

Speech

Speech by SFST at Corporate Governance Conference 2008 (English only)

Following is the speech by the Secretary for Financial Services and the Treasury, Professor K C Chan, at the Corporate Governance Conference 2008 organised by the Hong Kong Institute of Chartered Secretaries today (September 12):

Mrs Natalia Seng, Ladies and Gentlemen,

Good morning. It is with great honour that I give the opening address at the 6th Biennial Corporate Governance Conference organised by the Hong Kong Institute of Chartered Secretaries (HKICS). “Practical Corporate Governance: Corporate Risk” is the topic for discussion today.

I see many familiar faces and old friends around the room. Amongst us, we have company secretaries, accountants and auditors, directors, CEOs, CFOs and senior management of listed companies. You all carry responsibilities in ensuring effective governance of your companies or your clients’ companies in one way or another. It is a vote of confidence to Hong Kong’s corporate governance to see so many distinguished business and professional leaders willing to take precious time off their packed schedule to attend this conference.

Corporate governance is not about stifling the potential for your companies. To the contrary, if implemented properly and effectively, you will reap the benefit in good times by maximising your profit and in bad times, you will be prepared. It will ensure that you are not caught by surprise when the tide of market sentiment suddenly sweeps the other way. Nonetheless, measures on corporate governance, however nicely drafted, remain paper rules unless companies put them into practice to manage and control risk. I encourage you to bring the new ideas you learn back to your businesses, to reflect them, and to act on them as you see fit.

Today's sessions, in one way or another, point to the critical importance of corporate governance in running a successful business. I thought I would begin the day by sharing my understanding of the role that corporate governance, or lack of which, had played in recent financial crisis.

What is Corporate Governance and why do we need it?

We need it as a tool to balance the interest of different groups of stakeholders who may have different and often, conflicting goals. To cite a few examples:

- employees would naturally want to maximise their remuneration whilst shareholders would want to keep the costs low
- shareholders would focus on share value and may be willing to take a certain degree of risk to enhance the share value whilst creditors are risk adverse
- management and majority shareholders have the ability to influence decision made in the company and may have very different perspective to minority shareholders

What constitute sound Corporate Governance?

It is an internal control system within the company designed to give the right people, the information they need, including all the risks entailed, and allow them, after undergoing checks and balances, to make a decision on how best to maximise the firm's overall value.

It sounds simple and logical but all the stars need to align to make it happen.

Case Study

The subprime chapter unfolding in front of our eyes today aptly demonstrates the importance of corporate governance.

UBS

Let's take a look at the Swiss banking giant UBS, which has written off more debt from the subprime crisis than any other bank. UBS conceded in a shareholders' report prepared earlier this year that a blind desire for revenue led it to take more risks than it should have. UBS blames:

1. poor risk control
2. overly fast build-up of its investment banking activities
3. lack of clear management structures

as the main reasons for sustaining the huge losses.

What Went Wrong?

Central to good corporate governance is the opportunity for the right persons armed with all the relevant information to make the decision. Has UBS done that? Let's find out.

1. Did UBS properly evaluate the merits of the Asset Backed Security (ABS) / Collateralized Debt Obligation (CDO) business? Before embarking in the business in 2005, UBS commissioned an external consultant to identify strategic initiatives for the bank. The consultant's recommendation was to grow ABS/CDO business in order to close the gap with competitors and streamline the risk processes. It all sounds very kosher, getting an independent third party, who has no vested interest in the bank to give it a directional steer. However, the consultant was not commissioned to assess the risk capacity of the bank associated with the recommended product expansion, a key piece of the jigsaw.
2. Did UBS consider what the worst-case scenario could be, the maximum down

side risk as bankers would put it? UBS over-relied on the AAA rating of the asset. Had it carried out a comprehensive analysis of the portfolios, it may have realised that the positions may not perform consistently with their ratings.

3. Was there a risk versus profit analysis being carried out? It was eluded to in the shareholders' report that the ABS/CDO business was profitable not because it generated alpha return (i.e. return in excess of defined expectation) but because it exploited the cheaper-than-market internal funding available in UBS to finance the purchase of its subprime assets.
4. Was there sufficient challenge of the new business and its associated risks by senior management?
5. It was also revealed in the report that certain essential approvals were sought after investments in the subprime assets were made, by which time, it was too costly to unwind, which means the person tasked with giving the approval already has his arm twisted.
6. It is also common knowledge that bankers and traders are paid in accordance to how profitable they are that year. This remuneration matrix will inevitably drive bankers and traders to make as much money as quickly as possible without regard to the long-term well being of the firm.

Lesson Learnt

This is my key take-away from the UBS lesson:

- Checks and balances are important.
- Identifying the risks is essential. After all, you cannot decide what is best for you, without knowing what you are getting yourself in for.

- Compensation needs to be structured right to avoid a conflict between management and firm. However, I suspect you can never get it right. Management is paid aggressively to take risk and reaps personal gains if their gamble pays off, but the worst that can happen to them is to get fired, possibly with hefty severance.

