

Corporate Governance: A Framework for Implementation

Overview

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Foreword by Sir Adrian Cadbury

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The World Bank Group

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and Development/THE WORLD BANK
1818 H Street, N.W.
Washington, D.C. 20433, U.S.A.

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First printing May 2000

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It is a privilege to be asked to write a foreword to a report that deserves to be widely welcomed. With it the World Bank Group has put corporate governance firmly onto the world stage. Earlier initiatives in this field have in the main been nationally inspired, although a degree of convergence of governance standards is already under way through the influence of the OECD and of international investors. This report is the outcome of a close working partnership between the public and private sectors. It builds on what has gone before but broadens its scope. For the first time we now have a framework that encompasses the widely differing regimes, political, economic, and social, within which corporations carry on their activities around the world.

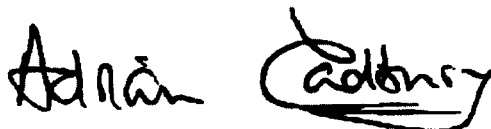
The way in which corporations order their affairs, whatever their ownership structure, varies even within a single jurisdiction. Corporations, whether they be family firms, the dominant form of economic organization, or state enterprises, work within boundaries set by law, by regulations, by those who own and fund them, and by the expectations of those they serve. The nature of these boundaries varies country by country and, crucially, changes through time. That is why, as the report makes clear, there can be no single, generally applicable corporate governance model. We can, however, all learn from each other, and the World Bank Group has set out the mechanism for just such an exchange of experience.

The report recognizes the complexity of the very concept of corporate governance and therefore focuses on the principles on which it is based. These principles—such as transparency, accountability, fairness, and responsibility—are universal in their application. The way they are put into practice has to be determined by those with responsibility for implementing them. What is needed is a combination of statutory regulation and self-regulation. The mix will vary around the world, but nowhere can statutory regulation alone promote effective governance. The stronger the partnership between the public and private sectors, the more soundly based will be their governance structures. Equally, as the report emphasizes, governance initiatives win most support when driven from the bottom up rather than from the top down.

It could be argued that international investors and capital markets are bringing about a degree of convergence in governance practices worldwide. But the standards they are setting apply primarily to the corporations in which they invest or to which they lend. These standards set the target, but it is one that is out of reach for the majority of enterprises across the world today. In the past these standards might have spread by a gradual process of economic osmosis. However, the pace of change today is such that to leave the raising of governance standards to natural forces might put areas of the world where funds could be put to best use at a competitive disadvantage in attracting them. Adoption of the report's proposals offers enterprises everywhere the chance to gain their share of the potentially available funds for investment.

Corporate governance is concerned with holding the balance between economic and social goals and between individual and communal goals. The governance framework is there to encourage the efficient use of resources and equally to require accountability for the stewardship of those resources. The aim is to align as nearly as possible the interests of individuals, corporations, and society. The incentive to corporations and to those who own and manage them to adopt internationally accepted governance standards is that these standards will help them to achieve their corporate aims and to attract investment. The incentive for their adoption by states is that these standards will strengthen the economy and discourage fraud and mismanagement.

The foundation of any structure of corporate governance is disclosure. Openness is the basis of public confidence in the corporate system, and funds will flow to the centers of economic activity that inspire trust. This report points the way to the establishment of trust and the encouragement of enterprise. It marks an important milestone in the development of corporate governance, and I cannot commend it too highly.

The image shows a handwritten signature in black ink. The signature is written in a cursive style and appears to read "Adrian Cadbury". The name "Adrian" is on the left and "Cadbury" is on the right, with a large, sweeping flourish underneath the "y" in "Cadbury".

Sir Adrian Cadbury
London,
September 20, 1999

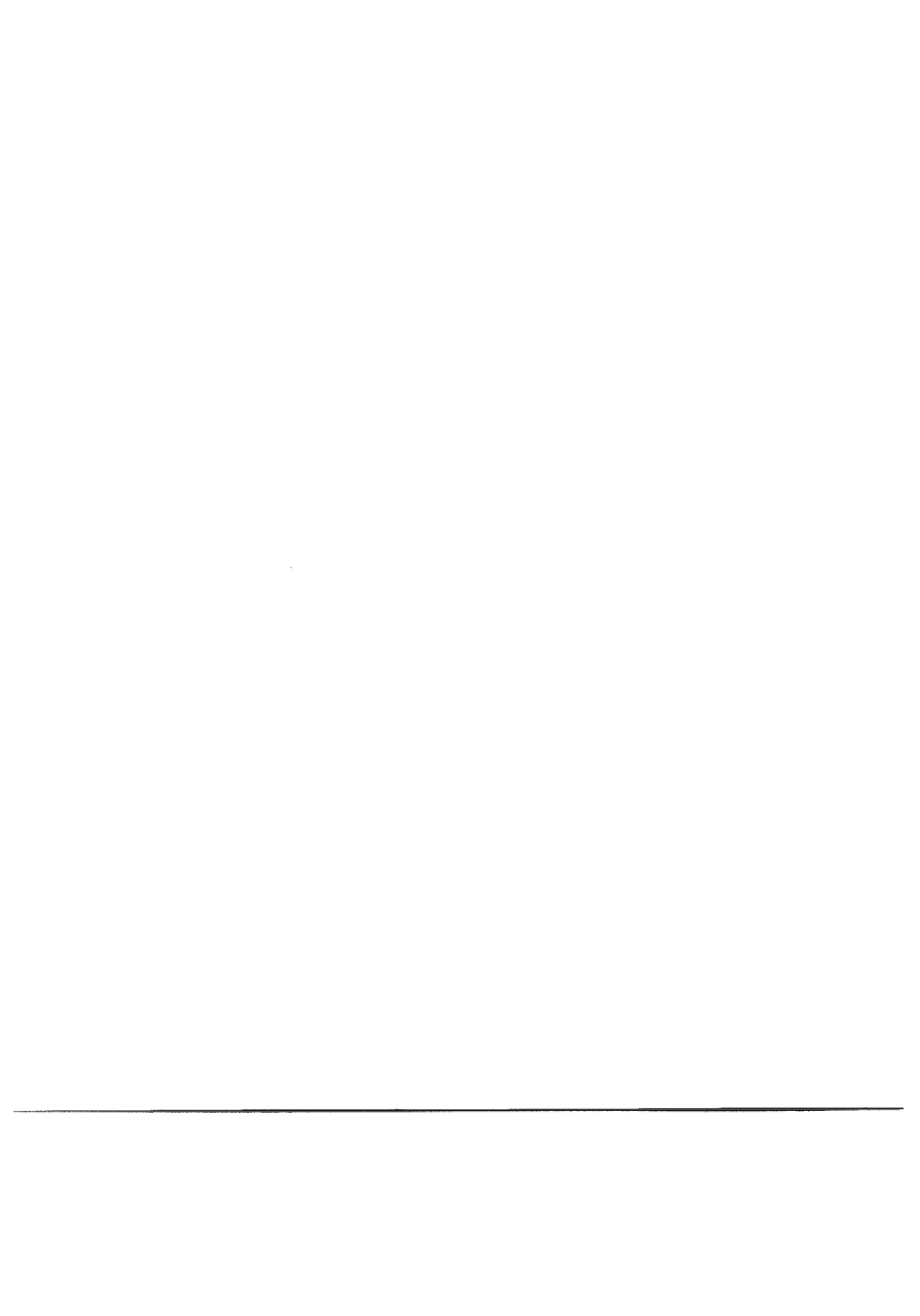
Acknowledgments

This overview is based on a longer report, *Corporate Governance: A Framework for Implementation*, to be published shortly by the World Bank. The report was prepared under the direction of Magdi R. Iskander, Director of the Private Sector Development Department. The overview was written by Magdi Iskander and Nadereh Chamlou. The main report was written by Nadereh Chamlou with inputs from Malcolm Rowat and with the assistance of Uzma Ahmad and Z. Selin Hur. The authors extend special appreciation to Anne Simpson.

