Man bites watchdog

In a speech to the Institute of Directors Annual Convention,[1] *the* **Governor** *discusses some of the issues surrounding large company collapses, and in particular the roles of auditors, the Boards of Directors and independent directors, pension fund trustees, lending banks and regulators. He argues for the need to make clearer each agency's role; for agencies to be more aware of their dependence on each other; and for more realistic expectations of how much these agencies can or should provide protection in a free market society. Action is, however, being taken or considered on accounting standards, auditing and corporate governance; a debate is under way on pension funds; and banks are examining ways of, for instance, guarding against collective over-lending. Some improvements can and must be usefully made, but the* **Governor** *finally warns against the risk of over-reaction and over-regulation. He urges that a sensible balance between investor protection and market freedom be maintained.*

We have recently witnessed some spectacular company collapses. The causes have not been identical, but there have been some common themes. One, unquestionably, has been over-ambitious expansion plans based on easy access to credit. A number of failures have been characterised by massive over-gearing and an inability to service the debt burden; in some cases, this seems to have prompted desperate attempts to keep the show going by misrepresentation and fraud. The losers have been a wide community of shareholders, employees, pensioners, banks and other creditors. I am frequently asked 'How could this have been allowed to happen?' and, of course, 'How are you going to stop it happening again?'. These are the questions I am addressing today.

I have put my remarks under the heading 'Man bites watchdog', which was a headline in the Financial Times in January. I suppose you could all easily guess who the man in question was—it was Robert Maxwell—but who do you think the watchdog was? Let me help with a list of possible candidates: the auditors and accountants; the Boards of Directors of the various Maxwell companies, or the independent directors of those companies; the pension fund trustees; the institutional shareholders; the lending banks; the various regulators—of companies, of banks, or of other financial institutions. This is not a random list. They have all at one time or another been suggested in the media, in conversations and in correspondence. I am sure many of you will have shared your own views with other people. In short we all have a tendency to look for scapegoats, and in the Maxwell case—as in others—there seems to be no shortage of candidates. It has not of course escaped me that the Bank of England is also on some people's list. We all have our favourites; few include themselves on the list.

I should add perhaps that the answer to my question—the watchdog in the FT headline—turns out to be an honourable exception and is not on my list of suggestions; it was in fact the press itself, which the FT upbraided for failing to resist more robustly the bully-boy tactics and the writs which kept revelations out of their columns.

I am not going to analyse the causes of the Maxwell collapse—indeed I doubt whether we yet know the whole story. My theme is rather how we should react to it, and for that matter to other company collapses. I shall look in turn at each of the possible candidates on the scapegoat list to see if any of them could provide a solution. There are probably representatives in this Hall today of each of the professions concerned, so that I confess to feeling just a little like Poirot at the end of a book. All the interested parties are detained here and it is my task—albeit, self-ordained—to move the finger of suspicion, and the evidence that guides it, from one to another. In which case, I should perhaps say right away that it will not alight at last on a single scapegoat.

Of course there is outrage, anguish and suffering when people face personal loss. Naturally so; and at such times it is perfectly understandable that people yearn for a risk-free world where some all powerful agency will protect us. But we also know that general prosperity springs from freedom. Sometimes that freedom is abused. We should not accept that abuse is inevitable or acceptable, but we should at the same time recognise the unacceptable costs—financially and indeed in loss of personal freedom—which would result from a system where all risks were removed. There is no way short of the thought-police to prevent every crime; and no way short of command control to remove risk in an economy—and we have seen how utterly self-defeating that is.

But nor would I want to preach for a world of total *laissez-faire*. On the contrary, there must be a legitimate balance between investor protection and market freedom.

With those caveats, I will nevertheless take a hard look at the expectations which we appear to have of protection and at where the performance of the agencies concerned seems

(1) At the Royal Albert Hall on 28 April 1992.

to fall short of those expectations—because I suspect that the main issue concerns expectations and that the solution will entail becoming clearer about who precisely is responsible for what and how far that responsibility runs. Let me go seriatim through the list of suspects. There is no significance whatever in the order in which I take them.

