of interest rates:** Even though insurers argued previously that unlocking interest rates was too difficult, many may now investigate seriously:
 - may have significant impact on opening p/h liability balances;
 - must work through administrative and audit issues.
- **Shadow Accounting:** Many may find it too much work for no P/L impact. US registrants more likely to use as it is required under US GAAP.

Insurance contracts with Discretionary Participation Features



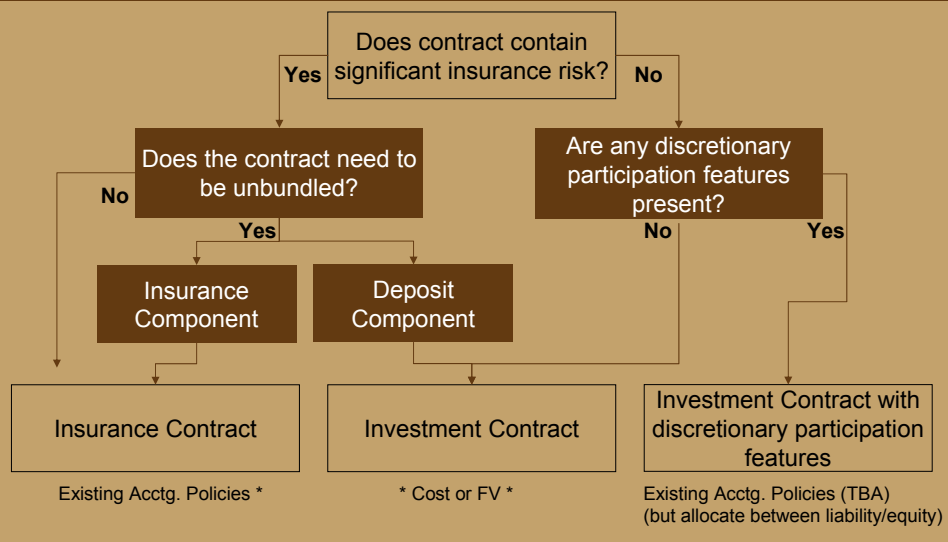
- May report the guaranteed element separately from the DPF.
- Choice of treatment of unallocated surplus.
- Must apply IAS 39 to in-scope embedded derivatives (with specific exemption for DPF surrender options).
- In other respects similar to all insurance contracts (i.e. continue existing policies subject to loss recognition etc.).

Investment contracts with Discretionary Participation Features



- In addition, the liability recognized must not be less than the measurement IAS 39 would apply to the fixed (or guaranteed) element.
- If insurance company presents investment contracts with DPF as liabilities:
 - premiums can continue to be presented as revenues;
 - show increase in liability as expense;
 - if accounted for investment contracts at amortized cost per IAS 32 fair value still has to be disclosed;
 - if fair value cannot be measured reliably then certain disclosures of reasons and (if possible) ranges of estimates should be given.

Investment Contracts



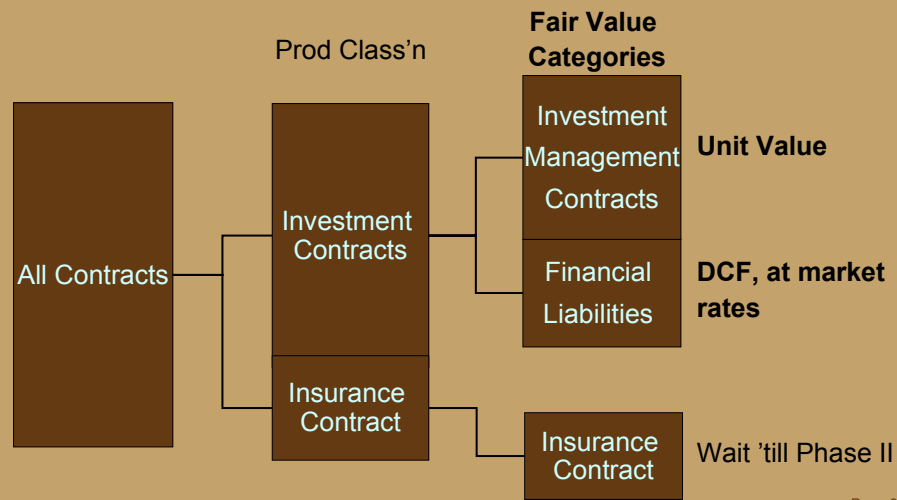
Unbundling



- An insurance contract can contain both
 - Deposit, and
 - Insurance components
- Eg a reinsurance contract
- Such contracts need to be split and valued separately
- However, if the rights and obligations are already recognised (eg a maturity value), there is no need to value them separately.
- Therefore need to review policies

Investment Contracts – Fair Value

Investment Contracts IAS 39 – Fair Value



Background



For investment contracts, two types of “DAC” possible:

- **IAS 39** – Netted in the effective yield calculation:
 - not recorded if liability is recorded at fair value.
- **IAS 18 “DAC”** – Costs expended to receive investment management margins in the future:
 - recorded even if liability is at fair value!
 - in this instance, think of DAC as separate from liability valuation!

Effects of IFRS 4 on non-life insurance



- Non-life insurance financial statements are also affected in the following ways:
 - catastrophe or equalisation provisions cancelled;
 - cannot establish new accounting policies measuring insurance liabilities on undiscounted basis or with ‘excessive prudence;’
 - requirement for loss recognition tests;
 - derecognise insurance liability only when extinguished;
 - claims development disclosures.

Catastrophe or equalisation provisions cancelled



- Insurance company shall not recognise as a liability any catastrophe provisions relating to possible future claims under future insurance contracts.
- Examples:
 - nuclear insurance – pools currently build up insurance reserves over years without claim;
 - property insurance – ‘bad weather reserve;’
 - equalisation reserve for motor insurance – Eastern Europe;
 - credit insurance – equalisation reserve (EU requirement);
 - terror risk reserve – in Israeli life assurance.

Alternative treatment of such reserves



- Insurance companies can include catastrophe reserve as a separate element of equity with movement in reserve going through statement of changes in shareholders' equity.

Excessive prudence

Addresses overestimates of insurance liabilities



Basis for conclusions:

- Insurers sometimes measure insurance liabilities on what is intended to be a highly prudent basis that lacks the neutrality required by the framework.
- Excessive prudence is not defined so theoretically cannot be eliminated.
- Sufficient prudence is deemed appropriate.
- IFRS 4 does not permit an insurer to adopt a new accounting policy that creates or increases excessive prudence.

Liability Adequacy Tests

Addresses underestimates of insurance liabilities



- At each reporting date carry out loss recognition test using current estimates of future cash flows under insurance contracts:
 - carrying amount of insurance liabilities
 - less deferred acquisition costs
 - less intangible assets (arising in acquisition / transfer)
 - less current estimate of discounted cash flows
= proven sufficiency;
 - otherwise premium deficiency reserve (add to UPR);
 - this should be done per line of business/portfolio

Claims development



- IFRS 4 – go back to period in which earliest material claim still outstanding arose, but no more than 10 years.
- When adopt IFRS do not present more than 5 years.
- Disclosure made in financial statements.

Definition of Reinsurance Contract



- An Insurance Contract issued by one insurer (the reinsurer) to compensate another insurer (the cedant) for losses on one or more contracts issued by the cedant.
- Insurance Contract => “significant insurance risk.”

Unbundling of deposit components of reinsurance contracts



IFRS 4:

- Unbundling is required if both the following conditions are met:
 - i. the insurer can measure the deposit component separately;
 - ii. the insurer's accounting policies do not otherwise require it to recognize all obligations and rights arising from the deposit component.
- Unbundling is permitted, but not required, if insurers can measure deposit component separately but accounting policy require recognition of an obligation and rights of deposit component.
- Unbundling prohibited if cannot measure deposit component separately.

Accounting for Reinsurance Contracts



- No distinction between prospective and retroactive coverages.
- Can recognize immediate gain when consideration paid is less than benefit gained.
 - cedant must disclose amounts.

Disclosures - Principle 1



- Principle 1 – An insurer shall disclose information **that identifies and explains the insurance-contract-related amounts** reported in the balance sheet, income statement and cash flow statement.
 - Accounting policies
 - Key amounts
 - Significant assumptions
 - Changes in amounts & assumptions

Disclosures - Principle 2



- Principle 2 – An insurer shall disclose information that helps users **understand the estimated amount, timing and uncertainty of future cash flows** from insurance contracts, (i.e. extensive risk management disclosure).
 - Compliance will be subjective
 - Considerable flexibility – insurers can ‘select’ emphasis
 - But significant implementation issue
- Terms & conditions; insurer’s objectives; insurance risk; interest & credit risk

Amount of disclosure

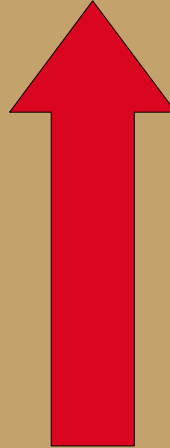


More work, practical constraints

More disclosure

Compliance issues; risks of future events indicating disclosure insufficient

Less disclosure



Disclosures

Significant Disclosures



- Actual changes in financial results for changes in key assumptions during the period.
- Sensitivity of reported IFRS net income and equity for changes in all variables that have a material impact, e.g., interest rates, equity markets, mortality, persistency.
 - These requirements demand a strong understanding of the entity's risk profile, in an economic and accounting sense. Surprises in these disclosures could open the door to lawsuits...
- These IFRS disclosures will be in the financial statements and covered by the audit opinion!

Significant Disclosures



- Loss Development Tables (P/C) – changes in claims estimates over time:
 - if underwriting year basis is chosen, then amounts will not tie to financial statements. However, phase II is likely to use underwriting year...
- Extensive information on how the insurer manages financial risk (qualitative and quantitative):

Phase 2 – What has the IASB said so far?



- Everything to be revised....
- Restart in May 2004:
 - knowledge book;
 - festival of accounting;
 - roundtable discussions and field visit;
 - specialized task force;
 - Insurance Advisory Committee retained;
 - presentations to Board.
- The aim is for an exposure draft by June 2006.

What has the IASB said so far? (continued)



- Basic approach: Asset/Liability for contractual rights and obligations at fair value rather than deferral (but DAC Asset is acceptable under IAS 18).
- Cash flows:
 - discounted (implied by fair value);
 - to include risk margins (as used by market)(implied by fair value);
 - no investment spreads (implied by fair value) so risk free discount rate..
 - ... plus Creditworthiness adjustment (implied by fair value);
 - contractual cash flows if ability to re-price significantly constrained, and
 - ... the policyholder rights to a restricted price must lapse with policy.
- Assumptions: not weaker than those for new policyholder on identical terms.
- Initial profit recognition: no net gain at outset.

What has the IASB NOT said so far?



- Margins recognised if consistent with contractual cash flows?
- Administration costs included?
- Par plans: Policyholder dividends as declared + constructive obligations? Equity or Liability?
- Options and guarantees?
- Unbundling?

Fair Value of Insurance Assets and Liabilities



- Disclosure of fair values at year-end 2006 have been deferred.
- IASB realised impracticability and took on board responses to ED 5.

Observation:

The deferral appears to indicate that the Phase II exposure draft (including principles on calculation of fair value of insurance liabilities and insurance assets) will not be ready on time.

