

The Roles of Market Discipline and Transparency in Corporate Governance Policy

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Opening remarks

In previous sessions, you have been discussing various vulnerabilities of the international financial system and related surveillance issues, some of which are quite technical and complex. In my remarks this afternoon, I will consider several rather basic factors that underlie the stability and robustness of financial markets and investor confidence – in particular, the critical interactions between corporate governance and the disciplining effects of well functioning markets. The importance of sound corporate governance to market stability and confidence has been dramatically illustrated by a series of incidents in the markets of the most advanced economies. These revealed certain weaknesses in corporate governance and related aspects of the foundations of our markets. For that reason, corporate governance issues have moved to centre stage in the financial policy deliberations of the OECD member states.² There has been considerable interest in corporate governance in OECD countries since the 1980s, but OECD systems, especially in countries with deep capital markets, were seen as robust and capable of dealing with their own problems with little official interference. This confident view is being re-examined. Significant steps towards strengthening corporate governance have been taken in a number of countries and others are being considered.

A particularly important issue in these deliberations involves the role that market discipline and transparency – the subjects of this roundtable - can and should play in strengthening corporate governance. The ways that the corporate governance system and practices, in turn, affect the functioning of markets must also be important considerations for policy. These relationships operate within the regulatory and legal framework, which should be designed to support the corrective forces of markets and enhance incentive structures. After further developing these concepts, I will discuss some of the supporting empirical evidence and the insights arising from recent experience. These are leading to an improved understanding of what constitutes “good corporate governance” and how market forces can contribute to the achievement of such governance. I will close with some remarks on the need for continued international dialogue on these issues.

Conceptual issues

One of the essential functions of financial markets is to price risk and value assets in order to enable investors to forecast what such assets will be worth in the future. Disclosure of current and past financial results and business operations is important to this function. Such information

1 The views expressed in these remarks in no way commit the OECD or its Member countries.

2 The 30 OECD Members are the following: Australia, Austria, Belgium, Canada, Czech Republic, Denmark, Finland, France, Germany, Greece, Hungary, Iceland, Ireland, Italy, Japan, Korea, Luxembourg, Mexico, Norway, New Zealand, Netherlands, Poland, Portugal, Slovak Republic, Spain, Sweden, Switzerland, Turkey, United Kingdom, United States.

is an essential input for pricing. Markets must be confident about the integrity of these data. Accounting and audit standards have an essential role to play, indeed they are almost in the nature of a public good. Yet in many cases, disclosure is still inadequate to form a fair view of a company's value. Where the level of transparency is low, greater risk and uncertainty are likely to be priced into asset valuations. One would also expect, *ceteris paribus*, financial markets operating in such an environment to be less liquid and for volatility to be greater. Shocks and surprises might also be more frequent.

We should recognise that more disclosure does not necessarily result in increased transparency, that is, the provision of information that provides market participants with a more accurate view of values and risks. I believe, for example, that requiring the continuous disclosure of market-relevant information would improve transparency; but the transparency argument for requiring full quarterly reporting is less evident.

Financial asset pricing requires not only disclosure of accurate financial statements but also disclosure of the main corporate objectives, standards and practices. Conveying this information to the market is, in my view, an essential aspect of transparency. Thus the *OECD Principles of Corporate Governance*³ call for regular, timely and accurate disclosure not only operating and financial results but also of information on commercial objectives, ownership structures, boards of directors and key executives and their remuneration, related party transactions, governance structures and internal controls. Additionally, information about policies towards stakeholders and corporate social objectives is also a desirable element of transparency.

Transparency also relates to the critical issue of trust. As Alan Greenspan reminded us in a speech last week⁴, "It is hard to overstate the importance of reputation in a market economy....Rules cannot substitute for character." When markets lose confidence in the integrity of information provided by a firm, that is, when markets no longer can trust the firm, the negative effects are likely to be dramatic. This is particularly the case for financial institutions for which the loss of reputation can mean the failure of the firm.

