GOVERNANCE

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A different form of governance

'Co-operatives such as Outlandish show that one can achieve the holy grail of marrying sound structures and processes with good behaviours and values, and thereby achieve good commercial, ethical outcomes for clients.'

Richard Smerdon

Governance in Latin America

'However, closer study of the firms listed on the BVL suggests that as firms internationalise either for finance or to access markets, good governance is becoming integrated into the business model so that regional firms operating in Peru or large so-called trans-latinas have significantly better compliance.'

John Lawrence

Content

Feature

Governance in Latin America

John Lawrence looks at the development of corporate governance in Peru.

Since the so called Washington Consensus of the 1990s when international financial institutions responded to the Latin American debt crisis by imposing macro-economic policies on the main economies in the region as a condition of debt rescheduling and debt forgiveness, there has been a parallel activity in exporting the institutions necessary to maintain what were believed to be more effective economies. However, these institutions have had to be adapted to fit with local cultures and do not necessarily mean the same as they do in the UK. One example of such an export was the progressive introduction of voluntary corporate governance codes in seven Latin American countries at the instigation of the OECD between 1999 and 2013.

I had the opportunity to study the introduction of one such code in Peru as part of a Master's dissertation and analysed the level of compliance with the code by the 208 firms on the Bolsa de Valores de Lima (BVL) from 2014 to 2017. The results of this work are a fascinating story of similarities and contrasts with how corporate governance is perceived in the UK. For investors in Latin American economies, whether as financial investors seeking alpha or as direct investors seeking partners, and for regulators planning new voluntary codes in the region, the research provides some valuable insights.

On the face of it, Peru should offer attractive opportunities for investment: the country has achieved 20 years of uninterrupted growth in GDP as a result of a clear macro-economic strategy and has just announced a five-year infrastructure development programme of c$120bn involving some 300+ projects. However, the stock market is relatively small compared with those in G7 countries as a percentage of GDP at less than half the G7 level of market capitalisation and at less than a tenth in terms of trading level. A small population of c 40 firms actively trade equity and for those firms, the float publicly traded tends to be a small proportion of equity.

Peru has had a poor track-record regarding the rule of law, and this can be expected to carry over to low respect for soft law such as a voluntary code. Peru was rated in 2014 as 62nd of 99 countries globally in the overall WJP Rule of Law Index and for Regulatory Enforcement 61st out of 99. These weaknesses in the regulatory framework were compounded by greater weaknesses in adjacent institutions: Peru earned poorer ratings for the level of perceived corruption in the executive, judiciary and legislative branches (79/99) and for the weakness of the criminal (67/99) and civil (83/99) justice systems.

The level of compliance with the 2013 Code varies significantly between firms and in no way resembles that in the UK; average compliance appears to be relatively low at c 63% average compliance with the Code but ranges from 25% to 98%. Some firms take compliance seriously, but many do not.

Also, the level of average compliance has remained static between 2014 and 2018. This is in stark contrast to the UK where the percentage of FTSE firms that comply 100% with the UK Code rose from 68% to 72% in the year to 2018. This is not because there are not ambitious targets for improving corporate governance in Peru, rather, the government agencies are absolutely committed to maintaining their grip on macro-economic policy and have not devoted their full attention to improving governance.

That said, the business culture in Peru has a very distinct character because of Peru's economic history of severe macro-economic instability and this is reflected in how firms have responded to a voluntary code. Typically, the corporate sector is characterised by family-controlled conglomerates with horizontally diversified businesses in low value-added sectors where they can secure dominant market shares. In 2015, just 42 business groups owned 177 of the firms listed, including three of the top four banks, the two largest insurers and two of the four pension funds. These firms have traditionally been wary of 'outsiders' so key aspects of the Code such as the introduction of Independent Non-Execs (INEDs), external board evaluations, introduction of rules governing third-party transactions and protection of minority shareholder rights are not adopted in quite the same way as they are in the UK. Analysis of compliance by question shows that 27 questions from the 88 in total receive less than 50% compliance, and most of those questions concern outsiders; whether participating at the board, evaluating board performance, attending the AGM or requiring transparent reporting for third-party transactions or corporate actions.