Adequate internal control and risk management systems would help alleviate many of these problems. The conference today thus provides a timely opportunity for the relevant stakeholders to exchange ideas on an important corporate governance question, namely how to manage corporate risks in a practical and profitable way!

Government Role

Why do the governments and regulators around the world want to get their hands dirty on the issue of corporate governance, when it sounds prima facie –ly, a housekeeping matter for corporations.

Financial Institutions

It is obvious in the case of financial institutions. Failure in a mis-managed bank may lead to a bank run or collapse, which can in turn cause the bank to fail on its various counterparty obligations to other financial institutions. Banks also provide financing for commercial enterprises, access to payment systems, and not to mention, a variety of retail financial services to the man on the street. In other words, there is a large number of stakeholders whose economic well being depends on the well-being of our banking industry. Accordingly, it is of paramount importance to the economy and hence the Government that the financial institutions have strong corporate governance structures.

Non-financial sector

They may not bring about systemic risks and the issues they face may be different from financial institutions, but good corporate governance is equally important. Many potential conflicts we discussed earlier still apply.

Example

Let's take the example of an airline company. As oil prices sky-rocketed in recent months, it would only be prudent for an airline company to consider hedging its fuel costs. Many investment banks will no doubt knock on their doors to flock their latest and greatest price-fluctuation-proof commodities derivatives. Now, who within the airline, is capable of and should make this investment decision? Is there someone on the board who has a good insight to oil prices? And someone with expertise on complex derivatives? Good corporate governance would ensure that the issues are properly hashed out before a decision is arrived at in the best interest of the company.

What has the Government done?

We help prescribe rules to set a certain standard but at the same time, we recognize the importance of good internal management for corporations. The Government, working together with the financial regulators, strives to maintain a moderate, but effective regulatory regime, to provide our investors with an appropriate level of protection, and to provide the framework and transparency for corporations and their boards to set up good internal management systems. Managing the risks facing the Hong Kong economy is the key to Hong Kong's financial stability and future development.

As a continuous effort to upgrade and improve our regulatory landscape, in recent years, we have –

- Enacted the Securities and Futures Ordinance in 2003 to strengthen the

regulation of securities and futures sector;

- Introduced statutory derivative actions in 2004 to enhance protection of minority shareholders' interests;
- Launched the Code on Corporate Governance Practices in 2005, which is benchmarked against the best prevailing market practices and international standards and which included provisions on independence and accountancy of the company management;
- Established the Financial Reporting Council, which came into full operation in 2007 to further strengthen the oversight of auditors and financial reporting of listed companies, thereby upholding the quality of financial reporting and enhancing the protection of investors.
- Embarked on a major exercise to rewrite the Companies Ordinance to modernise the legal infrastructure regulating both listed and non-listed companies and to strengthen the existing corporate governance framework

Banks

For banks, the Hong Kong Monetary Authority (HKMA) is their primary regulator. It adopts a risk-based supervisory approach and requires Authorised Institutions under its supervision to put in place adequate risk management and control systems to monitor the risks to which they are exposed, including credit, market, interest rate, liquidity, operational, legal, reputation and strategic risks.

Basel II, the revised capital adequacy framework of the Basel Committee on Banking Supervision (BCBS), among other things, encourages banks to adopt sound risk management practices. Hong Kong was one of the first jurisdictions to have implemented Basel II since 1 January 2007.

HKMA will continue to conduct thematic examinations, issue supervisory

policy manuals and maintain regular contacts with senior management of banks to identify major emerging risks to banks which require attention of both the supervisor and bank management and address challenges and recommendations raised by the Basel Committee and other international bodies stemming from the subprime crisis.

As many of you here today are company secretaries, directors or senior management of listed companies, I encourage you not to treat compliance with the regulations as a mere box ticking exercise. Creation of a sound internal control and risk management systems should enable companies to achieve strategic advantages – companies that are better able to monitor, manage and control risks, whether they are risks at the macro or micro levels, stand to rise above its peers. In the longer term, good corporate governance would help your companies establish better reputation and public image, as well as help prevent governance breakdowns.

Closing

Thanks to the joint efforts of business leaders including yourselves, professional bodies such as the HKICS and financial regulators, we have come a long way in improving our corporate governance framework. The improvements in corporate governance we have made have been recognized internationally, with Hong Kong being named amongst the forerunners in various corporate governance surveys.

We must not be complacent. While the Government and financial regulators would continue to closely monitor the development of corporate governance and mitigate risks at the external level, the real improvements would depend on your dedication and whole-hearted implementation of corporate governance system in your companies, including careful assessment and management of risks that your companies may be exposed to.

Last but not least, I would like to commend the efforts of the HKICS in organising the biennial Corporate Governance Conference for the sixth time and designating the timely issue of “risk management” as the theme this year.

Thank you.