This brings me to consider the critical role of market discipline, which works through a number of processes:

First, there is empowerment of shareholders, meaning providing the conditions under which shareholders have both incentives and the means to act to discipline management. I might add that until now, only a small minority of institutional investors could be characterised as "activist". However, one of the possible lessons of the corporate governance scandals since 2000 is that all institutions will have to give more serious consideration to the ways in which they exercise their ownership rights in the corporate sector.

Second, the market for corporate control is an important way in which shareholders exercise, in effect, an ultimate discipline over management;

Third, there are the many competitive processes in the general economy, that is, the competition in the markets for goods and services. This includes credit markets that ensure binding budget constraints for companies and a sound allocation of credit and capital. It is through the financial

3 These can be found at www.oecd.org under the "Corporate Governance" theme.

4 Alan Greenspan, *Corporate Governance*, at the 2003 Conference on Bank Structure and Competition, Chicago, Ill, May 8, 2003

markets and the relevant product markets that the important reputational elements of market discipline play their corrective role.

If these processes are to operate efficiently and effectively, markets need robust corporate governance arrangements – what we call “good corporate governance”. Very briefly, in addition to providing adequate transparency, the governance framework should specify the rights of shareholders and provide effective means for shareholders to exercise those rights. Such arrangements also include the elaboration of the duties of key participants such as boards of directors. A large part of this framework is decided by non-official arrangements such as stock exchange listing requirements and voluntary codes. However, policy has a role here in setting basic standards (or ensuring they are appropriately set).

The processes of market discipline discussed earlier are central to the effectiveness of the corporate governance arrangements which are worked out by the private sector; indeed, they drive the evolution of those arrangements. Accordingly, the regulatory and legal frameworks for the operation of markets should be essential components of corporate governance policy at the governmental level. That policy needs to take account of the fact that the effectiveness of market discipline is influenced by the efficiency of financial markets and that transparency is, in turn, a key determinant of market efficiency and the evolution of corporate governance. Attention needs to be given to the incentive structures that are established and to the provision of sufficient space for innovation and entrepreneurship.

Empirical evidence

Empirical work has produced strong evidence that transparency and corporate governance do indeed matter for both OECD and non-OECD regions and at both the country and individual company levels. High levels of transparency, as measured by indices of opacity, are found to be associated with lower country risk premia and costs of capital and higher trading volumes or liquidity⁵. Similarly, companies with less demanding corporate governance standards have been shown to experience higher capital costs and also to pay greater risk premia on their bonds⁶. Governance deficiencies have been shown to be associated with an increased probability that takeovers will not be successful and with a greater fall in the share price of the acquiring firm⁷. Moreover, the quality of corporate governance appears to have an effect on the ability of companies to manage risk and react to macroeconomic shocks. Companies with good corporate governance arrangements in Asia, especially Korea⁸, for example, weathered the financial crisis better than those with less developed governance structures in place.

5 PriceWaterhouseCoopers, Investigating the costs of opacity: Deterred foreign direct investment, April 2001; and Bhattacharya, et al, The world price of earnings opacity, forthcoming, Journal of Financial Economics, 2003

6 For example, one study focuses on the effect of takeover barriers which vary between US states. P. Gompers, J. Ishii and A. Metrick, “Corporate governance and equity prices”, NBER Working Paper, 8449, 2001; and a study for Germany looked at overall indices of corporate governance finding that it indeed did influence the cost of capital in the expected direction. W. Drobetz et al, Corporate finance and expected stock returns: evidence from Germany, ECGI Working paper in Finance, 11/2003

7 B. Hermalin and M. Weisbach, “Boards of directors as an endogenously determined institution: A survey of the economic literature”, NBER Working Paper, 8161, 2001

8 S. Johnson et al, “Corporate Governance in the Asian financial crisis”, Journal of Financial Economics, 58, 2000

What constitutes “Good Corporate Governance”? : The OECD Principles

An important question for public policy is whether we can we agree about what constitutes good corporate governance. How is this consensus being affected by recent developments?

