

Why Corporate Governance Matters to Financial Institutions

Presentation by:
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to

JP Morgan Chase

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Hong Kong

Topics

1. Why corporate governance matters
2. What is it? (Definitions)
3. A bird's eye view of reforms in Asia
4. Changing attitudes among investors
5. Governance issues in M&A

Topics

1. Why corporate governance matters

It's relevance is unambiguous!

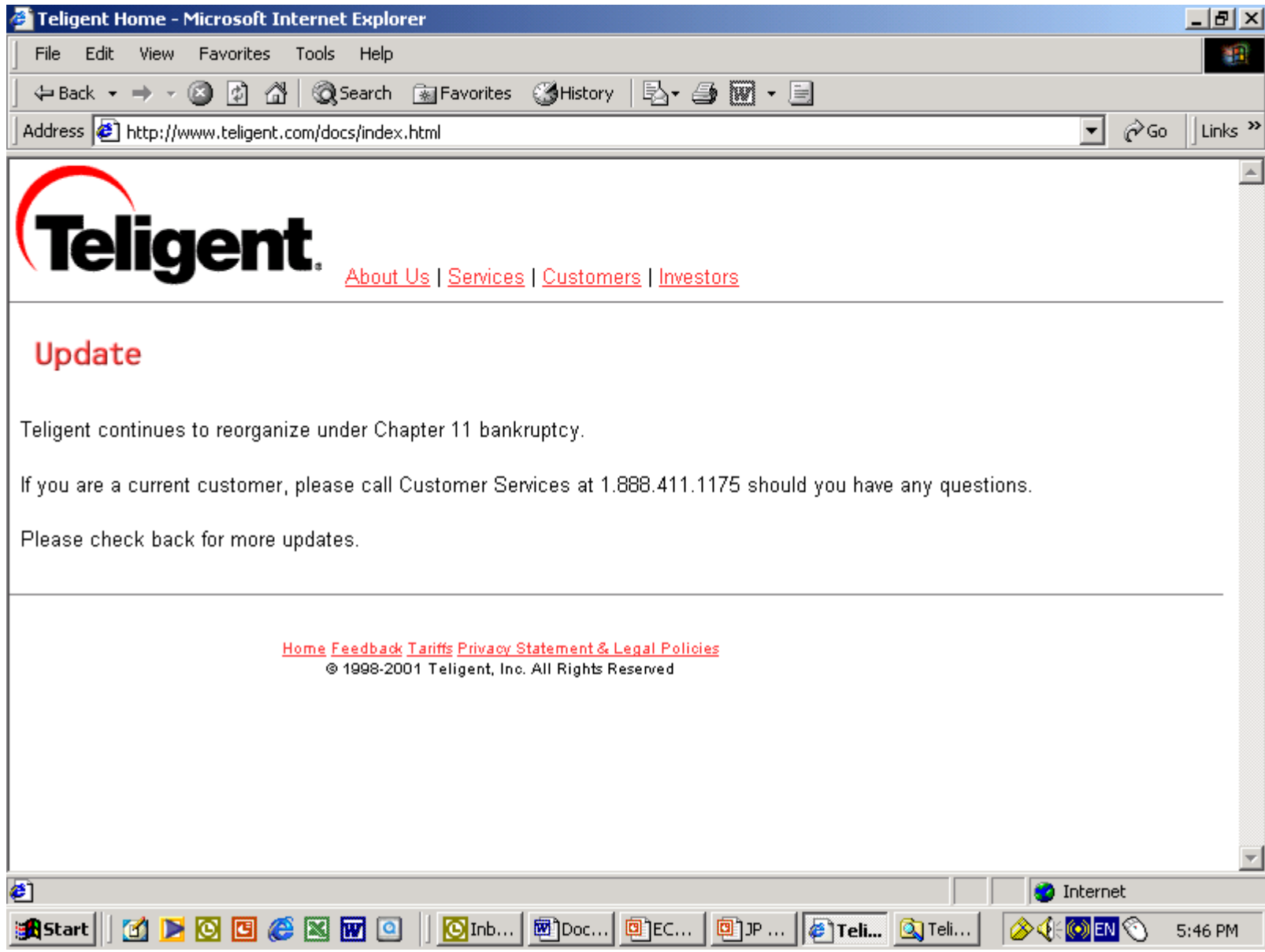
- A few recent examples that will be familiar:
Enron, Worldcom, Xerox, Andersen
- One might ask—is this only a Western problem?
No! Asia Pulp and Paper, Daewoo, Peregrine
- Who does it impact?
Employees, shareholders, suppliers (financial and trade), towns, countries....YOU!
- Media interest has skyrocketed

