CLSA
ASIA-PACIFIC MARKETS

# CG Watch 2010

## Corporate governance in Asia

ACGA
In collaboration with the Asian Corporate Governance Association


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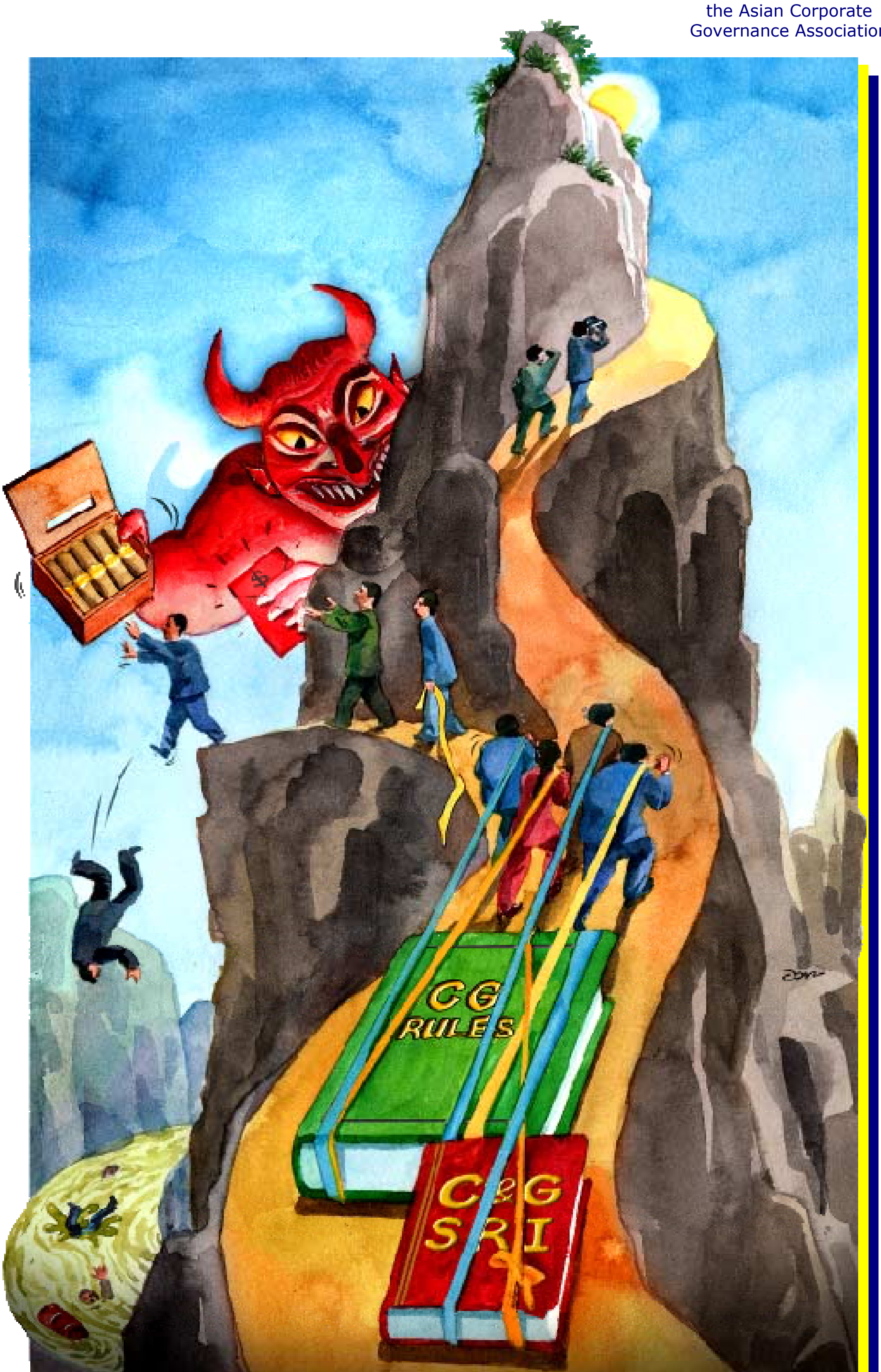
**Asia**
**Special report**

Higher ranked markets

**Singapore**
**Hong Kong**
**Japan**
**Taiwan**
**Thailand**

High CG stocks

**HK Exchanges** (388 HK)
**Nintendo** (7974 JP)
**Li & Fung** (494 HK)
**TSMC** (2330 TT)
**HSBC** (5 HK)
**Infosys** (INFO IB)
**Sony** (6758 JP)
**Sumitomo Metal** (5405 JP)
**Tokyo Electron** (8035 JP)
**Tokyo Gas** (9531 JP)
**Canon** (7751 JP)
**Wipro** (WPRO IB)




