EMERGING ECONOMIES TRANSITION

Corporate Governance in Asia

A COMPARATIVE PERSPECTIVE

GOVERNANCE

OECD

2001

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ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT

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FOREWORD

Corporate governance encompasses the relationships and patterns of behaviour between different agents in a limited liability corporation. Corporate managers and shareholders as well as employees, creditors, key customers and communities interact with each other to form the strategy of the company. Corporate governance refers to a set of rules and practices that frame such interactions. Adequate corporate governance setting should provide proper discipline on corporate management and ensure efficient operation of companies. Good corporate governance is a key to establishing a robust and competitive corporate sector, which serves as a source of economic growth.

Poor corporate governance was identified as one of the root causes of the recent Asian financial crisis. The absence of effective disciplines on corporate managers, coupled with complicated and opaque relationships between corporations, their owners and their finance providers, affected severely investors' confidence in the region's corporate sectors. Economies that took early steps to improve corporate governance have been recovering from the crisis at a more rapid pace than those who have not addressed this issue. The Asian crisis showed that good corporate governance is important not only for individual corporations to raise capital but also for an economy to achieve sustainable growth.

Against this backdrop, the "Conference on Corporate Governance in Asia: A Comparative Perspective" was held in Seoul, Korea on 3-5 March 1999. The conference was organised by the OECD under the framework of its Centre for Co-operation with Non-Members, in co-operation with the Korea Development Institute and with the co-sponsorship of the Government of Japan and the World Bank. This meeting created a momentum for policy dialogue on corporate governance in the Asian region, which resulted in the establishment of the Asian Corporate Governance Roundtable supported by the OECD and the countries in the region, in co-ordination with the World Bank and the Asian Development Bank. The Seoul meeting also provided an opportunity for non-Member Asian countries to contribute to the drafting of the OECD Corporate Governance Principles, which were later endorsed by the OECD Council at the Ministerial level on 26-27 May 1999.

This publication contains papers developed for the meeting. They describe and analyse various aspects of corporate governance with a particular focus on the countries in Asia. The major findings of the papers and the discussion at the meeting are summarised in two articles in the introduction. Part I consists of the papers that provide international comparative analysis, followed by Part II which includes the papers describing and analysing corporate governance practices of selected Asian countries.

The views expressed in this publication are those of the individual authors and do not necessarily reflect those of the OECD, or the governments of its Member or non-Member countries. Stilpon Nestor, Head of Corporate Affairs Division, and Takahiro Yasui, Principal Administrator in the Outreach Unit for Financial Sector Reform, have edited this volume. This book is published on the responsibility of the Secretary-General of the OECD.

Eric Burgeat
Director
Centre for Co-operation with Non-Members

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In the context of its special programme with non-member economies affected by the financial crisis, the OECD Centre for Co-operation with Non-Member Countries (CCNM) organised a senior experts meeting on "Corporate Governance in Asia", which took place on 3-5 March 1999 in Seoul. The meeting was co-hosted by the Korean Development Institute (KDI) and the Korean government, and was co-sponsored by the Japanese government and the World Bank.

The meeting proved to be very successful in bringing together a group of high level officials, private sector decision makers and academic experts from several Asian non-member economies (the People's Republic of China; Hong Kong China; India; Indonesia; Malaysia; the Philippines; Singapore; Chinese Taipei; Thailand) with their OECD counterparts in a frank and fruitful exchange of views on the issue of corporate governance. The debate developed around a set of country papers on corporate governance arrangements in the above countries and a set of substantive presentations by experts and consultants, including presentations by OECD, KDI and World Bank experts.

The continuing relevance of corporate governance as one of the main factors in the 1997-98 crisis and as an area of major policy reform was underlined by all participants. Deputy Secretary-General Joanna Shelton focused on the important role that the OECD Corporate Governance Principles were expected to play in the design of reforms and the international policy dialogue that would develop around them. Most of the countries declared their readiness to use the OECD Principles as a main benchmark and a gauge of progress in the context of this dialogue. Senior representatives from international organisations (Vice-President Shin of the Asian Development Bank and Director Iskander of the World Bank) joined Ms. Shelton and key participants in expressing the wish to see this type of regional dialogue on corporate governance continued. Co-operation between the OECD and these international organisations was deemed to be of central importance in the development of regional fora to facilitate dialogue and the identification of specific country needs in the area of corporate governance.

The following are some of the main policy conclusions drawn by the OECD Secretariat on the basis of the presentations and frank exchanges that took place during the meeting.

Main conclusions

Corporate governance has gained increased visibility among policy makers during the last few years. This has been the result of a number of different factors. The increasing globalisation of the capital markets has made it necessary for different systems of corporate decision making and control to become broadly compatible with each other, at least in terms of transparency, in order to be able to attract investors from other countries. Hence, a trend towards global convergence of corporate governance norms can be discerned. In addition to the globalisation of markets, some other factors are contributing to convergence: a more propitious environment for international co-operation and policy debate after the end of the cold war encouraged by the on-going communications revolution, and a clear convergence of legislative and regulatory trends, especially in the commercial law area.

The importance of the overall openness of the economy to competitive pressure in the product and factor markets should not be underestimated. Corporate governance improvements will produce their full benefits only if markets are allowed to function properly and transmit their signals to foreign and domestic investors, customers, competitors, creditors and employees. Transparency and accountability will not be effective if the information generated by markets is not adequate.

The Asian financial crisis has played the role of a catalyst in the corporate governance debate. One of the fundamental causes of the crisis is the lack of effective corporate governance mechanisms. On one hand, there is weak outside monitoring by stakeholders in firms, capital markets and credit institutions. On the other, there is a concentration of control in small groups of interests that very often are closely connected to the state and the financial sector. The lack of transparency of these arrangements, combined with increasing, direct or indirect, corporate exposure to international capital markets, created vulnerabilities that led to the crisis.

Corporate Asia has been plagued by over-investment, excessive conglomeration and over-indebtedness. These tendencies have been, to a large extent, a result of poor corporate governance mechanisms. Major shareholders in corporate groups, very often their "founding fathers", sought to retain control and appropriate most of the returns, while broadening their risk base. This resulted in unbalanced risk/return conditions and a perverse incentive structure, which encouraged all of the above tendencies.

To be sure, the fault does not lie only within the countries affected by the crisis. Many Western investors showed a low level of prudence in providing large amounts of financing, in spite of the opacity of corporate governance arrangements, and the precious little information on the activities and levels of liabilities of the companies or banks. Nevertheless, and irrespective of what needs to be done on improving the efficiency of international capital flows, an overhaul of corporate governance arrangements needs to be effectuated in the afflicted countries, if private, especially overseas, investment is to resume and companies are to meet their financing needs and resume their growth. For this to happen, several areas need to be addressed:

Protection of shareholder rights

Asian economies need to address the question of adequate protection for "outside" investors in their companies. A great part of the corporate governance problem emanates from the fact that transactions between corporations and their major shareholders were not adequately vetted by other shareholders. Such self-dealing practices were widespread in the region. In addition, the responsibility of directors has not been clearly defined and the "insider" domination of boards is evidence of their rather marginal role in protecting the interests of shareholders (or the company) as a whole. These rules need to be overhauled and listed companies need to show more willingness to protect investors.

Disclosure and transparency

It is now clear that the disclosure regime in most Asian economies was defective. While fundamental accounting standards seem to be in place, implementation was and is at best patchy. Corporate audits were far from accurate in giving investors a true picture of the liabilities in individual companies. Most important, the standards for consolidated financial accounting were not operative. Obscure cross-ownership patterns often shifted control in corporations in ways that were not known to shareholders. A web of off-balance sheet liabilities such as cross-guarantees of debt increased the risk exposure of individual companies. It is of the utmost importance that these issues are dealt with in order to increase the confidence of investors

Corporate restructuring and exit mechanisms

In many Asian economies, insolvency laws and their implementation fall well short of the basic functions they are supposed to fulfil in a market economy: to enhance payment discipline, to adequately protect creditors, to provide for a flexible framework for the re-organisation of illiquid but solvent enterprises, and to ensure an efficient re-allocation of resources of failed firms. The exit bottleneck destroys value and raises the cost of capital, especially in the crisis and post-crisis environment. In the wake of the crisis, exit issues sometimes need to be addressed from two perspectives: the more long term reform of the general insolvency legislation; and a crisis-related set of rules on corporate restructuring and work-outs between financial institutions and their major debtors. These special crisis rules need to be well integrated into the general plans for restructuring and recapitalising the banking sector and improving banking supervision.

The role of banks

Fundamental weaknesses in managing risk by creditors were a major issue in the Asian corporate debacle. This was often due to poor governance of the creditor institutions, often captured by their debtors or playing a credit-rationing role for the state. It was also a direct result of national financial sectors being relatively closed to foreign investment.

The role of stakeholders

As regards the role of employees in the current effort to re-structure and give a new direction to corporate behaviour and control, it might be very productive to consult and involve the employees who are often the ones who bear the brunt of these efforts.

But the adoption of corporate governance rules in itself might not be enough for substantially improving the performance of the corporations in the region. There is a great need to improve the infrastructure, which ensures an effective implementation of these rules. There are several areas that need to be addressed: improved capacity for the judiciary and for regulatory authorities in the capital markets; the emergence of a set of intermediary market institutions that will keep shareholders informed and assist them in the exercise of their control rights; and the continuing education of corporate directors, leading the behavioural change at the corporate level, without which reforms may never become effective.

The progress to-date

Some of the Asian countries have taken rigorous action to address the problems in the aftermath of the crisis. *Korea*, an OECD Member country, has been at the forefront of corporate and financial sector reforms: it is increasing transparency and independent monitoring of publicly held companies, has outlawed cross-guarantees and other “self dealing” transactions between affiliates and is taking important steps to improve the framework for insolvency. Most important, it is opening up to FDIC and patient capital in a move that will not only further integrate the Korean economy into that of its OECD and other partners, but will also play a pivotal role in modernising the corporate governance environment in the country itself. The entry of FDIC in the financial sector is particularly encouraging in this respect. *Thailand* is another country which has taken important steps, especially as regards the restructuring of its financial sector and the liquidation of financial companies; a corporate restructuring scheme and improvement of the legal and institutional framework for insolvency are also in progress, while the framework for minority shareholder protection is modernised by capital market authorities and the stock exchange. *Indonesia* is still struggling to put together a functioning corporate governance and exit environment: while informal restructuring initiatives - the so-called Jakarta initiative - seem to be starting to work, the newly revamped insolvency regime is not yet producing satisfactory results.

The meeting provided policy makers from public and private sectors with valuable insight into their neighbours' problems and solutions, and gave us all a broader perspective on the issues; it has confirmed the direction of the Principles as a non-prescriptive tool for policy debate. Participants also suggested further areas of corporate governance-related work, especially in the areas of market exit, smaller enterprises and social responsibility of corporations. In summary, it has been a very productive meeting and should be seen as a first step in a continuing policy debate on the crucial issues of corporate governance.

INTRODUCTION

by
Joanna R. Shelton

Market-oriented economies of the OECD and the rest of the world are at a watershed, as they rely increasingly on the strength of the private sector in what is rapidly becoming a world market. OECD economies, as well as many others, rely on the corporation as the engine for participation in the global market - to raise capital, create jobs, earn profits and divide the value-added among those contributing to its success.

The increased role of the private sector in the modern economy is one of the reasons for the increased focus on corporate governance in countries throughout the world. Other reasons include the increased international interdependence of countries and companies, and the new competitive circumstances for companies.

Many of today's fast-growing and highly successful enterprises deviate quite radically from the traditional image of smokestack or bluechip corporations. They are often more human-capital-intensive and highly dependent on intangible assets, such as brand names, patents, strategic alliances and organisational know-how. They may also operate under more flexible contracts with employees, business partners and other constituents.

Interest in corporate governance in OECD countries first arose because investors became increasingly concerned that in companies with dispersed ownership - particularly characteristic of the United States and the United Kingdom - management was pursuing objectives other than long-term returns to shareholders while, at the same time, managers were able to raise their own compensation in spite of poor company performance. The concern was especially acute among institutional investors, who account for a growing share of equity ownership in OECD countries.

In continental Europe and Japan, ownership concentration was greater, and yet it became evident to investors that equally serious problems were present in these countries. In particular, controlling shareholders - often allied with management - were able to pursue interests other than profitability. The use of off-balance sheet funds and other devices that could shield management from accountability to shareholders were even more prevalent than in the so-called Anglo-Saxon countries.

Despite these concerns, the means available to minority shareholders to influence management often were ineffective, and disclosure requirements for companies often were equally weak. Thus, much of the discussion in OECD countries over the past two decades has focused on the means to align the interests of management with those of the shareholders, and to find ways to assure that management will act in the interest of shareholders - who are, after all, the owners of the company. As companies in markets around the world have increasingly turned to the capital markets for outside funds, they have been obliged to become more attentive to shareholder value.

What is corporate governance?

What do we mean when we talk about corporate governance? In a narrow sense, corporate governance involves a set of relationships between a company's management, its board of directors, shareholders, and other stakeholders. These relationships, which involve various rules and incentives, provide the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined. Key aspects of good corporate governance include the transparency of corporate structures and operations; the accountability of managers and boards to shareholders (including foreign shareholders); and corporate responsibility towards employees, creditors, suppliers, and the local communities where the corporation operates.

In a broader sense, however, good corporate governance - the extent to which companies are run in an open and honest manner - is important for overall market confidence, the efficiency of international capital allocation, the renewal of countries' industrial bases, and ultimately nations' overall wealth and welfare. Countries wishing to attract private investment, notably from abroad, are now placing a greater emphasis on the way that corporations are operated and the way that they respond to the needs and demands of investors, wherever those investors may be located. This consideration is particularly important in the effort to attract the more patient, long-term capital that is so crucial for establishing the basis for sustainable growth and job creation.

While the emphasis on good corporate governance is not new, the financial crisis that began in Asia in mid-1997 persuaded policymakers world-wide of the need for better corporate governance standards, with increasing emphasis on the problems of non-OECD countries. The absence of effective monitoring mechanisms may have contributed to the excesses that contributed to the crisis. In particular, prevailing governance mechanisms in Asia and elsewhere often did not encourage management to use resources efficiently. Firms could and often did pursue objectives other than profitability, including conglomeration and the expansion of market share, while at the same time building up excessive debt. In addition, governance systems tended to protect the interests of controlling investors at the expense of minority investors, including foreign investors.

A related problem of corporate governance in Asia was present in banks, which on balance were not capable of engaging in basic credit analysis or of restraining the often unsustainable expansion plans of the corporate sector. While Asian banks were hardly alone in making such misjudgements, shortcomings in corporate governance systems in the banking sector, as well as problems in the prudential supervision of banks, probably impeded the ability of banks in this region to monitor the corporate sector and to be sufficiently aware of the impending crisis. It is important to add, however, that the shortcomings of foreign lenders in the Asian financial crisis, including their failure to monitor performance and to assess the level of risk before extending loans to often highly leveraged companies, also has come in for appropriate criticism.

As a policy matter, corporate governance is largely about establishing a legal and regulatory framework that promotes the emergence of credible and effective governance practices for the benefit of economies and society as a whole. Beyond that, the actual design - and certainly the implementation - of particular governance arrangements is best left to the various market participants. Good corporate governance should provide proper mechanisms for monitoring of management by the board and monitoring of the board by shareholders. Effective disclosure and monitoring will encourage management to pursue policies that provide competitive returns to shareholders, thereby encouraging firms to use resources more effectively. This, in turn, will help strengthen the competitive position of the firm.

While the corporate governance framework by itself is an important element affecting the long-term prosperity of companies, it is only part of the larger economic, social and legal environment in which firms operate. On the broadest level, the quality of macroeconomic management and the state of competition in product and factor markets have a powerful impact on firm performance. The state of market competition in turn is influenced by a range of government policies in areas such as trade, investment (both short-term and long-term) and competition policy. The legal system, accounting standards, labour market policies and patterns of equity ownership also have a strong bearing on corporate performance. Finally, business ethics and corporate awareness of the environmental standards and other societal interests of the communities in which they operate - sometimes called "good corporate citizenship" - also can have an impact on the reputation and long-term success of a company.

OECD Principles of Corporate Governance

In response to the growing interest in corporate governance in OECD countries, and sparked in particular by the Asian financial crisis, OECD Ministers in 1998 asked the OECD to develop a set of corporate governance principles that could be useful to OECD Members and non-Member countries alike. To fulfil this task, the OECD in June 1998 established an Ad Hoc Task Force on Corporate Governance with representatives from all Member governments and key international organisations, including the World Bank, as well as a number of private sector and labour representatives with special expertise in corporate governance. The Task Force sought maximum transparency in elaborating the Principles through a wide consultative process, which included many private sector and other non-governmental organisations, as well as representatives of non-Member countries. At their annual meeting, OECD Ministers approved the Principles in May 1999, and they are available on the OECD Website (http://www.oecd.org/daf/governance/principles.htm).

At a very early date, the Task Force decided not to attempt to develop a detailed international code of conduct or set of "best practices", which is best left to each country’s legislators, regulators and private sector bodies. Instead, the Task Force decided to delineate those basic principles that can serve as a reference point for governments and private sector participants as they evaluate and refine their own legal, institutional, regulatory and company-specific frameworks. The Principles build upon the experience of Member and selected non-member countries, private sector experience, and on previous OECD work in this area.

Although the Principles are primarily aimed at governments, they also will provide guidance for stock exchanges, investors, private corporations and national commissions on corporate governance as they elaborate best practices, listing requirements and codes of conduct. The Principles refer mainly to publicly traded companies, including financial institutions, but the general concepts embodied in them may have some application to small and medium-sized enterprises and to closely-held firms. The Principles will be non-binding and will not give detailed prescriptions for national legislation.

A Preamble to the Principles explains what they are designed to accomplish. We specifically state that there is no single model of good corporate governance; rather, we seek to delineate basic Principles that will be compatible with many systems. We also recognise that corporate governance practices are constantly evolving and improving with time. Thus, the Principles, too, must evolve over time; and they almost certainly will have to be reviewed in the future after some experience has been gained with their practical application. However, with these caveats, we do believe that the Principles establish an important benchmark for action by governments and the private sector.

The Principles themselves fall under five broad headings, with each basic Principle supplemented by explanatory annotations. These are:

The rights of shareholders

The protection of the rights of shareholders and the ability of shareholders to influence the behaviour of the corporation are key pillars of effective corporate governance. Therefore, those rights which shareholders should expect to be able to enjoy in all jurisdictions are specified in the Principles, such as the right to secure ownership and registration of shares, as well as the right to share in the residual profits of the company. The ability to participate in basic decisions concerning the company, chiefly by participation in general shareholder meetings, is set forth as an important right. The Principles call for disclosure of corporate structures and devices that redistribute control over the company in ways that deviate from proportionality to ownership. Another important right of shareholders is that transfers of controlling interest of the company should take place under fair and transparent conditions and that anti-takeover defences not be used to shield management from accountability. Finally, investors are urged to consider using their voting rights. This latter point is a very important, because shareholders - even large shareholders - can have no effective role in shaping major decisions affecting the corporation, if they fail to vote.

The equitable treatment of shareholders

In many cases, controlling shareholders, boards and management use their control over the corporation and over information to the detriment of non-controlling and foreign investors. This section of the Principles stipulates that board members, management and controlling shareholders should deal fairly with all shareholders. It also states that insider trading and self-dealing should be prohibited. The Principles call for maximum transparency regarding the distribution of voting rights among categories of shareholders and the ways in which voting rights are exercised.

The role of stakeholders

This Principle states that the corporate governance framework should recognise the legal rights of stakeholders and encourage active co-operation between corporations and stakeholders in creating wealth, jobs, and the sustainability of financially sound enterprises. This issue is more important than the relatively short text devoted to it might suggest. Certainly, we all recognise that one key aspect of corporate governance is ensuring the flow of outside capital to firms. However, a good corporate governance structure also has to be concerned with finding ways to encourage the various stakeholders in the firm to make much-needed investment in human and physical capital. As we point out in the Annotation to this Principle, the competitiveness and ultimate success of a corporation is the result of teamwork that brings contributions from a range of different sources, including not only investors, but employees, creditors, and suppliers as well. It is ultimately in the long-term self-interest of firms to recognise that their employees and other stakeholders constitute a valuable resource for building competitive and profitable companies, whether or not those employees or other stakeholders have a legal place in the corporate governance structure, as they do in some countries.

