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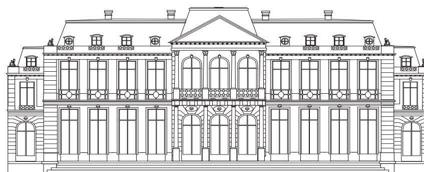

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"CORPORATE GOVERNANCE IN ASIA: A COMPARATIVE PERSPECTIVE"

Deunden Nikomborirak and Somkiat Tangkitvanich
Thailand Development Research Institute

Corporate Governance: The Challenge Facing the Thai Economy

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Index

Part I: Introduction and Summary

Part II: The Corporate Governance Environment and its Impact on Coorporate Performance and Finance

1. The general economic context
2. The corporate governance characteristics and their relevance to the financial crisis
   - *a. The corporate governance agents*
   - *b. The corporate behaviour, finance and restructuring*

Part III: The Regulatory Framework and the Role of Policy

1. Equitable treatment of shareholders and other stakeholders
   - *a. Shareholder protection*
   - *b. The role of the board of directors*
2. The importance of transparency and disclosure
3. The role of institutional investor

Part IV: Conclusions

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Part I: Introduction and Summary

Part of the East Asian crisis has been attributed to bad corporate governance which includes reckless lending by commercial banks, risky investment by managers, expropriation of company's funds by directors, managers or large shareholders, shady business deals and poor audits. While it would be somewhat far-fetched to attribute this crisis to bad corporate governance per se, but weaknesses in governance certainly rendered the economy much more vulnerable to economic imbalances. The bubble in the real estate and the property sector would not have been as large if banks and finance and securities companies were more cautious about their lending. The Bank of Thailand and the Stock Exchange of Thailand would have been better able to implement timely corrective measures should financial accounting and auditing properly expose the dire financial straits most banks and companies were in. But it is moot to talk about what could have happened. What is more interesting is that all of the sudden we are shouldering the cost of inherent weaknesses in our corporate governance.

Fire-sale of hire-purchase businesses taken over from the 56 closed finance fetched only 25-30% of the face value due to unreliable accounting[1]. Poor accounting also pose a major obstacle to the on-going debt restructuring process. Unreliable financial data has caused distrust among creditors and debtors. Intransparent management, weak internal corporate control and lack of effective monitoring also made foreign investors hesitant about buying up a minority share in Thai businesses. Hence, recapitalization has been slow coming.

The crisis brought a major shift in the structure of the Thai corporate ownership and control. Gone are traditionally family-run businesses. Individual shareholdings were replaced by those of the government and foreign enterprises. The on-going corporate restructuring provides a perfect condition to lay the ground rules for good corporate governance.

[1] The bid submitted by a (well-informed) foreign consulting company who also performs an advisory role to the government in the sale of seized assets, offered 50%. The 20% discrepancy is a crude reflection of the cost of unreliable financial data.

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Part II: The Corporate Governance

1. The General Economic Context

Thailand is a small open economy with a GDP of US$ 181 billion in 1996 (before the depreciation of the baht in July 1997) and a trade/GDP ratio of 0.7. The country underwent rapid economic growth in the late eighties and in the early nineties. Real GDP growth during 1985-90 averaged 10.31%. In 1994 and 1995, this growth continued, albeit at a slower rate of 8.9% each year.

Much of the growth was generated by the booming export sector. During 1985-90 export grew on average 24.92 per cent per annum. The high growth remained throughout the early nineties. In 1994 and 1995, export expanded at 21.34 and 23.58 per cent respectively. Traditional exports of agricultural products such as rice, tapioca and rubber were gradually replaced by manufactured goods namely computers and parts, electrical appliance, textile products and integrated circuits. It must be noted, however, that while these products may generate high sale values, they do not generate much value-added because of their high import contents.

Macroeconomic and political stability coupled with high domestic interest rates in the country have lent themselves to heavy inflows of foreign capitals, which helped fuel economic expansion, and later, the bubble. Capital inflows during 1990-95 averaged approximately 10% of GDP. While the size of the inflows continued to increas throughout the early nineties, the quality deteriorated sharply. The share of direct investment as a percentage of total capital inflows dropped drastically from 24.7% in 1990 to a mere 5.4% in 1995, while the share of loans surged from 70.48% to 87.13% during the same period. The difference was made up by portfolio investment, which also saw an increase in its share on average despite large fluctuations each year. Indeed, with a well-entrenched fixed exchange rate regime and rapid economic growth, foreign lenders did not hesitate to extend credits even to risky projects.

