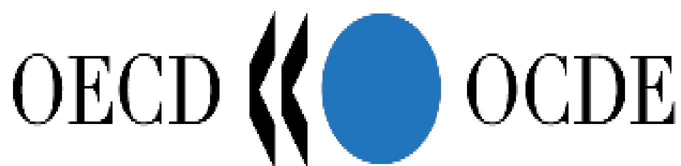

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Shareholder Rights and the Equitable Treatment of Shareholders

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Applying Corporate Governance Principles to Financial Institutions, Collective Investment Institutions and Insolvent Companies: Applications in the Asian Environments

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Applying Corporate Governance Principles to Financial Institutions, Collective Investment Institutions and Insolvent Companies: Applications in the Asian Environments

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Introduction

The application of corporate governance principles to financial institutions, collective investment institutions and insolvent companies may in the first instance seem an interesting principle in itself. The reality is that all of these entities wield substantial influence over industrial and commercial corporations and individuals. By forming financial conglomerates and becoming major players in capital market activities and by driving external funding , financial institutions especially become extremely important in promoting economic and social development of nations. Yet conversely, the strength of financial institutions depends on the power not only of companies to repay loans and debts, but also the role of legal and regulatory structures to protect investors and promote the development of companies and firms (Mayer & Moores, 2001).
This article will begin by reviewing the different financial models and the impact these have had on the legal systems, regulation and structures of corporate governance. The need for 'culturally appropriate' frameworks for corporate governance in financial institutions will be analysed. The second section of the article will be dedicated to the various reform measures that financial institutions can adopt to promote 'culturally appropriate' frameworks of corporate governance.In doing this the article also looks at the role of financial institutions in promoting good corporate governance. The article will also deal with the issues facing insolvent companies and their board of management. In doing so, it will draw heavily on the results of Project ACORN (Asian Corporate Governance) that was carried out in the Asia Pacific region.

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The Impact of Financial Systems

* The research for this article was contributed to by Dr Lydia Hearn, Senior Research Fellow, Murdoch University

Much debate has focused on the performance of different financial systems, and comparisons have been drawn[2]
between 'bank-oriented' and 'market-oriented' models. In particular, comparisons have stressed the difference between their approach to corporate financing, the level of bank ownership of corporate equity, and their degree of corporate control. For example, Japan and many South East Asian economies have been described as having bank-oriented systems, with high bank lending, high equity holding by banks, and close monitoring and corporate control (Patrick, 1997). However, increasingly it has been argued that this close relationship between financial institutions and companies in the bank-oriented system has reduced accountability and motivation (Schaede, Hoshi, McMillan, 2000). Thus in the past few decades, increasing emphasis has been placed on the new market-based, financial economies that are characterised conversely by their low bank lending to corporations, their modest levels of corporate equity, and their limited control over corporations.

In the US and the UK with which this "neo-liberal" system is most associated, the market based model has brought several benefits: enabling investors to diversify across domestic and international investments, while businesses have been better able to fund their ideas or expand their present functions, resulting arguably in more efficient use of resources, economic growth and improved standards of living (Larsen, 2002). Moreover, the market-oriented approach offers the possibility of overcoming two serious drawbacks of banking model, one being the ability of governments to finance budget deficits through their access to savings held within financial institutions, and the second being their inability to veto policies leading to inflation. Most importantly, in the Asian environment, pension funds have been used by several governments as a means to prop up budget deficits and this needs careful scrutiny in relation to corporate governance.
So the question remains, if the benefits of a market-based financial system are so obvious, then why is there a need for corporate governance (Larsen, 2002) and what form it should take? While many of the emerging economies have benefited from the influx of foreign direct investment, Argentina, in recent times stands as a clear reminder of the market-based model's vulnerability to financial crises, leading to a decline in investor confidence and an abrupt outflows of capital. Greater investment opportunities, including those across international borders, create greater risks that will only increase unless appropriately managed. While globalised markets have also made it easier to lauder money and shelter tax.

