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Transatlantic Corporate Governance Dialogue 2008

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Ladies and Gentlemen,

I am very pleased to be here with you this morning at what promises to be a very stimulating debate.

Jörgen Holmquist raised a number of interesting issues for today's conference. However, many of you know me well enough not to be surprised to hear that I already have a view on, at least, some of the topics that will be discussed today.

We live in difficult times. We are now a year into this crisis and things will get worse before they get better. On many occasions, I have stated that a considered response to the current crisis is what is best; there have been repeated calls by industry not to "legislate in haste" as we would then only "repent at leisure."

But time and tide wait for no one, as they say. One year on, there are areas that I have identified where there is definitely room for improvement. In the autumn, I will present proposals for legislation in certain areas by strengthening the existing prudential framework. These should help to stem the tide. However, these cannot be, nor should they ever be viewed as, a substitute for proper corporate governance.

Corporate governance is essentially about the behaviour of firms in good times and bad times. There is much room for improvement in the way financial institutions equip themselves to deal with the bad times. And that must inevitably start by addressing how they behave when the going is good.

Industry itself is well aware of its duty to address the most pressing problems. In July of this year, industry came up with its own response in the form of a report by the Institute of International Finance’s Committee on Market Best Practices . However, many of industry's own recommendations were not news to me especially on risk management, transparency, remuneration and credit rating agencies.

We had already told industry that they should enhance transparency and urgently address any weaknesses to their risk management systems. It will be a critical test for industry whether they can deliver on both.

Risk management

Financial turbulence can have many underlying causes. However, this time round, it is poor, indeed, sometimes disastrous, risk management by financial institutions which was partly to blame for the current financial turmoil. In the final analysis, such poor risk management is, in part, a result of failing internal governance.

Financial institutions will have to examine their internal governance framework with a view to embracing risk management. Risk management should be part of the strategy of the firm, the culture of the organisation,

It is the duty of senior management in financial institutions to address this. It is the role of the board to oversee this. In their respective roles, both senior management and the board need to ensure a holistic approach to firm-wide – and group-wide - risk management.

I leave it to you to debate the finer points of how best to integrate a firm's internal risk management strategy, after all that is what academics are for. But one area which I think would provide a good early warning of faults in a firm's risk management system is the firm's approach to transparency.

Market Transparency

There is an urgent need to improve transparency for investors, markets and regulators, by making sure that they are provided with proper information. This was one of our priorities in the ECOFIN roadmap of 2007.

We have strongly pushed the industry to come forward with a convincing proposal, in particular on exposures to structured products and off-balance sheet vehicles; and with basic data on primary and secondary markets. I very much welcome their efforts thus far, but would also like to stress that further efforts are needed to ensure meaningful disclosures about their risk exposures, risk management and accounting policies.

If industry delivers on the quality and accessibility of information provided to shareholders and investors alike, the ball will then be in the court of shareholders and investors. They should, then, use this information to ensure the proper management of firms. This would mean, applying their judgement to the financial institution's overall risk management strategy. From the risks exposures of the products they have been sold in the case of investors, to remuneration incentives of employees and executives in the case of shareholders. It would also greatly assist policy makers and regulators who would then have a feel for the exposures of financial institutions.

Remuneration

A word about remuneration. Up to now, there have been far too many perverse incentives in place. It cannot be either sensible or sane that compensation incentives encourage excessive risk-taking for short term gain such as the next bonus day or share option on offer. They need to be aligned with shareholder interest and long-term, firm-wide profitability.

However, I have always been of the view that addressing these perverse incentives is, in the first instance, the responsibility of industry and financial institutions themselves. I see that the IIF report comes to the same conclusion. This, of course, is no surprise. But we should also be aware that simply by changing the remuneration structure of the people who sell the products, we will not solve the problem. After all, where internal control structures work properly, employees should be prevented from taking excessive risks.

An effective internal control system should, in principle, always have been capable of preventing what we have witnessed in the last year, no matter what the remuneration structure looked like.

But it is not only remuneration schemes of employees which are at stake. The same is true, if not more so, for the remuneration schemes of board members. The Commission has always defended the position that shareholders, as the owners of the company, should have a strong say on this. This was the starting point of the Recommendation that the Commission adopted in 2004.

However, in evaluating the Recommendation last year, we found that only about a third of Member States had followed the recommendation that shareholders should be able to vote on the remuneration criteria applying to board members.

I think that in the light of recent events, Member States that have not yet done so, should reconsider their policy and ensure that shareholders can vote on the remuneration criteria of board members. A say on this issue would go a long way towards increasing or restoring shareholder confidence. It would force boards to do a whole lot more explaining than is done at present. In particular, shareholders will then be able to understand whether executive pay is linked to performance, whether it should be linked to performance or indeed, express their disapproval at a compensation package.

What we currently have is a situation where shareholders behave too much like shrinking violets – unwilling, unable but most of all unequipped- to curb corporate excesses. Shareholders should push their Member States to have a vote on this issue as laid down in the Commission Recommendation.Further action

One conclusion that I have drawn from recent events is that the EU must take action with a view to the role and the use of credit rating agencies. CRAs played a major role in the market turmoil by greatly underestimating the credit risk of structured credit products.

The recent IIF report also confirms the need to increase the independence of the credit rating process, transparency and quality of credit ratings. I appreciate that the recommendations made by the IIF are intended to foster this process. And I note that, at the moment, the agencies themselves are intensively working on improving their methods.

However, I have decided that we can no longer leave it to the rating agencies themselves to deal with this. This business is much too important for the stability of the financial markets for us to sit by watching from the sidelines. And that is why I intend to propose in October, a legally binding registration and external oversight regime whereby European regulators will supervise the policies and procedures followed by the CRAs. Reforms to the corporate and internal governance of rating agencies will be included.

Role of regulators and legislators

We also need to look at the role of supervisors in all this. It is clear that EU regulators need to cooperate more – it is not sufficient to have a national focus when financial markets are integrated at the EU level, and sometimes even at the global level. EU finance ministers agree with this, and there is a continued call for improvements to be made. That is why the Commission is preparing to revise its decisions establishing the EU supervisory networks.

The aim is to ensure that EU supervisors take account of the EU dimension in their daily work, and improve the likelihood of delivering convergent, EU-wide regulation. Key points will include a revised decision making process, better financing and setting certain work priorities at the EU level. This would go a long way towards strengthening financial stability in the EU Single Market. I will also soon propose some significant changes to our implementation of the Basel 2 regime – the so called Capital Requirements Directive. We need to strengthen certain aspects; get the incentives right for the originate- to- distribute model; large exposure regime; the distribution of home-host powers.

Conclusion

Ladies and Gentlemen, I hope your discussions today will help us to see what further conclusions might need to be drawn, in particular as regards corporate governance and financial stability.

It almost goes without saying, but I should nevertheless repeat it, that our dialogue with our US partners is essential to our reflections.

Indeed, looking forward, I am convinced that broader international cooperation among policy makers in all markets developed as a result of the credit crisis should be seen as a governance model for the future. In globalised markets, we need an international policy approach if we want to deliver efficiency and financial stability.

Thank you for your attention.