



## **The Fourth Asian Roundtable on Corporate Governance**

### ***Shareholder Rights and the Equitable Treatment of Shareholders***

**Stilpon Nestor**

Principal, Nestor Advisors Ltd.  
United Kingdom

## **The corporate governance crisis: An opportunity for Asian corporations?**

**Mumbai, India  
11-13 November 2002**

*The views expressed in this paper are those of the author and do not necessarily represent the opinions of the OECD or its Member countries, the ADB or the World Bank*

## The corporate governance crisis: An opportunity for Asian corporations?

*Stilpon Nestor, Principal, Nestor Advisors Ltd<sup>1</sup>.*

### A. Introductory remarks

Kenneth Arrow, the economist and Nobel laureate wrote in 1974 that “...virtually every commercial transaction has within itself an element of trust, certainly any transaction conducted over a period of time”<sup>2</sup>. Trust, in other words a reasonable expectation that market information, representations and promises made in the course of commerce are dependable, is therefore a fundamental ingredient of any functioning financial market, where traded securities represent a promise of returns over a period of time. We are currently witnessing a severe reduction in value caused by a loss of trust in market integrity. The bear market that is taking hold around the world is, in the words of Alistair Ross Goobey, “... at least in part, corporate governance bear market”<sup>3</sup>. No wonder then that the current crisis of confidence in US and some other key OECD markets has brought corporate governance to the forefront of investor, corporate and political attention around the world. One could view corporate governance as the “trust collateral” of corporations. The norms, processes, procedures and behavioural patterns that constitute good governance are not a substitute for honesty and decency of company officers. But their presence guarantees that, in the absence of criminal fraud, investors and other stakeholders can rely upon the information, representations and promises that emanate from the corporation—from its officers and board of directors.

In this brief presentation, I will try to distil a few important trends that are emerging in the wake of the confidence crisis, that are of direct interest to Asian corporations. I will then suggest some elements of a response by the latter to these global concerns. Throughout the presentation, the focus is on trust between corporations and their external providers of capital. This is the foremost post-ENRON issue in the market. However, it would be wrong to think that the importance of corporate governance lies solely with better access to finance. Companies around the world are realising that better corporate governance adds considerable value to their operational performance:

- It improves **strategic thinking** at the top, by expanding on the “bounded rationality” of even the most impressive, individualistic CEOs.
- It rationalises **the management and monitoring of risk** that a firm faces globally

---

<sup>1</sup> This presentation is largely based on the author’s introductory article in the International Financial Law Review’s special issue on corporate governance, published in October 2002 (Euromoney, London).

<sup>2</sup> Arrow, Kenneth (1974) “Gifts and Exchanges” Philosophy and Public Affairs” 1 (4), 343-362, at p. 357.

<sup>3</sup> FT Funds Section, 15/7./2002, page 6. Mr. Ross Goobey is the Chairman of the International Corporate Governance Network, a coalition of large institutional investors representing more than ten trillion dollars under management, and former chairman of Hermes, one of the largest UK pension fund managers.

- It limits the **liability** of top management and directors, by carefully articulating the decision making process
- It has long term reputational effects among key **stakeholders**, both inside (employees) and outside the firm (clients, communities, political/regulatory agents).

Indeed, empirical evidence finds corporate governance to be highly correlated to operational excellence. That is why even closely held, family- owned enterprises are increasingly using the corporate governance toolkit, such as high standards of accounting (even though the accounts are seen only by the shareholders “in the family”) or independent directors, to monitor and guide an increasingly professional top management.

## **B. The trends**

There are three key trends that corporations in Asia (but also in many OECD and emerging markets outside the US and the UK) need to take into consideration as they make their corporate governance choices and formulate their strategy:

**1. Institutional investors and outside providers around the world are now putting governance at the top of their agenda.** After interviewing several institutional investors for an 18 July 2002 article, the Asian Wall Street Journal concluded that “for institutional investors picking stock in Asia, corporate governance has become more important than financial issues”. This is interesting not only because it highlights the general importance of governance. The latter had already been brought to the fore by a number of surveys: The 2002 Investor Opinion Survey by McKinsey found that institutional investors said they would pay very high premia for well-governed corporations. These premia range from 12% for the UK to 25% for Indonesia, 27% for Turkey and 38% for Russia. Credit Lyonnais (CLSA), a broker, also updated its corporate governance report in 2002 and found that corporate governance is still robustly correlated to both financial performance and stock valuations. But the intriguing new element is the newfound importance of corporate governance to stock pickers (or active fund managers) in the investment selection process. Notwithstanding big words and good intentions, investment officers hitherto placed little importance on governance when they made investment decisions. Governance was a post-investment, ownership policy concern, largely confined to index-tracking funds that have little possibility of exit from their equity positions; in other words, a tool for value preservation and enhancement in the context of a passive investment strategy. Only a few enlightened players- such as Bob Monks, the US activist investor - chose to view governance as an investment criterion and their perspective was a “value” one: they invested in poorly managed/governed firms and aimed at value enhancement through governance improvement, brought forth by active ownership. The reticence to view governance at the investment stage might be changing. Funds around the world are starting to incorporate governance as a risk parameter in their investment decisions. In Asia, a number of large fund managers such as Zurich-Scudder and Alliance Capital are employing corporate governance as an investment criterion or screen. They have good reason to expect a direct correlation of governance to share price performance:

