Corporate Governance in Asia's Emerging Markets – an Overview

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Abstract

Corporate Governance (CG) has been viewed by many in the Western world as a particularly Western concept and mechanism. Current expectations by executive management groups of their Board run the gamut of "sober second thought" and conservative oversight focused on compliance issues, through involvement in strategy development and direction, to daily consultation on operational strategy implementation. The challenge along all points of this spectrum is the balance between independence and discipline on the one hand and self-interests of the Board members in the overall success of the corporation, from both a financial and an ego perspective.

This article outlines key findings resulting from focused interviews and in-depth reviews of research related to the practice of corporate governance in Asia. Interviews were conducted in Hong Kong (6) and Malaysia (12) and focused on CG in those two countries. The goal was to establish areas of consistency or divergence from findings in the interviews. Findings indicate that CG continues to struggle in areas of transparency and limited independence of Board members. Increased legislation in the focal countries studied (Malaysia and Hong Kong) has helped, but progress has been slow.

Keywords: *corporate governance, transparency, Hong Kong, Malaysia, minority shareholders*

JEL classification: O16

Background

In essence, Corporate Governance (CG), both as a practice and as a public corporate philosophy, represents good business practice from a financial perspective. In CLSA's survey of large-cap companies across emerging markets (a total of 495 companies those from including 11 Asian markets with a combined total of 34 companies from Hong Kong and 47 companies from Malaysia), the total average US$ return over the past five years has been 388% while the top CG quartile providing an average return of 930%. [1]

[1] All statistical data is drawn from *the* CLSA annual reviews of Corporate Governance in Asia (2001-2007). Patterns described in this study have been cross-referenced to the McKinsey study on CG (2000) and with interviews of corporate officers in Malaysia and Hong Kong.

In ten of the 11 Asian markets, including both Hong Kong and Malaysia but excluding Korea, companies in the top quartile for CG averaged 10 percentage points above their respective country averages in higher ROE. Similar correlations were found between ROCEs and CG performance.

Across Asian markets, stocks or companies at the top end for CG have been strong outperformers over the past one to five years. Companies in this group showed 54% above their market average. This contrasts with those companies in the lowest two CG quartiles whose stocks listed at 43% lower than the market average.

The tradition of the *family run business* in Asia represents a difficulty for evolving positive CG practice. Across Asia, 60% of market capitalization of companies is based on single shareholder domination (owning < 20% of the company). Under such a model, there is strong resistance to transparence, independence of Board, external accountability, and fairness to investors other than family. Traditional practice of the family-owned business nature represents a limiting factor in the short term to modern CG practice in both Hong Kong and Malaysia where the "primary founder as prime stockholder" still dominates business practice.

Privately held businesses comprise by far the majority of companies across Asia. In Hong Kong, for example, such companies, when put together with unincorporated businesses, represent about 99% of all business entities both incorporated and unincorporated. They contribute roughly 40% to HK's GDP and employ about 60% of the work force (Jones, 2001). Similar proportions accrue in Malaysia. Consequently, legislation and enforcement efforts that are currently confined to listed companies cover a very small fraction of Asian companies. Efforts to improve CG practice will necessarily have to explore avenues to encourage non-listed company participation.

The patterns for companies in which CG was not a priority indicate as willingness to mix Board membership with management responsibility (the same individuals sitting on both Board and management committee), a willingness not to control manager, executive or Board member actions through application of strict policy related to business ethics in its broadest sense, and a willingness to ignore the valid stated interests of minority shareholders and/or other stakeholders. Misstatement of numbers in the annual or other filed reports is a typical example of such practice.

The largest companies reviewed had much higher CG scores (see statement related to potential research bias outlined in Footnote 1). In the initial CLSA study in 1999 average overall CG score for the top 10% of companies by market cap was 71.8%, in effect 28% higher than the average CG score for the overall sample. In 2004, the same score was 75% and in 2005 it was 70%. Companies included in this group from Hong Kong include HSBC, Li & Fung, CLP, Cathay Pacific, Hong Kong Gas. No companies from Malaysia were in this top-ten large-cap group. In 1999 the first Malaysian company in the listing was BAT, in 19th place, with Malaysia's overall country score having dropped from 60% to 56% in 2005.

Although the various sources for statistical comparison have varied in their relative ranking of companies (see Appendix A for an amalgam of criteria used by various studies to evaluate CG), the conclusion that good CG equates with superior performance and companies with low CG underperform is valid. Across all studies this outcome was verified.

One of the key reasons for underperformance for companies lacking good CG is that investors – particularly institutional investors – are now more wary of stocks of companies having perceived low CG standards. Loss of investor confidence is self-fulfilling, causing reduced stock valuation and a negative spiral of overall company financial performance over time.