As the risks have increased so too has the urgent need for good governance within financial organizations. Yet how the international community can best develop a set of international standards of good practices for the financial world has raised many questions. Should the goal of corporate governance be to change all financial institutions to the more Anglo-American model of market-based systems and then develop a strict set of international/government regulations? Or should it be to strengthen the overall *financial architecture* with the intention being "not to decree what markets are or are not allowed to do, but rather to foster market decisions on the basis of clearer understanding of the risk involved and of the principles guiding financial policies" (Larsen, 2002).

While the Enron collapse and the WorldCom scandal have highlighted the need to pay as much attention to the risks and vulnerabilities arising in developed countries as we do to those in developing economies, few policy makers would be happy to return to strict government regulations. On the contrary, it is hoped that the new Basel Capital Accord (or Basel II) for the supervision of banks will offer the promise of promoting a more stable financial sector, with stronger credit risk management by financial organizations and built in rewards and sanctions (PECC/ABAC, 2002).

Moreover, the different economic, social and cultural needs of the South East Asian economies have become increasingly evident, leading to the questioning of "one model fits all" approach. For example, one area in particular where there are striking differences is in the ownership and control of companies, where in South East Asia in over 50% of the largest 100 listed companies there is a single shareholder owning the majority of the shares, whereas in the UK in under 5% of the largest 100 companies is there a single shareholder majority (Mayer & Moores, 2001). Similarly it has become evident that terms such as market-based or bank-oriented are somewhat ambiguous, and rarely do financial institutions fit into such a clearly compartmentalised definition. For example, Germany is traditionally described as bank-oriented, yet bank lending to corporate organisations has not been high in comparison to Japan, nor have German banks been thought to be actively involved in corporate activity. Similarly a great variety of pension structures exist across different countries and setting up hybrid models would be difficult and ineffective in the short-term.

Thus far more important than promoting either a bank-oriented or market-oriented model is for the institutions to develop a framework for enhancing "culturally appropriate" for strengthening corporate governance. While supporting the financial architecture and helping authorities to identify and implement regulatory and operational reforms needed for the development of their country's financial systems and their integration within the global system, these cannot be a substitute for good financial governance (Rocha, Gutierrez, & Hinz, 1999). As national authorities work with organizations, such as the IMF, World Bank, and OECD, on preparing Reports on the Observance of Standards and Codes (ROSC), the importance of processes and practices to foster sound market decisions on the basis of clearer understanding of the risk involved and of the principles guiding financial policies becomes all the more important.

The Role of Financial Institutions in Promoting Culturally Appropriate Frameworks of Corporate Governance

The dominant role of banks within the financial system, has meant that the banking sector has always received the major part of policy attention, with the result we have tended to ignore certain sectors of the financial system. Moreover, the recent spate of massive bank failures and the social costs attributed to these failures, has resulted in a large amount of intervention in the banking system. From this perspective, the role of the banking sector has been seen primarily as that of transforming short-term liabilities into longer term assets (loans), and consequently banks have been seen as highly vulnerable to risks (in terms of credit, interest, rate and currency rate risks, and to fraud and other agency risks). In recent decades there has been a great deal of discussion over what is the best approach to reducing these risks and limiting 'moral

hazard'. Many of the measures dealing with these problems have focused on what is termed *quantitative* regulations, looking at reducing risk and ensuring transparent reporting. However, such models can never be appropriate for all financial institutions, and hence their success depends on the co-existence of good *qualitative* practices that place the responsibility for compliance and supervision with the board members, external auditors and shareholders (Rocha, Gutierrez, & Hinz, 1999).

Yet while banks have played the dominant role, today with the average population ageing in many countries, insurance firms and pension funds are introducing growing risk to financial institutions. Traditionally pension funds have taken many forms, with several variations on mandatory or voluntary, public or private. Developing "one model fits all" strategies for regulating these organisations would seem highly given the range approaches in use at present. More importantly it would appear that to reduce risk and strengthen financial institutions would require: 1) developing the capacity of authorities to understand the risks involved within the new global financial system and develop prudential quantitative regulations; 2) enforcing the internal operational standards required to promote better governance as to containing risks; and 3) developing appropriate systems for regulating and supervising the insurance and pension industry (Crockett, 2002).

