



The Second Asian Roundtable on Corporate Governance

The Role of Disclosure in Strengthening Corporate Governance and Accountability

A Consolidated Report on Corporate Governance and Financing in East Asia

Executive Summary

Report prepared for the Asian Development Bank

**Hong Kong, China
31 May – 2 June 2000**

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A. The Objective of the Study

This report provides a summary of major findings of *A Study of Corporate Governance and Financing in Selected Developing Member Countries*, which include Indonesia, Republic of Korea (Korea), Malaysia, the Philippines and Thailand. The objective of the study is to evaluate the role of corporate governance in the five countries most affected by the Asian financial crisis. More specifically, the study aims (i) to evaluate the historical development, current state and major weaknesses of corporate governance and financing in the five affected countries; (ii) to establish a sound analytic basis for the design and implementation of policy and regulatory reform measures for strengthening the governance and improving the efficiency of financing and investment of the corporate sectors of countries in the region; and (iii) to identify areas where interventions by the ADB could be effective.

Generally, the problem of corporate governance arises because of the separation of ownership from control. This agency or moral hazard problem can exist not just between shareholders and managers, but also between controlling and minority shareholders, between shareholders and creditors and between controlling shareholders and other stakeholders including suppliers and workers. A sound corporate governance system should provide effective protection for shareholders and creditors such that they can assure themselves of getting a return on their investment. It should also help to create an environment conducive to the efficient and sustainable growth of the corporate sector.

A corporate governance system consists of a set of rules that define the relationships between shareholders, managers, creditors, the government, and other stakeholders (i.e., their respective rights and responsibilities) and a set of mechanisms that help directly or indirectly to enforce these rules. The "arms-length" financial systems of the United States and the United Kingdom promote dispersed ownership of debt and equity and liquid financial markets. There the principal agency problem is usually seen to be between management and investors. Corporate governance is exercised by portfolio investors through the enforcement of shareholder and creditor rights and through the market for corporate control. This system places great emphasis on the courts to enforce shareholders' rights over assets and cash flows. The "relationship model" of finance common in East Asia emphasises long-term relationships between firms and investors. The model places greater emphasis upon enforcement through trust embodied in relationships and internal controls. Countries fitting this model typically have more concentrated ownership and less liquid financial markets and emphasise the importance of control oriented block-holders. Corporate governance is exercised by block-holders, with the predominant conflict being between controlling block-holders and minority shareholders.

B. Key Features of Corporate Governance and Financing in the Five Economies

Ownership. The country studies found that all the five economies have concentrated corporate ownership. For publicly listed companies the average (not weighted by market capitalisation) top five shareholder concentration ratio for Indonesia, Malaysia, the Philippines and Thailand ranged from 57 percent to over 65 percent and 38 percent for Korea. The ownership profiles in all of the economies are characterised by significant family ownership achieved either directly or through holding companies or nominees. Corporate ownership by foreign investors varies across the five countries. In Korea, the outstanding shares of non-financial companies held by foreigners were around 5 percent (not weighted by market capitalisation). In Indonesia and Malaysia foreign ownership stood at 25.4 percent and 19 percent respectively in 1997. Contrary to some expectations there is no systematic evidence to suggest that cross-shareholding is widespread in the five countries. Controlling blocks are derived from a pyramid structure, also called the parent-subsidiary structure. A family-owned holding company owns shares of operating companies that usually are parent companies themselves, i.e., holding shares of other operating companies as well. The purpose of investing in other companies is to obtain strategic control, to facilitate supply contracts, and to obtain economies of scale through shared management and financing. Furthermore, there is generally considerable opacity in ownership structures, partly as a result of poor transparency and disclosure requirements.

Shareholder Participation and Protection. The country studies show boards of directors to be an ineffective oversight mechanism in safeguarding interests of all shareholders. This is because of the dominance of family-based controlling shareholders and also because of the lack of effective mechanisms that could provide checks and balances such as the representation of independent directors. The studies suggest that the effectiveness of boards of directors may also have been undermined by the chairman of boards of directors often being the chief executive officer (CEO) or a member of top management team. There is systematic evidence of a lack of independent directors or independent committees for remuneration, director nomination and audit. There is also relatively little use of incentive related pay that may indicate poor alignment of management's incentives with shareholders interests. The country studies find that in all the five countries, the mechanisms for participation by minority shareholders in corporate decision making were generally weak, shareholder participation was passive and legal protection for shareholders was inadequate. The country studies also report poor transparency and inadequate disclosure practices. A number of factors may explain these findings. Corporate insiders, mainly families and family groups, have little tradition of disclosure. Also disclosure requirements have been undermined by inadequate accounting standards and weak implementation of these standards, including failure to impose penalties for fraudulent financial reporting.

