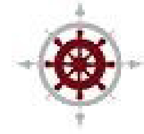


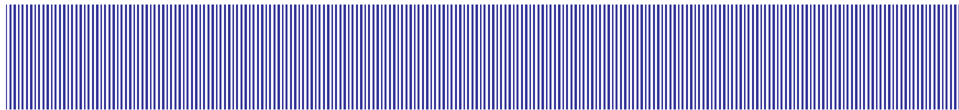
Transp.e.r.a

A communiqué on corporate governance *September 2015.*

Academy of Corporate Governance

(A Network Supported by Yaga Consulting Pvt Ltd)

Address at the UNESCO Madanjeet Singh Institute of South Asian Regional Cooperation, Pondicherry University.



International & Regional Cooperation in Corporate Governance – Developments & Challenges.

Dr.Y.R.K.Reddy
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Address at the Centre for South Asian Studies / UNESCO Madanjeet Singh Institute of South Asian Regional Cooperation, Pondicherry University

21, September, 2015.

Corporate Governance – Inflexion Points

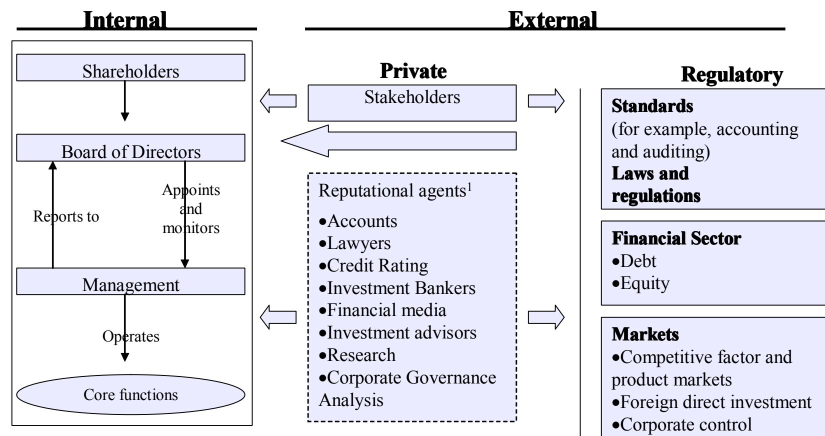
- Early foundations – Asia and Europe.
- The importance of "Corporations" in development – growing, not abating.
- The dynamics of "ownership" and "control" in modern corporations.
- The impact of trade liberalization, ICT, growth of TNC, financial liberalization, international investors, capital market development – especially in the 1990's.
- The Asian Financial Crisis, the idea of "Crony Capitalism" and the role of corporate governance to contain contagion and mitigate systemic risks.

- AFC and GFC as the key inflexion points for International / Multilateral cooperation in Corporate Governance. (Several studies including the UN Commission, OECD, GFSR, ICGN, FCIC etc. and several unfolding scandals.
  - Mainly argue for appropriate regulation / intense supervision (focus on regulatory capture, political nexus that is another type of "crony capitalism"; greater transparency and disclosure norms; early action from the State; public policy / plans for impaired assets; balance sheet repairs – consistency of treatment etc. at policy level (along with some multi-lateral moves)
  - At the enterprise level, the emphasis has been on advanced / robust / comprehensive risk management and qualified board oversight and activism; compensation / incentive structure that do not encourage false / fleeting profits and risks.

Need for "fundamental reboot" in Corporate Governance and Ethics

Accepted Framework

(Source: Corporate Governance Framework, Nadereh Chamlou, Magdi Iskande, World Bank)



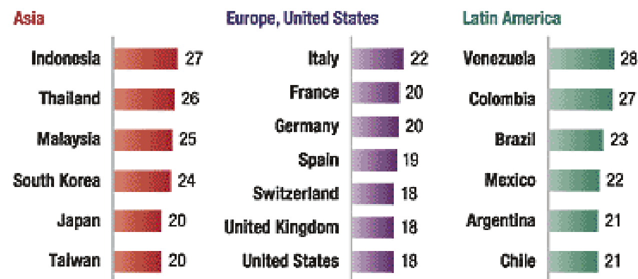
[1]*Reputational agents* refer to private sector agents, self-regulating bodies, the media, and civic society that reduce information asymmetry, improve the monitoring of firms, and shed light on opportunistic behaviour

Assumed benefits - to economies, companies…

- *Many studies have shown positive benefits. Eg: those of Mc Kinsey, ABI and IMF working paper on CGQ & CLSA study.*
- *Reducing corporate mortality and diminution of assets can hold great promise for economic growth.*
- *Other compilations had shown specific benefits such as:*

