



2005 Policy Dialogue on Indonesia

CORPORATE GOVERNANCE

Christian Strenger

Member of the German Government Commission on Corporate Governance
Member of the Supervisory Board, DWS Investment GmbH, Frankfurt

Session 2

**Corporate Governance in Groups of Companies: A German
Perspective**

**Bali, Indonesia
7 September 2005**

*The views expressed in this paper are those of the author and do not necessarily represent the opinions of the
OECD or its Member countries or the World Bank*

I. The economic importance of good Corporate Governance

- This is ample evidence of higher valuation for companies with good Corporate Governance:
 - Indonesia: 17% premium for firms with good Governance (Forum for Corporate Governance in Indonesia (FCGI) survey of 2004). 30% discount for firms controlled by a single or few domestic owner(s) with poor governance (Asian Development Bank Institute survey of 2004).
 - Compared with Korea and Thailand, good governance can exert a larger positive impact on market values in Indonesia (ADB).
 - Russia: strong positive relationship between Corporate Governance progress and market value development. Best example for acceptance of higher valuation argument.
 - Germany: 13% premium for companies with good Corporate Governance (McKinsey survey of 2002, now estimated to be below 10%).

II. Corporate Governance issues for company groups – the German legal system and the Governance environment

1. Overview of the German company law system

The German system of stock corporations (Aktiengesellschaft = AG) rests on three pillars: the Shareholders (represented mainly in the General Meeting), the Management Board and the Supervisory Board.

The Shareholders

- The Shareholders elect (only) the members of the Supervisory Board in the General Meeting; the Supervisory Board appoints the Management Board.
- Shareholders have no direct authority over the Management Board other than the annual right of discharge (which is, however, without legal sanction). The General Meeting cannot vote on normal business affairs.
- One share has one vote (except for non-voting preferred shares that are of little and decreasing practical importance).

The Two-Tier Board System

- The Management Board

- The Management Board manages the company and its business in its own responsibility and autonomously.
- Any action of the Management Board must be solely in the best interest and to the “benefit of the company”. Otherwise the Board members are legally liable.
- The Management Board members generally represent the company both in and outside the courts of law.

- The Supervisory Board

- The Supervisory Board appoints or dismisses the members of the Management Board. It also deals with any conflicts arising for members of the Management Board or the Supervisory Board.
- Management Board's actions are to be independently reviewed and controlled on a continuous basis.
- Board tasks are enhanced by committees for auditing, remuneration and nomination etc. This requires increasing qualification of Board members.
- The German Corporate Governance Code requires an annual Board review to confirm the efficiency of the work, the scope of the tasks and the quality of implementation.

2. German Group Company Law

Corporate Governance for company groups in Germany has to be formally divided into two parts: (i) groups based on contractual legal agreements and (ii) groups based on the virtual power of a controlling position in a company.

- Contractual Company Groups (Vertragskonzern durch Beherrschungsvertrag)

- In contractual company groups the then subsidiary commits to give up the control over its business to the controlling company through a domination agreement (Beherrschungsvertrag) in exchange for compensation of any loss arising out of the control situation (sec. 291 et seq. German Stock Corporation Act = AktG).
- This contract must be approved by both General Meetings if both companies are organized as stock corporations (AG).
- A key element of this structure is that fair compensation must be offered to minority shareholders of the company becoming a subsidiary.

- De facto Company Groups (Faktischer Konzern)

- De facto Company Groups are based on a control position through voting rights without a domination agreement. Such ownership control is equally possible under German law (sec. 311 et seq. AktG).
- As there is no domination agreement, the Management Board of the controlled company has to report annually on its subordination and dependence in relation to the controlling company. This should provide the relevant disclosure to the minority shareholders.
- Any unfavorable action by the controlling company must be fully compensated at the end of each financial year for the controlled corporation. Otherwise the minority shareholders of the controlled company are entitled to bring actions against their Management Board as well as against the parent company (sec. 317 AktG).
- However, it is quite difficult for shareholders to bring actions and therefore quite rare in practice because of a possible lack of information on any unfavorable actions taken by the controlling company. There is quite a risk for the minority shareholders to see only part of the profits and receive adequate compensation.
- Groups based on controlling stakes are generally a contradiction to the German stock corporation system that requires the Management Board of any stock corporation to act independently. The legal framework and minority protection in practice have been part of the legal discussion in Germany for decades without any satisfying solution yet.

