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Corporate Governance For Financial Institutions

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CORPORATE GOVERNANCE FOR FINANCIAL INSTITUTIONS: A CHINESE TAIPEI PERSPECTIVE

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Several months before this presentation is to take place, CalPERS decided to withdraw from some Southeast Asian capital markets. This is a warning sign that efforts should be redoubled to improve corporate governance in Asia. Personally, I see modest progress. I also believe economic down times present a better opportunity for corporate governance and capital market reforms.

Financial institutions present a unique set of corporate governance issues. The fixed claimants (depositors) are visible and a multitude. Agency cost may increase by moral hazards inherent in the banking system. Fear of bank runs and the TBTF (Too Big To Fail) syndrome trouble politicians and tie the hands of policymakers and regulators. This makes corporate governance for financial institutions all the more important.

The Ecology of Corporate Governance in Asia

In this short presentation I hope to deal with some (and certainly not all) corporate governance issues for Asian financial institutions. At the outset, it is important to put these issues in the proper context and proper categories. While some of them are more generic issues affecting all business firms, some affect businesses in Asia, and others are more specific to financial institutions. My own research in law reform in Chinese Taipei and other projects with the Asian Development and Stanford Law School in recent years has convinced me that there is an ecology for corporate governance in Asia.

Frankly speaking, this ecology is the political economy of which the particular Asian firm is a part. Where this Asian firm (particularly for a financial institution) operates across borders, at the risk of generalization, then the relevant political economy may be pan-Asian. Political economy informs how corporate governance institutions were set up, or why some of such institutions have been lacking or dysfunctional, and why certain new institutions are introduced (in functional or formal sense) to displace existing corporate governance institutions. Political economy can also explain why some reforms don't work, and why government policies are compromised, and what kinds of trade-off regulators are keen to address.

I also think a paradigm shift, precipitated by forces of change causing and following the Asian financial crisis of the late 1990s, is taking place slowly. Again, at the risk of generalization, the traditional Asian paradigm had been contained political development, strong state directives and intervention in the marketplace, suppression and fragmentation of the financial markets, weak and uninterested judiciary, ownership concentration with strong potential for expropriating minority shareholder and other stakeholders, lack of mergers and acquisitions, and insufficient competition in the domestic market.

The new paradigm, of course, will be the opposite, or a significant moderation, of excesses of the traditional paradigm. Forces of change are globalization, technology advancement and democratization. At the end, however, indigenous political will for economic reform (including reform of the financial institutions) will determine the pace and extent of corporate governance reforms in respective Asian economies.

The Importance of Making Financial Institutions Act Like Such

Are They Banks or Credit Rationing Agencies?

In much of Asia, many financial institutions are not really financial institutions in the textbook sense. Some are politicized so that they *ration* credit and do not provide the *intermediation* function prescribed by modern theories of finance. A financial institution may be called a bank, but it does not behave like one in the modern sense. Unless there is a political and societal commitment to privatization and substitution of budget measures for policy loans, corporate

governance within the board rooms of these so-called banks alone would not work.

Wrong Types of Banks

There are some financial institutions in Asia whose types of ownership and business models have long passed. I mean the credit co-operatives and credit departments of farmers' associations and fishermen's associations, like the case in Chinese Taipei. These ownership forms are not efficient, and they are susceptible to local factionism and temptations to affiliated party lending. In Chinese Taipei, these community depositary institutions have been a chronic problem of bank supervision, and as a sector presented the highest nonperforming loan (NPL) level. In 2001 Chinese Taipei began to close them down, through a debt resolution process using revenues from business taxes collected from credit institutions in general.

State-Supported Postal Savings Systems

Reflecting the development model of a much earlier period, there are postal savings systems in some Asian economies like Japan and Chinese Taipei. They are semi-banks as they take deposits (and sometimes sell some life policies) but they do not lend themselves. Their size actually dwarfs that of the largest full-blown banks in the economy. To give full meaning of bank regulation and corporate governance of financial institutions, they should be reconstituted, re-aligned, scrapped or otherwise changed so that they are integrated into the modern national economy.

