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TRACKING CORPORATE GOVERNANCE IN ASIA

Corporate governance practices have improved in Asia since the Asian Financial Crisis although disparity exists across the region. Besides promoting economic growth and financial stability, corporate governance will become even more important over the next decade as investors place greater emphasis on environmental, social and governance issues.

History is littered with numerous examples of corporate collapses arising from poor corporate governance practices. Although the corporate governance movement began in the 1970s in the United States, it only attracted a great deal of attention and interest in the aftermath of the corporate and banking scandals in the 1990s and early 2000s. Poor governance impedes economic growth and increases financial market volatility; both the 1998 Asian Financial Crisis ("AFC") and the 2008 Global Financial Crisis ("GFC") underscore this fact and the consequences of weak governance.

Research shows that during the AFC, countries with the lowest corporate governance were also those which experienced the largest currency depreciation and stock market decline. Following this, policymakers in the region undertook a series of structural reforms to strengthen their economies to deal with future external shocks. Apart from financial and corporate restructuring, many adopted new laws to address corporate bankruptcy and governance. This led to stronger balance sheets in both the public and private sectors which allowed the Asian corporates to fare better during the GFC.

20 YEARS ON FROM AFC

A joint biennial corporate governance watch survey conducted by the Asian Corporate Governance Association and CLSA shows the overall breadth and depth of corporate governance practices have improved across Asia since the AFC. Yet the disparity in ranking across the region is significant; Philippines and Indonesia have to do much more to bridge the gap. The survey also indicates that countries such as Singapore and Hong Kong come out tops due to robust legal, regulatory and economic institutions (see fig.1).

Out of all the assessed categories, corporate culture ranked the lowest across the region while accounting and auditing scored the highest due to the acceptance of international accounting and auditing standards by governments and independent audit regulation (see fig.2).

Fig.1: CG watch market scores: 2010 to 2016

(%)	2010	2012	2014	2016	Change 2014 vs 2016 (ppt)	Direction of CG reform
Australia	-	-	-	78	-	-
1. Singapore	67	69	64	67	(+3)	Mostly sunny, but storms ahead?
2. Hong Kong	65	66	65	65	-	Action, reaction: the cycle of Hong Kong life
3. Japan	57	55	60	63	(+3)	Cultural change occurring, but rules still weak
4. Taiwan	55	53	56	60	(+4)	The form is in, now need the substance
5. Thailand	55	58	58	58	-	Could be on the verge of something great, if...
6. Malaysia	52	55	58	56	(-2)	Regulation improving, public governance failing
7. India	49	51	54	55	(+1)	Forward movement impeded by vested interests
8. Korea	45	49	49	52	(+3)	Forward movement impeded by vested interests
9. China	49	45	45	43	(-2)	Falling further behind, but enforcement better
10. Philippines	37	41	40	38	(-2)	New policy initiatives, but regulatory ennui
11. Indonesia	40	37	39	36	(-3)	Losing momentum after progress of recent years

Fig.2: Market category scores (CG watch 2016)

(%)	Total	CG rules and practices	Enforcement	Political and regulatory	Accounting and auditing	CG culture
Australia	**78**	80	68	78	90	74
1. Singapore	**67**	63	63	67	87	55
2. Hong Kong	**65**	63	69	69	70	53
3. Japan	**63**	51	63	69	75	58
4. Taiwan	**60**	54	54	64	77	50
5. Thailand	**58**	64	51	45	77	50
6. Malaysia	**56**	54	54	48	82	42
7. India	**55**	59	51	56	58	49
8. Korea	**52**	48	50	53	70	41
9. China	**43**	38	40	36	67	34
10. Philippines	**38**	35	19	41	65	33
11. Indonesia	**36**	35	21	33	58	32

Business culture is different in Asia compared to the Western nations. Many companies do not engage in open communication with shareholders to avoid unwanted attention. This holds true for the listed companies that are majority family-owned; related party transactions, cross-shareholdings and minority shareholder rights are some of the key areas that will come under scrutiny.

INTERESTING OBSERVATIONS

A standard approach to corporate governance is difficult due to varying regulatory, cultural and economic differences between countries. Nonetheless most countries tend to adopt these six OECD Principles of Corporate Governance in their national corporate governance frameworks:

1. **Ensuring the basis of an effective corporate governance framework**
2. **Rights of shareholders**
3. **Equitable treatment of shareholders**
4. **Role of stakeholders**
5. **Disclosure and transparency**
6. **Responsibilities of the board**

The implementation mechanism, however, varies across jurisdictions. The framework, for example, can be on a 'binding', 'voluntary' or 'comply or explain' basis. Under the 'comply or explain' approach, companies have to comply with the general principles of the corporate governance codes under the stock market listing rules but non-compliance is allowed based on the premise of full disclosure.

Fig.3 shows that more countries prefer the principles-based 'comply or explain' approach as it is less rigid and allows companies to go beyond the minimum requirements. On the flipside it can be ambiguous and too broad to be an effective guide. The rules-based 'binding' approach, on the other hand, provides clarity and standardisation but may not be suitable for all companies.