Disclosure and transparency

A strong disclosure regime is widely recognised as a central and indispensable element of an effective corporate governance system. The Principles provide that timely and accurate information should be disclosed on all material matters regarding the financial situation, performance, ownership, and governance of the company; and further, that this information should be prepared in accordance with high quality standards. The Principles also call for an annual independent audit, in order to provide an external and objective control on the way in which financial statements have been prepared and presented.

The role of the board

The board is the main mechanism for monitoring management and providing strategic guidance. OECD countries have a number of different board structures, and nuances can be found in the relative weight that the board should place on monitoring the conduct of management versus that of providing a broader strategic vision for the corporation. Nevertheless, the accountability of the board to the company and its shareholders is a basic tenet of sound corporate governance everywhere. The Principles make it clear that it is the duty of the board to act fairly with respect to all groups of shareholders, to deal fairly with stakeholders and to assure compliance with applicable laws. Among the responsibilities of boards are: reviewing corporate strategy and planning; overseeing management (including remuneration); managing potential conflicts of interest; and assuring the integrity of accounting, reporting and communication systems. The Principles also stress the need for board members being able to exercise objective judgement on corporate affairs, independent of management.

Next steps

Concerning the implementation of the Principles, it is clear that this work must involve intensive collaboration with non-member countries from the very start, as well as an ongoing policy dialogue between OECD countries and non-member countries, in co-operation with other international organisations, including particularly the World Bank, with which the OECD has already developed a close and complementary relationship.

The meeting on "Corporate Governance in Asia" is only the beginning of a process that should continue. The OECD Principles could be just one part of a wider dialogue on various aspects of corporate governance, in workshops or conferences that could be organised on a regional basis or possibly in some other ways. We are very open-minded as to the ways in which further dialogue with countries beyond the OECD membership might proceed. Whatever form this co-operation may take, strengthening the corporate governance framework in countries around the world is now recognised as one key element in laying a strong foundation for the resumption of economic growth in Asia and elsewhere and for a more stable international economic system.

Part I

CORPORATE GOVERNANCE: COMPARATIVE TRENDS

CORPORATE GOVERNANCE PATTERNS IN OECD ECONOMIES: IS CONVERGENCE UNDER WAY?

by
Stilpon Nestor and John K. Thompson*

I. Introduction

Neo-classical economics suggests that a firm which operates in a competitive product market and meets its capital needs in an efficient capital market should maximise the welfare of its owners (as they would otherwise not supply it with capital) and that of its customers (by pricing its products at their marginal cost): the enterprise is thus the proverbial "black box". But,

"... in the real world things are not that simple...Creditors want to be sure that they will be repaid, which often means firms taking on less risky projects ... managers would rather maximise benefits to themselves (by) preferring policies that justify paying them a higher salary, or divert company resources for their personal benefit or simply refuse to give up their jobs in the face of poor profit performance .... Large shareholders with a controlling interest in the firm would, if they could, increase their returns at the expense of ... minority shareholders." (Prowse 1996)

The list could be longer: employees, suppliers, customers, the community as a whole. There are substantial costs that result from the divergence of the interests of different agents. Corporate governance is the outcome of the relationships and interactions between these agents. An optimal corporate governance structure is the one that would minimise institutional costs resulting from the clash of these diverging interests.

Costs are the result of two main incidences: the long string of agency relationships that characterise today's large firms; and the impossibility to write complete contracts between principals and agents on the exact tasks of the latter. Hence, in the words of Professor Hart (1995):

"governance structures can be seen as a mechanism for making decisions that have not been specified by contract".

But why do these costs matter? Because the performance of the enterprises might be significantly influenced by their size and the identity of their bearer[1]. For example, if too many of these costs are borne by shareholders, the cost of equity financing will rise and the structure of the capital market will be seriously tilted towards debt financing and/or direct or indirect state subsidies. Employment and labour relations might also be shaped by governance structures: where labour has an important role in defining company strategy there might be losses in the efficient redeployment of resources; on the

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contrary, where employees are kept completely outside the information flow and decision making process within the firm, there may be a lower commitment to the firm's development and more social costs may arise down the line.

And if these costs matter to corporations, why do they matter to governments? Everybody would agree that corporate governance regimes are (and should remain) the product of private, market-based practices. There are however important policy angles. From an economic policy perspective, rising institutional and transaction costs in the realm of corporate decision making and finance impacts on the competitiveness of economies, on the corporate investment levels and on the allocative efficiency of capital markets. From an institutional perspective, corporate governance is of direct relevance to policy makers because laws, institutions and regulations are one of its most important sources (and of its costs). Company law, securities regulation, prudential regulation of banks and pension and insurance companies, accounting and bankruptcy laws impact on the way corporations make their decisions and behave in the market and towards their different constituents. To come back to Hart's aphorism, the legal and institutional framework shapes most of the relationships that are outside the contractual realm. Policy makers are responsible for striking the best balance between mandatory law and contract in each jurisdiction and thus providing the optimum mix between flexibility and the predictability that legal formality brings.[2]

There are a wide variety of corporate governance regimes in OECD countries. Over the years, individual economies developed different capital market mechanisms, legal structures, factor markets and private or public institutions to act as owners or corporate governance principals in the economy. These arrangements might vary even within the same country according to the sector. They are very often the result of institutional, political and social traditions. Understanding and accepting this variety of approaches is a fundamental first step for analysing the impacts of increasing globalisation on national systems.

Despite different starting points, a trend towards convergence[3] of corporate governance regimes has been developing in recent years. Pressures have been rising on firms to adapt and adjust as a result of globalisation. Their products are having to compete directly on price and quality with those produced internationally, which mandates a certain *de facto* convergence of cost structures and firm organisation that, in its turn, might spill-over on firm behaviour and decision making. But most important, convergence might be the result of globalisation in the capital markets: new financial instruments (such as ADRs and GDRs), deeper integration of markets, stronger, international competition and the emergence and growth of new financial intermediaries have radically changed the corporate finance landscape in a global way, at least for the larger enterprises. The latter, along with the governments of their countries, are increasingly conscious that, in order to tap this large pool of global financial resources, they need to meet certain governance conditions.

In this paper, we survey the observed patterns of corporate control, that are found in the major OECD countries in order to arrive at a general taxonomy of governance regimes and trace their evolution through time. We will start by providing for a stylised description of the different patterns of governance (keeping in mind that every country has ultimately its own unique arrangements). There are those that are founded on arm's length, market-based relationships between firms and their investors (who are thus "outsiders"); and those whose accountability trail leads to specific interests of "insiders", that are more permanently linked to the firm: major shareholders, banks, workers. We will then provide for an overview of how the role of the various corporate governance agents has changed over the last couple of decades in different systems. We will further try to identify why the behaviour and positioning of these agents is changing and whether the different patterns are converging. Finally, we will provide for some tentative conclusions and contain some thoughts on the shape of the future policy debate on corporate governance.

II. The different systems of corporate governance

In this section we survey the observed patterns of corporate control that are found in the major OECD countries in order to arrive at a general characterisation of the different categories of governance regimes and trace their evolution through time. While it will be argued below that the systems may be converging at this time, it is clear that if one goes back a few decades, patterns of corporate governance differed drastically among OECD countries. The ways in which large, widely-held limited liability companies are governed reflect a wide variety of ownership structures in equity markets, of patterns of corporate finance, and of company laws and securities regulations. One traditional way of describing governance regimes has been to distinguish between "insider" and "outsider" systems.[4]

Table 1. Distribution of outstanding listed corporate equity among different categories of shareholders in selected OECD countries

per cent at year-end-1996

	United States	Japan	Germany	France	United Kingdom[2]	Sweden	Australia[3]
Financial sector	46	42	30	30	68	30	37
Banks	6	15	10	7	1	1	3
Insurance companies and pension funds	28	12	12	9	50	14	25
Investment funds	12	..	8	11	8	15	..
Other financial institutions	1	15[1]	-	3	9	-	9
Non-financial enterprises	-	27	42	19	1	11	11
Public authorities	-	1	4	2	1	8	-
Households	49	20	15	23	21	19	20
Rest of the world	5	11	9	25	9	32	32
TOTAL	100	100	100	100	100	100	100

1. For Japan, pension and investment funds are included in Other financial institutions.
2. United Kingdom figures are for end-1994.
3. Australian figures are for end-September 1996. Investment funds are included in Other financial institutions.

Source: OECD Financial Accounts, The Conference Board International Patterns of Institutional Investment (New York 1997), Banque de France, G.P. Stapleton Ownership of the Australian Share Market and Implications for Securities Regulation (forthcoming), and OECD Secretariat estimates.

The outsider model

The classic "outsider" systems are found in the United States and the United Kingdom. The distinguishing features of the outsider model are 1) dispersed equity ownership with large institutional holdings; 2) the recognised primacy of shareholder interests in the company law; 3) a strong emphasis on the protection of minority investors in securities law and regulation; and 4) relatively strong requirements for disclosure. In these countries, equity is typically owned by widely dispersed groups of individual and institutional investors. Although these countries have long traditions of equity ownership by individuals, a phenomenon of institutionalisation of wealth is occurring in which an increasing share of national income is managed by institutional investors (i.e. mutual funds, pension funds and insurance companies). Institutional investors are emerging as the largest owners of equity in the United States and already are the dominant owners of industry in the United Kingdom (see Table 1). Institutional investors tend to operate on the principle of portfolio diversification. They have one basic objective, which is to maximise the return to their investors in keeping with their mandates and in doing so employ the most modern techniques in pursuing their investment strategies. Typically, they have no interest in running the company and have no other relation to the company except for their financial investment.

Table 2. Financial assets of institutional investors
as a percentage of GDP

	1990	1991	1992	1993	1994	1995	1996	1997p
Australia	49.3	58.3	60.2	74.5	73.2	75.3	83.8	83.9
Austria (1)	24.3	25.9	24.3	27.8	31.8	35.5	39.4	..
Belgium	44.4	48.9	47.0	56.3	59.4	59.1	63.0	..
Canada	58.1	63.8	66.3	76.0	79.8	85.8	94.6	102.0
Czech Republic (2)	..	..	..	23.0	18.2	..	..	..
Denmark	55.6	59.4	53.7	61.2	65.1	64.1	67.1	..
Finland	33.2	37.1	35.8	44.2	55.5	49.6	57.0	..
France	54.8	62.4	60.5	72.5	75.6	75.9	83.1	90.6
Germany	36.5	38.2	33.7	38.1	44.1	46.3	49.9	57.5
Greece (3)	6.5	8.8	8.5	14.3	18.8	23.4	28.5	..
Hungary	..	2.5	2.5	3.1	3.7	4.0	5.7	..
Iceland	45.7	49.9	49.9	57.8	68.8	71.1	78.7	85.3
Italy	13.4	22.4	18.5	26.3	32.1	33.2	39.9	53.2
Japan	81.7	79.4	78.1	81.3	84.8	76.9	77.6	75.3
Korea	48.0	47.8	52.3	56.7	57.5	57.9	57.3	37.2
Luxembourg (4)	926.8	1237.5	1630.5	2166.5	2170.2	2139.1	2310.4	..
Mexico (5)	8.8	9.4	5.6	7.4	3.5	3.8	4.5	4.7
Netherlands	133.4	143.6	132.8	148.5	157.7	161.0	169.1	183.8
New Zealand	..	..	..	..	..	36.6	38.1	34.3
Norway	36.0	38.0	32.6	39.6	43.2	42.5	43.4	..
Poland (6)	..	..	..	0.5	1.9	1.6	2.0	0.4
Portugal	9.0	14.9	17.3	25.7	31.9	31.9	34.4	31.7
Spain	16.0	22.9	22.8	29.9	36.4	38.1	45.4	56.1
Sweden	85.7	93.8	75.6	102.6	105.4	114.5	120.3	..
Switzerland (7)	119.0	61.1	119.4	69.9	148.6	77.3	152.4	92.7
Turkey	0.6	0.5	0.5	0.9	1.0	0.8	1.3	0.6
United Kingdom	114.5	126.3	115.3	164.1	149.3	164.1	193.1	..
United States	123.8	137.2	141.3	151.6	149.7	167.0	181.1	202.8

Note: There are no data reported for Ireland.
(1) 1990: Excluding pension funds.
(2) 1995-97: Data not available.
(3) 1990: Excluding insurance companies and investment companies. 1991-92: Excluding investment companies.
(4) 1990-94 and 1996: Excluding insurance companies.
(5) Excluding pension funds.
(6) Excluding pension funds. 1990-93 and 1997: Excluding insurance companies.
(7) 1991,93,95,97: Exluding pension funds.
Source : OECD 1998b

The "outsider" system can be also characterised as a market-based system, inasmuch as it relies heavily on the capital market as a means of influencing behaviour. The system is also characterised by a legal and regulatory approach that favours use of the public capital markets and is designed to build confidence among non-controlling investors. In countries with outsider systems, the legal framework supports clearly the right of the shareholders to control the company and makes the board and the management explicitly accountable to the shareholders.[5]

The legal and regulatory regime was developed on the assumption that a dispersed body of investors own the company, that these investors act in isolation from each other and that they need reliable and adequate information flows in order to make informed investment decisions. Regulation has traditionally been structured to provide relatively complete information to investors and to create relative equality among investors regarding access to information. Thus, the system can be described as "disclosure-based".[6] Some market-based systems have elaborate rules to prevent groups of shareholders from communicating and sharing information among themselves without making information available to all shareholders. Regulatory authorities have traditionally been willing to allow investors to assume risk as they see fit, even though they have usually enforced strict disclosure standards to prevent investors from being deceived about the actual amount of risk being assumed.

Unlike many insider systems, which thrived in bank-dominated environments, there have traditionally been two channels of financial intermediation in outsider systems. In the banking sector, finance has tended to be short-term and banks have tended to maintain "arms' length" relationships with corporate clients. Most of these countries had traditions of an independent investment banking (or merchant banking) sector as well as specialised securities market intermediaries. Equity finance also tended to be relatively important with low debt equity ratios being the norm. Also, reflecting the tradition of wide equity ownership, equities tended to represent a high share of financial assets and a high share of GDP (see Table 2).

Theoretically, the shareholders, through the use of their voting rights, have the power to select the members of the board and to vote upon certain key issues facing the company. In practice, the fragmentation of ownership has proven to be a serious impediment to the actual exercise of such control. In the past, investors in outsider systems were not especially concerned with corporate governance inasmuch as it was presumed that they could not and did not wish to exercise their governance rights. The main means for investors to discipline management has been the buying and selling of company shares. The capital market has provided the ultimate means for shareholders to discipline management. If the company is poorly managed and/or if shareholder value is neglected, investors react by selling shares, thereby depressing prices and exposing the company to hostile take-overs. Such a model presumes ample disclosure of information, strict trading rules and liquid stock markets.

Much of the early thinking about corporate governance evolved in the context of the outsider model. It was the separation between ownership and management that led analysts as long ago as the 1930s to identify the potential agency problems when a dispersed group of shareholders were unable to monitor and to control the behaviour of management.[7] Indeed, as recently as the late 1980s, many analysts had concluded that the agency problems that characterised outsider systems might inevitably lead to poor corporate performance.[8] Management was thought to have effectively shielded itself from accountability while shareholders were thought to be focused on short-term results. Many analysts compared the market-based system unfavourably with the insider systems in which corporate control was exercised by agents having more permanent economic linkages to the company. In more recent years, the pendulum has swung the other way, as companies in the US and the UK have managed to carry out sizeable restructuring and show impressive gains in profitability. Thus, more recently observers have become much more positive about the capacity of the capital markets to encourage efficient economic behaviour.

Table 3. Market capitalisation of listed domestic equity issues
as per cent of GDP at year-end

	1975	1980	1985	1990	1993	1994	1995	1996
Australia (Assoc. of SE)	22	40	37	37	71	67	70	80
Austria	3	3	7	17	16	16	14	15
Belgium	15	8	26	33	37	36	37	44
Canada (Toronto and Vancouver)	30	45	45	43	61	59	66	86
Denmark	11	8	26	30	31	34	33	41
Finland	..	..	..	17	28	39	35	49
France	10	8	15	26	36	34	33	38
Germany (Assoc. of SE)	12	9	29	22	24	24	24	28
Greece	..	..	..	..	..	..	14	19
Ireland	..	..	..	..	..	..	40	49
Italy [1]	5	6	14	14	15	18	19	21
Japan	28	36	71	99	68	77	69	66
Korea	..	..	..	43	42	50	40	29
Mexico	..	..	..	16	50	31	32	32
Netherlands	21	17	47	42	58	67	72	95
New Zealand	..	..	39	20	56	53	53	56
Norway	..	..	16	23	24	30	30	36
Spain	32	8	12	23	25	25	27	33
Sweden	3	10	37	40	58	66	75	95
Switzerland [2]	30	42	91	69	114	109	129	136
Turkey	..	..	..	..	20	17	12	17
United Kingdom	37	38	77	87	122	114	122	142
United States (NYSE, Amex, and Nasdaq) [3]	48	50	57	56	81	75	98	114

Note: 1. Italy - All Italy on a net basis since 1985
2. Switzerland - only Zurich through 1990.
3. United States - including foreign shares in 1975.

Source: Fédération internationale des Bourses de valeurs and OECD Secretariat estimates.

The insider model

In most other OECD countries and nearly all non-Members, ownership and control are relatively closely held by identifiable and cohesive groups of "insiders" who have longer-term stable relationships with the company.[9] Insider groups usually are relatively small, their members are known to each other and they have some connection to the company other than their financial investment, such as banks or suppliers. Groups of insiders typically include some combination of family interests, allied industrial concerns, banks and holding companies. Frequently, the insiders can communicate among themselves with relative ease to act in concert to monitor corporate management, which acts under their close control. Furthermore, the legal and regulatory system is more tolerant of groups of insiders who act together to control management while excluding minority investors. Hence, the agency problem, which characterises the outsider system, is of much less importance.

Patterns of equity ownership differ significantly from "outsider" countries. One characteristic of countries with insider systems is that they have generally experienced less institutionalisation of wealth than the English-speaking countries. Until recently, no class of owners was found comparable to the pension funds, mutual funds and insurance companies of the US and the UK who have emerged as the largest and most active class of shareholders. Additionally, those institutions that do exist often face regulatory limits on their ability to invest in equity.[10]

Insider systems have usually been bank-centred. Patterns of corporate finance often show a high dependence upon banks and high debt/equity ratios. Instead of arm's length lenders, banks tend to have more complex and longer term relationships with corporate clients. Capital markets are in general less developed than in outsider systems. In contrast to the market-based system, which insists upon public disclosure of information, the insider system is more willing to accept selective exchanges of information among insiders. This confidential sharing of information is typical of the way a bank interacts with borrowers[11]. Reflecting the reliance on bank finance and the lack of sophisticated institutional investors, the range of financial assets available to the public has been comparatively narrow and banks have dominated financial intermediation. Regulatory policy often functions by prohibiting "speculative" activity rather than by insisting on strong disclosure. The elaborate systems to regulate capital markets that are found in market-based countries did not develop fully in bank-centred systems. For example, Germany did not have a national securities markets regulator until very recently; securities market regulation was left to the state governments or to the exchanges.

Insiders may control a company either by owning an outright majority of voting shares or by owning a significant minority holding and using some combination of parallel devices to augment their control over the company. Among the devices that are commonly used to redistribute control one can mention corporate structures, shareholder agreements, discriminatory voting rights and procedures designed to reduce the effective participation of minority investors. In general, the legal and regulatory system tends to be relatively permissive of such mechanisms.

Some corporate structures, particularly "pyramid structures", enable those with dominant positions in the parent company to exercise control with only a small share of the total outstanding equity of the firm. Other common ways of redistributing control are through issuance of multiple classes of shares with the insider group having increased voting power. Capped voting is used to limit the number of votes that investors may cast regardless of their equity ownership[12].

In some governance systems, cross-shareholdings are used to create significant shareholder cores, which are often used in combination with devices such as cross-guarantees and shareholder agreements to diminish the influence of non-controlling investors on corporate policy. This potential may be increased if the informal group has special linkages to other participants in the governance process (e.g. banks or government) or to management.

Shareholder agreements are a common means for groups of shareholders, who individually hold relatively small shares of the total equity, to act in concert so as to constitute an effective majority, or at least the largest single block of shareholders. Shareholder agreements usually give those participating in the agreements preferential rights to purchase shares if other parties in the agreement wish to sell and can also contain provisions that require those accepting the agreement not to sell their shares for a specified time. Shareholder agreements can cover issues such as how the board or the chairman will be selected and can oblige those in the agreement to vote as a block.[13]

In addition to outright redistribution of voting rights, some companies have voting procedures that place practical obstacles in the way of shareholders who wish to vote. In the past, many companies had tended to see the AGM as a formal exercise, which was tightly controlled by management. There may have been some possibility for shareholders to be informed by management, but the capability of shareholders to voice their views, query management and directors and participate in decisions was narrowly circumscribed.

