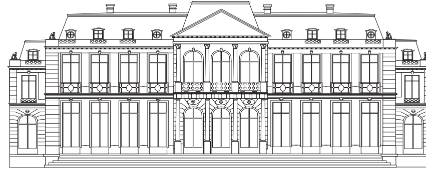
Organisation for Economic Co-operation and Development



Organisation de Coopération et de Développement Économiques

in co-operation with

the Korea Development Institute

and with the co-sponsorship of the Government of Japan and the World Bank

Conference on "CORPORATE GOVERNANCE IN ASIA: A COMPARATIVE PERSPECTIVE"

Il Chong Nam, Yeongjae Kang, and Joon-Kyung Kim
Korea Development Institute

COMPARATIVE CORPORATE GOVERNANCE TRENDS IN ASIA

Seoul, 3-5 March 1999

1. The Asian Economic Crisis and Corporate Governance

The scope and severity of the economic crisis that swept through the East Asian region less than two years ago are well documented.[1] However, consensus has yet to be made about the underlying causes of the crisis, the relative importance of each cause as well as the relationship among them. At the outset, it was a seemingly sudden reversal of foreign capital flows that triggered a currency crisis, initiating in Thailand and then spreading out across the region.[2] Shifts in external conditions, in particular increased competition from other developing countries such as China and Mexico, are said to have eroded the export competitiveness and hurt the profitability of the firms in the region. These developments may have been factors in triggering the flight of foreign capital out of the region in that they raised concerns among investors about the ability of those firms to repay their debts. Certain macroeconomic and exchange-rate policy measures undoubtedly played an important part, especially in the last months leading up to the crisis.

At a deeper level, inherent instability in the international financial market, often stemming from herd mentality and contagion effects, was identified as a key factor that triggered the currency crisis. Without a credible lender of last resort at the international level, a rational creditor is prone to the incentive to withdraw her lending out of an otherwise healthy country if she expects the other creditors to do the same thing. The resulting outcome is a massive and sudden pull-out by foreign investors, and such a flight to quality eventually exerted contagion effects on the neighboring countries and across the region. This kind of creditor panic is *rational* in the sense that it is a particular equilibrium, albeit bad, out of the multiple equilibria possible under the circumstances.

More importantly, various structural defects in East Asian economies, such as prolonged moral hazard, crony capitalism, lax prudential regulation and supervision, and weak corporate governance, have been lying at the center of the crisis. In particular, underdeveloped corporate governance systems and inadequate financial supervision have already been recognized, and are perceived to have contributed to the region's vulnerability to a crisis in general and to the reversal in creditor perceptions before the onset of the current crisis. In all likelihood, any one of these factors can not be singled out as a sole cause of the crisis. Rather, they all acted together to bring about the initial currency crisis.

Another important aspect of the East Asian crisis was that the initial currency crisis

---

* The authors gratefully acknowledge the help from Sung Wook Joh and Jun-Il Kim.

[1] Furman and Stiglitz (1998), Goldstein (1998), Radelet and Sachs (1998, 1999), World Bank (1998).

[2] In the course of six months during 1997, the combined net inflow of $97 billion reversed itself into the net outflow of $12 billion. This turnaround of $109 billion represents about 10% of the pre-crisis GDP of the five countries. See World Bank (1998).

Copyright © OECD All rights reserved

quickly degenerated into a full economic crisis with massive corporate bankruptcies and soaring unemployment. In this regard, it is important to distinguish between the currency crisis and the subsequent collapse of corporate and financial sectors, although they are certainly related. It could be the case that a more astute policy response and/or better institutional arrangement in the international financial market may have averted a currency crisis which entailed an economic crisis of this magnitude.

However, the structural deficiencies in the East Asian economies played the role of a magnifying lens through which the initial liquidity crisis was quickly turned into a full-blown economic crisis, not to mention their contribution to the onset of the crisis. Korea's economic crisis provides a prime example of such a magnifying linkage. Indeed, Korea's financial crisis started from a string of large corporate bankruptcies, which in turn significantly undermined the health of domestic financial institutions. The lack of transparency and information caused a free-fall of foreign investor confidence in the face of deteriorating financial soundness. In the post-crisis period, fundamental structural weaknesses in Korea's financial and corporate sectors, particularly heavy reliance of the corporate sector on debt financing and large non-performing loans held by financial institutions, caused the severe credit crunch and subsequently massive corporate bankruptcies and severe recession in the real sector.

Among various structural weaknesses in the East Asian countries, failures in the corporate governance systems have received particular attention as not only one of major causes of the crisis but also the magnifying channel in the post-crisis development. Although there has been little rigorous analysis that systematically relate the specific forms of corporate governance failure in the affected countries to the crisis, a useful framework to understand this issue in our context is proposed in a recent paper by Rajan and Zingales (1998).[3]

They investigated the interaction between a large influx of foreign capital and the absence of adequate contractual infrastructures. According to their theory, in the face of ample investment opportunities in East Asian countries in which business environment was largely *relationship-based* and reliable institutional mechanisms that could protect their long-term investments were weak, foreign investors found it optimal to confine themselves to primarily short-term investments. As the short-term investment entailed little cost of flight, a shock could relatively easily induce an exit en masse equilibrium. They subsequently argued that a country in the process of capital market liberalization has to either accept the risk of financial fragility in

[3] Recently, several papers examined the relationship among corporate governance, legal protection of investors' interests and the financing of firms across countries and found that the better they are protected the larger and wider is the capital market and the less concentrated is corporate ownership. Others examine the relationship between corporate governance and corporate performance, although their conclusions are mixed. See La Porta, Lopez-de-Silanes, Schleifer and Vishny(1997, 1998) and OECD (1998) for a comprehensive survey.

Copyright © OECD All rights reserved

the absence of necessary institutional development, or improve its financial infrastructures to transform its system for allocation of financial resources into a *market-based* (arm's-length) system.

The relationship-based system and weak corporate governance in East Asian countries went hand in hand with each other until the current crisis brought to light the combination's flaws and abuses. Since the early days of economic development when firms were largely financed by bank loans under government influence, close links among firms, their banks, and the government have developed through ownership, family ties and political deal making. Both firms and banks within this relationship-based system felt little need to develop elaborate corporate governance mechanisms, since the former were able to rely on banks to continue to finance their projects and the latter felt comfortable under the explicit or implicit government guarantee. On the other hand, outsiders had little incentive to heavily invest into a new relationship given the lack of protection provided by the underdeveloped corporate government system.

By contrast, the market-based system allocates financial resources through explicit contracts and associated prices. To the extent that contracts are inevitably incomplete, investors who supply funds to a firm are better protected if the firm is equipped with better corporate governance mechanisms with a higher level of transparency. Thus an economy's move from the relationship-based to well-functioning market-based system requires improvement of its corporate governance system.

Looking beyond the relationship between corporate governance system and the financial crisis, the issue of corporate governance also has important implications on economic restructuring and growth as it is an issue related to the functioning of both financial and non-financial firms, as well as the market as a whole.

Corporate Governance and Economic Restructuring

When the East Asian governments liberalized their capital markets, foreign investors from the market-based system rationally chose mostly to lend primarily on a short-term basis in the face of the existing relationship-based system and weak corporate governance, as explained by Rajan and Zingales (1998). Meanwhile, capital market liberalization was not accompanied by the development of requisite market and regulatory institutions, in particular prudential supervisory functions in the financial sector. Thus while the banking sector rapidly expanded its lending to the corporate sector, banks failed to play a proper monitoring role.

Under these circumstances, it is likely that some of the funds newly provided by foreign investors were misallocated, lowering overall corporate profitability and raising vulnerability.

Copyright © OECD All rights reserved

To be sure, the relationship-based system can perform the task of resource allocation relatively well through inter-temporal cross-subsidies within a firm or inter-firm cross-subsidies within a business group, especially when legal and contractual infrastructures are not well developed and price signals are not informative. But the problem of resource misallocation can be significant under the relationship-based system since it does not use price signal and lacks monitoring and discipline from the market.[4] These deficiencies hurt most when abundant funds need to be allocated among new investment opportunities, which was the case in the East Asian countries after the liberalization.

The results of all these developments during the 1990s until the onset of the crisis were rising leverage and falling profitability in the corporate sector, a poorly supervised banking sector with increasing corporate loans largely financed by short-term foreign debts, and an underdeveloped securities market.[5] This is certainly not a situation of crisis in itself, but a dangerous mixture that is quite vulnerable to one. Once the crisis hit the region, indeed, corporate bankruptcies spread throughout the region and exacerbated difficulties of the already ailing banking sector. There seems also to be a consensus that some kind of restructuring in both the corporate and financial sectors would have been inevitable even if the currency crisis had been averted, while the extent of needed restructuring and the associated economic and social costs would vary among the countries.

To draw policy implications, it is important to note that the pre-crisis situation in East Asia was not just an unhealthy outcome but an *equilibrium*, in which all the players, firms, banks, and foreign investors (and policy-makers to some extent), behaved rationally to pursue their own interests given the other players' behavior under the economic and institutional environments described above. This suggests two implications.

First, the rules of game have to be changed for a better economic outcome to be obtained in equilibrium. The key characteristics of the pre-crisis environment were a relationship-based system, weak corporate governance, a liberalized capital market, and inadequate financial supervision. One obvious policy direction leans toward the market-based system in order to take the best advantage of liberalized and open capital markets by strengthening corporate governance and supervisory institutions, as pointed out by Rajan and Zingales (1998). The other direction goes back to the old relationship-based system with a government-directed financial sector and underdeveloped governance and market institutions. Not only does this move have inherent inefficiencies but would entail serious growth

[4] For recent evidences for relative performance of the relationship-based system, see Hoshi, Kashap, and Scharfstein (1991), Weinstein and Yafeh (1998), Peek and Rosengren (1998), Calomiris and Rammirez (1996).

[5] This characterization of course involves a bit of simplification since there were some exceptions. (For example, the corporate profitability did not fall in Malaysia.) See World Bank (1998) and Radelet and Sachs (1998) for more detailed accounts.

Copyright © OECD All rights reserved

implications as explained later.

Second, a third party is needed to change the rules and to coordinate the players' move to a new, better equilibrium since no individual player has any incentive to do so unilaterally. A natural candidate is the national government, in cooperation with international organizations and other governments. The most important function of the third party is to provide leadership. Thus it does not have to be a single entity, and other parties from the private sector should be welcomed to join.

Corporate Governance and Economic Growth

As Radelet, Sachs, and Lee (1997) argued, the East Asian countries have achieved their phenomenal economic growth with export-oriented policies by successfully integrating national production with international production, through specific institutions such as technology licensing, original equipment manufacturing, and export processing zones. This strategy enabled the economies to begin with low-technology manufactured export activities and gradually upgrade to high-technology products.

Now these economies stand at the crossroads facing important decisions on how to sustain continued economic growth without creating, and suffering from, bubbles in the non-tradable sector. Other than maintaining stable macroeconomic environments, the following three related policy issues can be identified.

First, market liberalization will continue to be important. As long as exports remain a key to future economic growth and development, the domestic markets and production processes need to be ever more deeply integrated with the global economy. Second, provision of low-cost long-term financing to the corporate sector is going to be crucial. As the impetus of growth for an economy increasingly comes from the high-tech sector, production and development processes become more capital intensive, and the corporate sector needs to adjust their financing accordingly to stay competitive in the international markets. In this regard, healthy growth of the securities market along with a prudent banking sector will be instrumental.

Third, better investment decisions and a mechanism to induce such decisions will be needed more than ever. As the economy places more emphasis on technological advancement and integrates itself more deeply into the global economy, production and investment decisions become more complex under the diverse market environments. For an efficient investment decision to be made, not only should all the relevant information be efficiently aggregated, but

Copyright © OECD All rights reserved

also the incentives of any given decision-maker need to be aligned as close to the social efficiency as possible. This observation points to the importance of the signaling function of market price, and to the effectiveness and transparency of corporate governance systems.

The above discussion suggests that sustained growth in a globalized economic environment will require an efficient use of price signals, healthy and well-functioning financial markets, and effective and transparent corporate governance mechanisms. We have already argued that these ingredients can only be acquired through the move toward a market-based system by strengthening corporate governance, and developing market and supervisory institutions. Although the third party's leadership role will be as important in this transformation, voluntary involvement and coordination among individual players from the private sector can be more easily achieved since they can recognize the mutual benefits over the long haul.

Even when it is agreed that corporate sector reform is in order in the Asian countries, the following important questions still need to be answered if proper policy options are to be formulated and successfully implemented.

