The Future of Corporate Governance in Capital Markets Following the COVID-19 Crisis

KEY FINDINGS

OECD

30 June 2021

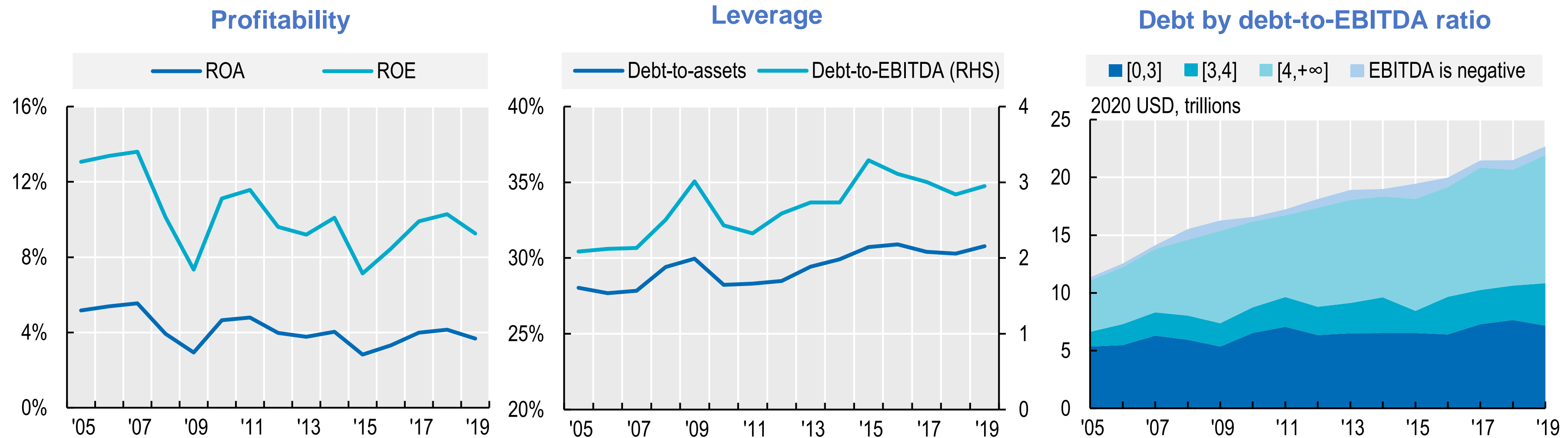
About this report

- The COVID-19 crisis has highlighted structural changes in capital markets and calls for an adaptation of corporate governance policies.
- Well-functioning capital markets that can allocate substantial financial resources for long-term investments will make a critical contribution on the road to recovery from the crisis.
- Simultaneously, a **strong corporate governance framework is essential for a well-functioning capital market**, fostering an environment of market confidence and business integrity.
- Corporate governance rules and practices will need to be adapted to the post-COVID-19 reality, particularly with respect to issues such as increased ownership concentration; environmental, social and governance (ESG) risks management; digitalisation; insolvency; audit quality; and creditor rights.
- *The Future of Corporate Governance in Capital Markets Following the COVID-19 Crisis* provides an evidence-based overview of developments in capital markets globally leading up to and including the COVID-19 crisis.
- The report presents trends that can be used to shape policies that will support the recovery and formulates the key policy messages that will guide the review of the *G20/OECD Principles of Corporate Governance*.

Corporate and capital market landscape

1. Performance and leverage of listed non-financial corporations
2. Investment by non-financial corporations
3. Public equity markets
4. Corporate bond markets
5. Owners of the world's listed companies

Performance and leverage of listed non-financial corporations



Source: OECD (2021), The Future of Corporate Governance in Capital Markets Following the COVID-19 Crisis

- **Profitability in non-financial corporations has remained subdued over recent years.** In 2019, both return on equity (ROE) and return on assets (ROA) were still lower than pre-2008 financial crisis levels.

- Globally, listed corporations have experienced an **increase in leverage.** This is visible in particular when looking at the level of indebtedness against the capacity to generate operational profits, measured as the debt-to-EBITDA ratio. The aggregate debt-to-EBITDA ratio increased from 2x to 3x between 2005 and 2019.

- The total outstanding debt has been mainly accumulated in firms with lower debt servicing capacity. The **debt owed by firms with debt-to-EBITDA ratios over 4x has more than doubled** from USD 4.4 trillion in 2005 to USD 11.1 trillion in 2019.

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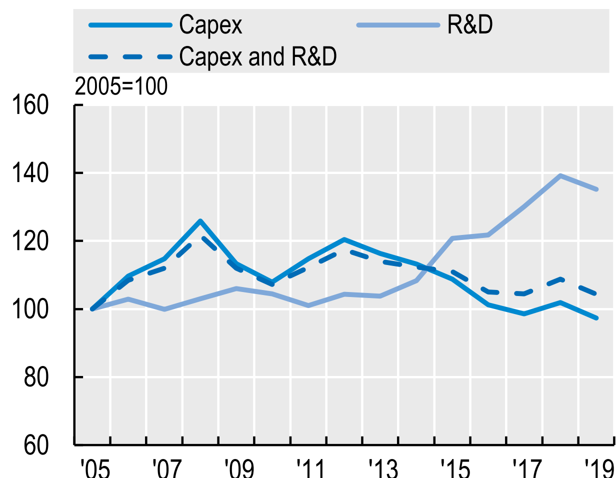
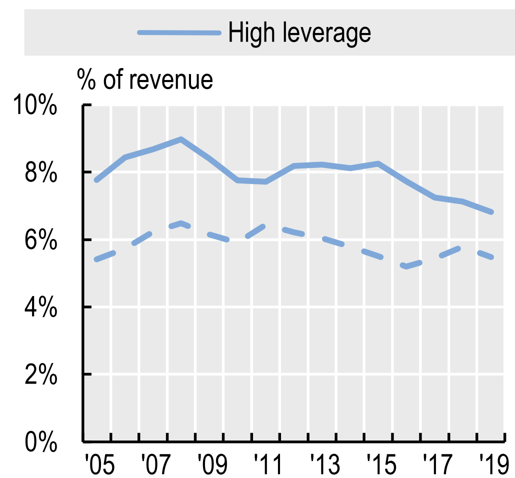
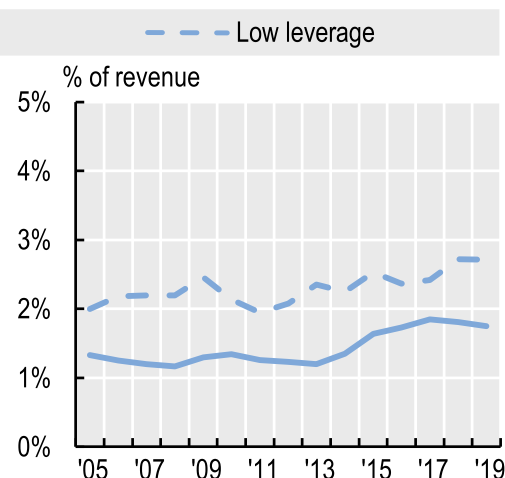
Investment by non-financial corporations