Creditor Monitoring and Protection. Creditors in general have little input into companies' management and decision making, and their role in corporate governance is weak. First, creditors themselves are poorly governed. This is explained by weak internal control and inadequate regulatory frameworks for the banks and non-bank financial institutions. In many of the affected countries, banks' internal risk management systems appear to be underdeveloped. Capital adequacy and solvency requirements for banks are generally rudimentary with only weak mechanisms in place to ensure compliance.

Secondly, the lack of competition and creditors being parts of conglomerates or effectively owned by the same families who own the borrowing firms undermined banks' role in monitoring. Thirdly, implicit and explicit government guarantees of loans may have further weakened creditors' incentives to monitor and discipline bad borrowers and to recognize non-performing loans. The country studies provided a general picture of weak legal protection of creditors, due partly to the inefficient judiciary system in these countries. Moreover, insolvency laws and procedures are generally ineffective, both in protecting creditors and disciplining borrowers.

The Market for Corporate Control and Product Market Competition. The market for corporate control has been largely inactive in these countries. This is partly a function of government policy but it also reflects the difficulties of mounting hostile take-overs when ownership is so concentrated. The country studies also documented the high degree of concentration of industry. Firms themselves are typically part of groups or conglomerates that are highly diversified. Internal capital markets and systems of cross subsidies within these groups are the main obstacle to market competition as an instrument of corporate governance.

Capital Markets and Corporate Finance. Capital markets are not well developed in most East Asia countries. In the affected countries, except Malaysia, internal finance amounted to no more than 30 per cent of total finance, and external finance dominated corporate financing. The most important form of external finance was bank loans. The insignificance of internal finance may be explained partly by the rapid growth of the corporate sector, and, for some countries, in particular Korea, the poor corporate financial performance. There was also a positive correlation between ownership concentration and the level of leverage. The lack of a well-developed capital market may also be one of the main reasons that in some countries firms have relied mainly on bank finance. The insignificant role of corporate bonds in corporate financing is explained by regulatory restrictions, the ineffectiveness of legal procedures in cases of insolvency, and the lack of market infrastructure, such as credit rating agencies. Firms undertook extensive foreign borrowing because liberalized foreign interest rates were more favorable than the regulated domestic interest rates. Moreover, pegged exchange rates were seen to guarantee against exchange rate fluctuations, so that firms chose not to hedge their foreign debt.

Other Findings. The country studies also provided the following observations. Firstly, there are significant variations in the quality of corporate governance and financing across the five countries. Overall, Malaysia scores higher than the other four countries, which appears to be consistent with experiences of these five countries during the financial crisis. The relatively good performance of the Philippines appears to have been the result of prudent banking practices set in place after the financial crisis of the early 1990's in this country. Secondly, especially in Malaysia, but also in the other four countries, even before the outbreak of the Asian crisis, the governments initiated some measures to strengthen and modernize the regulatory framework for the corporate sector and capital markets. The basic regulatory structure for the corporate sector in these countries appears to be in place, although there are gaps and loopholes, and some areas need to be modernized. The major problem in the legal and regulatory framework appears to be that of poor enforcement. The poor enforcement might have been caused by a number of factors, including the problem of general governance (e.g., the existence of widespread corruption

in some countries), ineffective judiciary system, the lack of trained and qualified personnel for legal enforcement, and to some extent, the preference for private negotiation and out-of-court settlement by concerned parties in disputes.

C. Recent Reforms in Corporate Governance in the Affected Countries

Reform measures have been proposed or implemented in areas of corporate ownership, shareholder participation and protection, transparency and disclosure, and bankruptcy procedures, aimed at strengthening the protection of minority shareholders and creditors. These measures have taken the forms of amending various corporate and securities laws and regulations, introducing self-regulatory codes of corporate governance, and improving the institutional framework for promoting and enforcing rules of sound governance practice.

