Profile: Jane Diplock

Wanted: Behavioral and Cultural Change Agents

Preventing another crisis requires a change in behaviors and business culture, according to securities regulator Jane Diplock.

Intro

Although Jane Diplock is a prominent national and international regulator—and heavily involved in dealing with the damage of the financial crisis—she is, in her own words, "not an advocate of regulatory solutions, if other solutions can achieve the same end." In this interview, she highlights a number of critical issues that emerged from the financial crisis, and provides a series of recommendations, especially on what the various market participants can do to prevent future crises.

Jane Diplock: A brief bio

Since 2001, Jane Diplock has been Chairman of the Securities Commission of New Zealand (see below). Since 2004, she is also Chairman of the Executive Committee of the International Organization of Securities Commissions (IOSCO, see below). Before coming to New Zealand, Jane Diplock was barrister and solicitor of the ACT Supreme Court and High Court of Australia and barrister of the New South Wales Supreme Court. She is a fellow of the Institute of Public Administration of Australia, Chevening fellow at London School of Economics, fellow of the New Zealand Institute of Management, and a member of the Financial Crisis Advisory Group.

See also www.iosco2009.com/Diplock.html.

Securities Commission of New Zealand

The Securities Commission of New Zealand is New Zealand's main regulator of investments. Its purpose is to strengthen investor confidence and foster capital investment in New Zealand by promoting the efficiency, integrity, and cost-effective regulation of its securities markets.

See also: www.seccom.govt.nz.

IOSCO

IOSCO is the international organization of security regulators. Through IOSCO, regulators:

- Work together to promote high standards of regulation in order to maintain just, efficient, and sound markets;
- Exchange information on their respective experiences in order to promote the development of domestic markets;

- Unite their efforts to establish standards and an effective surveillance of international securities transactions; and
- Provide mutual assistance to promote the integrity of the markets by a rigorous application of the standards, and by effective enforcement against offenses.

See also: www.iosco.org.

Governance issues are at the core of the financial crisis

All major economies and jurisdictions have governance codes now, and still, they did not prevent the financial crisis. What went wrong?

“If you look at the global financial crisis, corporate governance is really at core of all of the issues that we have experienced, because the drivers of the behavior of an entity aren’t appropriate. Therefore, you will not get appropriate reporting, and you will find that the users of the financial statements will not get appropriate outcomes because they will not be able to see the economic reality of the company. So at the heart of the financial crisis, I think, is a failure of corporate governance.

“One of the very wise things that a colleague of mine on the Financial Crisis Advisory Group, John Bogle,[1] has said actually reflects my own thinking. He has described the financial crisis as a crisis of 'ethic proportions.' Fundamentally, what we saw was the eventual overwhelming of traditional, centuries-old standards of conduct by unregulated market forces. In fact, self-interest got out of hand.”

Can you give some examples?

“Look, for example, at risk management, which is a critical area of corporate governance. A large number of financial and other institutions engaged in excessive risk-taking—for example, by creating off-balance-sheet vehicles to get around the various capital requirements. But when these ‘non-existing’ assets turned into toxic liabilities, they eventually came back on the balance sheets of the financial institutions, and sometimes brought them down completely.

“Valuations of assets that were put onto the balance sheet of banks caused significant issues because in many cases, these valuations were clearly wrong: reliance was placed quite unreasonably on credit rating, rather than on deep assessment and analysis of the nature of the product and the inherent risks.

“Risk management practices were clearly flawed, because you cannot imagine anything more inimical to the interest of the company than management and boards of directors engaging in such risky activities that could bring the company to ruin, which is what actually happened in some of these companies. Perhaps the links between risk management pay and bonuses, and the performance of board directors, are all part of the same corporate governance or ethical issue, because they influence the behavior of company management. This has been thoroughly highlighted by the current global financial crisis.”

“What we need in corporate governance is more constraints on self-interest, and those constraints can come from within the company itself, its culture and its behaviors, or they can come from outside the organization, driven by regulation. Ideally, it would be better to have the constraints coming from within the company itself.”