- What are the comparative advantages or disadvantages of the "old" corporate governance in the Asian economies, as opposed to that of more advanced economies? If the old system worked in the past, why change it now? What determines the optimal form of corporate governance?

- Why did the East Asian countries that are in trouble now not introduce the reforms before the crisis and stick to their old way of doing business? How much did the endogeneity of law matter? Does it still matter?

- If reform in corporate governance is needed to better protect investors, what are the impediments to the implementation of the reform measures?

- Considering that the forms of corporate governance differ even across the advanced economies, what reform measures are appropriate for each developing country?

- To the extent that the corporate governance structure is an outcome of a game that is basically determined by the economic environment of a country and not a simple variable that the government can change overnight, what is the role of government and how will corporate governance systems evolve in the East Asian countries?

- Is there a trend emerging in corporate governance structures among the advanced economies which developing countries can, or should, model themselves after?

Copyright © OECD All rights reserved

Some of them will be answered to some degree in the remainder of the paper while others will warrant further study beyond the scope of this paper. Section 2 presents key aspects of corporate governance system, according to which the realities and patterns of corporate governance in the Asian countries will be reviewed in Section 3. Section 4 discusses the challenges and future policy options for the region.

2. Key Aspects in Corporate Governance System

As with any other economic institution, a successful corporate governance system must accomplish the tasks of coordination and motivation. The decisions and actions of the interested

Copyright © OECD All rights reserved

parties, i.e. shareholders, management, and creditors and potential investors in the financial market, need to be coordinated to protect the shareholders' interests and efficiently advance other corporate goals. At the same time, the relevant parties must be motivated to carry out their parts in the coordinated system through rewards for taking appropriate actions, and punishments for failing to do so.

Three main requirements for effective corporate governance are usually identified. *Transparency* is a must for generation and use of information needed for efficient coordination and motivation. *Equity* is about protecting legal and contractual rights of the interested parties, and helps to set the boundary and parameters of the corporate goals that management is mandated to pursue. *Accountability* is a key to providing adequate incentives and discipline for the management so that it is properly motivated.

An efficient corporate governance system would ensure that a firm is managed to increase its value to the shareholders, subject to legal and contractual constraints, and help achieve the socially efficient resource allocation given that financial and product markets relevant to the firm are properly functioning as well. Failures in corporate governance on the other hand could result in a sub-optimal allocation of resources, overly risky investments, abuses and downright theft by management, expropriation of "outside" shareholders and creditors by controlling shareholders, financial distress, or even bankruptcy.

With those tasks and requirements in mind, we will take a broader view of corporate governance and review the corporate governance systems in the Asian countries by examining the following five aspects, or subsystems, of corporate governance in the following sections.

- *"Internal" corporate governance* concerns the relationship between management and shareholders, or between corporate insiders (management and controlling shareholders) and outside shareholders. Important institutions and legal and contractual arrangements of the internal corporate governance system include the rights of shareholders, and the means to their protection and ex-post remedy; the role and responsibility of the board of directors and its composition; as well as disclosure and listing rules.

- The *internal and external corporate governance system of financial institutions* ensures that they are managed as profit-seeking entities with due consideration on soundness, rather than functioning as simple conduits of funds into the corporate sector. Proper risk management and credit evaluation by financial institutions constitutes the core of internal governance, while prudential regulation and supervision are institutional devices for external governance to ensure the soundness of both individual institutions and the financial system. Without effective corporate governance of financial institutions, the discipline from the financial market would be significantly weakened.

Copyright © OECD All rights reserved

- *"External" corporate governance by the financial market* concerns the relationship between the firm and other suppliers of funds such as creditors. The regulatory and legal environments, and institutions of the financial market constitute this external governance system. It reinforces internal corporate governance by monitoring the efficiency of a firm's investments, and requires adequate internal governance of financial institutions for its effectiveness.

- *"External" corporate governance by the market for corporate control* concerns the relationship between the firm and potential investors/entrepreneurs in the stock market. Among the important elements in this external governance system are stock market regulations regarding merger and acquisition (M&A), corporate charters and bylaws with respect to hostile take-overs, and disclosure and listing rules. It complements internal governance by disciplining inefficient management with a take-over threat while rewarding efficient ones with rising stock prices.

- *Governance by insolvency mechanisms* concerns firms which have fallen into deep financial trouble or gone bankrupt due to failures in their internal and external corporate governance or simply as a result of bad luck, or a combination of both. Formal insolvency procedures through the courts, informal workouts, and even the M&A market to some extent affect the corporate governance of those firms through changes in ownership structure and often management in the process of redistributing the financial claims among the shareholders and other investors. These *ex post* changes in corporate governance structure by insolvency mechanisms can have *ex ante* effects on the incentives of the current management, controlling shareholders, and other investors. Consequently, the structure and actual workings of the insolvency mechanisms will play a significant role in determining the structure and performance of the other internal and external governance systems of the firm.

It goes without saying that each of the five governance subsystems does not function in isolation. Rather, they are closely interrelated and complementary in constituting a single integrated system of corporate governance which is adapted over time to the given economic and legal environments of the firm. In this respect, it is important to look at not just the form but the substance of corporate governance in an economy, and in particular, to examine additional elements in the analysis of the Asian countries given their particular paths of economic development and growth.

First, we need to look beyond corporate governance at the individual firm level. It is well known that a small number of families dominated the corporate landscape in most East Asian countries.[6] Given this, the relationship among the firms within a business group

[6] Korea, whose economy has been dominated by *chaebols* for decades, seems to be the best example in

Copyright © OECD All rights reserved

controlled by a single family is necessary in order to gain insights into corporate governance in the real sector. A tight linkage among the firms under unified control could lead to better firm performance by pooling resources and information as well as by reducing transaction costs. However, there is also a clear danger that such singular control of several firms may facilitate the expropriation of non-controlling (outside) shareholders by the controlling shareholders.

In some countries, the controlling shareholders have frequently utilized inter-firm transactions as a means to divert resources from one firm to another and to increase their welfare at the expense of the outside shareholders. In such countries, one of the most crucial issues with respect to corporate governance is how to identify whether the inter-firm transactions within a group are value-enhancing for both firms or not. Equally important are the issues related to how to provide the adversely affected parties with the means to prevent the detrimental transactions beforehand and to seek redress for the damage afterwards.[7]

Second, we also need to investigate the role that the government played in the development of corporate governance of some East Asian countries. Let us take the case of the inadequate governance structures and lax prudential regulation of banking institutions that lie at the heart of most Asian countries' failure in corporate governance. A large part of the failure in the governance of the financial sectors in the affected countries is undoubtedly attributed to the simple fact that these countries are still developing economies with only a short history of market capitalism. Consequently, relevant market institutions and other legal infrastructures are still underdeveloped.

Nevertheless, in some East Asian countries, there is a possibility that the institutional arrangements have been kept from evolving into ones that correspond to the economic conditions due to the influence of the elite in political and business spheres, as suggested by the endogeneity theory of law. Reports on some East Asian countries that relate corruption to the economic crisis also refer to this possibility.

A more important source of the failure in the financial sector governance can be found in governments' interventionist industrial policies. Governments' direct control on the

---

this regard. However, the dominance of family-controlled groups of firms is also pronounced in most other Asian countries, although the degree of their dominance may vary from country to country.

7 It is worth noting that there still exists a strongly-held view in some East Asian countries that the tight relationship among the firms in a conglomerate under a unified control was a key to the past successes of many Asian firms and should not be disturbed in the future even though it may entail expropriation of outside shareholders. According to this view, the inter-firm transactions within a conglomerate are attempts to internalize otherwise infeasible transactions in the imperfect and underdeveloped markets, and any damage to some parties are the unavoidable transaction costs due to the market imperfections. The argument often goes as far as saying that the expropriation of outside shareholders cannot be a problem because they should know fully well that they could be expropriated when they decide to invest in the firms. This is in fact an apt description of the relationship-based system and its key weakness, and we have already argued the need to go beyond the relationship-based system of resource allocation.

Copyright © OECD All rights reserved

allocation of financial resources has distorted the incentives of financial institutions creating a severe moral hazard, and impeded the development of necessary corporate governance mechanisms. It also has adversely affected governance in the corporate sector. As governments provided subsidized credit to firms in the targeted industrial sector, and implicitly shared their investment risk, those firms, and more importantly the dominant shareholders of those firms, were excessively protected from market competition and discipline.

In the next section, we will document the major patterns and realities of corporate governance in the East Asian countries and analyze the important characteristics of governance structure within the framework described above.

3. Corporate Governance of the East Asian Countries

3.1 Overview

The corporate governance structures of the East Asian economies have generally been associated with a high concentration of ownership and control by a few families, low level of property right protection and weak enforcement, high leverage of corporations, loose monitoring and screening by lending institutions, and ineffective banking regulation[8]. This assessment by and large conveys an image that closely resembles the true picture of the corporate governance landscape in East Asian economies. For instance, high concentration of ownership and control of corporations by families is a characteristic shared by all countries in the region. However, country reports for the East Asian countries, as well as the existing literature, indicate that there exist significant differences across countries in several key aspects.

First, there exists a significant difference between two groups of countries in the overall quality of corporate governance systems and their legal infrastructures for property right protection. Hong Kong, Singapore, and possibly Malaysia appear to maintain significantly higher standards in corporate governance and at the same time have developed more sophisticated and adequate legal systems to protect property rights than the rest of the countries. A low level of property right protection and weak enforcement, loose operation of lending institutions and ineffective regulation of the financial sector are characteristics shared by Indonesia, Korea, Thailand, and the Philippines, but not by Hong Kong, Singapore and Malaysia.

The degree of leverage in the corporate sector, which was believed by many to have been closely linked to both the boom and the bust of the East Asian economies, varies widely across countries. Further, the profitability of firms and their ability to service their debt also vary

[8] Our coverage of East Asian countries in this paper is generally limited to seven countries, Hong Kong, Indonesia, the Philippines, Thailand, Singapore, Malaysia, and Korea.

Copyright © OECD All rights reserved

significantly. The dominance of conglomerates and the impact they have on the performance of corporations and lending institutions also differ significantly throughout the region. While concentration of ownership and control of corporations (and banks in some countries) by families is a universal phenomenon in all seven countries, it is especially severe in Indonesia, the Philippines, and Thailand, where the largest ten families control half of the corporate sector in terms of market capitalization, according to Claessens et al (1998b). Hong Kong and Korea are behind these countries in rank, but not by much as the largest ten families control about a third of the corporate sector according to the same study.

It is interesting to note that Hong Kong does not seem to suffer from the c*haebol* problem that is widely believed to be responsible for the failure of the Korean economy, even though the concentration of control by large families is roughly the same. It is also puzzling that widespread self-dealing, high leverage, and failed investments of large size occurred in Korea, but not in Hong Kong. Furthermore low interest coverage ratios and high probability of bankruptcy that characterize the shortcomings of the c*haebols* in Korea do not seem to be prevailing features of Indonesia, the Philippines, and Singapore.

The relationship between banks and corporations as well as factors behind the relationship differ across countries as well. While the banks and other lenders in Hong Kong and Singapore appear to function properly in their risk management, lending institutions in the other countries displayed lack of expertise in operation and conflicts of interests among managers or dominant shareholders that led to expropriation of small shareholders and depositors. The scores on the adequacy of prudential regulation are similar.

In the remainder of this section, we document and compare key aspects of the corporate governance systems of the seven countries that led to the above assessments.

3.2 Corporate Governance of Corporations

Copyright © OECD All rights reserved

Distribution of Ownership and Control

Ownership concentration in the hands of a single individual or family is prevalent in most Asian countries except in Japan. Ownership concentration is more obvious in smaller firms than in larger firms.[9] However, even for large firms in some countries, ownership concentration exceeds 60%.[10] The data on the Philippines and Indonesia show one sixth of total market capitalization can be traced to the ultimate control of a single family, the Suhartos and the Ayalas. (See Claessens, et al. (1998b))

< Table 3-1> Ownership Concentration of the Ten Largest Firms

Asia		Latin America	
India	38%	Argentina	50%
Indonesia	53%	Brazil	31%
Korea	23%	Chile	41%
Malaysia	46%	Colombia	63%
Philippines	56%	Mexico	64%
Thailand	44%		

Source: La Porta et al. (1998)

In Hong Kong, most listed companies tend to be controlled by families. More than 50% of all listed companies have a single shareholder or family that hold a majority of shares. Cross-holding is also prevalent in group-affiliated firms. When a family does not hold a majority of shares, the family will usually be represented by the senior executive director and retain control. The government and banks hold a negligible portion of ownership and do not engage in corporate governance.