Valuable contributions to the preparation of the report were received from Noritaka Akamatsu, Randolph Anderson, Robert E. Anderson, David Cook, Olivier Fremond, Omkar Goswami (India), Holly Gregory, Kris Hurlley, Michael Lubrano, Gerald Meyerman, Claudia Morgenstern, Jules Muis, Sonia Plaza, Michael Pomerleano, Sue Rutledge, Manuel Schiffler, Andrew Stone, and Douglas Webb. Helpful comments were received from Messrs. Joseph Stiglitz, Shyam Khemani, Stijn Claessens, Chad Leechor, Christopher Juan Costain, John Williamson, Simeon Djankov, and Milan Brambhatt.

Informal comments were also received from external experts: Ira Millstein, Holly Gregory (Weil, Gotshal and Manges), Sir Adrian Cadbury, Jonathan Charkham (United Kingdom), Stilpon Nestor (Organisation for Economic Co-operation and Development), Michael Gillibrand, Phil Armstrong (Commonwealth), and Herbert Morais (International Monetary Fund).

The report was edited by Meta de Coquereaumont and Bruce Ross-Larson of Communications Development Incorporated. Vannee Dalla and Nenuca Robles provided organizational and production support.



Why corporate governance matters—more than ever

Corporate governance systems have evolved over centuries, often in response to corporate failures or systemic crises. The first well-documented failure of governance was the South Sea Bubble in the 1700s, which revolutionized business laws and practices in England. Similarly, much of the securities law in the United States was put in place following the stock market crash of 1929. There has been no shortage of other crises, such as the secondary banking crisis of the 1970s in the United Kingdom and the U.S. savings and loan debacle of the 1980s. The history of corporate governance has also been punctuated by a series of well-known company failures: the Maxwell Group raid on the pension fund of the Mirror Group of newspapers, the collapse of the Bank of Credit and Commerce International and Barings Bank. Each crisis or major corporate failure—often a result of incompetence, fraud, and abuse—was met by new elements of an improved system of corporate governance.

Through this process of continuous change, developed countries have established a complex mosaic of laws, regulations, institutions, and implementation capacity in the government and the private sector. The objective is not to shackle corporations but rather to balance the spirit of enterprise with greater accountability. The systematic enforcement of law and regulations has created a culture of compliance that has shaped business culture and the management ethos of firms, spurring them to improve as a means of attracting human and financial resources on the best possible terms. This continuous process of change and adaptation has accelerated with the increasing diversity and complexity of shareholders and stakeholders. Globalization, too, is forcing many companies to tap into international financial markets and to face greater competition. This has led to restructuring and a greater role for mergers and acquisitions and to expanded markets for corporate control.

The developing world has also faced its own corporate governance challenges. For instance, in Russia, a substantive share of the profits of an oil company was siphoned off by its controlling shareholder, leaving the company in debt to its creditors, employees, and the state. In the Czech Republic, thousands of small shareholders lost their investments as “tun-

neling” schemes by insiders stripped privatized companies of their assets. The economic crises in East Asia and other regions have demonstrated how macroeconomic difficulties can be exacerbated by a systemic failure of corporate governance stemming from weak legal and regulatory systems, inconsistent accounting and auditing standards, poor banking practices, thin and unregulated capital markets, ineffective oversight by corporate boards of directors, and little regard for the rights of minority shareholders. Unfortunately, the brunt of the impact has been shouldered by the poor, setting back social and economic gains by a generation in some countries.

Increasingly for developing and transition economies, a healthy and competitive corporate sector is fundamental for sustained and shared growth—sustained in that it withstands economic shocks, shared in that it delivers benefits to all of society. Countries realize that just as overall governance is important in the public sector, so corporate governance is important in the private sector. They also realize that good governance of corporations is a source of competitive advantage and critical to economic and social progress. With globalization, firms must tap domestic and international capital markets in quantities and ways that would have been inconceivable even a decade ago. Increasingly, individual investors, funds, banks, and other financial institutions base their decisions not only on a company’s outlook, but also on its reputation and its governance. It is this growing need to access financial resources, domestic and foreign, and to harness the power of the private sector for economic and social progress that has brought corporate governance into prominence the world over.

Sound corporate governance is important not only to attract long-term “patient” foreign capital, but more *especially* to broaden and deepen local capital markets by attracting local investors—both individual and institutional. Unlike international investors who can diversify their risk, domestic investors are often captive to the system and face greater risks, particularly in an environment that is opaque and does not protect the rights of minority shareholders. As a group, however, domestic investors frequently constitute a large potential pool of stable long-term resources that are critical to development. If local capital markets are to grow, cor-

porate governance standards will need to improve to give investors the protection required to encourage them to provide capital.

Many developing and transition economies lack the supporting institutions and human resources so critical to sound corporate governance. The challenge for them is to adapt systems of corporate governance to their own corporate structures and implementation capacities, public and private, to create a culture of enforcement and compliance. They need to do so in a manner that is credible and well understood both internally and across borders—and they need to do it far more quickly than did developed countries before them. Because effective corporate governance can promote enterprise and ensure accountability, it is an essential foundation of the global financial architecture and central to the World Bank Group's mission to fight poverty.

Corporate governance has only recently emerged as a discipline in its own right, although the strands of political economy it embraces stretch back through centuries. The importance of the subject is widely recognized, but the terminology and analytical tools are still emerging. The burgeoning literature on corporate governance has largely neglected developing and transition economies. This report develops a framework for corporate governance reform based largely on the operational experience of the World Bank Group and practitioners in the field. This framework is used to identify the major elements and processes of reform required in emerging market economies and the contribution that the World Bank Group, together with its partners, can make to the objective of promoting enterprise and accountability.

Balancing diverging interests

What makes corporate governance necessary? Put simply, the interests of those who have effective control over a firm can differ from the interests of those who supply the firm with external finance. The problem, commonly referred to as a principal-agent problem, grows out of the separation of ownership and control and of corporate outsiders and insiders.

In the absence of the protections that good governance supplies, asymmetries of information and difficulties of monitoring mean that capital providers who lack control over the corporation will find it risky and costly to protect themselves from the opportunistic behavior of managers or controlling shareholders.

Without meaningful protection for external capital providers, those who control the corporation can use their position to misappropriate economic benefits, often at the expense of the long-term performance and value of the enterprise. Where poor corporate governance is the norm, the problem extends beyond underperformance in the corporate sector to greater vulnerability of the financial system, since it is difficult for local capital providers (banks and institutional investors) to avoid governance risks. Lack of meaningful protection for capital providers makes it harder for firms to get financing on favorable terms.

