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Plenary Session VI
Corporate Governance: The Key to Sustainable Financial Markets

Panel comments[1]

By

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Prof. Jesus Estanislao
Distinguished Guests
Ladies and Gentlemen
and many old friends

I am honoured to be invited this morning to join such a distinguished panel to discuss why Corporate Governance is Key to Sustainable Financial Markets. Based on the number of conferences that I am called to speak on this subject, interest in corporate governance in Asia must be growing, and public awareness improving.

Because of time constraints, let me go straight into the heart of corporate governance issues in PECC area. I am not an expert on the other side of the Pacific, so my comments are limited to East Asia. The issue is: can the Asian model of corporate governance compete in a global world?

[1] The views expressed here are totally personal and do not reflect the views of the Securities and Futures Commission, Hong Kong

There is of course no single Asia Pacific model, since corporate governance is part of institutional culture, which has been framed by history, legal traditions and social structures. However, it would be true to say that with some exceptions in Japan and Hong Kong, there are relatively few institution-led companies in Asia. Many Asian companies are still family-controlled, dominated by their founders or their families. Other leading Asian companies are state-owned or -controlled. Many have clusters of companies, whether they are Japanese keiretsus, Korean chaebols or Indonesian congloms. Unlike American or UK corporate history, which had perhaps at least one hundred years' head start, modern Asian corporate growth was more recent in origin. Thus, the governance structures are still hierarchical – top down and lineal, in contrast with more modern Western matrix management structures.

Asian corporations have tended to be more leveraged than their European or American competitors, with global strengths in some areas, such as export manufacturing, agricultural produce, property, and selected service sectors, such as trading, logistics and commerce. However, Asian banks and financial sector expertise have been generally lagging relative to their European and American competitors, mainly because of the legacy of non-performing loans and lack of external competition.

Until the Asian crisis, corporate and state policies were highly mercantilist, focusing on building market shares, and profit margins were secondary. Both the government and the banking system were supportive of such growth. They did not have too scientific concepts of risk management, engaging in short-term borrowing to finance long-term projects (especially property and large-scale manufacturing capacity). Add to this an exposure to foreign currency borrowing without export earnings, many corporations became vulnerable to the Asian crisis shocks.

We realize that it is no longer returns to growth that matters – it is return to equity. It is not returns to family or the majority shareholder, but return to all shareholders. It is not return to management, but return to people – all workers and stakeholders. In essence, the heart of corporate governance is return to society, the mission of all good corporate citizens, with accountability to all stakeholders.

Trends of Competitive Challenge

Whether Asia Pacific companies can meet the global competitive challenge depends on several key factors. The new information rules suggest that there are not only supply side economies of scale, but also demand side economies of scale. As products become more and more technology oriented and capital intensive, initially Asian companies tried to build larger and larger factories. However, the economic centre of gravity is now drifting towards larger markets, where strength of potential demand may determine future trends of production pattern. Hence, the power of growth of the Indian and Chinese markets are attracting huge FDI from multinationals because of the huge supply of cheap labour, but also the magnet of mass markets. Smaller economies and corporations will have to specialise and go for market niches.

In this competitive game, corporations will be rated according to the following criteria:-

(1) Corporate Governance – clarity of mission and corporate values;
(2) People talent – do you have good leadership and are you hiring the best talent?
(3) Market space – where and what is your market reach?
(4) Risk management – how well do you manage your risks?
(5) Discipline – are you meeting the key disciplines of self-discipline, regulatory discipline and market discipline?

With global investing and global choice, companies and markets will be benchmarked against global standards, including global standards of corporate governance.

There is one further global megatrend that drives the demand for corporate governance change – demographics. As population ages, more and more savings are being concentrated in large asset managers – or global financial institutions that cover the whole range of banking, insurance, securities, asset management and derivative products. This concentration of buy-side investors, using global and local indices to benchmark their investment strategies, is demanding higher and higher standards of corporate governance, liquidity and transparency. If you do not meet their investment criteria, the domestic liquidity will shrink, as many Asian markets are now experiencing.

Based on these criteria, the commercial case for good corporate governance is now unanswerable. Globalisation and better technology are not just about outsiders judging our markets, it also provides the means for domestic investors to access overseas markets. Investors like consumers have access to overseas products and markets. They are not obliged to shop in the local market. They will seek the markets that provide the best risk: reward balance. In this equation a key element of risk is trust. Without trust any assessment of risk increases bringing a demand for higher rewards. A McKinsey survey indicated that investors are prepared to pay a significant premium for a well-governed company. Equally, a World Back Study in 1999 across 150 countries found a strong causal relationship between better governance and better development outcomes.