In Korea, where conglomerates (*chaebols*) are prevalent in the economy, direct control

[9] It is a difficult task to analyze cross-country corporate ownership structures in Asian countries. Due in part to the lack of proper disclosure requirements on ownership, information on ownership concentration and distribution is scarce and sometimes not reliable. Also, ownership patterns are very complicated, involving indirect holdings through holding companies and cross-holding (interlocking holding). Therefore, evaluating the magnitude of the ultimate ownership and control by a single investor requires information on each firm's ownership and organization. Unfortunately, we do not have comprehensive and extensive information. Consequently, our analysis relies on already published information on each country's ownership structure.

[10] However, this is not unique to Asian countries. Latin American countries such as Argentina, Columbia and Mexico exhibit over 50% of ownership concentration as well. Such high concentration might be related to the lack of proper protection for minority shareholders rights as suggested by La Porta et al.(1998).

Copyright © OECD All rights reserved

by the largest individual shareholder is relatively limited as the ownership concentration is around 10% for large *chaebol*-affiliated firms. However, cross-shareholding by other affiliated firms that own an additional 30% of shares enables the largest shareholder to control the firms. Even though banks and other financial institutions hold more than 20% of shares, they have not engaged in corporate governance because until recently their voting was regulated so as not to affect other shareholders' votes. Foreign ownership is expected to increase its role in corporate governance to induce firms to pursue shareholders' value as their stake increases. In 1998, foreign ownership accounted for 18% of total market capitalization.

In Singapore, block holders constitute on average more than 60% of ownership. The ultimate owners of block holders are government, corporations or sometimes individuals. By law, banks and funds are not allowed to hold shares in firms. Government linked corporations are dominant in the economy. Even with privatization, the government still maintains majority ownership through its holding companies. Among firms, cross-holding is common.

In Thailand, through holding companies, individual and family shareholders own more than 60% of corporations while banks and institutional investors do not directly own a large block non-financial firms. The role of banks is more that of a creditor rather than of an investor.

Distribution of ownership shows us the distribution of the claims to cash flows of a firm, but does not by itself give sufficient information about the control structures of corporations. Although there undoubtedly exists a close relationship between ownership and control, there are few studies that systematically relate the two. The study by Claessens et al. shows many important features of the concentration of control in East Asian countries. First, when we treat every corporation equally, concentration is generally high in all seven countries, but higher in Indonesia, Malaysia, Thailand, and Hong Kong than in the other countries. <Table 3-2>, quoted from Claessens et al. (1998b) summarizes the distribution of control for some Asian countries using unweighted shares. When using a 20% cut-off level, the proportion of corporations controlled by families is the highest in Indonesia, followed by Malaysia, Hong Kong, Thailand, Singapore, Korea, and the Philippines, in that order. Korea and the Philippines appear as the countries where control by families is the weakest. The picture does not change greatly when an weighted average of market capitalization is used.

Copyright © OECD All rights reserved

<Table 3–2> Control of Publicly Traded Companies in East Asia
(unweighted)

Country	Number of Corporations	Widely Held	Family	State	Widely Held Financial	Widely Held Corporation
10% cut-off						
Hong Kong	330	0.6	64.5	3.7	7.1	24.1
Indonesia	178	0.6	67.1	10.2	3.8	18.3
Japan	1240	41.9	13.1	1.1	38.5	5.3
Korea	345	14.3	67.9	5.1	3.5	9.2
Malaysia	238	1.0	57.7	17.8	12.5	11.0
Philippines	120	1.7	41.3	3.6	16.8	36.7
Singapore	221	1.4	51.9	23.6	11.5	11.5
Taiwan	141	2.8	65.6	3.0	10.4	18.1
Thailand	167	2.2	50.8	7.5	17.9	21.7
20% cut-off						
Hong Kong	330	7.0	66.7	1.4	5.2	19.8
Indonesia	178	5.1	71.5	8.2	2.0	13.2
Japan	1240	79.8	9.7	0.8	6.5	3.2
Korea	345	43.2	48.4	1.6	0.7	6.1
Malaysia	238	10.3	67.2	13.4	2.3	6.7
Philippines	120	19.2	44.6	2.1	7.5	26.7
Singapore	221	5.4	55.4	23.5	4.1	11.5
Taiwan	141	26.2	48.2	2.8	5.3	17.4
Thailand	167	6.6	61.6	8.0	8.6	15.3

Source: Claessens et al. (1998b)

<Table 3-3> Control of Publicly Traded Companies in East Asia
(Weighted by market capitalization)

Country	Number of Corporations	Widely Held	Family	State	Widely Held Financial	Widely Held Corporation
Hong Kong	330	7.0	71.5	4.8	5.9	10.8
Indonesia	178	6.6	67.3	15.2	2.5	8.4
Japan	1240	85.5	4.1	7.3	1.5	1.6
Korea	345	51.1	24.6	19.9	0.2	4.3
Malaysia	238	16.2	42.6	34.8	1.1	5.3
Philippines	120	28.5	46.4	3.2	8.4	13.7
Singapore	221	7.6	44.8	40.1	2.7	4.8
Taiwan	141	28.0	45.5	3.3	5.4	17.8
Thailand	167	8.2	51.9	24.1	6.3	9.5

Source: Claessens et al. (1998b).

Copyright © OECD All rights reserved

The results by Claessens et al. are somewhat surprising because they appear at odds with the common belief that in the East Asian countries most of the corporations are firmly controlled by a certain family. For instance, firms that are not controlled by any family are a rarity in Korea, with the exception of those controlled by foreign firms and state-owned enterprises.[11] Some of the apparent discrepancy may be explained by the particular way the authors defined control, which seems too simplistic to capture the complex mechanism through which corporate control is acquired and maintained. In most East Asian countries, where shareholder rights are not well protected, a minority block share may not confer much leverage on small shareholders in the firm's decision- making process.

The high proportion of control by 'widely held' in <Table 3-3> may be explained similarly. We believe that a more micro-level study that includes a detailed analysis on the incentives of the individuals or families who are the key players, and the institutional constraints they face, may reveal that control is more highly concentrated by families in most East Asian countries.

While the role of institutional investors in corporate governance is receiving increasing attention around the world, it remains quite limited in all of the countries in East Asia. Scattered evidence suggests that ownership by institutional investors is generally small compared to more advanced countries. More importantly, institutional investors do not actively participate in the governance of firms even when they possess a significant proportion of shares. Country reports for Hong Kong and Singapore all report their limited participation in the governance of corporations. In Korea, institutional investors had been barred by law from exercising voting rights until very recently.

Country reports for Hong Kong and Singapore all report a relatively low level of participation by institutional investors. Banks owned 10.2% of stock market capitalization, while non-bank financial institutions in Korea owned 12.7% in 1997.[12] The Country report for Thailand (1999) showed that domestic banks and other financial institutions own around 13% of the 150 largest listed companies.

Existing studies provide us with information about the general state of ownership

---

[11] Kia Motors was long viewed as the only large firm whose control was not concentrated in the hands of a family. After experiencing severe financial difficulties, now its control is in the hands of a *chaebol* family.

[12] We can say that banks are institutional investors in Korea because the ownership and control of banks by corporations or *chaebol* owners have been prohibited in Korea. But, some of the investments by the non-bank financial institutions that have ties to *chaebols* may have been made based upon considerations other than returns from investments.

Copyright © OECD All rights reserved

distribution as well as some information about the control of corporations. However, the link between ownership and control is still foggy in most cases. This is especially true when we consider large conglomerates. Conglomerates controlled by families is not a prevailing feature in Singapore or Hong Kong, but is one of the key features of the rest of the economies.[13] It is widely known that pyramid schemes and cross-shareholding are widely used in acquiring and maintaining control of several or more firms by a single family. However, very little is known about the actual patterns of crossholding and how they enable a family to successfully acquire or maintain near absolute control of firms. In some cases, even the objectives of the controlling shareholders of large conglomerates are hard to pinpoint.[14] In many casese, the effects that the legal and regulatory environments have on the ability and incentives of the families in the context of corporate control are unclear as well.

Governance Structure within Corporations and Regulatory Environments

A high concentration of corporate ownership and control of corporations by families in all of the countries generally lead to governance structures that enable the dominant shareholding families to make key decisions on their own. Appointments of board members are almost entirely at the hands of those families in control of the firms. Thus, there is a possibility of conflict of interests between dominant shareholders/ managers and minority shareholders. Despite this common characteristic of ownership, actual realization of conflict of interests and expropriation of minority shareholders appear to be much less serious in Hong Kong, Malaysia, and Singapore than in the rest of the region. Country reports for these countries do not show widespread expropriation of serious nature, although they acknowledge the possibility of expropriation due to family dominance.

Expropriation appears to have reached a serious level in the other countries. For instance, the state of corporate governance within Thai corporations is aptly summarized by the country report for Thailand, which lists such flagrant activities by managers as illegitimate decision-making in a shareholders' meeting that does not meet quorum. Korea seems to be in a similar situation. Episodes of expropriation are abundant. Even the biggest and most successful corporations that also have significant foreign ownership were engaged in scandalous practice. Considering that foreign investors have a much louder voice than domestic investors in Korea, we expect higher incidences of expropriation by dominant shareholders in corporations with smaller foreign ownership.

---

[13] Country papers for Hong Kong (SFC, 1999) and Singapore (Mak Yeun Teen & Phillip H.Phan, 1999).

[14] For instance, c*haebol* owners in Korea frequently acted in ways that appear to be inconsistent with the maximization of firm value under their control by exposing their firms to excessive risks or by forcing the firms to invest huge amounts of money in big projects whose prospects did not seem to justify the

Copyright © OECD All rights reserved

The apparent difference between Hong Kong, Malaysia, and Singapore on the one hand, and the rest of the countries on the other leads one to wonder about the sources of this difference. Among many factors that determine the degree of expropriation or more generally the performance of a governance structure, ownership distribution and legal infrastructures that protect shareholder rights are most crucial. These two determine the rules of the game, according to which interested parties pursue their objectives as well as the payoffs that the parties receive at the end of the day.

<Table 3-4> summarizes some key facts about shareholder protection allowed by the legal systems of various East Asian and other emerging countries.[15] The table reveals some of the areas where corporate governance of a country could be problematic. For instance, deviation from the one share-one vote rule of some countries may help dominant families in the relevant countries not only in maintaining their control of corporations, but also in their expropriation of minority shareholders by preventing the emergence of minority block shareholders with voting rights. Absence of mandatory disclosure of connected interests in Indonesia and Malaysia could be a fertile ground for self-dealings that result in expropriation.

---

investment.

[15] This table was derived from Box 4-2 of the World Bank Report, "East Asia: The Road to Recovery". A column on Korea has been added to it.

Copyright © OECD All rights reserved

<Table 3-4> Corporate Governance in East Asia and Other Emerging Economies

Variables	Description/Effect	Korea	Indonesia	Malaysia	Philippines	Thailand	Mexico	India
Right to Call Emergency Shareholder Meeting(percent shareholder Meetings)	Facilitates shareholders control	YES 3	YES 10	YES 10	YES 10	YES 20	YES 33	YES 10
Right to Make Proposals at Shareholder Meeting	Facilitates shareholders control; increased opportunity to prevent biased decisions by insiders	YES	YES	YES		YES	NA	NA
Mandatory Shareholder Approval of interested Transactions	Protects against abuse and squandering of company assets by insiders	YES	YES	YES	YES	YES	NA	NA
Preemptive Rights on New Stock Issues	Protects against dilution of minority shareholders; prevents insiders altering ownership structure	YES	YES		YES	YES	NA	NA
Proxy Voting	Facilitates shareholders control	YES	NO	YES	YES	YES	NO	YES
Penalties for Insider Trading	Protects against use of undisclosed information at the expense of current and potential shareholders	YES	YES	YES	YES	YES		
Provisions on Takeovers Legislation	Protects against Violation of minority shareholders' rights	YES		YES	YES	YES		
Mandatory Disclosure of	Both financial and	YES	YES	YES		YES		

Copyright © OECD All rights reserved

Non-Financial Information	non-financial information data are important to assess a company's prospects							
Mandatory Disclosure of Connected Interests	To protect against abuse by insiders	YES			YES	YES		
Mandatory Shareholder Approval of Major Transactions	Protects against abuse by insiders. Protection can be enhanced through supra-majority voting	YES	YES	YES	YES	YES	YES	
One Share-one Vote	Basic right; Some shareholders may waive their voting rights for other benefits such as higher dividends	YES	NO	YES	NO	NO	YES	NO
Allow Proxy by Mail	Facilitates shareholders control	YES	NO	NO	NO	NO	NO	NO

Source : World Bank (1998a).