Forecasting risk is difficult

New economy, old ideas:

“In the last three years, growth through acquisition has been a critical part of the success of many companies operating in the new economy. In fact, I would say that M&A has been the single most important factor in building up their market capitalization.”

Alex Mandl, former Chairman & CEO, Teligent
(Comment to a meeting of the M&A Group in late 1999.)



Lessons from Alex Mandl

- “Hedge your bets”: don’t assume the capital markets will always support you.
- ✓ “Get profitable quicker”: narrow your “footprint” to the top 10-15 markets and go deeper into them, rather than going for national coverage.
- “I should have fought harder” with the board on raising new capital.
- ✓ “Go find other capital” and spend less time on mergers (for which the numbers don’t work).

(Source: Interview with *Washington Business Forward*, July 2001)

Shareholder abuse has a long history

- Inherent potential for “agency conflict” between weak and dispersed public (or “minority”) shareholders and strong company managers. Hence, “owners” cannot control managers, who should be agents of the former.

(Adam Smith, 1776; Berle & Means, 1932.)

- Inherent potential for expropriation of shareholder value by dominant shareholders (usually a family or the state) through related party transactions, and the *de facto* suppression of shareholder rights.

Integrity of capital markets

Corporate governance aims to support:

- The development of quality companies with sustainable business models.
- The building and maintenance of investor protection, hence confidence.
- The attraction of long-term patient capital (eg, pension funds) into a market.

A macro view

“The proper governance of companies will become as crucial to the world economy as the proper governing of countries.”

James Wolfensohn, President, World Bank, 1999

Topics

2. What is it? (Definitions)

Sir Adrian Cadbury

Corporate governance is:

“The system by which companies are directed and controlled.”

Sir Adrian Cadbury was a former chairman of Cadbury-Schweppes and was chairman of The Committee on the Financial Aspects of Corporate Governance, which produced the seminal “Cadbury Report” in the UK in December 1992.

Ira Millstein

“Corporate governance concerns the relationships between a corporation’s managers and shareholders, based on the foundation that the board of directors is the shareholders’ agent to ensure that the corporation is managed in the shareholders’ best interests. **The paradigm is simple: Managers accountable to boards and boards accountable to shareholders.**”

Ira Millstein is a senior partner of Weil, Gotshal & Manges LLP, a New York law firm, and an outspoken proponent of corporate governance in the US.

OECD

Corporate governance:

“... involves a set of relationships between a company’s management, its board, its shareholders **and other stakeholders**. Corporate governance also provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance...”

Preamble, OECD Principles of Corporate Governance, 1999

Global Trust Bank

“Corporate governance is about the nitty-gritty of how a company fulfils its obligations to investors and other stakeholders. It is about **commitment to values and ethical business conduct and a high degree of transparency.**”

Preamble, “Corporate Governance Code”,
Global Trust Bank Ltd, India

Commonwealth Association

“Corporate governance is essentially about leadership:

- Leadership for efficiency;
- Leadership for probity;
- Leadership with responsibility;
- Leadership which is transparent and accountable.”

“Principles for Corporate Governance in the Commonwealth”,
Commonwealth Association for Corporate Governance (CACG),
November 1999.

Teh Kok Peng

“Corporate governance is the **enhancement of corporate performance** through supervision, monitoring of management performance and ensuring the accountability of management to shareholders and stakeholders.”