The opening of the notorious Bangkok International Banking Facility (BIBF) in 1993 marked an important step leading to the crisis. The initial intention of the government was to establish Bangkok as the regional financial hub by allowing local enterprise to have access to overseas capital. But freeing capital flows without concurrent liberalisation of the domestic banking industry left a gaping disparity

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between the cost of foreign loans and that of domestic loans; the lending rate differentials were as high as 8-10 percentage points. Local businesses undoubtedly jumped at the opportunity to borrow cheaply from abroad. Consequently, the amount of foreign debt shot up sharply from US$ 50.3 billion in 1993 to US$ 65.5 billion in 1994 and a further US$ 83.3 in the following year. In the process, Thai businesses have become heavily leveraged.

The exchange-rate peg not only fuelled the bubble economy by encouraging heavy inflow of foreign capitals, but also destroyed many local export industries pre-maturely as the appreciated in real terms. Basic international finance would tell you that, if a country were to sustain a nominal exchange rate peg to another currency, its inflation rates must correspond with the rates which prevails in the country to whose currency its currency is pegged. Data reveals that while the inflation rate in Thailand was lower than that of the US before the baht stabilised at 25 baht to the dollar in 1988, thereafter the Thai rates persistently exceeded those in the US. The cumulative difference between the Thai and the US inflation rates during 1988-1997 amounted to approximately 17%; in other words, the baht appreciated 17% against the dollar in real terms.

The real appreciation of the baht to the dollar did not cause much damage to Thai exports prior to 1995 as the dollar was weakening against the Yen, the currency which dominates the country’s trade account. But thereafter, the dollar reversed its trend and appreciated against other major key currencies such as the Yen and the Deutsche Mark. The strong dollar had a devastating impact on Thai export, which plunged from a 23% growth in 1994 year to a mere 0.9% growth in 1995.

The strong baht adversely affected many export industries particular labour-intensive goods such as textiles, footwear and integrated circuits and parts, which lost their competitive advantage to low-wage competitors such as Indonesia, China and Vietnam. The slowdown of the once booming export sector represented an ominous sign of the pending economic crisis.

By the middle of 1996, a year before the crisis, alarming macroeconomic ratios such as the current account deficit at 8% of GDP in 1996 and the foreign debt at 51% of GDP, put Thailand in the watchlist of the IMF as well as that of foreign investors. What was most worrying is not so much the size of the foreign debt, rather, the composition. The ratio of short-term debt to total foreign debt increased drastically from 22% in 1990 to approximately 45% by the end of 1996. That is, out of US$ 94.3 billion of outstanding foreign debt in 1996, US$ 43.7 billion was short-term debt. This number came

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threateningly close to the stock of foreign exchange reserves, which stood at US$ 45.83 billion. There were doubts whether Thailand could readily honour its commitments should all short-term loans be recalled. Hence, confidence in the Thai baht -- for the first time in a long time -- was shaken. The exchange rate peg regime, once sacred, became questionable.

The baht came under a series of attack since early 1997. The central bank intervened heavily to sustain the exchange rate peg, only to succumb to relentless speculative attacks of hedge funds of enormous proportions. The Bank of Thailand, which had long prided itself over the stability of the baht that allowed many years of macroeconomic stability and economic prosperity, blindly defended the currency. In total, US$ 23 billion was spent in a series of attempt to shore up the baht. On the eve of the baht float, the stock of foreign exchange reserves net of currency swap arrangements was a mere US$ 2.3 billion. With such paltry reserves, there was no other way but to let the baht float.

The sharp depreciation of the baht left commercial banks and many local enterprises with loans in foreign currencies heavily indebted. Most affected were large companies involved in the property, real estate, infrastructure and heavy manufacturing sectors, which had direct access to foreign funds. As local commercial banks and finance companies were also exposed to such companies, the deterioration of the health of real sector had serious impact on the financial sector. As a result, 56 finance companies have been closed, 4 banks have been taken over by the government and 2 banks were bought by foreign banks. Thailand ended up with 1.2 trillion baht worth of seized assets from the finance companies, the salvage value of which is anyone's guess. It may lie anywhere from 20-30%. Unemployment, virtually non-existent before the crisis, is likely to reach 4-5% or 2 million umemployed in early 1999. The economic crisis has also begun to take its toll on the number of bankruptcy, which surged in 1998.

