Some Reflections on Corporate Governance

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By Sir Roderick Deane

The President, Dr Jack Dowds and Mrs Dowds,

The Vice-President Kerry Heath and the Honourable Justice Paul Heath

The Executive Officer Mr Bruce Butler

Ladies and Gentlemen

My Father, Reginald Roderick Deane, joined the CIS in 1948 after returning from war service abroad. He remained a member throughout his working life. It was at his instigation that I too became a member in 1965. The international nature of the qualification was an important consideration. Between us, we thus span 64 of the NZ Division's 75 distinguished years.

It is thus a great priviledge and pleasure for Gillian and me to be here tonight to share in this celebration of the long and successful life of one of New Zealand's splendid institutions, Chartered Secretaries New Zealand. Those of you who govern and manage the organisation can look back on the 75 years with great credit. The present 1300 members and the life and vigour of CSNZ attests to that.

For many years the title Secretary had great status. It not only described one of the most senior corporate officers but it was also widely used for some top political roles and to describe the heads of most government departments. The change of these to the ubiquitous CEO title I think was a backward step and one that probably had an impact on the image of our own Institute.

In any event, while the good news is that the CSNZ is in such good order after 75 years, which seems like a long time, the bad news is that I realise that I am only four years younger, which now seems like rather a short time to be around and I am hoping for a lot more, just as CSNZ is doing.

There is some other good news. The bonus of being over 70 is of course that my investment in health insurance should finally pay off; that there is nothing left to learn the hard way; and that people no longer regard me as a hypochondriac. Moreover, I can eat dinner at 5 pm without being thought odd; in a hostage situation I will be released first; anything I buy is unlikely to wear out; and my secrets are safe with my friends because they cannot remember them either.

But I should turn to the matters at hand before I forget what they are.

Given the concentration of the CIS on professional governance and commercial administrative matters I thought I would this evening share with you some reflections on these matters from a long and fortunate life spent at the most senior levels within the government, academic, corporate and voluntary charitable worlds. I am deeply conscious that failure to learn the lessons of history runs the costly risk of us repeating them.

In thinking about these issues, it is interesting to recall that in the mid 1980's New Zealand survived a foreign exchange crisis not unlike that which faces a number of European countries today. As it happens, the Euro assigns a single exchange rate to all its individual member countries which is not determined by their own individual economic situations but rather by the state of the Euro zone as a whole.

So the profligacy of the governments of Portugal, Italy, Greece, and Spain, the so-called PIGS, has induced severe imbalances in their economies remarkably similar in kind to that which we faced almost 30 years ago.

Our response to that crisis, and it was indeed a crisis, was to rejoin the world by freeing up our amazing array of restrictive and regulatory policies and pursuing a commonsense bunch of fiscal, monetary and exchange rate policies. The results were an initial period of painful adjustment followed by a lengthy period, 1988 to the early 2000's, when we achieved the fastest growth rate in productivity (i.e. output per person and per unit of capital) we had recorded for very many decades and indeed one of the best performances in the OECD at that time.

However, as the 2000's progressed we once again sadly lost our way. Senior Government figures of the time misguidedly and mistakenly labelled the earlier reforms as "the failed policies of the past". Fiscal surpluses became fiscal deficits as the government of the day sought political favour, external deficits persisted despite the strong world economy until 2007, and many problems attracted the government's unfailing impulse to regulate.

The present government acknowledges these dilemmas but has failed to be rigorous enough to turn the situation around. One disconcerting consequence has been that our overseas debt as a proportion of GDP is now at similar levels to those of the Euro zone cot cases.

One may wonder how many New Zealanders appreciate the gravity of this situation.

For an organization like ours, the CSNZ, it is interesting to ask ourselves what does all this amount to ?

Many of the areas that we concentrate our attention on have been subject to more intensive regulation over the past decade or so. At the same time, New Zealand's economic growth rate has slowed while both our overseas debt and fiscal situations have worsened. This has been despite favourable commodity prices. Of course, the Christchurch earthquakes have compounded our challenges.

For me, this raises the question of whether we need to reflect further on the wisdom of our regulatory structures. If more regulation is such a good idea, why has improved economic growth been so elusive ? The reasons for the slowdown in productivity growth are several and complex but let me talk about one of them, the huge regulatory morass faced by the commercial world today. We can all draw upon some illustrative but telling anecdotes.

In the simplest sense the major sign of a growing economy is a growing private sector and thus an expanding corporate world. This should imply a growing stock market. We have a new Financial Market Authority (FMA), and numerous regulations around investment advisers, insider trading, takeovers, promotion of competition, and disclosure of corporate information.