Phase 2 probabilities



- Measure contractual rights and obligations from insurance contracts
- Discounted at rate that does not take into account expected return on assets
- Adjust for margin for risk and mark up demanded by market
- Not be less than premium entity would charge to accept new contracts for the unexpired period

P/C Loss Reserves



- Active trading markets for loss reserves do not exist.
- Fair value measurement would likely be based on models using market concepts:
 - undiscounted estimate of future payments;
 - discounted for time value of money, plus
 - margin for risk and uncertainty (“Market Value Margin” or “MVM”).

P/C Loss Reserves



Assessment of P/C Actuarial Methods

Estimating undiscounted reserves:	GOOD
Discounting estimated future payments:	GOOD
Estimating market value margins*:	DEVELOPING
Calibration of MVM methods**:	EMERGING

Practical Issues:

- * MVM's are not additive, and therefore, consolidation issues exist.
- * Small companies' effect?
- ** How many standard deviations? Which percentile of a distribution?

Lessons Learned



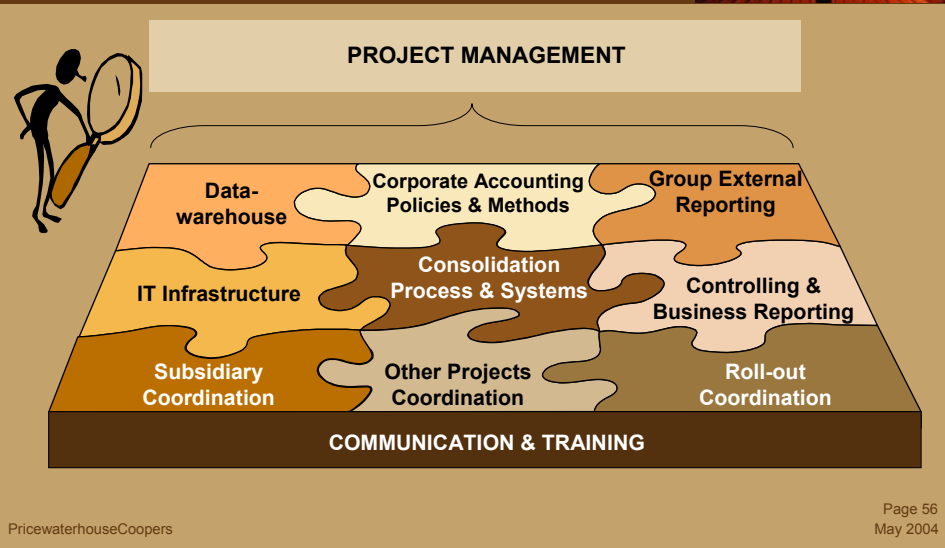
An update of what we are seeing in European IFRS conversion projects...

Reach of Issues



- Difficult to grasp the difference between a change in a primary basis of accounting versus a secondary...
- Impacts abound:
 - Internal Reporting: IFRS-based Strategic Plans; Product Profitability; changes to KPI's?
 - Other departments affected: IT; Actuarial; Tax; Regulatory (may replace regulatory basis in some territories); Financial Risk Management/ALM; Treasury; M&A...

Putting it all together...



Resource Issues



- Has become a major issue in Europe
- Lack of fully-dedicated resources, companies finally believing that the project is complex and staffing up ...
- Difficult to find IFRS proficient resources for implementation project...
- Training of operational people that will work with IFRS everyday...
- Training of Audit Committee and other exec's...

Getting Past the Technical Stuff...



- Many projects currently struggling with the “doing” stage.
- It’s easy to write accounting technical papers, easy to set deadlines and begin the process to prepare IFRS numbers, but thereafter the going gets tough...
 - technical issues that require more than technicians...
 - modelling, Data Gaps, Systems, Journal Entries, Chart of Accounts and other sundry issues that Parent Co’s do not fully appreciate...
 - those that ignore these issues will likely experience ‘*excel hell*’ post-implementation and will need start a new project to ‘embed’...

Lessons Learned



Moving forward while the IASB doesn’t...

- Companies that prepared early did not find it a “waste of time”, e.g., product classification...
- Takes time to appreciate that “similar” is not the “same”
 - “The devil is in the details...”
- New issues are being found every day – the ‘Wild West’...
 - IFRS is principles-based, “Guides” will not be issued...

Top 15 Implementation Issues



- Shareholder and analyst understanding.
- Understanding/analysing impact on financial performance.
- Managing and understanding volatility.
- Commitment and involvement at all levels of the organisation, including the Board.
- Significant resources required.
- Underestimation of the amount of work involved.
- Competing priorities.
- Costly/time consuming to embed into the organisation.

Top 15 Implementation Issues



- Data availability and system requirements.
- Re-alignment of management information reporting/systems.
- Interpreting and applying the “principles.”
- Minimal expertise within the organization.
- Training (“Knowledge transfer”) of management as well as finance functions in all locations.
- Multiple reporting bases.
- Moving Target – finalization of options and issues within the IASB’s proposed standard(s).

Conclusions



- IFRS will transform the way analysts, investors and other key stakeholders judge value and performance
- Insurers are concerned about volatility but it is coming
- IFRS 4 provides companies with considerable flexibility, but...
- It involves a lot of work!



**Bruce Cameron - Director
PricewaterhouseCoopers China**

Bruce Cameron is a Director in the Shanghai actuarial practice. He has over 24 years experience in the insurance industry .

Bruce has been involved in the full range of corporate actuarial activities with leading Australian and Asian insurance companies.

Recent Experience includes:

- IPO preparations, including Appraisal value calculation, Statutory and IAS confirmation for several top Chinese life insurers.
- Actuarial due diligence for investors seeking to buy insurers in Hong Kong, China, Chinese Taipei and Sri Lanka
- USGAAP conversion for leading Chinese life insurers.
- New entrant study for life insurers in China, including product design, profitability and business plan preparation.
- Appraisal valuations and capital forecast requirements for State owned Chinese reinsurance company.
- Regular audit work for a number of Chinese insurers.
- Pension liability calculation, both IAS and USGAAP basis for Chinese operations
- Advice and presentations to the Chinese regulatory authorities on product design and financial management.

Tel: +86 (21) 6386 3388

Email: bruce.cameron@cn.pwc.com



DOC.NO.2-(11)

Issues in Implementation - an industry perspective

Nigel Hazell

Regional Director, Finance and Operations, CMG Asia

International Accounting Standards

Implications for the Life Insurance Businesses of the Commonwealth Bank Group

-1-

Life Businesses in the Group

Australia

New Zealand

Hong Kong

Fiji

China

Vietnam

Indonesia

-2-

For each business, accounts required for:

- local reporting (usually year ending 31/12)
- group consolidated reporting (year ending 30/6)

-3-

Accounting Boards adopting IAS

- to different extents
- in different ways
- at different times

-4-

Impacted Areas for life insurers

- Valuation of Investments (IAS 39)
- Valuation of Policy Liabilities (IFRS 4, IAS 39)
- Other

-5-

Valuation of Investments

Requirement

- Categorisation of assets as:
 - available for sale (AFS)
 - traded
 - held-to-trade maturity
- P& L to reflect realised gains/losses of AFS, plus gains/losses (realised or not) of traded assets.
- Equity to reflect unrealised gains/losses of AFS.
- Derivatives to be recognised on-balance sheet and measured at fair value.

Actions

- Decisions required on strategy for each asset type, in order to categorise.
- Market value or financial modelling of derivatives.

-6-

Valuation of Policy Liabilities

Requirement

- Categorisation of life business into insurance and investment contracts.
- Investment contracts accounted for under IAS 39.
- (No change yet for “insurance contracts”)

-7-

Valuation of Policy Liabilities - Categorisation

Insurance Contract involves “significant insurance risk”

- Separate treatment of riders and basic plans.
- Extraction of investment element from insurance contract if cash flows independent.

-8-

Valuation of Policy Liabilities - Treatment of Investment Contracts

Implications

- DAC, adopting “variable” acquisition costs.
- Use of surrender value as a valuation floor.
- Valuation of guarantees and options (“embedded derivatives”).

Solution

- Use of actuarial modelling, and stochastic modelling for guarantees and options.

-9-

Other Implications for Life Insurers

- Unit Pricing
- Loan Impairment Provisioning
- Goodwill

-10-

Unit Pricing

Requirement

- Assets to be accounted for under IAS 39 (i.e. fair value or amortised on effective yield basis). Potential valuation changes for interest rate swaps etc.

Implications

- Potential jump in unit price at transition \Rightarrow arbitrage risk.

Possible Solutions

- Change in trust deed to immunise against IAS.
- Amortise price jump over several years.

-11-

Loan Impairment Provisioning

Requirement

- Provisioning to be on "incurred loss" basis (not expectations of future losses).

Actions

- Change in provisions.
- Investigate scope for IBNR provisions.

-12-

Goodwill

Requirement

- Goodwill from acquisitions no longer amortised. Subjected to annual impairment testing instead.

Actions

- Annual impairment testing of goodwill.

-13-

Non-Financial Impacts

- Differences between accounts in:
 - published financial statements
 - statutory returns to regulator

⇒ could impact dividend policy.....
.....and timing of surpluses / PVFP??
- Inter-relationship with Sarbannes-Oxley.
- Investor Relations.

-14-

Phase II is the big one

-15-



DOC.NO.2-(12)

**Compliance, Business Ethics and Corporate Governance in
Financial Institutions**

Juliet McKee

NZPECC Finance Forum Convenor



APEC FINANCE AND DEVELOPMENT PROGRAM

Workshop on Strengthening Corporate Governance in Financial Institutions

19 - 22 May 2004

Shanghai National Accounting Institute¹
Shanghai
P.R. China

Juliet McKee NZ PECC



Compliance, Business Ethics and Corporate Governance in Financial Institutions

Juliet McKee

Saturday 22nd May 2004: 0900hrs – 1015hrs

2

Juliet McKee NZ PECC



A Journey not a Destination

Mervyn King SC

3

Juliet McKee NZ PECC



Compliance versus Performance

4

Juliet McKee NZ PECC



Corporate Governance Culture

- **Trust,**
- **Integrity**
- **Intellectual honesty**

- **Common law duties of**
 - **Good Faith,**
 - **Diligence,**
 - **Care**
 - **Skill**

5

Juliet McKee NZ PECC



**How do we build a climate
in our community with
a respect for the intent of the law ?**

6

Juliet McKee NZ PECC



The fundamental requirement is a framework of sensible, practical, fair legislation and regulatory frameworks, within a community which respects the law and its intent.

7

Juliet McKee NZ PECC



Ethics is what we do because it is “right”

But:

**Different family backgrounds
Different schooling
Different religions**

8

Juliet McKee NZ PECC



Ethics are principles and these principles are articulated through many avenues to work harmoniously together

9

Juliet McKee NZ PECC



Strong ethics fosters a sense of competency and creates confidence in all stakeholders

10

Juliet McKee NZ PECC



???