The immediate task was to save thefinancial sector. To this end, the government has set up the Financial Institution Development Fund (FIDF) which provides the required financing to bail out financial institutions. In May 1998, FIDF borrowings stood at approximately 700 billion baht or US$ 18.42 billion (at 38 baht per US$). Seized assets from closed finance companies have been gradually auctioned off by the Financial Restructuring Agency (FRA). Debt restructuring is also under its way, but is still met with very little success as debtors and creditors cannot agree on how much "hair cut" creditors are supposed to take and what the future business prospects will be. Several laws are also being revised in order to facilitate quick debt restructuring such as the bankruptcy law and the foreclosure law. The

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alien business law and the land-ownership law are also being revised to create a more attractive investment environment.

2. The Corporate Governance Characteristics

a The corporate governance agents

As in most countries, ownership among Thai corporations is concentrated. Table 1 exhibits the average size of equity share of the 3 largest shareholders among 10 largest listed Companies in 1998. In case of Thailand, the share was 44%, a figure which is not considered high when compared with those of other Asian and Latin American countries. Also, similar to most other East Asian countries, control of the Thai corporates is often in the hand of a single individual or family.

TABLE 1: OWNERSHIP CONCENTRATION IN 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)

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The management of Thai business enterprises has been predominantly family-run as pioneered by Chinese merchants. Many of such families have prospered and built their empires that cut across many sectors in particular banking, finance and securities, agro-industry and telecommunications. Families such as the Sophonpanich (Bangkok Bank), the Lam Sam (Thai Farmers Bank), the Techapaiboon (Sri Nakorn Bank), the Chearavanont (Chareon Phokaphand Conglomerate) and the Chirativat (Central department store and hotel chains) -- to name a few --dominated the Thai corporate ownership landscape. Although some of these businesses have become publicly listed companies, founders managed to keep a controlling share within their family. This may all change with the current crisis, however.

Struggling to emerge out of massive debt burden as a result of a sharp depreciation of the baht and the burst of the economic bubble, many of these family-run business empires have had to shed many of their subsidiaries to keep their core businesses afloat. Other less-fortunate ones have had to sell off large equity shares in their core businesses. Those involved in banking for generations saw their ownership evaporated within a stroke of government's mandated capital write downs, while those in finance and securities lost their entire business through the mandatory shut down and subsequent nationalisation of 56 finance companies. Most of those whose companies survived the crisis have had to surrender a large (sometimes controlling) equity share to foreign companies. Indeed, the current crisis have had, and will continue to have, a significant impact on the Thai corporate ownership structure like never before.

The emerging post-crisis corporate ownership structure is one that is less-family oriented and more dominated by the government and foreign investors. Subsequent to the nationalization of commercial banks, the government has become the largest equity owner in the banking industry. Seven (out of 14) commercial banks are now state-owned. More can be expected through the current government-sponsored recapitalization scheme. Significant increase in foreign shareholding is also expected in many sectors, in particular those most affected by the crisis which includes banking, finance and securities, insurance as well as public utility services such as energy and telecommunications as can be seen in table 2. Pending the passing of the revised Alien Business Law which may allow much larger foreign equity holding, the Thai corporate ownership could be witnessing much greater foreign presence.

With concentrated shareholding, control of Thai corporates fell almost entirely in the hands of large shareholders, unchallenged by other stakeholders such as smaller shareholders or creditors. Through majority shareholding, the owners have the power to appoint directors and managers, make

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major corporate decisions which require majority share approval, approve interested business transactions or even change the corporate charter.

The key question is *who controls the Thai corporate*? The composition of investors with a potential controlling-share – i.e., top 5 largest shareholders -- are mostly private companies or holding companies (38% of total number of top 5 shareholders) as can be seen in table 3. Take note, however, that many of these companies are unlisted companies that only serve the interest of a single individual or family. These "captive companies" are easily detected as they are often named after the individual or the family. Thus, a large part of ownership by private companies represents, in fact, individual ownership. According to the study by Claessens, Stijn, Simeon Djankov and Larry Lang (1998), 61.6 % of all publicly traded companies in Thailand are family controlled.

Individual shareholders represent the second largest group of top5 shareholders with a 21.38%. Bar foreign banks, other institutional investors – i.e., commercial banks, insurance companies and finance companies -- appear not to exercise a significant controlling share among listed Thai companies. This can probably be explained by the 10% cap on equity share banks can acquire in non-financial public companies (20% cap in the case of finance and securities companies). But as we shall see later on, these figures can be deceiving.