The combination of corporate finance patterns (i.e. high levels of debt finance) with ownership concentration and additional devices to shield management from outside pressure resulted in considerable cohesion within the insider group, which was virtually immune from discipline by minority investors. Even if the share price was bid to low levels, as long as the insider group maintained a consensus on appropriate corporate policy, outsiders were powerless. The fact that management could be controlled by a comparatively small identifiable group does not necessarily mean that the insiders were able to formulate and pursue better policies. In the absence of a clearly agreed long-term objective, such as financial returns to shareholders, "insider" companies seem to have considerable difficulties in specifying long-term goals. Since the interests of many stakeholders have to be reconciled, the company may tend to pursue a more diffuse, and possibly conflicting set of goals.[14]

Insider systems exist in several varieties. In some European countries, commercial banks play a leading role, with Germany being the classic example. It is worth emphasising that in these cases the banks are powerful, independent and mostly private institutions. The universal banking system enabled them to dominate all facets of financial intermediation, with the capital market remaining considerably less developed than in other high income countries. The German tradition is for each firm to have a “house bank” which took responsibly for most financial transactions of the company. We have already noted that bank- based systems often rely on confidentiality as information is shared between the bank and its corporate clients, an attitude which to some degree runs counter to that of outsider regimes which requires strong public disclosure.

In addition to holding considerable equity portfolios themselves, banks name representatives to the boards of the companies and are seen as exercising a leadership role in non-financial companies or among groups of companies. They are often seen as representing all shareholders: their power extends beyond direct share ownership, as they hold and vote shares for individual investors.

While Germany has the classic bank-centred system of governance, several other European countries, such as Austria, Switzerland, the Netherlands and the Scandinavian countries also display important features of the former. However, in the Netherlands, Switzerland and some Scandinavian countries, domestic institutional investors are significant and have some voice in corporate governance.

In some countries (e.g. France and Japan), the pattern has been one of interlocking share ownership among groups of financial and non-financial companies. In France, the process of privatisation that began in the mid-1980s posed a problem for the authorities of how corporations would be monitored after having been sold to private investors. Lacking powerful domestic institutional investors and wishing to develop a transitional form of governance, systems of inter-company holdings were elaborated that enabled French industry to maintain some degree of control by those having more stable relationships to the company. These cross holdings were supplemented by shareholder agreements.[15] In Japan the technique of control has been through *keiretsu* structures which brought together groups of industrial and financial companies and customers with suppliers. The Japanese system also had a central role for banks in which the main bank was expected to assume a leadership position within the group.[16]

Numerous national variations on these models can be identified and all systems are undergoing rapid change. In the first place, it is worth mentioning that there have always been a number of systems, which stand somewhere between insider and outsider models. In particular, in the smaller English-speaking countries, such as Australia, Canada and New Zealand, the pattern of ownership is more concentrated than in the US or the UK with family-owned companies often predominating. However, the strong recognition of shareholder rights, institutional ownership of wealth, the tradition of strong legal regulation of securities markets and heavy insistence on transparency in accounting give these systems many points in common with the US and UK. Countries with this kind of system in general have less experience with the phenomenon of activism by major institutional investors as a factor influencing change in corporate governance. On the other hand, they have extensive experience in dealing with the problem of balancing the interests of controlling investors with those of minority investors, particularly through strong systems to promote securities regulation, rules governing transparency and disclosure and strong requirements of independence for board members

The family/state model

The main characteristic of this sub-category of the insider system is the important role of a small number of "founding" families of entrepreneurs in many areas of the economy, on one hand, and the pervasive role of the state on the other.

The founding families and their allies usually exercise control over an extensive network of listed and non-listed companies. They are often shielded from risk by directly holding only a limited number of shares. Most of the rest is held by other corporations in the group or other "friendly" agents. Often, a minority is floated on the local exchange. The families that control the Korean *chaebols* own an average of less than 15% in group companies, the rest of the controlling blocks being held by other affiliates in a complex web of cross shareholdings.[17]

A common characteristic of such systems is that the concept of limited liability, i.e. the separation between the shareholders and the corporation (which has its own decision-making mechanism and assets/liabilities), is weak. In Greece, it was standard practice for the banks to ask for guarantees by the individual family shareholders for the granting of loans. In Korea, one of the most important hidden liabilities within *chaebols* was the cross-guarantees of bank loans between *chaebol* affiliates. As regards corporate governance arrangements as such, all decisions related to the strategy of different affiliates within the group, including the ones that are publicly quoted, are taken by a small group of family-related individuals in an informal way - i.e. outside the governing instances of the corporations (board and general meetings).

Box: Swedish experience

Sweden is an example of a traditionally family-dominated ownership system which through evolution over time now contains elements of both the "market-based" and the "insider" systems. The Swedish stock market is highly liquid and supported by a market-oriented legal framework of company law, securities regulations and disclosure practices. As in many other countries, institutional investors have successively come to dominate the scene with direct private ownership falling from about 70% of the market value in the early 1960s to less than 20% today. Foreign investors hold approximately one-third of the market value. Despite these distinct features of a market-based system, the owners of Swedish companies have generally been able to maintain and exercise considerable influence over corporate affairs. This is partly due to the role of intermediary investment companies. These investment companies are themselves listed joint-stock companies and serve as financial intermediaries undertaking minority investments in a few selected companies, which they actively monitor. The ownership function is also upheld by the system of multiple voting rights which reinforces the role of active owners. By 1992, the largest owner controlled on average 46% of the voting rights in the 62 largest Swedish corporations, and the five largest controlled on average 72%. The regulations regarding voting rights coupled with strong protection of minority shareholders, illustrate the emphasis Swedish authorities have placed on enabling active ownership to be established in Swedish corporations.

Alongside the few large family conglomerates there is often a pervasive influence of the state in the economy, usually a large state sector. The entire infrastructure as well as large parts of heavy industry and the financial system are usually in the hands of the state. This can be seen both as a result and a cause of the rise of family-based conglomeration: on one hand, the state has to be able to counter the concentrated power of these Shumpeterian giants. On the other hand, family-based businesses feel that they have to acquire political weight against such an overwhelming state presence by branching out in as many sectors as possible. There is a premium for sheer size, employment capacity and political voice.

In these systems, outside financing of the firm is overwhelmingly bank-based, as equity and the corporate bond markets are underdeveloped. Hence, the behaviour of the banks as monitors of corporate behaviour is very important. But banks are rarely the solid, independently governed and tightly regulated institutions that have become the norm in most OECD countries. Very often, banking systems are state-centred. In Italy, Greece and Turkey more than 50% of banking assets were under state ownership. Frequently, banks had ownership ties to their main corporate borrowers. In Korea, banks were only nominally privatised in the early 1990s, with control being left largely to the state.[18] Controlling the banking sector is crucial because it is used as a conduit to direct credit to selected sectors or, alternatively, to control the expansion of non-state industry. This credit rationing function has resulted in weak corporate governance of banks, a very low capacity to analyse credit risk and inadequate regulatory supervision of the banking sector. Competition has been kept at bay with strict restrictions or total bans on commercial banking for foreign financial institutions. At the end of the day, banks become either conduits of state subsidies or captives of the family controlled conglomerates.

A common trend in most of these systems has been the persistence of deficient market exit arrangements. High entry barriers, hidden subsidies to the local industry, and (usually indirect) obstacles to foreign direct investment lower contestability; hence, exit becomes less likely. Often the state steps in to either arrange marriages between failing corporations or take over failing firms in order to restructure them. The social safety net that, in most countries, is put in place as a counter weight to labour flexibility is usually weak or non-existent. Last but not least, insolvency legislation is rarely used as a means of reallocation of resources. Most of the time, it remains an antiquated mechanism, punishing debtors without benefiting the creditors.

But the family/state model has also produced some notable benefits, especially at the early stages of development of the relevant economies. The stability of ownership, high degrees of reinvestment of earnings and long-term commitment and firm-specific investment by stakeholders in firms has contributed to high rates of growth. Where the state managed not to be captured by either the interests of the “founding” families or of its own expanding bureaucracy, its presence may have actually encouraged investment and lowered the cost of capital. However, as these economies moved to a higher gear in terms of value added, capital intensity and, ultimately, the need for a knowledge-based economy, they moved away from these arrangements in order to tap into international capital markets. This adjustment has caused some important institutional shocks.

III. The changing role of corporate governance principals

Families, corporations and other blockholders

In the previous part, we briefly examined some stylised versions of ownership and control systems to be found in the OECD area. In some of them, concentrated ownership plays a predominant role in the way enterprises are governed. Controlling owners are the centres of gravity of these systems, high in stability and long-term commitment, but low in flexibility and the capacity to attract outside investment. There seems to be growing evidence that the role of agents we could generically name "blockholders", in both insider and outsider systems, is evolving.

Firms are beginning to address the obstacles to outside investment that cross shareholding arrangements represent. In France, the last few years have seen a systematic trend at unwinding such positions in every sector. From 1993 to 1997, inter-company holdings declined from 59% to less than 20% of total market capitalisation. Core shareholdings, or *noyaux durs*, in French companies declined by almost a third during the last decade.[19] The same wind seems to be blowing in Japan, where the simmering crisis in the financial sector seems to have shaken the foundation of several *keiretsu* and has signalled the beginning of the end (through the unwinding of complex cross-shareholding) for some of them. From 55.8% of total market capitalisation, Japanese cross-shareholdings have come down to 45.7% in 1997, while anecdotal evidence suggests that this trend has accelerated substantially in 1998-1999.[20]

This trend has also been reflected in the tighter regulation of other control devices such as interlocking directorates. Directors in French and Italian publicly-held companies have been subject to much tighter controls in recent years, as regards the number of board seats that they can occupy in different corporations.

Transparency related to ownership patterns (such as consolidated or combined balance sheets) has been the order of the day since the early 1980s in many OECD jurisdictions; the 7th European Company Law directive dates from that time. Better disclosure of business combinations has been one of the less acknowledged yet fundamental causes of the development of equity markets in economies dominated by complicated, obscure ownership arrangements, as the latter made risk assessment by outsiders almost impossible. Intensified disclosure of off-balance sheet transactions (such as debt guarantees or, recently, derivatives) is also becoming the norm in most OECD countries.

The fullest glimpse of the forces of convergence at work can be had by looking at the behaviour of blockholders in some of the countries concerned. In Sweden, the Wallenberg family is restructuring its whole portfolio of holdings with the aim of becoming an arm's length investor with a purely financial perspective and more active in international portfolio diversification. Japan and, since last year, Korea, have allowed the formation of holding companies (previously prohibited) with the goal of rationalisation of equity holding by blockholders. At least in some public pronouncements, some owners of Korean *chaebol* are slowly coming to realise that a shareholder-, rather than firm-driven diversification strategy is better adapted to global, open capital and product markets.

Convergence forces are also working in outsider systems. Alongside the evolution of rules-based governance mechanisms for the established "blue chip" companies, there has been a greater recognition of the possible benefits of continuing involvement by the founders of the firm and the resulting concentrated control patterns. Most of the hugely successful, high tech firms of the latest (mostly 1980s) generation are still closely-controlled, albeit publicly quoted. Private equity, venture capital and other forms of "patient" capital have adapted to this type of ownership and control arrangements. The willingness to accept "close" control arrangements has not been limited to private, closely-held corporations. Exchanges that specialise in newer and more innovative companies, notably NASDAQ with its high share of technology stocks, are often accommodating to closely controlled structures, mainly by recognising multiple voting structures and different classes of common stock.

Management

The corporate governance discussion started along the lines of the Berle and Means paradigm of large corporations with their share ownership dispersed among millions of small shareholders, and effectively run by their management. Management in turn is seen to wield enormous power because of the high monitoring costs and pervasive free rider problems encountered by the shareholders/principals. Effective control by managers allows them to pursue their own opportunistic goals instead of maximising the present value of the firm to its shareholders.

When management succeeds in de-linking its welfare from the interests of the shareholders, the only real means of enforcing accountability to shareholders is through the take-over mechanism. But transparency, technology and institutional ownership are rapidly changing the assumption about exit being the only way for shareholders to deal with a badly managed, broadly-held corporation (see next section). As for transparency, increasing disclosure on how firms generate and use their cash flow as well as so-called forward-looking statements have rendered managerial intentions and strategy more accessible to shareholder scrutiny. Direct disclosure of executive compensation - and a widespread effort to align managerial pay schemes with shareholder interests - has also contributed to higher constraints towards managerial opportunism. Exchanges in the UK and Australia have put forth self-regulatory codes of conduct on executive compensation. Most of these codes provide for a compensation committee headed by independent (i.e. non-insider) board members, accountable directly to the shareholders.

Transparency would be both expensive and meaningless without adequate technology. The amount of disclosure that a firm can easily provide today by using sophisticated computer systems would have been prohibitively expensive but to the largest of firms only a decade ago. On the other hand, the information currently generated by publicly-quoted firms would be largely meaningless if the corresponding software models for processing it were not available. In fact, it is the possibility to understand managerial behaviour through the available information and to offer to shareholders the possibility to vote or otherwise sanction management relatively cheaply that is behind the current trend to exercise shareholder “voice” rather than “exit".

Again, convergence is not only happening at one end of the spectrum. “Insider” countries used to experience low levels of managerial opportunism, due to concentrated ownership patterns. But recent trends in many European economies and in Japan to enhanced performance-based pay might be about to change all that. Managers are increasingly becoming residual claimants. Consequently, their interests are more and more aligned to those of shareholders in seeking to maximise the present value of the firm, rather than pursue objectives that are either purely managerial or are those of other blockholders.

Financial institutions

Market developments are obliging many categories of financial institutions to adapt their governance-related activities. With deregulation and growing international competition, the financial services industry confronts the prospect of consolidation and a requirement to generate profits. In pursuit of this goal, financial institutions are trying to find their optimal size and product mix. In this process of refocusing, corporate governance activities are seen more and more as distracting banks from their primary mission of financial intermediation and credit selection while creating conflicts of interest. Banks increasingly find that they have been expending considerable energies in exercising governance rights over companies. In recognition of this new reality, the two largest German banks have separated their long-term equity holdings into separate companies while the parent banks are no longer expected to focus on financial intermediation; this is possibly a first step to divestiture. Similarly, in

Japan the traditional ties of banks to industrial companies are loosening, as companies go directly to the international capital market for financing while the main banks have been seeking to disentangle themselves from non-financial affiliates in the recent banking restructuring.[21] In many European bank privatisations, the share issue has been accompanied or preceded by the sale of bank equity positions and a tightening of bank balance sheets.

Perhaps the most radical change of all can be found among the institutional investors. In those countries where institutional investors have not been significant, there is a considerable growth, especially in the mutual fund industry which, owing to international competition and deregulation, is expanding rapidly in many countries. With pension reform, a considerable growth in pension funds is also likely to occur, especially in countries that have up to now relied on pay-as-you-go, state pension systems.[22] In countries where institutional investors are already important, they tried to pursue "arms-length" relationships with companies in which they invested and, to defend their interests by selling shares when performance failed to live up to expectations. They could be characterised as "buy and sell" investors or active portfolio managers. A significant part of the institutional investor community, especially the pension funds, now finds this strategy unrealistic. This is because most of the pension fund assets are in portfolios that track indexes, thus limiting the possibilities of exit as regards individual firm shares.

In order to address limited exit possibilities, funds have found it useful to engage in "relationship investing."[23] In the US, the private pension funds have also faced the legal obligation to vote their shares and to make efforts to cast informed votes, thus requiring a certain amount of investor activism. Many public pension funds embarked on investor activism by targeting under-performing companies and seeking to induce the management of these companies to change their behaviour. In the UK, the legal requirements to become active have been less, but the concentration in the funds management industry has been even greater, meaning that exit is now a less realistic strategy than in the past. Additionally, the insurance industry in the UK has adopted an activist position.

A significant share of the institutional investor community has in effect altered its traditional "outsider" approach to investment. In some stylised sense, one could say that in the past fragmented investors each studied carefully the reports issued by companies and occasionally voted at annual general meetings while contact with management was to be scrupulously avoided since it carried the risk of conferring insider status, the main defence being to sell the shares of under-performing companies. Today, by contrast, investors have a far wider range of weapons in their arsenal. They have formed associations to share information and communicate with management and occasionally to urge management to change its behaviour radically. An entire industry has emerged to support the activist investor community, by producing and sharing company information and by forming groups to advocate changes in law and regulation, to define and to advocate better corporate governance practices and to highlight needed changes in practice on the part of corporations.[24]

Not all investors have adopted a strong activist stance. The mutual fund industry, one of the fastest growing sectors of the financial services industry, is generally far less committed to activism than the pension fund industry. This partly reflects the fact that the mutual funds must differentiate their products by applying their skills in assembling portfolios that are different from those of competitors and must demonstrate their portfolio management skill; they thus do not emulate but try to beat indexes. On balance, this sector is more likely to continue to pursue "buy and sell strategies". Nevertheless, while on average the mutual fund industry is less committed to activism than the pension fund industry, the trend among all mutual funds is to engage in some forms of activism, particularly by voting their shares. It is worth noting that some activist mutual funds have emerged.

In summary, banks in the insider systems are increasingly taking on many characteristics of the market-based outsider system. Meanwhile, the outsider system is evolving considerably, as a significant share of the investor community has moved a considerable distance from the traditional "arm's length" relationship in favour of more diverse ways of "relationship investing" and more active interaction with corporate management.

The state

In the post World War II years, the state assumed an important role in the economy of most OECD Member states as a regulator and (with the exception of the US) as an important owner of productive assets in the economy. This role has been radically redefined in recent years through the twin processes of deregulation and privatisation.[25] The reasons for a bigger state were multiple: they had a strategic and political economy dimension in the context of the cold war; the need to address income inequality in earlier forms of unbridled capitalism; concerns with consumer welfare, as natural monopolies were deemed hard to contain under simple competition rules; and financial considerations in a world where large capital flows were mostly state-related and the vast sums of capital needed to finance infrastructure investment could only be supplied with the direct participation of the state.

It is not within the limits of this paper to analyse the enormous changes that occurred in all of the above fields to generate privatisation, deregulation and commercialisation. We should nevertheless delve briefly upon certain corporate governance aspects of this equation. Privatisation was largely a response to enormous flaws in the corporate governance of state-owned enterprises (SOEs).[26] In most OECD countries, the process of decision making, appointment and firing of the directors and managers, and setting of objectives were largely politicised.[27] Economic efficiency receded into the background as the short-term interests of political agents became the principal motivation behind corporate strategy. Even in the few OECD countries (like France, for example) where an economically sophisticated bureaucracy and highly specialised and educated class of SOE managers emerged, the accountability problem did not go away: SOE corporate governance has been likened to a series of agents without principals.

Widespread state ownership in the economy resulted on the blurring of the lines between the legitimate public interest in the way certain goods and services (especially infrastructure and utility services) are supplied to the population and the commercial character of the production of such goods; firms found themselves following conflicting incentives; neither the public interest nor the commercial objectives were met.

In answer to the above shortcomings, OECD Member countries undertook an enormous privatisation effort. While privatisation in these countries as a whole gave proceeds of no more than US$ 20 billion in 1990, by 1997, this figure had increased to more than US$ 100 billion. The global figure (i.e. including non-OECD Members) for privatisation in 1997 was US$ 153 billion.[28]

Privatisation has resulted in one of the most swift and dramatic changes of context for utilities and infrastructure industries. Intense global competition between large multinational companies (both in terms of operations, control and ownership) with deep roots in the capital markets, has replaced a landscape of national, over-regulated monopolies in fragmented markets, financed primarily through budgetary sources - mostly, deficits.

Evidence on privatisation experience to date has consistently shown that a change in ownership has considerably improved performance at the firm level, i.e. in terms of both productive efficiency and profitability.[29] This is largely the result of vast improvements in corporate governance. In terms of financial objectives, such as fostering the development or further expansion of equity markets, privatisation has also been a great success. Countries like Italy, Spain and Portugal have seen the capitalisation of their stock markets more than quadruple as a result of privatisation in recent years.

Hence, privatisation has created the conditions for a profound change in the terms which shape the corporate governance environment.