Study Findings: General Statements about Asian CG

Any review of CG must take into consideration the reality that the macro environments within which individual company practices exist have a dramatic and telling impact on policy and behavior at the individual company level. Those country cultures that support good corporate governance practice will naturally result in both underlying philosophical support for strong CG and the development and enforcement of regulatory policy concerning CG practice. The CLSA studies (CLSA, 2001, 2004, 2005, and 2007) have listed between 5 macro-factors as core determinants of the CG characteristics exemplified by companies. These factors have been approximated in a variety of studies of international CG practice (Black: 2001 and McKinsey: 2000). Macro-environmental factors most influential in relation to international CG practice in keeping with the CLSA study are listed in Table 1.

Corporate Governance Marco-Factors[1]

Table 1

Corporate Governance Macro-Factors	*Importance**
Clear, transparent, and comprehensive rules and regulations	1
Committed and effective enforcement of rules and regulations	3
Political and regulatory environment affecting CG and ability of corporations to maximize value without arbitrary restrictions	2
Adoption of International Generally Accepted Accounting Principles	2
Institutional mechanisms to promote awareness and a culture of good governance	2

* 1= important 2= very important 3= extremely important

[1] Adapted from CLSA (2001).

Of the five factors outlined above, by far the most significant is the perception of political (and cultural) will to enforce the rules and regulations that are "on the books". As CLSA notes: "Without effective enforcement, corporations can and will get away with scandalous behavior." CLSA, 2001:36). This opinion was strongly reinforced by data gathered in semi-structured interviews at a series of international conferences on Corporate Governance starting in 2001 in Malaysia. Interviewed participants indicated that, while Malaysia has a well developed and codified system for the identification of requisite CG practice, enforcement has clearly been ineffective and selective to date. This represents, in their opinion, a significant limiting factor in the move in Malaysia to more consistently positive CG practices and its international business reputation.

For this reason, the simple existence of positive rules and regulations can be seen to represent only a good start in the overall CG journey. It is in and through the enforcement of the publicly stated regulations that the actual culture of CG becomes obvious in practice and significant from a corporate metric perspective. For this reason, on the scale of importance, the history and current culture of enforcement must be listed as by far the most significant determinant of any market appreciation of a CG premium for both a particular country macro-environment and for individual company performance.

In terms of the application of CG in Asia in general, the metaphor of the *carrot and the stick* represents an interesting and useful approach to identifying a pattern in emerging practice. Interviewers *consistently* indicated that *the stick* represented an unavoidable and core component underlying the movement toward acceptance and implementation of more acceptable CG practice across Asia and, in terms of this current study, in Hong Kong and Malaysia in particular.

Trends in data generated by both CLSA and McKinsey indicate that those companies in both Hong Kong and Malaysia that have adopted more transparent and responsive governance practices were also much more likely to have higher stock valuations and financial performance rations while those in the bottom quartile of performance had much poorer rations *without exception*. Also without exception was the observation that, as enforcement of regulations and public punishment of transgressors (the *name and shame* approach) was effectively implemented, corporate governance practice increasingly became more positive. While some interviewees noted that this was affected by the positive effect on financial performance measures, most admitted that the driving motivation for CG implementation was the principle of FOG-C ("Fear of getting caught!").

This pattern was particularly noticeable in Hong Kong, where a study of CG practices with the aim of bringing about radical reform in enforcement is being implemented. This initiative in Hong Kong is designed to make poor CG practice particularly costly from a legal perspective. In Malaysia, where enforcement is not yet well implemented and perceived to be selective in nature, new CG reporting regulations introduced in 2000 and reinforced by new securities listing requirements related to CG practice (implementation in the February – June, 2001 timeframe) have not had a significant impact on the movement toward more positive CG practice (CLSA, 2005).

Through the process of direct focused interviews and reviews of third party research studies and published reports, an attempt has been made to document trends and examples in both *common practices* as well as *best practices* in corporate governance in two specific Asian marketplaces: Hong Kong and Malaysia. In Hong Kong, structured interviews were carried out with 6 firms directly. Third party data was gathered in relation to an additional 38 firms. In Malaysia, structured interviews were carried out with 8 firms, with third party data gathered in relation to an additional 47 companies. Third party data focused almost entirely on firms in the medium and large cap categories, while interview data covered the whole spectrum of small to large firms. See Appendix D for a listing of firms reviewed.

Country-Specific Findings

Malaysia

While Malaysia has a well-developed set of regulations and rules related to CG performance areas, it was rated among the lowest in the Region in terms of enforcement. Reality is that enforcement has been selective in the past and is perceived to be politically determined. Analysis of practice over the recent past indicate a clear willingness of the Government and the Judiciary to interfere with enforcement.

