

***The Economic Society of Singapore Annual Dinner  
Wednesday 13 July 2005***

***“Shareholder value: Corporate governance, boards and  
CEOs”***

Dr Khor Hoe Ee, President, Economics Society of Singapore,  
Friends,  
Distinguished Guests,  
Ladies and Gentlemen:

As a wide-eyed 18-year old, I took up engineering on the assumption that it is easier for an engineer to pick up economics than for an economist to pick up engineering.

I had heard that it was pretty hard to find a one-handed economist who will come to a definitive conclusion. An engineer, on the other hand, will make clear decisions based on hard facts, logic and the realities of science and physical laws. I thought I could help build a better world as an engineer.

I soon learnt my mistake.

***Role of Economics***

Just as a set of accounting statements simply sums up a cascading series of considered judgments at a point in time, the best of engineering too is a series of trade-offs between desires and constraints, of judgments of the art of the possible against the odds of the improbable.

Likewise, economics can provide a practical framework for public policy and cost-benefit tradeoffs that can impact the lives of people for better or worse. Sound economic policies, sometimes seemingly heartless, can form a sustainable blueprint for a society's development and well-being in a practical and efficient way. The wrong economic policies, no matter how well intentioned, will introduce distortions and serious misallocations of resources which will ultimately subvert the good intentions in the most counter-intuitive ways.

### **Tribute to Economists**

Tonight, I want to make amends for my youthful mistake to pay tribute to all economists, and especially to those who have helped frame the pragmatic policies and trade-offs for our society. They helped set Singapore on a path of progress and development 40 years ago. Many in the audience tonight have personally experienced the dramatic change in their own life times. Indeed, many Singaporeans graduated from sleeping as children, together with several other siblings with feet tucked under the one shared bed, to owning their own apartments where their own children have their own beds.

In particular, I want to make special mention of Dr Goh Keng Swee, one time deputy prime minister of Singapore, and the architect of Singapore's economic miracle. He recognized the role of human capital long before talent and human capital became buzzwords in vocabulary of management consultants. He reasoned that if labour was the key, then China and India would have been leading economies over the past few centuries. If

resources were the key, then Africa would have been a bright prosperous continent. And so, among his many bold ideas and innovative initiatives, he pushed for the development of human talent and invested in education as the key to unlock the potential of an impoverished population on a bare granite rock.

Dr Goh was also very clear about the dangers of misguided good intentions. Do not add more rules, he admonished his bureaucrats – there may be unintended outcomes if you do not know what the market knows. In other words, Dr Goh believed in leaving as wide a space as possible for the market to operate instead of fostering a dirigiste hand of micro-managing planners and regulators. That was how a young democratic socialist government came to adopt a free market economy.

### **Elements of a Thriving Economy**

Within a robust market economy framework, businesses can grow and thrive, people can learn and earn a living, and communities can progress in harmony. However, an economic framework is a necessary but insufficient condition for a society to grow and progress in a fair, just and efficient manner.

To give substance to the dream and vision, several elements are needed: a clean, honest government and an efficient minimalist civil service, to form the solid foundation for the house; an innovative and dynamic business community, with businesses and companies forming the bricks; and a value system of integrity and honesty, which provide the glue and mortar to hold the bricks together in a strong leak-proof structure. Within the walls, resilient

family units, ethical values, education, healthcare, justice and security form the pillars and rooms to make the house a home.

This evening, I would like to share some perspectives on governance and shareholder value, and the roles of board, mgt and CEO, as one vital component for a vibrant economy in the context of a fast globalizing world.

### **The original business unit**

The business firm or company is the basic productive unit of an economy.

In the hunter-gatherer phase of human development, the basic productive unit is also the family – you eat what you gather or hunt.

As civilizations formed, you may increase your productivity by working co-operatively in villages, clans or cities. You may even have pepper futures in India or paper money in China. True, you may also borrow from your extended family or friends to fund the caravan expedition, but the basic ownership structure was the individual, with his family as his labour force.

