

Improving global frameworks for corporate regulation: an Australian perspective

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Through most of the latter half of the 20th century, forums for economic cooperation among nations were primarily focused on removing artificial barriers to free trade and investment across borders. With the growing recognition that the opportunities created by globalisation, particularly liberalisation of capital markets, carry significant risk, the agenda of organisations pursuing international economic development is increasingly directed at improving domestic standards of business regulation in areas such as corporate governance, insolvency frameworks and financial systems.

This article describes some efforts to improve the global corporate regulatory landscape in which the Australian Treasury has been involved, and makes some observations about the merit of engaging in such activities in light of Australia's international trade and investment relationships. It concludes that although there are significant challenges ahead, the potential benefits from improving corporate regulatory systems warrant Australia's ongoing involvement.

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Australia's international trade and investment relationships

An ongoing commitment to opening product, services and capital markets both in Australia and overseas continues to change the patterns of trade and capital flows between Australia and the rest of the world.

Most Australian trade currently occurs with Japan, the United States and China (see Table 1). The clear majority of Australia's trade (71 per cent of exports and 70 per cent of imports) occurs with countries within the Asia-Pacific region.

Table 1: Australia's trade relationships

2003–04 (\$m)

	Top 5					Group				
	Japan	China	USA	Korea	NZ	ASEAN	EU	APEC	OECD	All
Exports										
Value	19,811	9,936	9,479	8,484	8,091	12,268	12,932	77,797	61,373	108,993
Percentage	18.2	9.1	8.7	7.8	7.4	11.3	11.9	71.4	56.3	100.0
Imports										
	Top 5					Group				
	USA	Japan	China	Germany	UK	ASEAN	EU	APEC	OECD	All
Value	19,945	16,101	15,338	7,986	5,430	20,558	31,502	91,096	81,860	131,022
Percentage	15.2	12.3	11.7	6.1	4.1	15.7	24.0	69.5	62.5	100.0

In contrast to Australia's trade relationships, Australia's investment relationships are deepest with the United States and the United Kingdom (Table 2). Future investment trends may involve a shift towards emerging market economies within the region, particularly those with whom Australia continues to strengthen its trade relationships (for example, China and emerging Asia-Pacific Economic Cooperation (APEC) economies).

Australian outward investment has traditionally been directed towards the United States and the United Kingdom. The relationship with the United States remains the predominant one, as reflected by the significant investment stocks and strong flows in Table 2. In recent times, trans-Tasman market integration has progressed at a significant pace, with Australian investment in New Zealand (and vice versa) increasing rapidly. A significant proportion of outward investment has been in the New Zealand banking sector.

Table 2: Australia's investment relationships stock at 31 December 2003 (\$m)

	Top 5										Group		
	USA	UK	NZ	Japan	Netherlands	ASEAN	EU	APEC	OECD	All	USA	UK	OECD
Outward													
Value	211,004	82,644	37,088	21,873	12,702	16,340	148,418	309,964	432,584	508,218			
Percentage	41.5	16.3	7.3	4.3	2.5	3.2	29.2	61.0	85.1	100.0			
Inward													
Value	297,311	258,792	88,743	44,771	32,692	30,715	340,733	438,505	731,848	978,135			
Percentage	30.4	26.5	9.1	4.6	3.3	3.1	34.8	44.8	74.8	100.0			

flows in year to 31 December 2003 (\$m)	Top 5										Group		
	USA	UK	NZ	Japan	Netherlands	ASEAN	EU	APEC	OECD	All	USA	UK	OECD
Outward													
Value	26,846	3,776	6,918	1,746	493	-1,060	11,079	35,406	47,577	51,987			
Percentage	51.6	7.3	13.3	3.4	0.9	-2.04	21.3	68.1	91.5	100.0			
Inward(b)													
Value	47,946	14,375	21,674	479	-12,719	-5,241	17,620	32,161	67,686	96,715			
Percentage	49.6	14.9	22.4	0.5	-13.15	-5.42	18.2	33.3	70.0	100.0			

(a) International Capital Markets

(b) Negative figures in this table represent a net withdrawal of investment

Source: Australian Bureau of Statistics, *International Investment Position*, Supplementary Country Statistics, Cat. No. 5352.0, Canberra, 2004.

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As the United States and the United Kingdom are the world's largest funds management centres, significant investment flows between Australia and other countries are likely to be channelled through funds managers based in those jurisdictions. This could obscure the ultimate ownership of these investments.

Increasingly, Australia's capital needs are being sourced from international capital markets, where securities might be offered to investors in a number of countries simultaneously. The growth in offshore issues of residential mortgage backed securities (home loan securitisation) is a key example. The regulatory framework required to underpin such activity is one that must increasingly be suited to commercial practice within international capital markets, rather than that of any given country.

