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"The Global Financial Crisis and Its Impact on Asian Corporate Governance Reform"

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Agenda

1. Lessons learned from Asian corporate governance reform: 1999-2009

2. What substantive improvements have been made in Asia?

3. Impact of the Global Financial Crisis on corporate governance reform in Asia

4. Conclusion

1. Lessons learned from the last decade

- In the late 1990s, various arguments were made in favour of better corporate governance. It would:
  - Lower the cost of capital
  - Lead to a stronger share price / higher valuation
  - Protect investors against downside risk
  - Help companies manage risk more effectively
  - Improve market liquidity and investor confidence
  - Minimise risk posed by family and state ownership

- Which ones have stood the test of time?

Test of time – 1

- **Lower cost of capital**
  - ➢ Tricky to assess the link between good CG and cost of capital (external factors come into play), but anecdotal evidence suggests that well-governed companies have stronger relationships of trust with shareholders, bondholders and bankers, and enjoy lower capital costs over time.
- **Stronger share price / higher valuation**
  - ➢ Again, difficult to prove causality, but correlations tend to prove strongest in downturns. Some anecdotal evidence that new IPOs with good CG tend to sell in the higher end of their price range.
- **Protecting investors against downside risk**
  - ➢ There is no question that this is true. Numerous failures in both public and private equity show how poor CG can lead to the destruction of shareholder value.

Application of GMI ratings

- In February 2008, Raj Thamotheram, Director of Responsible Investment, AXA Investment Managers, examined company ratings data from Governance Metrics International (GMI), a New York-based agency, and found that GMI's research indicated that there was "a positive relationship between their scores and a number of financial measures such as earnings growth and return on equity".
- His team found that:
  - "Between 2003 and 2007, companies that were upgraded for CG scores were more likely to outperform the benchmark index and vice versa."
  - "Companies with higher CG scores tended to outperform those with lower scores when the economic backdrop was more uncertain, with lower scored companies outperforming when economic confidence was improving." (Note: This accords with CLSA's research.)
  - "Companies with higher CG scores tended to have lower volatility, lower beta and lower value at risk than those with higher scores."

Test of time – 2

- **Managing risk more effectively**
  - If implemented well, governance tools such as board committees, structured reporting, a stronger internal audit function and a more robust external audit can help managers better think through the management of different risks.
- **Improved market liquidity and investor confidence**
  - External factors affect liquidity, but markets with better governance (HK, Singapore) do have stronger liquidity over time than those without (Philippines, Indonesia). Outliers include China and India.
- **Minimising family and state ownership risk**
  - Greater transparency and accountability does reduce risk of investment in family firms and SOEs, but the same applies to any company. Quality of CG in family firms and SOEs varies greatly, hence need to draw distinctions and differentiate. But succession planning can be very problematic for family firms.

Other lessons learned

- “Form vs substance”: A superficial debate that misses a key point—both form and substance matter. Form usually comes first.
- “Shareholders vs stakeholders”: Another overly simplistic debate—good stakeholder management enhances firm value over time (which is good for shareholders).
- “CG is bad for entrepreneurs”: But entrepreneurs also have to manage risk and reputation! CG tools can help them do this, make better strategic decisions and prepare for IPOs.

Higher standards are good:

HK's market grown throughout the period of CG reform

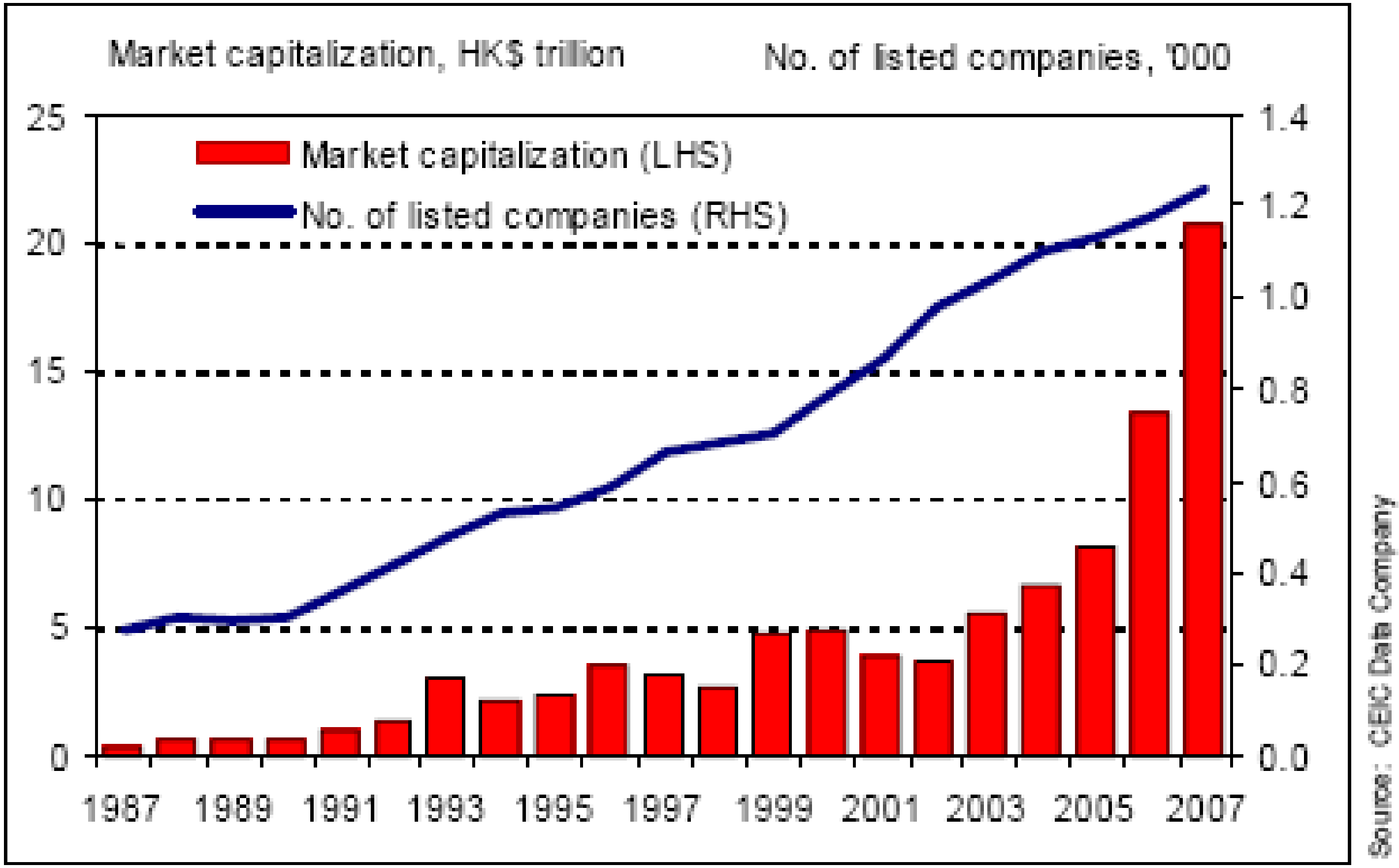

*Chart taken from Bauhinia Foundation report, 2008.

2. Substantive improvements in Asia over 1999-2009

Area	Improvements
Financial Reporting	More detailed disclosure rules; faster reporting; quarterly reporting; disclosure of “material” events, director pay, director dealings.
Board composition and function	Introduction of independent directors, board committees, director training; higher expectations placed on directors; higher fees paid to directors.
Shareholder rights	Formal rights strengthened; retail activist groups formed; institutional investors started voting their shares and taking engagement more seriously.
Accounting / auditing	Local accounting standards brought more into line with international standards (ditto auditing standards); independent regulation of audit profession in some markets.
Regulatory enforcement	Financial regulators still under-equipped, but there has been more focus on enforcing listing rules and key securities laws (eg, insider trading).

3. Impact of the Global Financial Crisis on Asia: First reactions

- **Emotional noise**: The credit crunch started in the US, so this 'proves that US corporate governance is flawed'. We can therefore ignore global CG standards and go our own way.

- **Considered position:** The credit crunch may have started in the US, but other markets had weaknesses too. And not all US companies have failed (ie, not all have poor governance). The crisis highlights yet again the importance of sound governance to the management of risk.

- **Weaknesses in the emotional argument:**
  - It offers nothing new—just more of the status quo. How will this approach help markets with problems (eg, Japan)?
  - It does not differentiate between Western companies that have failed and those that have survived and done well.
  - US corporate governance is not the same as UK or European corporate governance. Asian regulatory systems draw ideas from all three places.

Global standards are not identical to US standards

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, therefore, would be counterproductive.

But the "GFC" has caused some reassessment of reform

- **Independent directors**
  Can they effectively supervise management? Are they sufficiently well informed? Do we expect too much?

- **Regulatory enforcement**
  Is enforcement having the required deterrent effect (especially in criminal areas)? Are consumers properly protected?

- **Disclosure-based regulation**
  Are strict rules on disclosure sufficient to protect investors?

- **Role of shareholders**
  Why aren't shareholders playing a more active role as shareowners? What conflicts do they face?

➢ These are all sensible and healthy questions to ask, which leads to…

…Unfinished business

The GFC gives even greater impetus to the following areas of unfinished business:

- Strengthening shareholder rights
- Enhancing corporate disclosure
- Enhancing regulatory enforcement
- Improving the functioning of boards
- Putting a governance foundation under social and environmental challenges and risks

Strengthening shareholder rights

- **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). Malaysia scores better on this issue!
- **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. Some markets have particularly weak regimes (eg, India). Independent shareholders should have the right to approve major related-party transactions.

Enhancing corporate disclosure

- **Continuous disclosure:** Prompt disclosure of material "price-sensitive information" is weak in many markets.
- **Account preparation:** Auditors often say that the preparation of accounts by issuers could be improved.
- **Accounting consistency:** Investors point to examples of companies that apply accounting standards differently depending on what produces the best result for them.
- **Speed of reporting:** Issuers in some markets have long deadlines for releasing interim and annual results.

Enhancing regulatory enforcement

- **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

- **Board composition and skills:** 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. Vs adopting a "cookie cutter" model.
- **Independent directors:** If implemented well, they can bring considerable value to a board. But controlling shareholders need to allow them "voice" and value diversity of opinion.
- **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.

At the same time, the crisis gives some markets (eg, China, Japan) the confidence to pursue their own ideas on board reform.

Governance and sustainability

- "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 institutional investors to incorporate environmental, social and governance **risks** into the investment process. For example:
  - United Nations Principles of Responsible Investment (UNPRI)
  - Greater engagement with companies on material aspects of their environmental, social and labour practices.
  - Global pension funds looking for fund managers who can invest along ESG lines.
- As climate change looms ever larger, these questions become more urgent.

4. Conclusion

- The Global Financial Crisis does raise some uncomfortable and difficult questions for corporate governance reform. But these are questions that should be asked in any case.
- Some markets will be emboldened to pursue their own ideas on reform, but all markets will be affected by global standards to varying degrees (if they are part of the global economy).
- The GFC will, on balance, lead to greater emphasis on corporate governance reform, rather than less, in the coming decade. There remain many areas of unfinished business.