

Big Changes Coming in Corporate Governance

The integration of the stock markets of Bogotá, Lima and Santiago has important potential to make the companies of these countries grow. To succeed, they will have to overcome great obstacles. The main one, perhaps, is to strengthen their norms of corporate governance.

The value of assets invested in pension funds in Colombia, Chile and Peru is about US\$ 125 billion. This is five times more than the amount Colombians have saved in local pension funds.

If this were the only reason, it would be more than sufficient to speed up the process and bet on the integration of the stock markets of the three countries. Such a project would put at the disposition of the companies of these Andean countries the money of 16 pension funds, a sum 17 times the amount required to finance the widening of the Panama Canal.

With the integration of the markets, investors also gain in the diversification of their portfolios. This does not relate solely to being in different countries, but also in spreading risk among sectors. Seventy-eight percent of the shares of the Colombian market are concentrated in the manufacturing industry and 53% of the Peruvian is in mines and raw materials. On the Santiago Stock Exchange, in contrast, diversification is greater. Thirty-two percent are in services, 26% in mines and raw materials, 12% in other sectors and 11% in commerce.

Naturally, in a realistic scenario, putting trading of the shares of the Lima, Santiago and Bogotá Exchanges on a single screen is not a simple matter.

On the one hand, investment experts like Manuel José Balbontín, founder of Compass Group, the Latin American fund manager from Chile, believe that even though integration is inevitable, conforming domestic financial regulations will take at least two years.

In his opinion, the greatest difficulty will be the resistance of some of the 117 stockbrokers in each of the countries. "That's natural. The firms will want to defend their market niches." Nevertheless, there are already some brokerage firms that have opted to aggressively internationalize their operations. This is the case with Colombia's Interbolsa, Peru's Selfín, and Chile's Larraín Vial, each of which has an active presence in the region. And this is not to mention multinational financial institutions such as Grupo Santander.

For his part, Mike Lubrano, director of corporate governance of the US firm Cartica Capital, which specializes in the management of emerging markets assets, raises another issue of enormous relevance for getting this project underway. This has to do with strengthening the principals of corporate governance among issuers and institutional investors in the region.

And there are still some unresolved issues in this respect. How is privileged information defined and how are cases involving it handled? What about mistreatment of minority investors? How can the transparency of information be increased? Many of these problems were resolved in Chile in the process of its admission to the OECD. Now it is Colombia and Peru's turn.

Lubrano raises serious questions about the responsibility of pension funds when an investment does not earn the expected returns or when the company in which the fund has invested fails. He suggests that the directors that represent the funds on the boards of such companies should have to explain their actions.

He also suggests, to the possible irritation of some observers, that the representatives of the fund with the largest holding in the company be required to explain its decisions.

Regardless of how such cases are resolved, what is certain is that the agents of the three exchanges will have to speak among themselves and jointly adopt the highest standards of company practices relating to boards of directors, relations with shareholders and other stakeholders, in what is referred to as "corporate governance."

If they do not do so, it will raise the potential of regulatory arbitrage, in which issuers choose the location with the least amount of requirements to operate.

Interesting challenges are coming for Colombian companies that will have to think about better transparency, more detailed reporting on the quality of executives and members of the board -- justifying in detail their actions with respect to minority shareholders, worker and suppliers -- management of conflicts of interest and the use of international accounting standards. Will this be difficult? Maybe, but the benefits of almost doubling market capitalization overnight would seem to justify it.

[Free translation – Cartica Capital]