Source: OECD (2021), The Future of Corporate Governance in Capital Markets Following the COVID-19 Crisis

- Corporate investment is essential for developing the productive capacity of an economy. But globally, **investment levels have not grown significantly since 2005.**
- However, this masks **large changes in the composition of investment.** Between 2005 and 2019, **Capex decreased by 2.7% while R&D investments grew by over 35%** as a share of GDP.
- Investment dynamics differ depending on company financial characteristics. For example, **low leverage companies devote a larger share of their revenues to R&D relative to high leverage companies. The opposite is true for Capex.** This underlines the importance of equity financing to support riskier and innovative projects, represented by R&D investment.

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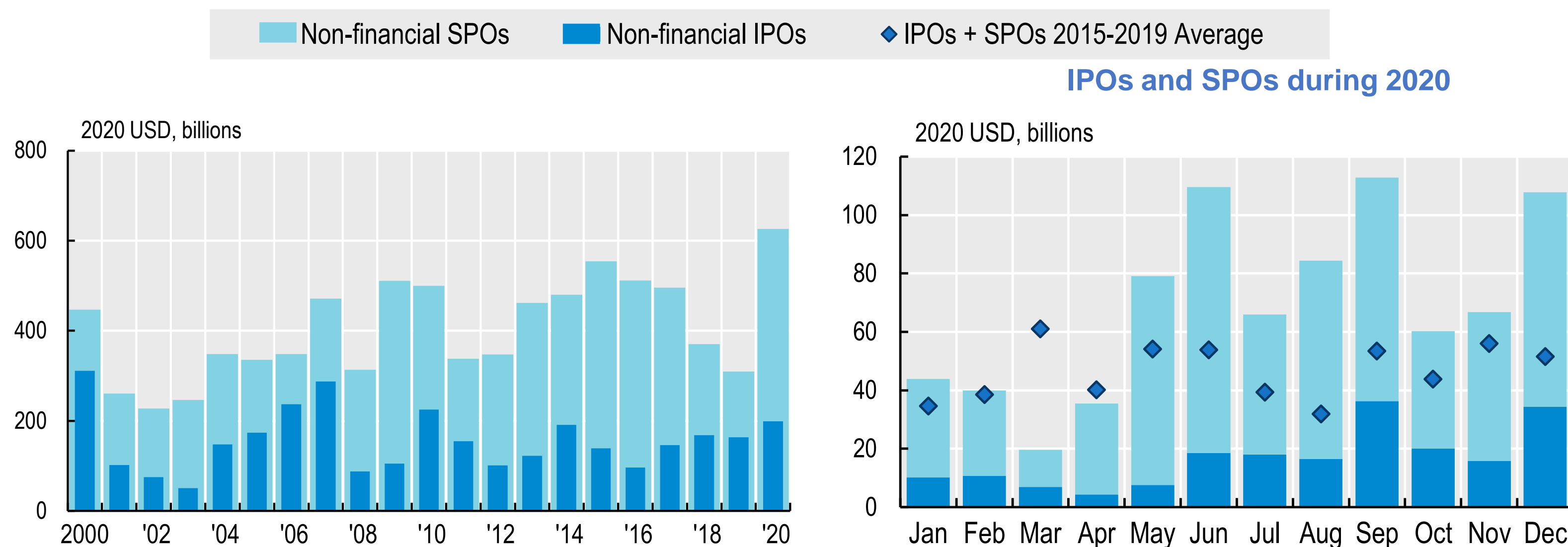
Public equity markets - 1

Initial public offerings (IPOs) and secondary public offerings (SPOs) by non-financial corporations



Source: OECD (2021), The Future of Corporate Governance in Capital Markets Following the COVID-19 Crisis

- Access to public stock markets plays a key role in providing companies with equity capital that gives them the **financial resilience to overcome temporary downturns and undertake long-term investments.**
- Issuance in public equity markets during 2020 reached a 20-year high in real terms, with companies raising USD 826 billion in equity financing.
- Particularly, the **third quarter of 2020** saw a **peak** in capital raising activity compared to the previous 5-year average, mainly driven by secondary public offerings by already listed companies.

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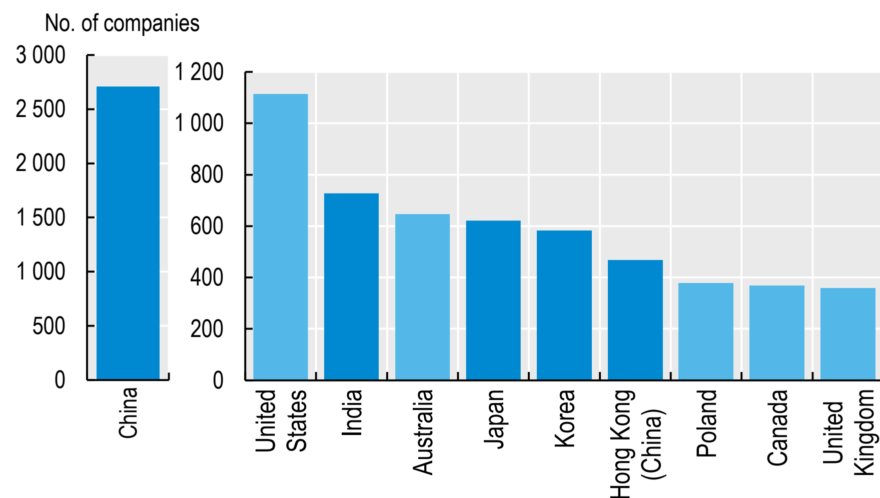
Public equity markets - 2