  More sustainable / socially responsible business practice.
  Better tax collections – especially in the Medium Enterprises.
  Improved Valuation of Assets
  Improved Access to Capital
  Lower Cost of Capital
  Improved Efficiency.
  Reduced risk and hence diminution of assets.
  (The linkages between CG, Financial Sector Development and Economic Growth have been researched well and proven)

The promise of CG Premium / "Mountain of Sugar Candy":



CG Gap Analysis - Asia

CG Watch market scores: 2010 to 2014

(%)	2010	2012	2014	Change 2012 vs 2014 (ppt)	Trend of CG reform
1. = Hong Kong	65	66	65	(-1)	Weak leadership, tough enforcement
1. = Singapore	67	69	64	(-5)	International vs local contrast continues
3. Japan	57	55	60	(+5)	Landmark changes, can they be sustained?
4. = Thailand	55	58	58	-	Improving, but new legislation needed
4. = Malaysia	52	55	58	(+3)	Improving, but still too top-down
6. Taiwan	55	53	56	(+3)	Bold policy moves, can they be sustained?
7. India	48	51	54	(+3)	Bouncing back, Delhi more supportive
8. Korea	45	49	49	-	Indifferent leader, more active regulators
9. China	49	45	45	-	Focus on SOE reform, enforcement
10. = Philippines	37	41	40	(-1)	Slow reform, improved company reporting
10. = Indonesia	40	37	39	(+2)	Big ambitions, can they be achieved?

Source: Asian Corporate Governance Association

International Cooperation and Convergence – Since 1997

- The role of Financial Stability Forum (now Financial Stability Board).
- Role of OECD – Principles, Capacity Bbuilding, SOEs.
- Role of IMF-World Bank - ROSC.
- Role of IFC – Washington.
- Role of BIS.
- Commonwealths early work (CACG) and that of Global Corporate Governance Forum.
- Role of ICGN – London.

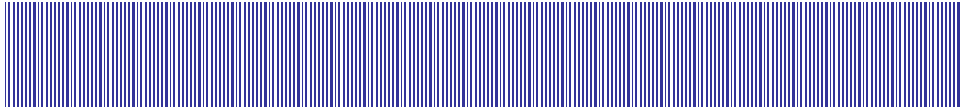
Corporate Governance has now become very much part of socio-economic development agenda.

Regional Cooperation - Select Instances

OECDs Regional Initiatives:

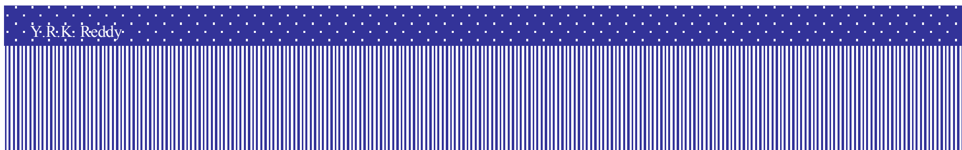
- Eurasia Group on CG for Capital Market Development
- Latin American Round Table on CG
- Latin American Network on CG for SOE,
- MENA
- Network on CG of SOEs in Southern Africa.
- Asian Roundtables and Asian Network for SOEs.

(Leading to several reports, task forces, surveys, advocacy, capacity building)



- Regional efforts by IFCs GCGF+.

Tool Kits, Training Packs, Capacity Building, Promotion of Regional Centres of Excellence, and Now much Advisory work. Includes some work in South Asia too.



Role of AsDB, AfDB etc.

- The efforts at NEPAD, APRM, ACGN,
- The efforts at ASEAN – CG Scorecards, Integration of Capital Markets etc.,

CG in South Asia - Continued Intl. Concerns..

- *Board composition – Selection, Competence and Independence.*
- *Quality and functioning of Board Committees.*
- *Boundary management among Management, Board and Ownership.*
- *Board practices and quality of dialogue.*
- *Succession-planning and long-term incentives.*
- *Related Party Transactions.*
- *Preferential Shares – misuse.*
- *Institutional investors` policy & practice – docile and non transparent.*
- *Quality of shareholder meetings and voting esp. disregard of minority shareholder rights and interests.*
- *Quality of Disclosures.*
- *Sustainability management / CSR.*
- *Quality of supporting Institutions – Legal, Regulatory.*
- *Quality of Compliance and regulatory forbearance.*
- *Audit profession – quality and oversight.*
- *Overall CG Discipline / Culture.*

