THE RIGHT KIND OF CONTROL

A WELL-DEFINED CORPORATE GOVERNANCE STRUCTURE PROVIDES BENEFITS FOR INVESTORS AND COMPANIES ALIKE. BUT WHAT DOES SETTING UP SUCH A SYSTEM ENTAIL? **NICK BRADLEY** AND **IAN BYRNE** OF STANDARD & POOR'S FIND OUT.

The OECD issued the following in April 1999: "Corporate governance is the system by which businesses are directed and controlled. The corporate governance structure specifies the distribution of rights and responsibilities among different participants in the corporation, such as the board, managers, shareholders and other stakeholders, and spells out the rules and procedures for making decisions on corporate affairs. By doing this, it also provides the structure through which the company objectives are set, and the means of attaining those objectives and monitoring performance."

This OECD definition is one that can encompass a range of interpretations of what is relevant to corporate governance. The key phrase 'other stakeholders' can cover creditors, but also employees, the environment and society as a whole. Pragmatically, if you want to measure and calibrate corporate governance – say, for the purposes of comparing companies – you would have to make a distinction between what can and cannot be measured and calibrated objectively, and what is measurable but where calibration may be difficult or subjective. Here, we will look at aspects we believe can, currently, be measured and calibrated objectively; this leads us to define stakeholders as shareholders and creditors.

IS CORPORATE GOVERNANCE AN INVESTMENT RISK? The past ten years in the US has seen the emergence of vocal institutional investors who have pressed for improvements in corporate governance – and with more than 50% of US equity in the hands of the institutions, it is a voice to be heard. US pension funds (the largest 25 of which own in excess of 40% of foreign equity held) have also become long-term investors in the stocks they hold – the corporate governance practices of companies become even more important to those institutions.

Outside of the US, poor corporate governance is often cited as one of the main reasons investors and lenders are reluctant, or unwilling, to invest in or lend to companies in certain markets. It can also explain why, in some economies, the shares of many companies trade at a significant discount to their true value. Even better governed companies are 'tarred with the same brush' – almost a case of guilt by association. For many investors and lenders, corporate governance is an another risk that requires assessment when evaluating potential investment or lending opportunities. If investors are unable to evaluate that risk, they are likely to be reluctant to invest or will require a significant premium to mitigate the unknown. In other cases, lenders will require a significant margin over the cost of borrowing before they will lend to companies where governance practices are inferior. In many cases, where the investor or lender is unable to evaluate the risks associated with governance practices, equities or loans may be incorrectly priced. This disadvantages the company and raises the cost of capital.

WHAT ARE THE BENEFITS OF GOOD CORPORATE GOVERNANCE? One of the aims of good governance should be to introduce checks and balances to create the conditions necessary to facilitate external finance. This view is supported by a number of studies including *CLSA Emerging Markets, The Tide's Gone Out: Who's Swimming Naked?* (October 2000) and *Saints And Sinners: Who's Got Religion* (July 2001). The October 2000 study evaluated the corporate governance practices and performance of 115 large cap stocks in 25 emerging markets. It found that the price of shares of those companies with high corporate governance standards have been more resilient during market downturns. The July 2001 study was expanded to include 495 emerging market companies of differing size.

The study said: "Superior financials of high corporate governance companies support premium valuations. Sustained value creation of these companies as well as greater focus of investors on corporate governance as an investment criterion in itself will result in continued share price outperformance over the medium term."

Taking this a stage further, higher share prices should lead to a reduction in the overall cost of capital and a body of quantitative research is starting to support this position.

The market rewards those companies that do change. Some studies have shown that efforts by a company to improve the quality of its board have a significant and positive effect on share price. Similarly, companies that continue to engage in activities that place the interests of management over those of shareholders tend to trade at a discount relative to other companies in their sector.

On a macro-level, other studies have shown that in countries where higher investor protection measures existed, and where corporate governance standards were higher, the impact of economic crises was generally less. Studies in the US have examined the depreciation of currencies and the decline of the stock markets in a number of emerging economies during the Asian crisis of 1997-1998. The studies revealed that countries with higher standards of investor protection were better insulated against market turmoil than those where investor protection laws were weak.