Auditors and accounting standards

I start with auditors and accounting standards. There is undoubtedly an 'expectations gap' here: a gap between what users of accounts expect of company reports and accounts and what is actually delivered in some cases. Both the narrative and the figures should tell the story clearly and consistently from year to year. But there is confusion still about who precisely is responsible for what in the provision of information about a company. Is it the directors? The formal answer is 'Yes', but do the auditors not have some responsibility too? Certainly investors seem to expect it, and auditors are plainly charged with ensuring that a set of accounts represents a 'true and fair' view of the company. The question is how exacting that standard is and how far the responsibility goes. And then on top of that there is the burning question of whether auditors have a responsibility for finding abuse or even fraud, and for blowing the whistle when they do. Should they be willing to act for companies without properly constructed internal audit arrangements?

Certainly these issues need to be addressed given the suggestions—even complaints—that, in a small but highly significant number of instances, accounts failed to give an accurate picture of a company's financial position. It has plainly at times been too easy for a villain to obscure his tracks, but the problem probably goes wider than that—so that there is a need to re-establish confidence in corporate reporting generally.

These issues are being addressed with considerable energy: by, amongst others, the Accounting Standards Board, the Auditing Practices Board and also by the Committee on the Financial Aspects of Corporate Governance, chaired by Sir Adrian Cadbury. Many professional accountants recognise that the expectations gap must be closed—or at least narrowed—partly by tightening up on the setting of standards, partly by more rigorous application, and partly by better monitoring to ensure that they are observed.

On the other side of the coin we need to make the expectations of users—and here I mean to include lenders, analysts, brokers and insurers—we need to make their expectations more realistic by a mixture of clarification and education. And we must get away from what at times seems to be a grossly oversimplistic approach to analysing companies, with a handful of ratios—particularly earnings per share—being regarded as the beginning and end of an analysis. It is also for *users* to make clear what they want from company accounts: they will have to make a bigger contribution to the debate than up to now. Listed companies, banks and institutional investors should recognise their advantage in supporting the Financial Reporting Council which is the guardian of the Accounting Standards Board.

We are therefore awaiting the conclusions of the various bodies considering these matters with great interest. The reaction to them will be very important.

Boards of directors and independent directors

The response must come of course not just from users and the accountancy profession—but also from company boards and their independent directors. Discussion of their role really comes under the heading 'Corporate Governance'. There has been a lot of talk about this in recent years. It is perhaps time to move beyond talk. And indeed the Association of British Insurers, the Institutional Shareholders Committee, the Institute of Chartered Accountants of England and Wales and their Scottish colleagues have all recently urged a number of measures to improve corporate governance.

Everyone recognises the prime importance of the freedom of management to drive a business forward. But that freedom *must* be exercised within a framework of effective accountability; that much, at least, is clear from the spate of corporate scandals and major failures we have seen. In the first place, this means acceptance by shareholders of their responsibility as the owners of companies—something which is easier to say than to bring about in a culture where liquid markets and highly dispersed institutional ownership can make it easier to sell a holding than to take concerns to management. But there are encouraging signs of change.

Proper corporate accountability also requires mechanisms for proper checks and balances to prevent a concentration and abuse of power; for example, separation as a general rule of the role of Chief Executive and Chairman, the appointment of independent directors, the setting up of Audit Committees. I know very well that not all our leading industrialists agree with these prescriptions. Sometimes they characterise them as the thin end of the wedge towards a European-style two-tier board structure. Personally I make no such link. No-one could seriously suggest that the current framework and arrangements are ideally suited to the complexities of our current corporate life; capitalism has evolved too much since those arrangements were first developed. So I favour the thrust of the calls for better corporate governance; indeed the Bank has been on that side of the debate for some years now. Again, Sir Adrian Cadbury's Committee will shortly have more to say on the financial aspects of this subject.

In my view the onus is on the opponents of the tide for change to say what they would do about the abuses and failures of the kind I am looking at today.

Pension fund trustees

While the debate on Corporate Governance has been under way for some years, discussion on the role and responsibilities of pension fund trustees is, comparatively speaking, just beginning. There *are* clearly questions to answer, concerning for example whether the Trustees should be independent in order to ensure their effectiveness. The National Association of Pension Funds has suggested some

sensible steps to this end, and has circulated a searching questionnaire to focus the attention of trustees on potential weak points in their arrangements.