Other Non-Banks

Different from state-supported semi-financial institutions are privately funded institutions which do not take deposits but they lend, provide financial leases, financial assurances and other financial products. Examples of these non-banks include General Motors Acceptance Corporation, G. E. Capital, and the like. But not all Asian economies allow such institutions. I think they add more competition and innovation in the Asian financial market, and laws and rules should be revamped so as to encourage their role in Asia.

There Is No Getting Away from CAMEL – An Elaboration

Some Asian financial institutions are kept afloat despite their deteriorated asset quality, because reform measures have not received enough political support. Unless senior policymakers and political leaders face up to these issues, reforming Asian financial institutions will always be easier said than done.

There is no getting away from the fundamental principles guiding financial institutions to safety and soundness, that is, CAMEL. To discharge their fiduciary duty (more on this later) and do a good corporate governance job, directors of financial institutions should ensure their capital adequacy, asset and management quality, earnings and liquidity.

Directors of Asian financial institutions should face up to the reality of asset quality, and Asian financial regulators should adhere rigorously to international standards on asset write-down. There should be a more surgical, and less Chinese herbal medicine, approach to cleaning up the NPLs and debt resolution. Sale and auction of NPL began in China and Japan recently. In Chinese, the First Commercial Bank is preparing a pilot program to auction off NPLs. Directors of Asian financial institutions should also scrutinize more closely lending to Asian corporate groups, so that they review credit risks by looking at the forest and not just the tree.

While taxpayers' money is often thought of as the solution to recapitalize depositary institutions, this is not sustainable. Directors of financial institutions must think about mergers and acquisitions as an important alternative. They should tell block holders (or themselves, if they are the block holders) that it would be better to have a smaller stake in a viable institution, than a large stake in a weak and failing institution. They should also explore ways to invite foreign investors, and ask themselves why they are not sought after by foreign investors if that is the case.

Directors of Asian financial institutions should develop a rigorous and long-term program to change the composition, vision and execution capabilities of their management team. First of all, they should avoid nepotism from block holders (state or family). They should also expose management to new business models and competitive strategies for financial institutions. They should also revamp the management information system of financial institutions to improve

efficiency.

Directors should seriously look at how their financial institutions can diversify their earnings and risks. In this regard, it is important to review cross-selling capabilities. Insurance companies and banks should avoid balance sheet mismatch. In their search for new financial products, the directors should also admonish the management team at their financial institutions to install effective risk management, internal control and compliance programs. In addition, following the Gramm-Leach-Bliley Act in the United States, Japan and Chinese Taipei has adopted similar financial holding company models for universal financial service. China may be interested in some regulatory model for universal financial service, too. Asian financial institutions have become financial conglomerates long ago. However, they achieved conglomeration through family (instead of regulated) holding companies and cross investment. Directors of the new financial holding companies should review their business model, conflict avoidance and cross-selling abilities.

Infatuation with land has been a major liquidity risk for Asian companies, including Asian financial institutions. In most parts of Asian, there have been recent efforts to enact or refine securitization legislation. It is important that directors of Asian financial institutions look into opportunities to securitize as a way to improve liquidity and diversify funding sources.

Legal Traditions and New Transplants: Independent Directors

Asian economies have a split legal tradition, some follow the Civil Law, continental approach while others follow the Common Law approach. In the area of corporate governance, the basic distinction is the composition of the board. In Civil Law Asian economies, there are two-tiered boards. Sometimes they are not two-tiered (like China and Chinese Taipei) and not even a "board" for statutory auditors or supervisors (such as *Gien Cha Jen* or *Kaansaiyaku* in China, Chinese Taipei and Japan) who can wield tremendous oversight power in their individual capacity. In the Common Law-influenced Asian economies, there is only a unitary board and independent directors hopefully provide the oversight function. Unfortunately, in most Asian economies, boards (be they unitary or two-tiered) do not perform well enough to ensure satisfactory corporate governance performance.