The Disciplines of Corporate Governance

Corporate Governance is like a three-legged stool resting on three basic disciplines: self-discipline, market discipline and regulatory discipline. The advantage of a three-legged stool is that however irregular the stool or rough the ground it sits firmly. But do not let that fool you. The legs may be firm but, if the legs are not in the right proportion you will find yourself slipping off a sloping seat. It is essential that the three disciplines are in proportion, then you can relax and sit comfortably.

Self-discipline

Let me start with the first leg of this stool – self-discipline. Family-based entrepreneurs all began with great self-discipline. But if you are tied down by family relationships, you may not be using the best talent. Exercising discipline within family structures does not have the same competitive edge as an organisation that hires the best and brightest, regardless of colour or creed. How can such family networks or state bureaucracies compete against modern, institution-led companies that not only hire the best talent, but also are able to use global networks and brands to out-think, out-flank and out-sell our best companies?

So far, Asian companies have been pre-occupied with their own internal succession and restructuring problems and tend to treat the need to share information with minority investors as what is required by law, rather than a calling of ownership. Earlier this month Standard & Poor's published a survey on transparency and disclosure standards of Asian companies. It commented that good corporate disclosure is a leading indicator of good corporate governance. A growing body of evidence shows that high standards of transparency and disclosure have an impact on the cost of capital.

Those companies that are seen as meeting only basic compliance standards are only given passing marks, but as S & P's report remarked this is no longer the benchmark expected.

Market discipline

If self discipline is not enough, we must look for help from outside forces - from market discipline the second leg of my corporate governance stool. One reason, why some markets are more efficient than others is clearly because market discipline is allowed to work. Protecting some parts of the market from competition has clearly been bad for the economy as a whole. In the corporate governance area, market discipline is exercised most often through the share price.

In the United States, large pension funds and institutional shareholders have found that over time their responsibilities to their beneficiaries have been made more explicit by regulators and by their investors. Hence, they have become more active and vocal in corporate governance issues, such as through ethical investments, and acting to change problematic management. Their market power has enabled them to be an effective force. Unfortunately, institutional investors in Asia tend to vote only with their feet, by selling out.

The other form of investor activism is to empower the investor through derivative suits. The US class action suits are the most powerful tool and probably the most punitive for the company that strays in conduct. Asian regulators have begun to encourage shareholder activism, such as in Taiwan, where in 2000, there were 456 lawsuits against companies. Malaysia and Korea have also witnessed such activism. But Asian regulators are still debating the advantages and costs of allowing class action.

Another market force which is emerging strongly is the arrival of rating agencies to offer corporate governance rating services in this region. By beginning to benchmark the quality of corporate governance disclosure and practice, such quality will be priced more accurately. Companies will be judged by the market on how they behave. This is market discipline working at its best.

Regulatory discipline

Which brings me to my third discipline that is provided by regulators. Where does regulatory discipline come in?

Policymakers have to provide the institutional framework and policies to attract investors. Regulators must drive reforms where necessary to meet international standards. Regulators must set the rules of the game in consultation with the private sector, and enforce these agreed rules, fairly and transparently. They must also protect investors through greater public education and disclosure rules. When cheating or fraud occurs, there must be *regulatory discipline.* But regulators, being the good bureaucrats that they are, tend to over-regulate. As my good Taiwan friend, Lawrence Liu, said, "Asian regulators over-regulate and under-enforce."

And what should we be enforcing more? In my view, three areas – the integrity of information, maintaining a level playing field and minimizing market misconduct.

Effective market discipline depends on many factors, but in particular it needs information. Investors' rights of action, even the right to sell, are only effective with reliable and timely information. The single most important lesson from the 1997 Asian Crisis is that reliable timely information is a market fundamental. Good information is a basic requirement for a modern society. Investors simply cannot make good investment decision based on incorrect or out-of-date information. The production and disclosure of high quality information, both accounting and non-accounting, has to be a priority of our work to improve corporate governance.

Many countries are updating their accounting standards to bring them in line with International Accounting Standards. In 2001 Hong Kong has issued six new accounting standards and amended another 10. Other countries have adopted International Accounting Standards or are amending their standards. Whilst this process of upgrading standards is never ending, especially with the new International Accounting Standards Board starting to get up to speed, the focus must now be enforcement of the quality of disclosure. Regulators need to ensure that preparers of financial reports and their auditors are held accountable when financial statements do not meet standards.

Investors will also shun those markets where there are scams and unlevel playing fields. Hence regulatory discipline really boils down to ensuring that the investors are treated equally, just as firms want to be treated equally in a competitive environment.

In conclusion, corporate governance is now a competitive necessity, and forums such as PECC do well to persuade our corporate captains that it is in their own best interests to rise to meet the challenges of higher global standards.

Thank you.

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