Research published in 2001 by Gompers, Ishii and Metrick<sup>4</sup> suggests that a portfolio of well-governed companies (as defined by their rating system) would have out-performed a portfolio of badly-governed ones by a significant 8.5% per year for a 10-year period starting in 1990. This result is controlled against several variables such as sector, size and other firm level characteristics.

Ratings and the search for quantitative tools are another indication of rising investor concern with governance. Standard & Poor's have been trying to generate business for a corporate governance rating system for some time and a few emerging markets exchanges like Thailand and Shanghai have been considering the idea of a mandatory rating system for their issuers. But quantifying governance risk is like trying to quantify equity risk in individual issuers. In contrast to credit risk analysis, which is focused on the probability of occurrence of a single event (default), the critical events for analysing governance are numerous, varied and often idiosyncratic to a market or a sector. Ratings are a confidence game and it may take much longer, if at all, for the markets to trust any rating system for governance.

Corporate governance is also driven by a post-crisis wave of financial sector reform in many—albeit, not all—Asian economies, which is changing long-established domestic patterns of finance. Companies find it increasingly hard to maintain access to local sources of finance that were until recently captured by them either directly—for example, by owning a sizeable part of the financial sector, as in pre-1998 Thailand—or indirectly, by influencing the government who, in its turn controlled the financial sector, as in pre-1998 Korea.. Domestic banks and non-bank financial institutions can no longer be depended upon to provide cheap finance because they increasingly have to meet the new realities of globalisation:

- A global cost of capital, adjusted for (mostly local) risk.
- Tougher regulators, as local banking sectors face systemic risks related to capital market liberalisation,
- Tougher international rules for managing and provisioning against credit risk
- Increasing international consolidation in the banking sector
- Increasing international/multilateral pressure on governments to end crony capitalism and get their macroeconomic act together

In this respect, Moody's has turned the heat further up by announcing in June 2002 the incorporation of corporate governance variables into its credit rating methodology. Governance might thus become an explicit consideration for corporations issuing debt or, in an implicit one for companies borrowing money from a bank: somewhere down the line, the bank will presumably face a higher risk classification of its loan portfolio if it lends to poorly governed corporations and will thus step up its own policing of clients' governance. A direct link between corporate governance and credit risk is the Trojan horse through which corporate governance may assume a direct role in the pricing of corporate cost of capital, even in Asian markets in which equity corporate finance is still

---

<sup>4</sup>Paul Gompers, Joy Ishii and Andrew Metrick (2001), "Corporate governance and equity prices," *NBER Working Paper*, available at: [www.nber.org](http://www.nber.org), posted in August 2001.

relatively underdeveloped and bank finance preponderant. Only corporations that can finance growth exclusively through retained earnings will be immune from governance concerns.

**2. Boards and independent directors are expected to assume increasing responsibilities in the way companies are governed.** The failure of boards in monitoring and strategically guiding top management is central to the current crisis in the US as it was central to the Asian confidence crisis in 1998. Consequently, the response to the crisis is zeroing in on board functions and responsibility. The US response will impact on corporations around the world. The boards and CEOs of non-US corporations listed in US markets might be facing liability in US courts for governance failures. The majority- French board of the French company Vivendi has been sued in New York for acquiescing to Jean Marie Messier's alleged concealment of the true financial situation of the company. The new corporate responsibility legislation passed in the US (the Sarbanes-Oxley Act) might have direct liability consequences for CEOs and board members in any US-listed corporation, possibly including the issuers of American Depositary receipts, which hitherto faced lower standards of behaviour. In addition, the listing rules of major US exchanges are in the midst of being revised. The New York Stock Exchange (NYSE) will requiring listed companies to have a majority of independent directors, have wholly independent audit, nomination and remuneration committees, adopt an internal corporate governance code and a code of ethics and file periodic governance reports. While the NYSE is not imposing its listing requirements on non-US issuers, it does require the latter to explicitly comply or explain why they do not comply. This will probably be another important convergence driver as the largest non-US corporations in the world have or aspire to have an NYSE listing. The new NYSE rules might thus become the global benchmark in listing requirements; they follow on the steps of a steady stream of "comply or explain" codes that have been integrated into listing requirements. What's more, insurance companies are likely to demand higher corporate governance standards from companies to which they provide director and officer liability insurance.

