Improving board performance in emerging markets
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The pressure keeps growing for companies to tackle a range of governance issues.

Improving the effectiveness of boards is a priority for corporations everywhere, but in emerging markets it is especially important. In most emerging markets, the institutions that help guard against corporate malfeasance—securities regulators, stock exchanges, the judiciary, institutional investors, equity analysts, accountants, and a probing media—are still relatively weak or lack critical mass. Boards may therefore be the most robust line of defense. As India's technology giant Infosys Technologies acknowledges in its annual report, "An active, well-informed, and independent board is necessary to ensure the highest standards of corporate governance."

The issue of sound boards is also well to the fore because of their clear link to the cost of capital. In 2002 McKinsey's global investor opinion survey showed that equity investors would pay a premium of 20 to 40 percent for emerging-market companies with strong boards of directors. More recently, a study by the Asian Development Bank Institute found that South Korean and Indonesian companies whose board-effectiveness ranking rose from the median to the top quartile saw their market value increase by 13 to 15 percent.1 In South Africa Mervyn King, the judge who headed the drafting of that country's corporate-governance code, observed that foreign capital flows to places that exude a "perception of good governance."

Debt investors too are paying more attention to corporate governance in emerging markets. In 2005 Moody's upgraded the credit ratings of issuers such as GS Caltex and SK Corporation (South Korea) and Lukoil (Russia), in part because of their improved governance, including developments at the board level. Our own experience confirms the significance of these trends. One financial institution in an emerging market, for example, recently set out to use governance reform as a way of achieving a higher valuation for its impending IPO. Another cited the possibility of an improved credit rating as a principal reason for reviewing its governance practices.

Although many companies in emerging markets are responding to the pressure for higher standards, a range of cultural, legal, structural, and operational issues not encountered in more developed economies hampers progress at the board level. Attempts to import best practices from Western countries tend to be frustrated. Governance changes that are accepted locally in principle—notably, more independent directors, the introduction of board committees (for instance, an audit committee), and the development of a written board charter—can be superficial exercises in practice. As a result, boards in emerging markets rarely get to grips with core issues, such as strategy, talent, and risk management, or with efficiency questions, such as information flows and the allocation of time.

Our work with companies across the world has helped us identify six characteristics that significantly influence the effectiveness of corporate boards in emerging markets: a high concentration of ownership, weak recruitment processes and a shortage of experienced directors, poor focus, an inadequate supply of information, complex cultural traditions, and underdeveloped legal regimes. Only by grappling with and understanding these issues will companies in emerging markets create effective systems of board governance.

A high concentration of ownership
In contrast to the Anglo-Saxon world, where corporate ownership is typically dispersed among many shareholders, a high percentage of listed companies in emerging markets have a dominant shareholder, whether a family or the state.

The Asian Development Bank Institute study mentioned earlier, for instance, found that only 6 percent of the surveyed listed companies in Indonesia and South Korea have diffused ownership, with no controlling shareholders; the figures for Thailand and Malaysia are slightly higher, at 15 and 23 percent, respectively.2 The first step in improving the effectiveness of corporate boards is therefore to secure the support of these owners, since they have the means and incentive to exert influence on their companies—for example, by appointing and removing directors. Without that support, boards will at best be limited to their legally mandated "watchdog" role (focusing on compliance and on protecting minority shareholders against expropriation) but won't be in a position to contribute to the business of the companies they serve.

Many companies are still run by a founder who is reluctant to give authority to a professional board

A growing number of governments in emerging markets have sought to improve the governance of state-owned enterprises, starting at the top with the board of directors.3 In Singapore, where government-owned Temasek has long embraced the virtues of good governance, companies such as Keppel and SingTel are now exemplars. The governments of China and Malaysia recently launched high-profile initiatives to improve the governance of their state-owned companies. In Malaysia these efforts have included the creation of a Management Leadership and Directors Academy to enhance the skills of board members and the development of a policy manual to help the boards of state-owned companies become more effective.

Getting family-owned enterprises to support board reform is often more difficult. Many successful ones in emerging markets are still run by a founder who, having built the business from scratch, can be reluctant to devolve authority to a professional board. As control of such companies passes to a younger generation that is usually more familiar with Western corporate-governance practices, the level of support for effective and professional boards usually rises. At one large Asian garment manufacturer, the second-generation CEO, who was educated in the United States, had no compunction about recruiting outside directors in order to secure a detached and independent perspective and additional expertise. At CLP Holdings, a Hong Kong-based utility in which the Kadoorie family has a substantial interest, third-generation family member Michael Kadoorie has spearheaded efforts to make the company a model of corporate governance. Today 6 independent directors sit on the 17-strong board, and CLP has received a number of good-governance awards.

Our own study of 11 large family companies, in both emerging and developed markets, that have flourished for many generations—the youngest is in its 4th generation, the oldest in its 11th—underlines a strong board's contribution to this form of enterprise.4 All of the companies in the survey have professional boards with a substantial number of outside directors. These boards help to create value by bringing complementary skills into the enterprise, providing a formal mechanism to separate business from family matters, and ensuring a smooth succession of management from one generation to the next.