Teh Kok Peng, President, GIC Special Investments, Singapore
(Comment made at ACGA’s first annual conference, Hong Kong, November 1, 2001)

Confused? Focus on principles

Corporate governance encourages:

- Transparency
- Accountability
- Fairness
- Integrity
- Sound strategy

With a view to:

- Enhancing corporate responsibility and ethical business practices.
- Enhancing and sustaining performance, and returns to all shareholders, over time.

Topics

3. A bird's eye view of reforms in Asia

Persistent problems in Asia

- Concentrated + family ownership:
 - Cross-shareholdings & over-diversification
 - Related party transactions
 - A limited takeover market
 - Insider traditions & issues of (dis)trust
 - Public co. vs private co. conflict
- State ownership (+ hasty privatisations)
- Weak regulatory systems
 - Poorly drafted laws, regulations and codes
- Underdeveloped legal & political systems

Convergence in standards

- Since the Asian crisis, there has been a marked convergence towards “global best practice” in the rules of virtually all major economies (relating to listed companies):
 - Shareholder rights
 - International accounting and auditing standards
 - Enhanced disclosure (financial + non-financial)
 - Board independence (independent directors, audit committees, etc)

The 1997-98 watershed

Pre-Asian Crisis

- Only 1 official governance code of best practice
- Independent directors mandated in 3 markets (HK, Sing, Malaysia)
- Audit committees mandated in 2 markets (Sing, Malaysia)

Post-Asian Crisis

- 9 official codes, 2 more in development
- Mandated (or in use) in 11 markets. Most markets mandate
- Mandated in 7 markets

Country snapshot

Country	National CG code?	CLSA weighted country score (%)	CLSA company average (%)	Range of CLSA company scores (%)
Singapore	Yes	74	65.4	32-81
Hong Kong	Yes (pre-crisis)	72	64.4	41-89
India	Yes	59	62.2	45-91
Taiwan	Draft	58	59.2	42-90
Korea	Yes	47	62.0	45-78
Malaysia	Yes	47	64.1	27-87
China	Yes	44	50.8	30-69
Thailand	Yes	38	60.0	35-77
Philippines	Yes	36	44.0	34-75
Indonesia	Yes	29	38.2	17-59

Source: ACGA; CLSA CG Watch, February 2002

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“Over-regulation & under-enforcement”

Country	National CG code	Comprehensiveness of CG rules	Effectiveness of enforcement
1. Singapore	Yes	8	7
2. Hong Kong	Yes (pre-Crisis)	8	6
3. India	Yes	8	5
4. Taiwan	Draft code	7	5
5. Korea	Yes	6	3
6. Malaysia	Yes	9	2.5
7. China	Yes	4.5	3
8. Thailand	Yes	7.5	2
9. Philippines	Yes	6	2
10. Indonesia	Yes	4	1

Source: CLSA: ACGA; ranking of 10

Topics

4. Changing attitudes among investors.

Now in the mainstream

“Corporate governance was a left-field issue
18 months ago. Now it is mainstream.”

Comment by a senior investment officer of a major
Hong Kong-based asset manager, July 2002.

Past priorities

Until recently, “board independence” was usually rated #4 or #5 after profitability, good management, clear accounting, etc, in most surveys of the priorities of institutional investors around the world.

Russell Reynolds, 1995 Survey of Investors

“For investors, better corporate governance is a means to protect or enhance financial performance, not an end in itself. Financial performance and prospects for growth are the two most important criteria for investors when evaluating investment opportunities. The quality of corporate governance, in itself, ranks fairly far down the list. For most investors, governance becomes an issue only when triggered by the circumstances of poor financial performance.”

Russell Reynolds Associates

“Redefining Corporate Governance”, 1995

Then in 1999

“Corporate governance is a clear factor in the investment decisions of institutional investors.

