La Reforma a los Principios de la OECD y su aplicación en Latino-América

Speech given to Seminario Internacional Bogotá

By Grant Kirkpatrick, OECD, July 10, 2003

I am very honoured to be here today to speak not only about the OECD Principles of Corporate Governance but also about the review process we are presently undertaking, the issues that we are looking at and the relevance of the process for Latin America. But in so doing I will also note that the experience in Latin America as documented by the forthcoming Regional Corporate Governance Roundtable Whitepaper is already having an impact on the review by focusing attention on some areas of direct concern for the region. (And I should add that representatives from Columbia, including Paola Gutierrez V present here today, have been active participants in the Roundtable.) Indeed, it is appropriate that experience from all five Regional Roundtables and from other countries should have an influence on what has become one of the 12 key international standards, including for emerging markets.

In the time available I want to briefly outline the procedure for reviewing the OECD's Principles, the lessons we draw from the Roundtables that should inform the Review, and finally some tentative comments about the relevance of the process for Latin America.

But first let me digress and briefly describe why the OECD has been responsible for developing a set of Principles and how they came to be a world standard. During the 1980s, OECD countries became increasingly frustrated by slow growth leading to a closer look at structural policies which has continued up to this day, with the OECD at the forefront. With the move to a market economy in Central and Eastern Europe at the beginning of the 1990s the OECD was also confronted with corporate governance problems which arose almost immediately, and by 1992 the issue was already important in the UK. It is hardly surprising therefore that the organisation undertook a review of corporate governance problems in Germany in 1995 as part of the annual review of its economic policies. Four other countries followed. So as you see the organisation was already active in the area before the Asian crisis broke in 1997.

With the Asian financial crisis, compounded by the Russian crisis the next year, there were widespread calls for a change in the world financial architecture, most notably by President Clinton. Discussions led to the founding of the Financial Stability Forum comprising G10 countries plus some emerging market economies, world financial regulators and standard setters. The understanding was that the world economy was indeed marked by some weak practices which amplified and in some cases helped cause crises. This led them to adopt 12 core standards and to set up a process for observing how they were indeed implemented with the World Bank and the IMF taking the lead in monitoring (but not setting the standards). Following the experience in Korea, Thailand and Indonesia, corporate governance was viewed as an important area requiring standards.

OECD Ministers also had the financial crisis in mind when they called on the organisation to develop a set of standards in 1998 that were finally agreed in 1999. It was logical for them to do this since the organisation was already involved in governance work. But there were other reasons why it was the OECD which took the lead. Above all, the OECD comprises the major corporate governance systems of the world (Anglo Saxon, Japanese, continental European, etc) it is a consensus organisation which means that broader interests have to be taken into account, and it has close contacts with both business and trade unions (i.e. civil society). It was therefore natural that the OECD Principles became one of the 12 core standards of the Financial Stability Forum and through their use by the IMF/World Bank and others such as the private sector, a world standard.

The Principles have in many cases influenced the development of national principles in both OECD and non OECD countries alike. They have also stimulated the setting up of five regional roundtables by the OECD and the World Bank in Latin America, Asia, Russia, South Eastern Europe and Eurasia. More of that presently.

The Review Process

The present review of the OECD Principles was mandated by our Ministers in 2002. At the time they also reiterated their view that the integrity of corporations, financial institutions and markets is essential to maintain confidence and economic activity, and to protect the interests of stakeholders. It is important to note that they also agreed to implement best practices in corporate and financial governance which entails an appropriate mix of incentives, balanced between government regulations and self-regulation, and backed by effective enforcement.

Being one of the twelve basic standards of the Financial Stability Forum and therefore an important component of the Review of Standards and Codes (ROSC) undertaken by the World Bank/IMF which also applies to Latin America, the OECD is taking an inclusive approach to the Review. Apart from member countries this group includes the Financial Stability Forum, IMF, World Bank, the Basle Committee on banking, the BIS, IOSCO and representatives of unions and employers.

The OECD is also reaching out to other interested parties. We have already had one meeting of an ad hoc group of experts in which Latin America is represented, and another such meeting will be held later this year. In March, a consultation was held between the group and stakeholders such as the World Association of Stock Exchanges, the International Federation of Public Accountants and the European Corporate Governance Institute. Another consultation will take place early next year.