Commercialisation of corporate governance of SOEs is a twin development to privatisation in many countries, including France, New Zealand and most of the Nordic countries. While some firms were kept in the public sector for a number of different - mostly, political - reasons, important reforms took place in the way these firms are governed. A clear regulatory and institutional separation between public interest and commercial objectives took place. The state as owner (and the treasury-type institutions that were mandated to pursue these interests) concentrated on maximising shareholder value; this task was facilitated by the partial floatation of companies, which, among other things, gave them a market value. Public interest and consumer welfare objectives (i.e. public policy issues) were assigned to different institutions. This has helped to clarify objectives and contributed to SOEs coming closer to private commercial firms, in terms of corporate governance.[30]

Employees and other stakeholders

By stakeholders the corporate governance literature has come to refer to a host of different interest groups intimately linked to the development of a corporation other than its management, its board and its shareholders; we have already discussed the role of the banks. We will now discuss briefly the role of the employees and also allude to other interests that in some cases have laid a claim as corporate governance principals, such as main suppliers or communities.

Many, but by no means all, of the "insider" countries have long recognised the importance of stakeholders in their corporate governance systems, in various ways. Germany, Netherlands, Belgium and Austria provide for minority seats in their supervisory boards[31] for employee representatives. In Japan, the supply chain is intimately linked through cross shareholdings, the backbone of the *keiretsu* system. In the US, employees are the beneficiaries of Employee Stock Ownership Plans (ESOPs), which might wield considerable corporate power and in some cases even control the corporations.

There are two issues here and they are often confused. One is whether employees can be viewed as something more than salaried labour from a governance perspective: the answer is yes, at least in many cases. Employees in OECD countries, where the economy is more and more knowledge-based and centred on the production of higher added value, are seen as making firm-specific investments that actually complement monetary investments by shareholders. The same can be said of long-term suppliers - especially exclusive ones, franchisees and communities that play host to one firm/factory.[32]

On the other hand, the concept of firm-specific investment should not be confused with that of incomplete, uneven or unfair labour contracts: for example, the fact that labour is affected in a more direct way by certain corporate decisions and its inability to contract these away is recognised and protected by states in the form of a default or mandatory "contractual" mechanism - labour law.

The second issue is how to address the reward of those investments. Most (if not all) corporate law systems recognise that the reward of investment (monetary, in-kind, firm-specific or other) is participation in the residual gains of the firm. This residual reward is present in the case of the *keiretsu* and the US/UK ESOPs. In fact, high firm-specificity of employee contributions is directly reflected in the relatively high share ownership by employees in the US high tech/software industry. On the other hand, there is little specificity in employee contributions in older, smokestack industries.

Direct (i.e. devoid of ownership) control rights, such as co-determination in Germany and other countries, do not seem to address the firm-specificity issue as they do not discriminate between industries or the nature of employment. Most commentators seem to agree that there are specific social/historical reasons for co-determination.[33] These reasons are illustrated by a strong history of "public interest" and often heavy state control of corporate chartering in Germany[34]. One consideration, pointed out by Hopt (1998) is that in the hitherto dominant model of corporate governance in Germany, co-determination may have "…fulfilled a consensus building function between capital and labour". But as capital becomes less and less bank-sourced and more market-based, co-determination may hinder adequate representation of these "new" capital providers.[35]

IV. The main causes of convergence

The globalisation of markets

Clearly, one force driving the convergence of corporate governance systems is the growing integration of financial markets. Investors in most countries increasingly accept the proposition that holding an international equity portfolio leads to higher returns and lower risk than a purely domestic portfolio. As a result, many pension funds now allocate a certain portion of their portfolios to international equities while a large number of specialised mutual funds have been developed to allow individuals to participate in foreign equity investment. As of now, this phenomenon of international diversification is mostly visible in countries which already have strong institutional investor communities, but as other countries succeed in developing institutional saving, one would expect it to be generalised.

At the same time, non-financial companies realise that broadening the investor base will lower their cost of capital and may also lessen volatility in the price of the company's stock. The desire of non-financial companies to attract international investors is manifested in several ways. Many companies are seeking to be listed in overseas markets. Special international tranches of public offering are frequently targeted to overseas investors. Facilities such as depository receipts have been developed to facilitate foreign investment.

The decision to rely on the public equity markets automatically increases the importance of institutional and foreign shareholders thus obliging management to give more consideration to the values of the new owners. The pattern of privatisation, high equity issuance and loosening of traditional inter-company ties has led to some remarkable changes in the equity ownership in some countries. In France, the combined share of foreign shareholders and financial institutions (banks and institutional investors) rose from 27% in 1993 to 55% in 1997 while in Sweden those two sectors rose from 34% to 64% of total equity holdings during the same period.[36]

The growing wish of both investors and issuers to operate in the international capital market requires some degree of acceptance of common values and standards. Institutional shareholders have brought with them expectations about shareholder value and are requiring firms to establish profit targets and to produce competitive returns on equity. Institutional investors also insist that companies respect international norms of governance, particularly concerning the duties of management and controlling shareholders to respect demands of minority investors concerning transparency and the procedures for exercising corporate control, especially at the shareholders meeting. Thus, in addition to the legal and institutional changes which are occurring in their home countries, companies are forced to adapt their behaviour in order to be able to tap global capital markets. Another big change that is favouring international convergence in corporate governance norms is the globalisation of product markets. Although trade liberalisation clearly predates financial market globalisation, its impact on corporate governance has not always been discernible.

There seem to be two powerful incentives for better corporate governance connected with the globalisation of product markets as well as with domestic deregulation. The first one is linked to the proposition that in a monopolistic environment there is less of an incentive to promote better corporate governance. A monopolist may be under less pressure to produce profit than a competitive firm and, in any case, will have greater capability to attain profit without basic adaptations of corporate strategy due to relatively weak competitive pressures. Hence monopolists may be more likely to retain older patterns of corporate organisation, cost and financial structures. But openness to competition makes it hard to retain old patterns. As competition intensifies, companies soon realise that there is a whole "corporate governance technology" that needs to be imported in order for production to become more efficient. This might include the way stakeholders (for example, employees and suppliers) interact with the firm; the ways in which corporate finance (and the resulting governance rights) is intimately linked with innovation and research and development; and that, ultimately, higher productivity and the resulting competitive advantages might partly depend on the way decisions are made and strategies are developed in industrial corporations.

An example of the impact of product market globalisation on governance patterns might be found in the changing role and diminishing importance of firm-specific suppliers. Globalisation coupled with the communications revolution allows even smaller enterprises to locate suppliers easily in remote parts of the world. This directly impacts on the need to develop close ownership or control links with hitherto long-term suppliers. Firms in many countries (for example the members of Japanese *keiretsu*) find it more beneficial to divest their stakes in suppliers (or major customers) and concentrate on providing more returns to their shareholders.

Market-driven or functional convergence[37] may be the most important force behind the emergence of international principles and their perceived need, such as the OECD Principles of Corporate Governance. The Principles are the first multilateral instrument in the area of corporate governance and the most important attempt at establishing elements of a global corporate governance language which reflect this functional convergence. Their preamble, however, suggests that a systemic convergence of legal systems is not part of their direct objectives:

"The (Principles') purpose is to serve as a reference point. They can be used by policy makers as they develop their legal and regulatory frameworks for corporate governance that reflect their own economic, social, legal and cultural circumstances, and by market participants as they develop their own practices".[38]

Path dependency and the politics of governance

The political and historical reasons for national idiosyncrasies have been the topic of many discussions among scholars. Some[39] have argued that history has sowed considerable divergence into national systems which are "path-dependent" and, hence, unlikely to converge at least in the medium-term, notwithstanding pressures from the capital markets. In other words, the dynamics of history should not be taken lightly when it comes to the shape of legal norms and institutions.

While political and institutional resistance to alien concepts, irrespective of their perceived efficiency, is a considerable constraint to convergence[40], these factors should not be overestimated in OECD countries, especially in our post-cold war, Internet era. Citizens are increasingly open to foreign ideas, customs and norms. The acquisition of major industrial companies (for example, Chrysler by Daimler Benz) or financial institutions (see the fate of the quasi totality of the British merchant banks) by foreign competitors does not seem to have caused any political problems. Shareholder activism *a l'americaine* seems to be paying well in so staunchly a continental corporate governance environment as Switzerland's; and recently a company which only two years ago was a state-owned telecom monopoly was subject to a highly contested hostile take-over bid in Italy.

There is also top-down convergence. The increasing exposure of policy makers to regional and global policy fora and the importance of these instances in shaping leaders' minds about reforms is more intense today than it was just a decade ago. European integration has made possible the implementation of a number of policies - such as widespread privatisation - that were hitherto politically unthinkable. The ready availability of other countries' experience and the wish to be part of an open world has made a lot of changes possible. Korea is a case in point: previous governments would have thought of selling two of Korea's largest commercial banks to foreigners within the same month as nothing short of political suicide. Finally, the fact that a group of government officials negotiated a "universal" text such as the OECD Principles speaks volumes about the political trends of convergence that are developing.

Legal convergence

Finally, there is the issue of laws and regulations. Legal infrastructure and its dynamics are included in the path dependency argument as they are an important part of the institutional apparatus, but it might make practical sense to look at them separately from the rest of political and social institutions. Widely differing systems of corporate law and securities regulation have been credited with an important role in explaining divergences between national ownership and control environments. Some commentators have made a distinction between common law and civil law countries and have analysed the impact of the two systems on governance. Under common law, the firm can contract out of most legal norms. In contrast, civil law, with its more rigid statutory rights, is perceived as less flexible in terms of economic decision making.[41]

Company law itself comes in many different shapes. The central concept of limited liability may be treated differently in different jurisdictions. In some countries, the "firewall" between a corporation and its shareholders is impenetrable, but for the worst kind of abuse. Others take a less austere view. In Germany, group legislation allows for piercing the corporate veil in situations where one firm in practice assumes decision-making functions of another.[42]

In the Anglo-Saxon tradition, the corporate concept is based on a fiduciary relationship between shareholders and the managers. In the continental tradition, the company has an independent will, i.e. in theory, what is good for the corporations might not be good for its shareholders. These differences might be traced down to company law particulars such as shareholder rights, the role of and changes in statutory capital and the responsibility of the board, just to mention a few.

However, these differences might not be as important as they look and they might be getting less and less important. To be sure, all countries recognise the preponderance of owners as the final arbiters of corporate strategy and make the concept of residuality central to the governance structure of the corporation. Secondly, the increasing importance of equity markets have subject the largest segment of the corporate sector to securities regulation - statutory law that firms cannot contract out of and that is fairly similar (although not at all identical) in common and civil law countries[43].

It seems that corporate governance-related legislation has been converging over the past few years. Recent German legislation[44] has substantially tilted the control of the decision making process toward shareholders and has increased transparency in the way accounts are prepared, especially as regards consolidation; it has also made important steps in facilitating take-overs. In France, the 1997 Marini Report on company law reform, recognised the need for a "contractualisation" of French company law, by allowing firms more liberties in the way they shape their financial structures. In Italy, the so-called "Draghi" law of 1997, significantly increased shareholder rights. In all of the above countries share buy-backs were allowed, in recognition to the fact that companies need more flexible tools to return money to their shareholders. At the other side of the spectrum, the US Securities and Exchange

Commission is becoming more tolerant of “relationship” investors and is more and more willing to grant so-called “safe harbours” for consultations between them and company management.

Finally, convergence is also the result of an increasing tendency of large firms to “choose” their regulatory environment. This, of course, is not due to legal eclecticism but rather to the need to tap the most liquid and cheap sources of capital. By choosing, for example to float their shares in the NYSE, large companies from a growing number of jurisdictions become subject to US securities rules and accounting norms. This will in time have a powerful impact on the shape of rules and institutions in their home countries. In a sense it is a “bottom up” convergence of legal and institutional norms.[45]

V. Conclusions

We have seen from the above discussion that convergence is indeed taking place for reasons related to the globalisation of financial and product markets, an increasing proximity of legal and institutional norms and a more open environment to ideas from outside the OECD area. Having said this, one should not expect uniform corporate governance institutions and arrangements in the world, just as one cannot expect the end of nation states in the foreseeable future. Ownership and control arrangements are still a part of a society’s core characteristics and will remain to a considerable degree idiosyncratic.

More cross-border equity investment and the growth of domestic and international institutions should be expected to result in a better mutual understanding between overseas investors and companies and consequently in an increased capacity for companies to access international sources of finance.

Access to finance is one driving source of convergence. The need to align risk and control rights is another. Accountability of managers to all their shareholders and their capacity to act for the good of the corporations, not their own or that of a particular set of blockholders, is also becoming a central concern in this respect. Most importantly, investors need to understand and assess their investments. Convergence in transparency and useful disclosure norms is therefore a key area where a lot needs to be done.

The OECD Principles of Corporate Governance are both a result and a facilitator of convergence. Without the latter, the need for a common language between the 29 Member states of the OECD and beyond would not have emerged. The multilateral character of this instrument testifies to the strong consensus emerging for the need of a common understanding on these issues. On the other hand, the open-ended and non-prescriptive character of the OECD Principles makes them a very valuable tool for the development of international dialogue for the promotion of better corporate governance. As this article has demonstrated, the variety of corporate governance arrangements found among OECD countries gives the Principles a universal character that transcends the developed/developing demarcation line.

Convergence does not mean victory of one system over the others. It should rather be seen as giving more choices to the enterprises when it comes to selecting a corporate finance and governance pattern. In fact, the patterns of ownership and control should ultimately correspond more to the needs and characteristics of a particular enterprise than to the “system” prevalent in the country. Last but not least, firms should have the possibility to move smoothly from one regime to another as they grow and their needs and constituencies change.

NOTES

1 A substantial amount of literature has focused on the relationship between governance and performance. Findings are often contradictory, which may be largely due to insufficient data. Millstein and Mac Avoy (1997) find that good governance at board level has a non-trivial impact on share prices. In a survey of the literature, Patterson (1998) finds little qualitative evidence to either prove or disprove such a link.

2 See Black and Kraakman 1996 and Black 1999.

3 Gilson (1998) looks at convergence in terms of function (when existing governance institutions are responsive to change without a change in the rules), formality (when the legislative framework is adapted) and contractual (when companies have to adapt contractually as domestic institutions are not flexible enough to accommodate change and political obstacles will not formal convergence). We use the term convergence in a more generic fashion, which encompasses all of these three aspects.

4 See OECD 1996.

5 See La Porta et al 1997.

6 See Fox 1998.

7 See Berle and Means 1933, and Dodds 1932.

8 See Porter 1992.

9 La Porta et al 1998.

10 OECD 1997.

11 Reflecting the reliance of bank finance, Schmidt (1998) also notes that "accounting and disclosure in Germany is not primarily aimed at...investors but...the protection of creditors...".

12 Pinto and Visentini (1998) provide for a fairly thorough review of such arrangements in their country reviews.

13 See Fukao 1995.

14 See Roe 1998.

15 See Morin 1998.

16 See Kanda 1998.

17 See OECD 1998.

18 Thompson 1999.

19 See Loulmet and Morin 1999.

20 See Yasui 1999.

21 See Yasui 1999.

22 See OECD 1998b.

23 For a description of what a large institution wants to see in a company in which it invests and the kind of relationship it wants to develop with it over time, see Clapman 1998, who describes the corporate governance policy of the largest US pension fund, TIAA-CREF.

24 See Latham 1998 and Gilson-Kraakman 1993.

25 See Nestor and Mahboobi 1999.

26 See Estrin 1998.

27 See Boycko et al 1996.

28 See OECD 1999c.

29 See, among others, Megginson et al 1994.

30 See Nestor and Mahboobi 1999.

31 In two-tier board systems, the supervisory board is responsible for hiring and overseeing the management board. The latter is actually running the day-to-day business of the corporation.

32 See Blair and Stout 1997.

33 See Hopt 1998, Pistor 1996 and Roe 1998.

34 Pistor (1998) argues convincingly that co-determination was "purely" political. Corporate governance considerations were viewed as externalities by its designers.

35 Roe 1998.

36 See Morin and Loulmet 1999 and xxx.

37 See Gilson 1998.

38 OECD 1999.

39 Bebchuk and Roe 1998.

40 See Charny 1998.

41 See La Porta et al 1997.

42 See Hadden 1983.

43 Coffee (1998) points out that "... convergence can occur (and is arriving) at the level of securities regulation, even while corporate law convergence has been largely frustrated".

44 Kon Trag 1998.

45 See Coffee 1998.

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LATEST DIRECTIONS IN CORPORATE GOVERNANCE

by
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I. Introduction

The most recent World Competitiveness Yearbook produced by the IMD Business School in Switzerland shows that Australia is now ranked 15th in world terms. We dropped from 14th in 1995 to 21st in 1996 and then pulled back to 18th last year. The most recent figure shows that we have made some fairly rapid progress over the last 3 years.

It is interesting to compare our position with New Zealand who shot up to 8th in 1995 but rapidly deteriorated to 13th this year as their reform process stalled. The other noteworthy comparison is Japan which has deteriorated from 9th position last year to 18th in the latest data.

It may seem surprising to commence a discussion on corporate governance by looking at the competitive rankings of economies. But this ranking must be one of our primary concerns, for in the contemporary debate over national direction and the appropriate balance between economic and social imperatives, the one fact that is frequently overlooked is that all of the desirable objectives to which we aspire such as high quality health, education, welfare, improved environment and social cohesion, are entirely dependent on our ability to create employment and wealth. This in turn is determined by our competitive positioning in the world. Corporate governance has to be looked at as one essential contributor to that competitive standing.

This year even more than last, with the global turmoil around us, we need to find ways to improve Australia's positioning in the rankings. The real question is, to what extent can sound governance contribute to this process?

There are three fundamental forces which will drive the Australian economy for the foreseeable future: liberalisation, globalisation and technology. Notwithstanding the current political debate, our success or failure in the future, as a community, will be entirely dependent upon our ability to identify the opportunities these forces have unleashed and turn them to our advantage. This is true in the arena of corporate and investor performance more than any other part of the economy. It requires a preparedness to proactively encourage change, to experiment and, whilst maintaining standards, to adopt a flexible approach in everything we do. It also implies far greater volatility in corporate performance than we have previously experienced.

One manifestation of these global forces has been a major shift in the balance of power between public corporations and their owners. Historically, as the limited liability company grew in size and

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ownership became more diffuse, greater power accrued to the board of directors as the representative of the shareholders. Through most of the post-war period, public company shareholders rarely exercised voting power in a co-ordinated sense. This is now changing dramatically.

The key driver in this power transition is the financing of retirement. The world's population is ageing rapidly in both industrial and developing countries. Only a few countries have well-funded private pension programmes.

Two-thirds of all people who have ever lived to the age of 65 are alive today. With birth rates falling and life expectancy increasing, the ratio of retired to working people will rise dramatically. The challenge is to develop effective retirement funding for the elderly which does not undermine private savings and investment through crippling levels of taxation on the young.

This is one of the major factors transforming the US economy at present, particularly the move from *defined benefit* pension plans, controlled by companies, to *defined contribution* pension plans controlled by individuals.

In the US and UK, pension funds have become key drivers in the search for improved corporate performance in seeking higher returns on capital for their shareholders. Similarly, small shareholder representative groups have become significant contributors to the debate. By contrast, in Japan and continental Europe, pension funds thus far have played a less influential role in corporate governance, with management often focused on other goals such as maximising the growth of sales or assets irrespective of the impact on profits.

As countries are faced with the necessity of re-organising retirement funding, the immediate impact on global corporate governance is a convergence of corporate goals on maximising shareholder value rather than more diverse objectives.

The drive for performance is most advanced in the US with the UK moving rapidly in the same direction. However, recent research (e.g. 1998 International Survey of Institutional Investors, conducted for Russell Reynolds Associates) suggests that Australian institutions, by contrast, tend to favour better conformance over better performance.

The rapid expansion in the global share owning population will have far-reaching implications not just for governance but also for societal attitudes toward reform, performance and political structures as the importance of the global competitive positioning of an economy becomes increasingly obvious to a wider cross-section of the community.

In both the US and UK relationships between institutional investors and corporations, whilst confrontational in the late 1980s and early 1990s, have become more positive and creative. Shareholder activism is seen as a major force in improving corporate performance.

A wide range of corporate governance guidelines were published in the early 1990s largely in response to the abuses of the 1980s. These included the Bosch Report, the AIMA Guidelines and "Strictly Boardroom" in Australia, the Cadbury and Greenbury Reports in the UK and many US publications.

