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CORPORATE GOVERNANCE IN DEVELOPING COUNTRIES: SHORTCOMINGS, CHALLENGES & IMPACT ON CREDIT

by

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“Good economic and corporate governance including transparency in financial management are essential pre-requisites for promoting economic growth and reducing poverty.”

NEPAD Action Plan

Mr. Chairperson,
Distinguished Ladies and Gentlemen:

Overview

Good corporate governance is imperative to inspire investors' confidence, expand the private sector, and stimulate economic growth.

It has been predicted that the “Proper governance of companies will become as crucial to world economy as proper governance of countries.”

It might be too early for some to agree; but evidence suggests this prediction, if it is not obviously true now, is very likely to come true in the near future.

Global recognition of the impact of corporate social irresponsibility; of the Asian financial crises; of corporate scandals in Enron and WorldCom in the United States of America; of Parmalat and Siemens in Europe; and of crises in financial circles in several major African countries over the last decade; in each instance, negatively affected the wellbeing and lives of thousands including employees, pensioners, depositors and ancillary enterprises. These raised alarms for effective regulation of corporations and led to panic in marketplaces, fall in stock prices, run on financial institutions, and quick-fix remedial actions.

On the other hand, in many developing countries, especially in Africa, heightened recognition of lost opportunities to mobilize financial resources on domestic and international capital markets through good corporate governance excited the interest of African Heads of State. This inspired the Heads of State to include corporate governance as one of four thematic areas subject to review under the African Peer Review Mechanism (the APRM). The APRM is a unique mechanism under which 26 African leaders have agreed to submit their respective countries and themselves to review introspectively by their compatriots and review Africa-wide by their peers in selected areas of governance. The selected areas are (i) political governance and democracy, (ii) economic governance and management, (iii) socio-economic development, and (iv) corporate governance.

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This need to closely examine the operations of corporations is justified for several reasons. Potential gains or losses which hinge on proper management of corporations could be financially profitable or economically devastating. Interest by the general public in developing countries to invest in listed corporations is rising. For example, during June 2007, in Kenya, a country with a long tradition of a stock market that is also undergoing the African Peer Review, an internet provider (AccessKenya), the first internet firm to list in East Africa, saw its listing on Nairobi's stock exchange oversubscribed by 363%. This oversubscription came from every category of investor – from individuals to institutional investors.

Such a rise in public interest means more is at risk. While this particular market participation in Kenya is through equity participation and not credit, financial resources are nevertheless being put at the disposal of the corporation with an expectation that those resources would be managed properly – that means managed efficiently, transparently and responsibly. The assigned subject of this speech places the accent on access to credit. This example is relevant however because equity investors expect their money back plus dividends, just as creditors expect their principal back plus a return (under Shari'a) or interest.

With that overview in mind, I shall speak briefly on the assigned topic:

Corporate Governance in Developing Countries: Shortcomings, Challenges and Impact on Access to Credit

A threshold question is how to define corporate governance? The definition of Corporate Governance employed by the African Development Bank is most apposite for this discussion. The Bank defines Corporate Governance as: “*The mechanism that frames duties and powers of corporations to deliver benefits to investors and those directly impacted by the corporation's activities.*” Note that this definition is not limited to a mechanism that delivers benefits to investors. Without rejecting principles of maximizing shareholder values, the definition goes further and includes consideration of “those directly impacted by the corporation's activities”. In corporate debacles, not only shareholders, but many others, including governments, form part of **stakeholders** that are directly impacted by corporate activities.

The emphasis in the assigned topic is on developing countries. Given the wide range of countries categorized as ‘developing countries’ that are at various stages and levels of development; their different legal traditions; their diverse cultural practices; the existence of capital markets in some countries and the absence of capital markets in others; the presence of credit rating agencies and credit bureaux in some countries but not in others; the several forms of corporations existing in almost all developing countries – such as State-owned enterprises (SOEs), publicly-listed corporations, cooperatives, closely-held corporations, and family-owned corporations; one must be careful, as always, not to generalize. It is important to bear in mind that while here we focus on corporate governance, in many developing countries, particularly African countries, of equal, if not wider relevance, would be enterprise governance (which encompasses a greater part of the private sector) since most businesses are not incorporated.