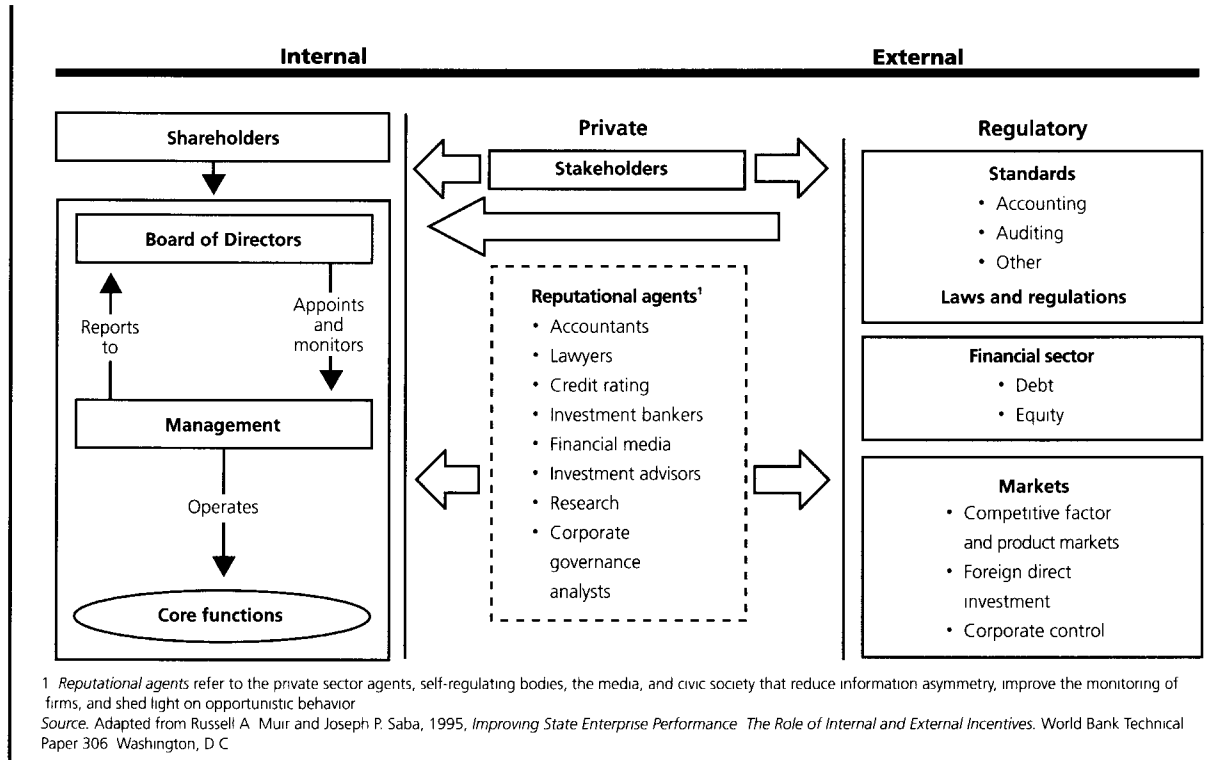
Just what constitutes corporate governance is still a topic of debate. From a *corporation's perspective*, the emerging consensus is that corporate governance is about maximizing value *subject* to meeting the corporation's financial and other legal and contractual obligations. This inclusive definition stresses the need for boards of directors to balance the interests of shareholders with those of other stakeholders—employees, customers, suppliers, investors, communities—in order to achieve long-term sustained value for the corporation.

From a *public policy perspective*, corporate governance is about nurturing enterprise while ensuring accountability in the exercise of power and patronage by firms. The role of public policy is to provide firms with the incentives and discipline to minimize the divergence between private and social returns and to protect the interests of stakeholders.

A corporate governance framework: the internal and external architecture

These two definitions—from public and private perspectives—provide a framework for corporate governance (shown in figure 1) that reflects an interplay between *internal incentives* (which define the relationship among the

Figure 1 Modern corporations are disciplined by internal and external factors



key players in the corporation) and *external forces* (notably policy, legal, regulatory, and market) that together govern the behavior and performance of the firm.

The internal architecture defines the relationships among key players in the corporation

In its narrowest sense, corporate governance can be viewed as a set of arrangements internal to the corporation that define the relationships between managers and shareholders. The shareholders may be public or private, concentrated or dispersed. These arrangements may be embedded in company law, securities law, listing requirements, and the like or negotiated among the key players in governing documents of the corporation, such as the corporate charter, by-laws, and shareholder agreements.

At the center of this system is the board of directors. Its overriding responsibility is to ensure the long-term viability of the firm and to provide oversight of management. In many countries the board is responsible for approving the company's strategy and major decisions and for hiring, monitoring, and replacing the management. In some countries the board has fiduciary responsibility for ensuring compliance with laws and regulations, including accounting and financial reporting requirements. For a going concern the board is answerable to shareholders, and in some systems to employees and creditors. Its task is to protect the interests of the company. When the company runs into financial difficulty, the duty of the board shifts to the company's creditors; the primary duty of the director is to the company rather than to shareholders.

The governance problems that need to be addressed vary according to the ownership structure in the corporate sector. At one end of the spectrum is the *publicly traded company with widely dispersed shareholdings*. There, the challenge is for outside shareholders to control the performance of managers. Since managers dominate, the key governance mechanism is the rules for selecting directors, who need to have enough independence to ensure that they will properly monitor managers' performance. At the

other end of the spectrum is the *closely held company with a controlling shareholder* and a minority of outside shareholders, where the manager acts at the dictate of the controlling shareholder. There the primary governance issue is how outside shareholders can prevent the controlling shareholder from extracting excess benefits through self-dealing or disregard of minority shareholders' economic rights. Common protections include limits on self-dealing by insiders, anti-dilution provisions, and appraisal or withdrawal rights for minority shareholders. Where a *publicly traded corporation* is dominated by a *controlling shareholder*, additional governance mechanisms may include voting rights, allowing outsiders representation on the board, and takeover rules limiting the "control premium" that insiders can appropriate.

External rules provide a level playing field and keep players in line

These internal mechanisms for corporate governance are strengthened by external laws, rules, and institutions that provide a level, competitive playing field and discipline the behavior of insiders, whether managers or shareholders. In developed market economies, these policies and institutions minimize the divergence between social and private returns and reduce costly agency problems, primarily through greater transparency, monitoring by regulatory and self-regulatory bodies, and compliance mechanisms. Notable among the institutions that discipline corporations are the legal framework for competition policy, the legal machinery for enforcing shareholders' rights, systems for accounting and auditing, a well-regulated financial system, the bankruptcy system, and the market for corporate control.

Firms are disciplined by contestible markets . . . The broader business environment creates compelling incentives for insiders to enhance the value of the enterprise. Competition and trade policies that ensure contestible markets reduce rent-seeking behavior. Together with policies that encourage foreign direct investment, competitive markets force insiders to improve corporate performance or risk bankruptcy or takeover. The discipline from competition

is likely to be felt earlier and more sharply if there is an effective *market for corporate control*. Underperforming enterprises become targets for acquisition by firms or investors who believe that they can create more value by running the enterprise themselves. Insiders have a powerful motive to improve the company's performance in order to retain control. A control market may also redress some of the imbalance of power between insiders and outsiders. If the market is orderly and transparent, a contest for control often produces greater economic benefits for outside investors and creditors (at least in the short run) than if insiders had continued to operate an underperforming enterprise without challenge.

