Banking on Corporate Governance

There has been much talk about corporate governance in East Asia, including Malaysia, following the 1997/98 economic crisis. This time around, the crisis was largely blamed on the corporate sector. The governments in the crisis-hit countries were generally viewed as having been prudent in their fiscal management. This indeed was the case in Malaysia where the government had been registering fiscal surpluses for several years prior to the crisis. Fiscal discipline was reinforced by a fairly sound monetary policy. All this, however, does not absolve the governments of all blame. For it can still be argued that the governments were absolutely responsible for creating a policy environment which had allowed if not encouraged the corporate sector to behave in a particular fashion that led to the financial crisis.

Although the governments in the region did show budgetary discipline and monetary prudence in the run-up to the crisis, they had overlooked the ballooning balance of payments (BOP) deficits, which were financed largely by volatile short-term capital inflows. To be sure, there had been other policy lapses as well contributing to the crisis.

Be all that as it may, the crisis did expose the weakness of the corporate sector not only in Malaysia but also elsewhere. An important lesson learned from the 1997/98 crisis was that poor corporate governance could lead to recklessness and excesses, resulting in severe financial difficulties of sorts. Hence the importance of good corporate governance.

Good corporate governance is more than a checklist of dos and don’ts. It is essentially an infrastructure of built-in checks and balances. Good governance is not confined to the top layer of the corporate hierarchy, as governance and processes are intricately inter-linked. It is not easy to define what corporate governance really means. The legal aspects of governance comprise rights, privileges, liabilities and obligations. The managerial aspects encompass the ways in which companies are directed and controlled. The ethical dimension would underscore the need to avoid conflicts of interest between ownership and management, and between corporation and the business ecosystem.

The essence of good corporate governance includes safeguarding the interests of stakeholders through transparency, accountability, trustworthiness and responsibility. It is incumbent upon the Board of Directors of companies to disclose how the principles subscribed to have been applied in practice. The board must ensure that a sound strategy is in place with adequate instruments to control hazards and to maximize opportunities, in addition to upholding integrity and high ethical values, and monitoring and measuring company performance. Setting performance targets and crafting effective mechanisms to translate targets into accomplishments are also an integral part of corporate governance. Good corporate governance also calls for good communications for the transmission of reliable, relevant and timely information to investors. Last but not least, corporate governance is also about culture, values and style.

Sticking to core competency is also an important facet of good corporate governance. Companies that had strayed away from core competency have paid a heavy price. One does not have to look very far for examples. There are quite a few at home in Malaysia where a major player in the infrastructure construction industry had veered into oil and gas, while a plantation group had deviated into banking and finance, with disastrous consequences.

Care must however be taken to ensure that the need for good corporate governance does not lead to rules that unduly restrict companies and stifle initiatives. The Malaysian governance code lays down the broad principles but stresses the importance of common sense in application while recognizing the need for some flexibility. Thus, the Malaysian code places considerable accent on the separation of company ownership from management, enforcement of existing rules, disclosure of non-financial information and related party transactions, risk management, internal controls and compliance.

It is not surprising why the mantra of corporate governance has gained such prominence in recent times. There have been many horror stories lately, with tons of skeletons falling from the closets. In 2001, there were 255 public listed companies with US$258.5 billion assets filing for creditor protection. High-profile cases include Enron (December 2001), Global Crossing (January 2002), Worldcom (July 2002) and Parmalat (January 2004). Experience has shown that the impact of corporate failures tends to be extensive affecting the management, shareholders, investing public and the employees with considerable negative externalities or knock-on effects.

Empirical evidence shows that all is not well at the top of corporate entities. A recent survey of financial institutions by the Economist has revealed that only an average of 15 per cent is confident about compliance procedures and only 25 per cent believe that there is full compliance with regulations and laws. The many corporate scandals in recent times have led to increased shareholder activism calling for substantial changes in management, increased regulatory pressure and aggressive enforcement of regulations and laws. The growing shareholder activism is not surprising, now that institutional investors account for over 60 per cent of public stocks. In the United States, pension funds exert much influence. For example, California Public Employees Retirement Systems (CALPERS) had forced boardroom changes in big companies.

To bring about better corporate governance, crisis-hit countries have resorted to stricter securities regulations, reforms in Company Law, stringent accounting practices and auditing standards, tighter Bankruptcy Law and stronger judicial enforcement. In recent years, several East Asian countries have enacted firmer regulations and laws to ensure good corporate governance. These include Hong Kong Code 1993, Japan Code 1998, Singapore Rules 1998, Malaysia Code 1999, Indonesia Code 1999, Korea SE Act and Commercial Code 2000 and Thailand SET Guidelines 2001.

In the Malaysian case, the basic approach has been to work with market forces by allowing the market to decide, which is tantamount to enforcement by disclosure. The market will punish companies with poor governance and reward companies with good governance. For investors tend to shift from stocks and markets with poor corporate governance to stocks and markets with better corporate governance. In Malaysia and other major bourses in East Asia, corporate governance has become an investment criterion. In any case, all said and done, good governance is not about compliance but about best practices for enhancing shareholder value.

There is a need to strike a balance, avoiding extremes. A “soft” approach is fraught with dangers, especially where the companies in financial trouble are rescued or bailed out by the governments, in which case there is a serious moral hazard problem. This is not to deny the need for government intervention in “too-big-to-fail” cases with large socio-economic implications. But such selective rescue packages must include strong punitive elements that would minimise moral hazards and deter similar occurrences. A “hard” approach, on the other hand, carries the risk of going overboard with rigid rules and regulations that would stifle initiatives and raise the cost of compliance to a level that would force corporate entities to de-list and opt for other modes. Strong business ethics, sound rules and regulations, best practices benchmarks, laced with adequate checks and balances, and an efficient monitoring system are the hallmarks of good corporate governance.

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