### **Evolution of the modern business unit**

The word of honour was very important. You judge whether to lend or help finance a major expedition, through your assessment of the integrity and capability of the man you know directly. In the pepper trade of Malabar during the Zheng He voyages of the 15<sup>th</sup> century, pepper traders of Cochin agreed on contracts, put their hands together with brokers and accountants, and under the watchful eyes of the Maharaja's personal representative, recited

the pledge “whether the price be dear or cheap, we will never repudiate it or change it”. Everyone was bound by the legal contract, and was morally bound by it as well. And yes, the maharaja’s personal representative was an important part of the governance and compliance system. The enforcer, as people would say.

In the absence of enforceable laws or the bounds of moral obligation, high interest rates and strong-arm harassment tactics were the twin tools of trade for lenders and investors to secure sufficient risk adjusted returns against potentially dishonest or defaulting borrowers. This was why moneylenders in under-developed societies got themselves the loathsome reputation of being loansharks, and gave usury a bad name.

With industrialization, impartially regulated markets became the more efficient process to bring strangers together as lenders and borrowers. Laws were enacted to throw contract cheats and loan defaulters into jail. Banks grew in place of loansharks as regulated intermediaries between lenders and borrowers.

Modern business organizations began to take shape. Strangers can subscribe to shares, whether to fund a tea and spice expedition or to build a ceramic factory. Unlike the owner chef deciding each year, based on his own sense of honour, obligation and gratitude, how much of his restaurant profits to share with his former boss who had given him retirement money to start his restaurant business, the share owners of today’s world have formal and legal rights to the profits and assets of the company through the bylaws and memoranda of articles. Shareholders no

longer needed to wait for the ship to return before they can tote up their share of loss and profits.

Thus was born the idea of shareholders and shareholder rights in a modern business enterprise.

### **Shareholder value in modern businesses**

Strangers and shareholders, no different from owner founders or chef owners, invest with the expectation of returns. Just as management and labour put in effort in return for wages, shareholders put in capital in return for profits. They take the first risk of loss, in return for the first right to the profits.

If there were no adequate returns, there will soon be no shareholders willing to invest in the enterprise. Even government shareholders are entitled to a proper return for their investments like any other shareholder. Their resources may be larger and hence may seem limitless, and their investment horizons may be much longer and hence their patience seems boundless, but without the same discipline of expecting a proper return, governments and countries like individual or institutional shareholders will eventually become paupers.

As enterprises grew and became more complex, owner founders began to recruit beyond their family and coterie of friends. Specialists and professionals began to form the core of business management. Some founders retired and passed leadership not to family members but to unrelated but trusted and proven professionals. Other owners sit on boards together with advisors,

friends or partners to supervise the company, leaving the day to day operations to professional management led by a CEO.

And so emerged the modern business structure, with owners and investors as shareholders, management as the operational executives, and boards as shareholder trustees to guide, supervise and oversee management in order to create shareholder value.

### **The board as shareholder trustee**

The issue of governance today needs to take into account the wide spectrum of shareholder configurations, ranging from sole proprietors and family owned businesses, to large corporations with diffused ownership.

The role of the board as a dependable trustee to safeguard shareholder interests becomes critical. This is what is meant by the fiduciary duty of the board, ie the duty as a trustee to act in the collective interests of all shareholders.

Take a simple example of a takeover situation: the management may choose to preserve their jobs, rather than accept a bid which gives the best returns to shareholders but lose them their jobs. This is known as the agency problem.

Of course, matters are usually not so simple. Some shareholders may prefer a short term immediate gain, through the sale, while others may see more potential for the company to grow further and derive better future income flows. Ideally, the board should base its recommendations on a realistic assessment of the net present value of the various choices available to the shareholders. But

ultimately the choice is for the shareholders to make, individually and collectively, at a shareholder vote. This is the right of the shareholders, which neither management, nor board, nor regulators should usurp.

A more common example of a board's oversight role on behalf of shareholders is the structuring of proper incentives for management. Again, the aim is to align management to shareholder interest, perhaps with a balance of short and long term incentives.

In this role, the board should be independent of management in order to undertake this duty objectively. It is not acceptable to incentivise management at the expense of shareholders. Thus, it makes eminent sense for a board remuneration committee to be independent of management, rather than of shareholders. This is also the reason why shareholders have the vote on directors' fees and compensation as well – to align the board too with shareholder interests.

In the recent case of a global investment bank, the shareholders would logically and most certainly have made a different decision from the board on the separation package for the high profile departing CEO. Many observers believe that the board had failed to act in the interest of shareholders, and was compromised by a misguided sense of loyalty and personal friendship to the CEO.