In general, though, the table gives the impression that corporate governance in East Asian countries does not appear as bad as one might have thought. Korea, for instance, scores “yes” on all accounts. Thailand also scores “yes” on most accounts. All of the East Asian countries covered by the table have laws or regulations that protect shareholders' interests in such crucial areas as mandatory shareholder approval of interested transactions, penalties for insider trading and mandatory shareholder approval of major transactions. For most of the items related to shareholders’ rights, East Asian countries apparently provide some legal protection. As shown in <Table 3-4>, no’s are rare. One share-one vote and proxy mail by vote are exceptions.[16]

Some countries have gone beyond the items covered by <Table 3-4> and have

[16] The other East Asian countries not covered by the table seem to meet most of the standards used in the table, although no accurate report on all accounts is available. For instance, Hong Kong requires

Copyright © OECD All rights reserved

introduced or already had in place additional measures designed to protect shareholders' rights. Appointment of independent directors is mandatory in Korea, Thailand, and Hong Kong. Korea recently even allowed cumulative voting to enable minority shareholders to better represent themselves on the board.[17] On the surface, corporate governance in East Asia generally appears quite satisfactory. However, having good laws is one thing, making them work is quite another in corporate governance as in most other areas.

In order to properly assess the adequacy of the corporate governance structure of a country, one needs to look deeper into the details of the institutional arrangements related to the above listed measures designed to protect shareholders' rights. The above list does not give answers to such crucial questions as what is the necessary proportion of votes for a measure to be adopted, what could minority shareholders do if a violation occurs, what are the eventual penalties for violators, what benefit could different classes of minority shareholders expect by acting against violators?[18]

In the case of independent directors, there also remain many questions. How can one be sure that outside directors are indeed independent of the management or dominant shareholders? What is the incentive of the outside directors to work in the best interests of shareholders? What penalties do they face when they fail to follow the course of action that is deemed proper? Many outside directors have recently been appointed by listed companies in Korea as mandated by a new law. But, there is a widespread fear that many of them have ties to management and are not expected to act in the interest of all shareholders. Cumulative voting schemes that became possible by recent legislation may be underutilized as many companies are scrambling to revise their articles of association in order to exclude their employment.

The measures listed in <Table 3-4> are designed to guarantee minority shareholders certain rights to information and participation in decision making. However, when control is concentrated, rights to information and participation in decision making may not be sufficient, because dominant shareholders could override the opinions of minority shareholders by vote. Thus, the effectiveness of remedial measures available to minority shareholders is crucial when dominant shareholders or managers act against the interests of the firm or shareholders. There are generally two types of remedies, criminal penalties for breaches of trust or class action suits for damages. The effectiveness of the penalties for violation of shareholders' rights to information and participation in the decision process is also important. For instance, unless they face serious penalties for not obeying the rules, managers may hide information about connected transactions or may go ahead with a connected transaction without seeking the

---

shareholder approval and disclosure of connected transactions. See the country reports for more detail.

[17] Most other countries, including Hong Kong and Singapore, do not allow cumulative voting.

[18] The answers to some of the questions are included in the country reports of some countries. For instance, the country report for Thailand contains the shares needed for some of the measures that are designed to protect shareholders rights.

Copyright © OECD All rights reserved

approval of shareholders.

We do not have enough information about the remedial measures and their effectiveness in East Asian countries. At least in Korea, the effectiveness of the remedial measures appears to be weak. Criminal cases for breaches of trust concerning dominant shareholders in large listed companies are rare. Class action suits are also rare because of two factors.[19] First, the reward that minority shareholders can get even when they win in the courts is generally very small as in most other countries. Second, restrictions on legal fees appear to limit the reward that attorneys representing minority shareholders can expect.

3.3 Conglomerates

Dominance of conglomerates combined with strong family controls over affiliated corporations raises the possibility of a type of expropriation that does not exist in conglomerates where ownership and control are not dominated by a single family. In the former case, the dominant family could use transactions between the firms under the same control to divert resources from one firm to another. For instance, the dominant family could force Firm A, in which it has 30% interest to sign a preferential contract with Firm B, which is 100% owned by it. The most popular types of preferential contracts observed are transactions of goods and services as well as assets at terms that are more favorable to Firm B than prevailing market prices, loans made to Firm B at below market interest rates, and loan guarantees.

It was quite common in Korea that minority shareholders had to take intolerable risks as the firm in which they held shares made loan guarantees to other firms controlled by the same family, or lent money directly to them. Considering that most large corporations in Korea are heavily indebted, loans from Firm A to Firm B have essentially the same effect as Firm A borrowing from banks and in turn lending to Firm B again at its own risk. Equity participation by connected firms frequently led to similar expropriation. Participation in new equity shares of a connected firm near insolvency amounts to an outright transfer of wealth from participating firms to the firm issuing new equities.

Simple diversion of money by a dominant shareholder from a firm under his control was not uncommon in some East Asian countries as the ample evidence of slush funds suggests. As

[19] There are a few cases of class action suits involving former managers of bankrupt banks and a couple of large companies belonging to conglomerates. But, they were initiated by *Chamyoyundai*, an activist group, and not by minority shareholders interested in money. The suits involving the former managers of bankrupt banks are not expected to give the minority shareholders much benefit even though they won in lower court because the former managers appear to possess far smaller fortunes than the damages awarded to shareholders.

Copyright © OECD All rights reserved

long as this diversion does not involve transactions between firms under unified control, it is not a problem that relates to conglomerates. However, concentrated ownership by a family in the firms belonging to the same conglomerate raises the possibility for a different type of expropriation by the dominant family, one that uses transactions between the firms under its control. This type of diversion differs from a diversion by an executive who is not a member of the dominant family in that it has to pass the eyes of the dominant shareholder and the other employees. Diversions by dominant shareholders are results of organized efforts by top employees of the firms, because active and intentional participation by some employees and acquiescence by some others are necessary. This suggests that job security, rewards, and in fact the whole career of most managers are determined by the dominant shareholders. Professional managers in some East Asian countries face an incentive structure that forces them to serve the interests of dominant shareholders and not the interests of the firm in general or the remaining shareholders.

In some Asian countries, the expropriation by dominant shareholding families that control large conglomerates does not stop at minority shareholders. In Korea, dominant families were in a position to command huge amounts of financial resources that the firms under their control borrowed. Inefficient investment of the borrowed money in large risky projects, as well as other more onerous uses, led many of the large corporations to become insolvent or bankrupt and eventually cost the lending institutions and taxpayers an unprecedented amount of damage. Similar situations occurred in Thailand, although the degree of expropriation appears milder compared to Korea.

Finally, high leverage combined with poor profitability of large firms in some East Asian countries may have aggravated the agency problem *vis-a-vis* dominant families controlling conglomerates. As many of the firms under their control were heavily indebted and suffered huge losses, the net values of the firms under their control shrunk quickly, as did the net worth of their shares. Although no accurate figures are available, we conjecture that the net worth of the shares of some c*haebol* families in Korea may be negligible, or considerably small compared to the amount of capital that is under their control today. Nonetheless, they are still tightly in control of large firms and huge amounts of financial resources, most of which came from loans that banks and other financial intermediaries made to the firms under their control. In a sense, quite a few families are able to maintain control of large firms and large sums of borrowed money without having proper ownership of the assets that is normally associated with control. The families that find themselves in such circumstances may find it even more attractive than before to divert resources from the firms under their control.

The above argument also has grave implications on the ownership of financial institutions in some East Asian countries. Some countries invited failure in their financial sector by barring the ownership of block shares and participation of shareholders in the governance structure of banks, for fear of undue influence by block shareholders who are related to the

Copyright © OECD All rights reserved

dominant families in the corporate sector. The recent crisis forced these governments to rethink the policies regarding the governance of banks. However, if they simply allow anyone to purchase shares of banks and take control, dominant families will probably be the only ones with the financial resources necessary to do so. Worse, the financial resources with which they purchase the equities of banks may mostly be derived from the money that firms under their control borrowed from financial institutions.[20]

3.4 Takeovers

Takeovers do not occur frequently and hostile takeovers all but rare in the East Asian countries. Recently observed large scale transfers of shares involving the transfer of control from domestic dominant shareholders to foreign investors and transfer of the ownership of production facility ownership to foreign firms are fire sales and do not characterize the M&A market in the region during normal times. Concentrated ownership by families is probably the main reason for thin M&A markets. We also believe that underdeveloped financial markets is a factor. Most of the East Asian economies are dominated by a handful of families who control the lion's share of the financial resources available through various ways, and there seems to be little room for large independent financial institutions with good governance mechanisms in place.

Although most countries have some regulations concerning takeovers, mainly aimed at guaranteeing equal treatment of shareholders, such regulations may not matter much any way, at least in the short-run. There simply is not enough ground for takeovers to take place.[21]

3.5 Debtor and Creditor Relations

At the risk of over-simplification, the salient feature of East Asian corporate finance is bank dominance, except for Hong Kong and Singapore. The lack of a well-developed capital market was the major factor behind such an unbalanced financing pattern. Under this circumstance, the primary responsibilities for corporate monitoring rested on creditor banks.

[20] Given the same chance, anyone can own and control banks. You first borrow money from bank A and then buy enough shares of bank B. You can even borrow from Bank A to buy Bank A.

[21] Most countries appear to have regulations on takeover activities, designed to give equal treatment of shareholders. Such regulations, however, entail the risk of discouraging takeover attempts. Realizing this, Korea recently removed a restriction that required one to purchase at least 50% of the shares if he intends to purchase 25% or more.

Copyright © OECD All rights reserved

However, the reality was neglected monitoring and oversight by banks, the high price of which culminated in the financial crisis. Indeed, even collusive connections between lenders and borrowers were not uncommon in many East Asian countries.

State Control and Moral Hazard

Neglected monitoring and oversight of corporate finance by creditor banks was the natural outcome of the distorted incentive structure which was largely affected by the policy environment. Undue state influence in credit allocation as well as lax financial supervision and regulatory framework, were characteristics of this environment. In many East Asian countries, the unhealthy links between government and banks resulted from the legacy of government-led economic development. Although government control waned in accordance to the financial liberalization efforts of the early 1980s, it continued, and banks supplied subsidized credit to firms favored by the government without aptly considering the creditworthiness of borrowers.

In most East Asian countries, government-directed credit, or policy loans, have been extensively utilized as an important instrument for industrial policies. Particularly, in Korea, government control of credit allocation was the most extensive among all East Asian countries. The Korean government took control of the banking system in the early 1960s, and during the heavy and chemical industry (HCI) drive of the 1970s, directed banks and non-banking financial institutions (NBFIs) to supply more than 50% of total domestic credit as a heavily subsidized policy loan.[22] Most banks were privatized in the early 1980s, but the state influence over the banking sector has remained substantial until recently. Indonesia and Malaysia had disappointing experiences with credit interventions, through state-owned commercial banks, targeting specific industries in the 1970s and early 1980s, and abandoned the schemes in favor of more functionally directed credit.[23] In contrast, Thailand, not to mention Hong Kong and Singapore, have not widely utilized credit instruments as a means to support private industries. However, Thai banks provided subsidized credit to public sector investment such as large-scale infrastructure investment.[24]

The provision of subsidized credit, coupled with interest rate controls, encouraged the

---

[22] Y.J. Cho and J.K. Kim (1995).

[23] World Bank (1993).

[24] Meanwhile, industrial development bank lending may also confer implicit insurance. It frequently signals areas of government commitment, providing an additional measure of comfort to private investors and banks (JDB/JERI 1993). In Indonesia, Korea and Taiwan, industrial development banks have been substantial long-term lenders. The Korean Development Bank supplied an average of a third of all loans and guarantees in the 1970s, and the development bank of Taiwan, the Bank of Communications, held about half of the assets of the banking system until recently. Conversely, Malaysia’s development financial institutions accounted for 2.9 percent of the assets of the financial system in the 1980s. Thailand’s industrial development bank has only 1 percent of the assets of the financial system. Hong Kong has no development bank. (World Bank, 1993)

Copyright © OECD All rights reserved

corporate sector to rely more on borrowings than equity financing. Since real interest rates remained below the marginal productivity of capital, over borrowing occurred, and the subsequent increases in financial expenses induced further borrowing. In addition, particularly in Korea and Thailand, the practice of providing cross-debt guarantees among affiliates of business groups allowed firms to borrow more easily. Such a vicious cycle ultimately led to unbearably high leverage and reckless capacity expansion in the corporate sector. In short, for every reckless borrower, there was a reckless lender.

