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&

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Corporate governance:

An effective tool for rebuilding the financial world

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**Chairman, Securities Commission New Zealand
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***“Corporate governance: An effective tool for rebuilding
the financial world”***

**Financial Services Academy and Securities and
Exchange Commission of Sri Lanka**
Continuous Professional Development Programme

28 September 2010, Colombo, Sri Lanka



I'm most grateful to the Financial Services Academy and Securities and Exchange Commission of Sri Lanka for inviting me to talk to you today.

My presentation will take in a number of issues relating to corporate governance, beginning with the global financial crisis, and going on to discuss environmental, social and corporate governance (ESG) reporting, integrated reporting, and the proposed work of the newly established International Integrated Reporting Committee.

I'll go on to outline the work of the International Organisation of Securities Commissions (IOSCO) in setting global standards for corporate governance, and that of the Financial Crisis Advisory Group (FCAG) on financial reporting.

It's a pleasure to come from the cold spring of a South Pacific island to a tropical island in the Indian Ocean. That our two nations are islands did not, however, protect either of us from the effects of the storm that was the global financial crisis.

In 2010, that shock is receding, and I note here the astounding recovery made by Sri Lanka. Last year your stock market gained more 100%, making it one of the best performing markets in the world.

The lessons of the global financial crisis

- The interconnectedness of global markets
 - disruption in one market can cause major disruptions in others
 - markets are global
- Markets matter
 - Prudential regulation of institutions
 - “virtuous twins” needed
- Governance matters
 - Traditional standards of conduct overwhelmed by unregulated market forces
 - “a crisis of ethic proportions”



The lessons of the global financial crisis

None of us, though, can afford to forget the lessons of the global financial crisis. The three most important are:

- the interconnectedness of global markets;
- that markets matter; and
- that governance matters.

Perhaps the most startling discovery was that, in the 21st century, neither national borders nor territorial waters could stand in the way of capital flows and, therefore, financial crises. Markets are now global: technology has made them so.

Before the crisis, few New Zealand or Sri Lankan investors and market participants could have imagined that the mis-selling of a mortgage product to an unemployed person in the suburbs of Chicago could impact on their economic futures and that of those around them.

It could, and it did. We discovered to our chagrin that disruption in one market was capable of causing major disruptions in other, apparently remote, markets.

The crisis also overturned the traditional belief that, so long as we regulate institutions such as banks, markets would look after themselves. We thought the self-interest that drove the



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markets meant they would discipline and take care of themselves, while continuing to deliver sustained economic growth and welfare.

The crisis demonstrated that this belief was woefully wrong-headed.

What's replaced it is the insight that the overall health of markets relies on the health of all their nodes and linkages, and the capital flows between them.

Regulation of markets *and* regulation of systemically important institutions are the virtuous twins of financial stability. Both must be in place if we are to avoid further crises

The third crucial lesson of the crisis was that governance matters. A strong case can be made that the replacement of traditional, centuries-old standards of conduct by unregulated market forces was a major precipitant of the crisis.

It demonstrated that good governance is necessary for a stable securities market. The underlying behaviours that led to the crisis arose in market conduct and infrastructure, and the risks were transmitted through the markets.

John Bogle, founder and former CEO of US company Vanguard Group of Mutual Funds and one of my colleagues on the international Financial Crisis Advisory Group (FCAG) has referred to it as a “crisis of ethic proportions”.¹

He places, and I quote, “a heavy responsibility for the meltdown on a broad deterioration in traditional ethical standards.”²

He argues convincingly that the prevailing philosophy allowed – even if its players did not expressly articulate it – the go-for-broke, winner-takes-all, short-term view that inevitably eroded and finally collapsed the markets and banks on which it relied to meet its ends.

¹ John C. Bogle: ‘A Crisis of Ethic Proportions: We must establish a 'fiduciary society.'’, *The Wall Street Journal*, 21 April 2009. <http://online.wsj.com/article/SB124027114694536997.html>.