[1] Founder of the US-based investment management company Vanguard.

Constraints on self-interest are needed

What should be done to get this ethical governance dimension right?

“What we need in corporate governance is more constraints on self-interest, and those constraints can come from within the company itself, its culture and its behaviors, or they can come from outside the organization, driven by regulation. Ideally, it would be better to have the constraints coming from within the company itself. But if it is clear that they are not going to come from within the company, then some external pressure needs to be applied.”

Align managerial behavior with the interests of the owners

Can you mention some specific measures that should be taken?

“We have seen the behavior of some managers of the financial institutions, where they have taken enormous remuneration and bonuses often based on excessive risk-taking, to the detriment of the company itself. Therefore, it is critical that we get the culture and the behavior of the managers of the companies better aligned with the interests of the shareholders and other stakeholders. And we have seen a mismatch in that. There are some interesting debates about this very issue—for example, in France and the UK. People are pondering whether proportionality of remuneration to performance should be mandated or at least suggested, and whether the other measures which would leverage greater shareholder participation should be endorsed.”

Shareholders should more actively pursue their ownership responsibilities

What should be done to get a better alignment?

“I am not an advocate of regulatory solutions if other solutions can actually achieve the same end. For example, I suspect that in the remuneration space, more shareholder pressure would have a salutary effect. That is a difficult issue, however, because shareholders have not been very proactive in their role as owners. They should actually start to take more action. If investors believe that the remuneration framework the board is actually suggesting is out of kilter with the shareholder returns that are being produced, then they should intervene. I do believe that in particular institutional investors should more actively pursue their shareholder responsibilities. That might be a way in which we could get some rationality in this debate, rather than via regulatory measures.”

Regulatory intervention only solves part of the problem

Would regulatory intervention not be a much quicker and easier option?

“I don’t think there is a silver bullet, there is not one regulatory or other solution. The US Sarbanes-Oxley Act (SOX), for example, was not the complete answer. It might have had some benefit in bringing to the board level certain accountabilities that otherwise may have been pushed down in the business chain, but it was only a solution for a small part of the problem. Much of this financial crisis has to do with behaviors and cultures, and I think that cannot be changed by regulation alone.

“I heard an interesting analogy the other day, made by the governor of our New Zealand Reserve Bank, who suggested that risk was a bit like a balloon; if you squeeze it in one place, it pops up somewhere else. Perhaps the balloon of risk was squeezed on the SOX end and then popped out in one of these other areas, but one hopes that somehow boards can get their hands around the whole risk balloon and manage it appropriately. Internal control over financial reporting is not the only risk, as we have seen to our cost in this financial crisis."

Boards should routinely check themselves against the applicable governance principles

Is there a need for additional corporate governance measures in New Zealand?

"The corporate governance issues we discussed are certainly alive in New Zealand. We have issued principles-based corporate governance guidelines, with supporting guidance. Anecdotally, we hear that boards in New Zealand routinely remind both management and themselves of the corporate governance principles, by systematically going through the guidance at the various board meetings and checking their own actions against it. I think this is a very good method of bringing back the core principles to boards and management on a regular basis. One of the things that can assist boards in reinforcing the behaviors and culture necessary for good corporate governance is asking themselves questions such as:

- Do we have sufficient independent directors?
- Do we have an audit committee?
- Is our audit committee chaired by someone other than the chairman of the board?
- Is our audit committee truly independent?

These are all areas in which boards should routinely test themselves against the principles. The New Zealand Securities Commission is monitoring compliance with these principles."

Liability frameworks encourage good (board) behavior

Such a corporate governance self-assessment would also be a good defense against liability issues faced by directors, which is one of the other persistent corporate governance issues that emerged from our studies. What would be your recommendations with respect to director liability?

"I am in the camp that says that the director-liability issue is overplayed. I worry that the 'don't make me take responsibility for my acts, or otherwise I don't want to play in the game at all' argument is an attempt to reduce the level of responsibility that directors take for their own behavior and for the good corporate governance of their companies, and I do not agree with that. I am of the view that when you take on the role of director, you are in a sense managing a company for the purposes of stewardship of other people's assets. In such a role, you have great responsibilities, and therefore you should also have liabilities. Action should be taken against those directors who are either reckless or negligent in the way they discharge their duties.