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Table 2: Post-crisis foreign acquisition of listed companies

Industry	Company	Foreign share 02/97*	Foreign share 11/98**	Investor- share
Agribusiness	Advanced Agro	29.38	37.04	Enso Co., USA
Banking	Bangkok Bank Ltd	25.00	48.78	The Government of Singapore
	Bank of Ayudhya	23.19	7.74	
	Thai Danu Bank			DBSa 50.27% share (03/1998)
	Bank of Asia			ABN-AMRO 75% share (03/1998)
	KrungThai Bank	17.00	12.64	
	Thai Farmers bank			GIC 15.1%
Commerce	Siam Makro PCL	35.97	45.06	
Energy	The Co-generation	32.61	59.83	
	Electricity Gen PCL	30.00	44.9	Sithe Pacific
	PTT exploration and production	20.00	32.16	
Entertainment	United Broadcasting	12.17	43.17	Multichoice Int'l Holding

Source: *HSBC James Capell: *Thailand Investment Strategy* , March/April 1997
** Capital Nomura, *Monthly Review*, November-December 1998
Note: Italicized figures are those from authors' own calculation based on SEC data. The presented foreign Ownership share exclude those smaller than 0.5%. Thus, the figures may be slightly understating the true

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Industry	Company	Foreign share 02/97	Foreign share 11/98	Details
Finance and Securities	S-one Securities	5.92	48.12	
	Nava Finance	*1.25*	*NA*	Taiwan's Yuanta 49%
	Asia Credit (SG Asia Credit)	*22.06*	*NA*	Societe General Cosby 51%
	Bangkok Investment (AIG Finance)	*15.63*	*78.79*	AIG Group 70%
	Union Securities	*NA*	*100*	Indosuez WI Carr 100%
	Sri Thana DBS Securities	*NA*	*100*	DBS Securities 100%
	Ekachart Securities	*0*	*NA*	BNP PrimeEast 70%
	TISCO	*41.97*	*51.77*	Bankers trust 75%
	Keitnakin	*3.8*	*28.8*	KEB, Bank of Tokyo,etc
	Asia Securities Trading (ABN-AMmro Asia)	*0*	*38.62*	ABN-Amro 35.3%
	National Finance & Sec	25	41.5	GIC 6.5%
Property	Land and House	25.00	30.00	
Chemicals and Plastics	National Petrochem.	15.38	22.49	
	Thai Plastic	23.09	25.91	
Electronic Components	GSS Tech	44.17	85.17	
	Hana Microelectronics	45.43	86.39	
Building and Furnishing	Siam City Cement	20.66	25.00	
	Siam Cement	35.00	47.63	
Communications	Shinawatra Satellite	15.24	24.76	

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TABLE 3: TYPE OF OWNERSHIP SHARE OF TOP 5 LARGEST SHAREHOLDERS AMONG 150 LARGEST LISTED
Thai companies in 1997

Type of Investor	Share
Private Companies and Holding Companies	38.38
Individuals	21.38
Foreign banks (including securities and nominees)	15.41
Domestic banks	5.18
Finance and securities Company	5.84
Insurance	2.00
Others	11.81

Source: Author's calculations from Stock Exchange Commission's data

Corporate control may vary widely across industries, however. Table 4 shows the top 5 shareholders classified by type of investor for selected industries. Individual corporate control is particularly prominent in the property and finance and securities sector, interestingly, the two sectors worst affected by the crisis (if not the two sectors which *initiated* the crisis). In the property sector, almost a half of the top 5 largest shareholders are individuals.

Foreign banks are among the list of top 5 largest shareholders in banking and finance and securities[2] as well as in energy, telecommunications and electronic industry. However, because of the 10% ceiling imposed on banks' holding of private companies' shares, their corporate control is usually limited. Only in few cases does a bank represent the largest shareholder.

Thai banks' corporate control appears to be concentrated only in financial businesses, namely, the insurance and finance and securities businesses, where banks are allowed unlimited ownership as can be seen in table 4. Banks and finance companies' control of listed non-financial companies is negligible and thus, not presented here. But this by no means implies that Thai banks have no interest in holding equity in non-financial industries. Thai banks do hold a controlling share

[2] Especially after the cap on foreign shareholding in these industries was lifted

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in several listed non-financial businesses through holding companies which are not subject to any kind of investment restrictions. Investment records of Thai commercial banks also reveal extensive investments in unlisted non-financial companies. The author hypothesizes that Thai banks prefer to invest in businesses where they can secure a controlling stake. Banks *do* recognize the value of corporate control.

