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CORPORATE GOVERNANCE:
A FRAMEWORK FOR IMPLEMENTATION
Overview Chapter

Attached for the September 27, 1999 meeting of the Development Committee is the Overview Chapter of a report prepared by World Bank staff entitled Corporate Governance: A Framework For Implementation. This document is for consideration under item 2.A of the Provisional Agenda. Ministers may wish to address this topic in their prepared statements.

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Corporate Governance: A Framework for Implementation

Overview

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 the Bank of Credit and Commerce International and Barings Bank. Each crisis or major corporate failure—often as 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 promotion 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. Recently, 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 "tunneling" 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 for financial resources, domestic and foreign, and for the need 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, corporate 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. Although the importance of the subject is widely recognized, 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.

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 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 relationships among key players in the corporation

In its narrowest sense, corporate governance can be viewed as 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 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; this is why the primary duty of the director is to the company rather than to shareholders.

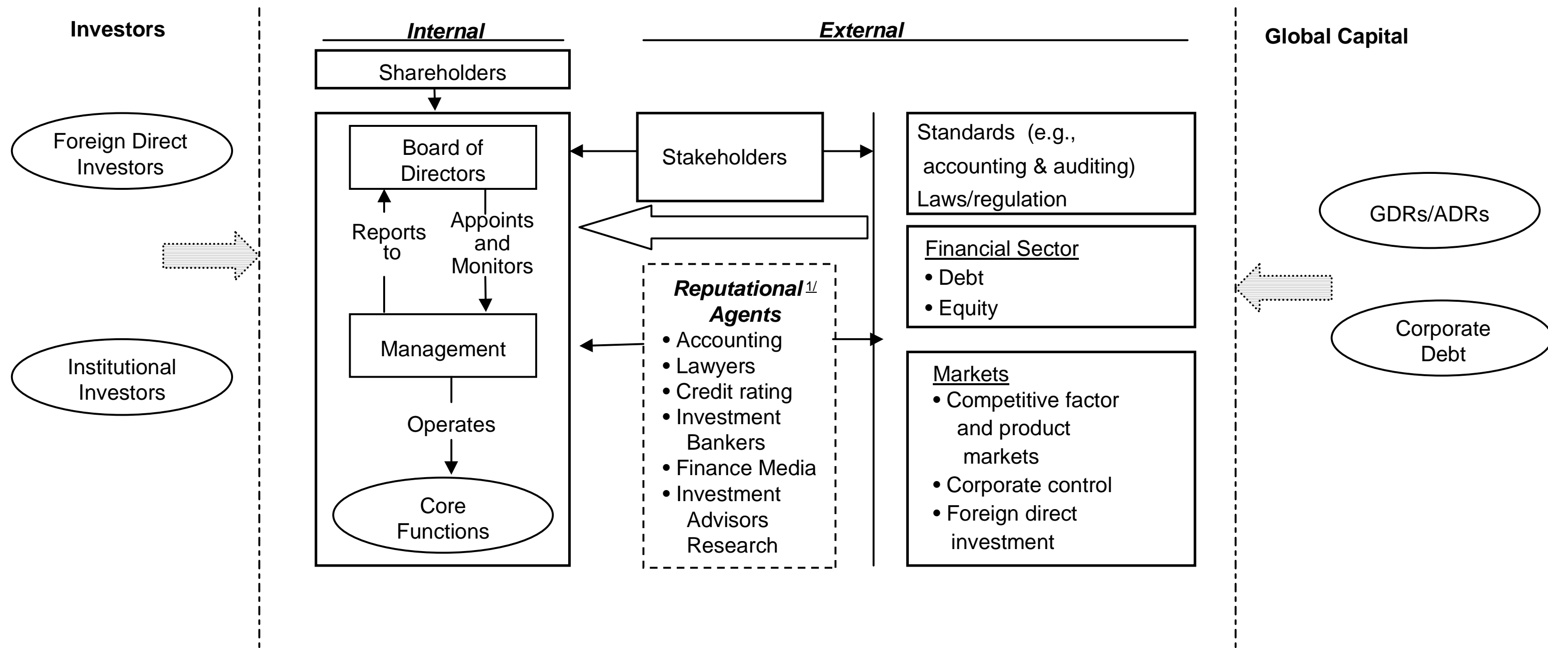
The governance problems that need to be addressed vary according to the ownership structure in the corporate sector. At one end of the spectrum is the *publicly traded company with widely dispersed shareholdings*. There, the challenge is for outside shareholders to control the performance of managers. 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 keeps 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



[1] "Reputational agents" refer to private sector agents, self regulating bodies, the media and civic society that reduce information asymmetry, improve monitoring of the firms, and shed light on opportunistic behaviour.

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 capital providers.

…..and transparent, efficient, liquid equity and bond markets.

Efficient securities markets send price signals rapidly, rewarding or penalising 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. They 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 play a monitoring role in the governance of start up firms, particularly in knowledge-based industries. They have the expertise, resources, and

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[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.

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 market structures, legal systems, traditions, regulations, 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 principles of business practice, 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 investors to harmonize corporate governance practice—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 banking supervision and prudential regulation), the International Organization of Securities Commissions (IOSCO), the World Trade Organization (WTO), and the International Labor 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 directed primarily toward 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 with 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 firm, but it also opens up opportunities for expropriation of outside shareholders.

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 poorly 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 only just beginning to emerge, such as reputational agents and active shareholders.

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 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 foreign ownership of banks (to bring much-needed financial, managerial, and technical capabilities to restructure the corporate sector[2]); 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 the growth of a 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, 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

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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 market 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 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 economic 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 also 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 it 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 (CDF), which emphasizes good corporate governance as a key factor in development effectiveness. The CDF 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.It 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 Labor 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.

C*atalyzing 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 effort. If the corporate governance agenda is to be scaled up, 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. 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, or 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 proivde 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 via 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. Corporate governance change will take a concerted effort in building consensus and sharing experience, expertise, and resources among all players. Above all, the private 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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This paper does not try to discuss in detail every facet of this rich topic, nor can it do justice to the issues covered. Some topics are covered in greater detail in the annexes. Additional reference materials are available through our help desk and corporate governance website (www.worldbank.org/html/fpd/privatesector/cg).