The government had to provide an implicit guarantee on bank lending as it played a major role in credit allocation. Also, given the tight linkage between the banking and corporate sectors, corporate failures had an immediate impact on the soundness and viability of banks. For these reasons, bailouts by the government in both the financial and corporate sectors over the business cycle were not uncommon practices in many countries. Thailand (1983-87), Malaysia (1985-88), and Indonesia (1994) experienced domestic financial crises that were, in part, resolved through partial or full public bailouts.[25] Korea was no exception. The Korean government was involved in massive bailouts on numerous occasions, including the emergency debt-freeze in 1972, industrial restructuring of major HCIs in the early 1980s, and industrial rationalization measures in overseas construction and shipping industries during the mid-1980s.

The government bailouts exacerbated the already weak market discipline and caused serious moral hazard problems. Excessive corporate leverage based on implicit risk-sharing by the government created the so-called "too-big-to-fail" hypothesis, which worked as an important exit barrier and often overshadowed the voices for financial market liberalization. Given the implicit state guarantees on bank lending, banks had little incentive to monitor client firms' investment decisions. Strict prudential regulation and supervision were hardly applied to banks given the fact that the government and banks were in the same boat in the sense that both acted as a risk-sharing partner of business firms. Indeed, in the course of bailout, management of rescued financial institutions and corporations was not replaced, further undermining incentives for prudent behavior.

The “too-big-to-fail” hypothesis was particularly relevant in Korea. Given the preponderance of the c*haebols*' market share and the vertically integrated industrial structure, the social costs of a c*haebol* bankruptcy would be enormous. In such an environment, the c*haebols'* incentive structure with regard to corporate financing was seriously distorted: the more they borrow, the safer they are. These fault lines, a remnant of Korea’s economic development, have made the business sector extremely vulnerable to unfavorable shocks and have increased systematic risk in the financial market.

Ownership Structure and Market Discipline

[25] World Bank (1998).

Copyright © OECD All rights reserved

The ownership structure of financial institutions is also a critical element in the fabric of corporate governance as it is directly related to the issue of conflict of interests. Bank ownership structure and the relationship between financial and industrial capital varied across countries, but at the same time, shared a few common traits to a certain degree.

In Korea, the social concern about the strong economic influence of *chaebols* translated into strict restrictions on bank ownership structure. In 1982, when the privatization of the banking sector was pursued, a ceiling of 8% was imposed on individual ownership of nationwide commercial banks, in order to prevent any single shareholder from exerting excessive influence and control over a bank's management. This restriction was further strengthened as the ceiling was lowered to 4% in 1994 as financial liberalization made progress. However, despite financial liberalization and deregulation, strong inertia of government intervention continued as the government influenced bank management primarily through appointing CEOs of banks, and acted as the only powerful governance agent. Consequently, 15 years after their privatization, banks still function like state-owned institutions in many respects. The continued government control or influence on banks seems to be a rather unique feature of the Korean banking sector, given the fact that the government did not have ownership in commercial banks after privatization.

In contrast, Korea's NBFIs were free of ownership restrictions except life insurance companies and investment trust companies. As a result, many NBFIs are currently owned or actually controlled by *chaebols*. As of 1997, the 70 largest *chaebols* owned a total of 109 financial affiliates – an average of five financial affiliates in the case of the 5 largest *chaebols* -- concentrated among securities firms, merchant banking companies (MBCs), non-life insurance firms, and installment credit companies. The close links between NBFIs and business groups have created scope for conflicts of interest. In fact, it appears that the *chaebols* have been using their affiliated NBFIs to finance the activities of other subsidiaries within their groups. In this situation, it is hard to expect prudent corporate monitoring by NBFIs.

The weak external governance by financial institutions on the Korean corporate sector can also be partly explained by the regulations with respect to banks' equity participation in non-financial firms. Korean banks had been regulated through a 10% ceiling on their equity shares in non-financial businesses. In 1998, the ceiling was relaxed to 15%, and commercial banks increased their shareholdings of non-financial firms in their asset portfolios. However, the underlying motivation for banks to increase their shareholdings in non-financial businesses seems to have been capital gains rather than management control or influence. In fact, a bank's equity share is hardly a threat of potential control power as it is quite low compared to other shareholders. Furthermore, a bank's control of firms as a shareholder was severely limited due to regulations mandating "shadow voting", an obligation for financial intermediaries to vote with the management who is also the major shareholder.

Copyright © OECD All rights reserved

In the Philippines and Thailand, many financial institutions and non-financial corporations are under common family-based ownership. In the Philippines, regulatory framework for preventing banks from becoming "cash vault" of a business group has been inadequate, if any, or simply absent. On the contrary, Thai banks and NBFIs were somewhat restricted in directly holding shares of listed non-financial business firms; for banks and NBFIs, 10% and 20% ceilings were imposed on equity shares in listed non-financial businesses, respectively. Nonetheless, Thai banks were able to, and indeed do, hold a controlling share in listed companies through their equity shares in holding companies, which are not subject to any investment restrictions. Investment records of Thai banks also revealed extensive investments in unlisted companies. However, the nature of financial institutions' relationship with enterprises transcends that of just a creditor and an investor.

In Malaysia, only a few of the 37 commercial banks are controlled by conglomerates. But prohibition on loans to related parties and its stringent enforcement by the central bank has greatly reduced opportunities for business groups to avail themselves of easy loans through their close ties with banks.

In Taiwan, the banking industry was tightly controlled by the government until the early 1990s: out of a total of 24 banks, 13 were owned by the government. In 1992, the banking industry was deregulated with new licenses granted to fifteen new commercial banks. In tandem with the financial liberalization, a ceiling of 5% was imposed on the business group's ownership of commercial banks, like the case of Korea. Although newly established commercial banks do have connections with certain business groups, government regulations place limitations on total loans that can be lent to affiliated business groups. In the meantime, Taiwanese banks were strictly regulated in their equity shares of listed companies, and recently were allowed up to 15% of bank's net worth. As a result, banks play a minor role in corporate governance.

In Hong Kong, most banks had been owned by families and confronted difficulties in the early 1980s. Reckless lending to connected parties was the major factor behind the banking problems. In order to deal with such abuses, not only was the regulatory power on bank ownership structure strengthened, but also restrictions on connected lending were implemented under the Banking Ordinance in 1986. Since then, various legislative provisions and policy guidelines have been continuously updated by the Hong Kong Monetary Authority (HKMA) to achieve internationally accepted standards. Currently, most banks belong to financial groups, and the approval of the HKMA is required in order to acquire 10% or more shares. Any person who exercises indirect control over the directors, even without voting rights, is also subject to approval by the HKMA. Thanks to these efforts, the banking sector has played an important role in corporate governance. Banks are only allowed to have equity shares in non-financial businesses of up to 25% of their capital base. Despite this restriction on banks' equity ownership of non-financial businesses, banks were able to effectively control corporate

Copyright © OECD All rights reserved

governance through efficient lending practices based on prudent risk assessment and reliable financial information.

In Singapore's case, the Banking Act limits the investments of banks in other non-financial businesses to a maximum of 20% of their capital base. Banks are more severely limited in their ability to acquire large equity shares in a single firm even though it may be less than the stipulated 20%. The exception to this rule is when a bank invests in companies set up to promote development in Singapore, which have to be approved by the central bank (the Monetary Authority in Singapore: MAS). In order to acquire high levels of ownership positions, banks have to undergo a judicial review process by the MAS. In addition to enforcing legislation, the MAS also performs regulatory supervision by directly intervening in matters of corporate governance. For example, it maintains the right to approve the appointment of directors on the boards of financial institutions.

Copyright © OECD All rights reserved

Prudential Supervision

Lax financial supervision and inadequately designed regulatory frameworks were common phenomena in all crisis-hit Asian countries. The problems in East Asia that emerged in the banking system include: 1) low capital adequacy ratios of banks; 2) poorly enforced legal lending limits on single borrowers or groups of related borrowers; 3) asset classification systems and provisioning rules for possible losses, which fell short of international standards; 4) poor disclosure and transparency of bank operations; 5) lack of provisions for an exit policy of troubled financial institutions; and 6) weak supervision.[26] For example, in Korea, although many NBFIs are owned by large industrial groups, financial supervision of NBFIs has been particularly lax, as can be seen from the fact that the basic prudential regulations such as capital adequacy requirements were almost absent until the onset of the crisis.

The financial liberalization trend, including capital market liberalization, in the absence of well-established prudential supervision was a disaster waiting to happen. Korea addressed the issue of financial supervision in its drive to reform the financial sector in 1997, but was hit by the crisis before any progress was made. The Philippines also strengthened its bank supervision, but its timing and scope fell short of the rapid financial sector developments, particularly the speed of global financial integration.

The underdeveloped information disclosure and accounting standards were also important factors behind weak governance of banks and poor bank performance. Due to the lack of reliable financial information about corporate performance, banks' lending decisions, for example, were made largely on a collateral basis. Even worse, bank credit tended to flow to firms with low creditworthiness simply because they were favored by the government or private bank owners. Such collateral-based lending practices discouraged banks from exercising credit analysis and risk assessment for the underlying investment projects. Such backward practices hindered the development of banks' expertise in credit evaluation, information infrastructure and accounting standards in many East Asian countries. For example, Thailand's single credit-rating agency TRIS was established only in the 1990s.

In sum, in most East Asian countries, weak corporate governance has been developed largely by implicit government guarantees on bank lending, unhealthy connections between lenders and borrowers under the relationship-based system and poor bank supervision, the so-called “crony capitalism” argued by Krugman (1998). In such an environment, many East Asian companies were encouraged to make reckless investments based on heavy debt financing, while financial institutions were discouraged from properly monitoring the soundness of borrowers and managing the risk in their loans portfolios.

[26] World Bank (1998a).

Copyright © OECD All rights reserved

Financial Structure and Performance

As described above, the absence of fully developed equity markets as well as easy borrowing due to weak corporate and financial sector governance led to high leverage without a direct link to performance in most East Asian countries. During the period of 1995 and 1996, the high degree of risk inherent in the liability structure was evident in Korea, Thailand, and Indonesia as shown in <Chart 3-1>. In particular, the corporate debt/equity ratio in Korea was the highest among East Asian countries, about four times higher than that of Taiwan. Owing to this highly leveraged financial structure, the financial expenses to sales ratio in Korea is three times as large as in Taiwan. Financial leverage has risen rapidly in Korea and Thailand in the last few years while it has declined in Hong Kong. Leverage in Malaysia, Singapore and the Philippines also rose but were still much below that of Korea and Thailand. Given the highly leveraged financial structure, many East Asian corporations were vulnerable to both internal and external shocks in a globalizing financial market.

Meanwhile, before the financial crisis, there were signs of deterioration in corporate profitability in most East Asian countries <Chart 3-1>.[27] This was most notable in Thailand and Indonesia: Thai and Indonesian corporations' profitability rate dipped from 10.7% and 8.9% in 1991-92 to 7.6% and 6.4% in 1995-96. Among the East Asian countries, Korea, Hong Kong and Singapore recorded relatively low returns, which also dropped but at a slower pace over the same period. Only in the Philippines and Taiwan did profitability increase. In the mid 1990s, the deterioration of profit performance did not show up at the macro level as investment rates were high and continued to drive output growth rates in most East Asian countries.

High leverage combined with deterioration of profitability have weakened the corporate sector's financial capability to service debts in most East Asian countries. <Chart 3-2> shows the interest payment coverage ratio, calculated as operating earnings over interest expenses, for eight East Asian countries. EBITDA (Earnings Before Interest payment and Taxes but adding back Depreciation) is used for measuring operating earnings. Therefore, those firms whose interest payment coverage ratios are below 1 are likely to go bankrupt. In 1996, Korean and Thai corporations had the lowest interest payment coverage ratios, about 2.1 and 2.7, respectively. Hong Kong, Malaysian, Indonesian, Philippine and Singaporean corporations averaged between 3.0 and 4.5. The country with the highest interest payment coverage ratio was Taiwan (exceeding 6.0) due to the low financial leverage and strong performance in profitability.

Such vulnerable financial structures of many East Asian companies could not withstand the combined shocks of increased interest rates, depreciated currencies, and large domestic demand since the onset of the financial crisis. Indeed, the number of bankruptcies surged,

[27] EBIT(Earnings Before Interest payment and Taxes) is used to measure profits.