. . . a well regulated banking system that operates at arm's length from the corporate sector. . . Competition for credit can produce better insider behavior as banks demand greater and more accurate information and better compliance with contracts. This ability to discipline insider behavior is greatly restricted, however, if the business environment has few creditor protections, weak contract enforcement, or unworkable bankruptcy laws. If the banking system and corporate sector are closely interlinked, corporate insiders may fail to share value with their creditors (and governments). If they are, in addition, insiders of the banks as well, they may appropriate bank resources for their own purposes. It has become increasingly clear in recent years that for corporate governance to be effective, the banking system also needs good governance. This is especially important in many developing countries, where banks provide most of corporate financing. This means that an effective governance system must include consideration of the role and responsibility of all capital providers.

. . . and transparent, efficient, and liquid equity and bond markets. Efficient securities markets send price signals rapidly, rewarding or penalizing insiders through changes in the value of their interests in the company or in the company's access to capital. The system of rewards and penalties is severely diluted, however, if markets are not transparent, investments are costly to exit, or, in the case of institutional investors, if the investors themselves are poorly governed.

Their performance is monitored and spurred by reputational agents and activist shareholders. Developed markets increasingly feature a dense network of *reputational agents*¹ who significantly reduce monitoring costs. They include accounting and auditing professionals, lawyers, investment bankers and analysts, credit rating agencies, consumer activists, environmentalists, and media. Keeping an eye on corporate performance and insider behavior, these reputational agents can exert pressure on companies to disclose relevant information, improve human capital, recognize the interests of outsiders, and otherwise behave as good corporate citizens. Some can also put pressure on government through their influence over public opinion.

Investors and activist shareholders have also championed governance reforms. Particularly in the United States but increasingly in other developed market economies, they have worked actively to ensure that managers and boards act in the interest of shareholders. Although these active institutional investors do not typically take a controlling ownership stake, their visibility and influence in capital markets give them a leverage that few corporations can afford to disregard. Venture capital firms too play a monitoring role in the governance of startup firms, particularly in knowledge-based industries. They have the expertise, resources, and responsibility to undertake intensive monitoring and overcome the information disadvantage that other investors may face.

There is no single model of corporate governance . . .

These internal and external features have come together in different ways to create a range of corporate governance systems that reflect specific mar-

1. *Reputational agents* refer to the private sector agents, self-regulating bodies, the media, investment and corporate governance analysts, and civic society that reduce information asymmetry, improve monitoring of the firms, and shed light on opportunistic behavior. Their actions influence both companies and governments.

ket structures, legal systems, traditions, regulations, and cultural and societal values. The systems may vary by country and sector and even for the same corporation over time. But they affect the agility, efficiency, and profitability of all corporations—private, publicly held, and state-owned. Among the most prominent systems of corporate governance in developed countries are the U.S. and U.K. models, which focus on dispersed controls, and the German and Japanese models, which reflect a more concentrated ownership structure. Recently, many countries and firms have updated their systems of corporate governance to reflect a broader and more inclusive concept of corporate responsibility that includes stakeholders, as reflected in the King Report for South Africa, the Commonwealth Association for Corporate Governance Principles, and others.

. . . but globalization is bringing harmonization

Despite the diversity of corporate governance systems, the globalization of markets is producing a degree of convergence in actual operations and governance practices. Countries and firms compete on the price and quality of their goods and services (which has led to a convergence of cost structures and firm organization that in turn has spilled over into firm behavior and decisionmaking). They compete for financial resources in global capital markets. Increasingly, they also compete on their regimes for corporate governance. These global market pressures are providing the impetus for private corporations to harmonize corporate governance practices—to reduce risk to investors and hold down the cost of capital to corporations.

Uniform standards are gaining currency. Similarly, governments, which retain priority in protecting savers, investors, suppliers, and the broader interest of the economy, are increasingly requiring that corporations operate in a fair, transparent, and accountable manner. Numerous public and private bodies have responded by establishing standards and norms related to important aspects of corporate governance. Among them are the International Accounting Standards Committee (IASC), the Bank for International Settlements (BIS, for bank-

ing supervision and prudential regulation), the International Organization of Securities Commissions (IOSCO), the World Trade Organization (WTO), and the International Labour Organization (ILO).

And agreement on basic principles for corporate governance is spreading. Through a consultative process involving OECD members and observers, the private sector, international organizations, and various stakeholders, the OECD has distilled from diverse national practices a set of principles of corporate governance. They deal mainly with internal mechanisms for directing the relationships of managers, directors, shareholders, and other stakeholders. They are also intended primarily for listed companies that function within an effective legal and regulatory environment with adequate competition.

The preamble to the Principles states that “the Principles are non-binding and do not aim at detailed prescriptions for national legislation. They can be used by policy makers, as they examine and develop their legal and regulatory frameworks for corporate governance that reflect their own economic, social, legal and cultural circumstances and by market participants as they develop their own practices.”

The OECD recognizes these broad Principles as a *starting point* for debate and consideration by governments seeking to raise standards of corporate governance. In brief, the principles cover:

- *The rights of shareholders* (and others) to receive relevant information about the company in a timely manner, to have the opportunity to participate in decisions concerning fundamental corporate changes, and to share in the profits of the corporation, among others. Markets for corporate control should be efficient and transparent, and shareholders should consider the costs and benefits of exercising their voting rights.
- *Equitable treatment of shareholders*, especially minority and foreign shareholders, with full disclosure of material information and prohibition of abusive self-dealing and insider trading; all shareholders of the same class should be treated equally. Members of the board and managers should be required to disclose any material interests in transactions.
- *The role of stakeholders in corporate governance* should be recognized as established by law, and the corporate governance framework should

encourage active cooperation between corporations and stakeholders in creating wealth, jobs, and financially sound enterprises.

- *Timely and accurate disclosure and transparency* on all matters material to company performance, ownership, and governance and relating to other issues such as employees and stakeholders; financial information should be independently audited and prepared to high standards of quality.
- *The responsibilities of the board*: the corporate governance framework should ensure the strategic guidance of the company, the effective monitoring of management by the board, and the board's accountability to the company and shareholders.

What it takes to succeed: a mix of regulatory and private voluntary actions

The OECD Principles draw on a report prepared by the Business Sector Advisory Group that emphasizes that good corporate governance can best be achieved through a combination of *regulatory* and *voluntary private actions*. On the regulatory side, the report noted that government interventions on corporate governance are most effective when consistently and expeditiously enforced and when focused on ensuring *fairness, transparency, accountability, and responsibility*. It stresses that regulatory measures, though necessary, are not sufficient to raise standards. Indeed, the strengthening of corporate governance standards has been advanced by many corporate leaders who recognize that prospering in the long term requires balancing business objectives with society's concerns.