Implications for Australia's regulatory framework

Australia's interest in comparing its own regulatory framework with those of other economies, particularly its trade and investment partners, is linked to its increasingly outward orientation.

An important influence on whether foreign interests are willing to engage commercially with Australia is its regulatory policy. As a relatively small and remote player on the global stage, Australia must be concerned with the consistency of its regulatory architecture with those in other countries.²

To the extent that business regulatory frameworks in Australia and its economic partners can be further aligned, trade and investment opportunities may be enhanced.

Corporate regulation and international economic cooperation

Forums committed to international economic cooperation, including the Organisation for Economic Cooperation and Development (OECD), APEC, the World Bank, the International Monetary Fund (IMF) and a range of similar institutions, devote significant efforts to promoting reform of the global corporate regulation landscape. These activities followed the recognition of sound corporate regulation as a facilitator of foreign investment, and a key tool in the prevention and mitigation of the risks associated with cross-border capital flows.

² A more detailed discussion of the relative cost disadvantages Australia faces in international engagement is contained in Department of Treasury (2003).

Role in crisis prevention and mitigation

Since the Second World War, the prevailing view of economic policy makers in most nations, including Australia, has been that physical trade between countries without artificial barriers is in the interests of all participants.

Along with free trade, liberalisation of capital markets is viewed by many as a key to increasing the potential economic growth of a country. Open markets for foreign capital can expand the range of available investment opportunities, allow for greater diversification of risk, provide channels for the dissemination of knowledge and new technologies, and improve the cost and accessibility of capital for business.

On the other hand, some commentators are not convinced that free flows of global capital (other than foreign direct investment³) necessarily result in benefits for all.⁴ There has been an association between high levels of international capital flows and financial crises.⁵ These risks are higher in emerging economies, where capital flows are more volatile, offshore borrowing is largely foreign currency-denominated and markets for hedging currency risk tend to be under-developed. In the Asian financial crisis, economies that had become reliant upon foreign sources of capital, particularly in the form of bank lending and portfolio investments, found themselves vulnerable to a reversal in flows. In the three year period 1994-1996 following substantial liberalisation of capital accounts, private capital inflows to Malaysia, Indonesia, the Philippines, South Korea and Thailand amounted to US\$220 billion. In 1997, at the height of the Asian financial crisis, US\$100 billion flowed out of those countries. Allowing the free flow of investment funds increases the risk that a sudden reversal in market confidence may spread panic and quickly cause an economy-wide crisis.⁶

Despite the risks, however, it is highly unlikely that the trend toward more cross-border capital flows will reverse to any significant extent. Expansion of world trade has historically been accompanied by expansion of cross-border capital flows as production tends to shift closer to end markets.⁷ Technological innovations in recent years, along with other developments such as innovations in financial instruments, have greatly increased the volume and speed of cross-border capital flows – including into developing countries.⁸

3 See subheading 'Role in attracting foreign investment' below.

4 The debate is canvassed in McLean and Shrestha (2002).

5 Eichengreen (2003), p. 5.

6 Sakakibara (1999), p. 182.

7 Eichengreen (2003), p. 15.

8 Marr (1997).

While capital controls may play a transitional role, the real issue in the longer term is not whether the cross-border capital flows should be restricted, but rather how the risks associated with them can be managed. In the wake of the Asian financial crisis there were a range of suggestions about measures to prevent excess volatility in capital markets from causing financial crises. There is now a general recognition that emerging economies need to be careful to sequence capital account liberalisation with other reforms in order to limit vulnerability. The solutions are not straight-forward, and draw on a range of coordinated initiatives. However, it has often been noted that one means of reducing the risks associated with capital account liberalisation is to have well-developed financial and corporate legal infrastructure, which includes robust regulatory standards in areas such as corporate governance and insolvency procedures.⁹

Role in attracting foreign investment

Attracting significant foreign investment was a key objective of some affected economies following the Asian financial crisis to mitigate the impact of the sudden reversal of capital flows. A particular target was direct equity investment, which is seen as a more stable form of capital than bank lending or corporate debt.

Effective corporate regulation has been identified as a factor in attracting foreign investment. It increases certainty and transparency for investors, potentially reducing the costs of international exchange and encouraging further international economic integration. As mentioned above, the benefits of foreign investment also include reducing financial constraints on economic growth and assisting development of expertise and technologies.

