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Effecting Corporate Governance Reforms in Asia and the Pacific: The ADFIAP Corporate Governance Rating System

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The Asian financial crisis of 1997 not only revealed the need for corporate governance reform in the region's business community, it also demonstrated the need for reform within national development finance institutions (DFIs). Recognizing the governance challenges in the region and the role that DFIs can play in addressing these challenges, the Association of Development Financing Institutions in Asia and the Pacific (ADFIAP) initiated a comprehensive program to improve corporate governance mechanisms within its member-banks and other financial institutions.

The centerpiece of ADFIAP's program is an assessment and monitoring instrument called the ADFIAP Corporate Governance Rating System (ACGRS). Consistent with other existing international governance rating methods, the rating system monitors the areas for governance reforms: Shareholder Rights, Commitment to Corporate Governance Principles, Board Governance, Disclosure & Transparency, and Auditing. By periodically tracking changes in governance policies and practices, the ACGRS evaluates the overall state and quality of governance in financial institutions.

The initial results of the project demonstrate that ADFIAP's program has had a large impact on the region. Participating member-institutions have made visible strides to improve corporate governance and have taken steps to sustain the progress made. Programs like ADFIAP's show that corporate governance reform is both desired by DFIs and is a goal that can be achieved through firm commitment and diligent monitoring.



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Background

The Asian financial crisis of 1997 not only revealed the need for corporate reform in the region's business community, it also demonstrated the need for reform within national development finance institutions (DFIs). Set up by national governments as specialized financial institutions, DFIs provide long-term financing and professional and organizational development assistance to enterprises that contribute to their countries' economic development and growth yet are inadequately supported by other financial institutions during their formative years. DFIs play an important role in a country's development and are an integral part of its financial system.

DFIs also play a central role in advancing corporate governance reforms in the region. Unlike commercial banks, development banks both provide financial assistance to enterprises and provide training and management expertise. To this end, in order to be effective in promoting good corporate governance, they must institute good corporate governance practices themselves.

Recognizing governance challenges in the region and the role that DFIs can play in addressing these challenges, in February 2003, the Association of Development Financing Institutions in Asia and the Pacific (ADFIAP) initiated the "DFIs for Corporate Governance" Project in partnership with the Center for International Private Enterprise. The project became the centerpiece of ADFIAP's collective and responsive effort to advance sustainable development by bringing together national development banks and promoting mechanisms of good corporate governance as the key to business sustainability in the region. ADFIAP's work is a response to the need for DFIs to adopt and institutionalize good corporate governance policies and practices in their organizations not only because it is the "right thing to do," but because it is essential to business success.

By leveraging its extensive network of 64 member-institutions in 32 countries in the region and its affiliation with government agencies and the private sector, not to mention its relationship with the Asian Development

Bank (ADB) that helped form the Association in 1976, ADFIAP was able to raise the needed funds to run the project from the private sector organizations. ADFIAP also worked with its members who voluntarily provided their staff and training facilities for the project.

The Strategy

ADFIAP member-institutions recognize the need to develop their governance systems in step with national efforts. In most countries, the government and central banks have paved the way for corporations and banks to institute reforms.

To that end, ADFIAP created several initiatives to assist its member-DFIs. First, it conducted a series of surveys of governance practices among its member-banks. Then, with assistance from CIPE, a regional seminar workshop identified international best practices and remaining gaps that future reforms should address. Workshop participants recognized that their financial institutions must periodically track the progress of these governance reforms.

Next, ADFIAP addressed the weakness of corporate governance in the region by encouraging boards of directors and member-banks to develop, write, and accept Codes of Corporate Governance, as well as to appoint a senior officer (or unit) to oversee, direct, and manage a sustainable good corporate governance program in their institutions.

Finally, ADFIAP developed an assessment and monitoring instrument called the ADFIAP Corporate Governance Rating System (ACGRS). Consistent with other existing international governance rating methods, the rating system monitors the areas for governance reforms. The ADFIAP version seeks to add significant value and relevance by focusing on priority areas identified by its member-institutions and assisted by governance experts.