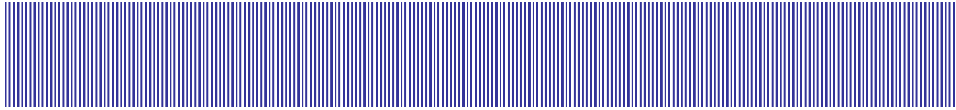
SAARC & CG

- Is it a sub-set of Economic / Financial Integration?
- A part of Capital Market integration?
- Role of SAFA – the committee on improvement in transparency, accountability and governance?
- The meandering movement of the CG Award – Best Presented Annual Reports & SAARC Anniversary Awards of CG Disclosures.
- How does it compare with other regional efforts?

Some Challenges

- Even the minimal expectations in Regional Cooperation in capital market integration appear to be challenging in many regions.
  - (Harmonisation of standards.
  - Mutual recognition and related liberalisation.
  - Infrastructure relating to exchange linkages.
  - Legal area harmonisation.
  - Buy-in from stakeholders).

- Resistance to Capital Market Integration in most regions due to:
  - Fear of competition from local players.
  - Fear of flights of capital.
  - Fear of dominance.
  - Fear of cross-border litigations and dispute resolution.



- Can CG be a softer and less threatening approach even if less ambitious?
- Can it focus on harmonisation of standards, Board capacity, media training, investor education aimed at better networking and mind-share for SAARC – leading to more regional investments than global?
- Should it be more actively supported by Corporates, stock exchanges or Governments for better buy-in (than multi-laterals only?
- Other challenges, views……debate!!!!

Public Enterprises Reform for Economic Spurt – Case for a Fresh Approach*

A. Political Economy of SOE Reform – A Snapshot:

There was no explicit policy of improving the governance of State-owned Enterprises (SOE) among most multi-lateral bodies till about a decade ago – as that could indeed be an effort to perpetuate a bad idea. Instead, there was unprecedented enthusiasm that took its roots in Thatcherism of Britain and spread virally, notably in Latin America and Eastern and Central Europe and the former USSR, to privatize any which way. It was, as if there was much cleaning-up to do than polish and restore rusty old goods. No wonder that the initial Codes for Corporate Governance and the subsequent standard-setting OECD Principles were based primarily on the assumption that corporations will be widely-held through public listing as in the UK and the US. Block-holding by the State or the Family Businesses or the Entrepreneurs was considered an interim position, if at all, in expanding capital markets that need to grow-up. Implicitly, block-holding with control was not considered the ideal and hence to be gotten over quickly.

However, there were early counter-views (example, by this speaker in 1998 and 2001) that pointed to the inevitability of State-ownership of equity on three counts – a) that, in the process of governance reform, there will be many commercial assets that the government may first corporatise before any privatisation can take place and hence there will be a pipe-line of SOE for decades (b) that there will be capacity constraints in the capital markets to absorb quick privatisation and hence it will be a long-drawn effort that will be further constrained by the "crowding-out" effect on private issuers and (c) that the Government may be compelled to nationalise private or privatised companies in public interest.

** Edited version of the First Lecture of SCOPE Economic Forum, New Delhi delivered on 10th December, 2014 by Dr.Y.R.K.Reddy, International Advisor in Corporate Governance & Strategy whose professional work spans 40 countries; Former distinguished Professor of Strategy, Author and Independent Director.*

The pitch in these arguments was that there is pressing need for strengthening the Governance structures and processes than concentrate on divestment, wide public holding and wholesome privatisation – as it could also lead to a "*giveupitis*" and worsen the quality of the assets drastically. Since then, the developments in the OECD`s perspectives and the Guidelines on Corporate Governance of SOE have marked a significant movement towards strengthening the governance ecosystem for SOE, albeit with the underlying objective of increased private holding / privatisation of assets over time.

The Global Financial Crisis has further underscored the importance of State-ownership, as Governments had to bail-out private corporations with acquisition of equity and infusion of debt. Even earlier to the fresh financial crises and economic downturn, some countries (especially in Latin America but New Zealand, the UK and South Africa as well) had to experience nationalization of privatized entities for a variety of compelling social and economic reasons. Thus, the inflexion points in the post-World War history of SOE can be summarized as:

- Euphoria with SOE till about late the 70`s.
- Doubt generated in late `70s with fiscal stresses, increasing advocacy of free-markets, and the growth of successful and efficient private corporations.
- Rejection of SOE in the `80s and the `90s with changed public policy discourse and massive privatisation movement around the world with multilateral support.
- Disaffection with privatisation due to doubtful economic benefits, accusations of corruption and "patrimonial capitalism", evidence of adverse social impact leading to some episodes of re-nationalisation etc., resulting in moderation and resort to soft / indirect privatisation.
- Conditional acceptance of State's ownership of commercial assets, especially after the bail-out of private corporations during the global financial crisis, with the aim of subjecting them to strong corporate governance reform and market discipline, even as different ways of privatisation can be considered on individual merits.