Further important aspects of German Company Groups are:

- Legal personality of the group itself

- The group has no legal personality as it cannot form a legal body. Consequently, it has no assets of its own. Each group company acts as own legal entity as only it has a legal capacity.
- There can be no separate Group Management Board and no Group Supervisory Board; but the Boards of the controlling company act as de facto Group Boards.
- The Group can neither become debtor or creditor neither use a trade name on its own and cannot be entered into the company register.

- Group structures

- If there is no group contract with a domination agreement, the Management Board of a subsidiary stock corporation (AG) has to act independently and on its own responsibility. This lack of full control over such subsidiaries makes them rather unsuitable for control purposes.

- In contrast, a limited liability company (Gesellschaft mit beschränkter Haftung = GmbH) is bound by the instructions of its owners. This is therefore a far more effective form for a subsidiary company. Consequently, subsidiaries are mostly organized as limited liability companies (GmbH).
- Example for international company groups with an Indonesian controlled company is the German HeidelbergCement-Group:
HeidelbergCement-AG as parent company holds indirectly through the “HC Indocement GmbH” (a German limited company) 65.14% of the shares of the Indonesian company PT Indocement.

3. Background of Corporate Governance in Germany

- Transparency, independence and the avoidance of conflicts of interest are the most important Governance issues also in Germany.
- Germany has different laws as basis of good Corporate Governance: company law, capital market law, securities law and takeover law.
- German Corporate Governance is laid down in the official German Corporate Governance Code (the Code). This code recites the legal background and gives best practice rules (Shall-Recommendations and Should-Suggestions). The Code was initially set up in February 2002 by a Government appointed Commission that revises the Code regularly (last in June 2005).
- The implementation of the Code recommendations is based on the **comply or explain** approach: Sec. 161 AktG requires that the Management Board and Supervisory Board of a listed stock corporation have to report compliance with the Code at least on an annual basis. Non-compliance with any of the Shall-Recommendations has to be noted and should be explained.
- The company’s auditor has to note in his report to the Supervisory Board any obvious deviation from the company’s “comply or explain” statement and has to certify that the statement has been permanently disclosed to the Shareholders.

4. Corporate Governance for German Company Groups

- The shareholder structure of the largest German stock corporations is today no longer characterized by a proliferation of controlling families or corporate shareholdings. Until a few years ago, banks dominated the majority of large listed companies through shareholdings, Board seats and credit relationships.

- Today, the key shareholders are institutional investors, both domestic and even more international. Bank ownership has significantly decreased during the last years.
- There are some examples of family controlled large DAX companies (Altana, BMW, Henkel). However, family control can only be exercised with full observance of the rights of other shareholders. In selected instances, the family shares are not entitled to vote on the annual General Meeting (i.e. discharge of acts of the Management or Supervisory Boards).
- Even though the Code does not have a particular chapter for company groups, principles of good Governance are broadly defined for Groups as well:
 - Controlling companies have responsibility for the Governance of all controlled companies (Preamble of the Code).
 - Members of the Management Board and Supervisory Board of the top group company are bound to the Groups best interests (sec. 4.1. and 5 of the Code).
 - The Management Board of the top Group company has to ensure the compliance with the laws and the Code by the controlled companies (sec. 4.1.3. of the Code).
- Minority protection of controlled group companies in the form of stock corporations is extensively covered by the law.
- Corporate Governance rules apply equally for Boards of quoted subsidiaries as for independent acting entities (Kleindiek 2003).

5. Particular Governance issues arising in company groups

- Conflicts of interest for controlled companies' Boards may arise from (i) being member of a group with group policies, business plans etc and (ii) at the same time having the duty to act for the own "companies benefit".
- Group wide reporting duties: There is no formal requirement for a detailed report by the Management Board of the controlling company to the Supervisory Board on business policy, the planned return on equity etc of the controlling companies. Such reports must cover only the controlled company (sec. 90 AktG). Therefore, it is necessary for the Supervisory Board to expand these reports of the Management Board to a level that covers all Group members.