Reducing Vulnerabilities by Strengthening 'Quantitative' Regulations

Quantitative regulations for risk management aim to diversify risk, limiting it to safe levels by:

- Ensuring minimum levels of capital
- Limited levels of lending to individual and group borrowers
- Transparent financial reporting through systematic classification of bank assets designed to disclosure real value of the bank's capital

In 1997, the Basle Committee's agreement on *Core Principles for Bank Supervision,* introduced a major effort to encourage prudent risk management through the development of a major international framework to harmonise financial regulation and supervision. More recently these efforts have been built upon through the IMF and the Financial Stability Forum (FSF) which was set up by the G-20, with the support of APEC and ASEAN+3, to reform the international financial architecture and to ensure ownership of all economies in the reform process. In May 2002, a Symposium on Risk Management, organized by the Finance Task Force of the APEC Business Advisory Council (ABAC), in collaboration with PECC, brought together senior officials of regulatory agencies, multilateral agencies and, banks financial advisory firms and academics from the APEC region to discuss the new Basle II Accord expected to be implemented in 2006. The goal of the Basle II will be to improve risk management at all levels of bank management including data collection on customers, management, staff, etc. and its main goal will be to improve transparency in all levels of procedure. Through its three pillar strategy, Basle II will aim to minimize capital requirements acting as a buffer against risk, strengthen cooperation between banks and regulators, and increase the disclosure of information. One key feature of Basle II is that it has been designed to offer a two-tier approach. The first for small, domestically focused banks who will be expected to provide greater disclosure of information; and the second for larger international banks who will be expected to develop their own risk management processes approved by national regulators. Strong incentives will be provided to encourage banks to step up

from one tier to the next through the implementation of well-developed risk management programs (ABAC, 2002).

The Basle II approach has brought with it however many serious concerns:

1. Implementing Basle II in the Asia Pacific region will induce a number of challenges, in large part caused by the fact that it has been developed once again without the active involvement of banks from within the Asia and Pacific region and as such it would involve a massive task of developing the regulatory structures and raising understanding among local regulators of credit risk assessments, the development of bond and equity markets through information about borrowing, etc.

2. Another challenge is related to the ability of Basle II to handle lending to small and medium size enterprises (SMEs) and micro-financing institutions, because the weighting of loans to SMEs has particular importance in emerging economies and micro financing institutions are unlikely to be able to compete with the larger banks.

3. In economies whose financial systems are geared more towards bank-oriented models Basle II could impose higher capital requirements for credit risk, because of local practices of using real estate for business loans.

4. The two tier approach may also raise dissatisfaction where national banks are working alongside international banks, since many smaller national banks are unlikely to have the capacity or resources to advance to the second tier and benefit from the incentives.

Thus while changes are required to strengthen the structure of financial supervision, perhaps there is a greater need for regulatory capacity building and an increasing recognition of the role which industry/regulator/academic cooperation can play in this process. Unless regulators are at the same stage in the learning curve as the banks they are regulating, significant risks emergence. While APEC have introduced the Financial Regulators Training Initiative, the governments in the Asia Pacific Region do not seem to place much importance with regard to governance in the government pension fund sector. More than 50 % of the participants in focus groups conducted for Project Acorn were directors of central banks, commercial banks and state owned and managed pension funds all at the same time. All had disclosed their interests in these competing institutions but no one had been asked to abstain from decision making processes within these organizations.

Improving Governance and Enhancing Qualitative Practices Related to Compliance and Supervision

Yet despite the growing emphasis on better and more appropriate ‘quantitative’ regulations, these cannot replace good bank governance, in part because they are often not appropriate to the local institution or environment, and secondly because they generally involve monitoring for compliance with rules after, and thus they fail to reveal the pending risks, or they reveal them too late.