² Presentation by John C. Bogle, “The Culture That Gave Rise To The Current Financial Crisis”, Seventh Annual John M. Templeton, Jr., Lecture on Economic Liberties and the Constitution, National Constitution Center, Philadelphia, PA, May 13, 2009.



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Why corporate governance matters

- Good corporate governance is good business
- Vital plank in investor protection
- Enhances investor confidence
- Without investor confidence, securities markets stagnate or decline



Why corporate governance matters

The lesson of the crisis wasn't that behaving well is *more* important than making a profit. It's that it's necessary to behave well *in order* to make a profit. Good corporate governance is good business.

Like regulators everywhere, I'm keenly interested in encouraging, and where necessary enforcing, good corporate governance. This is not the pursuit of ethical behaviour for its own sake, but because it is a vital plank in investor protection.

Investor protection enhances investor confidence, and, without investor confidence, securities markets stagnate or decline. That is something none of us want.

Most informed observers – including former US Federal Reserve chairman Alan Greenspan – now agree that the pre-crisis faith in markets to regulate themselves was misplaced.

Healthy markets require a healthy environment, and good governance is a crucial element of such an environment.



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What is good governance?

- Codification of sound ethical standards
- Prevents self-interest getting out of hand
- NZ Securities Commission's nine corporate governance principles set a minimum standard
- Increasing public expectation that governance be comprehensive: environmental, social and corporate governance



What is good governance?

Governance is the codification of sound ethical standards. It covers every aspect of how a company behaves. As a general principle, every decision a company makes and every initiative it institutes must be soundly based not just in the pragmatics of profit but in high ethical standards.

As John Bogle says, the aim of good governance is to prevent self-interest getting out of hand.³

Back in 2004, the New Zealand Securities Commission published eight corporate governance principles:

1. Directors should observe and foster high ethical standards;
2. Boards should comprise a balance of independence, skills, knowledge, experience, and perspectives;
3. Boards should use committees where these would make them more effective;

³ [Financial Reform: Will it Forestall a Future Crisis of *Ethic* Proportions?](http://www.huffingtonpost.com/john-c-bogle/financial-reform-will-it_b_656043.html), The Financial Fix, July 22 2010 [tp://www.huffingtonpost.com/john-c-bogle/financial-reform-will-it_b_656043.html](http://www.huffingtonpost.com/john-c-bogle/financial-reform-will-it_b_656043.html)



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4. Directors should demand integrity in financial reporting, as well as promptness and appropriate disclosure of company affairs;
5. Director and executive remuneration should be transparent, fair and reasonable;
6. Boards should regularly verify that the company has proper processes for identifying and managing risks;
7. Boards should ensure external audit processes are independent and of good quality;
8. They should foster constructive shareholder relationships, encouraging shareholders to engage with the company; and
9. In the context of the company's ownership and purpose, boards should respect stakeholder interests.

In New Zealand we continue to monitor company performance against these benchmarks, because encouraging and, where necessary enforcing, sound governance is a vital plank in investor protection and, therefore, market health.

These principles, though, amount to a bare minimum. We encourage companies to do more than this, and a good number of them do.

This century has seen a dramatic expansion of what the public believes good governance should consist of and take into account. Companies are increasingly expected to hold to a vision that covers not just their investors' bottom-line interests but the interests of employees and suppliers, local communities and the wider world.

Nowhere is this more evident than in the growing expectation that companies address the challenge of climate change. Investors are increasingly expecting to see an understanding of sustainability embodied in company policies and practices.

It's this modern, comprehensive view of governance that I'd like to talk to you about now.