# Stray not into perdition

## Asia's CG momentum slows

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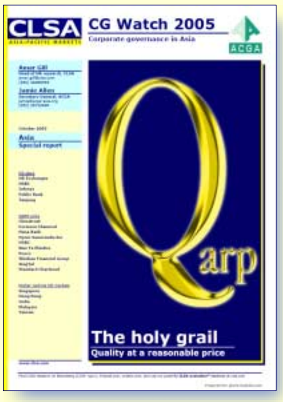



In collaboration with the Asian Corporate Governance Association

**Acknowledgements and disclaimer**

This report was produced in collaboration with the Asian Corporate Governance Association (ACGA), an independent, non-profit organisation based in Hong Kong and working on behalf of all investors and other interested parties to improve corporate governance practices in Asia. CLSA Asia-Pacific Markets is one of the Founding Corporate Sponsors of ACGA. For further information about the Association, including a list of its sponsors and members, see Appendix 1 of this report.

ACGA endorses the methodology used in this survey and contributed to the country analysis. It did not participate in the assessments of companies, for which CLSA retains responsibility.

## Stray not into perdition

**Market CG scores - Sinners repent**

Corporate governance standards have improved over the past decade, but even the best Asian markets remain far from international best practice. Regulators make it too easy for companies to get away with box-ticking. Markets still lack effective rules on fundamentals such as independent directors and audit committees. Not enough has been invested to make best practices work. Meanwhile, most institutional investors are yet to invest sufficiently in voting, engagement or stewardship. Rather than use the global financial crisis as a platform to push reform forward, governments have taken a complacent view, happy that the crisis this time did not start in Asia.

**Changes in market rankings**

On the ACGA-CLSA market rankings Singapore and Hong Kong switch places at the top this year while Thailand and Japan have seen the biggest improvements. Indonesia moves higher against the Philippines which scored the lowest. Korea has regressed and is now third from the bottom in the market rankings.

**Measuring governance**

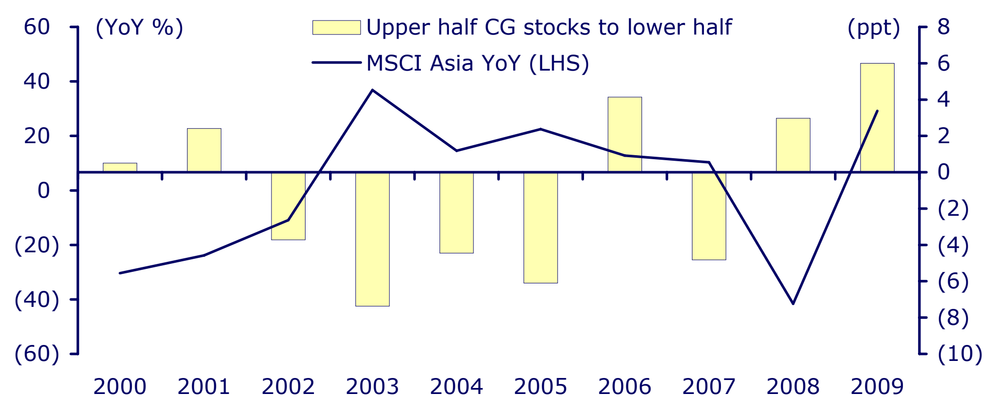
We have streamlined the CG questionnaire, revamped our Clean & Green (C&G) scoring and combined this with corporate social responsibility (CSR) for a 10% weight in the overall score. In all, we scored 580 companies in the region including Japan. In recent crisis years, the risk to CG was on the downside. Our corporate scores slipped in Indonesia and Taiwan but moved up in Singapore, India and Thailand. Like other regions, Asia has had some debacles but not a systemic breakdown in governance, unlike the experience of the Asian crisis in the 1990s. Reduced gearing of both companies and controlling shareholders has lowered the risk of conflicts of interest and of blowouts in the region. Average scores have remained steady; however a wider gap between companies in the better and worse markets is apparent.

**Social responsibility is on the rise**

Corporate social responsibility in terms of CSR-report publications is on the rise. Asia now accounts for more than 20% of global CSR reports versus 12% just five years ago. CSR reporting, however, is still mostly voluntary. Japan is clearly ahead with companies emitting large amounts of greenhouse gases (GHGs) required to calculate and report these emissions. But even Chinese firms are encouraged to publish CSR reports to improve the country's branding, reputation and competitiveness. Environmental laws have tightened, with higher associated fines/sanctions. Many companies however mistake contributing to local charities as CSR, when it is just a small part.

