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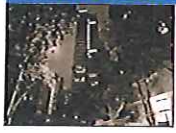

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Why corporate governance matters

| BY PATRICK LECOMTE |

The International Monetary Fund says, in a recent report, that the global financial crisis was partly due to a lack of corporate governance in the banking sector. Actually, most financial crises, which often cause serious economic damage, can be explained by shortcomings in corporate governance. That is why financial crises and scandals are usually followed by a push for better corporate governance practices.

In the US, the Enron debacle in the early 2000s was a case study in poor corporate governance having dramatic consequences, including the bankruptcy of a US$63.4 billion company and the de facto dissolution of Arthur Andersen, one of the five largest audit and accountancy firms in the world. The regulatory outcome was the Sarbanes-Oxley Act of 2002, which provided for such tenets of good corporate governance as the independence of audit committee members.

The same pattern is evident in Asia. Notably, in 1999, following the Asian financial crisis, the Organisation for Economic Co-operation and Development set up the Asian roundtable on corporate governance, which acts as a "regional forum for exchanging experiences and advancing the reform agenda on corporate governance". More recently, in 2004, the Association of Asean Finance Ministers in cooperation with the Asian Development Bank (ADB) undertook a few initiatives to promote better corporate governance in Southeast Asia, including a ranking of member countries for their corporate governance practices based on a "rigorous methodology benchmarked against international practice" and encapsulated in the Asean Corporate Governance Scorecard. This scorecard is used by the Asean Corporate Governance Taskforce to assess corporate governance practices in Indonesia, Malaysia, the Philippines, Singapore, Thailand and Vietnam every year.

Closer to home, the Monetary Authority of Singapore has been very pro-active in promoting good corporate governance practices. In a recent ACCA-KPMG survey, Singapore ranked third in the world for its corporate governance requirements, and came in tops in Asia-Pacific. Late last year, MAS turned its attention to the real estate investment trust (REIT) sector. In October 2014, it issued a Consultation Paper on the Enhancements to the Regulatory Regime Governing REITs and REIT managers, which included a number of proposals that generated some controversy in the industry. When put in the historical perspective of consistently stricter governance requirements in the West and in Asia however, its requirements are clearly positive for Singapore as an international financial centre and a regional leader in the listed real-estate sector.

So, what is it about corporate governance that seems to trigger debate among industry players and regulators? Actually, this is due to the very nature of corporate governance. Corporate governance does not exist as an absolute concept. It is contextual and depends on the environment and structure of each economy and industry group. Asian economies are known to follow a Confucian model of capitalism whereby a majority shareholder, whether a government entity, a family, or a conglomerate, tends to control a company's operations, triggering an array of agency issues between majority and minority shareholders. In that respect, in Asian economies possibly more than in Western ones, corporate governance rules embody a social contract between shareholders, managers and the greater society.

In an increasingly intertwined global economy, corporate malfeasances in one sector of the economy can lead to systemic risks spreading globally. Therefore, corporate governance practices have the potential to impact not only shareholders, but also the market in general, and indirectly, the whole economy. Beyond the fundamental notion of fairness among all shareholders, corporate governance has a bearing on other important concepts such as the resilience of a country's economy.

In international financial centres such as Singapore, which is ranked the fourth most competitive financial centre globally in 2014 (based on the Global Financial Center Index), it is essential for regulators to ensure their citizens are not too negatively impacted by systemic risks of finance and real-estate busts elsewhere. Protecting economies against potentially negative externalities triggered by transnational activities is a key objective of sound regulation. While companies trying to make money in the short term will plead for a reduction in red tape, regulators and market authorities have to balance this view with the overall stability of the system, as part of what post-global financial crisis researchers call sustainable capitalism.

As Asia is expected to be the growth engine of the 21st century, it is no wonder the region's economies and their corporate governance practices are now being scrutinised. After all, wealth comes with responsibility. In its assessment of corporate governance in Asia in 2014, the ADB reminds us that "[...] poor corporate governance has been proven to negatively affect investors' confidence, which consequently results in lower investment in the region. Nowhere is this clearer than the drop in foreign investments after the 1997 crisis that engulfed Southeast Asia. Hence, the [Asean] scorecard is a useful tool to demonstrate Asean members' commitment to sound corporate governance which will be important to increase foreign direct investment into the region".

In 2009, I decided to emulate the approach adopted by the ADB and the Association of Asean Finance Ministers, by designing a scorecard assessing the corporate governance practices of S-REITs. The assessment, which embodies the R-Index of corporate governance, includes eight major categories: board matters, audit committee, remuneration of the managers, REIT organisation (such as the role of the trustee), fees, related-party transactions, gearing and structure of ownership. Individual scores collected since the inception of Singapore's REIT regime were kept confidential, while aggregate findings were reported in *The Edge Singapore* in 2012 and 2013.

The R-Index is the first index of its kind, not only in Singapore but also in the world, with a specific focus on the listed real-estate sector. Many of its scorecard's provisions are now part of the MAS Consultation Paper, which shows the relevance of pushing the boundaries of research in such essential topics. The R-Index has enabled an objective analysis of the link between a REIT's corporate governance practices and its performance.

So, what are the findings? Should investors even bother about corporate governance? First, some bad news: There is no historical link between corporate governance and the operational performance of a REIT. This is consistent with other research done for other industry groups in Asia and the West. As the ADB explains in its 2014 assessment of corporate governance in the region, "the link between corporate governance and companies' profit is inconclusive".

However, there is a significant positive link between corporate governance and the stock-market performance of a REIT. Units of REITs with the best corporate governance practices, as assessed by the R-Index, have historically outperformed those of REITs with practices assessed to be not as good. In addition, the bid-ask spreads for these S-REITs have tended to be narrower. This is an indication that the market is more comfortable with S-REITs that have better corporate governance. For investors, more efficient trading of units in these REITs implies larger returns on their investments.

It would seem that corporate governance serves the greater good as well as individual interests. However, the imposition of corporate governance standards cannot be left to the invisible hand that the economist Adam Smith theorised about. Corporate governance requires the enlightened hand of regulators prepared to make smooth wealth creation one of their core missions. It seems to me this is precisely what MAS has been doing, and we should all be thankful for that. E

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