These companies have gone far beyond the strictures of law by adopting *voluntary* measures that improve the quality of disclosure, ensure that directors discharge their fiduciary responsibilities, and increase the commitment of managers to running companies transparently to maximize value but with due regard for stakeholders' interests. The evidence increasingly suggests that such behavior enhances the reputation and value of companies. That recognition has spurred the voluntary adoption of good

governance practices by firms that now find it necessary to abide by global rules set by global markets.

The challenge of corporate governance in emerging markets is daunting

The rich and complex governance system (of policy, laws, regulations, public institutions, self-regulated professional bodies, and managerial ethos) has evolved over centuries in developed market economies. In emerging markets, however, many elements of this mosaic are absent or countries are ill-equipped to address the corporate governance challenges they face. These challenges are all the more daunting because of the complexity of the ownership structure of the corporate sector, interlocking relationships between government and the financial sector, weak legal and judicial systems, absent or underdeveloped institutions, and scarce human resource capabilities.

The range of corporate structures makes the problems more complex

The ownership pattern across developed, developing, and transition economies is extremely varied. Among successful developed economies, both dispersed and concentrated shareholdings have provided an efficient base for growth and capital accumulation as long as there has been a well functioning legal and regulatory framework, active oversight by reputational agents, and adequate institutional and professional infrastructure.

The environment is different in many emerging market economies. The widely held publicly traded firms that constitute a significant part of the corporate sector in many developed countries are rare in emerging market economies. A more common pattern in developing countries is one of dominance by public sector companies or closely held family-owned and managed conglomerates with complex shareholdings. This concentrated pattern of ownership allows insiders to have tight control of the

The challenge of corporate governance in emerging markets is daunting

firm, but it also opens up opportunities for expropriation of outside shareholders and other providers of capital.

Transition economies face a different problem. Much of their corporate sector consists of “instant corporations” created through mass privatization programs implemented without the legal and institutional structures necessary to operate in a competitive market economy. With diffuse ownership, this has sometimes allowed insiders to strip assets and leave little value for minority shareholders. In both systems, there is a need to build institutions and professional capacity.

These corporate structures complicate the problems associated with asymmetries of information, imperfect monitoring, and opportunistic behavior and make corporate governance reform more complex.

Less competitive markets and weaker institutions make the solutions more difficult

In emerging market economies, the *business environment* lacks many of the elements needed for a competitive market and a culture of enforcement and compliance. Inadequate competition policies entrench large dominant firms, prevent new entry, and discourage entrepreneurship. Change in corporate control is often subject to ambiguous laws with uncertain implementation, giving management considerable latitude to delay or derail any takeover attempt.

There are significant differences in *legal and regulatory systems* and traditions across developing and transition economies, but disclosure requirements and legal protection for shareholders are seldom up to international standards. Outdated contract and bankruptcy laws impede efficient operation and orderly exit, and judicial systems are poorly equipped to offer the speed and predictability required in today’s global market. Even where legal and regulatory frameworks have been updated, enforcement remains uneven and sometimes selective, reflecting a critical shortage of skills and sometimes a misuse of official power.

Often the state has a heavy presence in both the *real and financial sectors*. It directs credit to privileged firms on subsidized terms through a poor-

ly regulated banking system that conducts little credit analysis and seldom monitors or disciplines large borrowers effectively. In many countries private conglomerates are formed around banks, which then dominate both real and financial sectors. These alliances, and the absence of arm's length transactions within them, have led to excessive concentration of ownership, overreliance on debt financing, high leveraging, and in many cases, investments in marginal or speculative projects.

These practices have also undermined the development of *securities markets*. Typically, trading volumes and liquidity are low, and securities markets are dominated by a few large firms. There are almost no long-term debt instruments. Institutional investors are few and not yet strong enough to insist on fairness, efficiency, and transparency. Their investments in emerging markets generally represent only a small part of a diversified portfolio, and even the bigger institutional investors generally lack the confidence or incentives to assert their influence as shareholders because of opaque rules. They often "vote with their feet" instead of voting their proxies, contributing to the volatility in global capital flows that has hurt many developing and transition economies. These conditions have also impeded the development of local pension and mutual funds. This environment offers little incentive for sound corporate governance in either the real or the financial sector.

Some countries have made major strides— by focusing on the "basics" . . .

Though reform is difficult, many countries have taken some of the necessary steps and a few have taken most of them, improving their institutions and human resources. Those that have stayed the course have seen impressive gains in corporate governance and economic performance. But even in this group, reform has been a long, uneven, and sometimes fragile process of ups and downs, successes and reversals. And some institutions are just beginning to emerge, such as reputational agents and active shareholders.

The challenge of corporate governance in emerging markets is daunting

Reforms have proved most effective when they have focused on fundamentals and have combined a complementary mixture of laws consistently enforced and incentives for firms to take voluntary actions. They have emphasized a comprehensive strengthening of *external sources* of discipline and *internal incentives* to improve corporate governance, especially by making corporate boards more effective and competent to exercise their duties of oversight and control over management. They have typically involved these elements:

- *Establishing competitive markets* by removing barriers to entry, enacting competition laws, establishing fair trade priorities, and removing restrictions on foreign direct investments, particularly in low-income transition economies, where foreign investors can take on the role of strategic investors.
- *Requiring transparency*, notably through the timely disclosure of material information about the financial and nonfinancial operations of the corporation.
- *Enforcing financial discipline* by severing the links between government, banks, and corporations; restricting directed and connected lending; restructuring banks and allowing private ownership of banks by reputable local and foreign strategic partners (to bring much-needed financial, managerial, and technical capabilities to restructure the corporate sector); strengthening prudential regulation and supervision; and improving enforcement of contracts to suppliers and creditors. These measures should lead to less reliance on banking systems for corporate financing and provide greater incentives for raising capital on equity and corporate debt markets.
- *Fostering growth of well-regulated and liquid securities markets* by developing the infrastructure required for efficient capital markets, protecting minority shareholders, allowing open-ended mutual funds, enlarging the volume of equity through privatizations of state enterprises in financial and real sectors (particularly infrastructure firms), reforming the social security system, and allowing private firms to manage properly regulated pension funds.
- *Updating and strengthening the legal, judicial, and tax systems* to ensure clarity and effective enforcement.

- *Building capacity* in major areas (accountants, regulators, bankers, company directors) by upgrading existing capabilities and preparing the next generation of professionals.

On the *internal* side, the focus of the reform is to make corporate boards more effective and competent to exercise their duties of oversight and control over management.

For these measures to work effectively, countries need to develop the necessary institutions and build human capacity. This takes years. While institutional and capacity building are essential tasks, countries no longer have the luxury of waiting until these measures come to fruition. In the short term, countries have “borrowed” or drawn on the discipline imposed by global markets, such as global investors, regulations, and reputational agents.

Many countries have allowed privatized infrastructure firms and utilities (often accounting for 50–75 percent of market capitalization) to issue American Depository Receipts and Global Depository Receipts or to list on large foreign stock exchanges, where financial disclosure requirements are generally higher than on local exchanges. This has raised the capacity of firms in an important segment of the local market to meet higher disclosure and reporting standards. Although some corporations still offer lower standards of reporting to domestic investors, they are gradually raising the benchmark for locally listed companies. Listing on external exchanges has also subjected firms to the scrutiny of foreign institutional investors, investment banks, credit rating agencies, and other reputational agents that follow the performance of listed firms. Drawing on foreign sources of discipline may initially raise local resistance, but it can help the economy integrate with world markets, prepare firms for global competition, and serve the interests of both domestic and foreign investors. These benefits can more than compensate for any short-term loss of liquidity in local markets.