**Higher CG stocks tend to perform better when markets are weak**

**Performance of upper half CG stocks to lower half vs MSCI Asia Pacific**




Source: CLSA Asia-Pacific Markets

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# Market CG scores - Sinners repent

**Market scores have changed with improved scores for Thailand, Japan, Indonesia . . .**

Once again, our *CG Watch* market scores and rankings have changed, with results that may surprise investors even more than the reordering that took place in our last survey in 2007. Thailand, Japan and Indonesia - having underperformed in the past, often for extended periods - stand out this year. Thailand enjoyed an eight percentage-point jump in its absolute score and wins the award for "most improved". Japan rose five percentage points and Indonesia three points. Given that reforms in Japan appeared to be stuck only two years ago, its performance in this survey shows what can be done when regulators show determination and market consensus starts to shift. As for Indonesia, the odds for a long time have been on it retaining last place in this survey. This is no longer the case, as it has moved ahead of the Philippines.

**. . . as well as Malaysia and China**

Two other markets which deserve special merit are Malaysia and China, whose scores rose by three and four percentage points. Although a better result than in 2007, Malaysia's progress is somewhat more incremental than Indonesia's and less surprising. Moreover, its ranking (sixth) has not changed. China's performance, relative to its 2007 score and position, is better across the board and builds on its improvements in our last survey.

**Worst performers are India, Korea and Philippines**

The worst performers this year are less of a surprise, although their final scores may be: India, Korea and the Philippines. India's score collapsed by seven percentage points, in large part because we overrated it last time (although we still believe it is improving slowly). Korea's slide accelerated, thanks largely to the anti-reform administration of Lee Myung-bak. And the Philippines fell because of disappointing results in most categories of the survey, expecially "CG culture".

**Scores in percentages. Markets listed according to 2010 position**

Figure 1

**CG Watch market scores: 2007 vs 2010**

| (%) | 2007 | 2010 | Change | Trend of CG reform |
|---|---|---|---|---|
| 1. Singapore | 65 | 67 | (+2) | Improving slowly, negatives cancel positives |
| 2. Hong Kong | 67 | 65 | (-2) | Some regression, static overall |
| 3. Japan | 52 | 57 | (+5) | Improving, but will reform be sustained? |
| = 4. Taiwan | 54 | 55 | (+1) | Static overall, loss of focus |
| = 4. Thailand | 47 | 55 | (+8) | Improving, but political uncertainties remain |
| 6. Malaysia | 49 | 52 | (+3) | Improving, but held back by "CG culture" |
| = 7. India | 56 | 49 | (-7) | Over-rated last time, but slow improvements |
| = 7. China | 45 | 49 | (+4) | Improving, but held back by "CG culture" |
| 9. Korea | 49 | 45 | (-4) | Regressing, turning inward |
| 10. Indonesia | 37 | 40 | (+3) | Improving, but weak political system |
| 11. Philippines | 41 | 37 | (-4) | Regressing, but new government may help |

Source: Asian Corporate Governance Association

**Singapore and HK should be performing at a higher level of CG**

What of Hong Kong, Singapore and Taiwan? Singapore regains the top spot this year with a two-point increase in its score, while Hong Kong falls by the same amount and moves back to second. Taiwan remains at fourth, with a marginally higher score than in 2007, but this time shares the honours with Thailand. These results, however, are nothing to celebrate, especially in regard to Singapore and Hong Kong. Both should be performing at a much higher level for financial centres that aspire to follow international standards and which have not yet, despite a decade of reform, cracked the 70% mark.

**Scores more important than the ranking**

While the ranking of markets is interesting and relevant, we believe readers (and especially regulators) should focus more on their scores, how these have changed, and what this says about their market and state of CG reform. This is why we have chosen this year to emphasise in this introducton not the simple ranking of markets, but the extent to which they have improved, stayed the same, or regressed.

**Some have improved, others slipped**

As the table above indicates, seven markets have improved in score this year (although two of those by tiny amounts) and four have fallen. The 11 markets could be divided into the following groups:

- **Improvers:** Japan, Thailand, Malaysia, China, Indonesia
- **Marginal improvers:** Singapore, Taiwan
- **Marginal decliners:** Hong Kong
- **Decliners:** Korea, Philippines
- **Outlier:** India (The country's decline in score was due more to a change in view on our part - we overrated India the last time - rather than a genuine regression in the quality of its governance regime. In fact, it is slowly improving).

**Can Japan sustain reforms?**

The above table also highlights whether these trends are likely to continue. Despite Japan's tangible progress over the past three years, it is not at all certain whether regulators can sustain reforms. Thailand has done well, but still faces serious political uncertainties that could cause its reforms to stall. And whether Indonesia can truly rise above its endemic corruption for a sustained period is anyone's guess.