More recently, numerous sets of corporate governance principles have been published. For example:

- CalPERS - Global Corporate Governance Principles (1996)

- Market Specific Principles - UK & France (1997)

- Market Specific Principles - Japan & Germany (1998)
- Core Principles & Guidelines - US (April 1998)
- TIAA-CREF - Policy Statement on Corporate Governance (September 1997)
- Business Roundtable - Statement on Corporate Governance (September 1997)
- Hampel Report on Corporate Governance - UK (January 1998)
- OECD Principles of Corporate Governance (May 1999)

Corporate governance is well established as a global issue. Whilst governance standards differ between markets internationally, on matters of principle they are converging, driven on the one hand by the institutional investor pressure for market transparency and investment performance, and on the other by the corporate search for access to competitive sources of funds. Undoubtedly this process will be accelerated by the current Asian financial crisis.

It is encouraging that much of the recent literature is focuses on the need for the adoption of non-prescriptive self-regulatory governance principles to promote improved performance, unlike earlier material which emphasised prescriptive, regulatory solutions.

Governance has moved from a *'trust me'* to a *'show me'* environment. Increasingly corporations will have to examine their wider corporate responsibilities in relation to issues such as:

- human rights;
- environment sustainability; and
- globalisation and consistent standards.

Internationally the debate had moved beyond the traditional shareholder versus stakeholder argument, to one of reviewing value systems and corporate legitimacy in a wider performance and risk context, driven increasingly by customer attitudes.

This arises from a pragmatic concern for corporate performance and risk if these issues are not addressed, as well as a debate on broader societal and corporate values (e.g. human rights implications of operating in developing countries, risks of continuing investment in fossil fuel industries, etc.).

Notwithstanding the convergence toward non-prescriptive, self-regulatory governance principles, there is relatively little discussion on measures to improve corporate *performance*. Most of the debate still concentrates on the *conformance* aspects of governance.

This is unfortunate given the global forces now at work. It raises the issue of initiatives Australia should take to gain competitive advantage in the performance arena.

II. Traditional perspectives

In Australia governance issues are being debated between some boards and investors with a degree of angst. This may be inevitable given the relatively poor performance of a number of larger Australian companies in recent time. Traditional attitudes can be characterised at the extreme by*:*

Investors taking the view that

- boards are often "clubby", arrogant and generally unresponsive to the need for transparency and performance; and
- such attitudes will only change if forced by prescriptive legislation.

Boards taking the view that

- their hands are tied by excessive legislation and compliance obligations;
- investors have little idea of the complexities of running a modern-day business;
- investors are driven by short-term criteria and have little interest in encouraging long-term performance; and
- fund managers also are driven by short-term performance targets and remuneration structures.

Clearly, between these extremes, much sensible communication and co-operation are taking place between investors, directors and regulators toward the common goal of improved performance

Unfortunately it is the extreme positions which often influence the governance agenda disproportionately. For example, some recent debate on governance seems to imply that the objective of legislation is to eliminate investor risk. In reality the success of the market economy is totally dependent on the ability of companies to undertake, and profit from, prudent risk taking. Mechanisms which constrain the risk taking ability of the corporate sector will only serve to further undermine international competitiveness and the well-being of the community overall.

There have also been implications that a more prescriptive governance environment would eliminate corporate malpractice. Regrettably there will always be a minority who choose to abuse the system, and whilst sound corporate governance should expose such practices more rapidly, it will never totally prevent them. Prescriptive arrangements can also be ignored.

Australia in particular has to guard against any reversion to a prescriptive approach. Notwithstanding recent reforms, we continue to be vastly over-governed and to operate in one of the most rigid and prescriptive legislative structures in the world. Many of the more deep-seated and intransigent rigidities of the Australian economy stem from this prescriptive history. Our traditional adversarial industrial relations system is a case in point, where an overly prescriptive approach resulted in boards of directors, managers, workforces and unions abdicating their responsibilities as the prescriptive boxes were ticked; the responsibility for performance was passed on to third parties through the industrial courts. Mediocrity and under-performance were the results, the most recent manifestation, sadly, being the waterfront dispute.

These mistakes must not reoccur in the governance arena. Good governance is a competitive advantage as much for the nation as for the individual company and will become more so as the globalisation of world markets continues.

III. A dynamic governance model

In the rush to establish global governance standards, it is a concern that corporate governance is seen as an end in itself rather than one component, albeit an essential one, in the totality which goes to make up a company's and a nation's economic performance. When viewed from this limited perspective, it takes little for the governance debate to stray back into the prescriptive arena.

The primary objective of sound corporate governance must be to contribute to improved corporate performance, to the integrity of financial markets and hence to the international competitiveness of an economy, all of which must be judged against the criteria of wealth and employment creation. Sound corporate governance is a necessary but not sufficient condition to achieving world-class performance. The economic settings of the economy, along with cultural and behavioural attitudes of shareowners, directors, management and workforce, and institutional arrangements, are equally if not more important.

World-class corporate governance standards will be to no avail if the strategic direction of the company is wrong, if strategy implementation by management is poor, if the quality of its directors is inadequate, or if institutional structures in the economy restrain, rather than encourage, performance.

The solution is not prescription, but rather an enabling system which encourages prudent risk taking and corporate performance. Such a system requires strong regulators able to act swiftly and effectively against those who transgress but does not impose an onerous legislative burden on the honest business people who make up the overwhelming majority of the corporate sector. It should be based around sound principles rather than *black letter* law, where regulators *tread lightly but carry a big stick*.

If we are to successfully move down a non-prescriptive self-regulatory path in the search for international competitiveness a *dynamic governance* model is required. Four requirements stand out:

Building trust

The level of trust between directors, investors, regulators and the community must be significantly improved. Trust requires transparency, built around sensible communication and realistic disclosure. Innovative Australian companies already make disclosure beyond the legal minimum; it is far better that disclosure is based on a judgement of market needs rather than prescriptive box-ticking. Corporate laggards on relevant disclosure will find it increasingly costly. On the other hand, excessive disclosure for its own sake, which increases the compliance cost but does not contribute to improved understanding of the business, should be resisted.

Earning freedom from excessive regulation

Directors and investors alike have to demonstrate continually that they justify public confidence in the self-regulatory approach. Unfortunately, as recent examples demonstrate only too well, the misdemeanours of a few can rapidly bring down the wrath of the public on the many in the form of heavy-handed government intervention.

The business and investment communities should both strive for a mature self-regulatory approach which minimises the swings of this regulatory pendulum. In short, *the price of freedom is eternal vigilance*.

Investor performance

Undoubtedly shareowner activism will continue to increase and should be seen positively as an essential driver of company performance and of the self-regulatory process.

However, whilst most attention recently has focused on boards and management, investors, particularly the institutions, must play a wider performance role and be subject to the same governance criteria. In particular, they must make considered use of their votes, as part of the competitive mechanism to give feedback on company and director performance, and also adopt a broader, more mature, perspective in encouraging long-term performance.

Flexibility in governance

There is no proof that any one model of corporate governance leads to optimum performance. Indeed to make such an assumption would be foolish in the extreme given the diversities of companies, industries and maturity levels.

Flexibility in governance must be encouraged, recognising that the appropriate governance model will vary not only between companies but also over time for any individual company. This is particularly so given the speed with which new companies are forming and the fundamental changes to corporate structures being wrought by new technologies and globalisation.

Thus companies must take upon themselves the responsibility for adopting governance practices best suited to their circumstances. Each company must decide which governance practices are relevant to investor decision-making and make disclosure accordingly. The market will judge each approach as it sees fit.

The development of corporate governance principles has been beneficial in focusing attention on the need for change. The priority now should be on the flexible application of those principles to assist performance, rather than on further refinement of principles for its own sake.

Overall, corporate governance must be seen in context. It is not an end in itself but one important element in the mosaic which goes to make up international competitiveness. Clearly whilst we must meet minimum international standards, we should be using our corporate governance performance to gain global competitive advantage. Rather than slavishly following international practice, we should be seeking governance innovations to this end.

We need strong boards, strong managements and strong investors working with a creative tension to achieve world-class performance. In the final analysis, corporate governance is about establishing a structure within which creativity can flourish. As part of that process there is a need for a broader strategic alliance between shareowners, boards and managements to further align their respective interests and accelerate reform across the economy, not only in the arena of corporate governance.

IV. Performance improvement

In seeking to improve Australian corporate performance, and the attractiveness of Australia for global investment, the following factors are essential:

Boards should:

- recognise the changing relationship between directors and shareowners as a positive contributor to enhanced performance;
- move their corporate governance emphasis from a conformance mind-set to a balance between conformance and performance;
- be structured to ensure directors contribute significant strategic perspectives, both domestic and international, to assist in determining corporate direction;
- accept the need for transparency and disclosure within the constraints of genuine commercial confidentiality;
- recognise the need for open and timely communication to shareholders and other stakeholders; and
- be proactive rather than reactive in their contribution to corporate performance.

Investors should:

- encourage flexible, non-prescriptive governance structures;
- take an active and constructive role in voting their shares and in working with boards of directors;
- recognise the need for a longer term perspective in making investment decisions;
- recognise that corporate performance will often be increasingly volatile in a rapidly changing global environment;
- seek disclosure of matters designed to improve genuine understanding of the business rather than disclosure for its own sake; and
- implement sound corporate governance within their own corporate structures.

Regulators and legislators should:

- test all regulatory and legislative initiatives against the need to encourage prudent risk-taking and corporate performance whilst ensuring the integrity of markets and corporate activity;
- act swiftly and effectively against transgressors; and
- continually seek to streamline legislation and regulation and to minimise compliance costs.

All parties should:

- co-operate to maximise the international competitiveness of the Australian economy, recognising that, notwithstanding recent improvements, the Australian corporate environment still has one of the most rigid and prescriptive legislative structures in the world. This is a major competitive disadvantage in a rapidly globalising world;
- focus on the need for a more cohesive and concerted effort to achieve fundamental reform throughout the economy, including:

- ∗ corporate law, OH&S, environment and trade practices legislation;
- ∗ tax and accounting;
- ∗ microeconomic reform;
- ∗ harmonisation with global standards where this brings competitive advantage; and

– be prepared to devote substantial resources to educating the community on the need for such change.

These efforts should be proactive rather than reactive in seeking to position Australia at the leading edge of competitive economies globally. Improvement in the above areas will do far more to enhance performance than excessive refinement of corporate governance guidelines in isolation.

V. Examples of recent corporate governance initiatives

United States

CalPERS

In 1996 CalPERS (the California Public Employees Retirement System, with assets in excess of US$110 billion), in the light of its increasing international investments, published a statement of *Global Corporate Governance Principles* which it regards as the minimum standard that markets throughout the world should meet to attract CalPERS funds.

CalPERS recognised that individual markets vary worldwide and moved on to publish separate market-specific principles for the UK and France last year, and principles for Germany and Japan earlier this year.

CalPERS also continues to refine its US governance criteria, publishing a revised statement on *Corporate Governance Core Principles & Guidelines* in April 1998. To quote this document:

> *"What have we learned during these past dozen years? We have learned that (a) company managers want to perform well, in both an absolute sense and as compared to their peers; (b) company managers want to adopt long-term strategies and visions, but often do not feel that their shareowners are patient enough; and (c) all companies - whether governed under a structure of full accountability or not - will inevitably experience both ascents and descents along the path of profitability. We have also learned, and firmly embrace the belief that good corporate governance - that is,* ***accountable governance*** *- means the difference between wallowing for long (and perhaps fatal) periods in the depths of the performance cycle, and responding quickly to correct the corporate course."*

> *"The document that follows is separated into two components:* ***Core Principles*** *and* ***Governance Guidelines****. CalPERS believes the criteria contained in* ***both*** *the Principles and the Guidelines are important* ***considerations*** *for all companies within the US market. However, CalPERS does not expect nor seek that each company will adopt or embrace every aspect of either the Principles or Guidelines. CalPERS recognises that some of these may not be appropriate for every company, due to differing developmental stages, ownership structure, competitive environment, or a myriad of other distinctions. CalPERS also recognises that other approaches may*

equally - or perhaps even better - achieve the desired goal of a fully accountable governance structure. CalPERS has adopted these Principles and Guidelines to advance the corporate governance dialogue by presenting the views of one shareowner, but not to attempt to permanently enshrine those views. As one shareowner, CalPERS believes that the ***Core Principles*** *represent the foundation for accountability between a corporation's management and its owners. The* ***Guidelines*** *represent, in CalPERS' view, additional features that may further advance this relationship of accountability."*

The Business Roundtable

The Business Roundtable (BRT), representing around 250 CEOs of the largest US corporations, released a revised *Statement on Corporate Governance* in September 1997. According to *Business Week* magazine "the biggest news in the Roundtable's report may be that once radical ideas about corporate governance are now firmly in the mainstream".

The BRT approach parallels that set out in the report on Director Professionalism, published by the National Association of Corporate Directors (NACD) in 1996, in stating that in corporate governance, no "one size fits all", and ultimate governance decisions must be left to each board and its unique circumstances.

Both the NACD and BRT acknowledge that, whilst details are important and board guidelines are useful, in the final analysis the substance of board performance is more important than the form, and substance depends on the quality and independence of the directors themselves.

United Kingdom

Hampel Report

In the UK the Hampel Committee on Corporate Governance was established in November 1995 to review the implementation of the findings of the 1992 Cadbury Committee on the Financial Aspects of Corporate Governance and 1995 Greenbury Committee on Director Remuneration.

The final report, published in January 1998, emphasised that the importance of corporate governance lies in its contribution both to business prosperity and to accountability. In the UK the latter has preoccupied much public debate over the past few years. The balance should be corrected.

A set of corporate governance principles are proposed, and it is suggested that companies include in their annual reports a narrative account of how they apply these principles, explaining any departures. Those concerned with evaluating governance are called upon to apply the principles flexibly recognising individual company circumstances.

The distinction is drawn between principles of corporate governance and guidelines. With guidelines one asks "How far are they *complied with*?"; with principles the right question is, "How are they *applied* in practice."

This approach represents a significant change from the somewhat prescriptive approaches adopted in the Cadbury and Greenbury Reports and is more akin to the Australian system under the ASX Listing Rules.

The principles are:

Directors

- *The Board.* Every listed company should be headed by an effective board which should lead and control the company.

- *Chairman and CEO.* There are two key tasks at the top of every public company - the running of the board and the executive responsibility for the running of the company's business. There should be a clearly accepted division of responsibilities at the head of the company, which will ensure a balance of power and authority, such that no one individual has unfettered powers of decision. A decision to combine these roles in one individual should be publicly explained.

- *Board balance.* The board should include a balance of executive and non-executive directors (including independent non-executives) such that no individual or small group of individuals can dominate the board's decision taking.

- *Supply of information.* The board should be supplied in a timely manner with information in a form and of a quality appropriate to enable it to discharge its duties.

- *Appointments to the Board.* There should be a formal and transparent procedure for the appointment of new directors to the board.

- *Re-election.* All directors should be required to submit themselves for re-election at regular intervals and at least every three years.

Directors' remuneration

- *The level and make-up of remuneration.* Levels of remuneration should be sufficient to attract and retain the directors needed to run the company successfully. The component parts of executive directors' remuneration should be structured so as to link rewards to corporate and individual performance.

- *Procedure.* Companies should establish a formal and transparent procedure for developing policy on executive remuneration and for fixing the remuneration packages of individual directors. No director should be involved in fixing his or her own remuneration.

- *Disclosure.* The company's annual report should contain a statement of remuneration policy and details of the remuneration of each director.

Shareholders

- *Dialogue between institutional shareholders and companies.* Both parties should be ready, where practicable, to enter into a dialogue based on the mutual understanding of objectives.

- *Constructive use of the AGM.* Companies should use the AGM to communicate with private investors and encourage their participation.

- *Shareholder voting.* Institutional shareholders have a responsibility to make considered use of their votes.

- *Evaluation of governance disclosures***.** When evaluating companies' governance arrangements, particularly those relating to board structure and composition, institutional investors should give due weight to all relevant factors drawn to their attention.

Accountability and audit

- *Financial Reporting.* The board should present a balanced and understandable assessment of the company's position and prospects.

- *Internal control*. The board should maintain a sound system of internal control to safeguard shareholders' investment and the company's assets.

- *Relationship with the auditors*. The board should establish formal and transparent arrangements for considering how they should apply the financial reporting and internal control principles and for maintaining an appropriate relationship with the company's auditors.

Extensive guidance on the implementation of these principles is contained in the report. Particularly noteworthy is the emphasis Hampel places on the need for pension funds to take a long-term view in managing their investments and for institutional investors to make considered use of their votes.

Subsequent to the release of its final report, the Hampel Committee submitted its proposed *Corporate Governance Principles* and a *Supercode*, incorporating the Cadbury, Greenbury and Hampel recommendations, to the London Stock Exchange (LSE). The *Supercode* has now been implemented in the LSE listing rules.

OECD

A further governance initiative has been the release in April 1998 of a *Corporate Governance Report* by the Business Sector Advisory Group of the Paris-based Organisation for Economic Co-operation and Development (OECD), chaired by US governance specialist Ira Millstein. AICD, Blake Dawson Waldron and the ASX provided input to the Group in late 1997, based on discussions with senior directors held in colloquia around Australia. The report, subtitled *Improving Competitiveness and Access to Capital in Global Markets*, outlines 25 governance "perspectives" for consideration by the OECD in formulating policy. Specifically the Group recommends that the OECD:

- encourage Member countries to adapt their corporate governance regulatory framework to changing competitive and market forces;

- formulate minimum international standards of corporate governance to promote fairness, transparency, accountability and responsibility;

- issue suggested guidelines for voluntary “best practice” for boards to improve accountability, as well as encompass board independence;

- encourage common principles for addressing the comparability, reliability and enforcement of corporate disclosure; and

- emphasise the impact which changes in corporate governance practices would have on society at large, and on the need to clarify responsibilities between the public and private sector.

The Advisory Group emphasises the need for flexible and adaptive governance systems, regulation that does not unduly interfere with market mechanisms, the encouragement of varying governance practices and for individual investors and corporations to practice voluntary self-improvement.

OECD Ministers have considered these recommendations and initiated further work to draft minimum standards, best practice code and regulatory principles.

THE LEGAL AND INSTITUTIONAL PRECONDITIONS FOR STRONG STOCK MARKETS: THE NONTRIVIALITY OF SECURITIES LAW

by
Bernard Black*

Abstract

An important challenge for all economies, at which only a few have succeeded, is providing an environment in which minority shareholders have good information about the value of a company's business, and confidence that a company's managers and controlling shareholders won't cheat them out of most or all of the value of their investment. A country whose laws and related institutions foster that knowledge and confidence has the potential to develop a vibrant stock market that can provide capital to growing firms. A country whose laws and related institutions fail on either count cannot develop a strong stock market, forcing firms to rely on internal financing or bank financing - both of which have important shortcomings. This article explains why these two investor protection issues are critical, related, and hard to solve. It also discusses which of the needed laws and institutions can be borrowed from countries with strong securities markets and which must be home-grown.

I. Introduction

A strong public securities market, especially a public stock market, can facilitate economic growth by providing a way for growing companies to raise capital. Securities markets have several potential advantages over the principal alternatives - bank financing and internal financing. First, countries with strong securities markets are less dependent on bank financing. Banks are an institutional form that is prone to credit crunches and other troubles, which can reverberate through the whole economy. Second, a public stock market lets companies rely more on equity and less on debt, which gives them greater financial flexibility in an economic downturn, and may reduce the downturn's severity. Third, a stock market lets companies rely more on external capital and less on internal capital, which helps companies grow rapidly, and gives companies that focus on a single core business an advantage over diffuse conglomerates. In the United States, conglomerates are seen as a failed experiment - they are usually less efficient than more focused firms. Conglomerates remain strong in countries with weak stock markets, partly because the conglomerate form can provide the access to capital that a rapidly growing firm needs. The shortcomings of bank finance and the internal capital markets run by conglomerate groups were, in significant part, behind the recent finance-driven economic troubles in East Asia and elsewhere.

But creating strong public securities markets is hard. That securities markets exist at all is magical, in a way. Investors pay enormous amounts of money for completely intangible rights, whose value depends entirely on the quality of the information that the investors receive and on the honesty of

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other people, about whom the investors know almost nothing. Internationally, this magic is rare. It does not appear in unregulated markets. Even among developed countries, only a handful of countries have developed strong stock markets that permit growing companies to raise equity capital.