. . . but they face resistance from powerful interest groups

Reform of corporate governance systems is politically difficult. Vested interests within firms generally oppose greater transparency and disclosure of

The challenge of corporate governance in emerging markets is daunting

both financial and nonfinancial information, arguing that the requirements are costly to comply with and put them at a disadvantage relative to local or foreign competitors. These immediate drawbacks, they claim, outweigh the potential longer-term benefits of higher share values and lower financing costs that can come with greater transparency. Worried about diluting their privileged position in the company's decisionmaking, insiders often oppose such substantive corporate governance requirements as one-share one-vote, cumulative voting, public tender offers, and independent directors. Giving greater power to minority shareholders is often opposed on the grounds that it could lead to foreign control of local firms, ignoring the benefits that could bring. Large firms tend to have considerable political influence and access to the public media, opening the door for bribery and corruption. In developing countries and transition economies, regulators or supervisors rarely have the political, human, and financial resources to prevail against the determined opposition of these vested interests.

Tough disclosure requirements and substantive changes in corporate governance are sometimes also opposed by members of exchanges (brokers, dealers, banks), who fear a loss of revenue if the measures discourage firms from listing. The threatened loss of privileged access to information can also provoke resistance to reform, particularly in smaller economies where ownership and control of industrial companies may overlap.

With such opposition, it is not surprising that corporate governance reforms (in developed countries as well as developing and transition economies) have often been driven by major economic crisis or serious corporate failure. The recent financial crisis in East Asia prompted countries to take major steps to strengthen governance—closing insolvent banks, strengthening prudential regulation, opening the banking sector to foreign investors, revamping bankruptcy and takeover rules, tightening listing rules, requiring companies to appoint external directors, introducing international accounting and auditing standards, requiring conglomerates to prepare consolidated accounts, and enacting fair trade laws.

The solution: ownership with due diligence

The challenge for developing countries is to take the next steps toward sound corporate governance before another crisis erupts. The important initial steps already taken will not become fully effective until the supporting institutions and implementation capacity evolve and adjust to new monitoring and regulatory needs. The culture of state intervention and policy influence by large conglomerates will have to adapt to a global environment that puts a large premium on a culture of compliance and enforcement.

Effecting this change of culture will require a combination of regulatory reform and voluntary private action in a sustained process of consensus and capacity building involving all the players. Each country will have to find its own formula by assessing its strengths and weaknesses, setting priorities and sequencing reforms, creating strong institutions, and developing the necessary human capital. *The winning formula has to be adapted to the corporate structure and the implementation capacity in the private and public sector.* It has to provide both the *incentives and the discipline* for the private sector to adopt and consistently practice sound principles of corporate governance. It also needs to encourage a broadening and deepening of local ownership that will enable firms to compete more effectively in world markets—often by adhering to best practices and rules set by global markets.

For countries where companies obtain financing mainly through the banking system, reforms center on restructuring and privatizing banks and strengthening prudential and regulatory systems. For countries with a large number of listed companies, the most effective tools have been tightening listing requirements, improving protection of minority shareholders, attracting reputational agents, and encouraging companies with large financing requirements to list overseas. In all countries, these steps have to be complemented by measures that minimize rent seeking, promote transparency and disclosure, and strengthen the enforcement capacity of the legal system. Given the limited institutional and human resources base, these policy and regulatory changes have to minimize the role of government in the day-to-day operation of business and focus on a core agenda of reducing eco-

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conomic regulation, strengthening prudential rules, and enforcing them consistently and relentlessly.

Corporate governance is not merely about enacting legislation. It is about establishing a climate of trust and confidence through oversight. Ethical business behavior and fairness cannot simply be legislated into being. Strengthening corporate governance is fundamentally a political process in which the government and the private sector have to join hands. There will never be sustained and meaningful public sector reform of governance laws and regulations until the private sector understands that support of reform creates a level playing field, which is in its best interest. And ultimately, for governance to be fully implemented, the private sector needs to build on the base of law and regulation with voluntary actions of its own.

World Bank Group strategy for helping countries develop and implement a comprehensive reform program

The Bank has long been active in supporting client countries in undertaking difficult structural changes requiring reforms of legal and regulatory structures, the financial sector, and enterprises, including privatization of state-owned enterprises. These programs have addressed many issues that are central to corporate governance: creating competitive markets, establishing regulatory and supervisory capability in banking and capital markets, introducing greater transparency, adopting international accounting and auditing standards, and strengthening the competence and independence of boards of directors. Because a scarcity of qualified professionals often poses the most daunting challenge to effective reform, the Bank has also financed technical assistance operations in support of institutional development and capacity building in many areas affecting corporate governance, including auditing and accounting standards, legal and judicial systems, financial sectors, and capital markets.

The IFC too has promoted better corporate governance by requiring that the firms in which it invests practice sound corporate governance and by insisting on proper internal controls and reporting. It has been instrumental in developing equity and corporate bond markets, including listing and securities

regulations. It has provided hands-on technical assistance to transition economies to establish sound systems of corporate governance. Similarly, MIGA has ensured that its guarantee operations have a high standard of corporate governance.

Marshalling support for corporate governance reform

The Bank Group is scaling up its work on structural reform in developing countries, and corporate governance is a key element in that agenda. The Bank Group's and others' objective is to work with partners (multilateral agencies, international organizations, the private sector) to broaden the debate on corporate governance beyond OECD countries to include developing and transition economies. While the Bank Group will respond to the growing need of client countries to adapt international best practices to their own circumstances and to implement legal and regulatory reforms, it will not be in the business of setting standards or creating codes. Rather, it intends to marshal support nationally, regionally, and globally for countries' own initiatives. This work will be supported by a more concerted emphasis on governance by the Bank Group in its ongoing policy, lending, technical assistance, and private sector activities.

At the national level, the Bank and its partners have supported a series of country self-assessments that identify strengths and weaknesses in corporate governance and help countries establish priorities. Complementing these assessments are investor surveys that identify market perceptions about the same issues. Together, the two assessments paint a clearer picture of corporate governance practices in individual countries, identify priority areas and pressure points, and set the stage for a comprehensive reform agenda. The twin objectives are to strengthen regulatory reform and enforcement while fostering private voluntary actions. This is consistent with the approach of the Bank's Comprehensive Development Framework, which emphasizes good corporate governance as a key factor in development effectiveness. The Comprehensive Development Framework further stresses the importance of the private sector, both local and foreign, as a major player in the development process. It calls for a participatory process that involves all the major stakeholders in the design and implementation of a comprehensive reform strategy.

At the *regional level*, the Bank has cosponsored with other multinational agencies (particularly, OECD, APEC, ADB, EBRD), that have also been active in this area and others a series of roundtables for Commonwealth, government officials, legislators, regulators, local and foreign firms, investors, and rating agencies to help craft a consensus for reform.