- **Violations of governmental regulations**
- **Accounting irregularities**
- **Fraud**
- **Falsification or destruction of company records**
- **Workplace violence**
- **Use of assets for private profit**
- **Discrimination**
- **Sexual harassment**
- **Conflicts of interest**
- **Release of proprietary information**

11

Juliet McKee NZ PECC



Whistle blowers

- **The Protected Disclosures Act 2000, NZ**
- **Hotline**
- **Chairman of the Audit Committee**

12

Juliet McKee NZ PECC



- **Who sets the moral rules?**
- **Who approves the Chairman's expenses?**
- **Was there a clear Business Expenditure policy?**
- **Were the Delegations of Authority agreed and understood?**

13

Juliet McKee NZ PECC



Nurture a culture of

- **Respect**
- **Integrity**
- **Trust**
- **Intellectual Honesty**

14

Juliet McKee NZ PECC



Directors must be

- **Diligent**
- **Aware of Their Duties**
- **Act in Good Faith**
- **At All Times, in the Interests of the Company**

15

Juliet McKee NZ PECC



The flow of information must be timely and accurate.

16

Juliet McKee NZ PECC



- **Rational decisions**
- **A culture of trust**
- **Social responsibility**
- **Boardroom confidentiality**
- **Collective responsibility**

17

Juliet McKee NZ PECC



The Board has collective authority but we must always remember that directors have individual responsibility and liability.

18

Juliet McKee NZ PECC



- **Does the law reflect existing values or does the law lead the way in creating an ethical framework?**
- **Will more legislation and regulations prevent corporate fraud, conflict of interest, and poor business judgment?**
- **How do we find the balance?**

19

Juliet McKee NZ PECC



No legislation will replace the basic requirement for strong business ethics, intellectual honesty and integrity in the boardroom.

20

Juliet McKee NZ PECC



Regulations regarding financial disclosure create expectations of fair and transparent dealings.

21

Juliet McKee NZ PECC



Decisions

- **More law, or, less law**
- **Highly prescriptive law, or less prescriptive law.**

22

Juliet McKee NZ PECC



**A Code of Ethics
complements the legislation of the land.**

23

Juliet McKee NZ PECC



**Legislation can be very prescriptive -
corporates must comply or face court
action and criminal charges.**

**Principles or codes of ethics allow
more flexibility.**

24

Juliet McKee NZ PECC



The purpose of a code must be clear.

- **Is it for internal purposes only or for external stakeholders?**
- **What will be the form of a code, the rationale, and the values?**
- **What will happen if directors do not comply: sanctions for non-compliance or reward?**
- **How will it be implemented?**
- **What are its limitations?**

25

Juliet McKee NZ PECC



Securities Commission New Zealand

Directors should observe and foster high ethical standards

www.sec-com.govt.nz

26

Juliet McKee NZ PECC



Securities Commission New Zealand

There should be a balance of independence, skills, knowledge, experience and perspectives among the directors so that the board works effectively.

www.sec-com.govt.nz

27

Juliet McKee NZ PECC



Securities Commission New Zealand

The board should use committees where this would enhance its effectiveness in key areas while retaining board responsibility.

www.sec-com.govt.nz

28

Juliet McKee NZ PECC



Securities Commission New Zealand

The board should demand integrity both in financial reporting and in the timeliness and balance of disclosures on entity affairs.

www.sec-com.govt.nz

29

Juliet McKee NZ PECC



Securities Commission New Zealand

The remuneration of directors should be transparent fair and reasonable.

www.sec-com.govt.nz

30

Juliet McKee NZ PECC



Securities Commission New Zealand

The board should regularly verify that the entity has appropriate processes that identify and manage potential and relevant risks.

www.sec-com.govt.nz

31

Juliet McKee NZ PECC



Securities Commission New Zealand

The board should ensure the quality and independence of the external audit process.

www.sec-com.govt.nz

32

Juliet McKee NZ PECC



Securities Commission New Zealand

The board should foster constructive relationships with shareholders that encourage them to engage with the entity.

www.sec-com.govt.nz

33

Juliet McKee NZ PECC



Securities Commission New Zealand

The board should respect the interests of stakeholders within the context of the entity's ownership type and its fundamental purpose.

www.sec-com.govt.nz

34

Juliet McKee NZ PECC



The Institute of Directors in New Zealand

The Code is not intended to be an exhaustive statement of directors obligations. It should be read in conjunction with the law applying to company directors and the provisions contained in the constitution of the company.

<http://www.iod.org.nz>

35

Juliet McKee NZ PECC



Reserve Bank of New Zealand

Three pillars

- **Self Discipline**
- **Market Discipline**
- **Regulatory Discipline.**

36

Juliet McKee NZ PECC



Corporate Governance principles provide a framework to ensure that the powers, rights and resources invested in the directors are exercised for the benefit of the enterprise, the benefits varying depending on the ownership structure and purpose of the entity.

37

Juliet McKee NZ PECC



The Challenge is to create a Corporate Governance culture of

Trust

Integrity

Intellectual Honesty

while fulfilling the common law duties of

Good Faith

Diligence

Care and

Skill

38

Juliet McKee NZ PECC



Legislation and codes of ethics must both reflect the same strong values of integrity, transparency, and intellectual honesty essential in the boardroom.

39

Juliet McKee NZ PECC



**APEC Finance and Development Program
Workshop on Strengthening Corporate Governance in
Financial Institutions**

**May 19 – 22nd 2004
Shanghai National Accounting Institute
Shanghai, P.R. China**

**Compliance, Business Ethics and Corporate
Governance in Financial Institutions**

Juliet McKee New Zealand PECC Finance Forum Convenor
Saturday 22nd May 2004: 0900hrs – 1015hrs

Introduction

Over the last few days we have discussed many aspects of corporate governance and the challenges facing the directors in our boardrooms. It has certainly reinforced for me that the role of the company director is very challenging. People often believe that they have reached the zenith of their career when at last they are invited into the boardroom. In reality, this is the start of a demanding new role quite different from any previous executive role. The boardroom dynamics are always changing. The problems are often hard to define. The solutions are not easy. I quote Mervyn King, Chairman of the King Commission on Corporate Governance, speaking on the role of the company director: “This is a journey not a destination.” It is a long difficult journey, constantly being exposed to new dilemmas. It is a commitment that can dominate ones thoughts every day.

Over the last fifteen years I have sat on over eighteen different types of boards, state owned entities, not-for-profit bodies, a publicly listed company and several small private companies. The ownership structure of the entity affects the reporting structure, and it also changes the emphasis on social versus commercial objectives. But throughout all boards there are common themes and I intend to draw those out in this paper.

Some years ago I learned an important lesson. I decided to “walk from a boardroom”, when I realised I simply did not share the values of the Managing Director. It was his approach to investment. I always wanted facts and figures and a sense of a general strategic direction before investing in yet another project. He was a true entrepreneur and made his recommendations based on his limited knowledge of the marketplace and its trends.

At first I was seduced by his knowledge, but as I learned more about the industry I started to question more closely and then I found our approaches diverged. A certain level of high risk is totally acceptable in a young growing company but his predictions of excessive returns in a short time became very suspect to me. Time after time the estimates were overly optimistic. We were responsible for other people's money. I was unable to continue supporting his high-risk proposals, when consistently they did not provide the returns predicted.

I have often reflected on the moment when it suddenly became so clear to me why I had to depart from this board. The more I understood about ethics in the boardroom the more I realised it was a clash with my fundamental values in life. Values underpin ethical behaviour – personal ethics. I felt that his irrational choice of investments proposed to the board was verging on unethical behaviour – business ethics. I emphasise there was no fraud or abuse of funds but something more subtle – a constant abuse of my own personal values and business ethics, the clash with my economist background which demanded sound analysis and clearly defined assumptions. I accept completely that any decision is dependent on the information available at that time. Often business decisions will be taken which might have been different if crucial information, which comes to light some time later, had been available. But I still firmly believe that one has a responsibility to take decisions based on a sound analytical approach with the information available at that time.

It does become unethical if the shareholders are expecting a consistent return. If shareholders accepted that they were investing in a highly risky, new start-up company and that they were quite likely to lose all their funds, then perhaps I should have accepted the high-risk nature of the investments. I should have tolerated the loss until one speculative venture became successful. Every investment was certainly speculative, and although high risk was part of a growing company in a changing environment, but there is fine line between proposing a business case to the board directors based on unfounded “facts” and half-baked ideas, and straight out deception.

In another example, I sat on a board with new leading edge technology; the directors were all very bright, exciting, entrepreneurial thinkers. Seeking detailed financial records was seen as an interruption to the brainstorming and development of new directions. The debate about performance and compliance was brought sharply home by this experience. Performance was the focus, compliance an unacceptable diversion. I started to feel like the Compliance Officer constantly seeking accurate records of financial expenditure and decisions taken. Some years later I am proud to say that this company is very successful with a sound foundation and clear framework for exciting strategic thinkers to determine strong healthy new directions.

Compliance and Performance

I continue to visit boards where the directors are obsessed with growing the companies and have scant respect for compliance with the regulatory bodies and the funding agents. There is a strong resistance to the cost of employing the staff to fulfil the compliance requirements. Many decisions have been made on instinct or “back-of-the-envelope” calculations, or on the advice of a “good friend” –the cost of employing a management accountant is seen as prohibitive. The extra costs of compliance are certainly a burden on small growing companies.

(Remember I come from New Zealand where the economy is made of 95% of companies with 19 or less employees).

Other people observe that following worldwide corporate collapses, directors have become too focused on compliance and process to the detriment of growing their companies. Directors are reluctant to take on new roles for fear of the overwhelming compliance obligations. The challenge for us in the boardrooms is to find a balance between compliance and performance, or, process and enterprise.

Seeking the balance...

We must create a Corporate Governance culture of trust, integrity, and intellectual honesty, while, as directors, fulfilling the common law duties of good faith, diligence, care and skill.

This culture will only be created in a boardroom if it reflects the wider aspirations of society and the standards of the business community generally reflected in the local legal framework.

How do we build this climate in our community, a respect for the intent of the law while focusing on building a profitable, sustainable company?

The law sets standards about personal and corporate liability. How do we ensure that we continue at all times to be an agent to those whom we represent, and, to those who have committed their wealth to us in the expectation that we will use it wisely and honestly in the best interests of growing the company? The fundamental requirement is a framework of sensible, practical, fair legislation and regulatory frameworks within a community, which respects the law and its intent.

But who sets the values, the lawmakers or society? In the world of Corporate Governance, it is the directors who must set the “tone at the top” regardless of the existing legislation. It is the intent rather than the letter of the law, which must be followed. The style of leadership and expected “Bottom line” will vary depending on the ownership of the company – a not-for-profit company owned by a religious group will have very different emphasis than a private company with entrepreneurial owners, and again different from a multinational corporate listed on more than one stock exchange.

What is meant by “ethics”?

Ethics is what we do because it is “right”. It is an inner sense of integrity and good judgment. But, in practice, each person’s inner sense of right and wrong varies. Each person in the boardroom comes from a different background, different family upbringing, different schooling, different life experience, and with different religious beliefs. Companies operating in different economies must respect the values of the culture within which they operate. It is important for each board of directors to articulate a set of values specific to the industry sector and local environment in which they operate.

Within each sector of the economy, values will vary in emphasis – the code of ethics for the property sector will be different than a code of ethics in the banking sector. Industry specific ethics must be adopted. I do believe these ethical codes will have a strong underlying theme and reflect the wider values of the community at large. Ethics are principles and are articulated through many avenues to work harmoniously together.

It is interesting to observe multinationals working in their country of origin.