The ACGRS was reviewed, tested, and revised in five national workshops held in Malaysia, Pakistan, Mongolia, Fiji, and Vietnam. After developing the final version in Manila, Philippines, the ACGRS was distributed to ADFIAP's member-institutions. It will

serve as a tool for helping them assess and monitor their governance reform progress. The areas for improvement and relative importance of each reform area are clearly specified in the rating system. These reform areas are: Shareholder Rights, Commitment to Corporate Governance Principles, Board Governance, Disclosure & Transparency, and Auditing. By periodically tracking changes in governance policies and practices, the ACGRS evaluates the overall state and quality of governance in financial institutions.

To extend the benefits of good governance to the stakeholders, particularly clients of its member-institutions, ADFIAP also developed another instrument called the “ADFIAP Checklist of Indicators of the Quality of Corporate Governance of Corporate Borrowers” (ACI-QCG). It has been found that corporate loan losses are associated with poor governance of borrower companies. By using the ACI-QCG, the financial institution sends a clear message to its borrowers that the quality of governance matters in terms of the way their loans will be processed and monitored.

ADFIAP hopes that these instruments will be adopted by its member-institutions as the centerpiece of their governance reform and monitoring process. ADFIAP is prepared to assist its members in the adoption and application of these instruments.

The Corporate Governance Rating System Explained

The ADFIAP Corporate Governance Rating System (ACGRS) is an adaptation and expansion of two rating instruments, namely, the German Corporate Governance Scorecard of the Deutsche Vereinigung für Finanzanalyse und Asset Management, or DVFA, and the one prepared and used by the Institute of Corporate Directors (ICD) in the Philippines.

The adoption of a corporate governance rating system for Asia-Pacific countries is suitable because their corporate sectors share a similar legal framework and institutional structure. In these countries, governments rapidly established DFIs to accelerate their economic development. These DFIs, most of which are members of ADFIAP, are the target users of the ACGRS.

By using a common corporate governance rating system, concerned governments and multilateral and private institutions can monitor the progress of corporate governance reforms within each country and in comparison with others in the region. It is a viable approach because there are regional financial markets that institutions in these countries can access. The competition for investments among regionally-based companies highlights the importance of good governance practices for all companies.

The ACGRS is schematically shown in Figure I. It follows the major criteria in the instrument developed by the German Society of Investment Analysts and Asset Management (DVFA) and used as a standard evaluation methodology for the corporate governance practices of publicly-listed companies in Germany.

Following the DVFA scorecard format, there are five elements in the ACGRS instrument, namely: Shareholder Rights, Commitment to Corporate Governance Principles, Board Governance, Transparency, and Auditing. ADFIAP modified DVFA’s second criterion to evaluate “Commitment to Governance Reforms” and the criterion of “Transparency” was converted to “Disclosure.” The overall standards for assessing an institution’s performance involve meeting expectations by investors and shareholders in each of these areas as described below.

1. Shareholder Rights. There are two variants of this element. For commercial banks and financial institutions other than DFIs, the focus is the shareholders. For governance to be considered good, shareholders expect to be informed and free to elect the management of their institution in an annual shareholders’ meeting. Minority shareholders expect fair treatment from their institution by allowing them to access information, to grant them opportunities for control of the institution in proportion to their shareholdings, and to seek redress for any act of expropriation of the institution’s wealth by dominant stakeholders.

For DFIs, the focus is the sectors of the economy and society that they serve. For governance

to be considered good, a DFI should fulfill its mission as specified by its only shareholder – the government. It should be forthcoming in its explanation of its institutional direction and accomplishments in the service of its beneficiaries.

2. Commitment to Corporate Governance

Principles. An institution should work in the best interest of its shareholders and guide the institution's operations to be compatible with the social, environmental, and public welfare of its country. This involves enhancing long-term shareholder value, adopting sound corporate governance policies, and complying with provisions of the institution's code of corporate governance.

3. Board Governance. Shareholders expect the board of directors to maintain effective governance over the institution and be accountable to them and the regulatory authorities. To meet this expectation, an institution needs to adopt sound policies and practices in selecting directors, appointing independent directors, and ensuring adherence to international best practices by the board.

4. Disclosure. Investors and shareholders expect the institution to provide them with adequate access to information, management analysis of financial results, and complete reports of annual shareholders' meetings. They also expect full disclosure of inter-institutional and related party transactions.

5. Auditing. Investors expect an institution to follow generally-accepted accounting standards for its financial reporting and to be audited by independent, professional external auditors.