There is only limited prior work on the prerequisites for strong securities markets. Black & Kraakman (1996) argue that protecting minority investors against self-dealing by company insiders is essential, but focus on company law and do not consider other necessary laws and related institutions.[1] Black (1998) argues that controlling information asymmetry is essential for building strong stock markets.[2] La Porta, Lopez de Silanes, Shleifer & Vishny (1997, 1998a, 1998b, 1999) develop evidence that legal protection of minority shareholders correlates with the strength of a country's capital market, but do not address which legal rules are most important or consider related institutions.[3] Modigliani & Perotti (1998) document an inverse relationship between measures of corruption and the strength of public securities markets.[4] Coffee (1998) is the closest in spirit to this paper. He argues that securities law that protects minority investors is central to the value of publicly issued shares, but that in countries with weak laws, companies can often piggyback on the securities markets of developed countries by listing their shares on stock exchanges in those countries.[5]

This article explores which laws and related institutions are essential for strong securities markets. My goal is threefold: to explain the precursors for the development of strong markets in countries, like the United States and the United Kingdom, that already have these markets; to offer a guide to legal and institutional reforms that could strengthen securities markets in other countries; and to offer some cautionary words for developing countries about the complexity of the laws and related government and private institutions that are needed to support strong securities markets, and the difficulty of creating this institutional infrastructure.[6]

There are two essential prerequisites for strong securities markets. A country's laws and related institutions must give minority shareholders: good information about the value of a company's business; and confidence that the company's insiders (its managers and controlling shareholders) won't cheat investors out of most of the value of their investment. If these two steps can be achieved, a country has the potential to develop a vibrant stock market that can provide capital to growing firms, though still no certainty of developing such a market. Conversely, a country whose laws and related institutions fail on either of these two counts cannot develop a strong stock market. This forces firms to rely on bank financing or internal financing.

Individual companies can partially escape the weakness of their home country's institutions by listing and selling their shares on a stock exchange in a country with strong institutions, and following that country's rules. But only partial escape is possible. Much still depends on the availability of local enforcement.

The connection between strong investor protection along these two dimensions and strong securities markets creates the potential for two separating equilibria to exist. In the first or "lemons" equilibrium, honest companies (except a few large companies that can develop their own reputations) don't issue shares to the public, because weak investor protection prevents them from realising a fair price for their shares. This decreases the average quality of the shares that are issued, which further depresses prices and discourages honest issuers. In the second "strong markets" equilibrium, strong investor protection produces prices that make it attractive for honest companies to issue shares, which increases the average quality of the shares that are issued, which further increases share prices and encourages more honest issuers. This article can be seen as an attempt to develop minimum conditions for achieving the "strong markets" equilibrium.

The analysis developed in this article also suggests that the standard debate over the merits of bank-centred versus stock-market-centred capital markets is partly misplaced. The standard debate posits that bank-centred markets can achieve stronger monitoring of management, while stock-market-centred markets offer greater liquidity but weaker monitoring due to dispersed shareholdings, albeit partly counteracted by a market for corporate control. The perspective offered here is that a stock-market-centred capital market is possible only if a country *first* develops strong monitoring along the dimensions of information disclosure and control of insider self-dealing. Bank-centred capital markets may be stronger than stock-market-centred capital markets in ensuring that companies are not only *honestly* run, but also *well* run. But even if this is the case (this remains a disputed question), this would mean only that the two systems have different monitoring strengths, with neither clearly dominating the other along an overall monitoring dimension.

I will address the prerequisites for a strong securities market in the context in which they are most acute - a public offering of common shares, often by a company that is selling shares to the public for the first time. Similar though less acute issues arise for issuance of debt securities.

Part Two of this article explains why controlling information asymmetry is critical for developing strong public stock markets, and which laws and institutions are needed to do so. Part Three explains why controlling insider self-dealing is equally critical, and the overlapping but somewhat different laws and institutions that are needed for this task. Part Four explores the extent to which companies can escape the weaknesses of their home country's laws and institutions by relying on foreign rules and institutions. Part Five considers the possibility that securities markets may involve a separating equilibrium, in which a country's market tends to gravitate toward either a "lemons" or a "strong market" equilibrium, depending on the quality of the local laws and institutions that support the securities market. Part Six discusses the implications of the analysis in this article for the conventional view that stock-market-centred capital markets produce weaker monitoring of management than bank-centred capital markets: they may, but only along some dimensions. Part Seven concludes by discussing which steps a developing country should take first, with the long-term goal of establishing a strong securities market.

II. Information asymmetry barriers to securities offerings

Information asymmetry and the role of reputational intermediaries

A critical barrier that stands between issuers of common shares and public investors is asymmetric information. The value of a company's shares depends on the company's future prospects. The company's past performance is important as a (partial) guide to future prospects. The company's insiders know about both past performance and future prospects, but investors don't know this information and can't easily find out. The insiders have information; investors need information.

Delivering information to investors is easy; but delivering *credible* information is hard. Insiders have an incentive to exaggerate the issuer's past performance and future prospects, and investors can't directly verify the information that the issuer provides. This problem is especially serious for small companies and companies that are selling shares to the public for the first time. For these companies, investors can't rely on the company's prior reputation to signal the quality of the information that it provides.

In economic jargon, securities markets are a vivid example of a market for lemons.[7] Indeed, securities markets are a far more vivid example than George Akerlof's original example of used cars. Used car buyers can visually observe the car, take it for a test drive, have a mechanic inspect the car, and ask their friends about their experiences with the same car model or manufacturer. By comparison, a company's shares, when it first goes public, are like a unique, unobservable car, on which investors can obtain only dry written information, that they can't directly verify. They have only the comfort of knowing that other, similarly (ill-)informed investors have reached similar conclusions about value.

Investors don't know which companies are truthful and which aren't, so they discount the prices they will offer for the shares of all companies. This may ensure that investors receive a fair price, on average. But consider the plight of an "honest" company - a term that I will use to mean a company whose insiders both report truthfully to investors and won't divert some or all of the company's income stream to themselves, apart from a market rate of compensation for management services. "Honesty" thus requires both truthful disclosure and nondiversion of value. I will focus in this part on disclosure, and discuss value diversion by insiders in Part Three.

Discounted share prices mean that an honest issuer can't receive fair value for its shares, and has an incentive to turn to other forms of financing. But discounted prices won't discourage dishonest issuers. Shares that aren't worth the paper they're printed on are, after all, quite cheap to produce. The prospect of receiving even a "discounted" price for worthless paper will attract some issuers.

This "adverse selection" by issuers, in which high-quality issuers leave the market because they can't obtain a fair price for their shares, while low-quality issuers remain, worsens the lemons problem faced by investors. Investors rationally react to the lower average quality of issuers by discounting still more the prices they will pay. This in turn drives even more high-quality issuers out of the market and exacerbates the adverse selection problem.

Some countries, including the United States, have partially solved this information asymmetry problem through a complex set of laws and private and public institutions that give investors reasonable assurance that the issuer is being (mostly) truthful. Among the most important institutions are reputational intermediaries, who vouch for the quality of particular securities. These intermediaries - including accounting firms, investment banking firms, and law firms - can credibly vouch for the quality of information because they are repeat players who will suffer reputational loss if they permit a company to exaggerate its prospects, exceeding the intermediary's one-time gains from permitting the exaggeration.[8] The backbone of these intermediaries is stiffened by the risk of legal liability if they endorse faulty disclosure, and government civil or criminal prosecution if they do so intentionally.

But even in the United States, "securities fraud" - the effort to sell shares at an inflated price through false or misleading disclosure - is an ongoing problem, especially among small issuers. Attempts by skilled con men to sell fraudulent securities are endemic partly because the United States' very success in creating an overall climate of honest disclosure leads investors to be (rationally) less vigilant in investigating claims by persuasive salesmen about particular companies. Investors' willingness to accept claims of past or future profits at something close to face value, in turn, creates fertile soil for fraud.

Most American investors still expect newly issued securities to be vouched for by reputational intermediaries. They expect financial statements to be audited, shares to be underwritten by a reputable investment banker, and the prospectus to be prepared by securities counsel. But this merely recreates the fraud problem one step removed. The United States' very success in creating an environment in which most reputational intermediaries guard their reputations, creates an opportunity for new entrants to pretend to be reputational intermediaries. Merely calling oneself an investment banker will engender some degree of investor trust, because most investment bankers are honest and care about their reputations, and because investors (rationally) don't fully investigate the claims that investment bankers make about the quality of their reputations. The other key intermediaries - accountants and securities lawyers - can similarly trade on their profession's generally honest reputation (notwithstanding the occasional snide joke about whether that reputation is deserved).

To employ the standard terminology of welfare economics, investment banking (or accounting or securities lawyering) involves an externality - any one participant can't fully capture the gains from its own investment in reputation. Some of the investment enhances the reputation of the entire profession, and is captured by others through greater investor trust in investment bankers as a class. That externality creates well-known problems. It reduces investment bankers' incentives to invest in reputation, since they can't capture all of the benefits of the investment. And new entrants can free-ride on reputational spillover from the established firms.

If one couples the ability to free ride on the reputations of other investment bankers with ease of entry, it will make sense for some entrepreneurs - whom I will call "bogus investment bankers" - to go into the investment banking business, intending never to develop their own reputations, but instead to profit by pretending to investors that their recommendation of a company's shares has value. In effect, bogus investment bankers steal some of the value of their competitors' reputations, while at the same time devaluing those reputations, because bad reputations spill over to the rest of the profession just as good ones do.

The result is ironic: reputational intermediaries' principal role is to vouch for disclosure quality of disclosure and thereby reduce information asymmetry in the market for securities. But information asymmetry in the market for reputational intermediaries limits their ability to play this role.

One possible solution is second-tier reputational intermediaries, who can vouch for the quality of the first-tier intermediaries. Voluntary self-regulatory organisations play, in part, the role of a second-tier intermediary. A second solution involves legal rules that make the intermediaries liable to investors, and various forms of government intervention aimed at establishing minimum quality standards for the intermediaries - licensing of reputational intermediaries; investigating cases where the intermediaries did not behave as they ought; revoking the license of a misbehaving intermediary; criminal prosecution if the intermediary misbehaves intentionally. The greater sanctions available through the legal system, plus the ability to collectivise the cost of enforcement (by spreading the cost of private enforcement among investors through a class action or derivative suit, and spreading the cost of public enforcement through taxes), may explain why these strategies seems to dominate over creation of second-tier reputational intermediaries.

A mixed solution, sometimes adopted in securities markets as a supplement to official enforcement, involves *mandatory* self-regulatory organisations. In the United States, for example, investment bankers must belong to a self-regulatory organisation (the available organisations are the New York Stock Exchange and the National Association of Securities Dealers). A member evicted by one organisation is unlikely to be accepted by the other. Thus, the organisation's power to evict a member becomes the power to put the member out of business, not merely deprive it of the reputational enhancement that voluntary membership could bring.

The resulting system, in which multiple reputational intermediaries vouch for different aspects of a company's disclosure, while self-regulatory organisations, private plaintiffs, and the government police the reputational intermediaries, can work tolerably well. But it is scarcely simple. And it may require, for continued success, some ongoing government effort (how much is an open question) to protect the reputational intermediaries against the depredations of bogus intermediaries who would otherwise profit from the unearned spillover of reputation to them, and perhaps bring the whole system crashing down.

The complexity of this response to the information asymmetry problem goes a long way toward explaining why many nations have not developed an acceptable solution to this problem. Their securities markets have instead fallen into what insurance companies call a "death spiral", in which information asymmetry and adverse selection combine to drive almost all honest issuers out of the market, and to drive share prices to zero.

In these countries, a few large companies may develop reputations sufficient to justify a public offering of shares at a price that, though below fair value, is still attractive compared to other financing options. But smaller companies have essentially no direct access to public investors' capital. They must obtain capital from intermediaries (usually banks), or the internal capital "market" of a conglomerate group, or else grow only at the rate permitted by reinvestment of past earnings.

For high-technology companies, information asymmetry is especially severe because these companies often have short histories, make highly specialised products, and participate in fast-moving industries that are hard for investors to understand. This makes it easier for insiders to exaggerate the industry's growth prospects, or the company's prospects within the industry. As a result, even countries with strong stock markets, such as the United States, have developed a specialised institution - the venture capital fund - that funds high-technology companies early in their life, and functions in significant part as a specialised reputational intermediary. Venture capital funds engage in detailed, costly investigation of companies that seek funding, and then implicitly vouch for these companies when they later seek to raise capital in the securities markets.[9]

Venture capitalist intermediation is expensive, but has thrived because, presumably, it adds value that exceeds its costs. One major reason is that venture capitalist intermediation reduces information asymmetry costs. A second is that intensive monitoring has value especially for early stage companies. Take the two together, and entrepreneurs prefer to pay the high price of venture capital funding, rather than sell stock to the public early in a company's existence.

Ronald Gilson and I argue in a recent article that to understand how venture capital funds operate, you have to understand the synergy between their visible role in providing financial capital and their less visible but equally important role in providing reputational capital and monitoring. For early stage, high-technology companies, the combination of these three services dominates the alternative that public securities markets offer of providing financial capital *without close monitoring*, or the alternative of monitoring and providing reputational capital *without investing*, which is a plausible institutional arrangement that we don't see.[10]

If developing a strong public securities market is hard, developing strong venture capital is harder still. Venture capital funds face a classic chicken and egg problem in getting started - a venture capitalist can't get funding until he develops a reputation for making good investments, but can't develop a reputation without making investments. Once the venture capital industry exists, new funds can be started by people who leave existing funds where they have developed a track record. But the initial stages of industry development, where this path isn't feasible, are likely to be slow. Thus, we should expect - and as we look around the world we find - that strong venture capital is even rarer than a strong public stock market.

High-technology companies are not the only area where specialised reputational intermediaries have developed over time. For money managers who manage pension funds and other institutional assets, a cottage industry has arisen of consulting firms who verify the money managers' performance claims, and a related industry that develops performance indexes against which the performance of a money manager with a particular style or investment focus can be measured. For bonds and other fixed-income investments, bond-rating agencies such as Moody's and Standard & Poor's offer quality ratings for different issuers.

The institutions that are needed to control information asymmetry

Successful securities markets have developed a number of institutions to counter information asymmetry, some of which were suggested above. Information disclosure centres on financial disclosure. I list below the institutions that I consider necessary. The list is necessarily judgmental, and is in an order that makes logical sense, not in order of estimated importance. Part Four combines this list and the related list of institutions to control insider self-dealing into a single table.

(1) Securities laws that require extensive financial disclosure, including independent audits of public companies' financial statements.

It is hard to imagine a successful stock market that does not require audited financial statements for public companies. The risk of financial statements that are either outright fraudulent or seriously misleading is too great. The ease with which fraudulent securities can be created means that securities markets attract con artists, who are skilled in spinning plausible stories about why a particular company has a marvellous future. Audited financial statements provide a critical reality check on these stories.[11]

(2) Accounting rules that address investors' need for reliable information.

Good accounting rules should provide information in a form that is useful to investors. They should facilitate evaluating a company's past performance, and comparing it with similar companies, in the same country and internationally, and limit managers' flexibility to pick and choose among alternate accounting practices in order to make their own firm appear more profitable. Overly flexible rules can reduce comparability, increase opportunities for fraud, and increase overall information asymmetry between companies and investors.[12] At the same time, the accounting rules must strike a sensible balance among investors' desire for information, the cost of providing the information, and companies' concern that giving detailed information to investors means giving the information to competitors as well.

(3) A rule-writing institution with the competence to write good accounting rules and an incentive to keep the rules up to date.

In many countries, accounting rules are written by the Finance Ministry, which tends to write the rules with a view to providing the information needed to collect taxes, rather than the information needed to attract investment or manage the business. Thus, the rule-writing task is ideally placed elsewhere - in a securities commission or perhaps, as in the United States and Great Britain, in a quasi-public "self-regulatory" organisation run by accountants and supervised by the securities commission or another regulatory agency.[13]

Writing good accounting rules requires close knowledge of how companies operate, appreciation for changes in corporate practices, which are often intended to take advantage of loopholes in the existing rules so as to portray a firm's performance as better than it really is, and the ability and incentive to write new rules and interpret old ones with reasonable dispatch. Other things equal, this may offer some reason to vest rule writing in a quasi-public organisation run by accountants, rather than a government agency.[14]

(4) A sophisticated accounting profession with the skill and experience to catch at least some instances of false or misleading disclosure.

At the end of the day, audit requirements and accounting rules are no better than the accountants who conduct the audits and apply and interpret the rules. Accounting is part science (following established rules), but an important part remains a skilled art - with the twist that the artist's task is to paint an accurate picture, while the subject is trying to persuade the artist that a more flattering portrait is a truer one, and a minority of subjects are crooks, prepared to do whatever they can to mislead the artist and thus the investors who are the ultimate viewers of the portrait. As a further twist, the subject is paying the artist's fee, so that the artist faces the omnipresent threat of being replaced if the portrait is less flattering than the subject wants.

Professionalism - both to see the truth that the subject has tried to conceal, and to resist the subject's pressure for an overly flattering portrait - is essential if the resulting portrait is to resemble reality and be comparable to other portraits painted by other artists.

(5) Securities or other laws that impose on accountants enough risk of liability to investors if the accountants have endorsed false or misleading financial statements so that the accountants will resist their clients' pressure for more favourable disclosure.

Accountants are reputational intermediaries. They sell their services in preparing and reviewing financial statements, but in doing so, they also rent out their reputations for conducting a careful audit that can catch some fraud, discourage most attempts at fraud, and for painting a tolerably accurate picture of a company's financial performance.

Experience teaches that at least some legal liability is an important buttress for the accounting firm's concern for reputation. Liability can help to persuade the firm to establish strong internal procedures to ensure that the audits it conducts, and the financial statements that it prepares or reviews, meet minimum quality standards. At the same time, liability risk provides a compelling argument that the accounting firm can offer to a client who is pushing hard for more favourable treatment than the accounting firm wants to offer.

The needed liability risk doesn't have to be great. I make no claim that aggressive, American-style class action litigation against accounting firms is necessary or even desirable. Perhaps a few lawsuits per decade, a couple of which result in a significant payout (in settlement or after a verdict), are enough. But if there is no liability risk, the temptation for even the largest accounting firms to squander reputation to gain a client will always be present and will sometimes be accepted.

(6) A sophisticated investment banking profession that will investigate the issuers of securities that the investment bank underwrites because the investment banker's reputation depends on not selling fraudulent or overpriced securities to investors.

Investment bankers are a second key reputational intermediary. In developed securities markets, they have learned to walk a fine line between being selling an offering and not overselling it. An important part of their role involves conducting a "due diligence" investigation of the issuer, to satisfy themselves that the issuer's future prospects are reasonably stated in the offering documents and oral sales presentations, that the issuer's managers appear to be honest, and that investors understand the major risks of the investment. For example, it is standard practice for an investment bank to conduct a background check on an issuer's insiders, and to walk away if the insiders have an unsavoury past.

Investment bankers' reputation is policed in a number of ways. First, securities purchasers will remember if an investment bank sold them a number of bad investments, and avoid (or pay less for) its future offerings. Second, just in case securities purchasers haven't noticed, each investment bank will keep track of the "aftermarket" performance of its own and its competitors' offerings, happily disclose to a prospective client its competitors' weak performance, and worry greatly if the aftermarket performance of its own offerings suffers, because this is a recipe for trouble in the medium to long term.

Third, in the rare cases when a major underwriter unwittingly sells shares for a fraudulent company, which then collapse in price when the fraud is discovered, this is considered a major embarrassment, not soon forgotten by investors (or by the bank's competitors, who will bring it up at every convenient opportunity).

(7) Securities or other laws that impose on investment bankers enough risk of liability to investors if the investment bankers underwrite securities that are sold with false or misleading disclosure, so that the bankers will resist their clients' entreaties for more favourable disclosure.

Experience teaches that at least some legal liability is an important buttress for an investment banker's concern for reputation. Liability can help to persuade the firm to establish strong internal procedures to ensure that the companies whose shares it underwrites meet minimum quality standards. At the same time, liability risk provides a compelling argument that the investment banker can offer to a client who is pushing hard for more favourable disclosure, or a higher offering price, than the investment banker wants to offer.

As for accountants, I make no claim that frequent litigation against investment bankers is necessary. A few lawsuits per decade, a couple of which result in a significant payout (in settlement or after a verdict), could well be enough. But if there is no liability risk, the temptation for firms to squander reputation to gain a client will always be present and will sometimes be accepted.

