

Business Spectator

COMMENTARY

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A facade of good governance

It has been nine days since administrators walked into Lehman and took control of the bankrupt firm. Once the dust settles, investigators will discover many things about the investment bank, but one thing sure to pique their interest will be issues regarding Lehman's governance.

If nothing else, this ongoing year of 'sub-prime discontent' has yet again highlighted the importance of appropriate governance arrangements and the requirement for these to be supported by robust risk management and ethical practices.

The collapse of Lehman has led us all to question how it is that a major financial institution can fail 'overnight' and to what extent such an event could have been prevented.

According to Lehman's corporate governance guidelines, which were amended in 2006, the company was "committed to industry best practices with respect to corporate governance" and apparently had all the appropriate governance arrangements in place.

The Lehman Code of Ethics acknowledged that in their industry, "integrity and ethical behaviour are all the more important because of the trust our clients must place in us" and that the "linchpins of that trust" are ethical standards and behaviour. Such behaviour is aimed at ensuring that business is undertaken "in a manner that protects and promotes the interests of our clients".

In addition Lehman had an established a finance committee to review and advise the board of directors on the financial policies and practices, including risk management.

Despite what appears to have been an appropriate framework for good governance and good risk management – a framework commonly applied in the financial industry throughout the world, including in Australia – Lehman failed, leaving not only a global trail of financial destruction but also a severe loss of confidence in market practices.

So can such a catastrophe occur in Australia? And if not, why not?

It has been acknowledged that the US financial market differs from the Australian financial market in one major respect: banking regulation.

Banking regulation in the United States is highly fragmented with no single bank regulator. Rather, banking is regulated by multiple organisations across multiple jurisdictions.

The approach of Australian Prudential Regulation Authority (APRA), the prudential regulator of the Australian financial services industry, to supervision of the financial sector "recognises that management and boards of supervised institutions are primarily responsible for financial soundness" and its approaches to supervision are primarily risk-based.

It is therefore no surprise that among the Prudential Standards and Guidance Notes issued by APRA and which authorised deposit-taking institutions (ADIs) in Australia are required to follow, there are standards on risk management and governance.

This approach is complemented by the disclosures required under the ASX Corporate Governance Council's Principles of Good Corporate Governance, in particular *Principle 7: Recognise and manage risk*.

However, this oversight of ADIs does not address the exposure of investors to the high risk of esoteric financial instruments promoted by financial institutions.

The recent report on the *Review of NSW Local Government Investments* highlights the “challenge facing product promoters offering complex investment products to NSW Council investors with limited broad investment experience” and the need to thoroughly explain the risks associated with such products.

This “challenge” highlights the need for improved ethical behaviour on the part of financial institutions, which may need to more rigorously assess a decision to offer a particular product to the market by considering characteristics other than likely profitability.

They may need to ensure that advice or promotion of the financial product is of a high quality, is objective, is ethical, and is in the best interests of the client/investor and that the risks are well understood by the client/investor.

The failure of Lehman underlines the need for the governance debate to move beyond the checklist template – recognising that it is impossible to regulate for ethics and common sense.

Accordingly, there is now increasing pressure on organisations to look beyond wealth creation and to take up a more ethical stance on corporate governance, as no amount of regulation can prevent the consequences of 'sub-prime' ethical practices.

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<http://www.businessspectator.com.au/bs.nsf/Article/A-facade-of-good-governance-JR7C4?OpenDocument&src=spb>