Be that as it is, I propose to discuss the topic by taking some common threads that run through corporate governance in many of these developing countries to identify (i) selected shared shortcomings and (ii) common challenges. I also identify some specific legal issues and deal briefly with the impact on access to credit.

Selected Shared Shortcomings

Corporations do not operate in isolated environments or in vacuums. They are subject to State-imposed rules and regulations as well as events and forces around them. As a result, corporate governance is affected by overall public governance. If economic and political governance at the country level is weak, the impact of that weakness almost invariably trickles down onto corporations operating within the country. It is logical therefore that corporate governance may be viewed as a compartment of broader, overall country governance. Arthur Mitchell and Clare Wee of Asian Development Bank's legal department put it elegantly in their article on *Corporate Governance in Asia* when they contend: “It is not possible to establish an island of good corporate governance in a sea of poor or underdeveloped public governance.”

In countries that have chosen the private sector as a main catalyst to economic growth and development, this choice should necessarily place good corporate governance near the top on the list of national priorities. Good corporate governance, however, can only be achieved if certain shortcomings in overall country or public governance are addressed. That requires strong political will and appropriate resources.

Analyses of circumstances in many developing countries confirm certain common systemic shortcomings. These shortcomings are perhaps most affected by law and the way laws are enforced. This is not surprising. The proposition is commonly acknowledged that at the base of good governance is a predictable, equitable, effective, and efficient legal and judicial system. Such a system must cater to the general needs of the people and the specific needs of economic operators participating in or desirous of taking part in the economy.

This emphasis on the Rule of Law is not overstated because law does form the basis of societal order. In a democracy, law is the popularly agreed communal compact upon which the society is governed.

Indeed, it is through a fiction of law that corporations are created and given existence. Through this legal fiction corporations are recognized as artificial persons with limited liability through which activities authorized by the State and expressed in the corporation's charter may be undertaken. Understandably, therefore, the inadequacy of a legal framework under which these activities are executed has been aptly referred to as part of the 'Rule of Law deficit'. A deficit in the Rule of Law affects public governance and transitively corporate governance.

This Rule of Law deficit manifests itself in systemic shortcomings that affect corporations and their access to credit. The shortcomings are sometimes commonplace and include overall defective legislations; malfunctioning judicial systems burdened by huge case backlogs resulting from, among other things, inadequate physical infrastructure; antiquated laws (both procedural and substantive), including laws on debt collection, insolvencies, and shareholders' rights; poor terms and conditions of service for judicial and related administrative personnel; weak accountability mechanisms including, and sometimes reflected in, ineffective service by securities regulators and banking supervisory regulators; failure of law enforcement and prosecutorial authorities to pursue claims arising from violations of securities or other financial laws or white collar abuses and crimes; and weak auditing and disclosure laws.

Challenges

Interesting results emerged from Regional Roundtables on corporate governance sponsored by the Organization for Economic Cooperation and Development (OECD). The twenty-five meetings of the Roundtables brought together participants from thirty-eight non-OECD economies. It revealed interesting common themes and challenges in corporate governance. The Roundtables covered countries in Latin America, Eurasia and South East Europe. Although other regions, developing regions, including Africa were not participants in the Roundtables, the lessons learned, experiences shared, and challenges identified are similar to those in many African and other developing regions. Those common challenges identified from the Roundtables are grouped as follows:

1. Enforcement
2. Ownership and Control
3. Shareholders Rights and Equitable Treatment
4. Responsibilities of the Board
5. Transparency and Disclosure
6. The Role of Stakeholders

Enforcement

With respect to enforcement, a major challenge arises from the general lack of effective enforcement of existing laws and regulations. Meeting this challenge requires recognition that the structure and capacity of regulatory and judicial frameworks are integral parts of the corporate governance

environment. The challenge is to narrow the gap between 'formal' provisions and actual implementation. This is critical because adherence to corporate formalities constitute the bedrock of corporate law and corporate accountability. Corporations in most jurisdictions are mandated to adhere strictly to statutorily stated formalities. Adherence to these can be very time consuming and financially costly.