B. Popular Recommendations and their Possible Implications:

Most of the current recommendations regarding reform of governance of SOE – mainly from the OECD and echoed by experts – have universal appeal and are working well in some socio-political-structural contexts. However, there are three currently popular suggestions that need particular analysis and validation in the Indian context.

First, is the creation of a holding company or a central entity that will hold the ownership rights of the Government and exercise them with independence and efficiency. The hope is that political interference and bureaucratic meddling will be reduced; that Boards and Chief Executive Officers (CEO) will be appointed objectively on merits; that strategic decisions will be carried out nimbly; that managements would be better empowered to bring their professional competence to play without hindrance or directives from political bosses etc. In this context, China`s State-owned Assets Supervision and Administration Commission (SASAC), Singapore`s "Tamasek" and Malaysia`s "Khazanah" are popularly cited (there are other examples as well, such as from Sweden, Finland, Vietnam, and Bhutan, lately). Contrary to the popular belief, SASAC reportedly controls only 117 central enterprises even as about 100,000 companies remain outside its purview (as also the Banking and Finance sector); it had non-ownership duties also including national security related ones till just a few years ago; there are many other State-owned Assets Supervision and Administration Authorities at the provincial, local government, municipal levels making the entire investor role of the Government a complex matter; there have been publicly expressed concerns on the efficiency of SASAC even as the productivity gap between the State-owned and private firms increased; and there is much scepticism on the mixed-ownership program (partial disinvestment) it reluctantly announced, as the Economist observed, for some large companies it oversees. Considering that the corporate governance standards by themselves are fairly moderate in China compared with many Asian countries and that the Board of Supervisors and employee representatives in them separates China from the others, the overall impact and relevance of SASAC model needs further study and validation.

Temasek of Singapore, considers itself an investment company and has portfolios of the private sector as well as of other countries. It has only about 30% of its portfolio located in Singapore; its portfolio of Government Linked Companies (GLC) has been declining while it has acquired considerable stakes in Government Linked Real Estate Investment Trusts (GLREIT), a new class that emerged since 2002; and it has been widely considered as a Sovereign Wealth Fund (SWF). Further, the GLC Boards that it oversees have dominant presence of current and former Members of Parliament and civil servants - more than the private sector. Yet, there is reportedly no political interference but a strong accountability and loyalty to the power structures in the Government. The transparency, disclosures, and overall governance and performance of the listed GLC have been rated far higher and improving compared to non-GLC listed companies. These aspects, perhaps, point to serious socio-political and cultural strengths that support efficient governance of SOEs in Singapore than merely due to devolution of ownership rights to a holding company.

Khazanah Nasional Berhad (Khazanah) is a Government Linked Investment Company that holds the equity of leading GLC apart from other portfolios. It regards itself as a "regional strategic investment house" exploring strategic investment opportunities in new sectors and new markets. The successful reform of the GLC in Malaysia too cannot be attributed to the holding structure model as much as to the strategic efforts of the Government in launching the GLC Transformation Programme in 2004, its oversight by the high-level Putrajaya Committee on GLC High Performance, the issuance of meticulously prepared operating manuals, development of Key Performance Indicators and close performance monitoring with strong professional support.

In contrast to the above, the UK has a "Shareholders Executive" that aims "to be an effective shareholder of businesses owned or part-owned by the government and to manage government's interventions in the private sector in order to secure best value for the taxpayer". Its portfolio companies – 23 in number and do not include Banks – are a wide variety accountable to many ministries. Depending on the shareholder mandate, it may assume *an executive role* (accountable to ministers directly); *joint role* (working alongside shareholder teams within departments); and *advisory role* (advising

shareholder teams within departments). Instituted initially within the Cabinet Office in 2003, it currently is part of the Department for Business, Innovation & Skills since 2009.