(8) Sophisticated securities lawyers who can ensure that a company's offering documents comply with the disclosure requirements.

Securities lawyers are a third major reputational intermediary - albeit less visible to investors than accountants or investment bankers. In developed securities markets, they have learned to walk a fine line between being accepting the favourable statements that the issuer wants to make, and cautioning the issuer and the investment banker about the need for cautionary disclosure.

Because securities lawyers are less visible to investors than accountants or investment bankers, I have not listed whether they face a significant risk of liability as a *necessary* condition for developing a strong securities market. But some liability risk for lawyers is surely a *useful* institution.

(9) A stock exchange with meaningful listing standards, and the willingness to enforce them by fining or delisting companies that violated disclosure rules.

Stock exchanges are a fourth important reputational intermediary. They establish and enforce listing standards, including disclosure requirements, because they understand that investors use the listing as a proxy for company quality, and that false disclosure by a few companies will taint all companies.

(10) Securities or other laws that impose severe sanctions on insiders for false or misleading disclosure, including criminal sanctions where appropriate.

Sophisticated accountants, investment bankers, and lawyers are a second line of defence against securities fraud. The primary defence, though, is direct sanctions against the insiders who attempt to carry out the fraud.

Some of the time, perhaps most of the time, insiders will want to preserve a company's ability to issue shares in the future, and will therefore want to maintain the company's reputation for honest disclosure. But insiders' concern for future reputation isn't enough to ensure honest behaviour. Some of the time, the company will be in a financial bind, where if it doesn't raise funds this time, there won't be a next time. In the language of game theory, the insiders are in the final period of a repeated game, where they have an incentive to cheat, since there won't be a next round in which the cheating can be punished.[15] Other times, the insiders' tenure in the company may be at risk, even if the company's solvency is secure. Here, the insiders face a final period, even if the company doesn't. Moreover, some con artists, attracted by the ease of creating valueless companies and selling valueless shares, will happily take whatever money they can raise this time, and then hope to sell another company's shares the next time.

The incentives of insiders to puff their company help to explain the universal use in public offerings of reputational intermediaries, who investigate and vouch for the disclosure that the insiders prepare. But just as some liability is important to ensure that reputational intermediaries behave as they are supposed to, some liability is important to ensure that insiders disclose honestly in the first place.

Financial liability of insiders to investors is not a sufficient deterrent, however. Insiders often have little wealth outside their firm, or can hide much of their wealth out of investors' reach. That makes criminal sanctions a critical supplement to the insiders' financial liability to investors.

(11) A securities regulator (and, for criminal cases, a prosecutor) who is honest; and has the staff, skill, and budget to pursue complex securities cases involving false or misleading disclosure.

Honest regulators and prosecutors are obviously essential. They tend to be taken for granted in developed countries, but are often partly or wholly absent in developing countries.

With regard to the need for a specialised regulator and specialised prosecutors, some securities cases involve outright fraud - the company has reported sales or inventory that didn't exist. Those cases aren't hard for a prosecutor to bring. But they aren't especially sexy either, and could get little attention from a prosecutor with limited resources, who would rather pursue muggers and murderers. Moreover, many securities fraud cases aren't so clear-cut. The insiders twisted the truth, but in a way that takes careful digging through the company's records to uncover, and skill to present in convincing fashion to a court. Moreover, the defendants often have enough money to mount a vigorous defence. Experience teaches that even in developed countries, few prosecutors have the skill or discipline to bring securities fraud cases. Specialisation is needed.

(12) A judicial system that is honest; sophisticated enough to handle complex securities cases; can intervene quickly when needed to prevent asset stripping; and can produce decisions without intolerable time frame (and with appropriate adjustments for the time value of money).

An honest judiciary is a must for any investor remedies to be meaningful. As with honest prosecutors, this element of a disclosure system can be taken for granted in developed countries, yet is often partly or wholly absent in developing countries. With regard to sophistication, the same subtle securities fraud cases that call for specialised prosecutors require sophisticated judges. A specialised court is ideal. A general court that sees a hefty percentage of securities and other complex commercial cases, perhaps because of its location in the country's financial centre, is an acceptable substitute.

Speed is important too. When insiders commit fraud, some of it can sometimes be retrieved if the prosecutors move fast to freeze the insiders' assets pending the final outcome of a case that the prosecutors plan to bring. Otherwise, it is as good as gone. Any con artist smart enough to run a good con is smart enough to move his assets beyond the prosecutor's reach if given a warning that they may be seized, or lost in a court action. Beyond that, while courts nowhere move quickly, differences in how fast they do move affect the salience of investor remedies. Moreover, a surprising number of countries award no or inadequate interest on judgements, which both undercuts the official sanctions and gives an incentive for the defendants to delay.

(13) Rules ensuring market "transparency": the time, quantity and price of trades in public securities must be promptly disclosed to investors.

One key source of information about value that investors rely on is the prices paid by other investors for the same securities. Investors may still make mistakes about value, but at least they know that they are not alone in their opinions. Transparency is a collective good that must be established by regulation. Large investors would prefer to hide their own transactions, to reduce the impact on price that their trades will have. Sometimes a stock exchange will have enough power to force all trades to be reported to it; more commonly, government intervention to mandate prompt reporting and ensure that all trades are reported in a single consolidated source.

(14) Rules banning manipulation of trading prices.

Transparency of market prices raises its own dangers. Especially in "thin" markets, insiders can manipulate trading prices to create the appearance that the shares are highly valued by outside investors, while dumping their own shares on the market. The principal response to this risk is rules against manipulating trading prices. These rules then need to be enforced. This requires a specialised regulator, because manipulation is notoriously hard to prove.

(15) An active financial press that can uncover and publicise instances of misleading disclosure, and criticise not only the company, but (when appropriate) the investment bankers, accountants, and lawyers as well.

Markets for reputation can work only if there is a mechanism for distributing information about the performance of both companies and intermediaries. Disclosure rules for companies help, as does reputational intermediaries' incentive to advertise their successes. But intermediaries can hardly be expected to publicise their failures. Their competitors may do so, but their reports may be discounted because they come from a biased source. An active financial press is an important source of reporting of disclosure failures.

A country's libel law is important here. The financial press can be chilled by libel laws that make it easy for deep-pocketed companies or intermediaries to sue anyone who is bold enough to criticise them. The chill is especially severe if the courts' honesty is suspect.

(16) A culture of disclosure that develops over time among accountants, investment bankers, lawyers, and company managers, that concealing bad news is a recipe for trouble.

In countries with strong securities markets, the sanctions against misbehaviour are collectively strong enough so that they reinforce a culture of compliance, in which a bit of puffing is acceptable, but outright lying is not. There are actions that no honest accountant, investment banker, or securities lawyer will be involved in. Moreover, very few managers will attempt clearly illegal actions, because they too grew up in a culture where disclosure is the norm, and where others are occasionally disgraced, or even sent to jail, for falsifying financial statements and the like.

Which came first: laws requiring disclosure, or a culture that supported disclosure, reinforced the laws, and made them politically feasible? This is an unanswerable question. Most likely, the two developed together over time, and were mutually reinforcing.

Additional useful institutions

The list of institutions in the previous section reflects my best judgement about which rules and institutions are the most important. It is by no means a complete list of the *useful* rules and institutions. For example, I argue above that it is important for reputational intermediaries, including accountants and investment bankers, to face a meaningful risk of liability to investors. It would also be useful for these intermediaries to be subject to a regulatory licensing scheme and risk regulatory sanctions, including fines, suspension and disbarment, for misbehaving individuals and, where appropriate, their firms. Those regulatory sanctions aren't listed above because I believe that, especially in less developed economies, private enforcement, through liability to investors, is likely to be a more effective tool for enforcing good behaviour by reputational intermediaries than public enforcement through regulatory sanctions. Even in countries with strong regulators, regulatory sanctions are imposed fairly seldom and primarily in egregious cases; they will surely be an even weaker constraint in emerging economies, which are likely to have fewer regulatory resources, and better uses for those resources (such as pursuing insiders who have committed fraud, rather than sanctioning intermediaries who have merely failed to catch the fraud).[16]

Conversely, I argue above that official enforcement of the rules against fraud is essential for insiders. Financial liability of insiders to investors is also useful, but isn't sufficient because in too many of the most egregious cases, the insiders have no wealth, or can hide their assets beyond the reach of private plaintiffs.

Mutual funds are another useful, complementary institution. They can collect money from individual investors, and provide them with both diversification and some insulation against inflated claims by con artists (who might fool novices, but will have a harder time fooling experts). In my judgement, a healthy mutual fund industry is more a result than a cause of a strong securities market, that itself relies on related institutions, including a law on investment funds that safeguards the mutual fund's assets against self-dealing transactions between the fund and the fund manager. Also, in a tolerably efficient market, small investors can freeride on the pricing judgements of professionals without the need to invest through an investment fund.

The length of this list suggests the difficult task facing a country that wants to develop a strong stock market. Most critically, formal disclosure rules are important, but are not enough. The harder task is enforcing the rules - both direct public enforcement and indirect enforcement through private institutions, especially reputational intermediaries like accountants, investment banking firms, securities lawyers, and stock exchanges.

III. Protecting minority investors against inside dealing

Inside dealing as an adverse selection/moral hazard problem

The second major obstacle to a strong public stock market is the potential for insiders to appropriate most of the value of the company for themselves - for 50% of the shares (less if the remainder are diffusely held) to convey 80% or 90% of the company's value. In some countries, where rules against insider dealing with a company are weak or routinely ignored, 50% ownership can convey essentially 100% of the company's value.

Insider self-dealing can occur in many variants and guises. But a useful division is between:

- *direct* self-dealing, where a company that the insiders control, but only partly own, engages in transactions, not on arms-length terms, that enrich the insiders themselves, their relatives or friends, or a second company that they own a larger percentage of; and

- *indirect* self-dealing, where insiders use information about the company that only they know to trade in public securities markets with less-informed investors (often called *insider trading*).

Of these, direct self-dealing is far and away the more important problem. First, it's far more profitable for the insiders. Direct self-dealing can turn 40% ownership (say) of shares into 100% ownership of profits, with little or no additional investment of capital. In contrast, insider trading takes capital and can't achieve anywhere near that level of profits. For one thing, insider trading depends on a liquid stock market, which the countries that haven't controlled direct self-dealing won't have. Without liquidity, you can't trade much, and without trading, you can't profit. For another, a long-term buy-and-hold investor can't be directly harmed by insider trading. You can only be on the losing side of a trade with an insider if you're trading. But more critically, if direct self-dealing is hard to control, insider trading in anonymous securities markets is even harder to control.

Moreover, without the institutions that are needed to control direct insider self-dealing, there is little hope of controlling insider trading. But the converse isn't true. A country could do fairly well at controlling direct self-dealing, without making the major additional investment needed to limit insider trading to tolerable levels.

The potential for insider self-dealing, whether direct or indirect, creates a lemons or adverse selection problem, which has the same structure as the adverse selection problem created by asymmetric information. Investors don't know which insiders are honest, and which will appropriate most of the company's value, so they discount the prices they will offer for the shares of all companies. This creates a dilemma for "honest" insiders who will not divert some or all of the company's income stream to themselves.

Discounted share prices mean that a company with honest insiders can't receive fair value for its shares, and has an incentive to turn to other forms of financing. But discounted prices won't discourage dishonest insiders. The prospect of receiving even a "discounted" price for worthless paper will be attractive to some insiders.

This adverse selection by issuers, in which high-quality issuers leave the market because they can't obtain a fair price for their shares, while low-quality issuers remain, worsens the lemons problem faced by investors. Investors rationally react to the lower average quality of issuers by discounting still more the prices they will pay. This drives even more high-quality issuers away from the market and exacerbates the adverse selection problem. As with asymmetric information, failure to control insider self-dealing can result in a "death spiral", in which insider self-dealing and adverse selection combine to drive almost all honest issuers out of the market, and drive share prices to zero, save perhaps for a few large companies that can develop reputations sufficient to justify a public offering of shares.

In important respects, the problem of insider self-dealing is harder to solve than the problem of information asymmetry. First, honest disclosure of information during a public offering of shares can't be undone once the offering is completed. In contrast, once a company has sold shares, the company's insiders can always renege on a promise not to self-deal. Indeed, insiders have an incentive to renege - to capture more of the company's value for themselves. That incentive is only imperfectly policed by the desire to maintain the company's reputation to facilitate a future offering of shares. Again, insurance terminology is helpful - the incentive to renege is known as moral hazard. Unless controlled, it can be sufficient by itself to cause a public stock market to collapse.

Second, false or misleading disclosure in a public offering often occurs in a formal disclosure document, and thus leaves a paper trail. If subsequent events reveal the business problems that the company tried to conceal, the deficiencies in the original disclosure will often be obvious enough to make it straightforward for regulators or investors to seek sanctions or damages against the offending insiders and, if appropriate, their accountants, bankers, and lawyers. In contrast, insider self-dealing is often hidden. It must be uncovered before it can be policed.

Third, once a company has issued shares at a discounted price, in a market characterised by information asymmetry, insider self-dealing, and resulting adverse selection and moral hazard, the insiders may feel *entitled* to appropriate most of the company's value for themselves. They will fiercely resist any change in legal rules that limits this opportunity. An example call illustrate why insiders can feel this way.[17]

Assume that Company *A* has a value of $100, and 50 outstanding shares, all held by insiders. The shares are worth $2 each. But outside investors may be willing to pay only 50 cents per share for additional shares, both because the outside investors don't know the company's true value and because they expect insiders to appropriate most of whatever value exists. Suppose now that Company *A* issues 50 additional shares at this price, for total proceeds of $25. Company *A* now has 100 shares outstanding, with 50 shares held by insiders and 50 shares held by outside investors, and total value of $125.

If the insiders behave honestly and keep only 50% of the company's value, they will have cheated themselves. Their shares will be worth only $62.50, while the outside investors' shares will be worth $62.50 - far more than the outside investors paid. The insiders' rational response is to self-deal by enough to ensure that they capture at least 80% of the firm's value - $100 out of the total value of $125. They will not feel that they have cheated anyone by doing so - they will feel instead that they have taken only their proper share of the company's value. They will fight against legal and institutional reforms that might prevent them from taking what they see as their fair share of the company's value.

Those reforms will help new issuers obtain a higher price for their shares, but can harm the politically powerful insiders of already public companies. But in fighting against reforms, insiders of already public companies also reinforce a system in which minority shares have little value, and which won't prevent them from taking more than 80% of the company's value, if they so choose - and some insiders will so choose.

The institutions that are needed to control insider self-dealing

Just as successful securities markets have developed institutions to counter information asymmetry, they have developed institutions to counter insider self-dealing. In some cases, these are the same institutions that control information asymmetry; in some cases, they are different institutions. The necessary institutions are listed below. The list is judgmental, and is in an order that makes logical sense, not in order of the estimated importance of different institutions. Part Four combines this list and the related list of institutions to control information asymmetry into a single table.

(1) Securities or other laws that require extensive disclosure of self-dealing transactions.

Insiders won't voluntarily announce to the world that they are engaged in self-dealing. Strong disclosure rules are needed, because if self-dealing transactions can be hidden, none of the other protections will be very effective.

(2) Requirements that a company's accountants review any self-dealing transactions and report on whether they were accurately disclosed.

Insiders have a powerful incentive to hide self-dealing despite formal disclosure obligations. Just as reputational intermediaries are needed to police companies' disclosure of financial information, they are needed to police disclosure by companies and insiders of self-dealing transactions. Unlike the situation when a company issues shares to investors, there is no discrete transaction for which investors can insist in intervention by reputational intermediaries. If this intervention is desired, it must be mandated. Accountants are the obvious intermediary that can play this role.

If accountants play this role, then we will also need:

(3) A sophisticated accounting profession with the skill and experience to catch at least some nondisclosed self-dealing transactions, and insist on proper disclosure.

For an insider who is determined to self-deal, having an accountant looking over your shoulder is an obstacle that can often be overcome by suitably disguising the transaction, or your interest in the transaction, by running one or both through multiple intermediaries. For review by accountants to be effective, they must be sophisticated enough to catch at least the less subtle subterfuges, and thus raise the transaction costs of self-dealing.

Expecting the accountants to catch every instance of self-dealing isn't realistic. It would cost too much to investigate every transaction. But that only reinforces the importance of an accounting profession that knows which closets the skeletons are most likely to be hidden in, so the accountants can make productive use of limited resources.

If accountants act as reputational intermediaries, we will also need:

(4) Securities or other laws that impose on accountants enough risk of liability to investors if the accountants have endorsed nondisclosure, or false or misleading disclosure of self-dealing transactions, so that the accountants will resist their clients' entreaties to let them hide self-dealing transactions.

The reasoning behind the need for some liability risk is the same as for financial disclosure in general. The accountants are paid by the company, and will inevitably face pressure to overlook suspicious closets, or to accept a suspicious transaction at face value. Professionalism is one bulwark against stopping an investigation too early, but some risk of liability to investors is an important bulwark for professionalism.

(5) Company law or securities law that establishes procedural protections for self-dealing transactions, such as approval after full disclosure by independent directors, noninterested shareholders, or both.

Disclosure alone will deter some self-dealing. But a lot of self-dealing can still take place if the underlying transactions are lawful.

In a country such as the United States, with a well-developed culture of independence for outside directors, and skilled courts that can ferret out self-dealing when a shareholder sues *ex post*, it may be sufficient to vest approval power solely in the independent directors. But often, the nominally independent directors won't be all that independent in fact, especially for a company with a controlling shareholder, where the directors serve at the controlling shareholder's pleasure. Thus, it will often be important to place approval power, especially for larger transactions, in the hands of noninterested shareholders.[18]

(6) Ownership disclosure rules that ensure that outside investors know who the insiders are, and that interested shareholders in fact cannot vote to approve a self-dealing transaction that requires approval by noninterested shareholders.

If noninterested shareholders are given decision-making power over self-dealing transactions, insiders will have an incentive to disguise their share ownership, in order to pretend to be noninterested. Disclosure rules are needed to prevent this.

More generally, as long as insider self-dealing is a significant risk, it will be important for outside investors to know who the insiders are. This will both help the outside investors to determine how much to trust the insiders this time, and give the insiders an incentive to develop reputations for not abusing their power.

(7) Strong sanctions against insiders for violating the disclosure or procedural rules governing self-dealing transactions, or for engaging in insider trading, including criminal sanctions where appropriate.

Oversight by reputational intermediaries, or requirements that a transaction, *if* disclosed, must be approved by independent decision makers, are important devices to enhance detection of attempted theft (for that is what insider self-dealing must be understood as), and reduce the frequency of the attempts. But they are no substitute for direct rules against theft, and meaningful sanctions against the thieves that are caught violating the rules.

Return of the ill-gotten gains is an insufficient remedy as long as the probability of detection is less than one. Damages equal to a multiple of the insider's gains are possible, but limited in effectiveness given the combination of limited insider wealth and the insiders' ability to hide, or remove from the jurisdiction, much of that wealth. Thus, criminal sanctions are a necessary supplement to civil damages.

(8) A securities regulator (and, for criminal cases, a prosecutor) who is honest, and has the staff, skill, and budget to untangle complex self-dealing transactions.

As for financial disclosure, honesty and specialisation are essential. In many countries, neither can be taken for granted. Insiders will often use transactional complexity and intermediaries to hide their interest in a transaction, and anonymous offshore accounts to hide insider trading. Proving a direct self-dealing case, or an insider trading case, often requires developing a chain of circumstantial evidence that will befuddle an ordinary prosecutor, or at least lead him to seek out easier cases.

(9) A judicial system that is honest, and sophisticated enough to understand complex self-dealing transactions involving multiple intermediaries.

Honesty and sophistication are again basic, and often absent. Because insiders are dealing with themselves, or (for insider trading) with an anonymous market, they can often arrange a self-dealing transaction without a telltale paper trail.

(10) Company or other law that requires public companies to have a minimum number of independent directors; and imposes on independent directors enough risk of liability for approving self-dealing transactions that are grossly unfair to the company, so that they will resist pressure from insiders to approve these transactions.

I suggested above that approval by nominally independent directors can be an insufficient safeguard against self-dealing transactions, because the directors' independence will often be in doubt. But it remains an important safeguard, and the directors' potential liability for not behaving independently is a central support for whatever value this constraint can have.

The independent directors must be given the benefit of the doubt, or else truly independent directors will hesitate to serve for fear of financial liability. But if the insider dealing is egregious enough, the need for liability outweighs the potential chill on directors' willingness to serve.