- Do their ethics vary when manufacturing and mining in other economies?
- Do they comply with the same labour laws in force ‘at home’?
- Do they have the same respect for the environment?
- What would happen if host economies required each multinational to work with their Code of Ethics as articulated in their country of origin?

Directors must function on moral principles that mirror the values of the business community in which the company operates. The values normally will be reflected in the legislation, codes of conduct, professional standards and in the local culture. But there does need to be recognition when working in a foreign culture that opportunities are not taken to exploit poorly developed legislative frameworks operating in the locality. Board directors must adopt the highest level of ethics at all times in all places.

Directors must foster a sense of competency and create confidence in all stakeholders.

How to manage unethical behaviour?

It is up to the directors to set the “tone at the top”. If directors do not set impeccable standards, how can you expect the culture throughout the organisation to behave ethically in all transactions?

What do you do when you encounter

- Violations of governmental regulations
- Accounting irregularities
- Fraud
- Falsification, or destruction of company records
- Workplace violence
- Use of assets for private profit
- Discrimination
- Sexual harassment
- Conflicts of interest, or,
- Release of proprietary information?

Increasingly boards are setting up processes to allow whistle blowers to be heard and to be protected, to encourage information to come forward. In New Zealand we have legislation, which protects the whistle blower from being exposed to ensure no repercussions for ongoing employment. Section 19 of The Protected Disclosures Act 2000 prevents disclosure of any information that might identify those people.

Some companies use hotlines connecting to an external third party, for example, the external auditor. Other companies encourage employees to speak to the Chairman of

the Audit Committee in complete confidence. In the same way a society sets values through sensible, fair legislation, a board of directors must set the “rules” through leading with clearly communicated, sound policies.

In my advisory capacity, I have worked with several boards where there have been misuses of credit cards, misunderstandings about expense claims – at first just a few thousand dollars, but in one case rapidly growing into nearly \$2 million.

But where was the code of ethics in the company?

- Who had set the moral rules?
- Who approved the chairman’s expenses?
- Was there a clear Business Expenditure policy?
- Were the Delegations of Authority agreed and understood?

There are times when it might be appropriate to do a Probity Audit – or more bluntly a Fraud Audit. Checking on the Chairman’s expense reports is a sensitive issue but there must be formal processes to provide the checks and balances.

We learn ethical behaviour by example. It is the directors of our companies who must set the standards.

Corporate Governance Culture

The boardroom must nurture a culture of respect, integrity, trust, and intellectual honesty. Directors must be diligent, aware of their duties, act in good faith and at all times in the interests of the company. The flow of information must be timely and accurate. Directors must have sufficient facts before them to take rational decisions in the boardroom based on the information they have at the time. Within a culture of trust, conflicts of interest are managed. Social responsibility is an integral part of all decision making. Sound stewardship of the company’s assets is the underlying goal of all decision making. Boardroom confidentiality and collective responsibility are basic rules. The board has collective authority but we must always remember that directors have individual responsibility and liability.

Legislation and Regulations

Excessive or outdated regulation and law has the potential to encourage disregard for the law.

- Does the law reflect existing values or does the law lead the way in creating an ethical framework?
- Will more legislation and regulations prevent corporate fraud, conflict of interest, and poor business judgment?
- How do we find the balance?

Corporate legislation and regulations challenge those with potential to be unethical. To avoid penalties directors might divert their focus from building a sustainable, profitable company to conformance and compliance. As Mervyn King says “If the intellectual energy, that Enron’s financial wizards generated during their creation of the complicated web of financial transactions, ensuring compliance with some 428 financial regulations, had been channelled on growing a sustainable company, imagine what a model of corporate success Enron would be today.”

Is it so that the law merely creates a challenge to those with poor judgment?

The values, culture, political sensitivity and management style of directors is the key to effective governance. No legislation will replace the basic requirement for strong business ethics, intellectual honesty and integrity in the boardroom.

Legislation can contribute to moulding the culture. The Sarbanes-Oxley Act is not the complete answer for supportive legislation; its critics are harsh, but there is a consensus that the intent to provide strong guidelines was correct. Investor confidence was so low in the US that it needed some form of reassurance.

The intent of good legislation is to provide sound ground rules. Corporate law must create a culture that encourages corporate executives to provide a clear picture of what's happening in the companies they oversee. Regulations regarding financial disclosure create expectations of fair and transparent dealings. Regulations require financial statements to be a true reflection of the company's financial picture, publicly listed companies must identify and disclose known trends, events, demands, commitments, and uncertainties that are reasonably likely to have a material effect on financial conditions or operating performance.

In the endeavour to get the best possible climate in the community for high quality moral standards in the board room, there are many decisions that have to be made, more law, or less law – highly prescriptive law or less prescriptive law.

If directors become constantly preoccupied with compliance because of restrictive and outdated law, it sets the tone creating a negative attitude towards law. It is important to set a culture that ensures all citizens, and particularly directors, respect the moral principle and intent of the law.

The key is to aspire to the very best standards in business law making. The public private partnership between corporates and their host state should not only be about individual endeavour but also on the way in which businesses more generally operate.

Codes of Best Practice

Codes of Ethics, or of Conduct complement the legislation of the land. The Code can be for internal purposes or external purposes. Either way, each director should sign a Code of Ethics or Conduct when they join a board.

The code can establish agreement about standards of morally acceptable behaviour within an organisation. It can provide guidance in moral decision-making. It can promote organisational integration and coordination.

A sound Code of Ethics sends a message to all stakeholders that will give them confidence and instil a sense of trust in those at the helm. It might enhance the reputation of an organisation amongst its external stakeholders, or it might deflect state interference in the internal affairs of a business or industry. The Code of Ethics communicates a public commitment to moral responsibility. An ethical code can be used to pre-empt legal action against a company. Through publication of an ethical

code, a board of directors can demonstrate that it is committed to very best endeavours to avoid moral malpractice.

Legislation can be very prescriptive, corporates must comply or face court action and criminal charges; principles or codes of ethics allow more flexibility. The OECD principles are geared to developed economies. The Commonwealth code allows for flexibility and an opportunity to explain if compliance is not appropriate for a particular situation. These are choices, which we in our own jurisdictions have to face up to – the extent we can command high standards without intrusive law.

In developing a Code of Ethics the purpose of a code must be clear.

- Is it for internal purposes only or for external stakeholders?
- What will be the form of a code, the rationale, and the values?
- What will happen if directors do not comply?
- Will there be sanctions for non-compliance or reward for complying?
- How will it be implemented?
- What are its limitations?

The insurance industry has particular circumstances where the investment is very long term and relies on the company being profitable long term.

- What rights should a policyholder have if an insurance company is mal-administered?
- What standards do you have for policyholders?
- Does the law recognise the special position?
- Do you have a special obligation in articulating moral principles for insurance with clients who will seek their return forty years ahead?

This is very different than for people who can buy and sell their shares without notice.

Three New Zealand Examples of Principles

The Securities Commission, The Institute of Directors and the Reserve Bank

1. The New Zealand Securities Commission recently conducted a survey amongst the directors in New Zealand to establish an accepted set of fundamental principles.

The following set of principles have been adopted: <http://www.sec-com.govt.nz>

- Directors should observe and foster high ethical standards
- There should be a balance of independence, skills, knowledge, experience and perspectives among the directors so that the board works effectively.
- The board should use committees where this would enhance its effectiveness in key areas while retaining board responsibility.
- The board should demand integrity both in financial reporting and in the timeliness and balance of disclosures on entity affairs.
- The remuneration of directors should be transparent fair and reasonable.

- The board should regularly verify that the entity has appropriate processes that identify and manage potential and relevant risks.
 - The board should ensure the quality and independence of the external audit process.
 - The board should foster constructive relationships with shareholders that encourage them to engage with the entity.
 - The board should respect the interests of stakeholders within the context of the entity's ownership type and its fundamental purpose.
2. The Institute of Directors in New Zealand has a Code of Proper Practice for Directors.

“The purpose of the Code is to provide guidance to directors in New Zealand to assist them to carry out their duties and responsibilities effectively and in accordance with the highest professional standards recognising that wealth creation is the mission of the board. The Code is not intended to be an exhaustive statement of directors’ obligations. It should be read in conjunction with the law applying to company directors and the provisions contained in the constitution of the company.

The Code offers guidance more on moral and ethical responsibilities than on those imposed by law” Etc <http://www.iod.org.nz>

3. The Governor of the Reserve Bank in New Zealand has implemented a new prudential supervision regime, which encourages banks to manage themselves prudently. www.rbnz.govt.nz (See Boardroom, IoD NZ, May 2004)

The Governor, Dr. Alan Bollard defines a framework involving three “pillars” to promote a sound and efficient banking system:

- A **self discipline pillar**, whereby we encourage sound corporate governance and risk management practices in banks
- 2) A **market discipline pillar** whereby we seek to reinforce the incentives for the depositors and other creditors of banks and the market generally to monitor and impose discipline on banks.
- A **regulatory discipline pillar** where by we impose selected prudential requirements on banks to further encourage sound risk management, and monitor banks regularly.

All banks in New Zealand are required to publish quarterly financial and risk-related disclosures, including information on each banks and banking groups capital position, concentration of credit exposures to individual counter parties, related party exposures, asset quality and provisioning, and interest rate, exchange rate and equity risks. Banks must also maintain and disclose a credit rating.

These disclosures are intended to strengthen the incentives for the prudent management of risks and assist depositors, among others to make well-informed banking decisions.

Who will benefit from creating strong ethical corporate cultures?

Who in particular will benefit? Corporate Governance principles provide a framework to ensure that the powers, rights and resources invested in the directors are exercised for the benefit of the enterprise, the benefits varying depending on the ownership structure and purpose of the entity. The relations between the owners, directors and managers and with the entity should be governed by principles whereby each of these groups, in the proper exercise of their rights and duties, promote the best interests of the entity as a whole.

The principles that you articulate for a boardroom for a life insurance company or for a bank will be different than for the car sales company. It is important to reflect the uniqueness of each boardroom in the agreed code of ethics. But it is most important that each boardroom has a code of ethics.

In conclusion – Creating an Ethical Culture in the Boardroom

The challenge before our directors is to create a Corporate Governance culture of trust, integrity, and intellectual honesty while fulfilling the common law duties of good faith, diligence, care and skill.

The legislative environment should provide support not be a distraction. An ethical framework manifested in a simplified Code should complement the legislation.

Would the public accept only a principles approach without complementary legislation? Companies rebel against a too detailed, prescriptive approach, but then if the approach is too broad companies seek guidance and certainty.

The challenge for regulatory bodies is to find a balance to expose rogue directors and, at the same time, to create an environment where companies who choose to work on the edge of the law will always follow the intent and the spirit of good care, diligence, skill and good faith.

We need a joint venture between morals. No legislation will provide for the director who chooses to be deceptive, or the CEO who chooses to withhold information.

The best we can achieve is legislation alongside codes of ethics, which reflect the same strong values of trust, integrity, transparency, and intellectual honesty, the fundamental values for directors in the boardroom.

Juliet McKee F.Inst.D, QSO.
Wellington New Zealand

May 2004.

Juliet@mckee.co.nz

Article for Institute of Directors publication *Boardroom*

Subject: The role of bank directors – a Reserve Bank Perspective

Length: 1,313 words

Deadline: 20 April 2004

Author: Dr Alan Bollard, Governor RBNZ

One of the Reserve Bank's duties is the prudential supervision of banks. In this context, the Reserve Bank has been thinking about the roles of bank directors in a banking system that is mainly foreign owned.