Ownership and Control

The Roundtables noted that in many parts of the world, ownership and control are highly concentrated in individual companies or groups of companies. Potential problems could arise from the combination of concentrated ownership, weak shareholder protection and insufficient disclosure. The challenge is to improve transparency and disclosure, make boards of directors more effective, and develop means to ensure equitable treatment of shareholders. The related challenge is to promote development of equity markets and avoid limiting access to financial resources which frequently occurs when controlling shareholders are permitted to extract private benefits from the corporation at the expense of minority shareholders. Although rules exist in many jurisdictions to protect minority shareholders or for shareholder derivative suits, these are rarely used. For example, in Liberia, a popular international corporate domicile, the Associations Law provides for shareholder derivative suits. Yet, no case has been brought before the Liberian courts invoking this provision of the statutes. As elsewhere, shareholders might be unaware of the law or prefer simply to vote with their feet by selling their shares.

Improving Board of Directors Effectiveness

A recurring challenge is to activate Boards of Directors to take independent decisions as fiduciaries of corporations and not as rubber stamps of controlling shareholders. The challenge is to increase the pool of technically competent potential directors capable of making informed and objective business judgments. This requires establishing training facilities and programs for corporate directors and developing strong audit committees of Boards of Directors. At the African Development Bank, financial support has been given to help build the capacity of directors in regional member countries. In Mozambique, the Bank provided funding to the institute of directors for training purposes.

Transparency and Disclosure

A main challenge identified is to introduce improved standards based on international best practices. In Africa, the African Development Bank was given the lead role by Heads of State in the African Peer Review Mechanism to recommend appropriate standards and codes for corporations and for the financial sector. The Bank's recommendations have been based on international standards being implemented in more developmentally-advanced economies. While the wherewithal to meet all the standards is not present in most African countries, achieving these standards remain aspirations. The desire, indeed the challenge as revealed by the Roundtables, is to close the gap between standards and actual practices. Disclosure of ownership in related parties transactions need to be pursued to encourage arms-length deals that do not lead to the mulcting of corporate assets. In a project in one of the Bank's regional member countries, the principal contractor also owned controlling shares in the financial institution through which the contractor channeled project payments. No disclosure of this relationship was made; neither were the transactions between the corporation that was project contractor and the corporation that was the financial institution done at arms-length. Problems with the project caused the Bank to freeze payments to the project corporation. This adversely affected the financial institution, which to the detriment of other shareholders and depositors, collapsed.

In summing up on challenges and looking specifically at Africa it can be said that inadequate administrative systems compounded by heavy bureaucracies stifle corporate development and governance in many African countries. For many African countries the main challenges are to reduce the bureaucratic impediments to business and corporate registration; improve and decentralize business registries; establish and integrate registries for secured transactions; strengthen and attract competent human resources back into African countries and the corporate sector; improve regulatory oversight; elevate more African corporations to the level where they can get internationally recognized credit ratings; improve the legal and judicial frameworks; and develop effective compliance mechanisms. In its Corporate Governance Strategy paper, the African Development Bank point out some of these challenges and note, in particular, that:

“. . . [I]nstitutions that are intended to provide checks and balances within the system (including prosecuting systems) are generally under-resourced and lack requisite skills, infrastructure and independence.”

It merits re-stating that the status of corporate governance reform in developing countries is not homogenous. Countries are at various levels of reform. In Africa, for example, the African Development Bank has found that in the East African region, Kenya, Uganda and Tanzania have made tremendous progress in putting in place self-regulatory institutions to promote corporate governance; in Central Africa there has evolved a uniform framework for companies laws, yet much needs to be done to strengthen institutions to promote good corporate governance and to create an enabling environment; in West Africa there is a commendable orientation towards harmonized implementation of good corporate governance standards for the banking sector and through OHADA uniformity of companies laws is being achieved in the francophone countries; in North Africa much progress has been made in harmonizing standards of corporate governance; and in Southern Africa, where a common benchmark (the King Commission Report) is being used, strong efforts are being made to improve the policy, legal and regulatory frameworks.