The attraction of all forms of capital is facilitated by well-developed legal and judicial systems, strong frameworks of governance, accurate and timely provision of information, and an appropriate degree of regulatory oversight and sanction. Well-informed markets, based upon transparent disclosure of information and relative certainty in property rights, help to avoid the social, economic and political costs of financial instability. An institutional investor opinion survey, conducted by McKinsey and Company in cooperation with the World Bank in 2000, found that corporate governance was considered just as important a factor when making investment decisions as reported financial performance.¹⁰

9 Eichengreen (2003), p. 303.

10 McKinsey & Company (2000).

Similarly, insolvency systems that are properly designed and implemented can boost confidence, thereby encouraging investment.¹¹

Treasury's involvement in initiatives to improve the global framework for corporate regulation

The Australian Treasury has been involved in a number of international projects to improve the global frameworks for corporate regulation and, in some cases, has instigated or led those efforts. Some recent examples follow.

Revision of the OECD Principles of Corporate Governance

The OECD comprises 30 economies of the developed world committed to democratic government and the market economy. It plays an important role in the facilitation of good governance in the public and corporate sectors of member and non-member economies.

An officer of Australian Treasury currently chairs the OECD Steering Group on Corporate Governance, which coordinates the OECD's corporate governance initiatives.

Recently the Steering Group has reviewed the OECD Principles of Corporate Governance. The Principles were first published in 1999 and have become widely accepted as the leading international benchmark on corporate governance issues. They became one of the Financial Stability Forum's twelve Key Standards for International Financial Stability.

The Steering Group's review of the Principles was commissioned in 2002 by OECD Ministers to ensure the Principles were sufficiently robust and up-to-date after a series of high-profile corporate collapses in member economies.

As part of the revision process, the Steering Group sought and received comments from individuals plus national and international organisations. The OECD Ministerial Council endorsed the revised Principles as recommended by the Steering Group in May 2004 and they have been published.¹² The key changes to the Principles are:

- greater emphasis on transparency and director responsibility through improved related party transaction disclosure and 'whistle-blower' protections;
- auditors being made explicitly accountable to shareholders;

¹¹ Hagan (2000), p. 50.

¹² OECD (2004).

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- new principles on shareholder access to information and ability to influence the board membership and remuneration commensurate with their voting share;
- requiring the disclosure of institutional investor voting policy and how they manage conflicts of interest;
- a new focus on the role of analysts and brokers in the governance system, including a requirement for the disclosure of conflicts of interest; and
- revision of the preamble and annotations to reflect changes in the corporate governance environment and to assist with implementation of the Principles.

The OECD Principles are a valuable tool in facilitating dialogue and improving corporate governance systems in both developed and developing economies. Their revision represents a significant milestone for the OECD in its efforts to strengthen corporate governance standards around the world. This will, in turn, facilitate economic growth and financial stability given the valuable contribution that good corporate governance makes in these areas.¹³

United Nations Commission on International Trade Law (UNCITRAL) Legislative Guide on Insolvency Law

In October 1998, following the Asian financial crisis, the Prime Minister commissioned a task force, chaired by the Treasurer, to advise on ways that Australia could assist international financial reform. That task force's report, published later in 1998, recommended that Australia propose, and actively encourage, an international guide on insolvency law by the United Nations Commission on International Trade Law (UNCITRAL).

This recommendation arose from statements in reports of Group of 22 working groups that strong national insolvency regimes were essential to address corporate financial difficulties early, before they accumulated and caused economy-wide crises. Strong insolvency systems were deemed an important component of crisis prevention, but also a significant element of orderly and cooperative crisis management.

Although there were some statements of principle regarding effective and efficient insolvency systems at the time of the recommendation, no detailed guidance on legislative frameworks had been developed. The task force report suggested that given its recent experience preparing a model law on cross-border insolvency and its broad constituency and expert contacts, UNCITRAL would be a suitable body to prepare a model legislative framework for national insolvency laws for use in a range of different legal systems and commercial environments.

¹³ de Brouwer (2003), p. 1.

Australian representatives put the proposal to UNCITRAL in 1999, which accepted its merits. The Commission provided its working group on insolvency law with a mandate to develop a comprehensive statement of key objectives and core features for a strong insolvency regime and a detailed legislative guide. The working group held a number of meetings at which many developed, developing and transition economies were represented. Expert observers from a range of non-government organisations also attended. Australia was represented by an officer from Australian Treasury.

In June 2004, UNCITRAL adopted the draft Legislative Guide on Insolvency Law prepared by the working group. It contains comprehensive commentary and recommendations about the legislative framework for insolvency of commercial enterprises, including liquidation and reorganisations.¹⁴

Australian involvement in international insolvency projects was recently considered by the Parliamentary Joint Committee on Corporations and Financial Services in its report on Australia's insolvency laws. The Committee noted that Australian cooperation in international efforts to build credible and effective insolvency systems benefited Australian businesses trading overseas and gave reassurance to Australians and Australian institutions whose funds were at risk with cross-border operations.¹⁵

APEC Corporate Governance Pathfinder Initiative

Australia has been involved in a number of initiatives in APEC on corporate governance and related issues.¹⁶ Most recent is the APEC Pathfinder Initiative on Corporate Governance (Pathfinder Initiative) which arose from a recommendation in the 1999 APEC report on strengthening corporate governance.