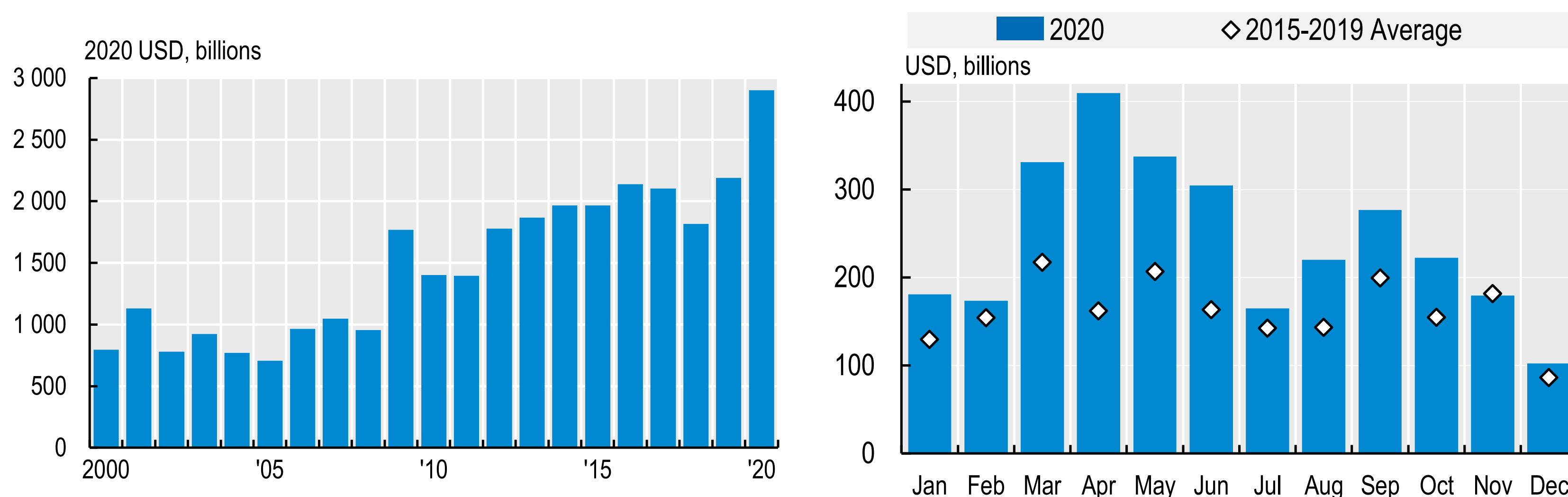
Top 10 jurisdictions by number of non-financial company IPOs during the last 10 years



Source: OECD (2021), The Future of Corporate Governance in Capital Markets Following the COVID-19 Crisis

- Since the mid-1990s, the public equity market landscape has undergone some important changes. One important development has been an **increased use of public equity markets by Asian companies**.
- **Chinese non-financial companies** have been **the world's most frequent users of IPOs** during the past decade, with about two and a half times as many IPOs compared to US companies.
- During the last two decades, some advanced markets have also experienced **a structural decline in the listings of smaller growth companies,** distancing a larger portion of these companies from ready access to public equity financing.

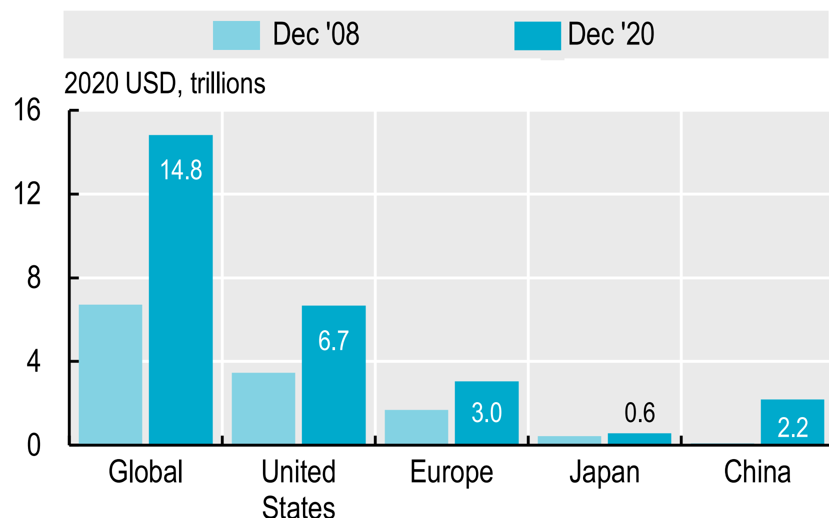
Corporate bond markets - 1

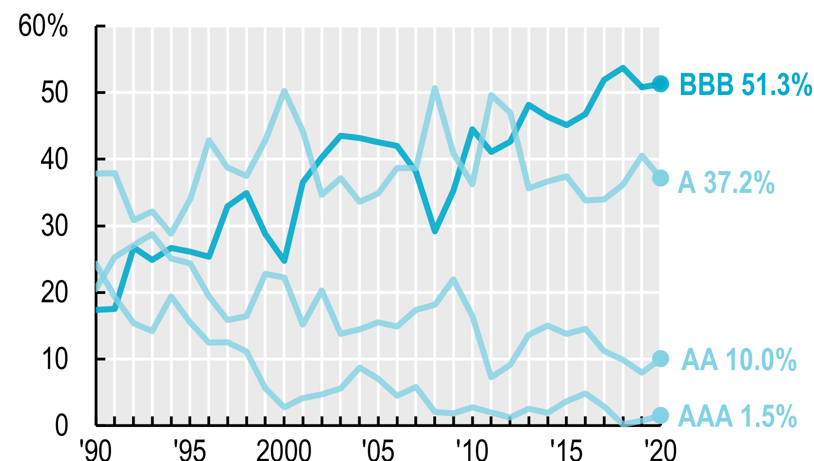


Source: OECD (2021), The Future of Corporate Governance in Capital Markets Following the COVID-19 Crisis