On the whole the trust law regulation of pension funds seems to have worked well in the past, but this has been questioned by the House of Commons Social Security Select Committee whose recent Report included a call for a Royal Commission to draw up a new pensions bill. The issues merit careful consideration. Certainly, we ought not to have wholesale change for its own sake: a major failure need not necessarily be an indictment of the whole framework. Many employers have voluntarily done much to benefit pensioners and we do not want a structure so rigid that it actually works to the disadvantage of the beneficiaries. But I have heard arguments from a number of quarters that the time has come for a comprehensive review: not only because of the Maxwell case but because of a perception that the current arrangements no longer match up to the complexities of the world. For myself I do think that, amongst other things, more needs to be done to clarify the ownership of pension funds and to protect beneficiaries when their companies are taken over or go out of business. And there is the question of whether we need some regulatory checkpoints to provide early warning signals of deviation from prudent behaviour, possibly coupled with better sanctions.

The lending banks

Turning now to the lending banks, it is obviously the case that they are often castigated for lending too much, too carelessly; or alternatively for taking in good faith security which protects them to the detriment of other creditors. Are they lending too much to extravagant adventurers and not enough, say, to small business and other deserving cases? Once again, it is in part a matter of expectations. The banks are expected to be both sound businesses in their own right and yet also to play a counter-cyclical role through troughs in the economy by maintaining support to struggling companies. Clearly there are a number of conflicting expectations here: we cannot always have it both ways.

I am not going to argue that the banks invariably get it right, because patently they do not. Quite apart from some obvious lending mistakes, the management of their relationships with customers has recently attracted sharp criticism. But I also know that they have in many cases gone to considerable lengths to help companies in difficulty which they believe have a reasonable prospect of a viable future. Furthermore, the great bulk of the provisions made by the clearers this year has been against lending to smaller businesses—a sign, I would suggest, that they have not been so frightened of risk that they have turned their back on the future creators of jobs and prosperity.

But we do have to face the reality that in a free market economy some enterprises will fail. Lots of them are small, a few are large and dramatic. In some of the large failures, the banks did in a sense get it wrong—but they are victims too. Why did they get it wrong in some cases? Partly because they occasionally allowed the intensity of competition to lower their standards of prudence. But it was not simply this—they were, I believe, rather like the rest of us, resting on a chain of inter-dependencies in which each party relies on the others to get their bit right.

In many cases, the banks did seek extra protection by taking security. But that security has itself often proved illusory. For example, cross-guarantees which at first blush seem to borrow strength from elsewhere may turn out instead to be a channel of infection in the opposite direction; and the value of collateral may be vulnerable to precisely the events which cause the business to fail in the first place. All of which may suggest that greater discrimination may be needed in evaluating security.

Collateral and security have of course featured prominently in the Maxwell case itself. I have been approached by a number of pensioners—or spokesmen on their behalf—urging me to persuade the banks to restore assets to the pension funds even if legally and properly acquired in the course of banking business. I fully understand why they ask. But I do not myself believe that as a society we should automatically expect one private sector group—in this case the banks—to make good losses suffered by other private victims of a collapse which they did not cause. Banks have responsibilities not only to their own shareholders but also to the millions who are their depositors. For these reasons I have not felt it right to intervene.

The regulators

I come now to the regulators—which also embraces the supervisors. Should they collectively, including the Bank of England, have stopped the lending spree by some kind of fiat?—although I should perhaps note that we *did* from time to time point up some of the dangers of overexposure to individual sectors of the economy and to particular kinds of transaction. Should the regulators—or could they—infallibly prevent the foolish from unwise decisions? I can speak here with most authority about bank regulation. Together with other bank regulators worldwide, we set limits on the amount a bank can lend to any one customer in relation to its own capital. The Maxwell case is not a so-called 'large loan' problem for individual lenders although the loans in aggregate amount to a very large sum of money. We cannot—and should not—second guess the wisdom of each bank's individual lending decisions. The relationship between a willing lender and a willing borrower is after all like all economic contracts at the heart of the free market system. It is not the task of regulators to prevent financial institutions from making lending mistakes.