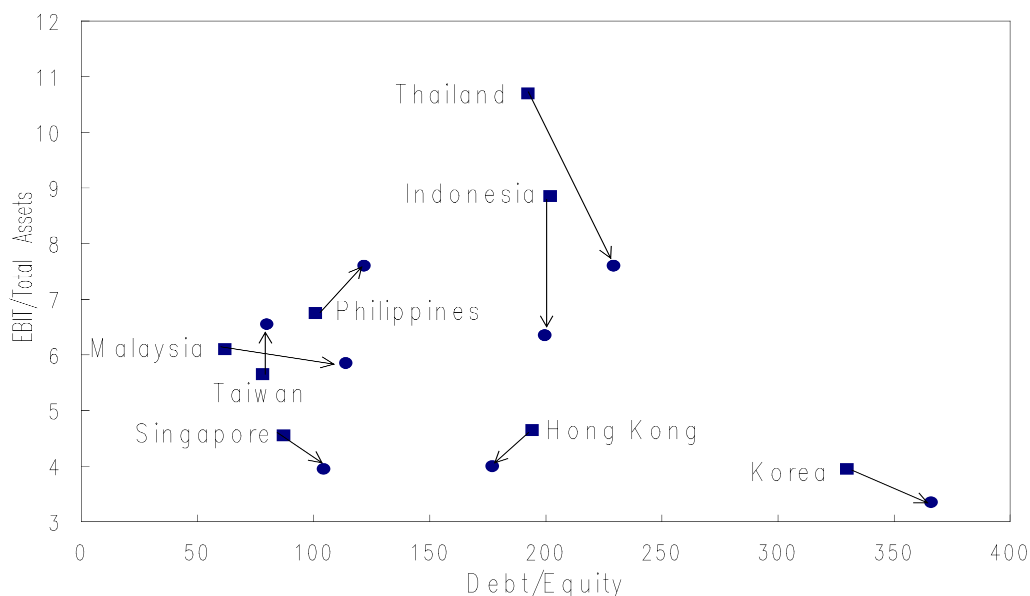
Copyright © OECD All rights reserved

particularly in Korea and Thailand. During the first quarter of 1998, the monthly average number of corporate bankruptcies exceeded 3,000, representing about a 200% increase compared to the same period of the previous year. Massive corporate bankruptcies immediately translated into a dramatic increase in non-performing loans (NPLs) of financial institutions. As of the end of June 1998, the estimated total of NPLs of all financial institutions, broadly defined to include loans classified as “precautionary”, was about 136 trillion won (32% of GDP), a 58% increase from 86.4 trillion won at the end of 1997.

Copyright © OECD All rights reserved

<Chart 3-1> Debt Equity Ratio and EBIT/Total Assets for East Asian Countries

(Unit: %)

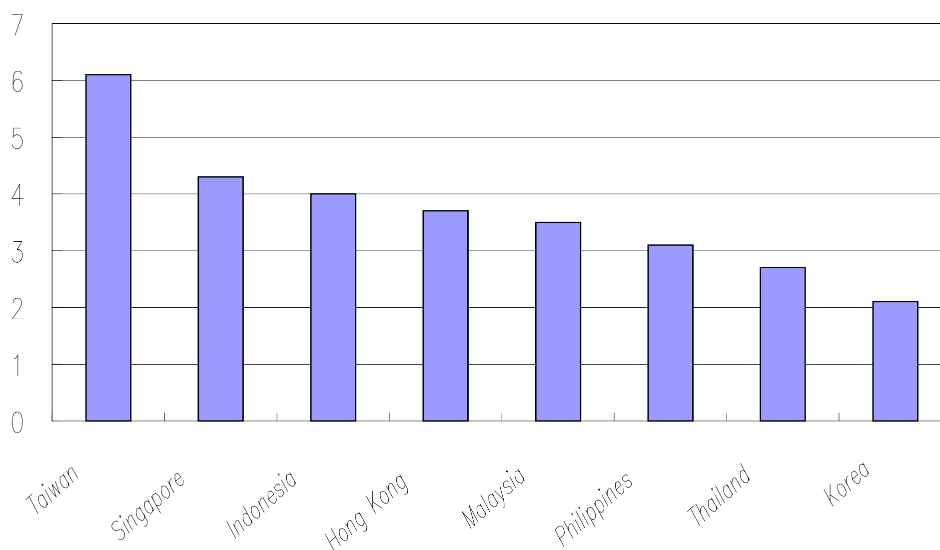


Note: ■ denotes average for 1991-92, • denotes average for 1995-96.

Data Source: Claessens, Djankov and Lang (1998a). Recalculated by author.

<Chart 3-2> Interest Coverage Ratio for East Asian Countries in 1996

(Unit: %)



Data : Claessens, Djankov and Lang (1998a).

Copyright © OECD All rights reserved

3.6 Insolvency Mechanisms

Broadly speaking, the insolvency system of an economy consists of formal insolvency procedures, informal workouts, and M&A markets.

There are usually two types of formal insolvency procedures in a corporate insolvency law regime. One is *liquidation* (or winding-up) in which the commercial activities of an insolvent firm are terminated and its assets are sold either on a piece-meal basis or as a whole. The other is *reorganization* (or rescue) which provides for the continuation of an insolvent corporate debtor with restructuring of the financial claims of its creditors and shareholders, and entails a change in the management and the ownership structure. *Informal workouts* can be used as an alternative to the formal procedures of the insolvency law regime when the debtor firm and its creditors would prefer to conduct negotiation of rescheduling or restructuring with more flexibility. They can be less costly and speedier than the formal procedures which involve the courts. *M&A markets* can play the role of an insolvency mechanism in that an insolvent firm can be bought by private investors, or be acquired by or merged into another firm, and the financial claims are repaid or rearranged in the process.

Formal Insolvency Procedures

All the countries in East Asia have an insolvency law regime which provides for the liquidation procedure, and in most cases, the reorganization procedure. In Malaysia and Singapore, the formal procedures are provided for in the Companies Act, rather than by separate legislation. In some countries, the formal reorganization procedure has not been a part of the existing insolvency law. It is under a Presidential Decree in the Philippines and the Pengurusan Danharta Nasional Berhad (PNDB) act of 1998 in Malaysia, and has been introduced only recently by the ongoing amendments in Thailand. All in all, it can be said that most of the Asian countries are equipped at least with the basic elements of a typical insolvency law process.[28] There are however some variations across countries in the details with respect to the degree of protection against secured creditors, the degree of judge’s involvement, the priority of different claims and the treatment of new funding within the procedure, among others. And some of the formal rules were not fully developed or adequately updated in many countries.[29]

More importantly, what role and to what extent these formal insolvency procedures played in the Asian economies is hard to assess since complete data on the actual insolvency

[28] They include petition for commencement, suspension of payment or stay of actions, meeting of creditors and management (or administrator), disposal of assets and distribution of the proceeds under liquidation process, and preparation and confirmation of reorganization plan under reorganization process.

[29] Relatively speaking, the insolvency regimes in Hong Kong, Singapore, and Malaysia have been more robust and better managed, and reported a higher number of cases.

Copyright © OECD All rights reserved

cases are not available, and the reports from the subject countries provide very little account of how they performed. It can be inferred nonetheless from a couple of observations that the insolvency law regime, as it was in most countries, was not effective in dealing with financially troubled firms, nor did it have a significant impact on the corporate governance structure as a result.

First, the number of insolvency cases was rather small especially in those countries that were hardest hit by the crisis. In Thailand, there have been few liquidation or reorganization cases of listed companies while there were practically no cases in Indonesia before the 1998 amendments. In the Philippines, there have been no liquidation cases for many years. Even the suspension of payments (reorganization) cases filed through the SEC numbered only 89 over 16 years, with almost two-thirds of the cases being filed during the last two years.[30] In Korea, the number of petitions for reorganization process had been fewer than 50 with about two-thirds of them accepted on average for the last 15 years before the crisis. Even considering the fact that these economies had been growing over the same period, the low number of cases suggests that the formal procedures were ineffective.

Second, new informal workout procedures have been recently introduced in several Asian countries. They are the “Jakarta Initiative” in Indonesia, the Framework for Corporate Debt Restructuring (“Bangkok Rules”) in Thailand, the Corporate Debt Restructuring Committee Framework (CDRC) in Malaysia, and the “Corporate Restructuring Agreement” among financial institutions in Korea. These informal procedures were largely policy responses to the mounting cases of financially distressed firms as the economies were undergoing difficult times while the courts and the formal procedures were suspected of being unable to handle them in an efficient manner.

A number of reasons can be offered. First, it is often pointed out that legal proceedings tend to be time-consuming and expensive in many Asian countries. This has to do with the level of development of legal infrastructure in general, and the lack of expertise and professional assistance within the court in particular since a separate bankruptcy court did not exist.

Second, there were cases where the rules were not specific or thought out enough so that they left room for much discretion by judges and for abuse by debtor firms. In Malaysia, a debtor firm can seek and receive summary relief form creditor actions under the reorganization procedure. The relief would last for a period of up to 9 months on a unilateral basis without the company being required to initiate a process of dialogue with its creditors and without the creditor being given a chance to present their case to the court before the relief is granted.[31] In Korea, as another example, a change in the Corporate Reorganization Act in early 1998 made

---

[30] ADB report (1999).

[31] Country paper for Malaysia (Malaysia Government, 1999).

Copyright © OECD All rights reserved

mandatory the wipeout of half of the existing shares if the firm is insolvent. Consequently the rest of 1998 saw a sharp rise in the number of cases of the composition procedure in which the management of the debtor firm is intact and such mandatory wipeout is not applied, as many controlling shareholders of failing firms scrambled to preserve their interests regardless of whether their firms' situation was suitable for the composition process or not.

Third, the heavy dependence on bank loans for corporate financing and the relationship-based system in many Asian countries set in motion a vicious cycle for the insolvency law regime. With a huge stake in each other through the large amount of debt, both banks and a troubled firm have incentives to reschedule the firm's debt without going through the court procedure, especially when they are closely tied by ownership or by government policy. In fact, following its industrial policy, the government often bypassed the formal procedure by bailing out the large corporations as in Korea during the 1970s and 1980s. As a result, the insolvency laws and the court system were not given sufficient opportunity to develop themselves as the economy's size and complexity grew. This in turn hampered development of the securities market for debentures or corporate bonds because potential investors in the market were not confident that their claims would be properly repaid in case of bankruptcy, and many chose to stay out. It reinforced most firms' reliance on loans from banks and other financial institutions.

Therefore, the formal insolvency procedures can be said to have been not much of a factor in liquidating or reorganizing inefficient firms and bringing about a change in management or ownership through debt-equity conversion in many Asian countries. This lack of disciplinary function from the insolvency law regime has contributed to the prevalence of a concentrated ownership structure and weak corporate governance in the corporate sector.

Informal Workouts

Generally speaking, there are two types of informal workout procedures among Asian countries. One is found in Hong Kong and Singapore whose procedures are largely based on the "London Approach" and are basically non-intrusive, voluntary and non-prescriptive.

The other is found in the four countries mentioned above: the "Jakarta Initiative" of Indonesia, CDRC of Malaysia, "Corporate Restructuring Agreement" of Korea, and "Bangkok Rules" of Thailand. The first three have a facilitating agency which can also function as an administrator of the procedure or as an arbitrator, while the last one is without a facilitator but heavily regulated and prescriptive. But they have in common the fact that they were introduced in the face of the danger of widespread corporate bankruptcy and with a view to facilitating an economic recovery.

To the extent that a systemic bankruptcy of the corporate sector should be avoided and

Copyright © OECD All rights reserved

that the existing formal insolvency procedures are not well developed nor efficient the aforementioned four informal workout procedures can be thought of as appropriate policy responses. However, there is no guarantee that they will achieve the following three important tasks of an insolvency mechanism in this context: 1) preventing bankruptcy of economically viable, though heavily indebted, firms, 2) preventing banks and other financial institutions from being unfairly expropriated to "save" the corporate sector, and 3) disciplining the incompetent management and reckless controlling shareholders.[32]

The potential obstacles to their success include: 1) the dearth of experience and commercial knowledge among those involved in the procedure; 2) the difficulty of bringing in a sufficient amount of new money and providing adequate protection for the creditor or new investors within the informal procedure; and 3) the ineffectiveness of the formal procedure as a threat to the creditors and the debtor firm in case of failure of the informal procedure.[33] In addition, the lack of effective corporate governance within the institutional creditors, such as banks, could fail to provide strong enough incentives for bank employees to actively strive for a successful workout. Since these informal procedures were introduced only recently, however, their performance still remains to be seen.