- Like equity, corporate bonds **provide longer-term financing** than ordinary bank loans and serve as a useful source of capital for companies that want **to diversify their capital structure**.
- Since the 2008 financial crisis, global corporate bond markets have seen **a significant and lasting increase in issuance**. The annual global issuance of non-financial corporate bonds has averaged **USD 1.87 trillion.** This is **more than twice the average issuance between 2000 and 2007.**
- In 2020, **a historical record of USD 2.9 trillion** of corporate bonds was issued globally by non-financial companies.
- During the second quarter of 2020, global corporate bond issuance amounted on average to **USD 350 billion per month**, which is **twice as much as the 2015-2019 average**.

Corporate bond markets - 2





Source: OECD (2021), The Future of Corporate Governance in Capital Markets Following the COVID-19 Crisis

- At the end of 2020, the global outstanding stock of non-financial corporate bonds reached a **historical record of USD 14.8 trillion**, **more than twice the amount in 2008.**
- In addition to the record volumes, the decline in the overall corporate bond quality in 2020 continued to be significant.
- Investment grade issuance has become **increasingly concentrated at the lower end of the rating scale**. The share of BBB issuance – the lowest investment grade rating – **has more than doubled from 25% in 2000 to 51% in 2020**.

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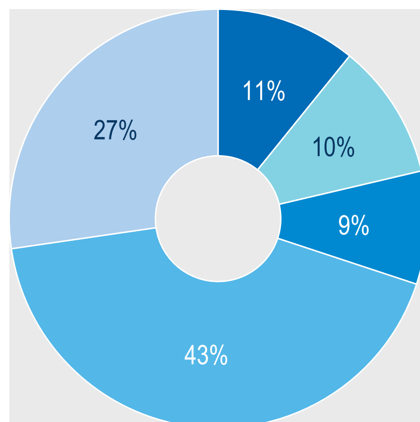
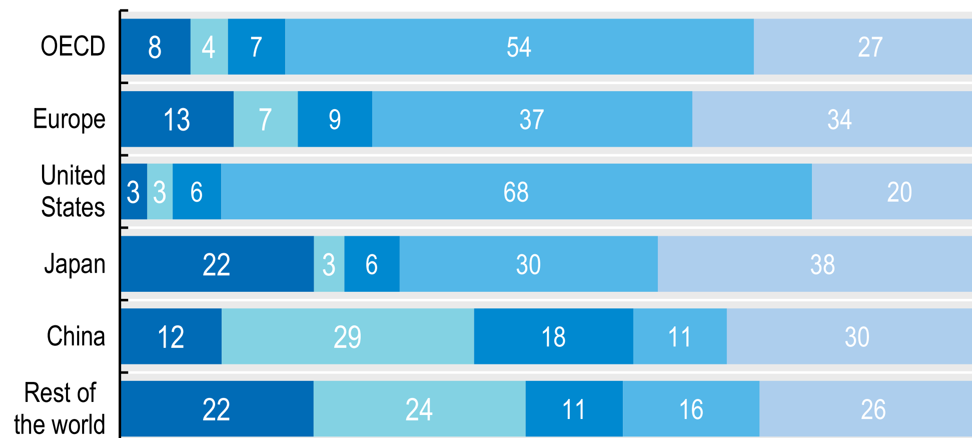
Owners of the world's listed companies

A. Global investors' holdings



B. Regional investors' holdings (%)



Source: OECD (2021), The Future of Corporate Governance in Capital Markets Following the COVID-19 Crisis.

- By the end of 2020, there were 40 531 listed companies in the world with a combined market value of USD 105 trillion.
- At a global level **the largest investor category is institutional investors**, which hold almost 43% of the global market capitalisation, followed by private corporations holding 11% and the public sector holding 10%.
- The relative importance of the different investor categories varies across markets. Institutional investors is the dominant category in the OECD countries, holding at least 54% of the equity. This is particularly notable in the United States, where institutional investors hold at least 68% of the equity, by far the most dominant investor category.
- In China, the largest investor category is the public sector, which holds 29% of all equity.

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Key policy messages

Making equity markets support recovery and long-term resilience

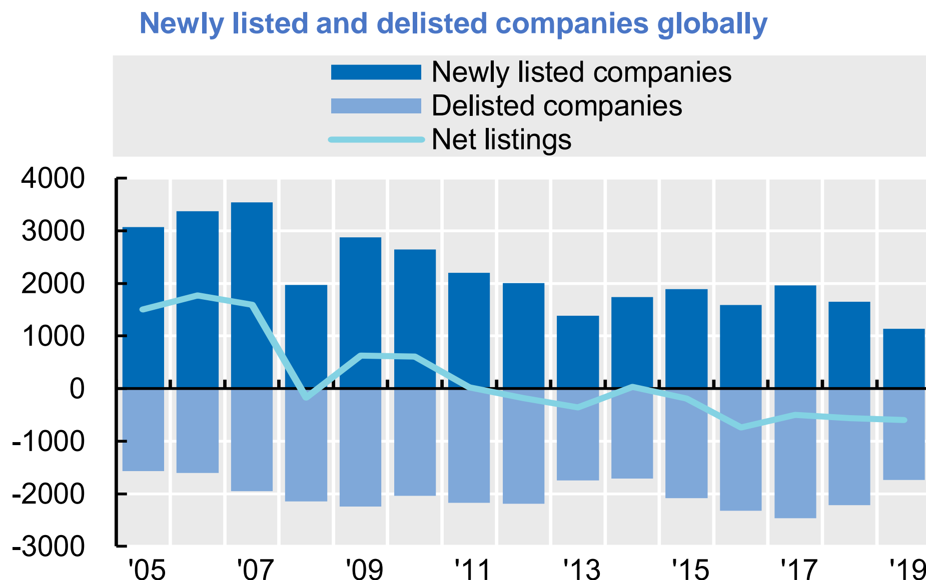
Adapting the corporate governance framework