Weak recruitment processes and a shortage of experienced directors

In any country, improving the effectiveness of boards calls for recruiting the right people. That lesson certainly hasn't been lost on the authorities in many emerging markets, where expropriations of minority shareholders have prompted reforms emphasizing the appointment of independent directors—people who have no financial relations with (or other material ties to) the organizations on whose boards they serve. Yet companies in developed and emerging markets alike increasingly realize that independence on paper isn't enough. Board members should also be people who can provide sound business advice and real expertise as well as engage effectively in group settings. As Jamshed Irani, an executive of Tata Group, has noted, the problem isn't "the number of independents but the quality of their contribution."

Unfortunately, a lack of professionalism and rigor in the recruitment process means that most boards in emerging markets fall short of Irani's aspirations. Many companies undertake little or no analysis of the skills and experiences that board members must have to carry out their responsibilities and don't vet candidates thoroughly.

To find the right people, boards in emerging markets can supplement the informal approach that many companies have adopted—word of mouth and personal networks—with the greater professionalism that an executive search firm can bring. In addition to skills and personal qualities, a key question is whether a candidate has enough free time to merit the appointment. When CLP Holdings was considering Hong Kong business professor Judy Tsui for its board, for example, an important topic of inquiry was the amount of time she could devote to board matters.

Nominations committees, which ideally should be responsible for identifying and screening candidates, have become commonplace in the United Kingdom and the United States but are only now starting to appear in emerging markets. Although directors in these countries are often appointed by the controlling shareholders, a growing number of companies (such as CLP and SingTel) have formed nominations committees as part of their efforts to upgrade their governance practices.

Given the dearth of suitable directors locally, companies in emerging markets may wish to follow the example of Lukoil, SingTel, and the South Korean steelmaker Posco by inviting foreigners to join their boards. But great care must be taken to ensure that anyone chosen understands not only the company and the industry but also the country and its culture; for instance, an Australian, who sits on the board of a Thai bank, has spent more than 30 years practicing law in that country. In some cases, boards appoint experienced foreign (or local) directors as mentors to provide new board members with guidance.

Poor focus

In our experience, most boards in emerging markets fall into one of two camps: they are either too interventionist or too passive. As a result of an unclear division of responsibility between the board and management, a shortage of management talent, and poor prioritization among tasks, many boards in emerging markets end up spending too much time on operations, investments, financing, and other short-term matters. They therefore don't devote enough attention to long-term topics, such as strategy, CEO succession, and leadership development.

At one financial institution we know, for example, the board convened 19 times in 2004, for five to seven hours at a sitting, because very few matters had been delegated to management. Areas that would normally be its preserve are often handled by boards in emerging markets because experienced executives are in short supply or boards don't fully trust the executives they actually have. In some instances, though, overly enthusiastic directors are to blame for a board's encroachment on management's turf. At one Latin American company, for instance, a nonexecutive director who serves on the audit committee visits managers at business units regularly to check the effectiveness of financial controls, thus bypassing the internal audit chief, who has primary responsibility for this function.

Such inefficiency compromises the ability of many boards to attract and retain talented people. At one company, two directors noted for their dedication and thoughtful contribution resigned out of frustration with the board's poor focus. One of them told us, "If the company wants to have good board members, it should utilize our time in a more effective and efficient way."

At the other extreme, some boards abdicate their responsibility for strategy and performance, talent, and risk management to executives or controlling shareholders. While it is management's responsibility to develop detailed plans in these areas, the board should provide meaningful input. At an Asian company well regarded locally for its governance practices, for example, the board's charter doesn't make oversight of the CEO succession and the development of leadership a core responsibility.

One director of another Asian company told us that during his 12 months on its board, he couldn't recall any discussion of strategy, performance management, or talent development.

Some boards are starting to correct the imbalance in their focus. The board of one bank in an emerging market recently defined clear roles for itself, the chairman, and the CEO and reduced the amount of time it spent on credit decisions by concentrating on the 30 percent of loans that represent 80 percent of total loan volumes and by setting up a credit committee. With a substantial amount of time freed up, the board can now have more productive discussions on strategy and other long-term issues. At an Asian conglomerate we know, the board has started to schedule full-day yearly meetings devoted entirely to strategy and to talent management.

In family companies, the family's view on potential CEO successors usually prevails, but the board can still play a constructive role by formalizing the succession-planning process and providing greater objectivity in evaluating promising family and nonfamily executives. Moreover, these companies can no longer assume that the next generation wants to be involved in the business. None of the three children of the man who founded one family-owned bank, for example, had any desire to go into it, because each of them was already pursuing a successful professional career.

An inadequate supply of information

In our view, real independence comes from possessing deep and reliable knowledge. But boards in emerging markets often receive too little of it—or the wrong kind. One Southeast Asian nonexecutive director complained to us, "I don't get enough information from management and must do research on my own to get the information that I need." In the Middle East, another nonexecutive director noted, "We don't get such things as competitor analysis, articles on our industry, and recent developments, which would help us fulfill our basic responsibilities."