But perhaps we should reflect on this.

Over the past decade or so, the total market capitalisation of the New Zealand stock market as a proportion of GDP has declined sharply to a barely significant figure today when compared to other countries, By way of contrast, apart from the global financial crisis (GFC) period, this ratio has risen strongly in Australia. So we have regulated everything that moves in relation to our listed companies while their aggregate value has declined in relative terms.

Capitalism, now something of an unfortunate word in our politically correct times, involves, as Schumpeter reminded us, a process of creative destruction. In this world, if companies get into strife, others take them over and fix them. Today, in our world, if companies are about to go bust, either the government steps in (such as in the case of too many finance companies) and squanders the taxpayers money; or we call for some new regulation to help out.

We introduced takeover regulations, ostensibly to look after small shareholders, but the main purpose of which has now turned out to be to inhibit severely the formerly very effective takeover adjustment process. Think of how few takeovers New Zealand now has compared to a couple of decades ago.

Moreover, those companies which are successful are the most vulnerable to regulatory intrusion today. For many years the industry which achieved by far the highest growth rate of productivity in New Zealand, based on the Government Statistician's figures, was telecommunications. So the Government regulated Telecom NZ and overnight in 2006 wrote off $3 billion of market value of New Zealand's largest company.

I wonder what we have gained from this type of regulation ?

The telecommunications industry faced such huge investment uncertainty that the new Government then promised to invest $1.5 billion of the long suffering taxpayers money into fast broadband without even conducting a cost/benefit analysis. We read about how few customers are taking up the new service. Hundreds of schools are now supplied but very few have taken it up. It is too costly.

When Stevenson's concrete operations fell upon difficult times, they wanted Fletcher Building to buy the business. I was Chairman of Fletchers at the time. This seemed like a good idea except that the Commerce Commission prohibited the deal. Five years later, with Stevensons concrete business on its knees and redundancies threatened for all the staff, the Commission changed its mind. In the meantime the losses amounted to over $10 million.

Once again, this does not seem to have been the right way to think about this dilemma.

With the new financial advisers regulations, it turns out that many organisations which previously provided advice to ordinary investors are now not prepared to do so because they judge the risks and the costs too severe. Those that do provide such advice charge fees which many of us would regard as very high indeed but in one sense are understandable. So for ordinary New Zealanders, who were meant to be protected by this regulatory framework, they are now finding it harder to get advice and it is more expensive.

Again one asks whether this is the wisest way to address this type of challenge ?

Beyond this, financial advisers often recommend that small investors should use managed funds rather than investing directly in shares. Not only does this involve higher fees, in effect a double layering of fees, but it also too often associated with inadequate performance.

Much research across various countries has shown that after accounting for fees and taxes, managed funds typically fail to out-perform the equivalent stock market index in 80% of cases. Moreover, for the 20% which do out-perform the index, one cannot predict from year to year which funds those will be.

We all know that voluntary governance can be superior to compulsory governance requirements. For example, when Fletcher Challenge encountered an insider trading problem in 1999, the board resolved the matter within two days and the offender left the company. Two shareholders took action against that person and won their case for a large compensation payment. The Securities Commission investigated and took six months to produce an inadequate report which achieved nothing.

All of us who have been associated with raising funds for companies know too well that prospectus requirements in New Zealand are now onerous and costly. So the traditional way of building and funding a company by listing it on the stock market has been substantially replaced by direct trade sales rather than initial public offerings.

Fletcher Building has probably purchased more companies in the past decade than any other NZ company but until the Cranes purchase in Australia a year ago, almost all the acquisitions had been by way of off-market trade purchases rather than on-market acquisitions. Owners wanting to sell their businesses are simply not prepared to undertake the risks and costs of a new listing.

In the same way, when companies need to raise new funds today, whether this be by way of debt or equity, overnight placements to institutional players have become the favoured technique. It is lower cost and lower risk. But this risks excluding the smaller shareholders unless special efforts are made to accommodate them.

Corporate reporting requirements have become so wretchedly detailed and complex that the pages devoted to such matters as remuneration and notes to the accounts now routinely outnumber the pages devoted to a company's strategy and operations.

We need to ask ourselves whether that is what we really are seeking from all the corporate regulations we have adopted ?

Annual reports, designed to inform shareholders, have become so complex that many share holders complain that they cannot see the wood for the trees. But I wonder how many of us understand that it is the Government which insists on the huge amount of detail now required which is simply confusing for many shareholders.