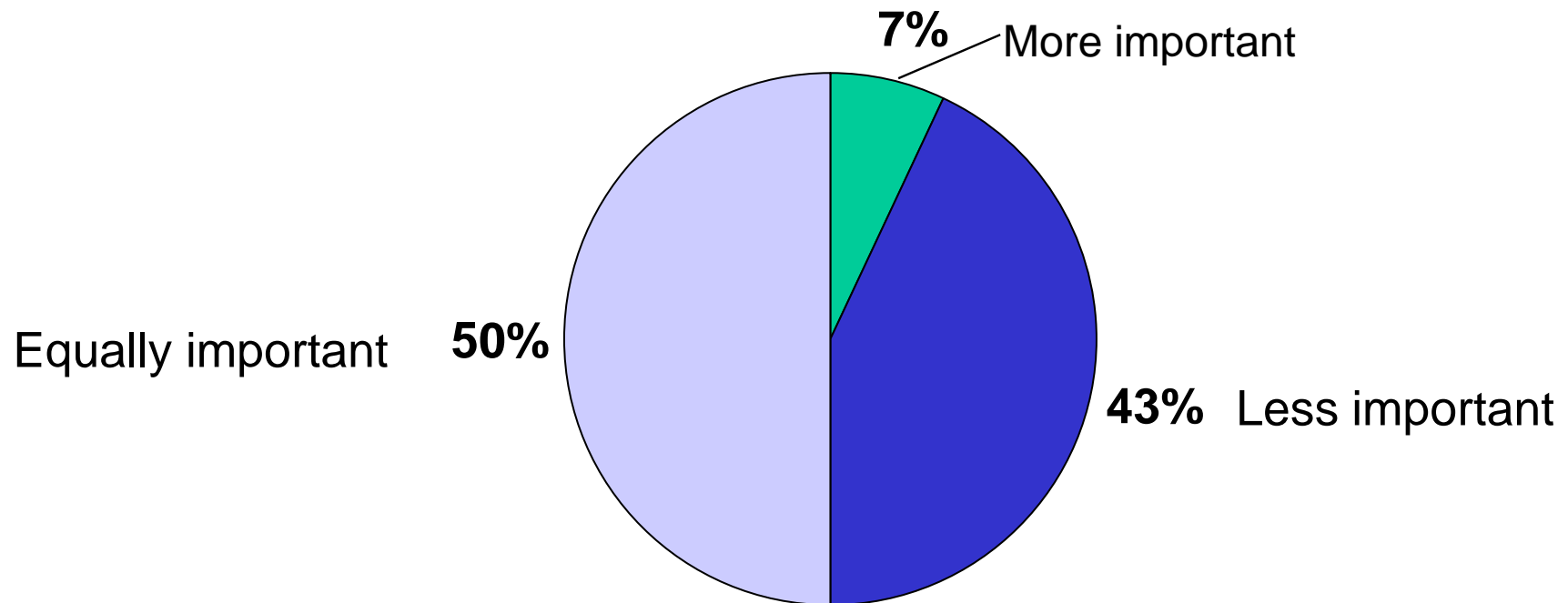
While institutional investors may look primarily at a company’s financial performance, a majority of German and US investors and a significant minority of Japanese and UK investors say that they have not invested in a company or have reduced their holdings because of a company’s failure to practice good corporate governance.”

Russell Reynolds Associates

“1999 International Survey of Institutional Investors”