The fact that the OECD was able to bring together some 30 countries and many stakeholders in 1999 to form a consensus on the *OECD Principles of Corporate Governance* shows that there is now general agreement about the overall features of good corporate governance. The agreement also implies a great deal about the basic policy directions which are needed. There are, of course, different ways of meeting the same principle or outcome such as independently minded boards or effective oversight of internal accounting systems. What constitutes the best way of achieving the desired outcome is a critical question for the private sector and for public policy, and will often differ from country to country.

It is also clear that the *Principles* are relevant well beyond the OECD area. The Financial Stability Forum includes the *Principles* in its set of 12 key international standards it recommends to all countries for achieving sound financial systems.⁹ IOSCO’s Emerging Markets Committee has also endorsed the *Principles*¹⁰ and the World Bank and the IMF are using them as a basis for their own work.¹¹ Most important, a growing number of transition and emerging market economies have also found them a valuable framework for considering their own challenges and priorities.

Good corporate governance standards should respond to changing conditions. Even though the *OECD Principles* highlight many of the problems identified in the 1990’s, it is now time to consider whether experiences since 1999 have shown that changes or improvements are necessary. We are currently in the beginning stages of this process which will take place over the coming year. As before, it will be an inclusive process seeking to establish a wide consensus. Accordingly, it would be both premature and inappropriate to speculate on the likely outcome of this process. But I will offer a strictly personal view on several areas where more specific and demanding guidance would be desirable.

First, the integrity of financial and non-financial reporting system needs to be more closely defined, especially with respect to dealing with potential conflicts of interest. Tougher audit standards and procedures, better board oversight, and improved enforcement are key issues here. The *Principles* should support efforts to raise the quality and promote the convergence of accounting and audit standards and should refer to international standards.

Second, the board of directors will have to play a more active role in ensuring the integrity of management, in part through better alignment of managerial incentives with performance and with the interests of the shareholders and the company. The board must also ensure its own integrity. A call for “independent” directors is sometimes put forward as an answer to both concerns but such concept does not always translate well without significant adaptation to existing legal and institutional frameworks. Even within a single country such as the US, the definition is not clear. In other countries, such as Germany the oversight board is assumed to be

9 Financial Stability Forum [www.fsforum.org/compendium/key_standards_for_sound_financial_system.html]

10 IOSCO [www.iosco.org/news/pdf/IOSCONEWS5-English.pdf]

11 World Bank [www.worldbank.org/privatesector/cg/cg_rosc.htm]

independent. The essential objective is to assure that the board is actually acting as a check on management in the interests of the shareholders, rather than as a captive of management.

Third, shareholders must be given the means to exercise a greater role in ensuring board integrity. This can be achieved by removing barriers to voting (including those impeding cross-border voting) and reviewing means to make voting on key corporate governance questions more effective. It is also essential for final investors to be able to hold institutional investors accountable for the ways in which they exercise governance rights on behalf of final beneficiaries.

Finally, implementation and enforcement need to be made more demanding. This is not simply a matter of more official regulation to replace or oversee self-regulation in areas such as audit standards where conflicts of interest are strong. Rather the development of regulation needs to reflect a healthy concern to avoid over-regulation: governments must be aware of the overall regulatory impact of a proposed measure. It is increasingly recognised that strengthened market disciplines have an important role to play in improving enforcement; market self-adjustment should be encouraged. Nevertheless, there is an evident need for stronger creditor rights in some countries, including a less forgiving banking system, for more contestability in corporate control in others, and for stronger shareholder activity in most countries.

The importance of corporate governance in the financial sector

Good corporate governance is required in all sectors, but is of particular importance in financial institutions. The financial sector plays the central role of intermediating savings and allocating capital in the economy. Firms in the financial sector are key players in creating market disciplines favouring better standards in the corporate sector more generally. Most of these firms have important fiduciary functions and act as internal or external monitors. In part due to the multiplicity of intermediaries and the increasing consolidation in the financial sector across different activities, conflicts of interest are numerous. This situation has been recognised and various contracts and internal controls have been developed to contain them. Most financial institutions are subject to special regulatory regimes which usually recognise the internal governance arrangements of these institutions as part of their concern as financial supervisors. Nevertheless serious deficiencies have recently come to light, raising questions whether financial market participants can always be relied upon to act in the interest of investors – whether conflicts of interest are providing the wrong kind of incentives. The cases of biased investment research and advice provided by investment banks in order to promote the offerings of clients who were the source of underwriting fees, the uneven records of the rating agencies in spotting emerging credit problems and doubts as to whether institutional investors have been effective monitors on behalf of final beneficiaries are key cases in point. The governance regime should mitigate such conflicts.