Table 4: Top 5 Shareholders of 150 largest listed companies classified by Industry

Sector	foreign banks	Thai banks	insurance	finance	company	individual	government*	Others **	total
Agriculture	2.86	0	2.86	8.57	54.29	22.86	2.86	5.72	100
Banking	15.38	0	4.62	4.62	38.46	1.54	21.54	12.31	100
Finance	12.50	11.81	0.69	8.33	29.86	29.17	3.47	4.16	100
Insurance	14.29	14.29	5.71	8.57	40	8.57	2.86	5.71	100
Construction	23.33	0	0	0	53.33	13.33	3.33	6.67	100
Property	3.64	5.45	0	9.09	27.27	47.27	3.64	3.64	100

Source: Author's calculation from data from the Stock Exchange of Thailand

* Government holding includes shares held by the Crown Property, the Ministry of Finance, the Financial Institute Development Fund, State-owned enterprises, and other government organizations.
** Others include mutual funds and shares depository centre.

If these indirect and unlisted holdings were to be taken into account, banks' control of the non-financial sector could be greater than what appears on the record. In general, however, the nature of financial institutes' relationship with the non-financial enterprises is more one of a creditor than an investor.

Tight cross-ownership among financial institutions has rendered the financial system in Thailand rather fragile. During the bubble era, many of the reckless lendings were negotiated by both commercial banks and finance and securities companies. Banks were more exposed to the manufacturing sector, while finance and securities companies were exposed to the real estate sector, the initial source of the speculative bubble. As most banks owned at least one finance and securities company, bank were also indirectly exposed to the bubble sector.

From Chart 1 it can be seen that finance companies' exposure to the real estate sector was as large as that of commercial banks in absolute terms, despite the fact that the size of their total loan

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extension was less than a third of the banks'. Excessive credit extensions fuelled the real estate and property bubble, which later spilled over into the manufacturing sector. As can be seen in Chart 1, the volume of loans extended to the manufacturing sector surged in 1993.

Such reckless lending led to the eventual government-mandated shut down of the 56 finance companies despite series of attempt by affiliated banks to bail them out by both credit and equity injection. Undoubtedly, the event severely crippled the entire banking sector, which was also beginning to feel the bite of a folding manufacturing sector. As the health of the banking sector begins to deteriorate, the ripple effect is now beginning to take its toll on some insurance companies affiliated with a commercial bank.

b. The corporate behaviour, financing and restructure

The financial system in Thailand has always been dominated by commercial banks. In 1996, bank loans contributed to 62% of corporate financing, followed by equities at 32% and bonds at 6%. The relatively high interest rates on deposits sustained by an oligopolistic banking industry inhibited the development of bonds and equity markets. Chronic fiscal surpluses during the period of rapid economic growth also precluded issuance of government bonds, without which the market has been too thin to support a secondary market.

In the absence of alternative source of financing, rapid economic expansion was afforded by expansion in banks' credit extensions. Consequently, the debt/equity ratio, or the leverage ratio, among Thai corporates rose dramatically from 1.6 in 1988 to 2.36 in 1996, the eve of the economic crisis (see Claessens, Stijn, Simeon Djankov and Larry Lang* (1998)). This ratio was highest among those of East Asian countries with the exception of South Korea and Japan, which showed leverage ratios of 3.54 and 2.37 in 1996 respectively.

As Thai companies are heavily in debt, much of the earnings went to servicing the debt. According to the study by Claessens, Stijn et al* (1998), 36.9% of earnings before income and taxes but after depreciation (EBITAD) was spent on interest payments in 1998. Again, this ratio was the highest among all East Asian nations with the exception of Korea, which sustained a 39.37% share.

It is thus clear that the Thai corporates were very much vulnerable to external shocks. The sharp depreciation of the baht no increased the debt burden of many Thai corporates dramatically. Coupled with a sharp drop in domestic demands, Thai corporates were squeezed by both falling revenues and increasing costs.

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This current crisis has had and will continue to have a significant impact on the structure of corporate financing in Thailand. With massive non-performing loans, a large part of commercial banks funds have been channelled into building the required reserves. Thus, funds available for loan extensions have been very limited. Thus, corporates have had to look for alternative source of financing. Most have turned to corporate bonds. With mounting debt incurred in bailing out financial institutes through the Financial Institution Development Fund, the government, too, has had to resort to borrowings through sales of government bonds. Thus, one can expect to see a major shift in the corporate financing from bank credits to corporate debentures and bonds.