- Group wide information rights: The Shareholders of a controlling company in Germany do not have the explicit information right about all business proceedings in the controlled companies. But such information is essential for Shareholders of a listed company on top of a Group because of the risk of unfavorable actions by the group members.
- *“Subsidiary shareholders should get sufficient information both on the relationships between the Group members and on transactions and procedures of the corporate business of all Group companies including the parent company.”* (Schneider 2000).
- Auditing matters are still a particular problem with Groups: the Supervisory Board of the controlling company has the duty to review the Group’s annual report (sec. 171 par. I 1 AktG) but has no similar information right concerning the controlled companies. The Supervisory Board is only entitled to inspect the books of the controlling company (sec. 111 par. II AktG) which does only contain consolidated information by the company’s auditor (Baums 2001).
- Insider information problems can arise if Board members of the controlling company receive confidential information also from the controlled companies. This concerns also the question of the timing of ‘ad hoc’ communication to the market that is required by law and strictly enforced by the Supervisory Authority (BaFin).

III. Relevant Indonesian and German Group Governance matters – some comparisons

1. Concentration of Shareholdings

- In Germany, pooling of shareholdings to consolidate influence is rare and decreasing due to the German Takeover Law of 2002. Such pooling arrangements would generally lead to a mandatory tender offer if more than 30% of the shares are bound by such pooling arrangements.
- Most Indonesian companies have a high concentration of ownership with corresponding voting rights, leading to effective control of the firm. A study by the OECD in 2000 showed that 67% of listed companies was family held and on average the top five largest shareholders controlled from 57% to over 65% of the company shares.
- In Indonesia, a shareholder acquiring more than 25% of the shares (or exercising control through having the ability to determine the designation and resignation of Members of the Management or Supervisory Board or having the ability to make changes in the company’s articles of association) must make an offer to all other shareholders at the highest price of the shares within the last 90 days.

- In Germany, after the introduction of a takeover law in 2002, a shareholder acquiring 30% or more must bid for all shares at the average of the share prices over the past six months (minimum price).

2. Group Structures

- Most German Groups do have a listed stock corporation (AG) on top and non-listed limited companies (GmbH) as subsidiaries (v. Werder 2003).
- German controlled companies are rarely listed companies. Due to a recent change in company law, squeeze-out of minority holdings under 5% is increasing.
- Indonesian Groups usually consist of both listed parent companies and listed controlled companies.

3. Transparency of shareholder structure and insider trading – a group governance issue

- The German Securities Law (Wertpapierhandelsgesetz = WpHG) requires reporting of any purchase of shares if the ownership exceeds or falls below the quorum of either 5%, 10%, 25%, 50% or 75% of voting rights (sec. 21 WpHG). Shares held by affiliated persons will be counted for the purchaser (sec. 22 WpHG). Such purchases are to be reported to the company as well as to the Supervisory Authority (BaFin).
- The Indonesian BAPEPAM rules require a report to BAPEPAM with regard to the ownership of 5% or more of the paid in capital and a report on any changes (e.g. increases) in ownership. Therefore, the Indonesian rules appear to be stricter than the German. But investors should have access to stake-building information by a requirement to notify the authorities if it becomes apparent that a group of investors is acting in concert.
- All insiders have to report to the German BaFin every trade without undue delay. This is particularly relevant if group subsidiaries are concerned.
- The Indonesian BAPEPAM rules require reporting on any purchase and the change in ownership to BAPEPAM if the person is a shareholder or any Management or Supervisory Board member that owns 5% or more of the shares.