In November, a consultation will be held with non-member countries organised in cooperation with the Global Corporate Governance Forum. In addition to the Roundtable participants, this meeting will also be attended by representatives of Africa, the Middle East and the Caribbean all of which have not participated in the Roundtables. Indeed, the experience gained by the OECD in organising a series of Regional Corporate

Governance Roundtables in conjunction with the World Bank is already feeding into the exercise. Finally, before completing the review with a submission to our ministers, the OECD will place them on the world-wide web inviting comments from the broader public.

The new set of Principles will be supported by a set of Guidelines covering the more specific requirements of different financial sectors. The OECD has already developed guidelines covering pension funds and a Committee of specialists is currently in the process of finalising a set for insurance companies. Specific guidelines for Collective Investment Schemes are also being developed in co-operation with IOSCO. As for the banking sector, the Basle Committee already has a set of guidelines based on the existing OECD Principles and, as they are a part of the existing review, they are well placed to assess where changes might be appropriate in the future.

Another area of importance, certainly so in Latin America, is state owned enterprises. The preamble to the Principles notes that the Principles might be useful as a tool to improve their corporate governance. We do recognise the special features of this sector and are preparing a more specialised set of principles based on a survey of existing practices.

The emerging policy priorities from the view of non-member Roundtable countries

I must add at the outset that the OECD has only facilitated the White Papers and has not been trying to impose in any way the OECD Principles but they have been a valuable framework to organise discussion and analysis. Ownership belongs to the numerous participants in the region. The fact that people from widely different cultural and institutional backgrounds can broadly agree on a corporate governance agenda is remarkable. It can, however, be achieved if the focus is on principles or outcomes rather than how to get there. This is a key strength of the Principles.

Across the five Regional Roundtables, most companies have a controlling shareholder. Usually this controlling shareholder is a family or an individual, but state control also remains important in a number of countries even after a decade of extensive privatisation. Controlling shareholders are relatively effective at overseeing management, but their interests may conflict with those of minority shareholders and other stakeholders. This is especially the case where they have little equity themselves but control the enterprise through such methods as pyramids, differential share voting rights etc. These conflicts can have adverse affects on the access of companies to capital, which is why they have often sought to have an in-house bank or financial company. Reducing these conflicts by improving minority shareholder protection is an important objective for all White Papers.

In many countries, improving shareholder protection requires better protection for basic rights, like the right to secure share ownership, or to attend and participate in the general shareholders meeting. Even in countries that do protect these rights, abusive related-party transactions represent a significant problem. Curbing these transactions is one of the main priorities for reform across the five regions. In many cases shareholders could

also do a better job of exercising the rights they have. This is particularly relevant for the pension funds and other institutional investors that are emerging in a number of countries.

The legal duty of board members to show a certain degree of care and act in the interest of the company and all shareholders is well established in the five regions, though the origin and exact nature of board members duties does vary across countries. Unfortunately these legal duties have little influence on actual board member behaviour. A wide range of reforms have been proposed and enacted to improve board composition and performance, in many cases by trying to increase the "independence" of board members. Nonetheless, improving boards remains a work in progress that needs to take into account the limited pool of experienced candidates.

A number of countries have mechanisms that would seem to encourage employee participation in the governance of the company, including works councils and employee share ownership. These do not, however, always work as hoped, and the Roundtables discussed various ways to improve employee participation in the wealth creation process.

Banks and other creditors encounter important difficulties in securing their rights and in many countries have been also adversely affected by severe financial crisis. In the last decade the governance of many banks was also considered to be deficient, with related and “soft” lending being all to frequent. Banking sector reform is now well advanced in many countries, but it remains to be seen if efficient commercial lending practices and risk management will follow.

Let me develop this point further. Good corporate governance in the banking sector 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. I could list a large number of other countries as examples.

One area where the greatest concern has been expressed, and some of the most intensive reform undertaken, is transparency and disclosure, especially of listed companies. International Accounting Standards now influence disclosure requirements in a number of Roundtable countries. Improved standards for auditing and non-financial disclosure, also based on international standards, are being introduced. However, implementation has lagged and the gap between standards and practice in a number of countries has become wider. Effective implementation of these standards remains a

global challenge. Specific concerns include poor disclosure with respect to related party transactions and opaque beneficial ownership and control.

Last, but not least, the gap between standards and practices goes well beyond transparency and disclosure. Perhaps the most widespread sentiment expressed in the Roundtables was the importance of improving the enforcement of existing law and regulations. Improved enforcement will require broad reform to improve the performance of the judiciary, empower securities regulators while preserving accountability and making more effective use of self-regulatory bodies. Some countries are also considering greater use of derivative and class action lawsuits to improve the enforcement of shareholder rights. Three of the White Papers have chapters specifically for enforcement, in addition to chapters corresponding to each part of the Principles.