On the *global level*, the Bank Group has worked closely with the OECD to broaden the dialogue on corporate governance beyond OECD countries. The OECD Principles would be a starting point—but not a reference point. The Bank Group has also worked closely with the BIS on banking systems, with the International Organization of Securities Commissions (IOSCO) on harmonizing listing requirements, and with the International Accounting Standards Committee (IASC) and the International Forum for Accounting Development (IFAD) on transparency issues. It has supported the World Trade Organization (WTO) and the International Labour Organization (ILO) on competition policy and labor issues. In the private sector, it has engaged the major accounting and auditing firms to ensure that their affiliates, which carry their name and reputation, adhere to the same international standards and guidelines.

Catalyzing reform through the Global Corporate Governance Forum

A good part of the knowledge and expertise needed to support corporate governance and related reforms already exists in the public and private sectors. A wide range of organizations has begun focusing on corporate governance. Although many of these efforts are still small and dispersed, together they account for substantial and diversified international reform efforts. If the corporate governance agenda is to be scaled up properly, a major effort is needed to distill this expertise and marshal it in a coordinated and timely way to support countries' efforts on both regulatory and voluntary fronts.

In a major step in this direction, the World Bank Group and the OECD signed a Memorandum of Understanding on June 21, 1999, to sponsor the Global Corporate Governance Forum (see page 25). The forum will bring

together other multilateral development banks, bilateral and international organizations, the IMF, the Commonwealth, APEC, IASC, IOSCO, and the private sector. It will provide a rapid-response mechanism for coordinating and channeling practical technical assistance to specific constituents, on a national, regional, and global basis, to help design and implement reforms. Above all, the forum will mobilize local and international public and private sector expertise and resources to champion and advance corporate governance on a fast track, emphasizing dialogue and consensus building.

The forum will build on what has already been achieved to help countries develop their own programs and institutions. To this end, the forum's activities will include:

- Broadening the dialogue to include perspectives from developing and transition economies.
- Supporting countries in carrying out self-assessments and investor surveys on the status and practice of corporate governance.
- Building consensus for policy, regulatory, and institutional reforms at global, regional, and local levels.
- Framing corporate governance strategies to take full advantage of the potential for private sector involvement.
- Developing the capacity of governments to design and implement reforms and the capacity of self-regulatory bodies to develop and execute their own regulations.
- Strengthening reputational agents.
- Sharing knowledge and best practices.
- Developing human capacity and building institutions to sustain and expand corporate governance practices.
- Addressing corporate governance issues that go beyond a specific country.

In implementing this ambitious agenda, the forum will be advised and supported by a high-level Private Sector Advisory Group. Leaders and captains of industry with established track records in corporate governance will lend their names and reputations to efforts to bring key stakeholders to the table to build a coalition for reform. The forum will also provide a channel for extensive consultation with important stakeholders (labor, organizations active in corporate governance, environmental agencies, NGOs, and

others) and build on initial efforts already begun through roundtables and consultative groups.

Time is short. Crises highlight challenges and offer opportunities for governments and the private sector to change behavior and the rules of the game. But while reforms are most often initiated in the wake of crisis, they should not be viewed in the context of a short-term anti-crisis package. Change will take a concerted effort in building consensus and sharing experience, expertise, and resources among all players. Above all, the private sector must see that implementing reform is in its own best interest. Likewise, reform of the public sector is central to an effective partnership. Because reforms are likely to yield results only over the medium to long run, sustainability and comprehensiveness in design and staying power during implementation are critical.

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The complete report on which this overview is based, *Corporate Governance: A Framework for Implementation*, will be published shortly by the World Bank. Additional reference materials on corporate governance are available through our help desk and the corporate governance Web site:
www.worldbank.org/html/fpd/privatesector/cg.

Memorandum of Understanding

1.0 Overview: A framework for co-operation

1.1 The improvement of corporate governance practices is widely seen as one important element in strengthening the foundation for individual countries' long-term economic performance and in contributing to a strengthened international financial system. Therefore, corporate governance has emerged as an important focus of efforts by multilateral organisations to assist countries in improving financial architecture. Efforts in the area of corporate governance could benefit greatly from closer and more structured co-operation. The International Bank for Reconstruction and Development ("the World Bank") and the OECD have agreed to broaden the global policy dialogue and co-operation on corporate governance reform and to respond to the need of individual countries to improve corporate governance.

1.2 Implementing strong corporate governance is fundamentally a process, in which the government and the private sector join hands. The central concept in this broad international co-operation is the promotion of dialogue and exchange of experience between the main public and private players on a global scale. Ultimately, change in corporate governance practices must be implemented at a local, country level. The establishment of a platform for international dialogue, structured around an agenda with broad public and private sector support and expertise, will lend important support to regional and country efforts to effect such change. This is because:

- 1.3 ● It raises awareness of the need to build consensus for the support of local, regional and global initiatives, in order to bring about a coalition for reform.
- 1.4 ● It is an efficient way to marshal international expertise in a concerted, co-ordinated and timely way and to identify, disseminate, discuss

and promote global and regional best practices, building on international experience.

1.5 ● It can be an effective tool for the identification of country and regional technical assistance needs.

1.6 The OECD Principles of Corporate Governance provide an important starting point. As it is stated in their Preamble:

The Principles are non-binding and do not aim at detailed prescriptions for national legislation. Their purpose is to serve as a reference point. They can be used by policy makers, as they examine and develop their legal and regulatory frameworks for corporate governance that reflect their own economic, social, legal and cultural circumstances, and by market participants as they develop their own practices.

1.7 However, the dialogue process should move beyond basic common principles of governance to help countries identify specific issues and problems and develop their own programmes and institutions to strengthen corporate governance. Regional and national codes of best practice have been developed over the last few years while important changes will continue to take place in this field. These will provide important input for discussion and dialogue that will contribute to the future reassessment of the OECD Principles.

1.8 The co-operative effort between the World Bank and the OECD will draw upon the respective complementary strengths and membership of the two organisations. It is also essential to build on the work of various international organisations in the effort to promote better corporate governance.

2.0 Structure

The proposed co-operation will be structured along two major initiatives: (a) the Global Corporate Governance Forum, and (b) World Bank/OECD policy dialogue and development.

(a) *Global Corporate Governance Forum*

2.1 *The Global Corporate Governance Forum* will be set up to provide a framework for international cooperation and create synergies for the design and implementation of joint or individual projects by participating countries and institutions.

2.2 The Global Corporate Governance Forum will:

- build a consensus in favor of appropriate policy, regulatory and institutional reforms
- coordinate and disseminate corporate governance activities
- provide support for regulatory and private voluntary action
- promote institutional development and human capacity building in the associated fields of corporate governance
- train the various professions and the other agents who are essential to bring about a culture of compliance.

2.3 The World Bank and the OECD will sponsor the Global Corporate Governance Forum, which will consist of regional development banks and other international organisations and groupings such as APEC, IASC, IOSCO, IMF, Commonwealth Association, private sector participants and institutions as well as donor and developing/transition countries. The Global Corporate Governance Forum will ordinarily meet once a year. It will approve the objectives, policies, and monitoring of the Forum's Secretariat. It will also review the annual work programme and the financial plan, as proposed by the Secretariat, with the support of the Private Sector Advisory Group.