But enhanced liability, tougher rules and more intricate processes are not enough to make boards effective and efficient. Policy makers should not "...waste their time trying to imagine systems so perfect that nobody has to be good", as T.S. Elliot put it. Being good means being honest, diligent and competent; but it also means having the time to do a good job as a director and the desire to link your reputation with the outcome of this work. Higher requirements for personal "goodness" are likely to result in a creeping professionalisation of boards and non-executive directors. Human resources are scarce and need to be trained for the job, especially in emerging markets. An increasing number of institutions have been set up to provide such training for professional directors in Asia, such as the Yale Institute for Corporate Governance in the US (largely focusing on Asian emerging market director training) and the Asian Institute for Corporate Governance in Seoul. Specialisation in independent director selection is also likely to increase considerably among executive search firms.

**3. Markets and regulators are increasingly focusing on the integrity of corporate advisors and the conflicts of interest that they face.** The current US crisis is very much about failures in the market infrastructure and its main constituents: accountants,

investment bankers and lawyers. Some of these issues became obvious in the wake of the 1997-98 Asian crisis. For example, the big five accounting firms managed at the time to successfully resist calls by the World Bank and others to adopt global standards in their audit processes following glaring failures in emerging markets that resemble very much the creative accounting and audit failures at ENRON, Global Crossing and World Com . They got away with it by arguing two contradictory points in parallel: that they were the only ones capable of offering investors global assurance because of their global presence and reputation; but that it was impossible for them to exercise control and impose high audit standards over local affiliates, governed by local partners, regulated by local authorities according to local standards. It is very possible that the current crisis in the US will have lasting consequences around the world on the delivery terms and consequent credibility of audit services, not least because of the seemingly wide extraterritorial provisions of the Sarbanes-Oxley act concerning regulatory oversight of auditors. In the medium term, increasing regulatory and investor pressure might result in the further unbundling of professional services currently offered by large accounting firms, a process that timidly started after the 1997-98 crisis —witness the recent sale of PriceWaterhouse Coopers’s consulting arm to IBM.

Conflict of interest issues have also arisen in the investment banking world. US regulators and courts are putting pressure on banks to commit sell-side analysts to serving investors instead of their own corporate finance departments. This might result in a more consistent and systematic scrutiny of governance issues. One bank (Deutsche) has already put together a specialised governance unit within its research department. Another consequence, though, might be that the banks and other corporate advisors whose livelihood depends on future mandates by corporate issuers, unrelated to governance, will be increasingly unable to fulfil their role of bona fide corporate governance advisor at the pre-IPO level, due to perceived conflicts. Corporations might need to adopt new criteria in selecting outside advisors in order to enhance their corporate governance credibility, so that perceived conflicts of interest are minimised. These new imperatives might in their turn have a lasting impact on the supply structure of relevant advisory services. For example, there might be a growing competitive advantage for “pure play” governance advisors, whose reputational leverage depends entirely on the governance of their clients.

### **C. The response**

I started this presentation by underlining the importance of corporate governance for investor trust. In Asian markets, one cannot overestimate the trust aspect. In fact, corporate governance is *ultimately* about trust not control. In countries with concentrated ownership structures, trying to improve corporate governance by forcing ownership change and the emergence of a market for corporate control will yield more problems than benefits. Such economies should, first and foremost, seek to capitalize on their agency advantage: as opposed to their Anglo –American counterparts, they have an

active, hands-on owner/driver<sup>5</sup> who can effectively police managerial opportunism and also has a consistent focus on the longer-term development and health of the company—an interest that was so cruelly lacking among the “star” top executives of recently failed US corporations. If, through well-adapted corporate governance mechanisms, they can reassure outside investors that they will not fall prey to insider abuse, Asian corporations might get the best of both worlds: they will face lower agency costs in policing management *and* lower risk in seeking outside capital.

However, in the past, these drivers have all too often ripped-off outside investors, so the Asian pattern for ownership and control has been viewed with grave suspicion by global investors. That is why policy reforms in the area have been on the front burner since the crisis of 1997-98 and have focused on contestability of insider abuse. In a sense, Enron happened here four years ago and the regulatory overhaul that followed had some time to produce results. Improving valuations in markets like Korea and Malaysia over the last 12 months are a testimony to investor appreciation of corporate governance reforms in these markets. But one should not overestimate the importance of public policy reform. Changing the law is the easy part. Implementing the new laws and building the relevant institutions is the hard part and it takes time. Investors will be weary of “bad” corporate attitudes in these markets for a long time.