Reporting on environment, social and governance aspects

- Good governance is good business
 - 84% of 200 global institutional investors willing to pay premium for shares in a well-governed company
 - 11% of US assets tied up in socially responsible investment
- US Securities and Exchange Commission (SEC): companies must disclose any information "material" to investors
- World Federation of Stock Exchanges report: move towards more sustainable business models



Reporting on environment, social and governance aspects

As part of its demand for social responsibility from those who govern, administer and do business, the public is increasingly expecting companies to report on environmental, social and corporate governance (ESG).

As part of the global community, we care and are affected by what businesses do or don't do in respect of their non-financial performance. It matters to us all.

Nowadays, smart companies recognise the power of this kind of transparency to drive investment. They are aware of the need to guard their own reputational risk, and they know that good governance – which must include sound policies and reporting on ESG issues – is, as many studies have shown, good business.

A pre-global financial crisis opinion survey⁴ found that more than 84% of 200 global institutional investors were willing to pay a premium for shares in a well-governed company, in preference to a poorly governed one with a similar financial record.

Three-quarters said board practices were at least as important to them as financial performance. In the aftermath of the crisis, those figures might be even more impressive.

⁴ Investor Opinion Survey, McKinsey & Co., June 2000 cited in *King report on Corporate Governance for South Africa, 2001*.



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Around 11% of US assets are now tied up in socially responsible investment.⁵

Earlier this year, the US Securities and Exchange Commission (SEC) released a paper on public securities disclosure requirements. It set a standard against which companies can determine their reporting obligations on climate change-related matters.

US companies must disclose any information "material" to investors – that is, whenever there is a substantial likelihood that a reasonable investor would consider the information important when deciding how to vote or make an investment decision.

Stock exchanges too face mounting market pressures that challenge their traditional business model. Beefing up their commitment to ESG disclosure is likely to give them a competitive edge in the form of new products and enhance their public reputation.

A recent World Federation of Stock Exchanges report notes that the world's stock exchanges are moving on three main fronts towards more sustainable business models:

- [raising ESG awareness and standards among listed companies;](#)
- [providing information, products and services for sustainable investors;](#) and
- [fostering specialised markets for specific sustainable investment niches.](#)

Limited snapshots of company performance no longer fit the bill. What investors and the wider community want is a panorama that takes in not just a wider view, but a longer-term one. One that accounts for the overall impact of corporate behaviour, and relates to the sustainability of the enterprise.

⁵ Based on an analysis by founder and director of Delsus Ltd Dan Siddy of a report commissioned in 2008 by the World Federation of Exchanges.



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Integrated reporting

- Presents panorama rather than just snapshot
- Combines ESG and financials in single report
- Ties governance into basic business processes
- Mainstreams non-financial goals
- International awareness of integrated reporting growing and deepening



Integrated Reporting

The way to present this panorama is via what's known as integrated reporting.

Admirable though it is to report on ESG issues in separate documents, the very fact of their separateness can limit a company's vision and policies. Combining all these elements in one report ensures the financial management perspective is married up with the wider social, governance and environmental perspectives.

This is the essence of integrated reporting, and it is a growing practice.

Integrated reporting ensures companies consider a lot more than the traditional, tightly defined, financial bottom line when making everyday as well as big decisions. It ties governance into basic business processes, and mainstreams non-financial goals.

This is no mere symbolic gesture. To be sure, integrated reports – or One Reports, as they are called – are a demonstration of commitment to ESG issues, but they are also a tool for achieving related goals. They ensure companies take action.

International auditing firm KPMG⁶ identifies three key features of integrated reporting:

⁶ KPMG Integrated Reporting, 2010.



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1. reporting that covers not just financials, but also economic, social, environmental and governance factors;
2. performance that follows a company' strategy and targets; and
3. reporting that serves a wide range of stakeholders.

Bloomberg Professional is a US company providing financial markets with news, information and analysis. In 2009, it began providing ESG data too.

One writer says that “the move to include this information as part of its service could be viewed as a signal that financial and non-financial information, linked One Report-style, is the future of corporate reviewing.”⁷

Awareness of integrated reporting is bound to grow and deepen internationally. More and more companies will practice it; more and more investors and stakeholders will encourage, even demand, it.

