International Efforts to Improve Corporate Governance: Why and How

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What is corporate governance and how does it relate to corporate responsibility

I have been asked to talk about international co-operation in the area of corporate governance. And there is an awful lot that is happening today, in every region of the world. The amount of discussion and activity by governments, financial markets and their regulators as well as companies is quite phenomenal. The OECD and its Principles of Corporate Governance is at the centre of the global debate. Along with our main partner, the World Bank, and others we are building a coalition for better corporate governance in most regions. And we are by no means alone. There is the Commonwealth Association for Corporate Governance, a private sector body that is doing extremely valuable work in Africa. There is the International Corporate Governance Network, which brings together key institutional investors; that's just a few of the on-going international efforts.

However, I will take the risk of understating some of the elements of this world-wide process by taking some of the few minutes I have to address the "why", before I get to the "how".

Different people often mean different things by corporate governance. From the perspective of the OECD Principles, the concept is two-fold:

- Corporate governance encompasses the relationships and ensuing patterns of behaviour between different agents in a limited liability corporation; the way managers and shareholders but also employees, creditors, key customers and communities interact with each other to form the strategy of the company. This is, one might say, the **behavioural side of corporate governance.**

- But corporate governance also refers to the set of rules that frame these relationships and private behaviours, thus shaping corporate strategy formation. These can be the company law, securities regulation, listing requirements'. But they may also be private, self-regulation. This is what we could call **the normative side of corporate governance.**

As I mentioned, the OECD Principles address both sides. On one hand, they articulate some key normative requirements for corporate governance (such as adequate

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shareholder protection and equitable treatment under the law). On the other hand, they also urge private sector action at corporate leve. Such action includes active ownership and governance by institutions and their intermediaries, high levels of competence in boards of directors and companies taking a long-term value view by taking into consideration various stakeholder interests.

At this stage, I would like to try briefly to link the issue of corporate governance with the broader issue of corporate responsibility. To begin by stating the obvious, the reason the 29 most developed nations of this world decided to draft a set of principles on how companies should be governed lies precisely with the increasing impact of private corporate behaviour on our collective welfare.

A lot of the issues related to corporate responsibility are addressed by rules and undertakings that are external to the corporation and thus are not directly related to its corporate governance. Environmental regulations and the treatment of employees, to take two of these issues, are, in most OECD countries, prescribed by specific laws and regulations. From a corporate governance perspective, the issue is most often full, transparent and prompt compliance. More importantly, it is about going over and above the regulatory minima, in order to enhance the long-term value of the corporation. Increasingly, equity markets discount the way companies are treating their customers, employees and communities in which they operate. Active owners with a longer- term view of shareholder value are making themselves heard.

In our globalised economy a lot of the issues related to corporate responsibility stem from the emergence of the multinational enterprise. The capacity of the MNEs to allocate resources across borders, to disregard national boundaries in producing and selling their goods has had a beneficial effect on investment, in both OECD and developing economies. There is overwhelming evidence to support this positive view of these firms. However, MNEs in the absence of global regulation, have bees sometimes perceived as using their capacity of “regulatory arbitrage” between national regulatory systems to escape national requirements; or using their power to shift resources in a way which might unduly hurt some economies in which they operate in; or engage in practices that many will find wanting in terms of fairness, equity or simply morals. In other words, MNEs are at once global and local citizens and are increasingly expected to act as such by the key constituencies they depend on.

Many MNEs, often working with other partners such as unions and NGOs, have taken steps to respond to these expectations and to help promote public confidence in their activities. They have issued codes of conduct containing commitments in various areas of corporate responsibility. They have improved the management controls and practices they use to honour these commitments in their day to day operations. Businesses are also working to improve their reporting practices in the social and environmental fields.

OECD governments are taking steps to reinforce and to complement these private efforts. A major step in this direction was taken, when the revised OECD Guidelines for Multinational Enterprises were adopted by the OECD member countries and by three non-member countries in June of this year. The Guidelines are the only comprehensive, multilaterally endorsed code of conduct for MNEs. First adopted in 1976, the revisions have updated the recommendations, which now cover 10 areas of corporate responsibility including labour relations, environment, information disclosure, anti-corruption and consumer protection. Although the Guidelines are not legally binding, adhering governments are committed to promoting their observance. In so doing, they help enterprises by providing a common frame of reference for private initiatives and to establish an institutional home for international efforts to encourage progress in the field of corporate responsibility.

Why do national and international policy makers care about corporate governance?