In order to defeat their “sovereign handicap”, i.e. the perceived institutional weakness pervading their home countries, Asian corporations can create value by undertaking governance reform at the level of the firm: not only will they lower investor risk and thus their own cost of capital; they are also going to benefit from direct benefits to their bottom line through better strategy formulation and more effective control of risks. In fact, many family-controlled Asian corporations are foregoing not only better access to outside capital but also the benefits of lower agency costs that seem almost inherent to the family model because family ownership is malfunctioning: often, different members of the extended family that are officers of the listed corporation will not hesitate to divert cash flows and assets from their own kin, because of poor governance at the family level. The result: all investors, whether insiders or outsiders, are losing.

The head of Ayala Corporation, the Philippines conglomerate that has considerably outperformed many of its domestic and international peers in Asia, summed up nicely what a typically Asian family-owned corporation needs to do in order to build trust<sup>6</sup> without betraying its culture:

“When Ayala Corporation went public in 1976, we made a very conscious decision that we didn’t want to find ourselves in any conflict of interest. All matters that relate to the family are elevated one level to a single family holding structure. Although it is not a public holding company, its ownership in Ayala corporation is direct and free of the

---

<sup>5</sup> Most often in Asia the drivers are extended families. Another driver is the government as a whole- or part- owner of corporations. Although trusting the government might be a difficult proposition, some experience in OECD countries (notably Sweden) indicates that under certain circumstances it is possible to design governance mechanisms that build trust between outside investors and the state as a shareholder. Asia has its own precedents (Singapore, Korea) to support a more pragmatic approach towards state ownership.

<sup>6</sup> See the interview of Mr. Zobel de Ayala with Ken Gibson in “A case for the family owned conglomerate” *Mc Kinsey Quarterly* (2002 Number 4) pp.126-137.

opacity and layering that one might find in other structures. Through that family structure, we choose who will represent us in the governance of the public holding company and act with one voice. ... All family members are free do with (the income from their ownership) as they please so long as they do not invest in ventures that compete with Ayala Corporation's business. This... ensures that if a partner invests with us, it will not be competing with another entity in which a family member has an interest....The CEOs of all our subsidiaries...are people of the highest calibre who are not from our family and are promoted and rewarded strictly on professional merit..."

If one follows this advice, one will be rewarded handsomely. In 2002, research by two World Bank economists<sup>7</sup> confirmed that firm- level improvements in corporate governance (as opposed to public policy reforms) matter more in less developed markets with weak institutions. Using data from 374 firms from 14 emerging markets and classifying firms according to the corporate governance rating system developed by CLSA, Clapper and Love conclude that:

- One standard deviation improvement in a firm from a less developed (i.e. emerging) market results in a 33% improvement in Tobin's q (a measure of market valuation of a firm's book )
- One standard deviation improvement in a developed (i.e. OECD) market results in an 18% increase in Tobin's q.

Firms with a governance edge will need to communicate progress to investors effectively in order to realise the value of their effort and investment in better governance. This can and should be done individually. But the market itself might benefit as much as the companies by giving the pioneers the opportunity to be recognised as a separate segment capable of attracting investor money and attention. This was the rationale behind the creation of the corporate governance segment in the Sao Paulo Stock Exchange (BOVESPA) in June 2001. Companies that list in one of the 3 levels of the segment face corporate governance requirements that increase with every level. Many of these requirements have to do with a more transparent ownership structure and enhanced protection of minority investors. Barely a year after its launch, the Corporate Governance index has already been a success. Companies accounting for 20% of total market capitalization and 19% of all trading activity have listed in the CG segment. Share price performance has also been much better during this turbulent year for Latin American markets. The Corporate Governance segment index fell by -1,58% versus a -23,3% fall for the general BOVESPA index. Volatility of the governance segment has also been half that of the general BOVESPA index.

#### **D. Concluding remarks**

In conclusion, Asian corporations need to become proactive in improving and promoting their own governance. Better corporate governance can be a win-win formula for both outside investors and the company drivers, i.e. the core shareholders, such as families, entrepreneurs or even governments. The drivers should not waste their time fighting

---

<sup>7</sup> Leora Klapper and Inessa Love (2002) "Corporate Governance, Investor Protection and Performance in Emerging Markets" working paper available at [www.ssrn.com](http://www.ssrn.com), posted in March 2002.

rear-guard action against better governance. They would be fighting against very powerful global forces. The current crisis in the US has only exacerbated what has been a long- term trend of governance convergence, resulting from the effective globalisation of capital markets. Instead of been dragged towards change, corporations should take the initiative and grasp the opportunity for creating value for themselves in this new environment.

In the end, though, it is up to investors to demand better governance, to recognize it and value it properly around the world, beyond stereotypes and oversimplifications. Investors need to learn appreciating that what is good practice in one context might be useless or even harmful window- dressing or box- ticking in another. After all, it was Albert Einstein that said: “Keep things as simple as possible but not a bit more”.