The Reserve Bank takes a particular interest in this topic because directors are fundamental to the way we supervise banks. In its banking supervision framework, the Reserve Bank places particular emphasis on the responsibility of directors to oversee the management of their bank's risks and risk management systems.

Most countries' supervisory arrangements do not place as much emphasis on the responsibility of bank directors as New Zealand does. The standard approach to banking supervision generally relies on a combination of rules constraining banks' risk positions, off-site monitoring of banks by the supervisors, and on-site examination.

In the early 1990s, the Reserve Bank concluded that this approach was far from ideal. We saw that this approach could increase the risk of poor management in a bank by reducing the incentives for directors to take responsibility for the prudent management of their banks. It's akin to a car owner saying "My car has a warrant of fitness – therefore I don't have to think about whether it is safe or fit to drive; somebody else has done my thinking for me."

As a result, the Reserve Bank implemented a new prudential supervision regime, which encourages banks to manage themselves prudently. Our framework involves three "pillars" to promote a sound and efficient banking system:

- A “self discipline” pillar, whereby we encourage sound corporate governance and risk management practices in banks.
- A “market discipline” pillar, whereby we seek to reinforce the incentives for the depositors and other creditors of banks, and the market generally, to monitor and impose discipline on banks.
- A “regulatory discipline” pillar, whereby we impose selected prudential requirements on banks to further encourage sound risk management, and monitor banks regularly.

All banks in New Zealand are required to publish quarterly financial and risk-related disclosures, including information on each bank’s and banking group’s capital position, concentration of credit exposures to individual counterparties, related party exposures, asset quality and provisioning, and interest rate, exchange rate and equity risks. Banks must also maintain and disclose a credit rating. These disclosures are intended to strengthen the incentives for the prudent management of risks and assist depositors, among others, to make well-informed banking decisions.

Each disclosure statement is required to include attestations, signed by a bank’s directors, saying whether or not the bank has adequate systems in place to monitor and control risks and whether those systems are being properly applied at all times. The directors are also required to attest that prudential requirements are being complied with.

Each bank director is required to sign their bank’s disclosure statement and to certify that disclosures made are not false or misleading. If a disclosure statement is found to be false or misleading, directors are subject to potentially severe legal penalties, including substantial fines and imprisonment. In addition, directors may face unlimited personal liability for creditors’ losses where creditors relied on a bank’s disclosure statement that was false or misleading.

We also require that banks incorporated in New Zealand have a minimum of two independent directors, who must also be independent of any parent company or other related parties, and a non-executive chairperson.

Our banking supervision arrangements also impose certain prudential requirements on banks, such a minimum capital ratio broadly in line with international norms, and a limit on a bank's maximum exposure to related parties, including a parent bank.

We see sound corporate governance in banks as fundamental to the prudent management of banking risks and, ultimately, to maintaining a sound banking system. In particular, we stress the following general principles:

- Bank directors must have relevant skills, experience and knowledge, and a sound understanding of their bank's business, the nature of its risks and its strategic direction. The ultimate responsibility for ensuring that risks are properly identified, monitored and controlled lies in the boardroom and not with the supervisor.
- An adequate representation of non-executive and independent directors on the board, and a clear separation of the position of board chairman and chief executive officer, is essential. Directors must be scrupulous in avoiding or managing potential conflicts of interest.
- Rigorous internal and external audit arrangements are essential. The external auditor must have a strong measure of independence and not be conflicted by having other significant contracting work with the bank.

These principles are relevant to banks in general and indeed to any company. However, banking in New Zealand also has some particular issues for bank directors.

All but two of the registered banks here are foreign owned, with the two New Zealand-owned banks being very small relative to the system as a whole. The foreign-owned banks operate either as subsidiaries or as branches of foreign banks, with all the large

retail banks being wholly-owned subsidiaries, or in one case a branch, of Australian banks. This raises particular complications for their corporate governance.

In the case of branches, in effect we are relying on the governance arrangements and board of directors of these banks in their home countries. A foreign branch of a bank is legally indistinguishable from the rest of that bank, and assets and liabilities can move quite readily between the branch and the rest of the bank, sometimes at the push of a button.

That's why for the systemically-important banks we require that they operate here as locally incorporated subsidiaries. That way the local bank has its own balance sheet, its own capital and its own board of directors. Importantly, a locally incorporated bank can be more readily salvaged and operated as a stand-alone bank if the parent bank failed.

But even here there are complications. Increasingly, both in New Zealand and elsewhere, international banks are managing their affairs as a global business, regardless of whether they operate in foreign jurisdictions as branches or subsidiaries. Core functionality, such as information technology, financial accounting and risk management, is being increasingly managed on a global level. In some cases, this is being done in a banking group's head office. In other cases, core functionality is being located in developing countries to take advantage of lower cost structures. In both cases, the legal boundaries between different parts of a banking group are becoming less relevant.

The critical issue for directors of bank subsidiaries in New Zealand – and for the Reserve Bank – is whether the banks are capable of maintaining core business functions in the event that parent bank or other out-source providers of functionality fail. Put differently, when directors of a bank subsidiary in New Zealand are assessing the bank's risk profile, capital and management systems, how much reliance should they place on the support of the parent entity? When core functionality is being moved out of the locally incorporated bank to other parts of the group – including IT, financial accounting and intellectual capital – how far should local directors go in requiring arm's length service contracts for

those services, and adequate back-up arrangements in the event of parent bank failure? When assessing the nature of the local bank's exposures to other parts of the group, how far should directors go in ensuring that the exposures are in the interests of the local bank?

These are issues on which the Reserve Bank is currently reflecting. We want bank boards in New Zealand to have the authority and capacity to ensure that their banks are being managed prudently in the interests of the New Zealand banking system. We want the boards to ensure that their banks are able to maintain core business functions even if the parent bank or other out-source functionality provider were to fail. And we want the boards to be fully accountable for their responsibilities. The Reserve Bank will be releasing a consultation paper on these issues later this year.



Juliet McKee

Finance Forum Convenor, NZ PECC

Juliet is an economist and company director, currently an independent director of Architecture Warren and Mahoney and of Windfarms NZ Ltd. She is a member of the New Zealand Book Council governing body and Marsden Management Board. Her extensive previous experience on boards includes, private companies, (Innovus), chairman of a publicly listed company, government appointee on an SOE board (Wellington Airport), on Crown Health Enterprises (Chairman of Coast Health Care, and director Taranaki Health Care) Deputy Chair of a Statutory Body (Broadcasting Commission), member of not-for-profit (NZ Book Council) school boards (Marsden Collegiate, Karori Normal, St Canices, Westport) and founding Chairman of the Buller Community Development Company in Westport.

Previous assignments have been diverse – as a reporter for the BBC in Tunisia; financial analyst for Shell in Gabon, West Africa; and as economist in the Reserve Bank of New Zealand. As an Economics graduate from Victoria University, Juliet also worked for the New Zealand Treasury on secondment to the Cabinet Office.

Juliet has served for three years each with United Nations in Geneva (UNCTAD) and the Commonwealth Secretariat in London. She was also a financial journalist for the Middle East Economic Digest.

In 1998-99, Juliet was based in the New Zealand Ministry of Foreign Affairs and Trade as the Business Relations Director for APEC.

Currently, as an economist and company director, her primary focus is advising on board effectiveness both in New Zealand and offshore, in both public and private entities. She is a mentor to directors in large New Zealand corporates and in not-for-profit organisations. She designs board effectiveness workshops to suit individual situations. Juliet presented key sessions at an intensive five-day course in Zambia in 2001 for five countries in the region. She has presented two-day courses for directors of Crown entities in Samoa and recently completed a series of half-day governance training sessions with each of the Samoan state owned trading bodies.

Juliet was awarded the Commonwealth Medal in 1990 for services to the Community and the Queen's Service Order for public services in 1996. She received the Institute of Directors Study Award to the UK in 1996.

Juliet was a member of the National Council of the New Zealand Institute of Directors from 1998 - 2002 and a member of the Wellington Branch Committee for seven years, the last two as Chairman. She is a Special Adviser to the Sheffield Academy of Corporate Governance and is a member of the Advisory Group of the Centre for Corporate and Institutional Governance at Massey University.



DOC.NO.2-(13)

Case Study: Corporate Governance in the APEC Economies

Zhichao Wang

China Insurance Regulatory Commission

Case study: China

Insurance Industry Governance And Insurers Corporate Governance

Wang Zhichao
Director, Rules & Regulations Division, Life Dept.
China Insurance Regulatory Commission(CIRC)

Shanghai National Accounting Institute(SNAI)
May 21, 2004

1
2004-6-28

Thanks for the invitation

- 1.Thanks for all those wonderful and excellent speakers and Presentations, which let us know more and deeper about the latest development about Corporate Governance
- 2.Thanks for all organizations which sponsored the Program, includes:
 - APEC Finance and Development Program(AFDP)
 - APEC Business Advisory Council (ABAC)
 - Pacific Economic Cooperation Council (PECC) Finance Forum
 - China National Committee For Pacific Economic Cooperation (CNCPEC)
- 3.Thanks for the Shanghai National Accounting Institute, who undertake the responsibility to provide good service for the workshop, and we all have experienced it.

2
2004-6-28

Main Contents

- 1, What Is my understanding of Governance?
- 2, The Governance situation and problem in China's insurance industry
- 3, The Governance situation and problems in China insurance company
- 4, The Orientation reform about China's insurance governance

3
2004-6-28

The critical fact:
More participants from bank sector
Less participants from insurance sector

This is common in eastern Asian countries, because we do lack of risk-management philosophy which is now accepted by all financial institutions, but originally, it is only the insurance terminology.

China's financial system is a bank-based system, that means there are potential risk if banking sector cannot supervise and manage itself, there need diversified financial institutions, especially life insurance company and asset management companies, and as I know, life insurance company and pension funds are called as "contractual saving institutions"

4
2004-6-28

prior to the presentation, I 'd like to
introduce our industry, as follows

- a, important figures
- b, definition of insurance
- c, functions of insurance

5
2004-6-28

a, important data figure

May 18, 2004

insurance industry total assets break the record, 1 trillion RMB yuan,
By the end of 2003

total premium: 388 billion,
life: 301 billion.

1980 3.5b premium,

average growth rate during 1980-2003:nearly 30%

In 1997,life premium exceeds the non-life premium

Compared with banking sector:

total assets: 28 trillion.

deposit: 3.7 trillion

6
2004-6-28

b, Definition of insurance

Insurance is the financial smoothing and arrangement mechanism for individual, families, enterprises, and for the government.

It provides the risk transfer mechanism from the insurance applicant to the insurer, assure the enterpriser to be actively involved the fortune making process, and then the GDP can grow, people can live richer and richer. We regard insurance mechanism as the institutional innovation as important as patent to push the market economy development and improvement.

Insurer can provide life, death, medical, old and disability protection coverage, so in the market, you can purchase the term life, whole life, endowment life, and annuity products, and also health insurance, accident protection, and private pension business, so if you follow China insurance market, you will be quite familiar with such products: Par policy, unit-linked products and universal products.

7
2004-6-28

C, functions of insurance

1, economic redemption
Traditional function

2, asset financing
3, social management
Modern insurance functions

Especially after 1997.