But let us go back to corporate governance proper. Many of you might be perplexed at the level of interest the issue is generating among policy-making circles. "Surely" you might say, "this is an issue for corporations and their shareholders, not governments and international organisations". Here are five good reasons that justify high levels of attention by policy makers:

1. The institution of the limited liability company could not have come about without the explicit backing of public policy and legislative action. This is not news. Since the 17th century, governments have had to legislate limited liability. They had to ring fence corporate property from the creditors of individual shareholders and vice versa. The effect of this--mostly, 19th century-- legislation has been tremendous. Today corporations account for a staggering part of wealth creation in OECD economies. The institutionalisation of today's market economies is a clear difference between our time and that of Adam Smith. This could not have happened without public policy intervention; and it will not continue to bear its fruits if policy makers do not continuously upgrade the basic rules of company governance, to reflect rapidly changing environments. It is interesting to note that no less than 17 OECD member states are going through extensive company law reform efforts as we are speaking.

It is also important to underline the importance of institution building for less developed countries. Poverty goes hand -in -hand with the lack of proper institutions. This creates a vicious circle of mismanagement, inefficiencies, expropriation and corruption. The lack of properly functioning private institutions, i.e. corporations, impacts directly on growth by limiting the availability of debt and equity investment. It also impacts on the distribution of income within a society: with more transparency and accountability major shareholders or state –appointed directors will have less of an opportunity to fatten their Swiss bank accounts at the expense of all the other stakeholders--and the society as a whole. Finally, the spillovers from weak corporate governance into the realm of public governance are evident to anybody who has dealt with development and transition issues. Unaccountable and opaque corporations are more than likely to undermine the rule of law and the effectiveness of government, creating and sustaining a vicious circle of corruption, bribery and mismanagement in the public sector.

2. In the world outside the US, the first few decades after the Second World War were characterised by state-led growth. But during the last two decades all of this has radically changed through privatisation (chart 1). Hence, the role of the private sector corporation as an engine of economic development and job creation has been vested with a new urgency and importance in the last two decades. Privatisation revenue in the world has totalled more than USD 850 billion in the 1990s alone. This grossly understates the amount of assets actually transferred to the private sector: many of these assets were not sold but turned over to private owners through various schemes that generated little revenue for treasuries. If one accounts for this under-valuation and also adds the revenues from the 1980s privatisation, the figure will be closer to USD1.3-1.4 trillion. This enormous transfer means new ownership and control structures, possibly much more unstable and much tougher on corporate elites than state ownership arrangements. It also means new relationships with labour and a fundamental shift in future employment creation to the private sector; and new modes of financing, essentially a switch from debt to equity. Corporate governance directly affects all of these areas. No wonder governments care more about how decisions are made in the private corporate sector nowadays.

3. Privatisation has also been a key factor in the phenomenal growth of equity markets (chart 2). A growing process of dissintermediation in the financial markets, shifting savings from the banking sector to equity (and bond) markets has been the other key factor of market growth. Countries like Italy and Spain have seen the size of their market capitalisation grow from 14 and 23 % of the GDP in 1990, to 49 and 73% in 1997 respectively. As an increasing part of the population become residual claimants of the corporate sector, policy makers care more and more about how these savings are used and allocated by corporations. Corporate governance becomes an issue of systemic stability in the financial markets, providing early warning mechanisms that might be a limiting factor to herd behaviour in difficult market situations.

4. Equity market growth has also been driven by the spectacular growth of financial institutions as equity owners in private corporations (see chart 3). Insurance company and pension fund assets stood at128 % of the GDP of OECD countries in 1998; while in 1980 they represented only 38 %. Moreover, the percentage of equity investment of these institutions has almost doubled over the last decade (see chart 4). According to some recent research less than 100 large non-bank financial institutions (mostly pension funds and insurance companies) hold approximately 20% of the top 20 more liquid markets in the world. These global shareholders are fiduciaries of millions of citizens. They have a long-term view of investment because exit is often not an option for them: most of their holdings follow stock market indexes. Thus, in addition to being a crucial element of financial stability, better corporate governance becomes increasingly a factor in the welfare of ageing societies.

5. International capital flows have grown tremendously since 1980—by a factor of more than 20. Moreover, the recent crises in emerging markets have demonstrated amply a fundamental shift in the nature of these flows: these flows are now largely private (more

than 85% as opposed to approximately 20% in 1980). In addition they are more and more directed towards equity—very much confirming the trend towards equity that I have just talked about (chart 5). Empirical research suggests that during the Asian crisis countries with the lowest corporate governance standards -- in terms of protection of minority shareholders in particular-- were also those which experienced the largest exchange rate depreciation and stock market decline. This has put corporate governance in the menu of issues that the architects of international financial stability have had to deal with. And this was the trigger for the drafting of the OECD Principles, a multilateral effort by 29 governments at a record one-year time. It is the reason for them being one of the 12 core principles for financial stability, in the taxonomy of the Financial Stability Forum.