14 The text of the Guide is available at:

www.uncitral.org/english/texts/insolven/insolvencyindex.htm.

15 Parliamentary Joint Committee on Corporations and Securities (2004), para. 13.12.

16 In 1998, the APEC Core Group on Corporate Governance was formed, led by Malaysia and also comprising Australia, the United States, the World Bank and the Asian Development Bank. In 2001, the Core Group delivered a report '*Strengthening Corporate Governance in the APEC region*' setting out measures that can be adopted by economies wishing to strengthen their corporate governance systems, with particular emphasis on developing member economies. The report includes an annex on the outcomes of a Corporate Governance Symposium hosted by Australia in November 1998, which brought together senior business people from member economies to identify priorities for corporate governance reform. The report is available at:

http://www.apecsec.org.sg/apec/apec_groups/other_apec_groups/finance_ministers_process.downloadlinks.0005.LinkURL.Download.ver5.1.9.

In 2000 and 2001, Australian Treasury provided the Chair and Secretariat for the APEC Task Force on Company Accounting and Financial Reporting. The Task Force promoted the use of high-quality, internationally acceptable standards of accounting, disclosure and auditing practices by business enterprises, taking into account the needs and diversity of developing member economies.

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The Pathfinder Initiative was designed to gather information on corporate governance regimes and to highlight areas of strength and concern. It was intended to promote continued policy dialogue on corporate governance among APEC members and with other organisations such as the OECD, the World Bank and the Asian Development Bank. It was also hoped that the Pathfinder Initiative would encourage members to undertake the World Bank's Report on the Observance of Standards and Codes (ROSC) process on corporate governance.

Governments in Australia, Korea, Malaysia, Mexico, New Zealand and Singapore completed the survey drafted by Australian Treasury. The Treasury coordinated the evaluation of the surveys, chaired a working group of participating economies and prepared a final report for APEC Finance Ministers in September 2004.¹⁷

The Pathfinder Initiative will contribute to encouraging continuing dialogue and promote use of the ROSC process on corporate governance issues. It will also add momentum to improving corporate governance standards in APEC economies.

Looking ahead

The initiatives mentioned above, among others, have contributed to improving the global corporate regulatory framework in recent years. Although progress has been made, there are still significant challenges ahead.

Key to the effectiveness of efforts to improve the global regulatory framework is ensuring that the recommended regulatory reforms can be adapted and applied in economies having a range of different commercial and legal systems.

Another major task going forward is development by emerging markets of the necessary institutional infrastructure for effective and efficient implementation and enforcement of modern market regulations. It is likely that, in future, more assistance efforts will be directed toward this regulatory infrastructure rather than substantive regulations.

Overcoming such challenges will require ongoing work, but has potential benefits for Australia. Improving the global corporate regulatory systems, particularly those in emerging markets in the Asian region, will contribute to making the investment climate more attractive for foreign investors. This will facilitate growth and increase regional trade and investment opportunities.

¹⁷ Department of Treasury (2004).

Improving corporate regulatory systems also helps to manage the risks associated with high reliance on foreign capital in situations where market confidence is threatened.

Aside from those factors, Australia needs to be mindful of the consistency of its own regulatory framework with international benchmarks. Accordingly, it could often be in Australia's interests to have its policy perspective represented in the process of developing standards of international best practice.

Efforts to improve the international corporate regulatory framework on a global scale complement Australia's efforts to improve access to financial services markets through its negotiation of free trade agreements. A key element of this strategy is the pursuit of mutual recognition of regulatory standards for investor protection. For example, the Australia-United States Free Trade Agreement provides for the establishment of a Financial Services Committee (FSC). The primary goal of the FSC is to reduce regulatory barriers to the greater integration of the financial services markets between the two countries, particularly in terms of providing improved access for United States investors to Australian securities and collective investment schemes. Australian Treasury will be leading Australia's participation in the FSC.

Australia is also involved in promoting cross-border trade and investment on a bilateral basis through better coordination of business law between Australia and New Zealand. This undertaking includes closer cooperation between competition regulators; closer integration of competition and consumer protection regimes; mutual recognition of offer documents for securities and collective investment schemes; common accounting standards; enhanced insolvency frameworks; better access to details about trans-Tasman companies; and closer integration of banking regulation.

Australian Treasury is one of a number of areas in the Australian government that has been involved in initiatives directed to improvement of global corporate regulatory systems. Australia's long-term economic interest is served by continuing to engage in those efforts as part of a strategy to promote and facilitate cross-border trade and investment for the benefit of all participants.

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