"I don't think the (non-executive) director model is broken. We see a large number of sound companies, well managed, with good boards, functioning very well. I think that you will find good directors and sound people willing to take on those responsibilities, even if that comes with a certain degree of liability. As liability is one of the drivers of good behavior, a sensible cautionary liability framework should be in place."

Take on a directorship only if you are comfortable with the board's values

What would be your recommendation for those taking on directorships?

"Values drive behavior, and therefore the corporate governance of a company. As there is clearly a reputational risk involved in a director role, people need to be very sure that they only take on a directorship in a company where they would be comfortable with the values of its board. This is an important part of their due diligence in undertaking the role of director."

A move to IFRS is vital (and so is its due process…)

Another important director responsibility is business reporting. What would be your recommendations in that area?

"I see the move to International Financial Reporting Standards (IFRS), issued by the International Accounting Standards Board (IASB), as absolutely vital. I know it's had some difficulties and some critics, but if anything has been made clear to us out of the global crisis, it is that capital is global. And global capital needs the support of one global set of financial reporting standards. My work on the Financial Crisis Advisory Group only reinforced that.

"I do see some issues about the urgency with which some changes in the accounting standards were required—which I understand from a business point of view—being in a sense contradictory with the due process required to get a broad consultation, to get the standards right and clear, and ultimately, to get a broad buy-in from the various stakeholders. The tension between the sense of urgency to reform current standards and the need for time to ensure due process is going to be a challenge for the IASB and its counterpart, the US Financial Accounting Standards Board (FASB), going forward, particularly as they progress towards convergence."

Establish standard-setter oversight

"And the other point I would like to make is on the governance of standard setters. I do believe that standard setters need a public-interest oversight body. The US Securities and Exchange Commission (SEC) oversees the work of the FASB, and IOSCO has initiated an oversight board for the IASB. And I think that is something that gives greater confidence in the independence of the IASB (see also 'IOSCO initiative on oversight for IASB')."

IOSCO initiative on oversight for IASB

In 2008, IOSCO, the European Commission, the US Securities and Exchange Commission, and the Japanese Financial Services Agency responded to concerns about the governance of the IASB standard-setting process.

They established a new monitoring board to interact with the International Accounting Standards Committee Foundation (IASCF), the IASB's oversight body. The IASCF Monitoring Board charter was signed in April 2009.

The Board includes representatives of securities regulators in both developed and emerging markets, thus reflecting the widespread use of IFRS. It gives securities regulators requiring or allowing the use of IFRS in their own jurisdictions a means of ensuring IFRS are being developed according to procedures and policies that protect investor interests.

The Monitoring Board interacts exclusively with the IASCF, not the IASB. This preserves the IASB's standard-setting independence, which is so critical to developing high-quality standards based on technical expertise.

Reduce complexity of financial reporting

"I think we all agree that the complexity of financial reporting needs to be reduced, including Sir David Tweedie,[2] who is quoted as saying, 'If you think you understand the financial-instruments standard, you haven't read it properly.' Areas such as financial instruments are very complicated, and therefore the related reporting standards easily get very complicated, too. It is a big challenge to try to simplify that accounting framework. It is quite important that we get on with it, and I am encouraged by the energy that the IASB and the FASB are putting into that project."

Financial reporting should present a snapshot of an organization's economic reality

"Financial reporting has a very clear purpose. It has to provide a snapshot in time of the economic reality of the business, and users understand that. Therefore, we should not import elements into accounting that distort that snapshot. Dynamic provisioning for losses relating to bank loans is a good example. If you put that through the profit and loss—and the argument for financial institutions to do so could be to lower the reported profits in order to limit dividends, remuneration, and bonuses—then you are trying to import a financial-stability objective into accounting, and I don't believe that should happen.