Creating an international framework through international co-operation: The OECD Principles

OECD Ministers adopted the OECD Principles in June 1999. They are the result of the work of a Task Force comprising all 29 OECD Member governments and the European Commission, private parties, the World Bank, IMF, and other international organisations. From the start, this work also benefited from a broad exposure to public commentary on successive drafts, including through the Internet. A number of important non-OECD countries participated in our consultations and provided written comments on the working drafts.

It is obvious from the above that the Principles could be described as the first multilateral effort to produce a common language of corporate governance. Even though the FSF has categorised them as "standards", the Principles are, at their present state of development. more of a conceptual framework for policy makers, companies, investors and others to address corporate governance in terms that are commonly understood around the world. They do put forward some key requirements that need to be met for an adequate corporate governance environment, irrespective of national backgrounds. But this does not imply forced harmonisation of the substantive norms--the Principles leave ample room for country differences. It does mean, though, that all differences become transparent; and it does facilitate the forces of convergence, that are currently at work, mostly driven by markets but also by the world's increasing cultural and legal proximity.

I do not want to go through the Principles in too much detail. Copies of them have been distributed to participants. But I would like to underline their main elements.

The OECD Principles cover five main areas: the rights of shareholders and their protection; the equitable treatment of all categories of shareholders; the role of employees and other stakeholders; timely disclosure and transparency of corporate structures and operations; and the responsibilities of the board towards the company and shareholders.

The protection of the rights of shareholders is a pillar of any effective corporate governance system. The ability to participate in basic decisions concerning the company, chiefly by participation in general shareholder meetings is set forth as an important right.

The Principles call for full ex ante disclosure of arrangements that redistribute control over the company in ways that deviate from proportionality to equity ownership.

But corporate governance frameworks should also ensure equitable treatment of all shareholders, including minority and foreign shareholders. Insider trading and self-dealing should be prohibited; the latter is really the scourge of most emerging markets. Personal material interests of the board and management members in matters affecting the corporation should be disclosed.

As I have already mentioned, the Principles recognise that it is in the long-term self-interest of firms to encourage active participation in the governance process by stakeholders (i.e. employees, creditors, long- term suppliers and customers among others). Legal rights of stakeholders should be effectively respected. Furthermore, factors such as business ethics and corporate awareness of environmental and societal interests of the communities in which it operates can have an impact on the reputation and long term success of the corporation.

The Principles call for a strong disclosure regime, acknowledging transparency as a key element of an effective corporate governance system. They call for timely and accurate information to be disclosed on matters such as the company's financial and operating results, its objectives, major share ownership and voting rights, remuneration of key executives, and material foreseeable risk factors. This information should be prepared and audited in accordance with high quality standards. The application of high quality standards for accounting and audit, including codes of ethics for auditors, is one of the most effective ways of preserving and enhancing the quality and credibility of capital markets. In addition to their commercial objectives, companies are encouraged to disclose policies relating to business ethics, the environment and other public policy commitments. Such information may be important to better evaluate the relationship between companies and the communities in which they operate and the steps that companies have taken to implement their objectives.

Finally, the board should be the main mechanism for effective monitoring of the management and for providing strategic guidance to the corporation. The Principles make it clear that it is the duty of the board to act fairly with respect to all groups of shareholders and with stakeholders, and to assure compliance with applicable laws. Board members should be able to exercise objective judgement on corporate affairs, independent of management.

Implementing good corporate governance through international co-operation: the OECD/World Bank partnership

The Principles would have remained a dead letter if the international community that helped produce them did not take steps for their implementation. To be sure, a lot of "bottom- up" work has been occurring among companies and sometimes investors in the form of voluntary codes. But this was clearly not enough given the pressure for change and the urgency of the task, especially from the perspective of emerging financial markets. The advocates for better governance in countries and companies need co-ordinated international support. There was also a clear need for a well-structured, sustainable policy dialogue that would use the new-found common language of the Principles to bring the different national players together around a table.

In order to address these pressing needs the OECD and the World Bank put together a far-reaching global co-operation framework. On June 16 1999, the OECD Secretary General and the President of the World Bank signed a Memorandum of Understanding to this effect The OECD Principles of Corporate Governance are the starting point and reference of this partnership. Its purpose is to broaden policy dialogue and co-operation on corporate governance reform and to respond to the need of individual countries to improve corporate governance.

The co-operation between the World Bank and the OECD is structured along two major initiatives: a **Global Corporate Governance Forum (GCGF)** and a series of **Regional Policy Dialogue** Round **Tables**.