4. Shareholders' participation in corporate decision making

- In Indonesia, the General Meeting is quite powerful as it has the power to appoint and dismiss the commissioners (Supervisory Board) and the directors (Management Board).
- Germany: Shareholders do not appoint or dismiss the Management Board. They delegate most controlling and monitoring rights to the Supervisory Board. However, they have to approve the consolidation, merger, acquisition, bankruptcy and dissolution of the company (Peltzer 2004).
- The regulatory reform in Indonesia of 1995 led to the Company Law and the Capital Market Law as well as the BAPEPAM and JSX rules. While over these 10 years Indonesia has made considerable progress on the formal side, market participants still think that the role of individual shareholders in participating in the company is of minor importance. Section 1.4. of the Indonesian Code For Good Corporate Governance could be an example: It seems to be natural for large shareholders to *“exercise influence over the corporate management by the exercise of the voting rights or otherwise”*.
- The Asian Development Bank Institute observed cultural barriers against holding high-placed individuals responsible for their actions. Another suggested reason is that controlling shareholders apparently try to influence the Management Board without sufficient respect for the minority investors.
- Opportunities for improving minority rights in Indonesia could be:
 - While Indonesian Company Law allows a cumulative voting system (through amending the company's Articles of Association by a 2/3 majority in the General Meeting), the predominant ownership structure seems to result in most of the companies not having such cumulative voting rights.
 - The Indonesian Shareholder has the right to commence actions against Members of the Management Board or the Supervisory Board if he holds 10% of the shares. This threshold seems to be too high compared to other countries. Korea has reduced from 5% to 1% for non-listed companies, and as low as 0.01% for listed firms. Germany recently reduced this threshold from 10% to 1% or € 100.000 of the share capital.
 - Indonesian company law allows proxy voting by mail, but according to the Forum for Corporate Governance in Indonesia (2004), in practice only very few companies allow proxy voting by mail. A large number of Indonesian shareholders have long distances to travel to attend General Meetings, so voting by mail could increase shareholder participation.

- Voting in Indonesian General Meetings is normally conducted by asking the question “is there anyone who disapproves?” and asking the disapproving shareholder to explain his decision. This tends to discourage shareholders from voting against the majority shareholder (Republic of Indonesia together with World-Bank and IMF 2004).
- General Meetings in Indonesia are attended by less than 50 people which appears to indicate a rather formal procedure, than a good debate of shareholder relevant issues. This is confirmed by the length of most General Meetings that last less than one or two hours in contrast to overly long meetings in Germany where 6-10 hours is common for large public companies with up to 10.000 participants (Forum for Corporate Governance in Indonesia, 2004).
- A large number of listed companies do not have a website at all. Because of that weak exchange of information, minority shareholders hardly exercise voting rights. To attract both domestic and international investors Indonesian quoted companies should not only provide Internet information about the corporate business but should also present their websites in English. This is particularly relevant for institutional investors.
- A Corporate Governance committee of independent members in the Board of Commissioners in Indonesian companies that would issue an annual report on its committee work could be an important step to improve Corporate Governance.

5. Supervisory Board and committees

- In Indonesia, identical groups of shareholders elect the Management and the Supervisory Board.
- The task of the Supervisory Board in Germany is advising and controlling the Management Board. The Code requires a sufficient number of independent and skilled persons as Supervisory Board members (particularly for the Audit Committee).

- The erstwhile scarcity of independently acting committees in Indonesian Boards of Commissioners appears to be a quickly reducing deficit (today over 97% of the public companies have audit committees and 99% of the companies have independent Supervisory Board members). There is no requirement for a majority of independent Board members. However, the JSX rules require a minimum of 30% of independent members, which can be considered satisfactory if the independence of the individuals is not only formal.
 In Germany, the Code stipulates that there shall be a ‘sufficient number of independent members’ without giving a specific percentage. This is mostly due to the special requirement that under German law of co-determination, up to 50% of the Supervisory Board must be made up of employee representatives (including up to 3 union representatives) that can hardly be counted as independent.
- The independent Supervisory Board members in Indonesia have the opportunity to give their independent opinion but apparently do not have much influence on the agenda and discussions of the Supervisory Board (Forum for Good Corporate Governance in Indonesia, 2004).
- Most of the Supervisory Boards in Indonesia meet less than five times a year and three quarters of the meetings last less than two hours, which is considered less than adequate by the Forum for Corporate Governance in Indonesia (2004). In Germany, four meetings a year are still the rule but the frequency of extraordinary meetings and committee work has increased substantially.