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Part III: The Regulatory Framework and the Role of Policy

1. Equitable treatment of shareholders and other stakeholders

a. Shareholder protection

The concept of shareholder's rights and duties as a corporate owner is relatively new to us. Only in 1993 was the Public Company Act B.E. 2535 introduced. The law offers a relative comprehensive protection of basic shareholders' right as shown in table 5. One may criticize that the minimum share required to exercise some of these rights tends to be somewhat high. For example, the right to call an emergency shareholder's meeting requires 20% of total eligible votes, whereas in most other countries, only 10% will suffice. But the only serious omission in the provisions for shareholder's rights protection is a mandatory approval by shareholders of interested transactions, the most common means by which corporate funds are expropriated in Thailand.

There are also regulatory loopholes, however. For example, in case the required quorum is not met, (prepared) decisions are made and recorded regardless. To validate these decisions, management would then call up several brokers and ask them to ask their clients (shareholders to send a backdated letter authorizing their proxy votes. Soliciting voting shares may not be sufficient, however, as the law also requires a minimum number of shareholders present at the meeting. To get around this rule, large shareholders simply hand out a single share to their friends and families or employees and ask them to show up at these meetings.

As a result of these regulatory loopholes, corporate decisions are rarely made at general shareholder's meetings. Minutes of shareholders' meeting are often drafted prior to the meeting and can take up to one year to be circulated. Thus, small shareholders are minimally involved in corporate decision-making and very little informed of corporate decisions. But shareholder's lack of participation in corporate management can also be a matter of choice rather than dictation of circumstances.

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Table 5: Protection of minority shareholders' rights

Shareholders' Rights	Availability	Minimum share requirement
Quorum for shareholder's meeting		1/3 of all votes ½ of all voters
Right to call emergency shareholding	yes	1/5 of all votes
Rights to dismiss directors	yes	¾ of voters present ½ of votes present
Rights to audit firm's financial statement and directors		1/3 of all voters 1/5 of all votes
Rights to make proposals at Shareholder meetings	yes	1/3 of all votes
Rights to sue directors for negligence of fiduciary duty	yes	5% of all votes
Mandatory shareholder approval of interested transaction	no	Transaction must be approved by the board of directors
Pre-emptive rights on new stock issues	yes	¾ of votes present
Mandatory shareholder approval of major transactions	yes	¾ of votes present
Proxy voting	yes	
Cumulative voting	yes	
Mandatory independent board committees	yes	
Mandatory report by large shareholders	yes	
Insider trading penalty	yes	

Source: Author's summary from the Public Company Law B.E. 2535

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In the past, minority shareholders rarely exercised their rights, as few are aware of their rights and duty as a corporate owner. Moreover, retail investors have been driven mainly be speculative motive during the boom years. Most were looking for the opportunity to make a quick profit. Few paid any attention to corporate fundamentals such as governance. As long as money kept flowing in, there was little incentive to monitor management.

Small shareholders' apathy is an insider's license to misappropriation of corporate funds. If minority shareholders do not show up at shareholder's general meeting, a blockholder with a mere 20% ownership share can easily dominate decisions made -- perhaps with a little help from his friends. There is thus, an urgent need to push for shareholders' activism in Thailand.

To be an optimist, this crisis may have given birth to shareholder's activism. When money dries up, it is finger-pointing time. They are now demanding accountability on the part of management and directors to corporate failure. News reporting small shareholders protesting at general shareholders' meetings has begun to appear. This nascent shareholder activism should be nurtured not only by provisions of protection of their rights, but also a guarantee of access to accurate and timely corporate information.

b. The role of the board of directors

The board of director is supposed to be *accountable* to shareholders by properly monitoring management. Since monitoring requires an arm's length relationship, directors should be *independent* from management. In a company where a large controlling shareholder is present, however, the board is often neither independent from management nor accountable to small shareholders. This is because the majority shareholder can appoint board members without the approval of other small shareholders through the majority rule. Consequently, both directors and managers represent only the interest of the large shareholder rendering the designed internal corporate control ineffectual.

There are several proposed measures that can promote independence of the board in the corporate governance literature including mandatory independent directors. The Cadbury Codes of the UK recommend at least 3 non-executive directors. The SET requires that at least two directors be independent directors. But the term "independent" only implies non-executive, which excludes only insiders – i.e., management and employees, and sometimes family members. It does not exclude those with personal ties with certain insiders. In a society where patronage runs deep, such ties can be rather entrenched.

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Thus, the boards of directors are often staffed not with qualified professionals who would monitor management of the company, rather, with friends and family of the controlling shareholders who would not oppose management. Therefore, when a single large shareholder holds the corporate reign, mandating independent directors is unlikely to lead to independence of the board.