For example, the 2013 Code generated a notional demand for 624 INED roles ie three INEDs per listed firm. There was a very limited supply of INEDs in the country and only recently have substantial resources been devoted to INED training through EY, the BVL and the leading universities. Even if a firm were to comply with the Code, the stipulated quota of three INEDs would not put INEDs into a majority position on boards and so their role in challenging management, contributing to strategy and ensuring compliance may be muted for the time being. Many boards interpreted 'independent' in their own way because, until 2019, there was no single definition of what this term meant in practice, and some INEDs were thought to behave more like consultants but would not gainsay a majority shareholder decision. In addition, many boards operate on a parliamentary basis and so integrating people with no financial

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interests in outcomes represents a cultural shift in board practice that has yet to become embedded.

Another cultural shift taking place is the understanding that Code compliance should map onto a culture of good governance throughout the firm. My research revealed several examples of firms with high Code compliance ratings, yet they continued with practices that would be more suited to a private company rather than a listed one and would not be in the spirit of the Code. EY and BVL run an excellent survey of the attitudes of 315 market participants every year (La Voz del Mercado - LVdM) and rate firms according to their governance.

There is not a perfect match between the Code compliance scores and the LVdM ratings (in both directions ie some firms with high compliance scores score less well on the LVdM ratings and vice versa). This suggests that the Code has some way to go to be a fool proof way of reflecting governance standards in Peru. However, closer study of the firms listed on the BVL suggests that as firms internationalise either for finance or to access markets, good governance is becoming integrated into the business model so that regional firms operating in Peru or large so-called trans-latinas have significantly better compliance.

These differences may be because operating abroad is seen as riskier and firms instinctively tighten up their governance procedures; and because operating an international business is complex enough without adding the uncertainty that informal governance generates so it makes sense to incorporate it into standard procedures.

In terms of minority shareholder rights, the Peruvian stock market has traditionally lacked institutional investors and elsewhere, these are key actors in shareholder activism and in scrutinising firm behaviours. In the past, this has been such an issue that one academic said that in Latin America, the classic agency problem existed between majority and minority shareholders rather than the classic form between shareholders and managers, and is common in civil law jurisdictions that follow the French model. The problem does not just affect small retail investors but even those with material investments. There is now a rapidly growing pension fund sector with four firms which are becoming more active in terms of recognising good governance as an investment criterion and engaging with listed firms, but they have some way to go to be considered influential investors.

The good news is that the situation is gradually improving. Boards do have independent directors and the regulators do have a handle on what is going on in firms. The change process has been gradual, some might say slow. Yet in 2017 business culture in Peru experienced a significant shock because the Odebrecht scandal that started in Brazil in 2014/2015 hit the press in Peru. Odebrecht was the largest construction firm in the region but also had by far the biggest slush fund for influencing decisions on awarding government contracts. In April, Alan García committed suicide for his alleged involvement in the maelstrom and when I was in Lima in May, the Sunday paper had 60 new photos of people being indicted for their involvement. Peru has the record for the largest number of Presidents imprisoned because of corruption and the conclusion should not be that only Peru has corrupt leaders! As a result of the impact of Odebrecht, both state agencies and civic society have become more serious about promoting good governance, strengthening regulators, stimulating the wider capital markets and training INEDs and as new generations of family members with international experience and MBA training take over control of firms so things are likely to start improving.

John Lawrence is a graduate of the Financial Times Non-Executive Director Diploma and holds three non-exec roles. He also has an MBA from LBS, an MSc in Latin American Development and is currently on the Doctoral programme at the UCL Institute of the Americas.

Conference News

ICGN 2019 Global Stewardship Awards 26 November 2019

A cornerstone of ICGN's policy programme relates to investor responsibilities and making effective stewardship a reality. The second Annual ICGN Global Stewardship Awards celebrate excellence in stewardship and will be presented in London on 26 November 2019.

The Awards Dinner will follow the Global Stewardship Forum, featuring leading experts from around the world.

This year there are four award categories:

- Stewardship Champion (individual, organisation or collaboration)
- Stewardship Disclosure - Asset Owner
- Stewardship Disclosure - Asset Manager (>$60 billion AUM)
- Stewardship Disclosure - Asset Manager (<$60 billion AUM)

For more details go to https://www.icgn.org/events/icgn-2019-global-stewardship-awards

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