IV. Enforcement – a key issue for quality Governance of company Groups

- *“Enforcement more than regulations, laws-on-the-books or voluntary codes is key to effective Corporate Governance, at least in transition and developing countries”* (Bergloef/Classens, Global Corporate Governance Forum 2005).
- Enforcement is essential for any regulation to be effective. Effective enforcement is elementary to build confidence in the legal framework of every economic undertaking and is therefore vital for investors.
- In Indonesia, there have been 51 reports and complaints on alleged violations against Indonesian capital market rules and regulations in 2004. 24 of those cases have been investigated and 6 cases have been brought up to the process of criminal investigation by BAPEPAM (Annual Report 2004).

- With the aim to further improve Indonesian governance, the BAPEPAM created in 2004 a specific Disclosure and Governance Development division and a subdivision for Corporate Governance Policy Development. These can be powerful drivers for governance progress if their work is really accepted by the companies and the enforcement authorities.
- In Germany, the ‘comply or explain’ approach of the Code seems to work well as there is now more than 90% acceptance of the Code-Recommendations by the large companies. That means that they also accept the obligations for all group entities.

V. Sanctioning of Governance behaviour by the capital market through Scoring or Rating Systems

A market approach to produce valuable results similar or even instead proper legal enforcement can be provided by a scoring or rating system that is easily usable by investors and analysts. Such a system must be acknowledged by most potential users. It then serves as a standard device to verify the compliance of each company in a systematic and condensed fashion.

Its particular features are:

- A systematic and easy overview of all relevant issues of good governance.
- Enable comparisons across industries and countries.
- Be readily available at no cost to all interested parties via the Internet.
- Ensure high degrees of usage: the completion of the scorecard via programmed tools (MS Excel) should also enable active dialoguing.
- Allow investors to set minimum scores for governance as part of their general investment policy.
- Such a scoring system will also enable companies to easily assess the ‘reach’ and the quality of their own governance situation.

In Germany, a Scorecard for Corporate Governance was originally developed by DVFA, the Society of Investment Professionals in Germany¹. It is mainly based on the German Corporate Governance Code and a few international best practice standards. It has also found good acceptance in other countries apart from Indonesia, i. a. Russia, the Philippines and Greece.

¹ Deutsche Vereinigung für Finanzanalyse & Asset Management - Internet access: www.dvfa.com.

The Indonesian scorecard system was developed by the Forum for Corporate Governance in Indonesia (FCGI) but has not seen active usage yet. Particularly in younger capital markets, such a tool is an indispensable way of pursuing better governance. Its easy and no-cost approach would seem to be a good way to lessen enforcement deficits and give investors a recognised way to ask their portfolio companies for progress in Corporate Governance.

VI. Resume

- Ample evidence confirms that high standards of investor rights (also in the legal system), demanding best practice standards of good Corporate Governance and convincing enforcement processes lead to higher market valuations. This is not only positive for shareholders but also for the companies as their cost of equity capital declines.
- Many Governance issues for company groups are similar in Germany and Indonesia. The major differences seem to be: the exercise of control, transparency matters, and the strength of enforcement (also by the capital market participants).
- Corporate Governance mechanisms and regulations can only be effective if truly respected and complied with. Effective enforcement is vital: While Indonesia appears to have made meaningful progress and formal legal parameters appear well developed, the main tasks are the regular updating of laws, regulations and codes and even more so their proper enforcement.
- Practical effects to improve Governance through Scoring or Rating Systems that are easily available for all market participants are a good way of enhancing legal enforcement.
- There appears to be substantial room for improvement in the Indonesian capital market: The ratio of market capitalisation to GDP in Indonesia is only 33% while competing Asian nations in 2003 showed ratios of well over 200% (Malaysia) and sometimes even 300% (Singapore). To exploit Indonesia's full potential, the pursuit of good Corporate Governance to attract domestic and international investors is therefore not a hypothetical suggestion.