1. The **Global Corporate Governance Forum** is donor- driven mechanism that is being set up right now in order to:

- provide a framework for international co-operation and create synergies for the design and implementation of joint or individual assistance projects
- raise global awareness for the need to promote better corporate governance, increase visibility for reform efforts and provide a vantage point for progress assessment
- co-finance a number of local and regional initiatives in the private and public sectors that aim at promoting corporate governance
- promote comparative empirical and analytical work to advance our understanding of corporate governance and its impact on economic performance

The Steering Committee of the Global Forum consisting of the World Bank, OECD and all participating bilateral and multilateral donors will develop the Programme of work of this ambitious exercise. In this, it will be benefit from yearly consultations with key recipients, whether private or public. A cardinal piece of the Forum's institutional set up is the creation of advisory groups that will provide for a continuous input of key corporate governance constituencies in the process. The first of these groups, the Private Sector Advisory Group has been set up. It is chaired by Ira Millstein, one of the most well-know corporate governance gurus. It has already managed to establish a task force between key institutional investors and Brazilian companies to promote better corporate governance. Ira and his group are going to Russia next month to start a much needed dialogue with the Russia so-called "blue chips", that have been plagued by poor governance in the past.

2. The **OECD/World Bank Regional Roundtables on Corporate Governance** are the second leg of our global partnership. They are organised by the OECD and the World

Bank Group in close co-operation with various regional partners who play an active role in their preparation and in setting the agenda.

In our ambition to advance the quality of corporate governance world- wide, we want to make the Roundtables an inclusive platform for policy-dialogue, where senior policy-makers, regulators, corporations, investors, labour organisations and others can raise concerns, exchange experiences and find solutions. We also seek to encourage contacts and build bridges between the increasing number of voluntary initiatives that are now emerging--I mentioned some of them earlier. And we want to provide expertise, also from outside the region, giving their perspectives and views on various developments and initiatives.

In short, the objectives of the Roundtables are

- To improve the understanding of present corporate governance practices in specific regions and inform the international community about national and regional reform initiatives.

- To identify key areas for improvement, both in the regulatory domain and in standard business practices and formulate an agenda for reform action.

- To facilitate full participation by the region in the ongoing international dialogue on corporate governance.

- Finally, the Roundtables should also serve as an instrument to identify the needs, and facilitate the provision, of technical assistance in the area of corporate governance.

It is important to note that the Corporate Governance Roundtables are not one-off events. Rather, they consist of a cycle of meetings taking place over a 21/2-3 year period. We believe that such a long-term presence is necessary in order to make a real difference, in order to develop and sustain a momentum for needed reforms and to cover all those issues and aspects that need to be addressed.

The structure and agenda of the different Roundtables are always adapted to the specific national and regional circumstances. But their respective work-plans also have some fundamental steps in common.

The first step is to map the landscape. In many countries there is still insufficient information about important background elements, such as ownership structures, board practices, accounting standards and practices, and so on. The Roundtables, therefore, have made quite an effort to bring such empirical material to the public. These findings can then be compared with the situation in other countries and also can be used to provide a foundation for further and more detailed analysis. Following this initial stage, the Roundtables are expected to focus on particular aspects of corporate governance that participants agree deserve special attention. For example, the Russian Roundtable quickly turned to issues related to minority shareholders while the Asian Roundtable recently held a meeting focussing on disclosure.

The conclusions from these discussions on individual aspects will eventually be reflected in what we call a "Regional White Paper on Corporate Governance", a report that will be adopted by the members of the Roundtable, which will contain an agenda for action and practical recommendations for reform, based on knowledge generated by the Roundtable discussions. It is important that these White Papers are products of the Roundtables with a real sense of regional ownership.

As of today this process has been initiated in three different regions where Corporate Governance Roundtables are up and running: Asia, Russia and Latin America. These Roundtables are all at slightly different stages of their work, but it can already be concluded that all of them have been very successful. They have all come to attract high-level participants, both from the public and the private side. And they have all, as we hoped at the outset, become a natural point of reference in their respective regions. As an example of their presence, I would like to quote from the APEC joint ministerial statement a month ago; it reads:

" *Sound corporate governance will encourage the return of capital to the region. We welcome the efforts of the OECD and the World Bank to raise the awareness of, and the commitment to, corporate governance reforms in the region through Roundtable discussions".*

Of central importance to the success of the Roundtables is the strong regional and local involvement. We have very active co-sponsors in all the regions typically the main stock exchanges, governments, the securities regulators, business organisations and investor groupings. The Asian Roundtable has the Asian Development Bank as a core co-organiser along the World Bank and the OECD.

In the coming 12 moths all three Roundtables will be reviewing the first drafts of their respective White Papers. In the case of Latin America, the first draft will be submitted in April to the Western Hemisphere Finance Ministers Forum as their key background on a corporate governance initiative they are undertaking.

A Eurasian Round table, comprising mainly of former Soviet Union countries (except Russia) is been launched in October. Looking even further ahead we are presently investigating the possibilities to establish also an African Corporate Governance Roundtable, possibly in co-operation with some regional partners, such as the Commonwealth Association for Corporate Governance.