Improving the management of environmental, social and governance risks

Addressing excessive risk taking in the non-financial corporate sector

Adapting the insolvency/restructuring framework for recovery and resilience

Making equity markets support recovery and long-term resilience - 1



Source: OECD (2021), The Future of Corporate Governance in Capital Markets Following the COVID-19 Crisis

- In an era when recapitalisation of many companies has become vital, the road to recovery will require well-functioning equity markets that can allocate substantial financial resources for long-term investments.
- However, since 2005 more than **30 000 companies have delisted** from stock markets globally, notably in the United States and Europe. This is equivalent to 75% of all listed companies today.
- The number of delistings has not been matched by new listings. This means that many thousand companies have become **distanced from direct access to public equity markets** in the form of secondary public offerings.

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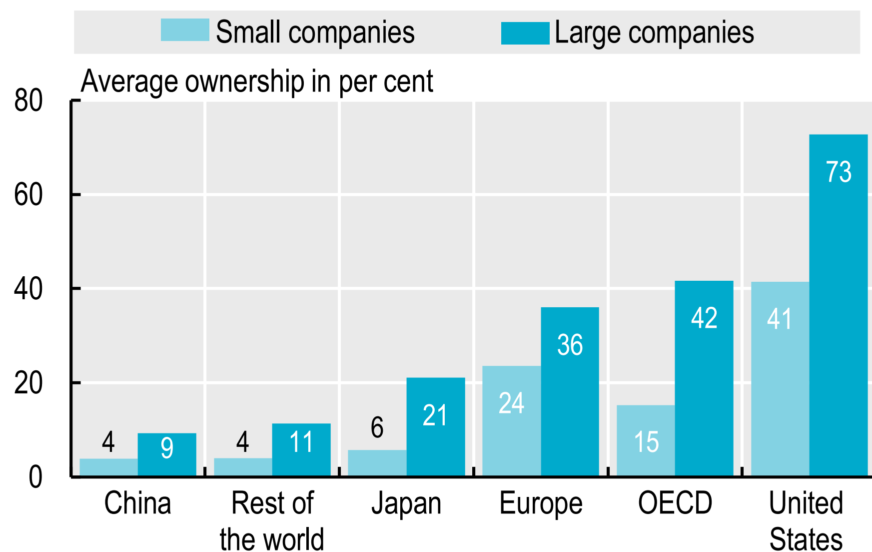
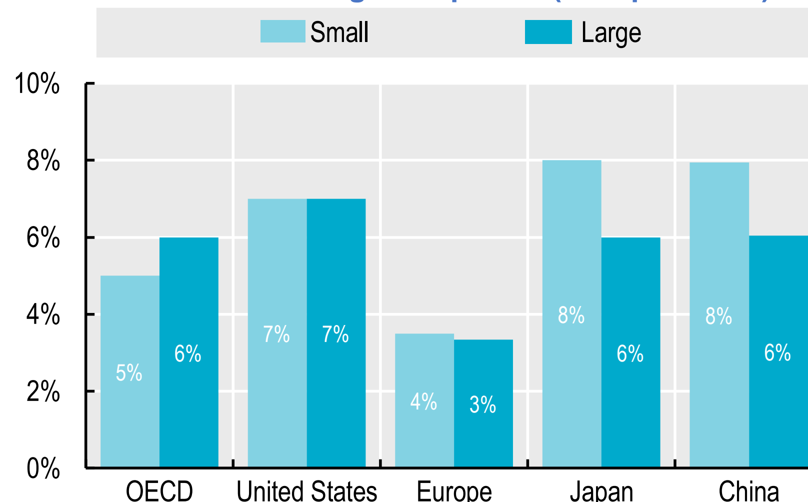
Making equity markets support recovery and long-term resilience - 2





Source: OECD (2021), The Future of Corporate Governance in Capital Markets Following the COVID-19 Crisis

- The shift from retail direct investments to indirect investments via large institutional investors has created **a bias towards large listed companies**, as the average share of institutional ownership in large listed companies is significantly higher than their ownership in smaller companies.
- The structure of investment banking activity is an important factor behind **high listing costs**, as high underwriting fees and stock price discounts **have discouraged companies from going public**.
- The **systematic acquisition of smaller growth companies** may also contribute to the drying up of the IPO pipeline of smaller independent companies that could potentially increase competition and challenge the status quo.