"I am not opposed to organizations having reserves that are clearly marked and articulated as a sort of buffer, and that is what we came up with in the Financial Crisis Advisory Group as the way forward. I do not believe we should try to outfit financial reporting with objectives other than providing a snapshot of the wider economic reality. I think this is a very important point. This does not rule out some form of an expected loss model, which is under consideration now. "

Put a contextual narrative around the numbers

"I am not certain that the complexity problem lies with IFRS itself. I think it is our approach to accounting, as we do actually need not only data, but also explanation. We need a contextual narrative of some sort, so that the numbers are not just standing there boldly. If the numbers do not stand up for themselves, the preparers of business reports need to explain to the users what they actually mean to the business. Otherwise, we just get data-driven outcomes that are not necessarily all that useful to the user. I think the recent IASB exposure draft on narrative reporting is a step in the right direction."

[2] Chairman of the IASB. See also the interview with David Tweedie later in this series.

Make narrative reporting a communications exercise, not merely a compliance exercise

How can we prevent these contextual narratives from turning into meaningless boilerplate?

"Management and directors' reports should be telling what is really happening in the business, and that is going to be the challenge for many preparers. I don't know if it is already included in the training of accountants and boards of companies, to develop an understanding that this is not a compliance exercise, but a communications exercise with your stakeholders. You need to get your message across as to what is the economic reality, and if the numbers are not enough, or if you need any further explanation, then it should be in a narrative of some sort."

Put the critical issues forward for your users

How should you structure business reporting so readers of the main information do not miss vital points that might be hidden in the footnotes?

"It comes back to good governance at the board, saying, 'Here are the critical measures for the company.' Actually putting the vital points forward for your users would be helpful, as they might not be well accustomed to the industry or might not know the economic situation that is developing. There is no simple solution for this, but there are basic principles for clarity, transparency, and being open about the current situation and the critical things for the company. To have that actually spelled out in your annual report does give the user a much better handle on what is happening."

Providing adequate disclosure without releasing proprietary information is quite well possible

What about the risk of giving away competitive advantage (through more transparent reporting)?

"My experience tells me that well-run companies can give quite a clear indication of where they are at in their business, without releasing information which third parties could use to their disadvantage. People hide a little bit behind the idea that if you tell too much then your competitors will gain advantage from that. However, it can't be a competitive disadvantage to be open about the various factors that are affecting your company and that are vital, because those are probably known by your competitors, and it will be affecting them as well.

"If you look at some of the well-run companies in Australia and here in New Zealand, they are very open in their reporting. Of course, there will be some ongoing negotiations that are not disclosed, but fundamentally it is not hard to get a handle on how that company is traveling. Good reporting is very useful to the owners and very useful to the management."

If you are buying or selling in a functioning market, then you should fair-value it

How important is fair value to users, and how should we move forward after the fierce fair value discussion in the midst of the financial crisis?

“Fair value is very important to users. I think where markets are liquid and functioning efficiently, fair value is the number that users would like to see. They want to know if they sold or bought it today—with a willing seller and a willing buyer—what the fair value would be.

“Where markets are not functioning properly, and are frozen or illiquid, and you are going to use a model valuation, then you should explain to the users, ‘This is not (the actual) fair value but a model valuation,’ and ‘We have used this fair value model and these assumptions to come to a valuation.’

“It is a more difficult question for assets which are held for a very long term as part of the business—for example, a whole portfolio of loans with no intention to sell. These assets should perhaps be valued in a different way. So the Financial Crisis Advisory Group came out with a mixed-model recommendation, which I am comfortable with. But I don’t agree with the idea that you wouldn’t use fair value, while you are dealing with a highly liquid, marketable asset. If you are in the business of buying or selling something that is in a working market, then you should fair-value it. If it is something you are planning to hold to maturity and that is your business model, then there is an argument for a mixed-measurement model.”

Don’t allow management to undertake valuation as it chooses

Is the hold-or-sell decision not a management decision?