Concluding remarks

In this brief overview I have been able to cover only the highlights of what is today a truly global undertaking. I have tried to point out how international co-operation in intensifying to achieve a number of goals:

- the formulation of certain basic rules of the game to address the lack of a global normative framework-- in spite of rapid globalisation in product and financial markets.
- the development of a continuing international dialogue to facilitate the emergence of a culture of among corporations and investors that views corporate governance as a value enhancing mechanism—not a burden imposed by outsiders.

- the marshalling of resources to help local, private and public efforts bear their fruits.

Hence, international co-operation is the way of the future. We have barely begun this undertaking and it is urgent that we proceed rapidly. Seattle, Washington and Prague indicate a growing concern among many that an unchecked globalisation might create disparities in the allocation of resources, disparities that will be hard to remedy. The world risks rejecting the enormous benefits of international investment and deeper capital markets if its main conduits and recipients, the corporations, are not perceived as efficient, transparent, accountable and fair institutions.

If you wish, you can find more information about the Roundtables and related corporate governance activities on the websites of the OECD (www.oecd.org/daf/corporate-affairs) the Global Forum (www.gcgf.org) and the World Bank (www.worldbank.org/html/fpd/privatesector/cg). From the web you will be able to retrieve background documents and summaries of the Roundtables. You will also find the dates and locations of future Roundtable meetings to which you are all very welcome.