8
2004-6-28

CIRC role

Regulator
Industry administrator

Target:

- 1, policyholder interest protection
- 2, insurance market stabilization
- 3, insurance industry development

9
2004-6-28

Industry nature

Initial stage but try to lift and promote

Development is our priority

Key contradiction: the gap between the supply and demand, insurers cannot provide proper products to satisfy clients needs.

10
2004-6-28

1, What is my understanding of Governance

Regulator view, Industry view and then insurers view

First of all, let's look at the role of company.

Company is changing people's lifestyle, changing the society, the supplier may allocate enough resources to transform the policy and influence the policy-decision process. the regulator and companies are living in the game theory, the company is entitled as a legal person, therefore, it also tries to survive, no matter it is beneficial or harmful to others and to the society.

Attention: we call insurance company as insurer.

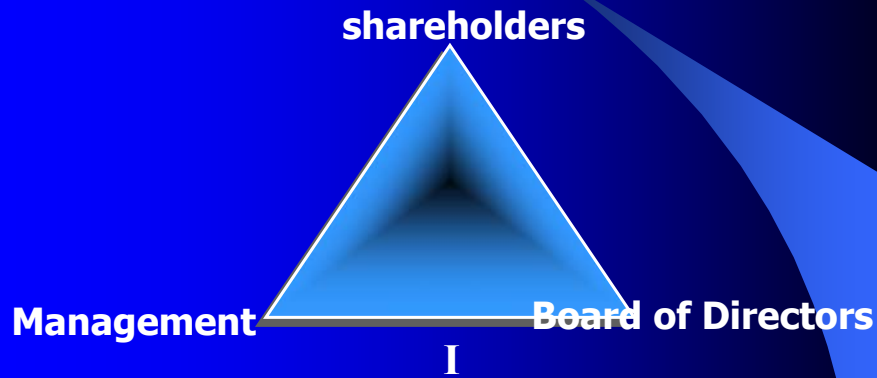
11
2004-6-28

What does it mean "corporate governance"? It is the relationships among many **interest-related parties**, who will decide the companies directions and performance. Main parties includes: shareholders, management (led by CEO), and Board of Directors. The other parties also includes the employers, customers suppliers debtors, and the community etc, the company should reflect their interests and influences.

Corporate Governance,
2nd Edition, 1995,2001
by Robert A.monks, Nell Minow.

12
2004-6-28

The interests balance among the triple parties in corporate Governance



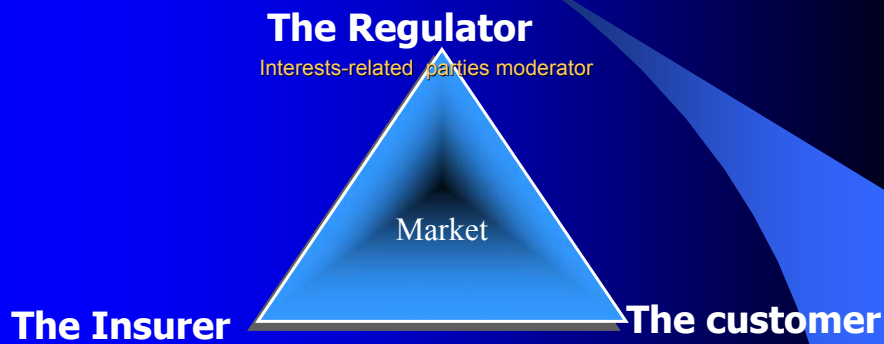
13
2004-6-28

2, The Governance situation and problems in China's insurance industry

- 1, why should we have had the industry perspective view?
the special position of CIRC, who is not only the Regulator, but also act as the administrator for the whole industry. Especially during the transit period from the planned economies to the market economies.
- 2, If we cannot have the industry perspective, we will never be able to construct and maintain a sound and health industry, we will be lost ourselves. We need to promote supervision effectiveness and efficiency, regulator is the last risk bearer for the industry risk.

14
2004-6-28

the industry Governance view



15
2004-6-28

market structure problem

There is no free market and fair competition but the trend is quite clear.

	market share	
2003	China Life:	54%
	top three life insurers:	86%
	Foreign insurers:	3%
2001	China Life:	57%
	top three life insurers:	95%
	Foreign insurers:	2%

Need enough suppliers to compete each other, and cut down the high mono-profit to a socialized level, to the average profit margin.

Need divisible market, meet different needs

16
2004-6-28

solution

More fair competition, not only based scale economic factor
New entrants: joint ventures, now we have more JV than domestic insurers

This May, we are authorized to approve another set of insurers.

Prudential solvency regulation and conduct regulation, for the time being, China just copy the European solvency margin principle, we are considering to research RBC principles, if you are not familiar with those terms, I just give you an similar situation, from Basle 1 to Basle 2

17
2004-6-28

customers problem

Information in-symmetry

Misled to purchase non-traditional life products

Not enough insurance knowledge

Complicated clauses

No NGO for policyholders

18
2004-6-28

solutions

Transparency
Product disclosure
Readable requirement
Professional staff requirement:
 the responsible actuary and lawyer

Plan to disclosure financial information
Plan to send the manual of consumers protection

19
2004-6-28

3, The Governance situation and problems in China insurance company

State-owned insurance company:China life, but it is already listed in New York stock exchange and Hongkong last year

SOE holding stock company:Pingan group (soon will be listed in HK)and Pacific group

Real Stock company: Xinhua(soon listed in mainland) ,Taikang life, Minsheng life.

Foreign branches: AIA shanghai, Guangzhou,Shenzhen, Beijing,Suzhou.et.

Joint Ventures:Manulife, Sunlife,CGU, standard life, Generaliz, Allianz,AXA,New york Life, Metlife, Cigna.et.

20
2004-6-28

Case by case strategy

China life group holding company
China life stock company.

- 1,clarify the relationship between group and subsidiary.
- 2,comply with the requirements from CIRC and SEC.

Encourage insurer list themselves, we regard this as regulatory innovation.

21
2004-6-28

General requirement

- 1,internal control directive in 2000
- 2,senior management regulation:fit and proper requirement, for instances, we ask some CEO to CIRC head office to talk to them, warn them,sometimes punish them
- 3,going-concern approach:pass exams,certificates,and continuous education.
- 4,industry platform:Data Bank

22
2004-6-28

Main problems

- 1, shares structure unreasonable: especially for state owned insurers and SOE holding stock company, some shareholders cannot play an supervision role effectively.
- 2, unsound Board Meeting: lack of the balance between chairman and management; less independent directors; some directors unqualified and disloyalty
- 3, lack efficiency incentives and punishment mechanism, difficult to assess the performance.
- 4, information disclosure not perfect

23
2004-6-28

4, The Orientation reform about China's insurance governance

24
2004-6-28

Problems still exist

Poor Corporate Governance:
Principal-agents problem(SOE and mutual company)
No real rep. of state ownership
Insider control

Because insurance have more relationship with the public, we are more concerned about its CG, and it must seriously consider the interests of other parties, for instance, the society, policyholders, and community.

25
2004-6-28

New Challenges

New entrant affiliated trade
Minority sharing of one foreign investor reach 24.9%
There are more and more JV who only have two shareholders.
Insurance industry more and more actively involved in the pension business, if not manage it properly, it will damage the interests of Chinese policyholders and pensioners.

26
2004-6-28

response

- 1, set up a team to do CG research sponsored by World Bank.
- 2, start to draft the Insurers Corporate Governance Directives, including the strengthening of Board of Directors, interest-balanced mechanism, appointed actuary, the chief risk officer, and revised internal control requirement. encourage insurers to setup special committee on investment, auditing, underwriting, claim-payment, reinsurance, nomination and remuneration.
- 3, launch a workshop, covers all directors and senior management level, ask them to attend the workshop within three years.
- 4, for the present stage, we are more concerned the industry governance than the corporate Governance, try to avoid industry systematic risk

27
2004-6-28

We are optimism about insurance corporate governance:

- 1, we nearly have already solved the only SOE insurer CG problem.
- 2, there are more and more real stock company to enter the insurance market, those insurer are willing to comply with the CIRC requirements.

28
2004-6-28



Thanks

谢

白

29
2004-6-28

Wang zhichao
Director, Rule and regulation Division, Life Dept.
China Insurance Regulatory Commission

Dr. wang has been working in financial Industry for 14 years, currently main engage in the life insurance system design, launch the China employee's examination, head and active involved in the two research, focus China Private Pension model and China insurers Corporate Governance.

He got his PhD from Southwestern University of Finance and Economic on pension, his master degree is granted by Beijing University, his major is statistics, but his important under-graduated period was spent in Nanjing University on Economics.

After his learning stage, he was enrolled by the People's Bank of China in 1990, and stayed there for 8 years, gains enough Macroeconomic experiences, monetary analysis and financial regulation. During that period, he had worked for Research and Statistics Dept., Foreign Financial Institutional Regulation Dept., and Insurance Dept. his focus were money and banking statistics, the relationship between money supply and inflation, economic growth rate, he has been involved the negotiation process in China's resumption into GATT and entrance into WTO.

Since he has already left Central Bank, he is now wholly engaged in the insurance sector, within past 6 years, he was shifted from regulatory Division to Actuarial Division and now head the Rule and Regulation Division, but still been working for Life Dept., CIRC.

During the past experience, he succeed in launching the forum on Private pension and insurance development, forum on the health insurance development, the actuarial round-table meeting in Beijing, Shanghai et. He also headed the China Mortality Revision project in recent years.



DOC.NO.2-(14)

International Trends in Financial Reporting

David Campbell

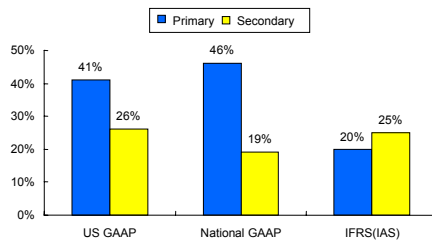
Asia Pacific Insurance Practice Leader, PricewaterhouseCoopers

International Trends in Financial Reporting

David Campbell
david.campbell@cn.pwc.com

The business impact of IFRS

Which accounting standards does your company use to prepare its consolidated financial statements now?

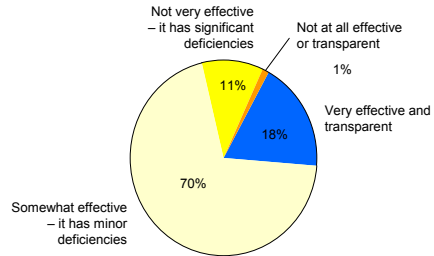


Source: A joint project between PwC and the Economist Intelligence Unit

Page 3

The business impact of IFRS

How effective is your current primary accounting standard of financial reporting at reporting/disclosing the underlying economics of your business?

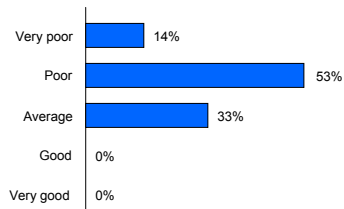


Source: A joint project between PwC and the Economist Intelligence Unit

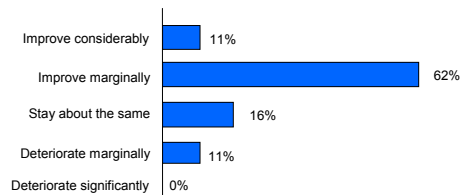
Page 4

Insurance analysts' perspectives on developments in IFRS

How would you rank the adequacy of European insurer's external financial reporting?