“What I don’t think you can do is to allow management to pick and choose between the models that will best suit the most robust numbers for today’s reporting. I fear that that is what some managers would prefer to do. They prefer to say, ‘If I look at the current fair value, oh gosh, with the market down, I don’t want to report that number. I’d rather say: I hold it to maturity and then I report another number.’ And of course, massaging of outcomes leads to gross lack of confidence in the markets, and when we have a lack of confidence, we get a herding instinct which leads to a very unfortunate downward spiral, as we have had just recently.”

Managers could also use the prescribed fair value model and explain their view in the narrative.

“That is an alternative view. Both are coming to the same end, which is to be transparent and open with the users of the financial report, to explain how you came to your valuation method. The mischief occurs where management wants to hold to itself the option of valuing assets as it would like to. We have seen this happen and it led to a confidence crisis in the market. We cannot leave it in the hands of managers just to undertake valuation as they choose.”

Assurance on narrative should be considered

In addition to the audit of financial statements, should auditors also provide assurance on the narrative?

“It seems to me that auditors are reluctant to provide assurance in the area of narrative reporting, and this may be linked to their liability. They tend to think that they are not required to do that, and yet this is the sort of assurance that can be extremely important to users of the financial accounts. Some sort of limited liability might encourage auditors to be a little bit bolder and a little bit more willing to give opinions that are more useful. On the other hand, auditors and good audits have been undervalued. Audit is critical, and users rely on those assurances. We need to get those assurances right and make them useful.”

Auditor liability needs to be addressed to make auditors less risk averse

What would be your suggestion to make auditors a bit more forthcoming?

"I think it is going to be increasingly necessary for the audit profession to be a little less risk averse. Therefore, this auditor-liability issue needs to be addressed. There are various models around the world that do limit auditor liability, and that is something that has been looked upon by policymakers here in New Zealand."

Implement international auditing standards

What should be the next steps in the area of auditing standards?

"In addition to accounting standards, we also need globally recognized international auditing standards that can be globally implemented in a similar way as IFRSs. IOSCO has made some positive statements about the International Standards on Auditing[3] (ISAs). That is an important step in the right direction. Accounting and auditing standards are in a sense two bookends of the same important financial reporting framework. The recently established International Forum of Independent Audit Regulators (IFIAR), the international audit oversight body, could play a useful role in this development."

Audit concentration

What is your view on the concentration in the audit market?

"The concentration of the audit market into the so-called 'Big 4' audit firms is a business phenomenon which has emerged. These firms hire good people and they undertake rigorous training for their staff. I do not necessarily see any regulatory intervention that should be undertaken. It might be that some of the second-tier firms should aspire to actually join the Big 4, and that could be a welcome development for the marketplace."

"Develop global, implement local," as an alternative for convergence

You advocated convergence of accounting and auditing standards. Should there also be global convergence of corporate governance standards and securities market regulation?

"My view is that it is possible to have global standards implemented locally. That is an alternative to strict convergence, and I think both approaches work. For accounting, I think it is important we have convergence to IFRS, but in securities market regulation we have global standards that are then implemented nationally. That is what we see in IOSCO: a coming together of virtually the whole of the global capital-market oversight, developing solutions that can be implemented domestically, but from a global idea. I think the IOSCO model works remarkably well and I believe that is the way for the 21st century. The 20th century was the century of structural solutions, and by the end of that century, some global institutions were challenged for reach and relevance. The 21st century is going to be one of network solutions, and that is what IOSCO offers."

[3] ISAs are issued by the International Audit and Assurance Standards Board (IAASB), an independent standard-setting board supported by IFAC.

What about global convergence of corporate governance standards?

"For corporate governance, we probably need some consensus on what should become the global standard. The OECD is working hard on this and it has done some very good work. The corporate governance principles that we put forward for New Zealand were largely based on the OECD principles. The model we use at IOSCO for securities regulation would work for corporate governance as well. As long as we can get global agreement on the shape of corporate governance principles, then we should be able to implement them domestically. And I think that model would work, because some jurisdictions have a principles-based approach, while some others want and require a far more legalistic or rules-based approach of corporate governance. We should note that much of the recent work in IOSCO relates to corporate governance. It addresses transparency, management of conflicts of interest, and other corporate governance issues in some major global players—for example, hedge funds and credit-rating agencies."