On the issue of rights of shareholders, the OECD surveyed the minimum shareholding requirement for a shareholder to request an extraordinary general meeting ("EGM"); more than half require a minimum 5% shareholding while within Asia the majority stipulated 10% (see fig.4).

Fig.3: Corporate governance implementation mechanism

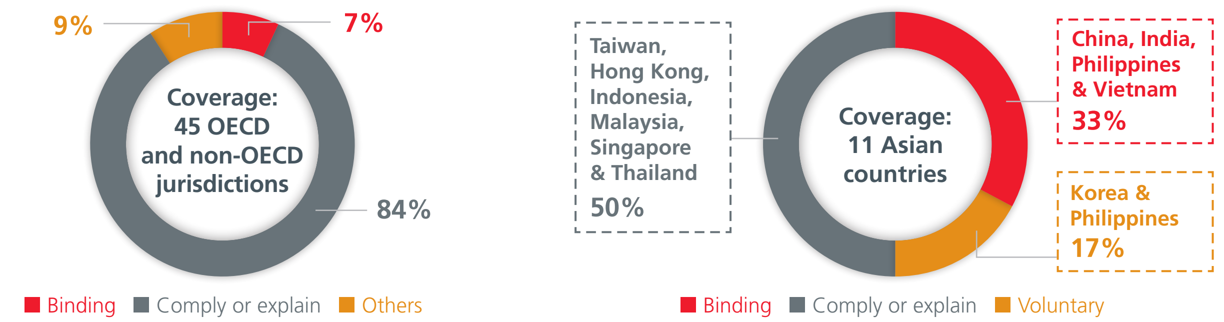
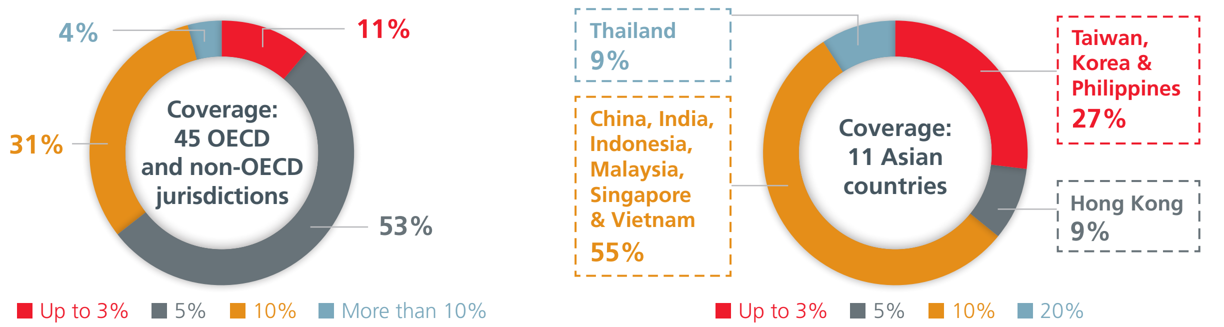


Fig.4: Minimum shareholding requirement to request an EGM



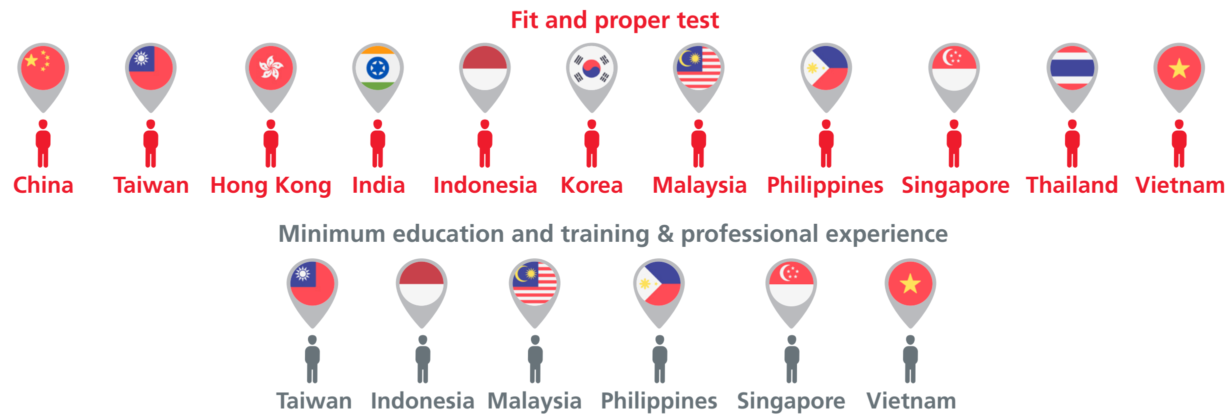
The equitable treatment of all shareholders is just as important and one way to assess this is to look at related party transaction and the approval process associated with it; 59% of jurisdictions require board approval for certain types of related party transactions. A similar percentage requires shareholder approval as an alternative or complementary feature (see fig.5).

Another area that warrants close examination is the board of directors; structure, size, independence and maximum term of office are some of the categories that come under scrutiny. Countries typically have a one-tier board system but more are now choosing to institute a two-tier system that delineates the supervisory and management functions. The size of the board varies with caps on minimum rather than the maximum number of directors. On the independence feature, the survey shows that most prefer to have at least 50% of independent directors. But within Asia, more countries have kept this ratio at 33%.