After the Asian financial crisis, there is now a strong trend in Civil-Law Asian economies to adopt Common Law-style independent directors, with various committees under the board of directors. This trend has occurred in Korea, and is brooding in Japan, China and Chinese Taipei. In January 2002, for example, China Securities Regulatory Commission also adopted a set of broader guidelines for best practice in corporate governance. The CSRC is not alone in this new initiative. As of this writing, the Securities and Futures Commission in Chinese Taipei has requested the Taiwan Stock Exchange and the Over-the-Counter Market to prepare similar guidelines. These TSE and OTC guidelines are expected to have been adopted at the time of this roundtable. To be sure, they are all heavily influenced by the prestigious OECD Principles of Corporate Governance.

These new guidelines are generic, and are applicable to but not specially tailored for corporate governance arrangements for financial institutions. In China, for example, by July 2002 two are required for each China-listed companies, and by July 2003, they should be one-third of the board of all such companies. In Chinese Taipei, the rule now is two independent directors and one independent supervisor for all companies seeking initial listing in 2002. The SFC plans to apply it across the board as soon as possible. It is important to see how these economies embrace new institutions like independent directors and make them work. For example, who will be these independent directors? How are their incentives? How would the traditional two-tiered board work in light of these new initiatives? Will there be further impetus for broader corporate law reform, as noted by the OECD in its Company Law Reform Symposium for developed economies in Stockholm, 2000?

Building A Field of Dreams

By requiring independent directors, the recent efforts in some Asian economies have plotted a demand curve for them. Will they (honest, truly independent, sensible, competent, value-enhancing directors) come? Not without a field of dreams. By this I mean a market where independent directors are offered pecuniary and other rewards in a sustainable way, so that they feel comfortable to come forward to serve. Specific measures include incentives (including stock options) for directors, support by company staff so that they become informed and can do a good job, and liability coverage (such as insurance and indemnity). This issue is difficult enough already for Asian corporations, and a market for

qualified independent directors of Asian financial institutions could be even thinner.

In addition, Asia tends to have older cultures, which are more prone to use formalism to pay lip service. Capital market regulators in Asia should be very careful in scrutinizing the independence of directors claiming such status.

Fiduciary Duty

Fiduciary duty, which includes the duty of care and duty of loyalty, has been much more developed in Common Law jurisdictions. Civil Law influenced Asian economies are learning to transplant fiduciary duty law as they are fostering the new corporate governance culture. For example, fiduciary duty was written into China's Company Law of 1994. Chinese Taipei adopted the same approach in amending her Company Law in late 2001, and adopting the same rule for the Corporate Mergers and Acquisitions Law of 2002.

Importantly, these laws should be scrutinized to ascertain to *whom* are the fiduciary duty owed. For example, under the formalistic Civil Law approach, this duty may be viewed as being owed to the company, which alone as the direct victim of any breach of such duty has standing to sue. This formalistic view, therefore, would be silly in light of the insider-controlled Asian listed companies. Indeed, taking into account of the M & A context, the CMAL legislation adopted by Chinese Taipei in 2002 specifically makes this fiduciary duty owed to all *shareholders*.

In the case of financial institutions, to whom should the fiduciary duty be owed presents an even more interesting question. Certainly, the Anglo-American model and Franco-German model, both of which have persuasive influence in Asia, are different. The former does not view creditors as the beneficiary of the fiduciary duty. Here I echo arguments made in some recent research by law and economics scholars in the United States that, where depositary institutions are concerned, the fiduciary duty be owed to *creditors,* that is, *depositors,* as well.

Interestingly, in some Common Law jurisdictions like the United States, courts are quite tolerant with respect to honest mistakes by directors and officers. This is known as the business judgment rule. It requires more than gross negligence to find directors liable for a breach of duty of care. However, these courts will

frown at any appearance of a breach of duty of loyalty. In Civil Law-influenced Asian economies transplanting Anglo-American model of corporate governance, will there be a business judgement rule? I think not.