Technology can help users make their own analyses

Would the use of technology help to make business reports more useful?

"We should be more forward-looking in our use of technology. The next generation of users is not going to flip through large amounts of paper. Their world is engaged in the Internet, and we need to be thinking about that in financial reporting as well. The use of technology—something like the XBRL framework and company websites—may allow people to do their own analyses in an easier and more user-friendly way. So when they get into the numbers, they can actually slice and dice them and do their own analyses."

Technology also opens the door to more continuous reporting. Would that be useful for investors and other stakeholders?

"As the credit channels have been constrained, we have been working here in New Zealand to free up capital-raising with existing shareholders. For example, we have based a new disclosure system on the continuous reporting of listed companies. Instead of issuing a full prospectus to raise further capital, listed companies can rely on updated continuous reporting. It shows us that current shareholders that are familiar with a company do not always want large prospectuses of 250 or more pages. Instead, they want to know what material changes have occurred since the last prospectus or announcement."

Are you also supportive of the increased use of more visual aids, such as charts and diagrams?

"I am a much more visual sort of person. I like to see something set out, and I get a clear view of it. I certainly support anything that increases the communication between the user and the preparer, and I think that diagrams et cetera are a good idea. However, we also need to get rid of the clutter. The narrative should not become the great novel; it should not overwhelm the numbers. Similarly, the charts and graphics should not become a sort of designer's dream. We should be aiming for clarity and brevity at the same time. That is quite a tension, I agree."

Key recommendations from Jane Diplock

1. What we need in corporate governance is more constraints on self-interest. The strongest form of defense comes from within the organization, its culture and its behaviors. In order to reinforce the behaviors and culture necessary for good corporate governance, boards should routinely check their own actions against the applicable governance principles.
2. It is critical to get the culture and the behavior of the managers of the companies better aligned with the interests of the shareholders and other stakeholders—for example, via better alignment of remuneration with the longer-term sustainable performance of the organization.
3. Shareholders and especially institutional investors should more actively pursue their ownership responsibilities. For example, they should intervene if they believe a remuneration framework is not closely enough aligned with the performance of the organization.
4. As directors take on great responsibilities, they should be exposed to liability as well. As liability is one of the drivers of good behavior, a sensible cautionary liability framework should be in place.
5. To avoid risk of reputational damage, people need to be very sure that they only take on a directorship in a company where they would be comfortable with the values of its board.
6. The move to International Financial Reporting Standards (IFRS) is vital, because the increasingly globalized supply of capital needs the support of one global set of financial reporting standards.
7. Financial reporting should provide a snapshot in time of the economic reality of a business. Elements that distort that snapshot, such as dynamic provisioning, should not be imported into accounting.
8. If the numbers in the financial report do not speak for themselves, a contextual narrative or explanation of what they actually mean to the business is required.
9. Preparers and boards should be trained to make narrative reporting a communications exercise, not merely a compliance exercise.
10. If organizations are in the business of buying or selling in a functioning market, they should fair-value their assets. If their business model is to hold their assets to maturity, there might be an argument for a mixed-attribute framework, in which such assets could be valued in a different way.
11. Auditors should be encouraged to provide assurance in the area of narrative reporting, as this can be extremely important to users of financial accounts. Addressing the auditor-liability issue might be helpful in this respect.
12. The International Standards on Auditing (ISAs), as issued by the International Audit and Assurance Standards Board (IAASB), should be globally recognized and implemented.
13. The model IOSCO uses for securities regulation—broad solutions that are developed globally but implemented domestically—would work as well for developing a global corporate governance standard.
14. Listed companies subject to a continuous-disclosure regime could possibly raise further capital from existing shareholders by using some form of continuous reporting, focusing on material changes, instead of issuing a full prospectus.

We welcome your feedback on these recommendations. To provide us with your feedback, please complete this brief survey.