As a result of the Phase One proposals do you think that financial reporting by insurers will...

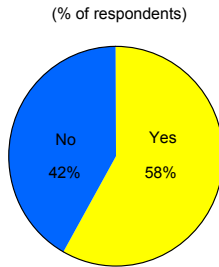


Source: IFRS – Global Reporting Revolution

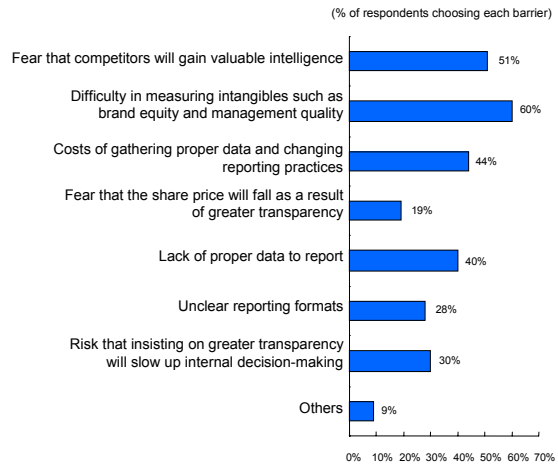
Page 1

The business impact of IFRS

Do current regulatory and financial reporting standards require you to report all the crucial issues facing your firm?



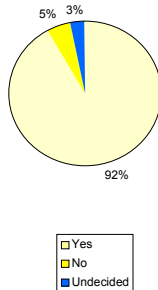
What are the principal barriers to greater transparency within your company?



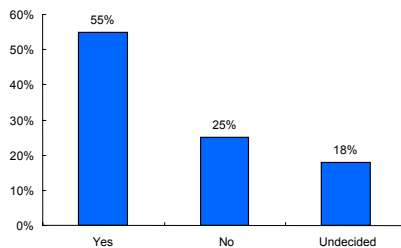
Source: EIU/PricewaterhouseCoopers Survey
Page 15

The business impact of IFRS

Do you believe that establishing one set of global accounting standards is desirable?



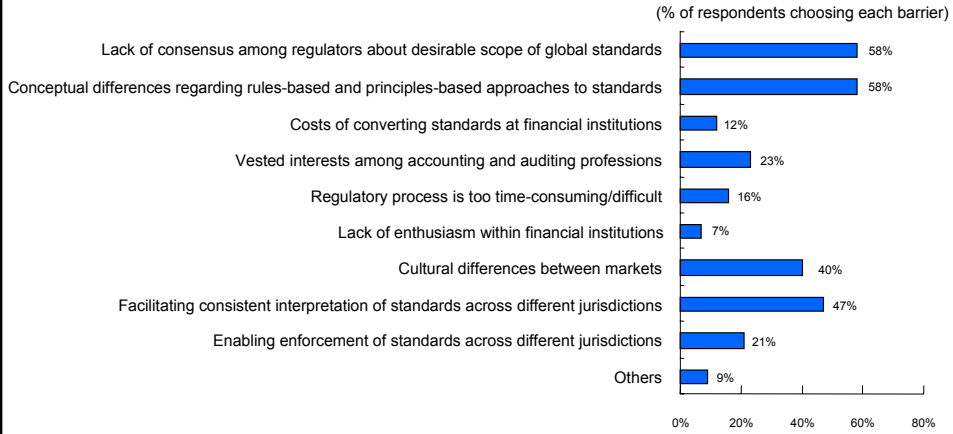
Do you believe that establishing one set of global accounting standards is achievable?



Source: A joint project between PwC and the Economist Intelligence Unit
Page 3

Survey results

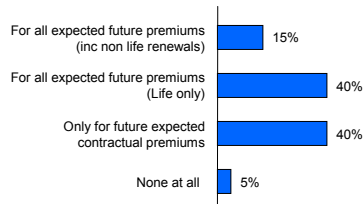
What are the main barriers to the creation of such global accounting standards?



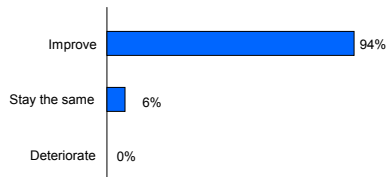
Source: EIU/PricewaterhouseCoopers Survey
Page 14

Insurance analysts' perspectives on developments in IFRS

Should any profits be recognised at point of sale?

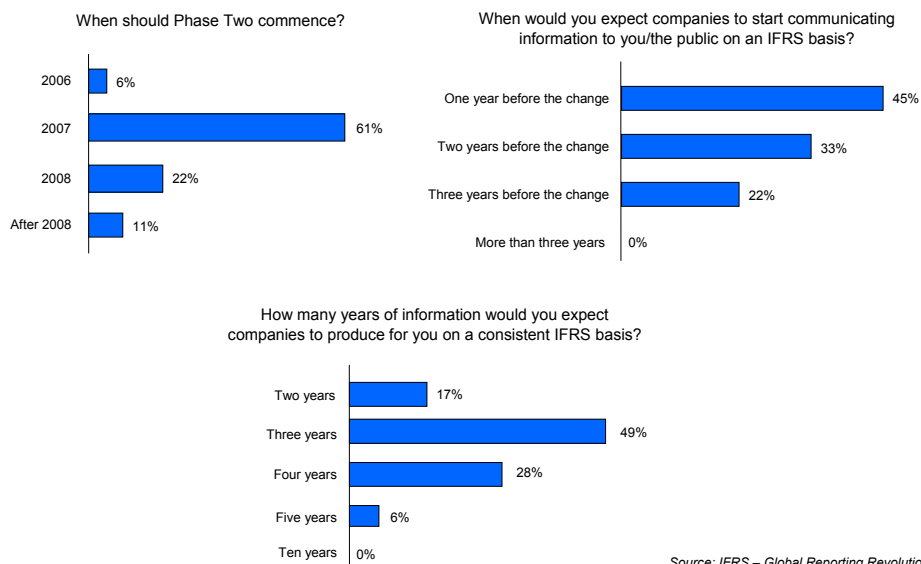


Do you think that as a result of the introduction of the Phase Two proposals the financial management of insurance companies will...



Source: IFRS – Global Reporting Revolution
Page 1

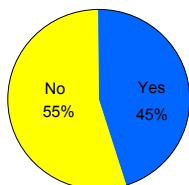
Insurance analysts' perspectives on developments in IFRS



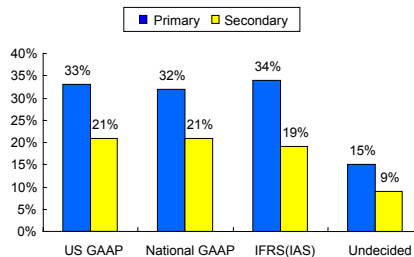
Source: IFRS – Global Reporting Revolution
Page 2

The business impact of IFRS

Is your institution required to adopt IFRS by 2005?



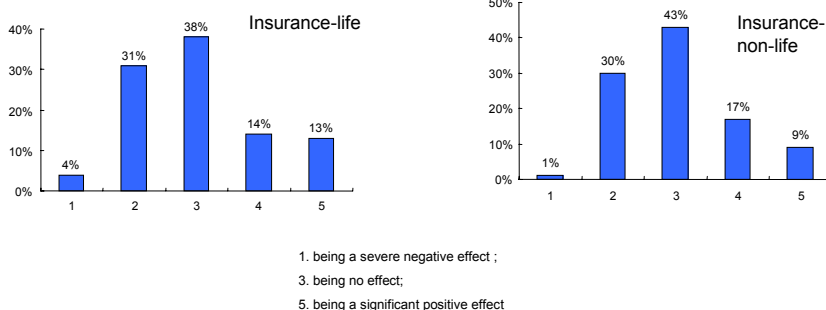
Which standards will your company use for financial reporting periods beginning in 2005?.



Source: A joint project between PwC and the Economist Intelligence Unit
Page 4

The business impact of IFRS

What effect will IFRS have on the bottom line of different parts of the financial services industry, in your view?

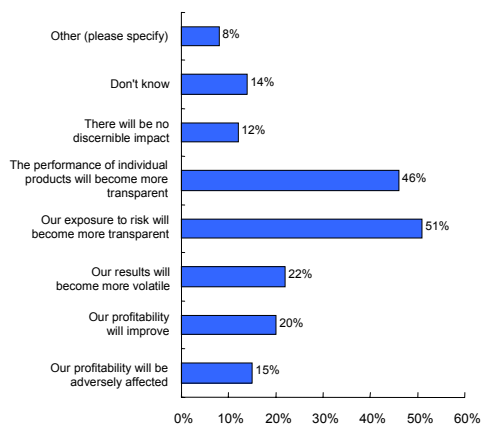


Source: A joint project between PwC and the Economist Intelligence Unit

Page 7

The business impact of IFRS

If your institution is moving to IFRS, what impact will the adoption of IFRS have on your reported results?

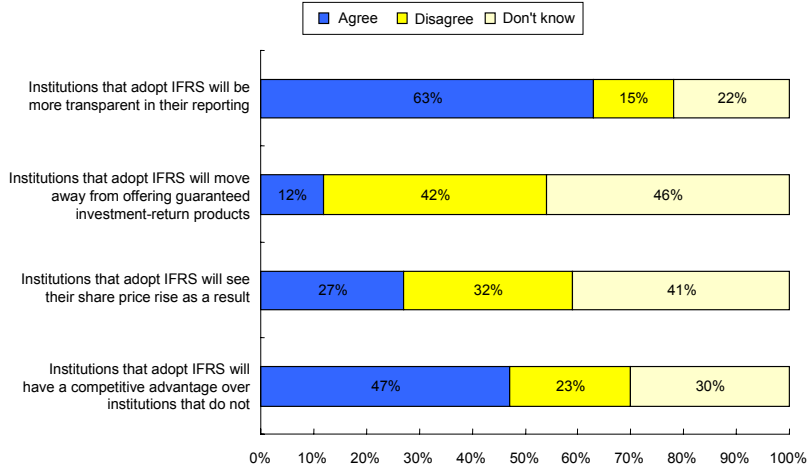


Source: A joint project between PwC and the Economist Intelligence Unit

Page 7

The business impact of IFRS

With which of the following statements do you agree or disagree?

