Corporate Governance

Why Corporate Governance

"Corporate governance is the system by which companies are directed and controlled."
Report of the Committee on the Financial Aspects of Corporate Governance (the UK Cadbury Code), London, 1992.

What is Corporate Governance?

Corporate governance refers to the structures and processes for the direction and control of companies. Corporate governance concerns the relationships among the management, Board of Directors, controlling shareholders, minority shareholders and other stakeholders. Good corporate governance contributes to sustainable economic development by enhancing the performance of companies and increasing their access to outside capital.

The OECD Principles of Corporate Governance provide the framework for the work of IFC in this area, identifying the key practical issues: the rights and equitable treatment of shareholders and other financial stakeholders, the role of non-financial stakeholders, disclosure and transparency, and the responsibilities of the Board of Directors. The OECD Principles are universally applicable to all types of corporate governance systems in countries at all levels of economic development. Since they were published in 1999, the OECD Principles have gained acceptance throughout much of the world as an appropriate framework for analyzing the corporate governance environments of different markets and as a starting point for developing approaches to evaluate the effectiveness of governance of individual companies. The challenge for IFC is to take this framework of international best practices of corporate governance and use it to add value to the wide spectrum of our client companies.

Why Corporate Governance Matters for IFC Clients

Access to Capital. Much attention to corporate governance issues in emerging markets among policymakers and academics has focused on the role governance can play in improving access for emerging market companies to global portfolio equity. An increasing volume of empirical evidence indicates that well-governed companies receive higher market valuations.* However, improving corporate governance will also increase all other capital flows to companies in developing countries: from domestic and global capital; equity and debt; and from public securities markets and private capital sources.

Improving Performance. Equally important and, irrespective of the need to access capital, good corporate governance brings better performance for IFC clients. Improved governance structures and processes help insure quality decision-making, encourage effective succession planning for senior management and enhance the long-term prosperity of companies, independent of the type of company and its sources of finance.

Why Corporate Governance Matters for IFC

Adding Value. Corporate governance is a priority for IFC because it presents opportunities for IFC to manage risks and add value to clients. In addition to the benefits to individual client companies, working to improve corporate governance contributes more broadly to IFC's mission to promote sustainable private sector investment in developing countries.

Reducing Investment Risk. It is in IFC's interest to reduce the risk of investments by improving the governance of investee companies. In the worst corporate governance environments, poor standards and weak enforcement continue to be a barrier to investment even for IFC with its mandate to work in frontier markets. Improving the corporate governance of investee companies allows IFC to work in higher risk environments. It should also bring an increase in the market valuation of companies and attract more investors, which together increase the opportunities for IFC to exit its equity investments on favorable terms. In recent years, IFC has worked with some of our highest-profile clients to improve their governance and to better communicate the quality of their governance to markets. Establishing best practices among high-profile clients has a positive demonstration effect that benefits other companies. By working with individual clients, IFC helps to increase the investment flows to developing countries.

Avoiding Reputational Risk. If IFC does not work to improve the corporate governance of client companies, then IFC takes on not only investment risk, but also a reputational risk for involvement with companies with poor governance or, in the worst cases, corporate scandals. This reputational risk is particularly serious where stakeholders in addition to equity

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investors stand to lose from governance abuses, such as, banks and insurance companies, where depositors and policyholders are vulnerable.

Developing Capital Markets. Improving corporate governance contributes to the development of the public and private capital markets.** Poor governance undermines the integrity of publicly traded securities and discourages the use of public markets as a means to intermediate savings. Poor standards of governance, particularly in the area of transparency and disclosure have been a major factor behind instability in the financial markets across the globe. This was seen in the case of the East Asian financial crisis of 1997, where so called "crony capitalism" combined with macroeconomic imbalances to interrupt decades of outstanding economic growth. Most recently, poor corporate governance contributed to the spread of corruption and fraud that led to the dramatic corporate failures in United States and Western Europe.

IFC's Comparative Advantage in Corporate Governance

IFC's Experience. Although the term "corporate governance" has only become widely used in recent years, IFC has worked on the key issues of corporate governance at the grass roots level for decades-- structuring client companies, appraising investment opportunities, and nominating Board members. This practical experience allows IFC to tailor global principles to the realities of the private sector in developing countries. Development banks and other investors working in emerging markets now look to IFC for leadership on corporate governance issues in developing countries.

Global Leadership. In addition to working directly with client companies, IFC plays a leading role in the global policy dialog on corporate governance and provides technical assistance to regulators, stock markets and others. In the former Soviet Union, China, the Middle East and elsewhere, IFC manages a set of large donor-funded technical assistance projects. IFC helps bring together corporate governance professionals worldwide. It co-sponsored the OECD Roundtables in Latin America and Eastern Europe and helped establish networks of Institutes of Directors in East Asia, Central and Eastern Europe and Latin America. IFC has convened meetings of international portfolio investors representing more than $3 trillion with local business leaders in Brazil, Russia and China to discuss what governance changes are needed to attract more capital.

Sustainability and Corporate Governance.

Corporate governance is one of the pillars of IFC's focus on sustainability following environmental and social sustainability. Better corporate governance increases the likelihood that the enterprise will satisfy the legitimate claims of all stakeholders and fulfill its environmental and social responsibilities. Accordingly, it contributes the long-term, sustainable growth of client companies. A company that is well-governed is one that is accountable and transparent to its shareholders and other stakeholders (such as, employees, creditors, customers and the wider society). In consequence a company with good corporate governance is also likely to improve in other aspects of sustainable development such as the environment and social development.

Further Reading

IFC, Annual Report 2002, pp.14-15, 23-25, 59, 68.
OECD, Principles of Corporate Governance, 2004.

La Porta, Rafael, Florencio Lopez-de-Silanes, Andrei Shleifer, and Robert Vishny, "Investor Protection and Corporate Valuation," Journal of Finance. Vol. LVII, No.3. June 2002.

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