The weights for each governance criterion are as follows: Shareholder Rights – 25%, Commitment to Corporate Governance – 20%, Board Governance – 25%, Disclosure and Transparency – 15% and Auditing – 15%. These weights are somewhat arbitrary in the sense that corporate governance research has not

prescribed a hierarchy of elements of sound governance. It is more useful to review the criteria that go into each of the five corporate governance elements.

The ACGRS instrument is in the form of a questionnaire that requires a respondent to assess the corporate governance practices in his/her institution. There are two versions – one for DFIs and another for commercial banks and other financial institutions. A survey administrator converts the responses into a weighted score for each question using a point equivalence system. The scores for each criterion are consolidated into an overall weighted average score of the institution.

A description of corporate governance factors used in the ratings is given below:

1. Shareholder or Beneficiary Rights

- a) Equality of voting rights of same class of shares
- b) Sufficient notice to small shareholders of annual general shareholders' meetings (AGSM)
- c) Efforts by majority shareholders to encourage minority shareholders to attend AGSM
- d) Degree of access by shareholders and beneficiaries to adequate, reliable, timely, comparative, and non-financial information
- e) For DFIs, focus of investment and credit programs to target beneficiaries and subsequent accountability to them

2. Commitment to Corporate Governance Reforms

- a) Goals of the institution, especially shareholder value in the case of banks and development goals for target beneficiaries in the case of DFIs
- b) Availability of a written code of corporate governance
- c) Policies of the institution regarding treatment of public investors
- d) Appointment of a Compliance Officer to ensure adherence to sound banking regulations
- e) Code of Ethics adopted by the institution for its directors

3. Board Governance

- a) Structure of the board of directors: roles, involvement in operations, number of members, independent directors, frequency of meetings, and written duties and responsibilities
- b) Qualifications and experience of directors
- c) Whether board committees are organized and actively functioning
- d) Management performance evaluation by the board
- e) Compensation system for management and directors

4. Disclosure

- a) Adequate access to information by investment analysts and shareholders
- b) Frequency and scope of information distribution and conformity of financial reporting with local and international standards
- c) Quality of reports prepared for the AGSM

5. Auditing

- a) Compliance of accounting system and audits with international standards
- b) Quality of independent auditors
- c) Publication of annual and quarterly reports
- d) Timeliness in publication of reports
- e) Disclosure of related party transactions according to regulations

In summary, the ADFIAP Corporate Governance Rating System (ACGRS) consists of the following:

1. An overview of the rating system and its elements
2. Two Corporate Governance Rating Questionnaires, one for DFIs and another for commercial banks and other institutions, complete with preparation instructions
3. An MS Excel-based spreadsheet for the point system and for tabulating the scores

Conclusion

As a result of the project, corporate governance practices by member-institutions in the region have been greatly improved, based on members' annual reports and

other publications provided to ADFIAP. Eight out of ten member-institutions now have either or both of their corporate governance policies and codes approved by their respective boards of directors. Almost all of them have named individuals and/or units in their organizations to monitor and facilitate the implementation of corporate governance programs and activities. The other tangible outputs of the project include:

- A total of 165 participants – directors and holders of senior management positions – from 23 countries in the region attended the training events.
- A total of 79 institutions – ADFIAP members, affiliates, and other networks – participated in the program.
- Eight country training program designs were developed.
- A new ADFIAP publication, “Governance,” was developed and produced for dissemination to members and the outside community.

Octavio B. Peralta serves as Secretary General of the Association of Development Financing Institutions in Asia and the Pacific (ADFIAP). For more information and to download a copy of the ACGRS, please visit <http://www.adfiap.org> or email at inquiries@adfiap.org.

ADFIAP is the focal point of all development banks and other financial institutions engaged in the financing of development in the Asia-Pacific region. Its mission is to advance sustainable development through its members. Founded in 1976, ADFIAP has currently 64 member-institutions in 32 countries. The Asian Development Bank is a Special Member of the Association. ADFIAP is also a founding member of the World Federation of Development Financing Institutions composed of regional associations in Africa, Asia-Pacific, Latin America and the Middle East. ADFIAP is an NGO in consultative status with the United Nations' Economic and Social Council. The permanent Secretariat of ADFIAP is based in Makati City, Metro Manila, Philippines.

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