Thank you

Annex

Chart 1

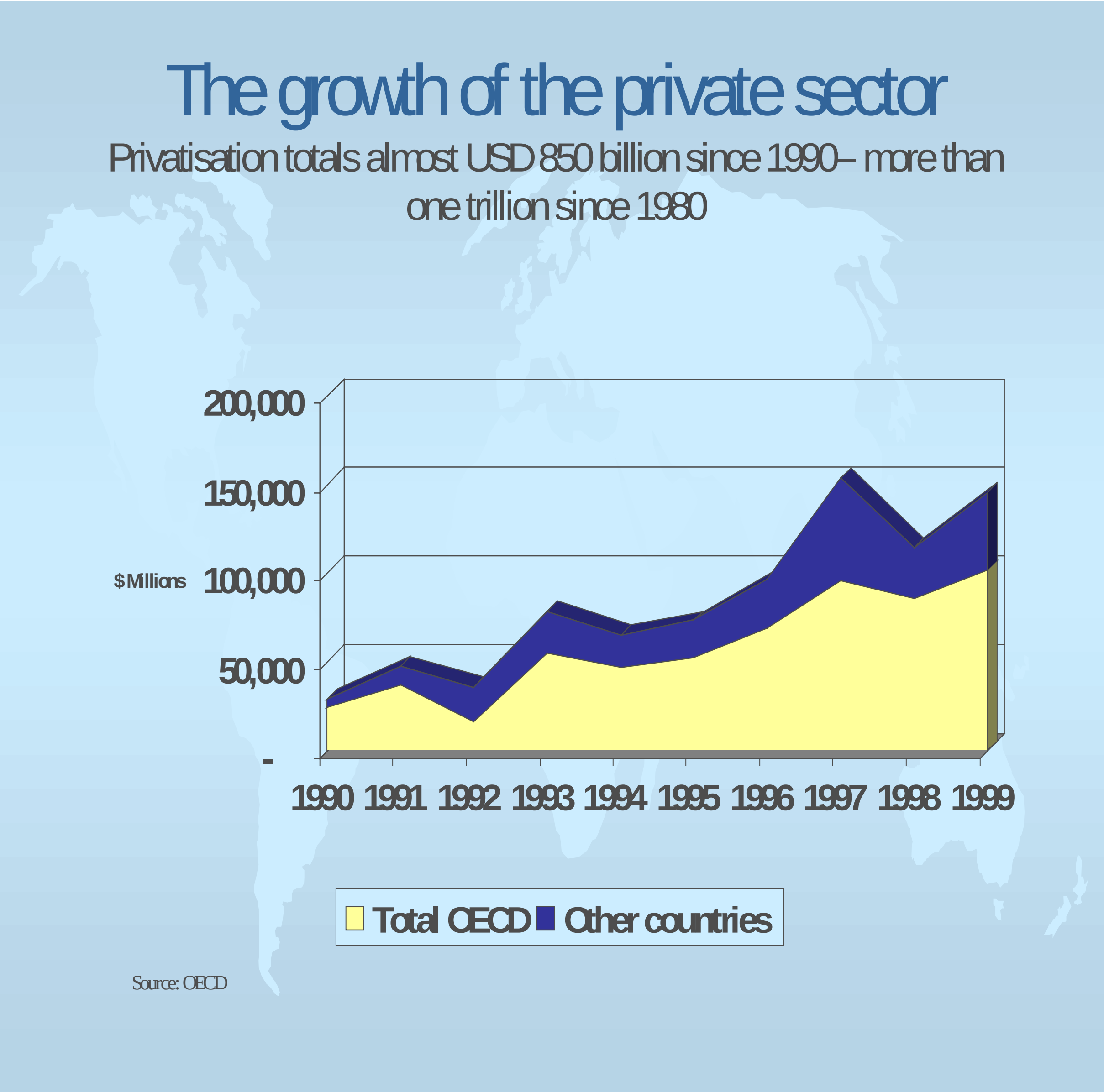


Chart 2

TABLE 2. MARKET CAPITALIZATION OF SHARES OF DOMESTIC COMPANIES IN OECD COUNTRIES

(In per cent of GDP-Main & Parallel Markets)

(Excluding Investment Funds)

	1990	1991	1992	1993	1994	1995	1996	1997	1998
Unites States	56	72	75	81	75	98	114	137	157
Europe	33	35	30	42	42	44	52	69	87
Austria	**17**	**16**	**12**	**16**	**16**	**14**	**15**	**18**	**17**
Belgium	**33**	**35**	**29**	**37**	**36**	**37**	**44**	**57**	**98**
Denmark	**29**	**33**	**20**	**30**	**32**	**32**	**39**	**55**	**57**
Finland	**17**	**12**	**11**	**28**	**39**	**35**	**50**	**61**	**124**
France	**26**	**31**	**26**	**36**	**34**	**33**	**38**	**49**	**69**
Germany	**22**	**23**	**18**	**24**	**24**	**24**	**28**	**39**	**51**
Greece	**18**	**15**	**11**	**15**	**13**	**14**	**19**	**28**	**67**
Ireland	**-**	**-**	**-**	**-**	**-**	**39**	**48**	**64**	**80**
Italy	**14**	**14**	**10**	**15**	**18**	**19**	**21**	**30**	**49**
Luxembourg	**101**	**103**	**94**	**150**	**196**	**176**	**191**	**215**	**229**
Netherlands	**42**	**47**	**42**	**58**	**67**	**72**	**95**	**129**	**160**
Norway	**23**	**19**	**14**	**24**	**30**	**30**	**36**	**43**	**32**
Poland	**-**	**0**	**0**	**3**	**3**	**4**	**6**	**9**	**14**
Portugal	**13**	**12**	**10**	**15**	**18**	**18**	**22**	**38**	**59**
Spain	**23**	**24**	**17**	**25**	**26**	**27**	**41**	**55**	**73**
Sweden	**40**	**41**	**32**	**58**	**66**	**75**	**95**	**116**	**123**
Switzerland	**69**	**75**	**78**	**114**	**109**	**130**	**135**	**225**	**260**
Turkey	**13**	**10**	**6**	**20**	**17**	**12**	**17**	**32**	**17**
United Kingdom	**87**	**97**	**89**	**122**	**112**	**122**	**142**	**156**	**175**
Asia, Pacific	89	84	59	66	74	67	63	50	65
Australia	**37**	**48**	**46**	**71**	**66**	**69**	**79**	**75**	**93**
Japan (Tokyo)	**99**	**92**	**62**	**68**	**77**	**69**	**65**	**51**	**64**
Korea	**43**	**33**	**35**	**42**	**50**	**40**	**29**	**9**	**38**
New Zealand	**20**	**34**	**37**	**56**	**53**	**53**	**56**	**46**	**46**