Some Legal Issues

On the basis of these common challenges and other observations, several legal issues require consideration. Let me point out a few. What measures should be promoted to avoid or solve deadlocks in corporate boards of directors, especially in closely-held corporations which are the most popular corporate form in developing countries? What mechanisms should be employed to protect the rights of minority shareholders in listed corporation? What measures are most effective to inform those minority shareholders of their rights? How broadly should rules pertaining to financial disclosure of interests required of members of boards of directors to prevent conflicts of interests extend? Should provisions of codes of conduct for directors be enacted into laws? What is the fiduciary obligation of a government official appointed by virtue of his/her office in government to the board of directors of a state-owned enterprise (SOE) or other corporate entity in which the government has an investment? How can the gap between laws on the books and implementation of the laws be narrowed? What is the appropriate role of shareholders in managing the business of the corporation? To what extent does the corporation owe a duty to stakeholders who are not shareholders and with whom the corporation has no formal contracts? Given the backlog of cases and inadequacies in many judiciaries in developing countries, what extra-judicial dispute resolution mechanisms are appropriate for shareholders to protect the corporation from mal-management?

Impact of Corporate Governance on Access to Credit

Good corporate governance principles apply to corporations, such as financial institutions, that provide credit as well as to corporations that seek to access credit from these financial institutions. Banks are the most important sources of credit for most corporations. Banks are also the main depositories of savings for those participating in the money economy. In developing economies, almost always, banks maintain a dominant position in the financial system. Whatever happens in the banking sector affects the overall investment climate and multiple stakeholders. Ineffective regulation of banks or inadequate prudential guidelines for their governance affect the nature and level of credit and have the potential of destabilizing the national economy.

In surveying the situation in Africa, a recent report on firm competitiveness states:

“Firm competitiveness in Africa continues to be constrained by the high cost of finance and limited access to it. The financial sector is largely failing to meet the private sector’s needs. Financial markets on the continent are less developed than the worldwide average, even after taking into account average per capita income and inflation. Africans also have disproportionately high offshore deposits. Interests margins are high Most organized securities markets are small and inactive; institutional investors often concentrate on bank deposits and real estate instead.”

These statements reflect the link between confidence in the governance of corporations providing financial services, levels of deposits and availability of credit. Proper governance of corporations can

reduce these costs. Corporations that are properly governed can expand their resource bases and attract capital domestically and internationally.

At the African Development Bank systemic due diligence exercises to ensure full compliance with corporate governance principles by partners involved in Bank-supported projects is fast becoming standardized. The African Development Bank knows that the business environment must be attractive to get the investments of local and foreign operators. The Bank also recognizes and reports that lack of transparency in the governance of firms and shortcomings in regulatory frameworks present major constraints for credit to small and medium-sized enterprises, which also have little recourse to financial markets to raise funds.

Conclusion

The status of corporate governance in developing countries is not the same. There are, nevertheless, certain shared shortcomings and common challenges. These bear directly on the availability of and access to credit. Governance of publicly-listed corporations, state-owned enterprises and of small or medium-sized closely-held corporations differ. But certain minimum standards must be maintained by all corporations.

Corporations do not operate in isolation. They operate alongside others in national, often global, economies. All corporations are affected by overall country or public governance. They are affected by the political and economic milieu within which they operate. Assuming the existence of the requisite political will for good governance in many developing countries, some changes could be made to improve corporate governance. These changes include greater transparency, improved recourse mechanisms for all stakeholders, better trained and independent boards of directors, effective legal regimes (including for debt collection and secured transactions), independent judiciaries with capacities to adjudicate matters speedily, and reliable credit reference bureaux. With these in place the private sector will serve more efficaciously as a catalyst for economic development.

Finally, let me end as I began with a quotation. South Africa's Mervyn King says: "*Good corporate governance makes good, hard-nosed business sense. . . . [S]trong corporate governance practices attract capital.*"

I agree entirely.

Thank you.