2.4 The Global Corporate Governance Forum will consult with representatives of non-governmental organisations and stakeholder groups with a specific interest in corporate governance.

2.5 A senior *Private Sector Advisory Group* (PSAG) will be established. The improvement of corporate governance practices within countries will require partnership between public and private sectors. The PSAG will engage the pri-

vate sector in playing a major role in the improvement of corporate governance practices within countries. Effective, continuing and easily accessible private sector support and input are essential elements in the process of policy dialogue and country-specific implementation envisaged by the two organisations.

2.6 The PSAG will consist of a small, flexible, representative group of private sector international leaders. The very senior level of the PSAG membership will enable the group to mobilise support among private sector players worldwide and carry weight with senior officials from the government/regulatory side. The group will be representative, drawing on individuals from different regions of the world and on all types of private sector players, from the corporate, institutional, individual investor and self-regulating bodies. It will be well integrated into the Global Corporate Governance Forum. It will report and advise the Global Corporate Governance Forum on the programme.

2.7 The mandate of the PSAG will be to:

- work with the Secretariat (see below) to promote good corporate governance in accordance with approved work program of the Global Corporate Governance Forum (as per paragraph 1.6 and 1.7).

2.8 ● advise on and assist in the development of regional and country-specific corporate governance programmes and of the activities of the Policy Dialogue and Development Round Tables (see below), by providing senior private sector participation and input.

2.9 ● advise on, and participate in country-specific technical assistance and educational efforts to improve corporate governance practices in the private sector, in close co-operation with members of the Global Corporate Governance Forum and its member organisations and institutions.

2.10 The World Bank Private Sector Development Department will house the *Secretariat for the Corporate Governance Forum*. The Secretariat will be responsible for managing the programme and will be accountable to the Global Corporate Governance Forum. It will present to the Forum for its approval the annual work programme to be prepared in consultation with

PSAG and other interested parties. The Work programme will consist of country-specific regional and international initiatives. A member of the Secretariat will be located at the OECD. Continuing close contact will be maintained between the responsible staffs of the two organisations.

(b) Policy Dialogue and Development

2.11 *Policy Dialogue and Development Round Tables* will be set up by the World Bank and the OECD on a regional (and, where appropriate, country specific) basis. The round tables will provide the framework for continuing policy dialogue and a multilateral process of exchange of experience. This process will bring together OECD member country experts and national decision-makers from the private sector and governments in different regions (or countries) of the world. The World Bank/OECD Seoul meeting and the recently established Corporate Governance Round Table for Russia are examples of such activities. The OECD will house the Secretariat for the Round Tables, with a permanent contact point at the World Bank.

2.12 A series of *joint activities for the research and dissemination of corporate governance information*, including publications, will be undertaken.

3.0 Procedure

3.1 Following agreement on the Memorandum of Understanding, a programme of co-operation for the next three years will be drafted, resources identified and tasks assigned to the World Bank and the OECD.

3.2 The World Bank and the OECD will agree on the initial composition of the Global Corporate Governance Forum and the Private Sector Advisory Group by August 1999.


3.3 The Global Corporate Governance Forum and the PSAG will be launched at a high level meeting in the context of the World Bank's Annual Meetings in late September 1999.

3.4 The implementation of the proposed co-operation is subject to the internal procedures of the World Bank and the OECD.

3.5 Both parties will use their best efforts to secure adequate funding for the implementation of the co-operation program.


Paris, 21 June 1999

For the World Bank



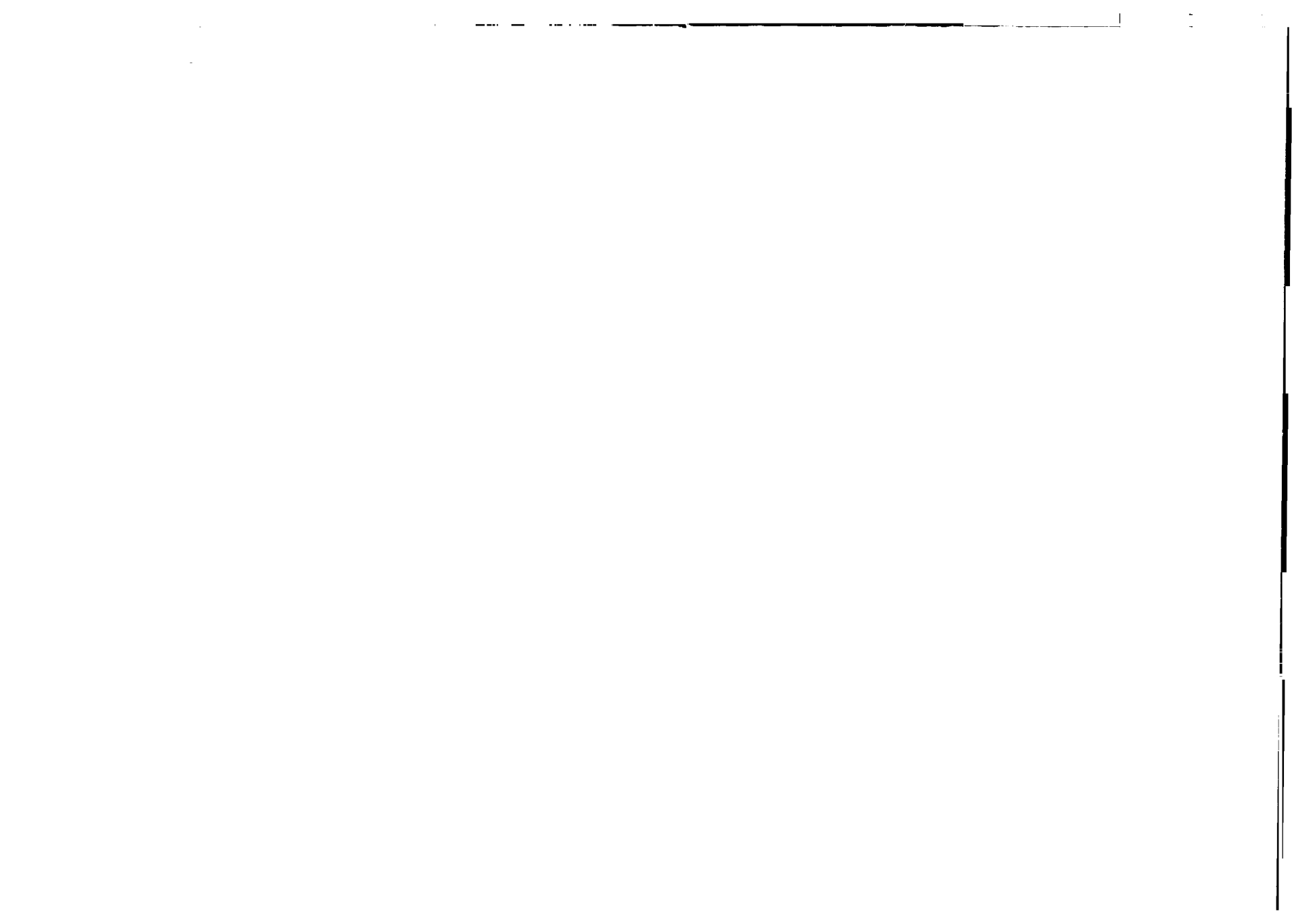
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To find out more

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