It's possible that in a few years from now, it will be required practice the world over.

The International Integrated Reporting Committee

- Steering committee of 33: CEOs of global companies, leading accountancy professionals, standard setters sustainable development experts, regulators, academics
- Remit: to create a globally accepted framework for accounting for sustainability in a consistent and comparable format
- Companies to disclose overall performance to meet needs of more sustainable global economic model



The International Integrated Reporting Committee

⁷

ibid



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The greatest challenge to integrated reporting is the absence of well-accepted standards for reporting on non-financial performance, and the lack of regulatory enforcement.

I'd like to tell you about a new initiative with which I've recently become involved, one that tackles the issue of comparable standards of ESG reporting head on. The International Integrated Reporting Committee (IIRC) has been set up by the Prince of Wales's Accounting for Sustainability Project and the Global Reporting Initiative.

The IIRC is chaired by the Prince of Wales's private secretary Sir Michael Peat, and its steering committee of 33 includes CEOs of global companies, leading accountancy professionals, standard setters, sustainable development experts, regulators, academics, and, I'm honoured to say, myself.

HRH The Prince of Wales has recognised that the world has never faced greater challenges – in the form of over-consumption of finite natural resources, climate change, and growing needs for clean water, food and a better standard of living for a burgeoning population.

He has said that we are currently “battling to meet 21st century challenges with, at best, 20th century decision-making and reporting systems.”

The IIRC's remit, then, is to create a globally accepted framework for accounting for sustainability. This framework will bring together financial, environmental, social and governance information in a clear, concise, consistent and, therefore, comparable format.

The intention is to help develop more comprehensive and comprehensible information about an organisation's overall performance – prospective as well as retrospective – to meet the needs of the emerging, more sustainable, global economic model.

The IIRC's work plan is to propose approaches to three main areas:

1. developing proposals for an integrated reporting framework;
2. raising awareness of the need for integrated reporting, and developing a consensus on the response required; and
3. establishing a formal IIRC or developing a handover strategy to pass on the work to a newly created or existing standard-setting body.

All of us have a stake in a sustainable society. While integrated reporting alone cannot ensure sustainability, it is nevertheless a powerful mechanism for helping us all make better decisions about the resources we consume and the lives we lead.

I believe we will look back on the creation of the IIRC as a turning point in the development of corporate reporting.



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IOSCO

- Recognised standard setter for world's securities markets
- 119 jurisdictional members regulating more than 95% of world's securities markets
- Works closely with sister organisations responsible for banking and insurance standard setting
- Exists to promote global financial stability
- Holds to three basic premises:
 - markets are global
 - market stability is crucial to economic health
 - good market conduct is crucial to market stability



IOSCO

Because the financial crisis brought it home to us that markets are global, minding our own business at home is no longer enough. In the 21st century, all matters relating to markets and their governance, regulation, financial reporting, accounting and auditing must be globally oriented.

This is where IOSCO comes in. It is the recognised standard setter for the world's securities markets, and I have the privilege of chairing of its Executive Committee.

Its 119 jurisdictional members regulate more than 95% of the world's securities markets. Most are independently constituted government regulators.

IOSCO works closely with sister organisations responsible for standard setting in the banking and insurance sectors: the Basel Committee on Banking Supervision and the International Association of Insurance Supervisors. Furthermore, it has two seats on the Financial Stability Board (FSB).

IOSCO is a vital part of the global financial system's regulatory architecture because it stands at the intersection of the ideas I have already outlined:

- that markets are global;



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- that market stability is crucial to economic health; and
- that good market conduct is crucial to market stability.

It exists to promote global financial stability by means of agreement on, and application of, consistent standards across the world's financial markets. Where those standards fail to be met, it aims to enable effective enforcement across jurisdictions.