One important instrument to realize a successful workout is the judicious use of debt-equity conversion. It can relieve the debtor firm from the immediate pressure of debt service, reward the creditors with a rising stock price if the conversion price has been set properly, and perform a disciplinary function with the change in ownership structure and in management. In the case of Korea, most of the workout programs approved so far under the Corporate Restructuring Agreement contain a debt-equity conversion provision.[34]

M&A markets have played a very minimal role as an insolvency mechanism in Asia since these markets have almost been non-existent due to the concentrated ownership structure and regulations in the stock market.

In summary, the reliance on bank loans and on ad-hoc informal procedures have left the formal insolvency procedures largely underutilized and underdeveloped in Asia while undermining the effectiveness of other mechanisms of corporate governance. However, there have recently been new amendments and reform efforts to improve the insolvency law regime in several countries including Indonesia, Thailand, Malaysia, and Korea. They are intended to

---

[32] An alternative approach to systemic corporate bankruptcy problem in Korea are proposed in Nam & Kang (1998c).

[33] ADB report (1999).

[34] One curious feature in many of the cases, though, is that the incumbent management or controlling shareholders remain in control even after their shares have been almost wiped out. It is not clear whether this reflects the competence of the incumbents or the aversion of the banks to exercise control over their client firm.

Copyright © OECD All rights reserved

further elaborate the rules for the purpose of speeding up the process and making its outcome generally more predictable and to make the reorganization procedure assume a bigger role in the corporate restructuring process.

3.7 Transparency and Disclosure

The standards and practices of accounting and disclosure in Asia have had much impact on the effectiveness or ineffectiveness of corporate governance and the development or underdevelopment of key financial markets in the Asian countries which are described in detail in the previous subsections.

In most countries, there are professional and quasi-government bodies who are in charge of setting and reviewing accounting and auditing standards. The disclosure rules are mostly regulated by the security exchange commissions and the stock exchanges. Their standards and rules try to follow the International Accounting Standards (IAS) and the disclosure regulations of the leading international financial centers such as the U.S. and the U.K.

However, there are still discrepancies both in the standards themselves and in practice. The key areas of difference or deficiency include: 1) valuation of assets, especially intangible assets and securities, treatment of extraordinary items, and disclosure of off-balance sheet items; 2) disclosure of information on corporate group and intra-firm transactions; and 3) disclosure of transactions with the parties related to a director or controlling shareholders. It has also been pointed out that the content and timeliness of interim financial reporting has much room for improvement.

Equally important to ensuring transparency and adequate disclosure is the effective enforcement of the rules. In some countries, the number of cases in which fraudulent accounting, violation of the disclosure rules, or ineffective auditing were detected and punished has been very small, and even the punishment has not been severe enough to deter future violations.

In short, the inadequate standards and rules and lax enforcement have helped to grant a free rein to corporate insiders at the expense of outside shareholders and to hamper development of the securities market. The good news is, there are ample signs that policy-makers have recognized the significance and long-term implication of the problems in this area, and have made their improvement a top priority. To the extent that the most immediate beneficiary of

Copyright © OECD All rights reserved

such improvements would be the investors in the securities market, it would help to get them involved in and contribute to the reform process.

4. Challenges and Future Policy Options for Corporate Governance in Asia

Except for Hong Kong and Singapore whose corporate governance systems have been sound, most Asian countries have made visible and indeed impressive progress in their reform of corporate governance systems over the past year or so. This is particularly so if we take into account the depth and severity of the problems in corporate governance shared by these countries as well as the short period of time available for change.

Specifically, the substantial portion of non-performing loans has been written off while corporate bankruptcies and mergers of financial and non-financial firms have occurred. These developments were practically unthinkable in the past in those crisis-hit countries. In tandem with these developments, the Asian countries have also strengthened their regulations and standards with respect to transparency and information disclosure. In addition, a number of institutional reforms have been implemented for the purpose of strengthening the rights of the minority shareholders, while prudential supervision on financial institutions has and will be upgraded on an on-going basis. Given the presumption that the improved regulations, standards and financial supervision are properly enforced to ensure the compliance of both financial and non-financial corporations, those developments will have a desirable effect not only on corporate governance and tax administration but also on the entire economy as well.

However, Asian countries have yet to make satisfactory progress in the area of market for takeover and bankruptcy proceedings. Although non-financial firms and banks were sold to foreign investors in the course of corporate and financial sector restructuring, such a development seems to be more the result of fire sale in the midst of crisis than the emergence of an active market for corporate control. It will take more time for the market for corporate control to emerge, particularly because of the concentrated ownership structure and the lack of well-developed capital market. Reforms in bankruptcy proceedings have also been only modest and, hence, most East Asian countries do not have an efficient institutional framework to reallocate the resources of insolvent firms.

In a nutshell, with all the significant improvements made since the onset of the crisis in the region, many fundamental reform agenda are still left unaddressed and unanswered, awaiting additional structural reform. The major remaining obstacles are found in the following areas: 1) the fragility of the legal and institutional framework and the lack of credible enforcement with regard to corporate governance systems, 2) an inappropriate modality of corporate and financial sector restructuring, 3) the lack of a well-developed capital market, and 4) the risk of distortionary impact on corporate governance of interventionist industrial policy.

Copyright © OECD All rights reserved

We will elaborate each issue and discuss available policy options.

First, as to the fragility of the legal and institutional framework regarding corporate governance, minority shareholders' rights are neither clearly defined in an *ex-ante* sense nor well protected in the *ex-post* sense. In particular, minority shareholders' right to participate in corporate decision making and have easy access to business information does not seem to be clearly defined within the legal framework. Furthermore, the *ex-post* remedy and punishment for the expropriation of minority shareholders by the major shareholders seems to be weak and inadequate. For example, illegal practices of breach of trust, expropriations bordering on embezzlement, and simple theft seem to be continuing in many East Asian countries, but the punishment on such abuses largely remains weak at best.

Of course, many East Asian countries do have institutional devices, such as class action suits, designed to protect minority shareholders' right from such illegal practices. But their practical effectiveness seems to be doubtful. For instance, theoretically, class action suits can help minority shareholders to protect their rights by filing civil claims against managers or major shareholders for their illegal practices and resultant costs impinged upon minority shareholders. In reality, however, in many East Asian countries, there exist many technical obstacles and legal impediments. Lawyers often have little incentive to undertake a civil suit due to ceilings on their legal service fees which are rigidly set at unrealistically low levels.

Furthermore, in many East Asian countries, the controlling shareholder(s) is not necessarily registered as a member of the board of directors, although most expropriations and violations are done under his approval. In this case, effective legal enforcement is not practically possible. In Korea, legal change has recently been made in such a way as to count the controlling shareholder(s) as a *de facto* director, but its legal status is not clearly defined. Therefore, it is quite difficult to effectively enforce the legal requirement for shareholder approval on connected transactions, unless the controlling shareholder is registered as a regular member of the board of directors.

Legal punishment for violations with respect to newly improved accounting standards and codes of practices must also be strictly enforced in order to secure reform credibility. However, legal enforcement in this regard has also been discretionary and short-lived at best in many East Asian countries. Under these circumstances, it is hard to expect accounting firms to fully comply with new accounting standards and rules.

There is no instantaneous fix for these problems. Rather, the government must continue to improve their legal and institutional framework for corporate governance, and strengthen their enforcement by "biting the bullet". To this end, the government should scrutinize the regulatory framework and legal institutions, carefully analyze the incentive structure embodied

Copyright © OECD All rights reserved

in the framework, and eliminate any unclear provisions in laws and regulations. At the same time, an appropriate incentive structure needs to be established for regulators in order to ensure credible enforcement. After all, no laws or regulations can make difference, no matter how well they are designed, unless they are properly enforced.

Second, the modality of financial and corporate sector restructuring must be consistent with clear market principles. At the outset, the financial and corporate sector restructuring, which are currently underway in many East Asian countries will have profound impacts on corporate governance in the region. The reorientation of the role of financial institutions and the normalization of prudential regulation, which are the most essential elements of economic restructuring, will be critically affected by the privatization of the recapitalized banks and the post-privatization governance structure. Therefore, the success of corporate governance reform will be seriously jeopardized if the privatization process is delayed or ill-managed, or a small number of families continues to exercise dominant control in both corporate and financial sectors, or if the state control in the financial sector does not phase out quickly. On the contrary, the emergence of sound financial institutions equipped with good governance structure and strong commercial orientation will exert a positive spill-over effect into the corporate governance systems of non-financial firms.

As corporate sector restructuring inevitably involves changes in ownership structure and corporate control, it has far-reaching implications not only for the business interests of financial institutions but also the governance structure of both financial and non-financial firms. There is little question that it is socially optimal to prevent financially troubled but economically viable firms from being liquidated. The essential question is how to share the losses or benefits among involved parties, including creditors and shareholders. Currently, the most desirable option for loss/benefit sharing seems to be debt-for-equity swaps, and setting the right price for the exchange lies at the core of this option. If, under the right exchange price, shareholders are supposed to lose their interests completely or partially, they must be strictly enforced to do so.

Unless the corporate workout programs currently under way in many Asian countries adhere to such clear market principles, they will further aggravate the problems rather than solve them. The deviation from market principles will translate into not only unfair and increased burden on taxpayers but also harmful distortion in corporate governance. Controlling shareholders of troubled firms will face distorted incentives if they are exempted from due responsibility for mismanagement or penalties associated with expropriations and illegal practices. Furthermore, such distortion in corporate governance is likely to spill over into other distortions in the fabric of both financial and product markets.

Third, underdeveloped financial markets in most Asian countries could impede successful corporate governance reform, given that profit-oriented and well-managed banks and

Copyright © OECD All rights reserved

other major lending institutions can play an essential role in corporate governance reform. In most Asian countries, however, there are few financial institutions that are not connected to the dominant business families. In addition, many lending institutions whose ownership structures are well diversified do not have adequate internal governance structures. In fact, many of them are in captive positions due to their large exposure to firms under the family control resulting from reckless lending practices.

As a result, the dominant family shareholders of large corporations and conglomerates in Asian countries tend to monopolize financial resources. There are few, if any, individuals or families other than the dominant families who can mobilize the financial resources necessary to obtain control of major financial institutions. Allowing the families who control corporations in the real sector to take or maintain control of financial institutions raises the risk of expropriation of minority shareholders as well as depositors of the financial institutions. Barring the families from taking control of financial institutions requires an alternative corporate governance structure for them. Government control of financial institutions proved to be a failure as the Korean experience revealed. For most East Asian countries, a third model for the corporate governance for financial institutions that will work reasonably well has to appear.

Fourth, interventionist industrial policies, which had constituted grounds for governance failures in the corporate and financial sectors, as well as in insolvency proceedings, may continue to stand in the way of corporate governance reform. Industrial policies of some Asian countries have been focusing on the economies of scale in strategic industries and implicit risk sharing with the private sector. Such policy orientation inevitably led to heavy government intervention in the financial sector, and hampered the emergence of proper internal governance structures of financial institutions. It also created wrong incentives for the controlling shareholders of the targeted firms in terms of excessive risk taking.

At the current stage of economic development, Asian countries seem to be faced with a dilemma in regard to the continuation of industrial policy. In order to foster the establishment of a sound and efficient governance structure in both the financial and non-financial sectors, interventionist industrial policy needs to be phased out quickly. For such transition to occur, however, these countries need well-developed capital markets, particularly market-based long-term financing facilities, in order to promote financing of large scale investment in capital-intensive industries, which had formerly been supported by directed credit programs within the context of the industrial policy. Given this dilemma, the possibility of continued industrial policy cannot be easily ruled out in Asian countries.

Copyright © OECD All rights reserved

Lastly, a few words are in order on public enterprises and competition policy. Given their sheer size in terms of GDP share in some East Asian countries, the importance of corporate governance in the incumbent public enterprises and their post-privatization governance structures cannot be overemphasized. Most public enterprises in their present form are more instruments of the government's industrial policies than business entities. Corporate governance reform in those public enterprises with stronger commercial orientation, including public monopolies in network industries, should start with a clear identification of and distinction between public interests and commercial profit incentives. Another important policy issue in regard to the privatization of public enterprises in the Asian countries is whether to allow those dominant business families to acquire controlling shares in those privatized enterprises on the block. Of course, answering that question requires considerations to a broad spectrum of socio-economic concerns. Nonetheless, as a bottom line, it can be argued that the acquisition of controlling shares by dominant business families must be financed by their own money, not borrowed funds. In this context, prudential regulation and internal governance of financial institutions are critical.