The more serious problem concerning corporate boards is the accountability of the directors. The law states clearly that directors are jointly responsible for clear violations of the rules of the law such as falsifying documents – i.e., shareholder meetings' minutes or the company's financial statement, concealing vital information from authorities, breaking the rules regarding distribution of dividends, extending loans to directors, etc. When it comes to the board's accountability to its fiduciary duty, however, the law is very much vague. The law states that directors are jointly responsible for "*performing their duty according to the law, the objective and rules of the company and the decisions made at shareholder's meetings, with honesty to protect the interest of the company"*

With such a statement, bar fraud and clear violations of the written rules and regulations, it would be difficult to prove whether a director has performed his duty adequately and in good faith to protect the interest of the company. The court has had very little experience in dealing with such cases. Much is subject to interpretation. In January 1999, the police is expected to file charges against 12 directors and executives of two defunct finance companies and a company producing electronics goods. These cases will set precedence with respect to the legal interpretation of the scope and scale of a board's accountability to the shareholders.

2. The importance of transparency and disclosure

It would not be an exaggeration to say that accounting is the soul of corporate governance because without accounting, corporate management cannot be monitored nor held accountable and corporate performance cannot be assessed. Regulators, policy-makers, investors and shareholders all rely on financial statement to assess a company's performance and financial standing. Yet, accounting is often an art more than mathematics. Inaccurate financial reporting can work to the advantage of corporate insiders but can be very costly for other stakeholders – i.e., small shareholders and creditors. It also undermines the market mechanism and may debilitate state regulatory supervision.

Accounting in Thailand is notorious for its creativity and imagination. Most companies have two accounts: one for management, another for the authorities such as the Department of

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Revenue or the Stock Exchange Commission. Unlisted companies may have three versions: one for the owner, another for the business partner, and a third one for the taxman. Poor accounting standard can be attributed to insufficient regulatory supervision and mild penalties in case of negligence or violations.

The major weakness in Thai accounting lies in the valuation method. Valuation of assets is a serious flaw in the Thai accounting process. Unclear rules pertaining to the methods by which assets can be valued represent a large loophole through which accountant can manipulate the numbers to make financial reports look good. For example, many financial institutions revalued their assets so that they remain solvent accounting-wise in order to avoid intervention from the Bank of Thailand. A public utility that failed to convince the Cabinet that a price increase is required, revalue their assets so as to inflate depreciation and hence, cost. Thus, without clear rules and regulations regarding valuation of assets, insiders will always be able to “window-dress” their income statement and financial accounts.

Auditing is not any better. Auditors are known to close accounts for their customers. The profession suffered further damage to its already tarnished reputation when the SET temporary withdrew its certification of profession of two well-known auditors from two reputable auditing companies -- one Thai, the other foreign. While such a penalty itself may not be severe[3], the social sanction proved much more caustic.

Auditing, like credit rating, suffers from potential conflict-of-interest. Auditors often develop a good business relationship with the company and thus, unwilling to report potentially damaging oddities.

To promote an arms-length relationship between auditors and the companies which they audit, it has been proposed that there be a pool of certified auditors. Each year, the regulator would allocate several auditors to a company through a lottery. A company can choose among the allotted auditors only. But such a scheme requires a relative large pool of qualified auditors, which is not currently available. Nevertheless, it is an idea worth thinking about.

While clearer valuation rules and stiffer penalties for professional negligence are required to help elevate the existing accounting and auditing standard, in the medium term, self-regulation can also provide solutions to the problem of audits. Many businesses adopt voluntary external auditing by reputable institutes to enhance the transparency of their corporate governance. In many countries,

[3]The revised auditing law, currently scrutinized by the parliament, imposes harsher penalties.

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the Association of Accountants or Auditors plays an important role in establishing an industry-wide accounting standard to which members must comply.

But self-regulation is not born out of ethics, rather economics. That is, a company will self regulate only if it pays to do so. American companies establish and advertise their corporate code-of-conduct because multi-billion institutional investors such as the California Public Employee Retirement System (CalPERS), set a corporate governance standard for companies in which it will invest. American credit-rating agencies also rate a company's corporate governance. Therefore, for self-regulation to realize, investors will have to demand it. Again, this crisis certainly made investors much more cautious about where they choose to put their money.

3. The role of institutional investors

As discussed above, small shareholders cannot expect to rely on the board of director to help monitor management when directors are appointed by a single controlling shareholder. An alternative would be to invest in mutual funds and have the fund manager watch over the portfolio for you. Similarly, bank deposits, insurance plans and pension plans can also be seen as an individual's indirect investment in corporate equity share. The only difference is that the individual is guaranteed a fixed return, while the financial intermediaries bear the investment risk. With their pool of resources and the size of their investment funds, institutional investors are perceived to be the ideal candidate to perform the corporate-monitoring role.