The CEO compensation issue becomes more involved in the case of family owned companies. Often, the CEO in a family controlled company may also be the chairman as well as owner shareholder. Thus, the owner chairman or owner director should not be involved

in the setting of CEO incentive or compensation. The issue is not about having a compensation committee that is independent of the shareholder. Rather, it is an important guiding principle that the interested beneficiaries should not be party to deciding their own compensation for themselves. Hence, the board remuneration committee should be free and independent of management as interested beneficiaries, rather than being independent of shareholders per se.

### **Conflicting shareholder interests**

But shareholders are not a homogenous group. They are no longer simply friends who trusted the founder and invested in him. Instead, you may have a complex mix of institutional investors with professional investment expertise, small retail punters interested in the next rumour to cash out, retirees looking for reliable income flows, family or founder shareholders, management and staff with stock plans, as well as short term hedge funds, long term pension funds, and even competitors and others.

Thus, judging what constitutes shareholder interest may be tricky. A hedge fund manager may bet on a directional movement of the share price in the event the company runs into trouble. He has zero interest what happens to the company so long as the directional movement gives him his returns for that week or month or quarter. Others may arbitrage between competitors. While they serve a useful function to seek out and eliminate the imperfections of the market, their interests are by no means aligned with other shareholders.

Therefore, in the modern economy, you have a complex interplay of different shareholders, board and management, with various inter-group and intra-group conflicts of interests.

### **Critical board functions**

The board in such a complex environment has 4 critical functions.

#### **- Guidance & Direction**

The first is to guide and direct management steadily, professionally and objectively. In this role, the board will normally work closely with management to map out strategies, spot gaps, critique plans, and to serve as a foil for the management to bounce off and refine ideas. The board functions as an experienced guide, friend and mentor of management by offering expertise, experiences and suggestions to further the business goals of the company. It also makes decisions on strategic choices, and takes responsibility for steering the business forward. In an emergency, the board may even take over the executive role in a company.

#### **- Independent management oversight**

The second role of the board is to provide independent oversight of management and hold management to task for delivery of results. This is the supervisor role. Here, the board needs to be independent of management in order to maintain its capability and capacity for objective judgment. They need to maintain clarity between their friendship and loyalty to the CEO and management, either from social or long association, and their fiduciary duty as the trustee of shareholders.

- Management evaluation and succession

Third, the board is responsible to ensure a strong management is in place. It has the responsibility to both hire and fire the CEO, and determine his or her incentive. This is by far the most sensitive, most awkward and yet most critical function of the board. To do this well, the board needs to continually and regularly assess management and succession options, and take an interest in getting to know the different management levels beyond quarterly interactions with the CEO. No board should be held to ransom by the CEO.

For boards which do not yet have a succession planning or CEO review process in place, it can be awkward to raise this. The decision to fire a CEO too is often taken too late, and usually after everyone else in the company and perhaps the investment community have come to that conclusion. This is even more so when the CEO is also owner and chairman of the board.

It is for partly for this reason, that it is ideal to consider a separation between the office of the board chairman as the leader of the board acting independently of the CEO, and the CEO as the leader of management. While it dents the ego of the CEO a little, having a separate chairman position is a constant reminder that the CEO and management team are ultimately professionals with a responsibility towards their shareholders. Regular executive sessions of the board without the presence of CEO and management allow the board to discuss CEO performance, compensation and succession freely and frankly. It helps to keep a healthy distance between the board and CEO.

Nomination committees are also very useful for the purpose of keeping the board spry and relevant, and membership selection independent of undue CEO influence. Of course, election of directors are the prerogative and right of shareholders. Shareholders exercise these rights regularly at shareholder general or extraordinary meetings. Thus, it is illogical to structure the nomination committee to be independent of shareholders. Indeed, many of the failings of boards can be traced to the failure to maintain objectivity and independence from a CEO, especially one who has been seen to have delivered, or one who is dominant or a friend.

- Proper conduct and compliance

Fourth, the board has a duty to ensure that the company and management comply with the laws of the land, and understand the risks of the business. Business risks in the modern context typically extend beyond single location business operational risks. It may include a complex range of exoteric financial and structured risks, as well as compliance and regulatory risk in a multi-national and multi-jurisdiction spread of operations. Since the board does not typically get involved with the day to day operations, it can fulfill this role only by careful attention to the systems and processes for compliance and risk management, and by their judgment of management integrity.