Our research in the region has indicated that implementation of good corporate governance is the most difficult issue gripping most of the Asian countries (Srinivasan, 2001). Indonesia, for example, has good code and laws in the area of corporate governance, while in other economies there are some prominent and highly active corporate governance associations such as the Malaysian Institute of Corporate Governance (MICG), the Philippines Institute of Corporate Directors and the Federation of Thai Industries. Nevertheless despite growing awareness of the importance of appropriate models of governance, recent research suggests that to date there has been little progress (PECC, 2002) and few banks have adopted the key mechanisms for improving the 'quality' of board members, shareholders and external auditors to contain risk (Rocha, Gutierrez, & Hinz, 1999) and the concept that one model fits all seems limited.

For example, many bank boards have not outlined either committee duties or CEO job descriptions, and as a consequence lack of leadership limits the chairman and board's ability to perform effectively. Furthermore, as research indicates directors are often well below average performers due to lack of expertise, lack of participation in discussion and lack of teamwork, while companies are often stocked with insiders and friends of the CEO and although regular meetings are often held, they are generally short and rarely is the agenda set by outsiders (PECC, 2002). Similarly, little attention is paid to risk management with too much short term borrowing occurring.

In order to overcome these problems, and protect investor interests so as to sustain the income of long-term capital from foreign shareholders, financial organisations must:

- Set rules regarding the roles and responsibilities of boards and management
- Outline functions and guidelines for directors with respect to appropriate conduct, disclosure and limitations on operations
- Outline mechanisms to manage risk and report errors
- Develop appropriate standards for accounting

Yet developing rules to improve the roles and responsibilities of board and management does not necessarily mean changing to a more market oriented system, but rather it means ensuring that 1) information flows effectively between companies, stockholders and financial institutions; 2) that there is clarity over the different roles which boards and management play, and areas of confusion are ironed out; and 3) safeguards are in place to prevent conflict of interest, protecting investor as well as company interests. This requires specifying core duties of both board and management, highlighting the CEO's authority to make business decisions and select top managers, while stressing the importance of chairmen and boards to keep committees sufficiently informed of important agendas, and to make detailed and accurate disclosures of accounts. On the contrary what is important is that the process of communication used should represent that which is most culturally appropriate for the local economy and that the rules must be clear and accepted by all stakeholders, including small investors. Likewise, as Ira Millstein concluded by saying at a recent corporate governance forum, unless the developing economies take into account that 'participatory' really means 'participatory' and not presenting the "Anglo-American"

model and asking these countries to 'take it or leave it' the international efforts to strengthen corporate governance within the financial community would fail[3].

Furthermore both internal and external auditing have become central to the financial system, as supervision and compliance with regulations offers integrity to the banking sector.

Regulating Changes in Life Insurance and Pension Funds

In the past, the greater emphasis with regard to policy in the financial system was directed towards the banking sector. Yet today, with the overall population in many countries ageing at an alarming rate, there has been a massive growth in insurance firms and pension funds (Mok, 1999), and hence these two industries are introducing a growing risk to financial institutions and are consequently becoming an important component of their corporate governance initiatives. For instance, in some countries as in the UK, pension funds, life insurance and mutual funds represent the largest ownership of listed shares. Yet in many countries these companies are presently confronting serious problems and at least two of the principal Asian life insurance firms are suffering from insolvency, while HIH a primary health insurer in Australia has recently filed for bankruptcy. Moreover, as pension funds typically represent the highest proportion of household wealth (Gustan & Steinmeir, 1998), the risks involved in these funds due to unforeseeable political change, war, economic crises, stagnation and inflation are creating increasing concerns.

Much discussion over the governance of pension funds gets caught up over which types of pension funds are safest since they come in a great variety of forms (Barr, 2002), including voluntary and mandatory contributions. In the latter case, governments may either mandate that employers introduce a Defined Benefit (DB) or in other words make regular contribution based on years of service, as in the case of Australia and Hong Kong, or alternatively they may mandate that workers make a Defined Contribution (DC) or provide a percentage of their salary to entitle them to a pension, as in the case of most Latin American countries. With increasing concerns regarding the ageing population more and more governments are moving towards the introduction of mandatory pensions intertwined with tax incentives to encourage greater uptake of private pension funds. Funds collected from these pension schemes are then generally paid into accounts in either banks or insurance companies, foundations/trusts/mutual funds, participating endowment insurance funds, and funds run by management companies (Rocha, Gutierrez, & Hinz, 1999). Most private insurance contributions are paid into management companies, foundations, trusts or mutual funds. Within banks, insurance companies and endowment insurance funds the quality of the corporate governance varies according to the institution, while it is generally accepted that pension funds run by management companies have a much higher level of transparency and clearer asset segregation (Rocha, Gutierrez, & Hinz, 1999).