Although the Malaysian Code on Best Practices (2000) outlines clear regulations related to CG practice and change in listing regulations on the part of the KL Securities has forced some formalization of company approaches to governance, progress has essentially stagnated currently. The decision to join the *Independent Directors Register* in 2005 may have a more immediate impact on publicly listed entities. The new regulations did reinforce a number of "best practices" that will be difficult to avoid for companies listed on the KLSE. Among the requirements are the following:

- Disclosure related to compliance with principles and best practices of Malaysian Code of CG (compliance is voluntary, but disclosure related to compliance is mandatory).
- Loans to third parties and unlisted holding companies no longer allowed (avoidance of repetition of Renong Group fiasco and the more recent MAS and Proton struggles related to transparency).
- Statement related to state of company's internal controls.
- One-third of directors must be independent (an accomplishment now possible through the membership as noted above in the *Independent Directors Registry).*
- All directors to attend mandatory training programs on the duties and responsibilities of directors and CG in general (courses are currently being offered and are heavily subscribed).

- All revenue, profit estimates or forecasts to be reviewed by external auditors prior to publication.
- Information provided to the Exchange must be clear, unambiguous, accurate, not contain any material omission, and not be false or misleading.
- Remuneration of directors to be disclosed in annual report (report by bracket of remuneration paid).
- Non-audit fees paid to external auditors to be disclosed in annual report.
- KLSE empowered to enforce against directors and advisers for breaches in Listing Requirements.

The above changes represent significant shifts in the formal requirements related to CG practice for listed companies. Two limiting factors remain, even in the light of these positive shifts:

1) the number of listed companies remains small compared to the percentage of business carried on by unlisted and unincorporated business entities. These remain unaffected by the requirements.

2) the climate of enforcement (i.e. the political will to enforce) remains untested.

The Government Finance Committee proposed in 1999 that the Employees Provident Fund (EPF) should take the lead to organize a minority shareholder watchdog group to protect the common small investor and lead a sense of propriety to CG practice related to smaller shareholders. Interviewees candidly indicated that membership on any such group would be politically and professionally suicidal and potentially personally risky. The underlying culture of business in Malaysia as currently structured would make the work of such a group difficult if not impossible to implement.

Malaysian Banks appear to have been granted increasing freedom to base loan decisions on business case data rather than political connections. Their recent decision not to provide credit to the Vice-Chair of a Malaysian political party for a questionable business move indicates increasing concern for transparency of decision making in this real of the business environment.

All of the cautionary details noted above notwithstanding, there remains the hope for improvement in CG practice for listed companies based on the formal reporting requirements at the SC. At a minimum, companies will be encouraged to engage in in-depth discussions of significant CG issues. If this development is paralleled with sufficient public enforcement activities and the rise in stock valuations and financial performance measures that current positive CG practice appears to yield, there is the hope for movement in CG practice in the Malaysian environment over the next several years.

Hong Kong

Based on the perception that CG practice in Hong Kong must shift its focus toward increased transparency and more positive protection of shareholder rights, there appears to be an increased awareness in HK that changes in CG need to be implemented. This has been matched by developments by the Hong Kong Monetary Authority (HKMA) to make rules for more stringent CG practice by the HK banks.

In addition, three studies were commissioned in the early 2000s to review specific aspects of CG practice. The studies included the composition of the Boards themselves (to ensure increased independence), shareholder practice (to ensure appropriate attention is paid to minority shareholders in a business environment dominated by family owned and controlled businesses) and corporate reporting practice (to ensure appropriate transparency and to limit the movement of financial assets within cross-held companies). Results of implementation of the studies have been mixed. The major changes have been an increased implementation of the separation of the Chair of the Board and CEO and increased transparency of decision-making.

Based on a culture of respect for people in positions of authority (such as Chairmen of the Board or Directors), shareholder activism related to abuses of position or simple ineptitude has not been a traditionally active entity in Asia in general and Hong Kong in particular. This has resulted in some levels of abuse and a generally understood practice that minority shareholder interests not in line with the (generally single) majority shareholder could be ignored or, at a minimum, not fully actualized. To counter this practice, a private activist (Mr. David Webb) launched the Hong Kong Association of Minority Shareholders (HAMS) with a view to promoting shareholder activism in HK. The association plans to its own CG ratings on listed companies, represent minority shareholders as a group in companies' annual meetings, and potentially take some of the worst CG cases to court.

The movement represented by HAMS represents a "best practice" in relation to CG for both Hong Kong and other countries in the Region. The culture of family-controlled businesses across the Region may well resist any essential changes in requirements for transparency, accountability, and responsibility related to the governance of their corporate dealings. In a cultural environment, however, where *face* and *shame* represent significant elements of public life, the development of such association may well increase progress in areas related to positive CG practice.