In summary: (a) The premise that a holding company structure distances the SOE from undue political interference leading to better performance by itself cannot be affirmed by looking at any of the above models. It could indeed be hope winning blindly over experience or logic. (b) On the other hand, if the political and regulatory conditions are such that they invite irresponsible interference driven by ulterior motives, the same ecosystem cannot be relied upon to create a high-powered holding company to be staffed apolitically and left to exercise its function independently. Such a powerful body could indeed be a proverbial tempting apple for the political system, resulting in its capture. (c) Further, going by the voting activism of leading government sponsored domestic institutional investors in India, it is probable that the super body mimics them, working mostly in tandem with political interests, explicit or implicit. (d) Most importantly, there are several Ministries which do not have any regulatory role and hence exist only on account of the SOE they are responsible for. Consolidation of ownership rights of the SOE in these ministries would result in reengineering / shrinking the Cabinet, *ab initio*, which has its own ramifications – a condition perhaps difficult to fulfil.

Second, there are suggestions for rapid disinvestment so that the Government reduces its fiscal stress, improves the float in the market, and hopefully, derives the benefit of market forces and its attendant discipline. Recent experience has shown that there is insignificant enthusiasm in capital markets for SOE stock and hence the State sponsored institutional investors have often come to their rescue in follow-on offers – and in effect, may have crowded-out the equity supply to private entrepreneurs and their innovations. There also has been some degree of "moral hazard" as the disinvesting SOE have the back-up / rescue plan in case there is lukewarm response to its offers – and hence, few SOE may have addressed / engaged the markets and the intermediaries to the same effect as their counter parts in the private sector perhaps do. Further, disinvestment, even below 51% to escape the tyranny of the much indicted "3-Cs", does not necessarily mean that the company will suddenly become a widely-held entity with control shifting to better owners than the government.

It is probable that the Government and its sponsored institutional investors will end up being the dominant stock-holders, and hence vested with control – as control can be achieved, in most countries, with about 20-30% block-holding. On the other hand, it is reported on analysing the World Bank Privatisation data that most privatisation through stock markets in the world does not result in change of control and hence the firms will continue to have the same quality of management and type of governance.

Third, there has been much talk on the separation of Chairman and CEO as a key panacea to the difficulties of the SOEs. The idea of separation must be understood in the context in which it was made – i.e. the assumed model of a widely held-company with possibilities of control shifting to the insiders that needs to be balanced by inducting non-executive Chairs and increased number of independent directors with attendant shareholder activism and markets for control. However, where the control is still with the government and there is little effective activism, induction of a non-executive chair may not create an independent mind of the Board. This is especially so, if one runs out of good Non-executive Chairmen candidates after the initial dozen of top-of-the-mind names. On the other hand, if the ambient political conditions have not changed, there is much scope for adverse selection of the Chairmen, as indeed is the case with most state-level public enterprises – in which the non-executive Chair and the political leadership work in tandem at the cost of the corporation, which is headed by a CEO with lower stature than a CMD. Further, given the cultural issues, an independent selection agency for picking up the Chairmen may assure competence but not insulation from pursuit of political interests one way or the other. Consequently, the idea of separation has to be evaluated after validation of implications and not as a notional balm for the performance ills of SOE.

C. The Coming Tide and a Possible Fresh Approach:

It is apparent that most attempted reforms of SOEs have ended up being short-term hopes and symbolist. They have neither addressed the key systemic challenges nor assured long-term competitive survival of the companies. Of the many apparent challenges, there are two that need special mention as they may indeed result in diminution of the SOE assets and destroy value abruptly.

First: The tectonic shift in the financial flows as noted by studies at the OECD and the potential shortage of equity capital as projected by Mc Kinsey Global Institute. Studies have indicated some heartening trends for the Emerging Market Economies (EME) as there is noticeable shift of wealth in their favour away from OECD countries, coinciding with their increasing contribution to global GDP which is expected to reach 57% by 2030. Gross fixed capital formation as a % of GDP also increased in 15 years from 34% to 45% in China and 25% to 30% in India while there has been a decrease in OECD countries from 21% to 18% during this period. Primary equity markets have shifted in favour of Non-OECD countries which have also reduced their raisings from OECD markets. Further, the Initial Public Offering (IPO) and Secondary Public Offering (SPO) have been increasing in EME compared to the OECD countries - notably China and Brazil. However, the amounts raised in countries such as India may not be sufficient enough to fund the much needed innovation, renewal and expansions apart from infrastructure that is critical to driving the rapid growth promised. Being risk capital, equity is the best class of finance to drive innovation and entrepreneurship that will be at the core of sustained growth and development – and yet there is relatively much less enthusiasm for equity in India compared to many other EME with only a fraction of household incomes being allocated to equity markets. It is estimated that during the five years ending 2013, only 1.5% of household financial savings have moved into capital markets constituting 0.6% of gross domestic savings and 0.19% of GDP. Further, over the years 1995-2012, some countries like China, Brazil and Turkey have attained rapid increase in market capitalisation as a percent of GDP with India trailing significantly. A key implication of this deficiency is that with higher dependence on debt, the country and its SOEs in particular, will have a structural disadvantage for growth and innovation vis-a-vis competition.