Good corporate governance in the banking sector, which mainly uses the funds placed on deposit by the general public and which has access to insured deposits, is especially important in order to control conflicts of interest. Such conflicts arise, for example, when commercial interests are able to gain control of banks, a pattern that is very common in emerging markets and not unknown in the OECD area. The private benefits of control are simply too great and can sweep away self-regulation and even prudential oversight. Not only does poor resolution of conflicts of interest in the financial sector weaken standards in other sectors, it also makes the economy as a whole more susceptible to shocks. For example, poor corporate governance in Mexican banks led to a great deal of related-lending on favourable terms. Such lending was associated, not

surprisingly, with an increased probability of default and led to a weak banking sector, which was unable to withstand macroeconomic shocks.¹² I could list a large number of other countries as examples.

More generally, many institutional investors with a fiduciary responsibility have been shown to have rather poor internal governance, which has at times hindered their own financial performance. “Who monitors the monitors”, has become a very important question. Regulatory authorities are undertaking a lot more activity in this area, for example, in some jurisdictions by insisting that institutional investors provide more adequate disclosure of voting policies and actions and the volume of resources devoted to monitoring

For our part the OECD has formulated corporate governance guidelines for pension funds¹³ and is now finalising guidelines for the insurance sector. Guidelines for collective investment schemes such as mutual funds are also foreseen. The Basle Committee has issued corporate governance principles for the banking sector, which also are consistent with the OECD Principles.

The role of the international fora

Governments have often found it useful in complex situations to utilise international fora and dialogue, sometimes in the form of peer reviews, to form a consensus about the way forward. Indeed, in the case of corporate governance this process is already underway in the OECD, the Financial Stability Forum, the World Bank and IMF and the International Association of Securities Commissions (IOSCO)¹⁴. The development of revised OECD Principles which provide increased guidance on applicability, implementation and enforcement in different legal and economic contexts is expected to contribute to the public policy debate. They should set a basic framework through which actual policies can be viewed and compared.

Such international dialogue is even more important than ever. First, we have seen with Sarbanes-Oxley that national actions can have important international implications. Second, after years of relative neglect, governments around the world have been very active recently in the field of corporate governance with varying combinations of aspirational principles and regulatory action. However, we should note that in many cases the actions undertaken are to a greater or lesser extent experimental. For instance, we don't yet know whether a correct balance has been found between additional restrictions and space for innovation and entrepreneurship. Perhaps the emphasis on independent directors will prove ineffective. What will be the impacts on the audit profession and audit standards as accounting firms are restricted in the scope of their work?

Continued monitoring and surveillance of how the corporate governance system is evolving and functioning will thus be important for some time to come. What I have in mind will build upon but go beyond the current Reports on Standards and Codes (ROSC) surveillance undertaken by the World Bank, which as the title implies, concern compliance with existing standards. The dialogue should also be an input for reviewing the standards themselves and for examining the relative

12 La Porta et al “Related lending”, *Yale IFC Working Paper* N0 02-19, May 2002

13 *Principles for Private Occupational Pensions* can be found at www.oecd.org under the theme “Insurance and Pensions”.

14 Financial Stability Forum, *Addressing Weaknesses in Market Foundations – Selected Domestic and International Initiatives*, at www.fsforum.org/downloads/Compendium.

merits in differing national situations of the various approaches which can be used to achieve the same outcome.

Concluding remarks

In conclusion, transparency is a key factor contributing to financial market efficiency and for providing the information necessary for market discipline to be effective. Market discipline and transparency, in turn, are of central importance to the provision of the robust corporate governance necessary for stable markets and investor confidence. The challenge for policy makers is to establish a framework within which transparency, market discipline and corporate governance can interact in a positive, coherent way that strengthens market integrity and economic performance.