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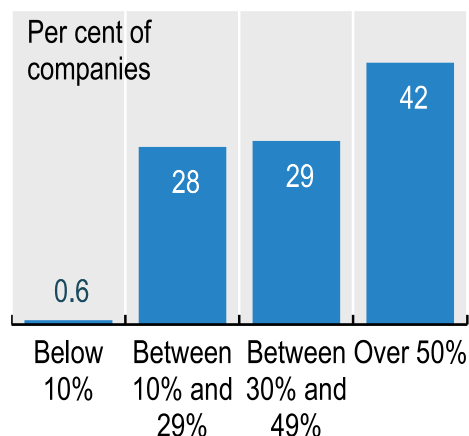
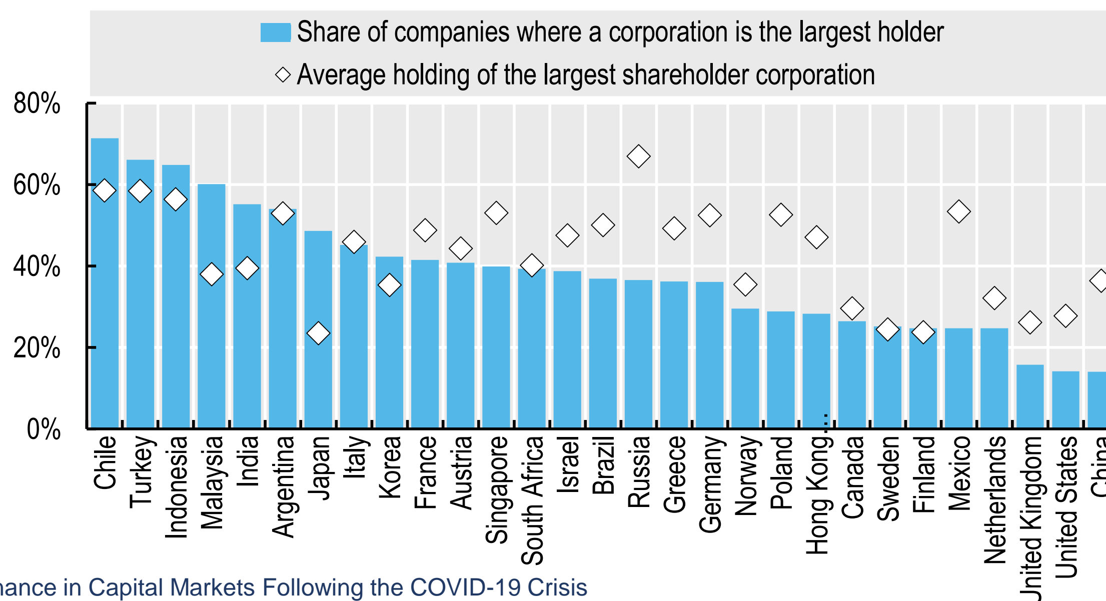
Making equity markets support recovery and long-term resilience - 3

- An **overarching policy objective** should be to facilitate access to equity capital for sound businesses. This will help strengthen the balance sheets of viable corporations and the emergence of **new business models**.
- A well-functioning public equity market also provides **ordinary households** with the opportunity to share in the return on capital, giving them additional options for managing savings and planning for retirement.
- Steps should be taken to address any **structural weaknesses** in the stock market ecosystem that discourage smaller growth companies from going public. Addressing the cost of listings and ensuring that there are no unnecessary barriers or regulatory and supervisory uncertainties for companies that want to use new alternative listing practices should be a priority.
- To balance the current focus on large listed companies by institutional investors, steps should be taken to improve the **visibility and attractiveness of smaller growth companies**.
- When evaluating an adaptation to the post-COVID-19 landscape, policy makers and regulators should carefully assess the **long-term costs and benefits of interventions**, and avoid over-regulation that may discourage companies from going or staying public.

Adapting the corporate governance framework - 1





Source: OECD (2021), The Future of Corporate Governance in Capital Markets Following the COVID-19 Crisis

- There has been a global increase in ownership concentration at the company level. In some markets, this is the result of the of dominance of **company group structures.** In several others, **governments have become important owners** of listed companies. Both trends bring challenges with respect to governance practices.

- In markets, like the United States, ownership is concentrated in the hands of institutional investors. The three largest institutional investors in the United States now hold a combined average of 23.5% of the equity in listed companies.

- The pandemic has raised concerns and triggered lawsuits with respect to the quality of risk-related disclosures. In addition, after the COVID-19 outbreak, there have been concerns that some companies may have re-arranged the terms for **executive remuneration** by adapting performance metrics and ignoring missed targets.

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Adapting the corporate governance framework - 2

A strong corporate governance framework is essential for a well-functioning capital market. It fosters an environment of market confidence and business integrity.

- Experiences from the pandemic call for improvements in the frameworks for **risk and crisis management** (including health, supply chain and reputational risks). Issues related to **audit quality, stock price manipulation and insider trading have also come to the forefront**.
- In certain areas, the monitoring and disclosure of risks may be enhanced by the **use of new digital technologies**.
- As a response to the increase in listed company group structures in several markets, special attention should be given to address **inadequacies in national disclosure frameworks** related to capital and control structures in company groups.
- Policy makers and regulators should ensure a **level playing field** with respect to transparency and governance between state-controlled listed companies and their private investor-owned peers.
- Countries should benefit from experiences during the COVID-19 crisis in order to advance or clarify their regulatory frameworks for **remote participation in shareholder meetings**.
- To ensure the link between **executive remuneration** and **long-term corporate performance**, experiences call for **renewed scrutiny** of the conditions and procedures for deciding and overseeing performance-related pay.

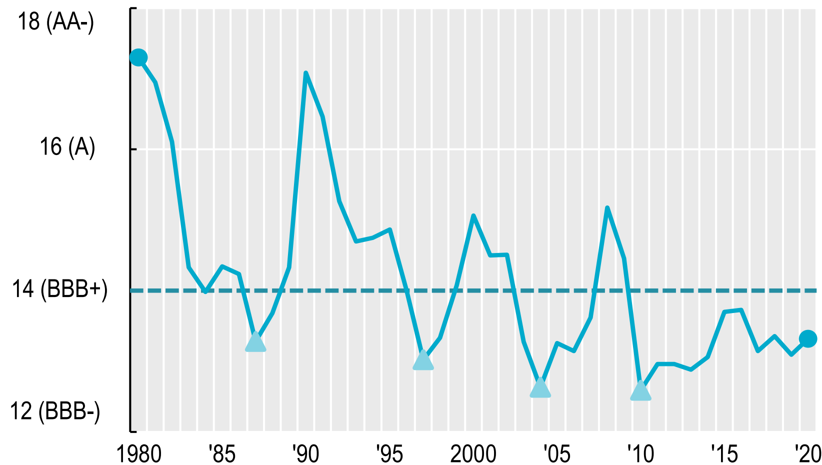
Improving the management of environmental, social and governance risks