Ownership. Some countries, notably Malaysia, proposed or introduced measures involving relaxing restrictions on shareholdings by specific groups. Also in a number of countries minimum requirements for stock exchange listings have been either introduced or increased. In most cases ceilings on foreign equity ownership have been removed. Also in Indonesia, for example, listed companies are allowed to offer additional equity directly to the public and not limited to rights issues.

Shareholder Participation and Protection. Reforms or proposed reforms in this area have aimed mainly at strengthening boards of directors, improving the role of Annual General Meetings (AGMs) and strengthening minority shareholder legal rights and protection. For example, a number of countries have already introduced mechanisms of shareholder democracy, such as one-share one vote, cumulative voting and class action suits. To promote greater transparency, countries have introduced changes to accounting and auditing standards, financial reporting systems and disclosure requirements

Market for Corporate Control and Market Competition. In a number of countries, notably Korea, as part of debt restructuring conglomerates have sold off non-core businesses and are focussing on core activities. This should have the effect of reducing inefficient lending practices through internal capital markets. All countries have lifted restrictions on hostile take-overs including bids from foreigners. The latter is part of policies designed to encourage foreign ownership and foreign direct investment, particularly in debt restructuring.

Creditor Monitoring and Protection. A number of countries introduced bankruptcy reforms to facilitate debt restructuring after the crisis. However, in all the affected countries, further reforms in bankruptcy procedures and foreclosure laws are required to strengthen the role of creditors in disciplining companies and managers, to protect creditors' rights, and to facilitate the process of corporate debt restructuring. In addition the mechanisms for enforcing covenants in loan agreements need to be reviewed.

D. Policy Recommendations for Strengthening Corporate Governance

Recommendations for further reforms are grouped into the following broad areas: (i) corporate ownership structure; (ii) corporate internal control and shareholder protection; (iii) external monitoring and discipline; (iv) capital market development and corporate

financing; and (v) regulatory structures. It is important to stress that these recommendations are not intended to be prescriptive and comprehensive. The recommendations point to several key areas to which the concerned government authorities in the affected countries might want to pay close attention in addressing weaknesses in corporate governance and financing. Each country should formulate its own reform plan and implement measures that suit its specific conditions.

Ownership Structure. Concentrated, family-based ownership structures appear to have hindered to some extent the development of sound corporate governance in the five countries. It is recommended that the governments implement policies to broaden share ownership, including participation by financial institutions such as pension funds and encourage active participation by foreign institutional shareholders that may insist on higher standards of disclosure and corporate governance in general. Governments need to develop policies to encourage greater transparency of shareholdings.

Internal Control and Shareholder Protection. In the presence of concentrated ownership and in the absence of external governance from mature capital markets and banks, governments need to strengthen the regulation of the behaviour of the internal governance agent, the board of directors. The key elements of regulations to strengthen the board of directors are: a clear specification of the fiduciary duties of directors that provides a sound basis for enforcement of prudential requirements on management of companies and for action by adversely affected minority shareholders against their boards; representation of independent directors in the board; and the establishment of independent subcommittees for important corporate matters, in particular auditing. These are also necessary provisions to support the promotion of shareholder activism.

To ensure that minority shareholder rights are protected, where not in existence mechanisms for shareholder democracy should be introduced. These include one-share one-vote and cumulative voting; raising majority percentage votes on critical corporate decisions; and introducing derivative or class action suits. In addition insider trading regulations and measures to prevent, detect and penalize self-dealings involving controlling shareholders should be reviewed and strengthened.

The quality of accounting, auditing and financial reporting needs substantial improvement. Recommendations include establishing a supervisory entity to regulate accounting, auditing and financial reporting practices and to enforce the standards; require that all publicly listed companies appoint independent directors and external audit subcommittees and mandate their functions and responsibilities to public investors; and the imposition of sufficiently severe penalties for fraudulent financial reporting.

Creditor Monitoring, Discipline and Protection. In the short to medium term in all of these economies, the key agents of external governance will be banks. To ensure that they fulfill this role major reforms are required. These include removing explicit and implicit guarantees by governments in favor of banks; limiting the shareholdings of non-financial companies in banks and of banks in non-financial companies so as to avoid conflict of interests; setting and strictly enforcing limits on lending by banks to affiliated companies, officers, directors and related interests. There is also a need to strengthen capacities for regulation and supervision of banks. These functions could be given to a specialized organization that may or may not be separate from the Central Bank. Banks should apply international standards of capital adequacy and the regulator should assure strict

compliance with these standards. Banks should follow international financial accounting, reporting and disclosure standards.