In line with the privatization of public enterprises, market competition should be promoted to maximize the efficiency gains from privatization. Further, competition policy needs to be strengthened across all sectors of the economy. It should be stressed that competition policy is complementary to good corporate governance, rather than a substitute for it. Indeed, there is a feedback linkage between the promotion of market competition and improving corporate governance. If we broaden the concept of corporate governance, market competition can be seen as an important external governance device for both financial and non-financial firms. And, market competition can only thrive in an environment that guarantees transparency, accountability and free flows of information at the individual firm level.

Copyright © OECD All rights reserved

References

ADB, "Insolvency Law Reform", *Preliminary Comparative Report*. 1999.

Akerlof and Romer, "A Looting: The Economic Underworld of Bankruptcy for profit", *NBER Working Paper* no. 1869, April 1994.

Association of Chief Executive Officers Committed to Improving Public Policy, "Statement on Corporate Governance", Sep 1997.

Berger, Philip G. and Eli Ofek, "Diversification's Effect on Firm Value", *Journal of Financial Economics,* vol.37, pp.39-65, 1995.

Borensztein, Eduardo and Jong-Wha Lee, *A Financial Distortions and Crisis in Korea,* Unpublished paper, June 1998.

Cadburry Report, *The Financial Aspects of Corporate Governance*, Dec 1992.

Campbell, J., "Understanding Risk and Return"*, Journal of Political Economy*, Vol.104, pp.298-345, 1996.

Cesar Saldana, "Philipphine Corporate Governance Environment and Their Impact on Corporate Performance and Finance", *OECD Conference Paper*, Mar, 1999

Charles Calomiris and Carlos Rammirez, "The Role of Financial Relationships in the History of American Corporate Finance", *Journal of Applied Corporate Finance*, Vol. 9, Summer, 1996.

Chinn, Minzie, "Before the Fall: Were East Asian Currencies Overvalued?", *NBER Working Paper* No. 6491, April 1998.

Cho, Yoon Je and Joon-Kyung, Kim, "Credit Policies and Industrialization of Korea" *World Bank Discussion Papers*, No. 286. Washington. D.C. 1995.

Choi, Woon-Youl and Yeong-Ho Woo, *Corporate Governance and Disclosurre : Receent Developments in Korea*, Korea Securities Research Institute, October 1998.

Claessens, Stijn, Simon Djankov, and Larry Lang, *East Asian Corporates : Growth, Financing and Risks over the Last Decade,* World Bank, mimeo, 1998a.

______, Who Control East Asian Corporations?, World Bank, December 1998b.

Claessens, Joseph P.H. Fan, and Larry Lang, *Ownership Structure and Corporate Performance in East Asia*, World Bank, mimeo, October 1998.

David Weinstein and Yishay Yafeh, "On the Cost of a Bank Centered Financial System: Evidence from the Cahnging Main Bank Relations in Japan", *Journal of Finance*, 53, 1998.

Denis, D.J., D.K. Denis and A. Sarin, "Agency Proble, Equity Ownership, and Corporate Diversification," *Journal of Finance,* Vol.52, pp.135-160, 1997.

Denuden Nikomboriak and Somdiat, "Corporate Governance: The Challenge Facing the Thai Economy", *OECD Conference Report*, 1999.

Fan, J, L. Lang and R. Stulz, "Corporate Performance and Related Diversification", mimeo, University of Chicago, 1998.

Copyright © OECD All rights reserved

Furman, Jason and Joseph Stiglitz, "Economic Crisis: Evidence and Insights from East Asia", Brookings Papers on Economic Activity, forthcoming, 1998.

Gertner, R., D. Scharfstein, and J. Stein, "Internal vs. External Capital Markets," *Quarterly Journal of Economics,* Vol.109, pp.1211-1230, 1994

Goldstein, Morris, "The Asian Financial Crisis: Causes, Cures, and Systemic Implications", *Policy Analyses in International Economics,* No.55, Institute for International Economics, June 1998.

IMF, *A International Financial Statistics*, Various issues.

Institute of International Finance, *A Capital Flows to Emerging Market Economies*, April 1998.

JDB and JERI (Japan Development Bank and Japan Economic Research Institute), "Policy-Based Finance: The Experience of Postwar Japan." Tokyo. 1993.

Jensen, M. C., "Agency Costs of Free Cash Flow, Corporate Finance and Takeovers", *American Economic Review,* Papers And Proceedings, Vol.76, pp.323-29, May 1986.

______, "Eclipse of the Public Corporation", *Harvard Business Review,* Vol.67, pp.61-74, 1989.

Joe Peek and Eric Rosengren, "The International Transmission of Financial Shocks: The Case of Japan", *American Economic Review*, 87, 1998.

Kim J. and L. Lau, "The Sources of Economic Growth of the East Asia Newly Industrialized Countries", *Journal of the Japanese and International Economics,* Vol.8, pp.235-271, 1994.

Klein, Benjamin, R.A. Crawford, and A. Alchian, "Vertical Integration, Appropriable Rents, and the Competitive Contracting Process", *Journal of Law and Economics*, Vol.21, pp.297-326, 1978.

Ko Chen-en and Chi-Chun Liu, "Corporate Governance in Chinese Taipei", *OECD Conference Paper*, Mar, 1999

Krugman, Paul, "The Myth of Asia's Miracle", *Foreign Affairs*, pp.62-78, November/December 1994.

______, "What happened to Asia?", *mimeo*, January 1998.

______, "The Return of Depression Economics", *Foreign Affairs* Vol.78-1, pp.56-74, January/ February 1999.

La Porta, Rafael, Florencio Lopez-de-Silanes, Andrei Shleifer, and Robert W. Vishny, "Legal Determinants of External Finance", *Journal of Finance,* Vol.52, pp.1131-1150, 1997a.

______,"Legal Determinations of External Finance" *Journal of Finance*, Vol. LII, No. 3, July 1997b.

______, "Corporate Ownership Around the World", *NBER Working Paper Series*, No. 6625, June 1998.

Lang, Larry H.P. and Ren M. Stulz, "Tobin's q, Corporate Diversification, and Firm Performance", *Journal of Political Economy*, Vol.102, pp.1248-1280, 1994.

Lins, K. and H. Servaes, "Is Corporate Diversification Beneficial in Emerging Markets?" *Working Paper*, University of North Carolina, 1998.

Mak Yeun Teen and Phillip H. Phan, "Corporate Governance in Singapore: Current Practice and

Copyright © OECD All rights reserved

Future Development", *OECD Conference Paper*, Mar, 1999

Malaysia Government, Corporate Governance in Malaysia an Assessment", *OECD Conference Paper*, Mar, 1999

McKinnon, Ronald I., *The Order of Economic Liberalization: Financial Control in the Transition to a Market Economy*, second edition, Baltimore: Johns Hopkins University Press, 1993.

______, Ronald I. And Huw Pill, "A Credible Liberalizations and International Capital Flows: The Over borrowing Syndrome, in Takatoshi Ito and Ann O. Krueger(eds), Financial Deregulation and Integration in East Asia", *National Bureau of Economic Research East Asia Seminar on Economics* Vol.5, Chicago, University of Chicago Press, 1996.

Morck, R., A. Shleifer and R. Vishny, "Management Ownership and Market Valuation: An Empirical Analysis", *Journal of Financial Economics,* Vol.20, pp.293-315, 1988.

OECD, Corporate Governance and Corporate Performance, 1998a.

______, *OECD Economic Surveys; Korea*, September 1998b.

______, Main Issues for Consideration for Governance Guidelines, *OECD Conference Paper*, Mar, 1998c.

Park, Yung Chul, "East Asian Liberalization, Bubbles, and the Challenges form China", *Brookings Papers on Economic Activity(2),* 1996.

Radelet Steven and Jeffrey Sachs, "The Onset of the East Asian Currency Crisis". *NBER Working Paper*, No.6680, April 1998a, Available from the Research section of the HIID website:www.hiid.harvard.edu.

______, "A The East Asian Financial Crisis: Diagnosis, Remedies, Prospects", *Brookings Papers on Economic Activity,* 1998b: 1, pp. 1-74.

______, What Have We Learned, So Far, From the Asian Financial Crisis?, 1999.

Raghuram G. Rajan and Luigi Zinglales, "Which Capitalism? Lessons from the East Asian crisis", *Journal of Applied Corporate Finance*, 1998 (Forthcoming)

Rajan, R., H. Servaes, and L. Zingales, "The Cost of Diversity: The Diversification Discount and Inefficient Investment", *Working Paper*, The University of Chicago, 1997.

Sachs, Jeffrey, Aaron Tornell and Andres Valasco, "Financial Crises in Emerging Markets: The Lessons from 1995", *Brookings Papers on Economic Activity*, 1996.

______, "The Wrong Medicine for Asia," *The New York Times*, November 3, 1997.

Scharfstein, D.S., "The Dark Side of Internal Capital Markets II: Evidence from Diversified Conglomerates", *Working Paper*, MIT Sloan School of Management, 1998.

Scharfstein, David and Jeremy Stein, "The Dark Side of Internal Capital Markets: Divisional Rent-Seeking and Inefficient Investment", *NBER working paper*, No.5969, 1997.

Servaes, Henri, "The Value of Diversification During the Conglomerate Merger Wave", *The Journal of Finance,* Vol.51, pp.1201-1225, 1996.

SFC, "Corporate Governance in the Special Administrative Region of Hong Kong, *OECD Conference Paper*, Mar, 1999

Shin, H. and R. Stulz, "Are Internal Capital Markets Efficient?" *Quarterly Journal of*

Copyright © OECD All rights reserved

Economics, (forthcoming), 1998.

Shleifer Andrei and Robert W. Vishny, "A Survey of Corporate Governance", *The Journal of Finance,* Vol. LII, No.2, June 1997.

Stein, Jeremy, "Internal Capital Markets and the Competition for Corporate Resources", *Journal of Finance*, Vol. 52, pp. 111-134, 1997.

Takeo Hoshi, Anil Kashyap, and David Scharfstein, "The Role of Banks in Reducing the Cost of Financial Distress in Japan", *Journal of Financial Economics*, 27, 1990

Williamson, Oliver E., "The Vertical Integration of Production: Market Failure Consideration," *American Economic Review,* Vol.61, pp.112-123, 1971.

World Bank, *The East Asian Miracle*, Oxford University Press, 1993.

______, *World Development Report, From Plan to Market*, Washington, DC, 1996.

______, *The Road to Recovery: East Asia after the Crisis,* Washington, DC, 1998a.

______, "Report and Recommendation of the President of the International Bank for Reconstruction and Development to the Executive Directors on a Proposed Second Structural Adjustment Loan in an Amount Equivalent to US$2.0 Billion to the Republic of Korea", *World Bank, Report No. P-7258-KO,* October 1998b.

In Korean

Chung Yoon Mo and Y. R. Son, Trend of Security regulation after Financial Crisis, *KSRI Research Paper*, Jan . 1999.

Jung Kwang Sun, "Corporate Competitiveness and Corporate Governance", *KIF, Research Paper* No. 4, 1994.

Jung Yoon Mo, Y. R. Son, "Trend of security regulation after Financial Crisis", *KSRI Research Paper,* Jun 1998.

Jwa Sung Hee, *Evolutionary Theory of Chaebol,* By-bong Press, Mar 1998.

Kang, Myung Hun, *The right of the minority shareholders in Korea*, KDI, Mar 1998.

Kang Jong Man, E. K. Choi, "The improvement of Corporate Governance in Korea", *KSRI Research Paper*, Jun 1998.

KDI, *Synthetic Counter-program for the Corporate Restructuring and Economy Performance*, Apr. 1998

KFTC, *Amended of Fair Trade Laws and Regulations*, Dec 1998.

MOFE, *Policy Response and Economic Accomplishments under the year of IMF program,* Nov 1998.

Nam, Il Chong, "An Economic Analysis of Bankruptcy Proceedings in Korea", *Korea Development Review*, 1993.

Copyright © OECD All rights reserved

______, "How to deal with self-dealings under current crisis situation", paper presented at the Congressional Hearing for the Revision of the KFTC Act, December 1998a.

______, "A Proposal for Public Enterprise Reform", Paper Submitted to the Transition Committee for the New Government, Feb. 1998b.

Nam, Il Chong and Yeongjae Kang, "The Fact-Track Approach to Corporate Bankruptcy in Korea", (unpublished mimeo) 1998c.

______, "Privatization Incentives and Policy Objectives", *Korea Development Review*(forthcoming), 1999.

Copyright © OECD All rights reserved