Countries with relative good corporate governance often have large institutional investors such as commercial banks in Germany[4], mutual funds in the US, or pension funds in the UK. The promotion of institutional investors in the case of Thailand should be made with much caution for two reasons.

First, institutional investors themselves do not have good corporate governance. After all, is it not because of the reckless lending by financial institutes that we are where we are today? How can then one expect to rely on these institutes to raise the standard of our corporate governance?

On this particular issue, one cannot help but wonder why commercial banks or finance and securities companies -- as creditors -- were not more involved in monitoring the companies to which they lend extensively as most housebanks such as those in Germany and Japan often do. This may be due to two reasons. First, a large part of the loans extended by commercial banks was secured

[4] German banks exercise corporate control through custodianship of shares deposited therewith.

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through personal connections. Thai banks rarely scrutinize the feasibility of the projects; rather they rely on personal relationship or reputation of the owner or the company. That is why most banks' loans are either unsecured or secured only by personal guarantees. Second, lending was extremely competitive. Everyone was willing to handout credits. Thus, if a bank imposed too many conditions on loans, a company could simply take its business elsewhere. During euphoria, prudence seemed unnecessarily costly. With insufficient regulatory supervision and inadequate internal control, there was a race to the bottom in terms of quality of loans extended. Reckless lending was contagious.

The second reason why institutional investors are a suspect is that they often have vested interest in the companies in which they invest. In June 1998, the Stock Exchange Commission temporarily withdrew professional licenses from four executives of the oldest mutual fund in Thailand. Two charges were laid: one for investing with "conflict-of-interest", and the other, imprudent investment.

To conclude, unless the corporate governance of financial institutions and other institutional investors markedly improves, one cannot pin much hope on either the board of directors or institutional investors in promoting the interest of small shareholders. After a lengthy analysis, we are back to square one. After all, in the immediate term, shareholders may have to take greater efforts in monitoring the corporations themselves.

In order to encourage shareholders to become more involved in a company's management, long-term equity holding will have to be promoted. This includes the introduction of corporate debentures and corporate bonds. Because the government had experienced continual fiscal surplus for almost a decade before the crisis, the bond market is still very much underdeveloped in Thailand. Now that the government has come to rely heavily on debt issues to raise required funds to rehabilitate and stimulate the economy, there are great potentials for the development of such a market.

Part IV: Conclusions

Thai companies, traditionally family-run, have yet to adapt themselves to the new corporate environment. While absolute control may no doubt lend much flexibility and adaptability to a family business, for a listed company, however, such control runs against the basic concept of accountability, equity and transparency, the three pillars of good corporate governance.

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The path towards building up good corporate governance is arduous. The crisis has exposed the inherent weaknesses in the governance of our corporate sector, but gives no clear directions to where we should proceed. Lessons from developed countries do help but the policy prescriptions are of limited applicability as they are built on a different set of assumptions regarding the institutional and legal framework, the underlying corporate ownership and control structure and the local culture.

At the heart of any good governance is information. Without adequate and accurate data, we cannot penetrate the corporate veil. Thus, accounting should be the very first target for reform. Much of the literature in this area advocates self-regulation. As mentioned earlier, one must realize that good or bad accounting is not a question of ethics, but economics. Gresham's Law of bad money chasing out good money accurately describes bad accounting chasing out good accounting. If your competitor can get away with manipulating or even falsifying financial report to make the company looks better than it actually is, then why should you submit a veritable report that may make your company looks worse than your competitor's? Thus, bad accounting *must* be penalized so that good accounting pays. Regulatory supervision must be strengthened and penalties made much harsher for professional liability.

Once good accounting is in tact, abusive behavior by insiders will be much more easily detected. The next step would be to ensure that abusers are held responsible for their misconduct. At this point, Insider trading Law, Public Company Law and Money Laundering Law must be strengthened to deter undesirable corporate misconduct. The efficiency of the judiciary process is also of utmost importance. Cumbersome court procedures can certainly undermine law enforcement as is the case in Thailand.

Indeed, there are myriads of other measures to promote good corporate governance such as board's independence, rights of the shareholders, development of long-term equity market, etc. These are also important but secondary to the ones mentioned above. If we get our accounting right and are able to take legal actions against abusive behaviour by corporate insiders, we believe that bad corporate governance will no longer pay.

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