McKinsey 2002

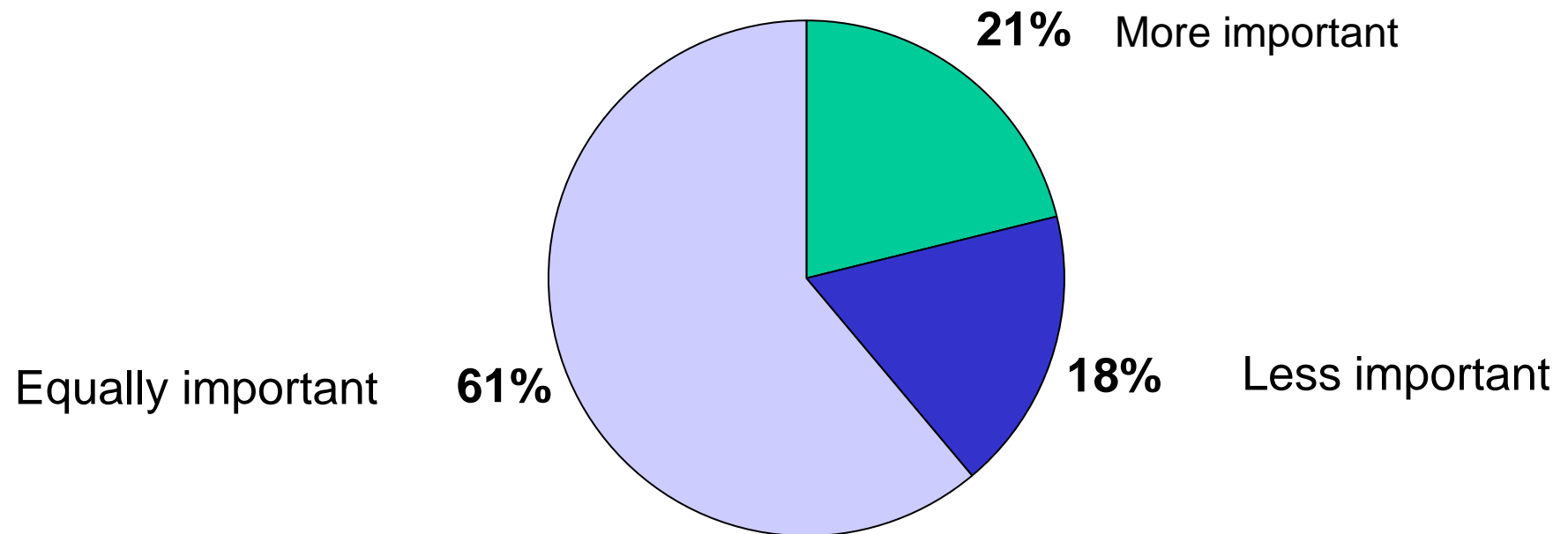
How important is corporate governance compared to financial issues when evaluating North American companies?



Source: McKinsey survey carried out in April/May 2002.