Some **final remarks** of an experienced market participant: The Corporate Governance world is steadily growing together due to manifold efforts by the OECD and other international organisations like the Asian Development Bank, the World Bank (including IFC), but also by private organisations like the 'International Corporate Governance Network (ICGN)'. They are all establishing 'Best Practice Principles' that are the yardstick for good corporate governance in a world-wide context.

So we are quickly developing a global culture where the differences are becoming smaller. This is greatly increased by the constant pressures of the market, particularly by the institutional investors who must do this to convince their investing clients by consistent outperformance. The trend is also increasingly supported by the companies who can reduce their cost of equity and quite often gain access to capital for the first time. This applies not only to emerging countries but also to higher risk companies that can attract equity capital if sufficient transparency and above average prospects are given. Last not least, the governments have an excellent way to improve the retirement living of their people: The pension systems can no longer be funded by them in a satisfactory way.

The motivation pursue good, even better corporate governance is therefore simply the self-interest of all concerned: the investors/shareholders, the companies and the governments. How to promote it best?

- Through incentives of a financial nature (like the tax and listing fee reductions introduced by the Indonesian supervisory agency BAPEPAM). Such incentives can, however, be only initial catalysts, they are not the lasting solution for better governance.
- Through high standards of transparency. This is not only helpful, it is the key word and the best driver for efficient markets. Equally, full transparency is the strongest enemy of old structures. These structures have outlived their useful purpose including existing control systems that will not hold up into the next generation.

What is needed therefore are open markets that are exposing the strengths and the weaknesses to everyone. Only then the market as best arbiter will be able to put a fair price on companies. At the same time investors will prefer to give their money to transparent companies with high standards of good governance. Any one resisting such openness will a loser before long. The joint task is to free-up all the resources that all countries so amply have: Indonesia and its present system of still too many controlled companies will be a telling example of a changed world in the future.

Annex: References

- Asian Development Bank Institute - ADBI (2004): Research Policy Brief No. 8.
- Baums, T. (2001): Bericht der Regierungskommission Corporate Governance (Report of the German Government Commission on Corporate Governance).
- BAPEPAM (2005): Annual Report 2004.
- Bergloef, E. / Claessens, S. (2005): Corporate Governance and Enforcement in Global Corporate Governance Forum, Focus 3: Enforcement and Corporate Governance.
- Black, B. (2001): The Corporate Governance Behaviour and Market Value of Russian Firms – Stanford Law School.
- Cromme, G. (2004): Stand und Entwicklungen von Corporate Governance in Deutschland, in: Corporate Governance Report 2004 (Corporate Governance in Germany – status and developments).
- Forum for Corporate Governance in Indonesia (2004): Review of Corporate Governance, in: Asia – Corporate Governance in Indonesia.
- Kleindiek, D. (2003): Konzernstrukturen und Corporate Governance: Leitung und Ueberwachung im dezentral organisierten Unternehmensverbund (Company group structures and Corporate Governance), in: Hommelhoff / Hopt / v. Werder Handbuch Corporate Governance (Handbook on German Corporate Governance).
- Kurniawan, D. / Indriantoro, N. (2000): Corporate Governance in Indonesia – presented at the OECD 2nd Asian Roundtable on Corporate Governance 2000.
- McKinsey (2002): 'Global Investor Opinion Survey', undertaken in cooperation with the OECD / World Bank 'Global Corporate Governance Forum'. Internet: <http://www.gcgf.org/>.
- Peltzer, M. (2004): Overview of recent corporate governance reforms, in: Germany in Global Corporate Governance Guide 2004.
- Republic of Indonesia / World Bank / IMF (2004): Report on the observance of standards and codes (ROSC) – Corporate Governance country assessment.
- Schneider, U. H. (2000): Der Auskunftsanspruch des Aktionärs im Konzern, in: Festschrift fuer Marcus Lutter (Information rights of shareholders in company groups).
- v. Werder, A. (2003): Kommentierung zur Praeambel, in: Ringleb / Kremer / Lutter / v. Werder: Deutscher Corporate Governance Kodex – Kommentar (Comment on the German Corporate Governance Code).
- World Bank (2005): East Asia and Pacific Region – Corporate Governance Country Assessment, Republic of Indonesia.