But there is another more difficult issue. Could the sum of individually prudent loans add up to an unsustainable and imprudent total? The answer is 'yes, it can'. It is my firm belief that each lender has a responsibility not only to ensure that he has a full financial picture before lending, but also that he continues by a mixture of covenants and monitoring to ensure that the borrower does not later borrow too much from others and so invalidate his earlier decision.

As a solution to this, some of the continental European banks in London have proposed a central credit register which would collate the debts of major borrowers. They argue that it would be an inefficient and costly duplication of effort for each bank to try to cultivate their own close knowledge of all the borrowers and that such a register would provide a useful cross check on a borrower's total indebtedness. To work, such a system would have to be comprehensive enough to avoid misleading, and it may be that in a global financial market unscrupulous borrowers would find it easy to cheat. Although the discussion on this subject is still incomplete, it is right to look properly at the issues.

I have not here spoken about the other regulators but the same general principles apply, and in addition we are all faced with a suggestion that the regulators should, so to speak, have seen the rogues coming and drummed them out of town. Frankly we do not have the right in a modern society to deprive people of the right to trade because we do not like the look of them: nor to condemn on suspicion alone. Poirot you recall often demands higher standards of evidence before reaching his conclusion than the other sleuths on the case who always want to arrest the easy suspect. Regulators are quite rightly in the same position, and it is why in some cases one hears it said that everybody in the market always knew. This does not entirely answer the puzzle why those who are free to be more choosey get caught out—but that is another matter.

Some lessons

So, where have we got to in our search for a scapegoat? Some critics have suggested that the Maxwell case is a failure of self-regulation—and by inference that it should be replaced by a new, official bureaucracy. I do not accept this at all. Which bit of self-regulation is supposed to be responsible for the failure? The chain of laws and agencies which deal with the various aspects of Maxwell combine a mixture of criminal and civil law, official regulation and self-regulation. Whatever the merits or demerits of self-regulation, this case does not of itself make a good object lesson one way or another.

By now I may have led you to expect an 'all is for the best of all possible worlds' kind of argument. That would be wrong. We have identified a number of roles where something is perhaps not quite right; and, more importantly, a tendency to believe that if everyone *else* does the right thing then we will be safe. We get caught out if our expectations of others are disappointed. Did the banks rely too much on the accounts: the shareholders too much on the independent directors; the regulators too much on the power of their rules to prevent excess? The answer in each case is 'Yes'—up to a point.

We therefore need to make it much clearer who does what, and the degree of protection provided by each agency's role. Expectations must be more realistic but, especially, the connections and dependencies must be better recognised. Action is already being taken or contemplated on accounting standards, auditing, corporate governance; a debate is underway on pension funds and should be encouraged; and banks are examining way of guarding against similar problems in the future. We also need to become clearer about precisely what can be expected of regulators and about what can be done to safeguard the independence of non-executive directors, accountants and other guardians of proper behaviour—so that very powerful individuals face similarly powerful obstacles to attempts to abuse their position.

Having said all that, you will not find me as a supporter of a blockbusting or portmanteau solution to the Maxwell kind of problem, but you will find me urging, encouraging, promoting the plural approach to try to get the balance right between sensible safeguards, informed by experience, and freedom to take legitimate risks. Then we will be creating the conditions in which the market mechanism works best. So the response must be balanced. We all enter into many economic transactions every day. Most of them rely on some presumption of ethical behaviour and goodwill. We rely also on a mixture of track record, of instinct and of other people's demonstration of trust. We can create various safeguards, but we will *never* have a fail-safe system. The price of freedom both for individuals and for enterprises seeking to be successful in creating prosperity is eternal vigilance, not eternal reporting. To stifle economic enterprise by too much control would be a disastrous over-reaction.

As to what happened in the Maxwell case, whatever one may say about the prime culprit, there have been lessons to learn. They are, in short, to ensure that connections are recognised and that expectations are realistic. This debate is, I believe, just starting—we must, of course, all strive to make such tragedies impossible in the future, while never forgetting that success to that end can never be absolute and that to over-react would be counterproductive.