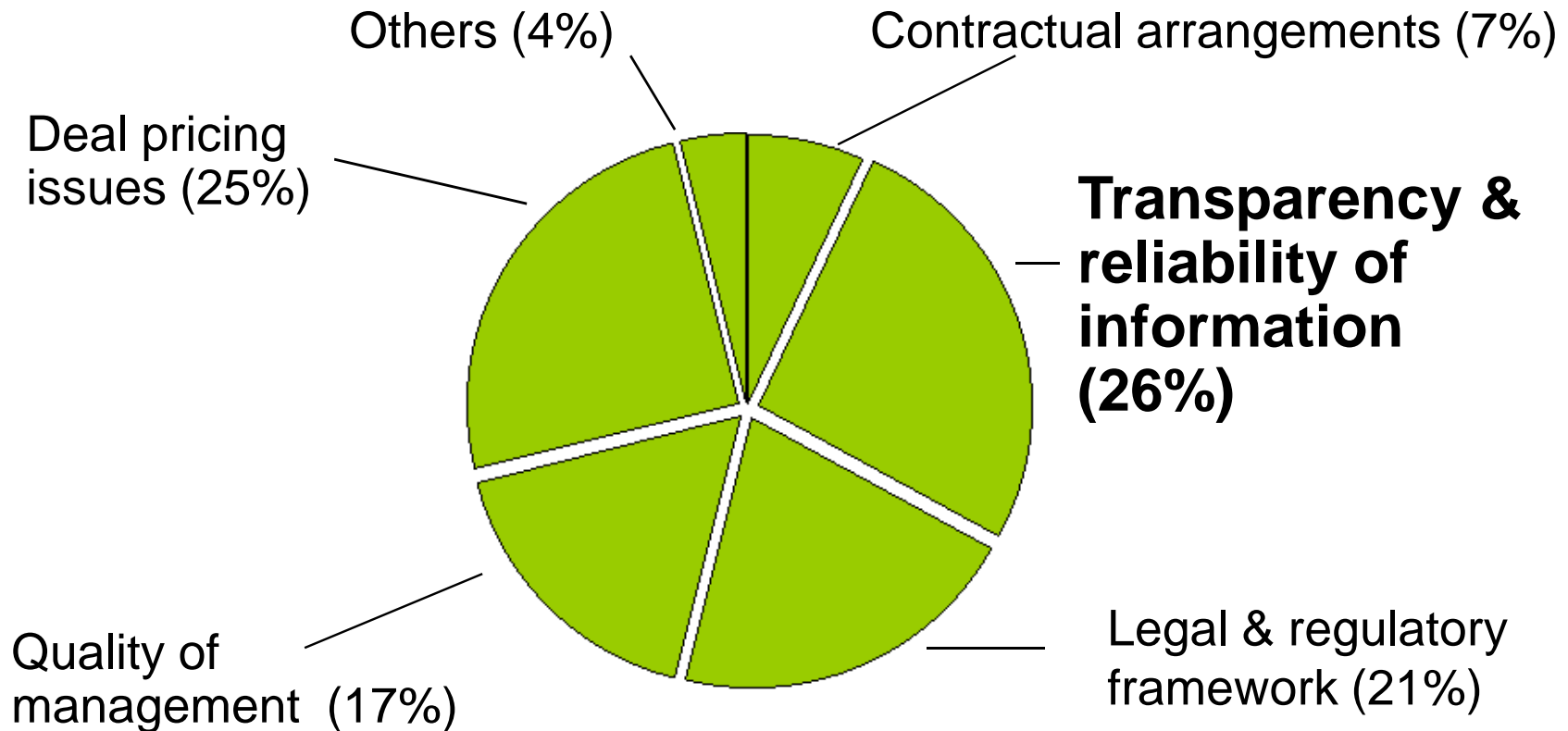
McKinsey 2002

How important is corporate governance compared to financial issues when evaluating Asian companies?



Source: McKinsey survey carried out in April/May 2002.

Concerns of strategic M&A investors in Asia



Source: PricewaterhouseCoopers, 2002

Topics

5. Governance issues in M&A

Themes

- Regulatory and political changes
- Merging different entities
- Governance of acquired companies
- Investor-protection tools

Regulatory and political changes

- Greater disclosure and accountability among Asian corporates should ultimately benefit strategic and financial investors.
- Investors may be able to use this new “culture of openness” as a lever to drive internal reforms in acquired companies.
- Corporate governance reform cannot work in isolation: it requires fundamental improvements or changes in political governance, the legal system and the professional sector (ie, accountants, lawyers) to work effectively.

Merging different entities

Will the governance cultures be compatible?

- **Transparency:** integrity of financial and non-financial data; status of accounting systems.
- **Accountability:** Board structure, degree of independence, board committees; and sophistication of risk management & internal audit.
- **Fairness:** Attitude of majority owner and/or senior management to outside shareholders.
- **Integrity:** Do both management teams have it?
- **Sound strategy:** Will the merger enhance shareholder value or destroy it?

Governance of acquired companies

Some specific questions:

- Is the board functioning effectively? Have you evaluated it?
- Does the board need outside or independent directors, an audit committee, a compensation committee, or other specialist committees/expertise?
- Is the external auditor too close to management?
- Does the company have a system of internal controls? A contingency plan?
- How does it manage risk? Benchmark this.
- Does it have a training programme for directors, staff?
- Do you really know who you are dealing with?

Investor-protection tools

A model from the private equity industry:

- “Corporate governance screens”
 1. Guidelines to follow during due diligence
 2. Monitoring/tracking investee company progress
 3. Medium for discussion and education
 4. Early warning triggers
 - *CG is an evolving, dynamic process.*

- Shareholder agreements
 - Board seats + structured board meetings
 - Reporting + escalation arrangements
 - Senior management appointments (eg, CFOs).