**Upside potential as well for both Singapore and HK**

On the upside, Singapore could see its score increase if it took certain clearly defined actions, some of which are relatively easy (such as mandating or encouraging companies to vote by poll at their AGMs) and some of which are not (such as completing its company law amendment process). Hong Kong could also increase its score, but to do so would require finding the political courage to reignite the reform process and for the government to think more strategically about the role of corporate governance in its capital markets - a little more highbrow than the mechanics of voting at shareholder meetings (something which Hong Kong, incidentally, has already resolved). The situation and rankings are therefore fluid.

## Scores comparable for the first time

**Scores are comparable with 2007**

It is worth emphasising that the market scores in this edition of "CG Watch" can be compared with our last survey in 2007 because the questionnaire applied to the markets is largely the same and our five-point scoring system has not changed. This contrasts with previous editions of "CG Watch", namely in 2004, 2005 and 2007, when we made significant changes to both the questionnaire and the scoring system in each of those years. This led to most market scores falling as questions (and our answers) became sharper and the scoring system became tougher. This did not mean that the quality of corporate governance in Asia was falling, rather that our assessment was becoming more critical.

This year, however, a fall in score generally indicates that a market has gone backwards. The one exception is India, for reasons noted above. (For more details on survey methodology, see the box at the end of Section 1. Appendix 2 provides the detailed survey questions and answers).

**We make comparison of Asian market CG scores with what might be expected as a world class benchmark**

## How advanced is CG in Asia?

While regulators undeniably like to focus on relative rankings, and we prefer to see whether a market has improved over the short to medium term, it is also worth asking what the absolute scores for Asia say about the state of development of the region's corporate governance. After more than ten years of reform, how advanced are Asian markets compared to global standards?

No template exists that points precisely to the level a country would have to achieve to earn the right to say it had a world-class corporate governance system. However, common sense and our own questionnaire suggest that a score of 80%+ would be a reasonable cut-off point. On this basis, one could construct the following table to show how much farther our 11 markets would have to go before they could claim to be world class.

**Even Singapore and HK have long way to go to claim to be truly world standard**

Figure 2

**Gap analysis: Asia vs nominal world-class CG benchmark**

| (%) | 2010 Score | World-Class Benchmark 80% |
|---|---|---|
| 1. Singapore | 67 | (-13) |
| 2. Hong Kong | 65 | (-15) |
| 3. Japan | 57 | (-23) |
| = 4. Taiwan | 55 | (-25) |
| = 4. Thailand | 55 | (-25) |
| 6. Malaysia | 52 | (-28) |
| = 7. India | 49 | (-31) |
| = 7. China | 49 | (-31) |
| 9. Korea | 45 | (-35) |
| 10. Indonesia | 40 | (-40) |
| 11. Philippines | 37 | (-43) |

Source: Asian Corporate Governance Association

We readily admit that this analysis, and our choice of 80%, is subjective. However, it does indicate that even the best Asian markets - Singapore and Hong Kong - have a long way to go before they can claim to be truly international.

**Market scores are a simple average of 5 categories**

## Category scores: What's in the mix?

The table below shows the percentage scores that each market gained in the five categories in the survey: "CG Rules and Practices", "Enforcement", "Political and Regulatory Environment", "IGAAP" (ie, accounting and auditing), and "CG culture". The total score for each market is a simple average of these five scores. Each category is weighted the same.

**Highest score for Asian markets is 67% with lowest score at 37%**

Figure 3

**Market category scores**

| (%) | Total | CG rules & practices | Enforce-ment | Political & regulatory | IGAAP | CG Culture |
|---|---|---|---|---|---|---|
| 1. Singapore | 67 | 65 | 60 | 69 | 88 | 53 |
| 2. Hong Kong | 65 | 59 | 63 | 67 | 80 | 54 |
| 3. Japan | 57 | 45 | 53 | 62 | 75 | 53 |
| = 4. Taiwan | 55 | 50 | 47 | 56 | 78 | 46 |
| = 4. Thailand | 55 | 56 | 42 | 54 | 73 | 49 |
| 6. Malaysia | 52 | 49 | 38 | 60 | 80 | 32 |
| = 7. India | 49 | 46 | 36 | 54 | 63 | 43 |
| = 7. China | 49 | 47 | 36 | 56 | 75 | 30 |
| 9. Korea | 45 | 43 | 28 | 44 | 78 | 33 |
| 10. Indonesia | 40 | 39 | 28 | 33 | 67 | 32 |
| 11. Philippines | 37 | 35 | 15 | 37 | 75 | 25 |

Source: Asian Corporate Governance Association