Yet several other risks affect pension funds including: portfolio or investment risks, agency risks, and systemic risks (Srinivasan 2001, Whitehouse, Yermo, 1999; OECD,

[3] OECD/World Bank Asia Corporate Governance Roundtable in ----, 2001.

1998). *Portfolio risks* refer to those caused by the fluctuation in asset prices, bubbles and crashes and unexpected increases in inflation. In reality, assets are generally held in pension funds for a much longer period of time and are not accessible as in the case of banks, and thus are not subject to the risk of runs and massive withdrawals in times of crises in the same degree. Diversification of portfolios within pension funds can also further reduce the level of risk. The most obvious form of *agency risk* is fraud, as in the case of the Maxwell case, and other major instances when client funds have been transferred into personal accounts. Since there are more fees associated with pension funds, there are greater opportunities for mismanagement of funds. *Systemic risks* refer to those linked to other areas of the financial system. For example, if assets are not clearly segregated from other bank activities, they may be affected by bank losses resulting from financial crises and the insolvency of a bank may result in loss of the pension scheme, and hence individual assets.

The supervision and regulation of pension funds have thus become major issues. Regulation generally involves (Rocha, Gutierrez, & Hinz, 1999):

- Licensing
- Governance rules
- Asset segregation
- Independent custodian
- External Audit
- Disclosure requirements
- Investment regulation
- Guarantees
- Minimum Capital and Reserves
- Regulations on Costs and Fees

Several developed nations within the OECD do not impose any form of restrictions other than those relating to the prudential management of portfolios, however it is generally recommended that emerging economies and Latin American nations impose strict rules and regulations initially and relax these over time (Queiser, 1998). This is particularly important with regards to guarantees, since there a few countries where these have not introduced major financing problems, and furthermore many of the countries that have introduced them still lack the legal framework for their regulation (Rocha, Gutierrez, & Hinz, 1999). Supervision of pension funds involves pre-licensing studies, on-going monitoring, and punitive/remedial supervision. The International Association of Insurance Supervisors (IAIS) has developed an international framework of core principles to monitor the supervision of this industry, the World Bank has been responsible for overseeing activities relating to the solvency of the insurance industry, and it has been the role of local regulators to deal with market practice.

Yet while strict compliance to and adherence with rules and regulations are important to limit the degree of systemic and portfolio risks, as in the case of the banking sector, in the short term the huge variation and number of insurance/pension funds will make the task of regulation and supervision highly complex and expensive to operate. For example, in Australia there are 30 times as many pension funds as there are banks and in Britain the figure is even greater (OECD, 1999). Thus ultimately, while practices like DB schemes, absolute guarantees, pension deferrals, and multiple portfolios will reduce risks, it will be the ability of economies to strengthen their supervisory

capacity that will improve the corporate governance of the insurance and pension industry.

Challenges and Issues Confronting Financial Institutions:

- To meet short fall of qualified directors
- To develop culturally appropriate governance structures
- To introduce more incentive compatible mechanisms for both boards and managers
- To clarify role and responsibility and strengthen laws and regulations
- To enhance transparency through effective auditing disclosure
- To raise quality of boards
- To develop capital markets
- To improve minority shareholder rights
- To limit the number of pension funds.

Risk Management Issues in Insolvent Companies

The issue facing boards of insolvent companies in the Asian region include the major issue of dealing with frauds committed by previous boards and board members. In many instances, these have been referred to the police and fraud related agencies but there are no clear directions on what should be done by the new board. This issue will be discussed as part of my presentation and a separate paper on this issue will be produced.

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