- : Not Applicable

Source : FIBV and OECD data base

Chart 3

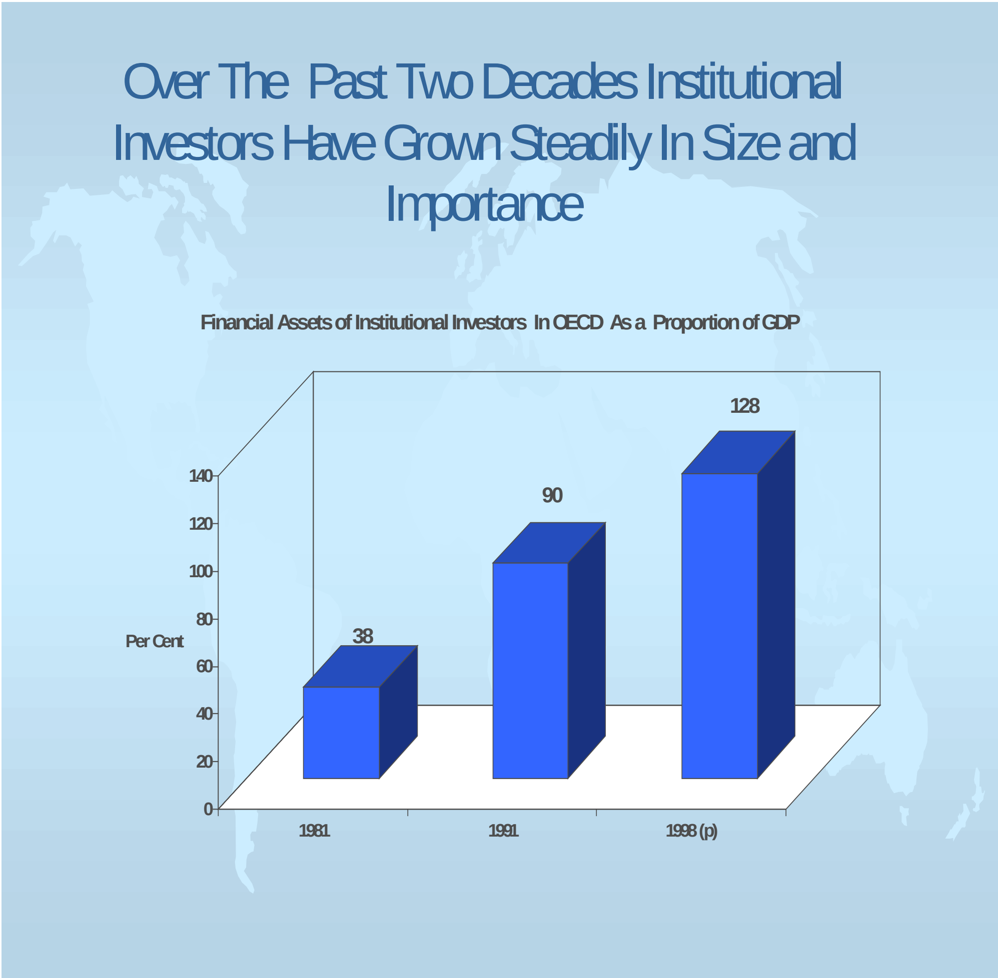
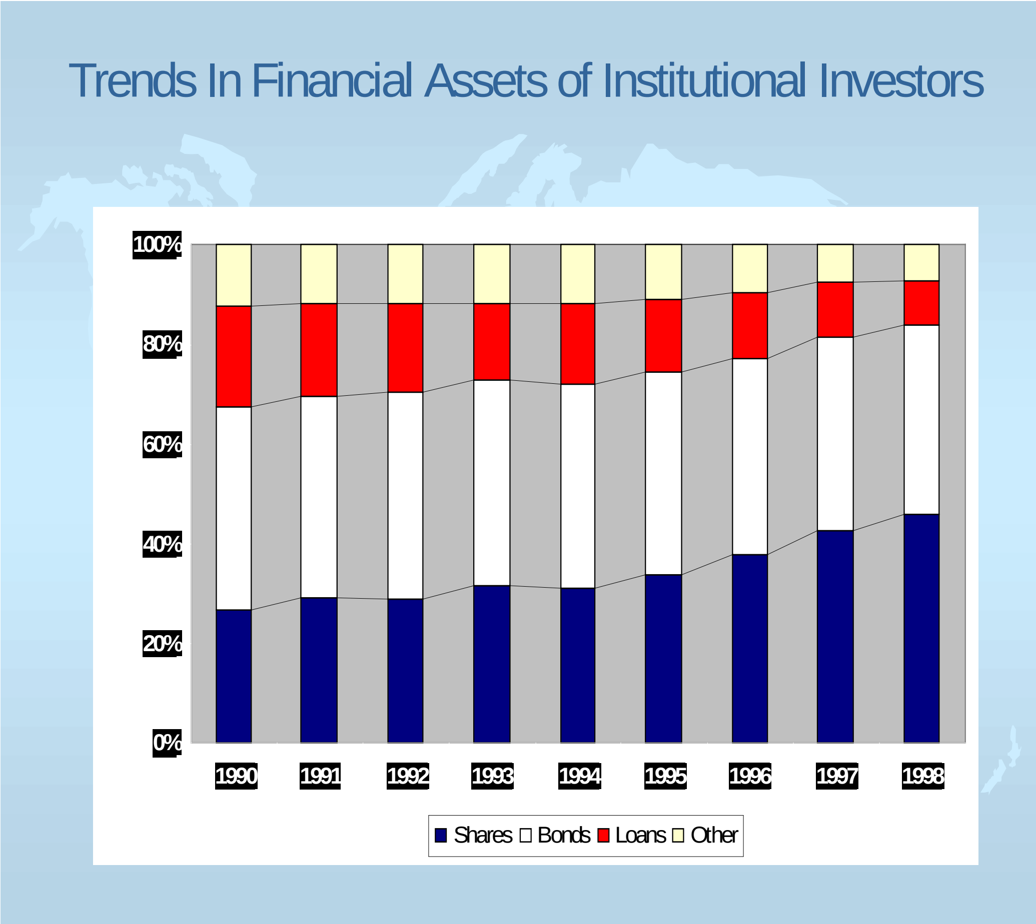
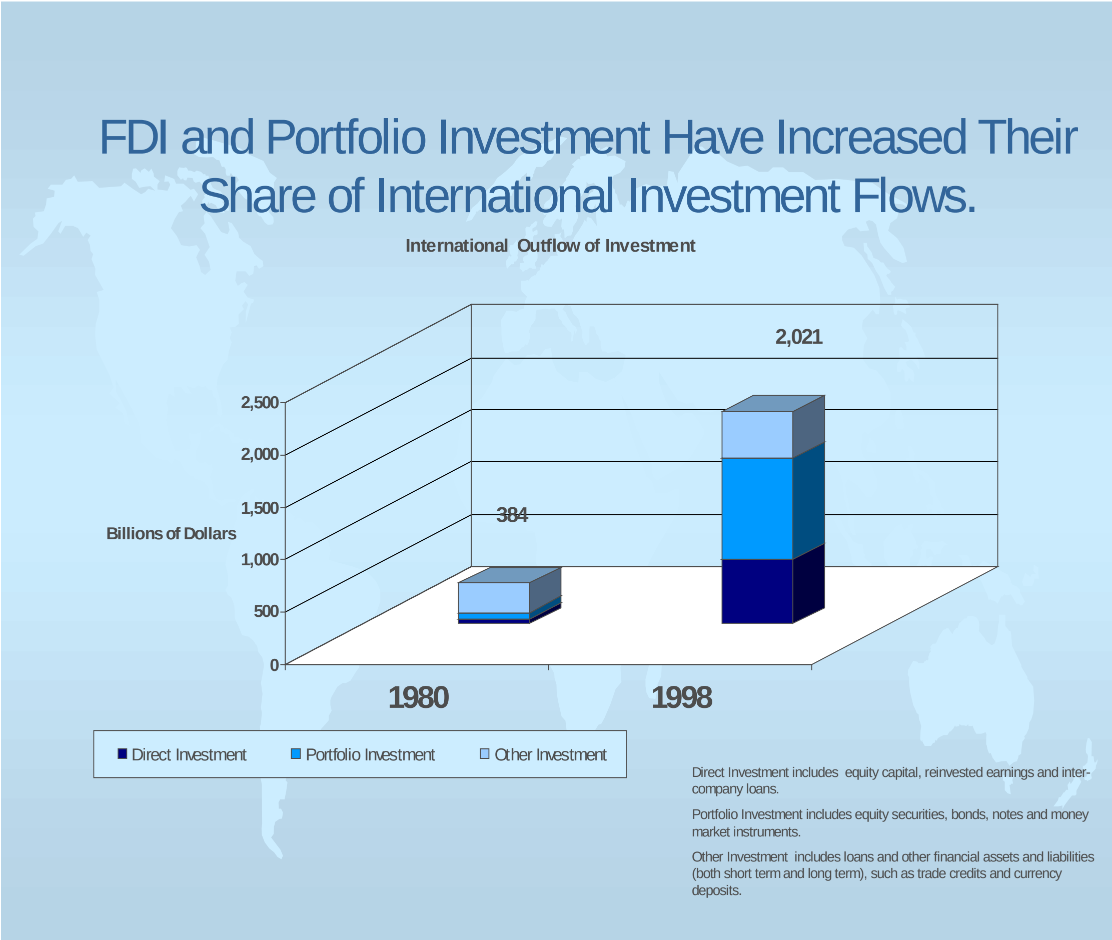

Over The Past Two Decades Institutional Investors Have Grown Steadily In Size and Importance
Financial Assets of Institutional Investors In OECD As a Proportion of GDP
Per Cent
140
120
100
80
60
40
20
0
38
90
128
1981
1991
1998 (p)

Chart 4



Trends In Financial Assets of Institutional Investors
100%
80%
60%
40%
20%
0%
1990
1991
1992
1993
1994
1995
1996
1997
1998
Shares
Bonds
Loans
Other

Chart 5


FDI and Portfolio Investment Have Increased Their Share of International Investment Flows.
International Outflow of Investment
Billions of Dollars
2,500
2,000
1,500
1,000
500
0
384
2,021
1980
1998
Direct Investment
Portfolio Investment
Other Investment
Direct Investment includes equity capital, reinvested earnings and inter-company loans.
Portfolio Investment includes equity securities, bonds, notes and money market instruments.
Other Investment includes loans and other financial assets and liabilities (both short term and long term), such as trade credits and currency deposits.