When I was Chairman of Fletcher Building, ANZ National Bank and Telecom NZ, each company was obliged to submit masses of data to the Government, usually monthly. The data covered all manner of matters, ranging from climate change to prudential requirements to performance issues to operational standards to pricing matters. What becomes of these truckloads of information is a something of a mystery.

Frequently, when a public servant needed some piece of information, they would call up the company. When told that the data had already been submitted they would sheepishly acknowledge that it would be so time consuming to find that it was simply easier to call the company expert and get it directly albeit for a second time. No one ever seemed bothered by the irony let alone the cost of all of this.

Many years ago, for banks, the financial authorities all around the world decided that housing was much less risky than other loans. So the Reserve Bank issued a proclamation that loans for housing only required half the proportion of bank capital to back them compared with other forms of lending.

So what happened ? The deposit required to buy a house declined sharply, sometimes to zero. Housing loans grew rapidly. But so did house prices. And then low quality house loans were packaged up and sold to other banks. This lead directly to the Global Financial Crisis, the GFC. As a consequence, new housing activity became depressed both in New Zealand and elsewhere. Without a trace of irony, the very same authorities then redesigned the financial systems' prudential arrangements.

In the same way, we all know that one of the biggest costs of building a house today is the cost of all the local government fees and resource consents. It is a dollar cost and a time cost. It is by far the single largest explanation of why it costs so much more to build a house in New Zealand than in Australia.

It recently took the NZ Productivity Commission over 300 pages to elaborate on why house prices were so high in NZ. Most of their major recommendations related to easing regulatory constraints.

I wonder if it worries the regulators that they bear so much responsibility for the burdens we have to carry as house owners ?

For many years, as Chairman of three of New Zealand's largest companies, I was a regular visitor to the Ministry of Economic Development, now with its splendid new name as the Ministry of Business, Innovation and Employment. In all those meetings I cannot recall a single meeting where the Ministry helped the companies I represented in the sense of any "development" or "innovation". All the meetings were about endeavouring to persuade some official, almost none of whom had never worked in the private sector, to grant permission for some activity over which they had control. This was invariably a costly and time consuming process.

I suspect that you could all provide numerous further anecdotes, many of substance and all raising questions about the usefulness of the regulations so beloved by our politicians and perhaps too often by New Zealanders more widely.

We regulate takeovers to help small shareholders and hardly any takeovers then take place.

We regulate financial advisers and too many of them become more costly for small investors.

We regulate annual reports to such an extent that they become lengthy and difficult to understand.

We regulate the stock market and the relative capitalisation value goes into steep decline.

We regulate prospectus requirements to such an extent that everyone avoids using them.

We regulate housing and drive up the cost of new houses.

We call a Ministry one of development and innovation and we fail to see the irony of its name or what it actually does.

We regulate the amount of information corporates have to provide to government officials and then the bureaucrats can barely find their way through the mass of data they collect.

We regulate a huge array of commercial activities yet most government bureaucrats have never worked in the private sector and know nothing about business. Even more disturbingly, too often they do not know what they do not know.

At the same time as we have gone through this disconcerting process of re-regulating ourselves, particularly in the second half of the 2000's, we have experienced a slowdown in productivity growth, a re-emergence of fiscal deficits, a ballooning of our overseas debt, a relative decline in our stockmarket and huge additional regulatory costs for the commercial sector.

Yet we all know that it is this sector on which inevitably we must rely to generate economic growth.

My own lesson from history is not that we should be free of regulation.

It is rather that we should be careful what we wish for.

When we advocate government intervention in private sector activities, ostensibly to ameliorate problems, we need to remember that such interventions invariably create a whole new set of further challenges.

History tells us unequivocally that smaller government and less regulation is better for economic growth than the opposite.

We require much larger doses of commonsense and much more rigorous testing of regulatory changes before we pursue them, including cost/benefit analysis of them. It is altogether too easy for politicians to endeavour to appease various interest groups via regulatory interventions without realising the offsetting and costly burdens they are creating.

New Zealand is a country of great opportunity.

We can compete with the best in the world.

Our Olympians have proven that. On the economic front, we proved it in the period from the late 1980's to the early 2000's. We can do it again but only with lower regulatory costs and an environment much more conducive to business opportunities.

Good governance is thus not just about good regulation.

It is much more about high professional standards and strong integrity around the board table.

It is about achieving the right balance between the interests of customers, staff, the community and shareholders.

It is institutions such as Chartered Secretaries New Zealand which promote and uphold strong governance standards. You have been doing so for 75 years. Long may it continue to do so.

Ladies and Gentlemen, thank you very much.