HOW CAN CORPORATE GOVERNANCE BE MEASURED/CALIBRATED? For all the above reasons, the need to introduce standards of corporate governance and build greater transparency in both developed and emerging markets is increasingly recognised. The OECD, World Bank and other multilateral development banks, for example, are seeking to improve awareness and conceptual understanding of corporate governance, as well as encouraging governments and companies to take practical steps to improve corporate governance practices.

At the government level, emphasis is placed on encouraging the building of a strong legal and regulatory environment, including the effectiveness and the enforceability of existing laws, as well as the level of transparency and disclosure required by the market.

At the company level, the measuring and calibrating good corporate governance practice is complicated by the existence of different models of corporate governance – defined, at least in part, by local legislation, structures and business practices. There is no one model of corporate governance that works in all countries and in all companies. Nor would you necessarily wish to impose a particular model onto all companies and countries.

However, if you focus on principles of good corporate governance, there are standards that can apply across a broad range of legal, political and economic environments. The Business Sector Advisory Group on Corporate Governance to the OECD has articulated a set of core principles of corporate governance practices that are relevant across a range of jurisdictions, which promote fairness; transparency; accountability and responsibility.

Focusing on those principles and using a synthesis of the OECD's and other international codes and guidelines of corporate governance practices as cornerstones, Standard & Poor's has created a corporate governance scoring methodology which is relevant and applicable globally. The methodology assigns scores to a company's overall practices and four individual components as follows:

- ownership structure;
- financial stakeholder relations;
- financial transparency and information disclosure; and
- board structure and process.

In all, 130 factors of a company's corporate governance practices are evaluated using both public and non-public information. To usefully measure and calibrate corporate governance practices the assessment process should be interactive between the company being analysed and the assessing organisation. Naturally, company analysis needs to take account of governance issues at the country level but if a company demonstrates 'good' or 'best' practices, no matter where they are located they should be recognised as such. Standard & Poor's also analyses the country level corporate governance environment in order to determine the extent to which external forces at the macro level support the internal governance structures and processes at the company level.

'THE NEED TO INTRODUCE STANDARDS OF CORPORATE GOVERNANCE AND BUILD GREATER TRANSPARENCY IN BOTH DEVELOPED AND EMERGING MARKETS IS INCREASINGLY RECOGNISED'

The extent to which a firm adopts and conforms to international codes and guidelines of good corporate governance practices, is reflected in the award of a corporate governance score ('CGS') on a scale from CGS-1 (lowest) to CGS-10 (highest). Investors and other interested parties are able to use the scores as part of the overall risk assessment process. A corporate governance score is an independent opinion, based upon transparent criteria and a standardised analytical process. It is not an audit, a rating, financial advice, nor a recommendation for a specific course of action.

LOOKING FORWARD. The growth of good corporate governance practice as a fundamental part of business in many economies is becoming more visible. The support of multi-lateral organisations such as the OECD and the World Bank is also well-documented. The international advisory community espouses the view that good corporate governance is a positive aspect of company behaviour.

However, good corporate governance is far from ubiquitous, even in the most developed markets. Investors and lenders have made it known that good governance is preferable. However, how can they assess the risks associated with poor governance practices against the search for returns? Some forward-looking companies have assessed and improved their corporate governance practices and a growing body of research indicates that this is paying off in financial performance – however, many remain unconvinced. They require more direct evidence or show concern regarding the effects of some aspects 'good' corporate governance on company performance and competitive positioning. The swift, wide and deep adoption of good corporate governance practices will benefit investors and companies alike. Treasurers can play a vital role in corporate governance. the association of corporate treasurers is known to encourage its members to play an active part in tackling risk assessment professionally. However, until investors possess and trust the appropriate tools to measure and compare the corporate governance risks and benefits, part of the argument has to be taken 'on faith'. Some companies view corporate governance as a compliance issue, or linked closely with issues that are either un-measurable or difficult to calibrate. This does not need to be so.

Benchmarking corporate governance practices on a globally comparable numeric scale is a significant development in enabling companies to maximize the benefits from adopting good corporate governance practices. It also makes a potentially significant contribution to the investor's toolkit. Helping to quantify the risks and benefits sheds some light on the way forward.

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