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# The Importance of Corporate Governance for an International Financial Centre

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Good morning ladies and gentlemen.

I would like to start by congratulating the Chamber of Hong Kong Listed Companies for arranging such a wide ranging, comprehensive and interesting conference on corporate governance. Today you will hear views on matters such as the role of regulators, compliance and enforcement in the PRC, corporate social responsibility, and lastly but by no means least what investors think. These are very substantive and important issues for the successful running of companies of which you have a vital role to play.

On my part, I would like to look at corporate governance from a broader perspective of overall competitiveness, and the role of corporate governance in maintaining market quality and the success of Hong Kong as a financial centre. I would then draw some lessons for corporate governance from the financial turmoil that has been troubling the advanced financial markets. Finally, I would look at what might be the right approach to corporate governance.

## Hong Kong's competitiveness

As the third largest market in Asia by market capitalisation, and seventh place in world rankings, this speaks well of the listed companies in Hong Kong. Institutional investors are particularly attracted to Hong Kong's stock market, accounting for two-thirds of market turnover, with overseas institutional investors accounting for 39 per cent and local institutional investors absorbing another 28 per cent.

Hong Kong has done well thus far in corporate governance rankings. For example, the CLSA report 2007 on Corporate Governance in Asia ranks Hong Kong the highest of 11 jurisdictions, ahead of Singapore, India, Taiwan and Japan. However, the report notes that companies in the Asian sample ex-Japan showed a much smaller improvement of 1.2 points in the average corporate governance score compared to previous years. This reflected the buoyant economic and market environment where there is generally less pressure on corporate governance.

Looking at the City of London Corporation report, Hong Kong is the third global financial centre after London and New York.  Hong Kong has managed to retain a strong position in a number of competitiveness areas.

What do these reports mean for Hong Kong?

First, Hong Kong owes its success to a combination of factors:

- rule of law that provides certainty
- a robust regulatory framework that promotes orderly and efficient markets
- efficient financial infrastructure
- talent pool of professionals
- enterprising business community
- presence of market participants from around the world
- corporate governance

Each factor is necessary for success but insufficient on its own. All have an important role to play to maintain Hong Kong's competitiveness.

Second, Hong Kong is in the lead, but the competition will quickly catch up with you. When one is at the top of the league, complacency is the biggest enemy.

Third, as Asia and the world are confronted with a very difficult economic environment ahead, with rising inflation and slowing growth, it spells opportunity for businesses and economies to shed fat and to become more lean and efficient and more attractive to investors. By so doing, companies can differentiate and position themselves to be more attractive to investors that would become more careful and discriminating with their funds in an uncertain economic environment. Investors would look to companies that show potential to ride through the tough economic times and increase the value of the company and share price.

In the context of today's conference, the relevant question is: "Do investors care about corporate governance?" Research findings point to a resounding YES. Papers on investor behaviour in countries as diverse as Brazil, Germany, Korea, PRC and USA have come up with the same clear message: in the long run investors value good corporate governance and are willing to pay a premium for it.

Investors are attracted to markets that provide the investment opportunities they are looking for. Just as investors will commit their money to companies that provide good corporate governance so they will commit their investments to markets that provide significant numbers of investment opportunities with good corporate governance. It is no coincidence that the world's two leading international financial markets, New York and London, have for many years been seen as leaders in setting the right standards for corporate governance.

Undoubtedly, the China story has been a compelling one. Hong Kong has been able to provide a trusted and reputable platform for investors from around the world to invest in Mainland companies that list in Hong Kong in accordance with its listing requirements and the Code of Corporate Governance.

So, the challenge and opportunity for listed companies in Hong Kong is to reflect on their approach to corporate governance and consider areas for improvement that can help to enhance the appeal of their companies to investors. The various areas that today's conference will discuss would provide some food for thought.

**Corporate governance - back to basics**

As you ponder on these issues, the experience of the market turmoil in recent years also offers some useful insights on how governance went wrong. Before I get to that, first let us consider the term "corporate governance", which is such an over-used term that it means many different things to different people. Basically, "corporate" is something that belongs to a corporate and "governance" is the act or manner of governing. So, corporate governance is simply the manner of governing a corporation.

For a more formal definition, we can refer to the Principles of Corporate Governance established by the Organisation for Economic Cooperation and Development (OECD), an international organisation that promotes economic growth, world trade and financial stability. The OECD principles are among 12 key standards that are internationally accepted as important for sound, stable and well-functioning financial systems. The OECD's definition of corporate governance is comprehensive, which I shall paraphrase as a system that directs and controls a business corporation by –

- laying down the rights and responsibilities of the different participants in the corporation, which includes shareholders and other stakeholders; and
- setting rules and procedures for decision-making; that
- provides a structure to set and attain objectives of the organisation, and monitors performance.

The best way to appreciate why corporate governance matters is to see what happens when corporate governance is weak. In the case of the Enron scandal, the board structure rendered it ineffective in checking management. In addition, the audit committee has been criticised for not scrutinising the accounts closely enough and did not pay serious attention to a whistleblower's concern over the extensive use of special purpose entities, which were treated as off-balance sheet items in its accounts that ultimately enabled Enron to conceal its losses from investors.