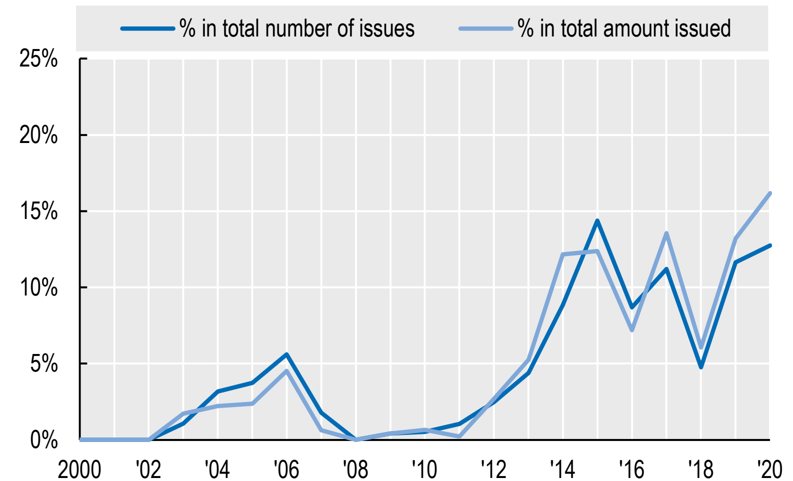
The COVID-19 pandemic has brought increased attention to the importance of identifying systemic risks and unexpected shocks.

When new types of risks, such as ESG risks, emerge or become more salient, companies, their shareholders and society at large all have an interest in the proper identification, management and disclosure of these risks. Lack of credible risk assessments not only increases uncertainty about expected performance and the long-term viability of individual companies, but also leads to inefficient allocation of economic resources.

- Companies should ensure that they have the **expertise, information channels, analytical tools, internal policies and practices** that are specifically tailored to assessing their ESG risk factors.
- In response to increasing demands that material information related to ESG risks should be disclosed to guide investor decisions and improve capital allocation, **policy makers and regulators should facilitate the development of comprehensive ESG frameworks**, notably with the purpose of producing consistent, comparable and reliable climate-related disclosure.
- **Corporate boards should demonstrate a leadership role** to ensure that effective means of environmental, social and governance risks oversight are in place, establishing **clear lines of responsibility and accountability** for the quality and integrity of the monitoring and disclosure system throughout the company and its subsidiaries.

Addressing excessive risk taking in the non-financial corporate sector -1

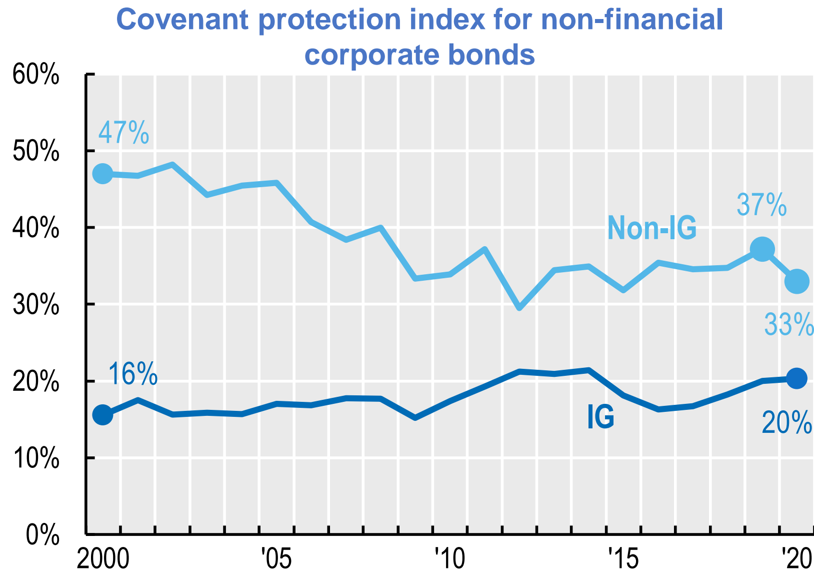


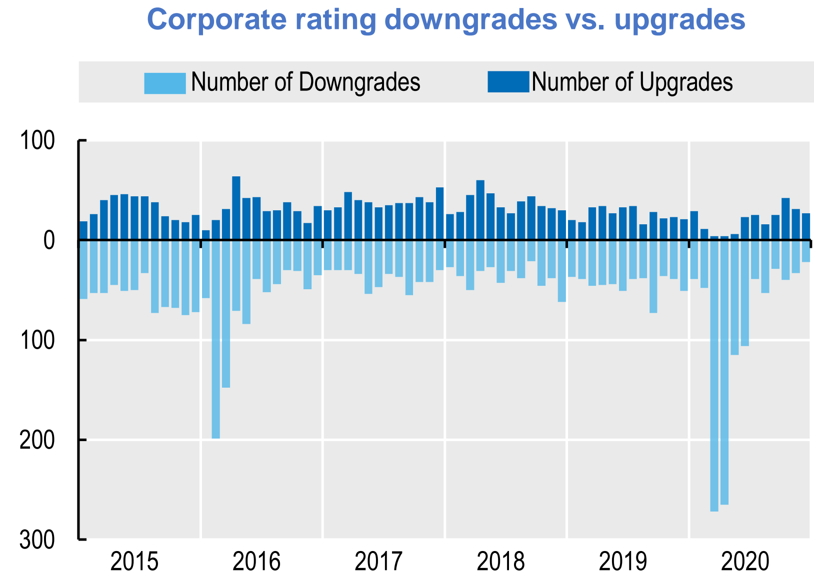


Source: OECD (2021), The Future of Corporate Governance in Capital Markets Following the COVID-19 Crisis

- At the onset of the COVID-19 crisis, there were already widespread concerns about the **declining quality of the growing stock of outstanding corporate bonds**.
- Over the past three years, the share of BBB rated bonds - the lowest investment grade rating - reached 52% of all investment grade issuance, up from 39% during the 2000-2007 period.
- One particular cause for concern is the increase in **low-rated bonds used to finance corporate payouts.**
- The share of non-investment grade corporate bond offering documents that explicitly mention share buybacks or dividends among the intended uses has grown from 0% in 2000 to 13% in 2020.