Experience from the OECD area

Good corporate governance standards should respond to changing conditions. Even though the OECD *Principles* highlight many of the problems identified in the area during 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 so that it would be both premature and inappropriate to speculate on the likely outcome of this process. However my own personal view is that the recent experience points to the need to closely consider the following:

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 as is the convergence of accounting and audit standards to international standards. We do not advocate any one accounting standard other than that any standard should be principles based.

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. 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. 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 application to Latin America

The Principles are not a straight jacket and need to be adapted to the situation of the country and indeed the region. This has been done in the development of the forthcoming Latin American White Paper. After that it will be important that each country establish its own programme which reflects its needs and institutions. Two questions are relevant: why should one care about corporate governance and will concerns change over time.

Why should we care about corporate governance?

While many of the economic problems confronting Latin America are either macroeconomic (exchange rate regimes, compatibility with fiscal policy) or microeconomic (trade policy etc) there are three reasons why one should care about the quality of corporate governance in the region and in any given country.

First, good corporate governance leads to increased economic efficiency and growth. This is not just a theoretical statement since there is now a body of empirical work to support this observation pointing to widespread agency problems (when the management are acting as agents for the owner who is the principle) and private benefits of control (i.e. pecuniary and other benefits such as high salary, company planes etc separate from dividends and capital gains on shares). Good corporate governance leads to improved use of capital which is scarce in many countries. Moreover, it allows new industries to develop. What constitutes good corporate governance will vary over time, a point I will return to later.

Of particular importance to countries in Latin America, good corporate governance including transparency encourages foreign direct investment and lowers the country borrowing premium for both the firms and the government. For example, one study by PWC estimated significant losses in FDI for Egypt, Turkey and Greece of some $1 billion dollars in each country just from lack of transparency.

Second, good corporate governance lowers the risk of crisis and in the case of an external shock it improves the robustness of the economy. Macroeconomic policy and good prudential regulation of the banks is of course important but experience in Asia and Latin America points to an important role for governance. For example, in Korea the better firms have weathered the crisis far better than those with less effective governance.

Third, good corporate governance is crucial for the legitimacy of a market economy. It is in no ones interest that the public comes to regard business as corrupt or immoral. Enron has been particularly important in this regard. The need to recover or reinforce legitimacy has also been a driving force in Korea and in many other countries such as Brazil.

The priorities for action to maintain good corporate governance will change over time

The priorities for action will vary over time in any given country as the economy evolves.

The pattern we have seen in Latin America and Asia (and also in many OECD countries) is that initially companies are owned and run by families. This solves a lot of what we call agency problems – does the management work to the benefit of the owners— although the world is full of examples of families splitting at some stage and of later generations retaining close control over management even when their own abilities might be limited.

At some point though such family companies will need to turn to bank credit and other sources of finance, and here the first major policy issues arise: how well is the banking sector governed, how is their lending behaviour (i.e. terms and volume of lending) affected by the corporate governance of the company, how effective are they in demanding good corporate governance from the family company, how well are their rights protected. Thus corporate governance means more than shareholder rights but also the rights of all providers of dedicated resources to the company and especially credit of all forms. The less creditors are sure of repayment and how they can use their rights to obtain a settlement, the more they will have to raise the cost of lending and reduce the volume.

Finally, at some point the family company will wish to continue to grow and will seek to broaden its equity base by bringing in outside shareholders. For a number of reasons the family will often seek to retain control of the company raising policy issues about the protection of minority shareholders, the disclosure of information etc.

Unfortunately the experience of the Roundtables and many OECD countries is that governments and the private sector have not kept up with these challenges

Concluding remarks.

In many countries governments and the private sector are now trying to move forward and to improve corporate governance so as to improve economic performance. 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). It is also underway in the Regional

Corporate Governance Roundtables and in these regions countries stand well placed to take advantage of such fora. The development of revised OECD Principles is expected to contribute to the public policy debate and will also be influenced by the experience in a wide range of countries. They should set a basic framework through which actual policies can be viewed and assessed.

However, it will still be necessary for a country to determine the critical governance problems it faces and to decide the specific course of action appropriate to its institutional and historical conditions. The Principles will help in these decisions and form a basis for assessing the actions to be undertaken. At the end of the day, however, the country will have to decide its own priorities and determine its own programme.

Thank you.