Still on this topic, the qualifications of the directors matter and these are implemented by law or code. Most jurisdictions require the entire board of directors to be qualified. Within Asia, 100% of the countries in the survey require a Fit and Proper clearance while half additionally require minimum education and training as well as professional experience (see fig.6). Interestingly, gender representation data from a Credit Suisse Research

Fig.5: Within Asia, more countries require both board and stakeholder approval for related party transactions

Fig.6: Directors' qualification requirements in Asia



in 2016 showed that Korea lagged the region while Thailand topped in terms of women in senior positions (see fig.7).

WHY IT MATTERS?

According to an Ernst & Young survey[1], 39% of the investors will rule out an investment immediately if there is a history of poor corporate governance. This number will likely increase as the millennial generation becomes the key driving force for the global economy. Millennials are known to strongly value corporate social responsibility ("CSR") initiatives.

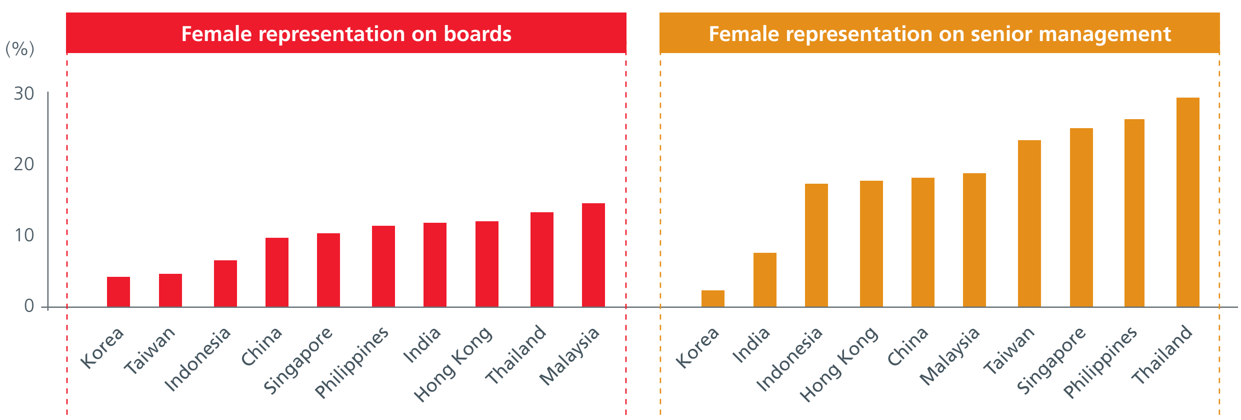
According to the European Commission, CSR is a concept whereby companies integrate social and environmental concerns in their business operations and in their interactions with their stakeholders on a voluntary basis. An increasing number of companies are including CSR initiatives as part of their overall corporate governance practices. This in turn allows them to infuse ethical norms and accountability measures into their business practices.

Corporate governance expectations have also increased since the GFC with a number of jurisdictions opting to embrace investor stewardship codes, first implemented by the United Kingdom in 2010. The code which is directed at institutional investors came into being, prompted by questions on whether a more active shareholder involvement in investee companies would have helped prevent or lessen the crisis. Most stewardship codes are voluntary and according to the Ernst and Young report dated 2017 it is still too early to gauge if they have had an impact on improving corporate governance. Nevertheless the adoption of these codes should encourage investor engagement, improve disclosure and transparency and contribute to the long-term success of companies.

Going forward, the world will see the growth and impact of millennials as a socio-economic group become meaningful. Individuals born after 1980 will constitute the largest age demographic in the world at more than 2 billion, versus 1.4 billion Gen Xers and 1.2 billion Baby Boomers. By 2020, they will account for around 50% of the global workforce – 75% by 2025 – and they will inherit the largest intergenerational transfer of wealth we have ever seen with more than USD30 trillion of global wealth to be handed down (see Millennials and Artificial Intelligence).

Given this generation's attention to environmental, social and corporate governance ("ESG"), and community engagement in general, investment strategies that integrate ESG principles and/or thematics resonating to millennials should be a major part of the future product offerings (see Mainstreaming ESG investing in Asia).

Fig.7: Women in senior positions in Asia



Sources: [1]Ernst & Young Global Limited – Investors see long-term financial benefits in companies with high ESG ratings, as at 2017. Fig.1 - 2. Asian Corporate Governance Association. Fig.3 - 6. Eastspring Singapore and OECD Survey of Corporate Governance Framework in Asia, as at 2017, and OECD Corporate Governance Factbook, as at 2017. Please note that the data for a number of countries come with individual conditions and requirements. Please note that the summary charts shown may not necessarily have taken into consideration all specific requirements in certain countries. For full details, please refer to [http://www.oecd.org/daf/ca/corporate-governance-factbook.html and https://www.oecd.org/daf/ca/OECD-Survey-Corporate-Governance-Frameworks-Asia.pdf]. Fig.7. Credit Suisse Research, as at 2016.

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