Conclusion

- Good governance is as fundamental to a company's long-term survival as good management.
- Governance is about much more than regulatory compliance. Ultimately, it is about competition and performance.
- Reform in Asia is moving quite rapidly, but enforcement of rules is a key challenge.
- Governance has become a mainstream issue for investors.
- Assessing governance requires both quantitative and qualitative tools.

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About ACGA

- The Asian Corporate Governance Association (ACGA) is a private, non-profit organisation incorporated under the laws of Hong Kong. It is dedicated to facilitating corporate and economic development in this region through improved corporate governance. Our principal objectives are:
 - To be a leading provider of independent information and analysis on corporate governance developments across Asia.
 - To promote constructive, practical and ongoing dialogue on corporate governance among and between key groups such as Asian companies, institutional investors, financial and professional intermediaries, and market regulators.
 - To advise and assist Asian companies on the implementation of good corporate governance practices.

Our principles

- ACGA is committed to advancing corporate governance that is disclosure-based and market-driven according to the following principles:

Transparency and accountability: These are fundamental to the long-term success of Asian businesses in an increasingly globalised world and are equally relevant to accelerating economic development in Asia.

Market participation: The positive efforts of businesses, investors, and financial and professional intermediaries are critical to the advancement of corporate governance in Asia.

Role of regulators: They should be rigorous in enforcement and allow market discipline to work.

Independence: ACGA will remain independent of any private- or public-sector interests.

Our sponsors

- ACGA was founded in 1999 by Lombard/APIC, a private equity fund management company, in cooperation with a board of senior executives and professionals from around Asia. Lombard continues to be a major sponsor. We are pleased to welcome the following companies as new corporate sponsors: Chubb Insurance, CLSA Emerging Markets, Sun Life Financial.



Activities 1999-2002

INFORMATION & ANALYSIS

- Published a report on corporate governance reform in 11 major Asian economies—“Building Stronger Boards and Companies in Asia”. We have distributed more than 4,000 copies of this report worldwide.
- Tracked governance developments in these same economies, undertook original research, and contributed articles to both specialist legal, financial and shareholder journals and the mainstream media.
- Made presentations, based largely on original research, at more than 50 conferences, seminars, workshops and business meetings around Asia, the United States, and Australia.
- Launch of the ACGA website in Q3, 2002.

Activities 1999-2002

GOVERNANCE DIALOGUES

- Organised the “Asian Business Dialogue on Corporate Governance 2001”, held in Hong Kong in November 2001. This conference, an informal dialogue focussing on practical issues, brought together speakers from key groups involved in the implementation of corporate governance in Asia—corporations, institutional investors, financial and professional intermediaries, and regulators. Early 2002, conference report publication.
- Organised a seminar for Korean companies in Seoul in May 2000—“Corporate Governance in Asia after the Crisis”.
- Worked closely with national and international organisations on education-related events and conferences, including the OECD, Harvard Business School, Hong Kong Society of Accountants, Hong Kong Institute of Company Secretaries, and the Institute of Internal Auditors of Thailand.

Activities 1999-2002

TRAINING AND ADVISORY

- Conducted a customised training course for the legal and compliance department of a major investment bank. In addition, core training modules are now being developed and are due for release in mid-2002.
- Responded to more than 300 requests for information on different aspects of corporate governance in Asia, or on global corporate governance principles and codes.
- Appointed to a new advisory committee, the SFC Shareholders Group, formed to advise the Securities and Futures Commission of Hong Kong on shareholder rights and investor protection issues.
- Participated in the judging of corporate governance awards schemes in Hong Kong and Thailand.
- Provided to companies our 'ACGA Quick Assessment' and additional advisory services to enhance corporate governance.

Our corporate members

You can join these names, as an ACGA member ...

- Coudert Brothers
- Hermes Focus Asset Management
- Hewitt Associates
- GIC Special Investments
- IMC Pan Asia Alliance
- State Street Global Advisors Asia
- Standard & Poor's
- TSMC