In Hong Kong, shareholder activism has already appeared to have some effect on corporations like Jardine Matheson, where minority shareholder action forced some share buy-back actions that respond to shareholder dissatisfaction with financial returns and related Board decisions over the last several years.

The recent publication (2007) by CLSA of a comprehensive evaluation of CG practice has encouraged firms to both address issues of governance as a priority issue and to become increasingly transparent about their progress. In Hong Kong, Swire Pacific recently took the initiative of discussing their governance practices directly with CLSA in response to an earlier report. On the other hand, the Swire group had clearly taken the comments of earlier reports to heart and wanted word to be circulated about their progress. In this sense, the public documentation and corporate comparisons both within a country and regionally represent a significant positive influence on corporate governance progress in Asia.

Summary

CLSA and similar organizations (McKinsey) who risk ridicule and attack for their high quality analysis and very public disclosure of findings deserve a large degree of credit for the promotion of modern CG practice in the Region. Given the Asian mindset, the practice of *name and shame* appears to be a more effective mechanism than praise for effective modern business practice. Higher valuations of stock along with better financial performance (the *carrot* part of the motivation equation) may not be too far behind as a driving motivator. Unfortunately these positive indicators associated with good CG practice tend to be more delayed in nature, while loss of face is both immediate and visceral in nature.

References

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Appendix A

Issues Indicative of the Potential Quality of Overall Corporate Governance (CG)[1]

a. Discipline

- Explicit public statements placing priority on CG
- Management incented toward achievement of a higher share price
- Sticking to clearly defined core business
- Having an appropriate estimate of cost of equity
- Having an appropriate estimate of cost of capital
- Conservative approach to the issuance of stock or options
- Focus on and review of debt management processes
- Debt used only for projects within declared hurdle returns
- Return of excess cash to shareholders
- Discussion in Annual Report on CG

b. Transparency

- Disclosure of financial targets (3 and 5 year ROA/ROE)
- Timely release of Annual Reports, semi-annual financial announcements, and quarterly reports
- Prompt disclosure of results with no pre-release leakage
- Clear and informative results disclosure
- Accounts presented according to IGAAP
- Prompt disclosure of market-sensitive information
- Accessibility by investors to senior management
- Publicly accessible sources of Company data (Website, telephone hotline, Investor Relations Department) where announcements updated promptly

c. Independence

- Board and senior management relationship to shareholders
- Board and senior management relationship to stakeholders
- Chairman who is independent from management
- Executive management committee comprised of individuals different from Board membership
- Audit committee chaired by independent director
- Remuneration committee chaired by independent director
- Remuneration committee comprised on individuals not on Boards of other companies in related or associated sectors
- Nomination committee chaired by independent director
- External auditors unrelated to company
- Board having no members who are representatives of Banks or creditors

d. Accountability

- Board plays strategic directional rather than executive role
- Non-executive directors demonstrably independent

[1] Modified from criteria developed by CLSA Emerging Markets Research Department (2001).

- Independent non-executive directors comprise at least half the Board
- Foreign nationals presence on the Board
- Full Board meetings at least every quarter
- Board members able to exercise effective scrutiny
- Audit committee that nominates and reviews work of external auditors
- Audit committee that supervises internal audit and accounting procedures

e. Responsibility

- Record on taking effective action against individuals who have transgressed established policy and practice guidelines
- Record on taking measures in cases of mismanagement
- Measures to protect minority stakeholder interests
- Mechanisms to allow punishment of executive/management committee
- Share trading by Board members following declared policy and fully disclosed
- Board size large/small enough to be efficient and effective

f. Fairness

- Majority shareholder treatment of minority shareholders
- All equity holders having right to call general meeting
- Voting methods easily accessible (e.g. through proxy voting)
- Information provided for general meetings clear, understandable, and complete
- Provision made to guide market expectations on fundamentals
- Issuance of ADRs or placement of shares fair to all shareholders
- Controlling shareholder group owning less than 40% of company
- Portfolio investors owning at least 20% of voting shares
- Priority given to investors relations
- Total Board remuneration rising no faster than new profits
- Board remuneration a mix of cash and options, with some Board members receiving only cash and some receiving only options

g. Social Awareness

- Explicit policy emphasizing strict ethical behavior (with demonstrable compliance)
- Avoidance of employment of child labour (with demonstrable compliance)
- Explicit equal employment policy (with demonstrable compliance)
- Adherence to specified industry guidelines on sourcing of materials
- Explicit policy on environmental responsibility (with demonstrable compliance)
- Abstention from business in countries where leaders lack social legitimacy (e.g. Myanmar)