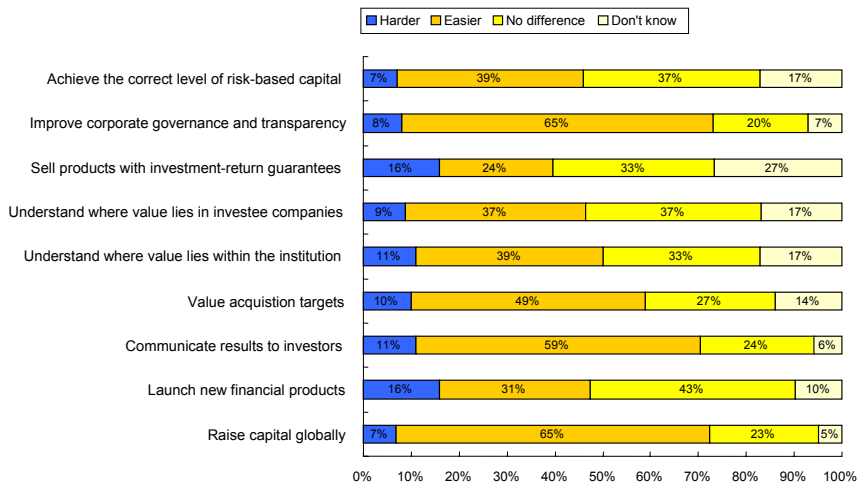


Source: A joint project between PwC and the Economist Intelligence Unit

Page 5

The business impact of IFRS

Will the adoption of IFRS make it harder or easier for financial institutions to:

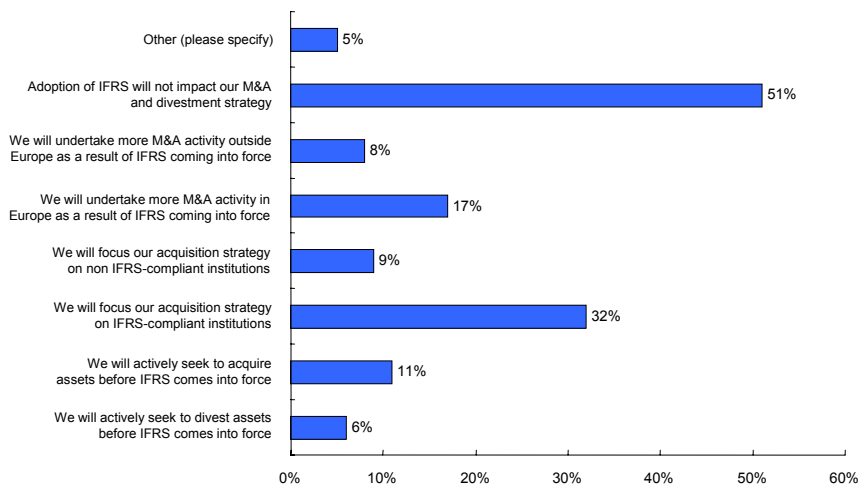


Source: A joint project between PwC and the Economist Intelligence Unit

Page 6

The business impact of IFRS

What impact will the adoption of IFRS have on your M&A and divestment strategy?.

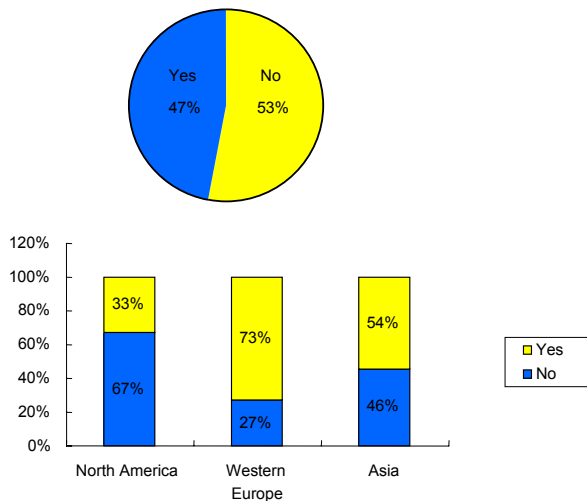


Source: A joint project between PwC and the Economist Intelligence Unit

Page 8

The disclosure challenge

Do you believe that the creation and adoption of a global set of generally accepted accounting standards would materially increase public trust in financial institutions?



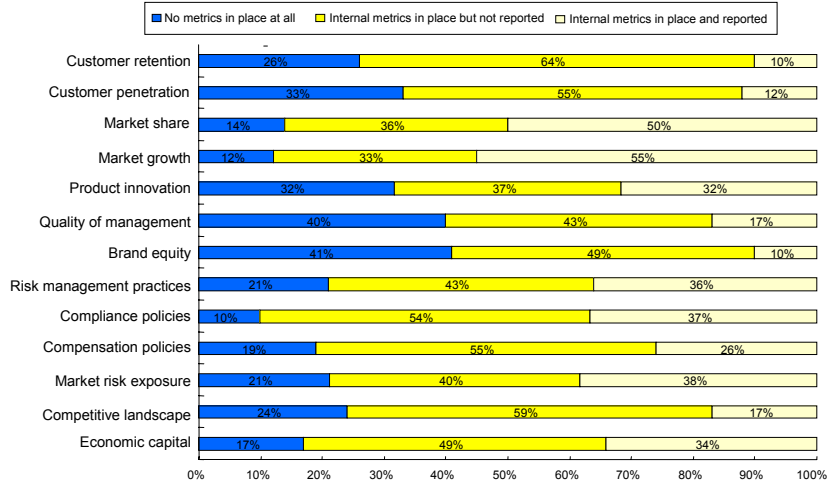
Source: EIU/PricewaterhouseCoopers Survey

Page 9

The disclosure challenge

Do you have metrics in place to measure the following areas of your business, and how many of them are being reported to stakeholders

(% of respondents rating each policy as extremely effective)

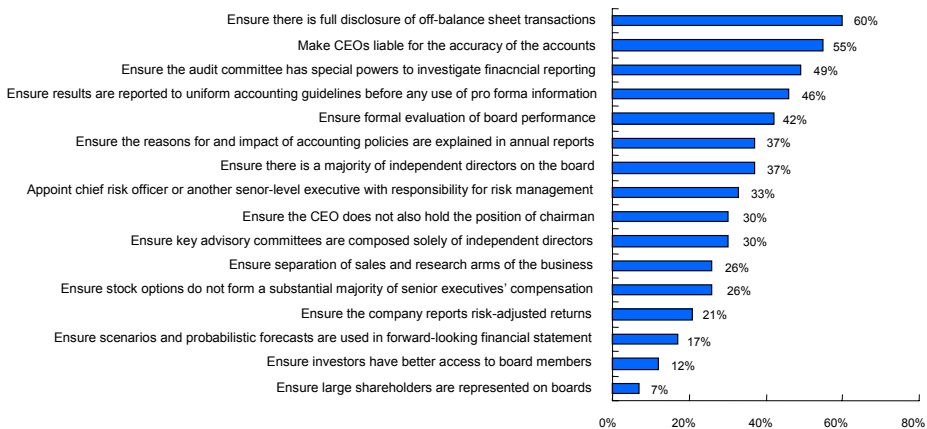


Source: EIU/PricewaterhouseCoopers Survey
Page 10

The governance challenge

Which of the following corporate governance policies are or would be most effective at improving trust in financial institutions

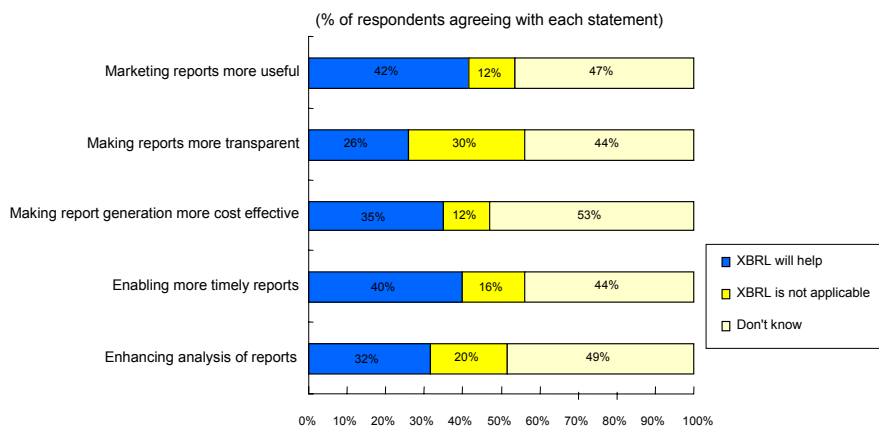
(% of respondents rating each policy as extremely effective)



Source: EIU/PricewaterhouseCoopers Survey
Page 12

The disclosure challenge

What roles will XBRL play in enhancing the corporate reports used by the market and other company stakeholders?



Source: EIU/PricewaterhouseCoopers Survey
Page 11

Conclusion

- Fair value likely to lead to greater transparency....
-and greater volatility
- Significant impact on product and hedging strategies
- Global convergence desirable, but not in the CEO's lifetime!



David Campbell - Partner
PricewaterhouseCoopers China
PwC Asia Pacific Insurance Practice Leader

David Campbell is PricewaterhouseCoopers Insurance Practice Coordinator for the Asia Pacific Region and also leads the South East Asian Actuarial Practice. He lives in Shanghai and undertakes a range of actuarial and other projects in China, Hong Kong and the region.

David has over 25 years of experience in consulting to insurance companies and other financial services businesses, in North America, Europe and Asia.

Recent experience includes:

- Actuarial due diligence and valuations for investors seeking to buy insurers in Hong Kong, Mainland China and Chinese Taipei.
- China market entry study for a USA based specialist casualty insurer, focussing particularly on distribution channels and profitability and growth prospects
- China market entry strategy for an Asian based life and non life insurer, including joint venture feasibility study and partner selection
- Insurance mergers and acquisitions in Greater China (including Hong Kong and Chinese Taipei)
- Appraisal valuations and Capital Forecast for capital raising by the State owned Chinese reinsurance company, China Re.
- IPO preparations for two of the top 4 Chinese life insurers.
- USGAAP conversion for a top 3 Chinese life and non life insurer

David is a regular speaker at conferences and seminars on a range of subjects. He has given presentations recently in Bangkok, Dalian, Hong Kong and Beijing on subjects varying from economic capital through bancassurance to the structure of the risk management and actuarial functions in today's leading insurer. His recent article on entering the China insurance market was published globally in PwC's Insurance Digest.

Tel: +86 (21) 6386 3388

Email: david.campbell@cn.pwc.com



高博文 (David Campbell)

- 合伙人，普华永道中国精算服务部
- 英国精算师协会会员

高博文先生是普华永道亚太区保险行业的领导人之一，同时他还领导东南亚地区的精算事务。高先生现定居在上海，负责领导在中国内地、香港及其他区域的各项精算项目。

高博文先生在北美地区，欧洲及亚洲从事保险和精算咨询工作方面已有超过25年的经验。

他近期的相关工作经验有：

- 为国外投资者在中国大陆，香港及台湾地区寻找可合作的保险公司提供精算方面的审慎性分析和价值评估；
- 为一家美国的专业信用保险公司提供进入中国市场的分析研究，特别是针对于分销渠道、收益率及其发展前景的研究；
- 为一家亚洲的寿险和非寿险保险公司拟定进入中国市场的战略计划，包括对其建立合资公司的可行性研究及合作伙伴的选择；
- 为国内的保险公司（包括香港和台湾地区）的合并和收购计划提供咨询服务；
- 为一家中资再保险公司的资本募集提供价值评估和资本预测；
- 为中国前四位寿险公司中的两家提供上市准备计划；
- 为中国前三位保险公司中的一家实施美国国际会计准则的转换；

高博文先生经常被邀请在各大学术研讨会上发表演讲。他近期已先后在曼谷、大连、香港和北京等地就当今领先的保险公司的经济资本、银行保险代理、风险管理及精算职能等课题发表了多次演讲。此外，他近期的有关于“如何进入中国保险市场”的论文还被刊登在普华永道全球发行的保险杂志上。

电话: +86 (21) 6386 3388

电子邮件: david.campbell@cn.pwc.com