- Integrity as the glue

Ultimately, the proper functioning of a board and management in a company depends on integrity. This includes integrity at the institutional, professional and personal levels.

The simplest level is honesty at the personal and individual levels, to know what is personal and what belongs to the institution, and not to cheat and steal.

The second level is professional integrity – to have the courage to act objectively and professionally, and keep the obligations of friendship and personal loyalty separate from the call of professional responsibilities and duties. This applies to both board and management as well as other professional service providers and regulators.

Finally, institutional integrity requires an ethical culture within the board, management and staff to walk the talk, and protect and add to the reputation of their institution. Those who make use of institutional positions or reputations for their own personal interest are guilty of destroying the institutional integrity.

### **Governance framework**

As you can see, quite apart from the already difficult business of earning a dollar from customers, day in day out, in a highly competitive and volatile market, and growing your business in a rapidly globalized world, boards, managements and CEOs have to manage a complex web of regulations and relationships through thoughtful and professional governance processes.

As McKinsey defined in a 1996 survey, a well-governed company is responsive to investors, and has a board that is sufficiently

independent of management to hold management accountable to shareholders.

- Level playing field

In other words, the purpose of modern governance is to protect shareholder interests and rights, reduce conflicts of interest and enable fair treatment of all shareholders, especially but not limited to minority shareholders. Discrimination against major shareholders or family shareholders is based on the misguided hope of preventing the inevitable few black sheep from making mischief. It is simply not possible to legislate crime and risks out from business and society, unless you stop everyone from doing anything at all.

- Substance over Form

Governance is not about ticking the rule box. In the Enron case, each transaction in the chain fulfilled the rules of form, but taken as a whole, were entirely improper in substance.

- Calculated risk taking

Like the caravans of old, modern business is about taking risks, in return for rewards. It is not a straight line linear relationship between input and output, efforts and results. The best designed system may not necessarily be the winner. In every venture, there are market risks, execution risks, financial and economic risks. Consumer fads are unpredictable, and timing and luck counts too. There will be failures even with the best of intentions and the best of execution.

Therefore, corporate governance is not about the absolute reduction of risks. Without risks, we will at best be looking at risk free returns of government bonds and treasury bills, or returns from money kept under the mattress or in the home safe.

### **Conclusion**

In conclusion, as we continue to refine and modernize our governance guidelines for the next phase of our development as a regional and global business hub, it is even more important that we recognize and celebrate the presence and rights of shareholders. They are the capital providers to drive investments, innovations and returns. Family shareholders and individual entrepreneurs continue to be the engine of new enterprise formation, and should be encouraged and applauded, and not conscribed. Institutional shareholders drive value and professionalism, and should be co-opted to help set professional standards.

Regulators must not believe they can micro manage the business better than the market – or better than the boards and managements of the businesses in the market – or better than the shareholders whose capital has been put at risk. Indeed, regulators should put shareholders at the centre of the effort to improve governance, be they major shareholders, institutional shareholders, minority shareholders or family shareholders. All other players, whether regulators, lawyers, accountants or academics, play a supporting role in driving for shareholder value on a fair footing, much as the maharaja's personal representative did several hundred years ago in Cochin.

We should also not mix up the roles of the individual as shareholder, board member and CEO, when formulating rules of engagement.

Most of all, let us not believe that form can replace substance. Rules cannot substitute for integrity, nor can rules eliminate risks.

We need regulators to entrust the board and management with as wide a space as possible to make their business judgments, manage their business and innovate within the bounds of ethics – remember what Dr Goh said. The corollary is that we do require regulators and prosecutors to punish criminal acts of cheats and crooks out to defraud others.

When in doubt, we should simplify rules, instead of adding to complexity. And let the market determine the outcome, under the active participation of shareholders of all stripes and colours.

The market needs a simple framework that is clear and practical, with clear principles of shareholder rights, and of substance over form. This helps to foster thriving, dynamic and innovative businesses, more than any number of speeches exhorting the business community to be innovative and grow boldly.

May I end by wishing all of you good health and prosperity in the year ahead, and also congratulate the winners of the MAS-ESS Essay Competition.

Thank you.