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Asian Corporate Governance Association (ACGA)

"Corporate Governance in Asia: Current Issues and Regulatory Impact of the Credit Crisis"

Presentation by
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Agenda

1. Current Issues and Unfinished Business
2. Regulatory Impact of the Credit Crisis on Corporate Governance in Asia
3. Conclusion: Things to do

1. Current issues and unfinished business

A tale of two decades in Asia:

- 1999 – 2008: First decade of CG reform
  - Fundamental policy and regulatory change
  - Introduction of new codes of best practice
  - Increasing focus on enforcement
  - Steady rise in participation of investors
- 2009 – 2018: Second decade of CG reform
  - Strengthening shareholder rights
  - Enhancing regulatory enforcement
  - Improving the functioning of boards
  - Merging of CSR and CG into "ESG"

Strengthening shareholder rights

- Common, unfinished business around Asia:
  - **Proxy voting:** Earlier release of final AGM agendas and circulars; full "voting by poll"; publication of detailed voting results.
  - **Fairer "general mandates":** Tighter rules on dilutive private placements sought (eg, Hong Kong, Japan, Singapore and Taiwan). Maintain the line in Malaysia!
  - **Privatisations/delistings:** Protection for minority shareholders (eg, approval processes) are weak in much of Asia.
  - **Related-party transactions:** Need to ensure that minority interests are protected in connected transactions.

Enhancing regulatory enforcement

- Common themes and issues:
  - **Regulatory backbone:** Investors would like governments to send a clear and consistent signal on enforcement.
  - **Securities law:** A faster, fairer approach to dealing with insider trading and fraud is needed.
  - **Listing rules:** Most exchanges have weak powers to enforce their own rules; investors want to see more rigour and efficiency.
  - **CG Codes:** These are rarely "enforced" or promoted; exchanges could be more proactive (eg, in IPOs).
  - **Transparency:** Regulators could be better at disclosing their enforcement actions and processes.

Improving the functioning of boards

- Are most listed companies, especially the smaller ones, getting value from their boards?
  - **Board composition:** Is it appropriate, given the strategic direction and needs of the company?
  - **Board committees:** More thought could be given, in many companies, to the choice of committees, how they operate and what they should achieve.
  - **Independent directors:** If implemented well, they can bring considerable value to a board. But controlling shareholders need to allow them "voice".
  - **Director expertise:** The word "training" is despised by most directors. Yet regulations and investors expectations are continually changing. A good director is an informed director.

CSR + CG = ESG

- "CSR" (corporate social responsibility) is changing and morphing into "ESG" (environmental, social, governance).
- ESG puts an explicit governance foundation under CSR.
- Greater focus on the need for investors to incorporate environmental, social and governance **risks** into the investment process. For example:
  - United Nations Principles of Responsible Investment (UNPRI).
  - Greater attention on whether newly listed companies meet requisite environmental and labour standards.
  - Global pension funds looking for fund managers who can invest along ESG lines.
- Question: Should it be E + S + G, or "G" as the basis and framework for "E & S"?

2. Impact of the Credit Crisis on CG in Asia

- As with the Enron collapse, there are two broad responses in Asia to the credit crisis (from a CG perspective):
  - **"The emotional reaction"**: Since the credit crunch started in the US, this proves that global CG standards (based on the US) are irredeemably flawed. We should reject them!
  - "**The balanced reaction":** The credit crisis highlights yet again the importance of corporate governance—and the extent of unfinished business. We need to strengthen governance further, using best available ideas and practices.
- The emotional reaction offers nothing new—just more of the status quo. (How will this help to rebuild confidence?)
- The balanced reaction allows for a critique of current rules and practices, both in one's own market and the US, UK and Europe—hence offers a way forward.

Aside: Global standards draw upon, but are not the same as US corporate governance. For eg...

Global standard	Comment
Split chairman & CEO	Separation of the two roles is widely seen as positive. In the US, one person occupies both roles in most companies: the "imperial CEO".
Balanced board	Most jurisdictions recommend some form of balanced board involving EDs, NEDs, INEDs. In the US, boards typically comprise one ED (the CEO) and a group of "independent" directors.
Shareholder rights	Although litigation rights in the US are strong, shareholders otherwise have limited rights. Global best practice allows shareholders a range of preventive rights on share issuance, calling meetings and so on.
Director elections	Most board elections are based on "majority voting" (directors need more than 50% of votes to be elected). The US mostly still operates according to "plurality voting": only a few votes needed to be elected; shareholders cannot vote against directors.

- Rejecting global standards would be counterproductive.

Aside: Board structures differ around the world, but some core principles are common

	OECD Principles	USA	UK	Germany*	HK	Malaysia	Japan
Board structure	Not defined	Single	Single	Two-tier	Single	Single	Two-tier
Directors should be accountable to shareholders	Yes	Yes	Yes	Yes (and to employees)	Yes	Yes	Yes
Boards should be independent of, and supervise, management (ie, independent directors)	Yes	Yes	Yes	Yes	Yes	Yes	No

*Answers refer to the Supervisory Board in Germany.