Compounding the challenge of shallow equity markets in some EME like India, a study by Mc Kinsey Global Institute estimates that the world may face a $10.2 trillion shortage of equity in the next few years even as the global financial flows seem to have retreated and financial globalisation is at crossroads, post-financial crisis. Closing the potential gap in equity demands specific efforts to increase investor confidence and improve intermediation

between savings and corporate needs. The issue of equity gap must worry SOE in India even more as they attract much lesser response from private and retail investors as indicated earlier. Thus, it is imperative for them to augment even further, the internal earnings to finance strategic makeover, innovation and growth.

Second, SOEs in India seem to be particularly vulnerable to disruptive technologies. There is the weight of the past ("sunk-cost") and the hope of a safety-net ("moral hazard") that are strong constraints relative to their competitors. Thus, technological advancements in 3D printing, advanced materials, robotics, renewable energy, internet of things etc., (as the 12 potentially economically disruptive technologies noted by Mc Kinsey) may become opportunities to ride the tide for the strategically nimble - or a tsunami to drown, for the others. If the SOE do not belong to the former class, then there will be an asset-graveyard soon with increased sickness among them.

State-owned commercial assets are too valuable and dear for the country to be allowed to waste away or decline in the midst of symbolic and un-validated experiments. Dag Detter and Stefan Folster, estimate that central governments alone hold more commercial assets than private equity firms, hedge funds, pension funds, sovereign wealth funds and the super-rich. They estimate that by managing their assets better, central governments can generate annual returns of $3 trillion which will be equivalent to the annual global investments in infrastructure (including transportation, power, water and telecom) or more than the GDP of India. In the case of India, the share of Central Public Sector Enterprises (CPSE) alone is significant – leaving, for the present, the state-level public enterprises and other commercial entities such as the Railways and Postal. As of fiscal `12-`13, there are 277 CPSE, with a total investment of Rs.8,50,599 crore; capital employed of Rs.15,32,007 crore; Gross revenue / turnover of Rs.19,45,777 crore. Studies have repeatedly indicated the significant scope for better capacity utilization, project planning, financial strategy and planning and cost management among the CPSE. The capacity to weather cyclical downturns, fight sickness and make a come-back has been illustrated time and again in the public sector, at large. It is not improper to estimate that the CPSE can enhance their gross revenues by 10% p.a and reduce costs by 10% p.a for a couple of years from the low hanging fruit, by

which time strategic opportunities could evolve. Without even reckoning the potential positive ripple effects in the economy, this should contribute to about 1.8 % of additional nominal GDP p.a for the initial two-three years, which is a very significant economic spurt.

To derive this benefit for the economy with least lagged effect, a fresh approach is necessary – to draw up an actionable agenda considering, among others, the broad steps indicated below:

- Re-evaluate and validate the current reform measures being considered in the light of the foregoing critique and analysis;

- Look at new mechanisms such as a high-powered Commission / Authority directly within the Prime Minister's Office (or a strategic makeover of the Department of Public Enterprises and other related bodies), to review recommendations, plan, iterate and implement the oversight / governance reform including that of articulating an ownership policy and reengineering the operational interface between ministries and the CPSE.

- Refocus CPSE minds from ministerial gravity to obsession with market institutions (capital markets, in particular), competition, value enhancement and survival. Disinvestment, monetising, securitisation, restructuring of assets, public listing, mergers & acquisitions etc., should all fall within the scope of a coordinated dialogue and action with direct oversight and strategic guidance from this authority.

- As part of the restructured governance reform, the MOU system (which was once described as more memoranda than understanding), extract clear strategy and action plan for internal reform within companies for squeezing value from hidden pools in each company and aggressively enhancing internal revenue.

- Launch a larger "Value Mission" in tandem with the above and reinterpret corporate governance as more than mere compliance - as a strategic and innovative effort for extracting value from within and

creating measurable value for the shareholders and the society, a responsibility of both the Boards and managements, enlisting the partnership of key stakeholders.