Many of the bankruptcy reforms that have been undertaken were expedients, introduced after the crisis to facilitate the immediate restructuring of bankrupt enterprises. It is argued that the bankruptcy laws of the countries should be thoroughly reviewed. A well-designed set of insolvency procedures should allow debtors and creditors to resolve insolvency problems informally if possible. Informal procedures could take the form of work-outs supervised by the Central Bank or some other agency, as in the London Approach; or pre-packaged Chapter 11's; or debt equity swaps. Formal procedures with bank based finance are likely to require clear rules for receivership or administration. If bond financing is important, a mechanism for reaching agreement between creditors may be necessary. Introducing a moratorium on creditor claims and debtor in possession restructuring must be done in a way that maintains the creditors' incentives to take an active role in governance. We also argue that governments need to review the securities laws to ensure that debt claims are enforceable and creditors can enforce their rights on assets permitted as collateral.

Market Competition and the Market for Corporate Control. To promote governance through product market competition governments should review their industrial development policies to eliminate remaining biases toward subsidies, implicit and explicit guarantees, entry and exit barriers and various other forms of protection. They should review their competition policies to enable entry and exit of domestic and foreign companies whilst regulating monopolies and anti-competitive practices. In addition governments should review their Corporate Laws for possible impediments to acquisitions of companies by outside investors, for example, “poison pills”, restrictions in voting by the board, limits on acquisitions of shares by a stockholder, etc. Governments need to formulate their Take-over Codes to adopt internationally accepted practices.

Capital Market Development and Corporate financing. Asian capital markets are characterized by a “missing middle” of institutional shareholders. Development of an institutional investor community is vital to the promotion of the role of outside shareholders in monitoring firms. Indeed these institutions and in particular foreign institutions will demand higher standards of transparency and disclosure and be a force to improve standards of corporate governance. Governments should review regulations of and accelerate the development of equity as well as debt markets. Policies to increase the supply of quality equities and corporate bonds trading with sufficient volume and liquidity will encourage institutional and individual investors. It is recommended that governments review public listing, trading rules and supervision systems in order to ensure that markets are operating efficiently. Of special importance are those related to disclosure, insider trading, public listing and de-listing rules. Also the quality of trading and settlement systems needs to be assessed.

We believe that banks are likely to remain the main mechanism of corporate financing in Asian economies. The relationship model in which they play the central role has not provided a prudent source of funds nor a sound disciplining mechanism for the investing and financing behavior of large shareholders. Banking systems, under present methods of supervision, have failed in their governance role. Re-capitalized, independent and

properly supervised banks should do better. However, we recommend that governments make efforts to simultaneously develop securities markets as a source of corporate financing.

Regulatory Structures. We recommend that the regulatory structures of banking and capital markets be reviewed. The appropriate balance between external and self-regulation should be assessed. In many cases, information costs and the nature of incentive problems will make self-regulation appropriate. However, in some cases external regulation with statutory penalties for non-compliance will be required. Ultimately corporate governance issues can not be addressed independently of this broader range of issues. Further, amending corporate laws and regulations cannot guarantee the strengthening of corporate governance. The enforcement of these laws and regulation is at least as important as the laws and regulation themselves, if not more so.

Priority Reform Areas. We recommend that governments identify a few priority areas where corporate governance reforms could be most effective in the short to medium term. Among measures aiming at strengthening external discipline, one priority area is prudential regulation and supervision of banks and non-bank financial institutions. Given their current dominance in corporate financing, banks and non-bank financial institutions as creditors should play a greater role in monitoring and disciplining non-financial corporations, not only in insolvent, but also in solvent states. Among measures aiming at strengthening corporate internal control, improving standards of accounting, auditing and financial reporting systems and their enforcement should be placed on the top of the reform agenda. Measures such as developing capital markets, promoting market competition, facilitating the market for corporate control and encouraging participation by institutional shareholders are important and should be implemented without delay. However, it may take a considerable period of time either for these mechanisms to be in place or for their effects to be felt.