Its work has always focused on addressing risks to investor protection and on the fair and efficient functioning of financial markets. However, whereas a decade ago IOSCO was a network of regulators setting aspirational standards that jurisdictions looked to import into their own domestic regulatory frameworks, the requirements of regulating securities markets in the 21st century have led to it becoming more operational.

Each member jurisdiction retains its sovereign capacity to set and regulate its own standards, but each also has a vested interest in implementing the standards IOSCO sets by consensus. This approach gives IOSCO an international reach that benefits the entire global community.

The organisation has been ideally placed to play a leading role in the international response to the global financial crisis, and has been recognised by the G20 as a major contributor to that response. One important aspect of this has been in the area of accounting and disclosure.

IOSCO's work on financial reporting

- Sound financial reporting a necessity:
 - enhances market transparency
 - mitigates systemic risk
 - levels the playing field for investors
 - enhances investor confidence
 - encourages people to invest in securities markets
 - grows the economy
- IOSCO and members:
 - comment on International Accounting Standards Board (IASB) draft standards
 - contribute to development of IASs
 - closely involved in work of IASB Monitoring Board and Financial Crisis Advisory Group (FCAG)



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The drive for integrated reporting doesn't for a moment lessen the importance of sound financial reporting, and the global financial crisis highlighted a number of financial reporting issues.

Sound financial reporting contributes hugely to market transparency, thus helping mitigate systemic risk. Appropriately executed, it helps level the playing field for investors. It is the mechanism by which investors and potential investors measure the economic reality of entities at any given moment.

Sound financial reporting also enhances general investor confidence, encouraging people to invest in securities markets, and thereby growing the real economy.

This is why regulatory bodies around the world set such store by accounting and accountants. This is why IOSCO takes such a keen interest in the machinery, governance and outcomes of global standard setting for accounting and auditing.

IOSCO and its individual members comment on draft standards released by the International Accounting Standards Board (IASB) as exposure drafts. They also contribute to the development of IASs.

Since the global financial crisis, IOSCO has been closely involved in initiatives to improve transparency by way of better quality disclosures, and enhancements of the governance of international accounting standard setting.

The formation of the IASB Monitoring Board by IOSCO was one the most important of these. The work of the Financial Crisis Advisory Group (FCAG) is also worth noting.



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Financial Crisis Advisory Group

- Formed 2008 to investigate and advise on implications of the GFC for financial reporting
- Comprises 18 recognised financial market leaders
- July 2009 report recommendations:
 - importance of effective financial reporting
 - recognition of the limitations of financial reporting
 - convergence of accounting standards
 - standard-setter independence and accountability



Financial Crisis Advisory Group

FCAG, on which I have had the honour of serving, was formed in late 2008 as an FASB and IASB joint initiative to investigate and advise on the implications of the global financial crisis for financial reporting.

It comprises 18 recognised financial market leaders, and is jointly chaired by the Chair of the Netherlands Authority for Financial Markets, and a former Commissioner of the US Securities and Exchange Commission.

FCAG's July 2009 report⁸ made several key recommendations to the FASB, the IASB and the G20. As I said at the time, the report highlighted the importance to financial stability of high-quality accounting standards, faithfully applied via rigorous, independent audit.

FCAG's recommendations took the form of four broad principles, and I'll look at these one at a time.

1. The importance of effective financial reporting

⁸

<http://www.iasb.org/NR/rdonlyres/2D2862CC-BEFC-4A1E-8DDC-F159B78C2AA6/0/FCAGReportJuly2009.pdf>



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The report noted the limitations exposed by the financial crisis of current reporting standards. It emphasised the critical importance of financial reporting to market participants, including investors and regulators.

It recommended:

- simplifying the reporting of complex financial instruments
-
- exploring alternative standards for loan-loss provisioning, and
-
- improving standards relating to off-balance sheet issues, such as consolidation and de-recognition.