With regard to the board structure, the finding was that the independence of the board was questionable, given the involvement of some board members in consultancy work for Enron, or their outside interests being dependent on Enron. In addition, the board had difficulty in checking information provided to the board, as the chairman and CEO was the only representative of management on the board and had control over the information flow.

The subprime crisis offers an insight into the shortcomings in risk management that exposed many financial institutions to excessive risk-taking and losses. It was revealed that there were cases where there was no established risk management committee, or if one existed, it did not function effectively. There has also been dissatisfaction among risk managers as some felt that they did not get the respect and authority to do their job, as firms tended to have a bias in favour of business lines over risk management.

The lesson here is to get back to basics. It is important to have a proper structure that clearly sets out the separation of duties and responsibilities, the decision-making process, and a system of controls, monitoring and reporting. Having put the structure in place, put it to work. Make sure that the departments and staff are given the necessary authority to act. And there should be a process to check to see if the structure of governance is working as intended.

**Corporate governance – getting it right**

I now move on to a question that many of you may have - what is the right approach to corporate governance. I must confess that there is no simple answer to this question. What is right for one market may be inappropriate for another.  At the end of the day, it is up to each jurisdiction to decide what best suits their market, in light of their own circumstances such as state of market development, legal system and experience.

In general, regulators are faced with the need to find the right balance between investor protection and market development. It is not always that easy or straightforward to get the regulatory balance right in a particular situation, given the diverse interests of different stakeholders.

Experience shows that after a crisis, there is usually a public outcry and demand to set things right so as to minimise the opportunity for a repeat of the failures. In this situation, there is always the danger of an over-reaction in tightening regulations that may result in unintended consequences of a policy. The time pressure that is placed on policymakers to make the changes as quickly as possible also does not help the situation.

Sarbanes-Oxley was introduced in the aftermath of various high-profile corporate scandals in the US. In the recent experience of the subprime crisis, calls have been made to tighten regulation and even to overhaul the regulatory structure.

I am aware that many commentators question whether Sarbanes-Oxley has been a bit too much.

I think there is little dispute over the main thrust of Sarbanes-Oxley, which is that directors have to be seen to be responsible for the financial information and take reasonable steps to ensure that the processes and systems producing financial information and safeguarding assets are sound and operating.

However, as a process I think the accepted wisdom is that it may have been too bureaucratic and the implementation may have been too legalistic resulting in unnecessary expense for all listed companies. I can understand directors who are determined not to breach the law will comply with its requirements at all cost, as after all, the cost of legal and audit fees will be passed on to the shareholders.

But on the debate whether Sarbanes-Oxley went too far, and if so whether the implementation should be fine-tuned rather than scrapping the whole idea, this is something for the US to decide as they seek the right balance between investor protection and efficiency, against the backdrop of competitive global markets.

What then has been Hong Kong's approach to corporate governance? Our approach has been to follow the best international approach with a bias towards the London model. Essentially, the practice in Hong Kong is to have:

- Some specific requirements that listed companies are required to follow. For example, to have an audit committee and to have a minimum number of independent directors.
- Some "comply or explain" provisions in the Code on Corporate Governance Practices. What this means is that a listed company does not have to comply with each provision but, where it does not, is expected to explain to investors and the market generally its reason for not doing so.
- Some recommended practices of the Code which are for guidance only. A listed company is not expected to state whether it has complied with a recommendation or to publish its reasons for not following the recommended practices.

After two full years of operation I understand our Exchange is now reviewing whether there is a need to revise the Code.

The Code provides the basic corporate governance expectation for companies listed in Hong Kong. But that is just the beginning. For each individual listed company, the pressing issue is to ask itself what is the right corporate governance for its company. Just like it is for each jurisdiction to decide what is right for its own market taking into consideration the local circumstances, the decision on what is right for each listed company is for the company itself to determine in light of its circumstances. Each board of directors must determine how its company should be governed.

Corporate governance is now a field of economics and one of the areas studied is the effect of good corporate governance on performance. Research shows that clear internal accountability, well-defined responsibilities, and a fuller understanding by management of risks are some of the elements of good corporate governance that add to a company's performance.

**Conclusion**

In conclusion, the message that I would like to leave with you, as directors and executives of listed companies, is that the continued success of your companies depends on finding the right corporate governance structure that best meets the needs of your companies and the expectations of your investors.

Good corporate governance pays both in good times and difficult times. It gives investors the confidence in the value proposition of your company over the long haul. This will attract investors who are prepared to pay a premium for the shares of companies with the right corporate governance.

Remember also that the base provided by regulations and the Code is just that, a base for companies to build on. The rest is up to you to design to suit your needs.

Finally, it is important to pay attention not only to the form or structure of corporate governance, but also to the substance if corporate governance is to work and yield the expected benefits. In other words, put the plan into action.

On that note, I thank you for listening. I am sure you will have a very interesting day.