I think not because under the Civil Code concepts of a mandate contract, the standard of care is ordinary negligence. On the other hand, failure to effectively avoid conflicts of interests has been a weakness of Asian corporate governance systems. Conflict avoidance should be a top priority of directors of Asian financial institutions, particularly as these institutions begin to embrace the financial supermarket model through a financial holding company.

Transparency

One of the reasons for CalPERS's recent withdrawal from Southeast Asia is lack of transparency. In the financial sector, the issue of optimal transparency of financial institutions has troubled directors and regulators alike. Regulators should impose more stringent disclosure requirements on Asian financial institutions. Directors of these institutions should repel the cultural bias against disclosure to outsiders. Improved transparency improves firm value. Just look at high-tech companies like Taiwan Semiconductor Manufacturing Corporation in Chinese Taipei.

Conclusions

Financial institutions in Asia traditionally have been viewed as public institutions. In this sector, there is a great need for privatization, which is not just having the government reduce or eliminate their stakes in the financial institutions. Asian economies and financial systems have to rely more on private ordering and market discipline. Corporate governance occupies the top spot of the private ordering menu. It is a bitter medicine for Asian financial institutions, but that is why medicines make healthy patients.

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Biography

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Lawrence Shao-Liang Liu is a partner at Lee and Li, Attorneys at Law, the leading law firm in Chinese Taipei. He is also concurrently a Professor at the Graduate Institute of Law of Soochow University in Taipei. He specializes in matters concerning competition, corporate, securities, investment, and banking laws and policies. For over a decade, he has represented many leading international companies in cross-border transactions involving investment, licensing, mergers and acquisitions, financing, securities offerings, joint ventures, privatization, telecom, establishment of various financial institutions, and compliance with competition and regulatory laws.

Born in Taipei in 1955, Lawrence S. Liu received his Bachelor of Law degree from the NTU in 1977, and then received his Master of Laws degree from the University of Pennsylvania in 1980, and his Doctor of Law degree from the University of Chicago in 1982. Mr. Liu is a member of the Taipei Bar Association, State Bar of California, International Bar Association [IBA], Inter-Pacific Bar Association [IPBA] and American Bar Association. He served as a Council Member of the IPBA and the Chairman of its Financial Institutions and Transactions Committee. He has been a Country Representative for the IBA and served as Council Member on its Asian Advisory Council. He is an arbitrator and also served as a standing member of the Board of Supervisors of the Commercial Arbitration Association of Chinese Taipei.

Mr. Liu has been frequently consulted by ministries, agencies, and the local and foreign business communities in Chinese Taipei on issues involving public policies and law. He is often interviewed by and often writes/comments for the media in Taiwan on issues concerning law, finance, business, and political economy. He was an advisor to the Preparatory Office of the Fair Trade Commission in Chinese Taipei in 1991, and has served as a member of the Industrial Advisory Council and the Task Force on Macroeconomic Development in Mainland China, both of the Ministry of Economic Affairs. He also advises the government on APEC, WTO and OECD issues.

In 1995 Mr. Liu took a year's leave of absence from law practice to serve as the first Executive Director of the Coordination and Service Office for the Asia-Pacific Regional Operations Center, a department within the cabinet-level Council for Economic Planning and Development of the government of the Chinese Taipei. Charged with launching Chinese Taipei's APROC initiative to integrate with regional economies, enhance competitiveness, and improve the economic and social environment, he spearheaded the CEPD's program to enact economic reform legislation and streamline administrative processes for economic activities, and was instrumental in the passage of 12 legal bills to this effect in 1995.

Mr. Liu's wide academic interests include law and economics, law and social change in Chinese Taipei, comparative legal institutions and systems in Chinese Taipei, China and Hong Kong, competition and regulatory policies, judicial review, international trade and finance, the relations between law and economic development/reform, firm theory and corporate law, and the legal, economic and political issues in Taiwan-China relations. He frequently lectures on these topics at local and international conferences and symposiums for academics, professionals, and business executives. His professional and academic publications can be provided upon request. He has also visited at Columbia Law School and Stanford Law School in the United States.

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