Addressing excessive risk taking in the non-financial corporate sector - 2





Source: OECD (2021), The Future of Corporate Governance in Capital Markets Following the COVID-19 Crisis

- In the **low interest rate environment** of the past decade, **bond investors** became increasingly willing to **forego their own protection** by agreeing to weaker covenants to reach higher returns.
- In the first 3 quarters of 2020, the **covenant protection index** for non-investment grade bonds reversed a small recent upward trend and **experienced a rapid decline**, dropping to 33%.
- The COVID-19 outbreak caused **sharp reversals in earnings expectations** for companies and significantly weakened their interest coverage and profitability ratios, resulting in a **significant number of downgrades during 2020**.
- In March 2020 alone there were 272 downgrades of non-financial companies. Although the total number of downgrades declined somewhat in May and June, it remained above 100.

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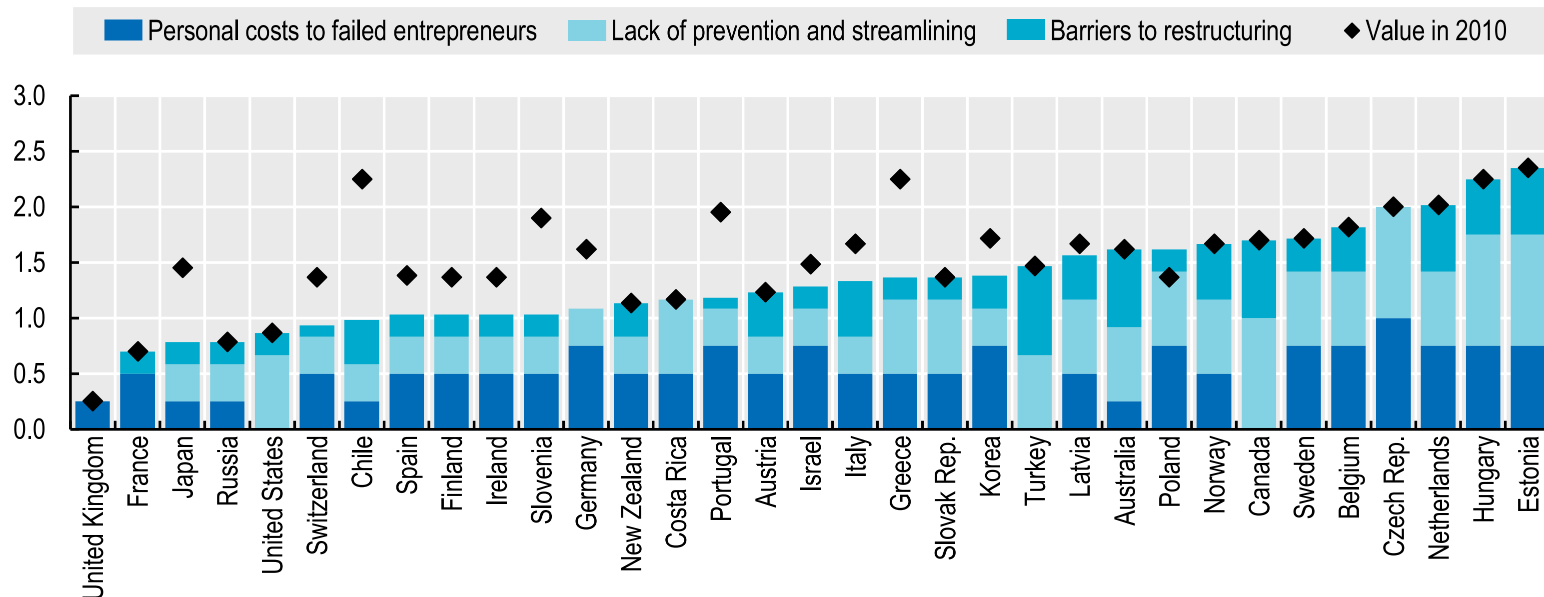
Addressing excessive risk taking in the non-financial corporate sector - 3

Increased use of bond financing has **highlighted the important role of corporate bonds in corporate governance** and the conditions (covenants) that bondholders may stipulate with respect to e.g. dividend payments, capital structure and disclosure.

- The regulatory framework should **require companies to disclose if they are at material risk of not meeting their bond covenants**, particularly in markets where the use of corporate bonds has only recently grown to be significant.
- Companies should also **disclose if their current financing arrangements include terms that would limit their ability to obtain additional funding**, as well as how these terms could influence the outcomes of workouts or lead to liquidity problems that would make them unable to maintain current operations.
- With regard to debt-financed buybacks, **the management and board are best placed to decide on the optimal capital financing structure**, subject to the approval of the shareholders. In doing so, however, they should **ensure that proper risk assessment procedures are in place** considering different scenarios, the best long-term interest of the company and its financial soundness.

Adapting the insolvency/restructuring framework for recovery and resilience - 1



Source: Adalet McGowan and Andrews (2018); OECD (2021), The Future of Corporate Governance in Capital Markets Following the COVID-19 Crisis

- There are significant differences across countries with respect to **the cost and expected recovery of an insolvency**, which will affect the handling of pandemic-related solvency issues. The lower the score in the above graph the more efficient the insolvency regime is.
- Responding to the COVID-19 crisis, many jurisdictions have made temporary changes to their insolvency practices and extraordinary measures are still in place.
- The portion of non-viable firms will increase in the near-term. Finding the right balance between avoiding insolvency of viable firms and maintaining the timely initiation of insolvency proceedings is important to ensure that **resources are not tied up in underperforming companies.**

Adapting the insolvency/restructuring framework for recovery and resilience - 2

Given the severe economic consequences of the pandemic and the already witnessed increase in insolvencies in industries such as air transport, hospitality, real estate and related sectors, it is crucial to **ensure sound governance of insolvency and restructuring processes** that allow for efficient and swift exits of non-viable companies and successful restructurings of viable ones.

- Policy makers and regulators should take the opportunity to **review the overall efficiency of their insolvency frameworks** and the extent to which **market-driven workouts** can serve as an effective practice to preserve, restructure and re-allocate productive capital.
- Fit-for-purpose insolvency regimes that are coherent across jurisdictions will be essential.
- Considering that the portion of under-capitalised, non-viable firms will increase in the wake of the pandemic, temporary measures introduced should be re-visited to **ensure that resources are not tied up in systematically underperforming companies**.

Thank you for your attention!

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