2. Recognition of the limitations of financial reporting

FCAG noted that financial reporting – although critical to market transparency – has limitations. It encouraged financial report users to apply their own judgment or due diligence, particularly on price transparency.

It encouraged authorities to set up robust infrastructures to foster price transparency, particularly for structured products and derivatives.

It urged financial institutions to ensure they maintain effective price verification processes in order to improve asset and liability valuations that are independent of sales trading and other commercial functions.

3. Convergence of accounting standards

A very significant recommendation by FCAG to the G20 was to push for a single global accounting standard by converging IFRS and US GAAP.

As I'm sure you are aware, the existence of these two financial standards significantly hinders market transparency. It also hinders direct comparison of entities that are using separate standards, particularly those engaged in cross-border activity.

It requires international investors and potential investors to understand both financial reporting frameworks. This creates a risk of significant issues being lost in translation.

FCAG encouraged the IASB and FASB – along with national governments, financial market participants and the global business community – to make every effort to achieve a single set of globally converged financial reporting standards.

It also encouraged national governments to set firm timetables for implementing IFRS. It recommended international accounting firms take the lead in harmonising accounting standard interpretations across jurisdictions.

4. Standard-setter independence and accountability

Finally, the FCAG report emphasised the importance of maintaining accounting standard-setter independence from commercial and political pressure.

It stated the need for independence to be balanced by due process. Due process includes engaging with stakeholders, and thorough monitoring board oversight conducted in the public interest. It recommended that monitoring board membership include securities regulators from a wider range of nations.

Conclusion

- Old securities market models no longer work
- Vital to recognise importance of the “virtual twins”
- Network thinking helps us understand systemic risk and develop regulatory tools
- Jurisdictional frameworks will be pulled into broader international framework: this is where our best interests lie
- *“To now rebuild without rethinking would expose the financial system in the future to a repeat of the crisis just passed.”*
 - Australia Securities and Investment Commission Chief Economist Alex Erskine

Conclusion

The global financial crisis brought home once and for all that our old securities market models no longer work. The post-crisis situation demands an overhaul of traditional, orthodox theories of financial stability.

Our concept of systemic risk must recognise that financial stability is as much the concern of securities markets regulators as it is of prudential supervisors.



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The 20th century financial model suggested structural or mechanistic solutions that are now out-dated. The 21st century is likely to be the century of networked solutions. This paradigm closely resembles the ecological model, in that all aspects of a system are connected, so what happens in one part is likely to affect the rest.

The value of conceptualising the global financial system as a network is that it will help us find ways to understanding systemic risk in markets and to develop appropriate regulatory tools for identifying, assessing and managing these risks.

As I pointed out at the start, no jurisdiction or market stands alone. We must acknowledge our common interests in financial markets or face the punishment of further global crises.

Until now, securities market regulation and overall corporate governance have been the province of individual jurisdictions. I believe it won't be long before we see a more global effort in pursuit of convergent standards.

IOSCO stands at the forefront of this new networked approach. It seems increasingly likely to move towards looking at the drivers of corporate behaviour in various areas, such as conflicts of interest in credit-rating agencies and hedge-fund transparency.

We are likely to find various jurisdictional frameworks increasingly pulled into a broader international framework.

A new paradigm is not always good news, of course. It takes imaginative effort and a willingness to change our world view.

It also takes a good deal of hard work to explore and put into operation the practical implications for policy, regulation, accounting systems, and – most importantly – international cooperation. Only a global approach to the aftermath of the crisis and its ongoing challenges will help prevent such a catastrophe occurring again.

I'd like to leave you with this thought from Australian Securities and Investment Commission Chief Economist Alex Erskine.

He acknowledges that the old ways of thinking about economic policy, prudential policy and securities regulatory policy partly caused the crisis and need to be rethought, that “To now rebuild without rethinking would expose the financial system in the future to a repeat of the crisis just passed”.

I couldn't agree more, and I invite you to join those of us ready to do this necessary and exciting rebuilding.

Thank you.