- Note: These principles are aspirational, not necessarily a description of reality. Yet they surely remain part of the solution to the current crisis?

Some initial observations

- The credit crisis spread to many developed economies, regardless of their CG system, suggesting no one "model" can be blamed for it.
- Did CG failures start the crisis? No, but weak governance in many US and European banks appeared to facilitate excessive credit expansion. Where were the directors?
- The Asian banking system is relatively strong (no doubt in part due to the reforms of the last decade and stricter central bank policy). Japan is something of an exception.

What did cause the crisis?

- Loose monetary policy fueled credit expansion
  - Central banks focussed on consumer-price inflation, not asset-price inflation. Unwilling to "prick the asset bubble".
  - Large macro financial imbalances between nations.
- Financial innovation and competition
  - Excessive securitisation of loans that increased, not reduced, risk. Optimistic debt ratings. No regulation or exchange trading of new types of exotic derivatives.
  - Commercial bank involvement in proprietary trading.
- Investor myopia and optimism
  - An uncritical belief in efficient markets. Excessive borrowing.
- Unbalanced compensation packages
  - Short-term bonus incentives that encouraged huge risk taking without any "clawback" if things went wrong.

Global regulatory responses

- G20, April 2, 2009, London (www.g20.org)
  - Strengthen international regulatory cooperation.
  - Strengthen prudential regulation of financial institutions (ie, stricter capital requirements to 'build buffers in good times' that can be 'drawn down in bad times').
  - Expand scope of regulation to cover 'private pools of capital' (ie, hedge funds, private equity).
  - Tax havens, accounting standards, credit rating agents
- Financial Stability Forum (www.fsforum.org)
  - New reports and recommendations on "enhancing market and institutional resilience", "procyclicality in the financial system", "sound compensation packages", and "cross-border cooperation on crisis management".

Aside: Some G20 initiatives are new, some bring a sense of deja vu

G20 statement on compensation policies says:

- "The principles, which have today been published, require:
  - firms' boards of directors to play an active role in the design, operation, and evaluation of compensation schemes;
  - compensation arrangements, including bonuses, to properly reflect risk and the timing and composition of payments to be sensitive to the time horizon of risks. Payments should not be finalised over short periods where risks are realised over long periods; and
  - firms to publicly disclose clear, comprehensive, and timely information about compensation. Stakeholders, including shareholders, should be adequately informed on a timely basis on compensation policies to exercise effective monitoring."
- Does this all sound familiar?!

National regulatory responses – US

- US SEC, April 6, 2009
  - Mary Schapiro, SEC Chairman, outlined an 'ambitious agenda' of proxy access, disclosure reforms and increased market supervision. For eg:
  - Shareholders can more easily nominate directors.
  - Enhanced disclosure of compensation, governance, director qualifications and risk-management policies.
  - Increased oversight and regulation of market professionals and intermediaries, including hedge funds, investment advisors, credit rating agencies. More oversight of the credit default swap market.
- What comes from this remains to be seen.

National regulatory responses – UK

- "The Turner Review", March 2009
  - Lord Turner, Chairman, Financial Services Authority (FSA), published an extensive report (>120 pages) on the global banking crisis. Recommends some radical systemic changes in the regulation of banks.
  - Increasing the quantity and quality of bank capital; creating "counter cyclical capital buffers".
  - Regulation of credit rating agencies and introduction of risk-based remuneration policies.
  - Analysis of "macro-prudential" risks across the entire financial sector—and use of "countercyclical levers".
  - "Intense supervision" by the FSA of individual bank strategic decisions, risks and competence. The end of "light touch regulation".

Impact on Asia – Positive

- Global regulatory developments always have a major impact on policy in Asia.
  - Banking regulators will no doubt take these new ideas seriously (eg, prudential regulation) even if the Asian banking system is more conservative and currently in reasonable shape.
  - Note – Five Asian countries in the G20: China, India, Indonesia, Japan and South Korea.
  - Most financial regulators will happily extend scope of regulation to cover unregulated sectors (hedge funds, credit rating agencies, credit default swaps). But some markets may be reticent for competitive reasons.
  - New thinking on remuneration will filter through into regulatory policy.

Impact on Asia – Neutral

- Some of the US SEC's proposed reforms are not needed in Asia, since shareholders already have these rights (eg, nomination of directors).
- Some Asian banking regulators may be reticent to adopt the "intense supervision" approach advocated by Turner. Not least because they may not have the expertise to do so.
- Some securities regulators will be very disappointed that "light touch regulation" is no longer with us!

3. Conclusion: Things to do

There remain many areas of improvement in Asia:

- The list of unfinished business discussed earlier
  - Shareholder rights, regulatory enforcement, more effective boards, integrating ESG.
- Regulatory governance
  - Government support for financial regulators remains inconsistent and often undermined by powerful interests
  - Regulators are perennially under-resourced and behind the market curve. (Do governments want regulatory systems to succeed? Do they know what is required?)
  - Financial illiteracy is widespread, hence opportunities for fraud and mis-selling of products are large. Is the consumer really protected?

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