At some companies, the board receives stacks of data but little useful information that would aid constructive discussion and decision making. One bank director told us, "I get a thick binder before every meeting. We do not get the reports that we need. Instead, we get a lot of paper on a facility up for renewal, while a one-page summary with key information on customer financials and relationships would be enough."

A multitude of reasons can explain this information gap. At some companies in emerging markets, management wants a pliant board and keeps nonexecutive directors in the dark. In any case, as in Western companies, nonexecutives face a huge information asymmetry compared with management; if the latter won't cooperate, the former probably won't be able to acquire a deep and accurate understanding of a company. Of course, a director in such situations can in theory resign—and some do—but as a practical matter, in emerging markets too many nonexecutives treat their positions as sinecures.

In other cases, management may not understand the type of information that is most useful to the board, perhaps because of poor communication on the board's part about what it would find most helpful or management's failure to grasp the board's need for high-level, synthesized information. The chairman of one Asian conglomerate, who sensed that its board needed a better understanding of its expanding business portfolio, recently asked management to organize briefings on the various operating units.

Management should furnish information that lets the board develop an accurate picture of the company's current performance and underlying health (that is, the ability to sustain performance over time). A survey McKinsey conducted in 20055 revealed that boards in emerging markets are even more eager than their counterparts in developed ones for additional information on financial matters and on nonfinancial topics such as markets, external networks, organization, and operations (even boards that are excessively engaged in operational matters may not be receiving all of the relevant information).

Some companies are responding: Hong Kong's Mass Transit Railway (MTR), for instance, provides its board members with financial and nonfinancial metrics (such as passenger delays, ticket rejections, and the performance of escalators) and links its performance on them to the compensation of the management team.6 Of course, companies must strike a balance between improving the board's understanding of operations and encouraging it to tinker with train schedules or purchasing decisions that are clearly management's responsibility.

Some companies in emerging markets are striving in other ways to broaden the types of information available to directors. The board of one Asian conglomerate now meets in a number of different locations to give the directors an opportunity to visit its far-flung operations. At CLP, the audit committee recently toured the facilities of a newly acquired company to learn more about it.

Complex cultural traditions

With few exceptions, effective boards reflect a culture in which ideas flow freely, constructive dissent is encouraged, and the level of respect and trust among members is high. Many of the ideas discussed previously—such as recruiting intelligent, independent-minded, and committed directors, structuring their meetings to allow meaningful discussion, and arming them with relevant knowledge—contribute to a strong board culture.

Yet Western notions of healthy board dynamics—lively discussion and passionate debates—may not fit well in cultures where open disagreement is frowned upon or seniority and hierarchy dictate relations in all spheres of life. In South Africa, for instance, it is difficult for a young director to challenge openly a more senior one, regardless of the merits of the argument. The same holds true in many parts of Asia. In these countries, boards use other means, such as expressing concerns in writing or in private dinners with the chair, to encourage the exchange of ideas and to handle disagreements.

Family-owned companies in emerging markets face a similar challenge when a family member chairs the board. Other directors, executive or nonexecutive, often defer to the chairman in such situations. To build a vibrant board culture, the chairman could allow nonexecutive directors to speak up first, give them opportunities to confer on their own, and appoint nonexecutive directors with high social and business standing.

Underdeveloped legal regimes

As definitions of independence tighten across developed and emerging markets alike, boards are increasingly expected to include people who have few or no family, business, or social ties to management or to controlling shareholders. Yet companies in many emerging markets must contend with underdeveloped legal regimes in which confidentiality and noncompetition agreements are hard to enforce. Some independent directors, knowing that they are unlikely to be punished, take advantage of this situation. At one Asian company, for instance, a nonexecutive director was observed calling a potential bidder to discuss the board's plan to evaluate the bids for a supply contract.

Faced with the choice of divulging commercially sensitive information to independent directors, with no assurance that it won't leak, or of keeping them in the dark, some companies in emerging markets choose the latter course. This reluctance to share information is especially understandable in countries where the courts are so inefficient or corrupt that the company, its shareholders, or other stakeholders (such as regulators) are in effect discouraged from taking action against directors suspected of bad conduct.

In countries where the legal regime is highly unreliable, boards can recruit independent-minded people who move in the social circles of the top managers or the controlling shareholders. Given the consequences of misbehavior to the social position and reputation of these people, they are more likely to act appropriately, but they are also unlikely to meet the technical definition of independence. Boards should consider each case individually, though at times they may well conclude that this trade-off is justified.

Nonetheless, there is a long-term imperative to strengthen the legal system so that the concept of the independent nonexecutive director can work in emerging markets.

In most emerging markets, as in developed ones, intense pressure from regulators, investors, and the media has put corporate boards in the spotlight. But directors and other stakeholders face unique challenges in emerging markets. Companies there will thus create a vibrant and constructive board environment only if they understand and address the structural, cultural, legal, and operational issues specific to them.

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