(11) Sophisticated securities lawyers who can ensure that a company satisfies the disclosure requirements and procedural protections governing self-dealing transactions.

A disclosure document for a self-dealing transaction, developed to obtain shareholder approval for the transaction, or an annual disclosure document that lists self-dealing transactions during the past year, will commonly be prepared by securities counsel. An important safeguard of accuracy is counsel's willingness to insist on full disclosure, to conduct enough due diligence to satisfy themselves that the disclosure is accurate, and to warn their clients about the risks of partial disclosure.

(12) An active financial press that can uncover and publicise instances of insider dealing.

Insiders will be more reluctant to engage in self-dealing, and independent directors, accountants, and securities lawyers will be more vigorous in policing it, if a country has a financial press that is ready and eager to publicise misdeeds. As with the press's role in improving financial disclosure, a country's libel law is important, to ensure that press reporting is not unduly chilled by fear of a libel suit from an insider, who can finance the suit largely with someone else's (the company's) money.

(13) A culture of compliance that develops over time, among accountants, lawyers, and company managers, that concealing self-dealing transactions, approving a transaction that is seriously unfair to the company, ignoring the procedural protections for these transactions, or trading on inside information is a recipe for trouble.

In countries with strong securities markets, the sanctions against insider self-dealing, in both its direct and indirect variants, are collectively strong enough so that they reinforce a norm against such transactions. The culture further reduces the frequency of the transactions, and improves the quality of those that occur. The transactions that occur still may not be entirely fair to the company, but they are less likely to be grossly unfair.

To take one (of many) recent examples of Russian self-dealing, it would simply never occur to the managers of an American oil company to propose that the company sell its oil to supposedly unaffiliated offshore companies, that no one has ever heard of, for $1.30 per barrel, when the market price is $13 per barrel.[19] The managers wouldn't propose this, the independent directors wouldn't approve it, and if it somehow occurred anyway, the accountants would qualify their report on the company's financial statements, the press would report the scandal, and hanging over everyone would be the threat of both civil and (for the managers) criminal liability.

Which came first: laws controlling self-dealing, or a culture that frowns on them, reinforces the laws, and makes them politically feasible? This is an unanswerable question. As for the disclosure norms, the two likely developed together and were mutually reinforcing.

Thus far, the list of necessary institutions has focused on the institutions needed to control self-dealing. I list next the additional institutions that are needed specifically to control insider trading.

(14) Securities or other laws that prohibit insider trading, suitably defined.

To be effective, a ban on insider trading must include a ban on tipping others, as well as on trading yourself.

(15) A good overall financial disclosure regime

The better the overall financial disclosure regime is, the harder it will be to hide gross direct self-dealing. Moreover, the better the information that is provided to the public, the smaller the profit opportunity from insider trading.

(16) A stock exchange with meaningful listing standards, the willingness to enforce them by fining or delisting companies that violate the rules governing self-dealing transactions, and the financial resources and skill to run a surveillance operation that can catch at least some insider trading.

For direct self-dealing, stock exchange enforcement, through delisting (or the threat of delisting), is an important supplement to official enforcement. For insider trading, the stock exchange is the institution that is best able to monitor its own trading, looking for unusual trading patterns that suggest insider trading.

As for information asymmetry, this list is a judgmental effort to assess the most important institutions, rather than an exhaustive list of *useful* institutions. An example of a useful institution in a country where self-dealing is an important risk: rules requiring a new controlling shareholder to offer to buy out all other shareholders at a per share price comparable to the price that the controlling shareholder paid in acquiring control. This rule gives comfort to outside investors that, while they must still bet, to some extent, on the honesty of a company's current controlling shareholders, they have an assured exit, at a reasonable price, if control changes hands.

Still, the list is ample to suggest the difficult task facing a country that wants to control self-dealing well enough to develop a strong stock market. Once again, rules on paper are important but not sufficient. Enforcement is critical. The Russian company law offers a good example. It contains reasonably strong procedural protections against self-dealing transactions. But in practice, Russian companies routinely ignore the rules on self-dealing transactions because there is no enforcement. Insiders hide the transactions, and (sometimes corrupt) prosecutors and judges usually let the insiders off the hook in the rare case when a transaction is exposed. Reputational intermediaries - including major investment banks and major accounting firms - have chosen to look the other way.

(17) Rules ensuring transparency of trading prices.

Insider trading flourishes in the dark. The better the trading price is as a guide to actual value, the harder for insiders to profit from trading with outsiders. This requires not only general financial disclosure, but also rules ensuring transparency of trading.

(18) Rules banning manipulation of trading prices.

The downside of market transparency is that the public reporting of trades permits insiders to manipulate trading prices. "Pump and dump" schemes, where insiders of small companies use prearranged transactions at rising prices to create the appearance of a hot stock, and then sell their own shares at inflated prices, are an endemic problem even in developed markets. Enforcement of antimanipulation rules by specialised regulators is the only remedy.

The length of this list is intended to suggest that developing strong securities markets is a difficult task, not that it an impossible one. Incremental steps can help, at least for large companies that can rely in significant part on their own reputations. Among developed countries, for example, Italy and Germany have taken important steps in the last several years toward improving disclosure. At the same time, these countries have experienced a significant increase in initial public offerings, and in the ratio of market capitalisation to GNP. I don't think these changes are a coincidence. It is likely that Italy and Germany would realise even stronger growth in stock market capitalisation if they enhanced not only their disclosure rules but also their procedural protections against self-dealing transactions.

But these changes do not come easily. The new German and Italian disclosure rules have been controversial, partly because while they make it easier for new companies to go public, they also transfer wealth in already publicly traded companies from insiders to outside shareholders.

IV. Can companies and countries with weak institutions piggyback on other countries' institutions?

Given the difficulty of creating the interrelated institutions that are needed for strong securities markets, an important question is the extent to which a company located in a country that lacks many or all of these institutions can piggyback on the more developed institutions of other countries. A related question is the extent to which an entire country can piggyback on the institutions of other countries. Jack Coffee, in particular, argues that individual companies can in large measure piggyback on another country's institutions.[20] I'm more sceptical. This part is devoted to that question.

Table I below lists the institutions that are necessary for strong securities markets, organised somewhat differently than in Parts Two and Three in order to emphasise the overlap between the institutions needed to ensure good disclosure (Part Two) and to control insider self-dealing (Part Three). I also offer in Table 1 a crude judgmental ranking, on a 1-5 scale, of the ease with which a *company*, or an entire *country*, can piggyback on foreign institutions, instead of relying exclusively on local development. Explanations of particular rankings follow the table. A rough translation of the 1-5 scale is:

5: Easy to piggyback (as easy or nearly as easy as for a company already located in the foreign country).

4: Piggybacking is feasible, not too difficult, and likely to work reasonably well.

3: Piggybacking is possible but difficult and/or will work only moderately well if achieved.

2: Piggybacking is very difficult and/or won't work very well if attempted.

1: Piggybacking is not feasible to any significant extent.

Table 1: Ease of Piggybacking on Foreign Institutions

Securities Market Institutions		Needed for:		Possibility of Piggybacking	
		Information Disclosure	**Insider Self-Dealing**	**for a *Company***	**for a *Country***
1	Securities laws requiring full disclosure of financial results and self-dealing transactions	X	X	4	3
2	Strong, publicly enforced civil and criminal sanctions against insiders for violating the disclosure and self-dealing rules	X	X	2	2
3	An honest, sophisticated securities agency (and prosecutors for criminal cases)	X	X	1	1
4	Honest, sophisticated, well-functioning courts	X	X	1	1
5	An active financial press	X	X	2	2
6	A culture of compliance with the disclosure and self-dealing rules by managers, reputational intermediaries, and independent directors	X	X	2	1
7	Good accounting rules	X	X	4	3
8	A good organisation to write accounting rules	X	X	4	3
9	Requirements for audited financial statements	X	X	4	3
10	A sophisticated accounting profession	X	X	4	2
11	A sophisticated investment banking profession	X		4	2
12	Sophisticated securities lawyers	X	X	4	2
13	A stock exchange with meaningful listing standards and an active insider trading surveillance operation	X	X	4	2
14	Market transparency	X	X	5	4
15	A ban on market manipulation	X	X	2	1
16	Civil liability risk for accountants	X	X	3	2
17	Civil liability risk for investment bankers	X		3	2
18	Civil liability risk for insiders	useful	X	1	1
19	Civil liability risk for independent directors if they approve gross self-dealing		X	1	1
20	Auditor review of the adequacy of disclosure of self-dealing transactions		X	3	2
21	Procedural controls on self-dealing transactions (review by independent directors, noninterested shareholders, or both)		X	3	2
22	Independent directors who can control insider self-dealing		X	3	2
23	Ownership disclosure rules		X	4	3
24	Securities or other laws banning insider trading		X	3	2
Mean ranking:				**2.96**	**2.08**

Table 2: *Company* Rankings for Ease of Piggybacking

Ranking	Frequency
1	4
2	4
3	6
4	9
5	1
mean: 2.96	

Table 3: *Country* Rankings for Ease of Piggybacking

Ranking	Frequency
1	6
2	11
3	6
4	1
5	0
mean: 2.09	

The rankings are intended to take us beyond general discussion of the feasibility of piggybacking into more detailed consideration of which institutions can be piggybacked and which can't, and the on-the-ground obstacles to effective piggybacking. That, in turn, can lead to a local reform strategy that concentrates effort on the institutions for which piggybacking is least feasible.

Despite the judgmental nature of the rankings, some general themes emerge. First, there are no easily transplantable institutions. There is only one 5 in the table above - in the company rankings for market transparency. The core problem is local enforcement and local culture. Even world class laws need to be understood and enforced. Understanding depends on local culture, and full enforcement depends on local institutions. Without enforcement, a strong culture of compliance isn't likely. With neither good enforcement nor good local culture, investors will (rightly) discount the credibility of a company's promise to obey the tougher rules of another jurisdiction, even a promise that is moderately well bonded by listing on the other country's stock exchange and hiring internationally known accountants, investment bankers, and lawyers. Moreover, not that many companies can afford the high local cost of world-class accountants, bankers, and lawyers.

It may help to consider a concrete example. Vimpelcom, a Russian telephone company that went public in the United States, is listed on the New York Stock Exchange, has most of its shareholders in the United States, and is fully subject to US accounting requirements and securities laws. All that effort will help Vimpelcom's shares to trade at higher multiples of expected earnings than a comparable Russian company that follows domestic rules. But investors will still discount Vimpelcom's shares, compared to those of an American company with the same apparent future prospects. They know that Vimpelcom's insiders can always cheat and get away with it. In the future, they might decide to do so, no matter how sincere their current promises to the contrary.

Second, while we shouldn't perfect transplants, an individual company can borrow a reasonable number of institutions from abroad. In 16 of the 24 categories, I rate piggybacking potential for an individual company at 3 or above. Table 2 provides some simple statistics:

Third, it's harder for a country as a whole, and thus for its smaller companies, to piggyback on foreign institutions than it is for a single company to do so. For example, adopting international accounting standards can seem to be relatively straightforward for a country, just as it is for an individual company. But for the country as a whole, the feasibility of adopting wholesale a complex set of international rules, and more importantly, how effectively the new rules will be implemented, is limited by the sophistication of the local accounting profession.

Table 3 provides the country rankings analogous to Table 2. No institutions receive a 5 ranking, the only institution that receives a rank of 4 for ease of piggybacking is market transparency, and only 7 institutions receive a rank of 3 or 4. The mean rating drops almost a full point, from 2.96 to 2.08.

Fourth, the most basic, and hence perhaps most important institutions are the hardest to transplant. One can't transplant honest or competent regulators, prosecutors or judges. Thus, one can't transplant enforcement against locals, insiders and independent directors. There are severe limits on how well one can transplant culture, especially without local enforcement to reinforce the cultural norms.

The reasoning underlying these rankings follows.

(1) Securities laws requiring full disclosure of financial results and self-dealing transactions (company ranking 4; country ranking 3).

It is reasonably straightforward, if somewhat costly, for a single company to list on, say, the New York Stock Exchange or NASDAQ and subject itself to US disclosure and accounting rules. The company and its insiders still may not follow them as attentively as an American company, nor as reliably if the company gets into financial trouble and faces a final period problem. Hence the ranking of 4 instead of 5.

For a country as a whole, borrowing disclosure rules isn't as easy. The American securities laws can't be simply copied and transplanted wholesale to another country. An attempt to do so will fail, they won't mesh with other local institutions, will likely conflict with other local laws, will be far more complex than needed, and will in some respects be *weaker* than needed, because official rules can be less strict when informal enforcement is strong. Instead, borrowing securities law from abroad takes careful work, often involving collaboration between domestic draftsmen and foreign experts who can explain how their rules really work. This is a lot of work. The end product will inevitably be imperfect even before it gets to the legislature. If my own experience (in Russia, Mongolia, Vietnam, and Ukraine) is any guide, the disclosure rules will be still more imperfect when it emerges from the legislature. Thus, with the exception of accounting rules (discussed below), I can't rate the transplantability of a whole body of law any higher than a 3.

(2) Strong civil and criminal sanctions against insiders for violating the disclosure and self-dealing rules (company ranking 2; country ranking 2).

When it comes to direct sanctions against insiders, there isn't that much that a single company can do. Its foreign assets are potentially vulnerable to a suit in the foreign country where it lists its shares. The company is subject to delisting - a kind of civil sanction - if it misbehaves. But both of these exposures are limited, and affect insiders only indirectly, through the shares they own. A company can't do much to create direct enforcement against its own insiders, unless the country chooses to does so.

Countries, too, have a hard time importing strong sanctions. Stronger rules can be adopted, but, especially for criminal rules, they have to fit within an existing legal framework. They can't simply be adopted wholesale, the way that disclosure rules can. Moreover, the rules are, in the end, no better than the enforcement, which can't be imported at all.

(3) An honest, sophisticated securities agency (and prosecutors for criminal cases).
(4) Honest, sophisticated, well-functioning courts.
(For each: company ranking 1; country ranking 1.)

These institutions are at the heart of a good national investor protection system, and unfortunately are neither transplantable nor easily created.

(5) An active financial press (company ranking 2; country ranking 2).

The financial press must be, for the most part, homegrown, and can't be tailored to the needs of a particular company. And it can be chilled by overly broad local libel rules. At the same time, there is some room for importing foreign standards of reporting, by welcoming the international financial press (Wall Street Journal, Financial Times, Economist, and the like). They can provide some reporting themselves, and can raise professional standards by example.

(6) A culture of compliance with the disclosure and self-dealing rules by managers, reputational intermediaries, and independent directors (company ranking 2; country ranking 1).

Culture is inherently largely local. A single company can take some steps to import a culture of disclosure and compliance. It can hire foreigners to sit on its board of directors, and in its financial department. That helps, but only so much. The bulk of the staff will be local, and can often hide local skeletons from the foreigners. And their thought processes, as they think about disclosing something they'd rather hide, will be influenced primarily by national culture and expectations, not the perhaps different norms their company has tried to instil.

(7) Good accounting rules.
(8) A good organisation to write accounting rules.
(9) Requirements for audited financial statements.
(For each: company ranking 4; country ranking 3.)

Audit requirements and accounting rules are among the easiest for a company to borrow from abroad. The rules exist in reasonably clear form (the most common choices are US General Accepted Accounting Principles, or the steadily improving International Accounting Standards), as do rule-writing organisations that keep the rules up to date. The company, at some extra cost, can keep two sets of accounts, one following local rules and the second following the chosen international rules, and can hire an international accounting firm to audit its accounts and review its financial statements. Lack of local enforcement will still limit the credibility of the financial statements to some degree. Overall, extra cost and lack of local enforcement explain why this collection of institutions receives a 4 for transplantability, rather than a 5.

At the country level, transplanting accounting rules and audit requirements is not as simple as for a single company. As a formal matter, a country can adopt wholesale a set of foreign accounting rules, including future changes in those rules, and accompanying audit requirements. But the effectiveness of the new rules and audit requirements will depend on the sophistication of the local accounting profession. Any one company can, at some cost, import foreign accountants. A whole country cannot.

The country feasibility rating of 3 is a blend of the 4 rating for an individual company, and the 2 rating for the transplantability of a sophisticated accounting profession. A second reason for the lower country rating is that in the near term, if the local accounting profession is too weak, or too small in number, it may not be practical to adopt international rules, or widespread audit requirements, because there aren't enough trained accountants to implement them.

(10) A sophisticated accounting profession.
(11) A sophisticated investment banking profession.
(12) Sophisticated securities lawyers.
(For each: company ranking 4; country ranking 2.)

These reputational intermediaries that support good disclosure in strong securities markets (all but the investment bankers) are also important for controlling self-dealing. An individual company can, at a cost high enough to make this feasible only for large companies, hire international accountants, investment bankers, and securities lawyers. This can produce reasonably effective reputational intermediation, albeit still not worth as much as in a jurisdiction with strong local enforcement.

A country can do a little bit to piggyback on the existence of international accounting, investment banking, and law firms. Most obviously, it can permit them to enter, compete with local firms, and hire local people, some of whom will later leave to join local firms or start their own firms. That merits a 2 ranking for ease of piggybacking, but no more than that. The job of building a sophisticated profession remains a decades-long one, that requires an initial investment in university-level education, and in the rules that will create the demand for these skilled professionals, that will lead talented young people to choose these professions.

(13) A stock exchange with meaningful listing standards and an active insider trading surveillance operation (company ranking 4; country ranking 3*).*

An individual company can list its shares on a foreign exchange, and thereby obtain most of the reputational benefits from doing so.

For a country that wants to build a stock exchange, the rules and trading systems can be imported, though they will surely need to be adapted to local rules and local needs. Another potentially feasible strategy, though so far not a popular one, is to build no stock exchange at all, and expect local firms to list abroad. These possibilities make stock exchanges easier to borrow than other reputational intermediaries, warranting a 3 ranking.

(14) Market transparency (company ranking 5; country ranking 4*).*

Of all the institutions in the chart, market transparency is the easiest to transplant. For a company, transparency can be ensured by listing on a foreign exchange in a country with strong transparency rules, and hiring a good registrar, which will refuse to register share transfers that don't comply with the transparency rules. This warrants a 5 ranking.

For a country, the same strategy is feasible. One needs transparency rules for the stock exchange(s), rules on when registrars should record share transfers, plus some ability to enforce the rules against both the exchange and the registrars. Even with the extra enforcement issues, a 4 ranking seems warranted.

(15) A ban on market manipulation (company ranking 2; country ranking 1).

An effectively enforced ban is an important accompaniment to market transparency rules, to make sure that the trading information that is conveyed to investors is an accurate reflection of investor sentiment. Unfortunately, making such a ban effective takes good local enforcement, because whether trading is benign or manipulative depends heavily on local facts, on *who* is doing the trading.

An individual company can be helped somewhat by a good stock exchange-maintained record of trades, and the participating broker-dealer. That warrants a 2 ranking. But for a country, sophisticated enforcement is critical, and can't be imported.

(16) Civil liability risk for accountants.
(17) Civil liability risk for investment bankers.
(For each: company ranking 3; country ranking 2.)

A company that offers shares overseas, subject to overseas rules, using international accountants and investment bankers, also subjects the accountants and bankers to foreign liability. But proof problems should not be underestimated. Intermediaries are typically liable only if their conduct is culpable in some way - whether the degree of culpability be negligence, gross negligence, recklessness, or something else. Proving culpability, when the facts are local and often hard to uncover, will often be a daunting task. Thus, in practice, weak local enforcement capacity reduces the liability risk faced by reputational intermediaries.

(18) Civil liability risk for insiders.
(19) Civil liability risk for independent directors if they approve gross self-dealing.
(For each: company ranking 1; country ranking 1.)

Insiders and independent directors will generally be locals and hold their assets locally. In practice, they will be liable (if at all) only under local law, which brings us back to local courts, which aren't transplantable, and local rules, which are only moderately transplantable. In practice, I can't think of a case where foreign investors have successfully obtained damages from locals, even for egregious behaviour. Most investors don't even try.

(20) Auditor review of the adequacy of disclosure of self-dealing transactions.
(21) Procedural controls on self-dealing transactions (review by independent directors, noninterested shareholders, or both).
(22) Independent directors who can control insider self-dealing.
(For each: company ranking 3; country ranking 2).

A country can establish procedural devices such as these to control self-dealing. But the procedures can still catch only a fraction of the self-dealing that insiders engage in and then try to hide. The true independence of independent directors will depend, in significant measure, on the country's cultural norms. And the incentive to self-deal will remain present as long as local enforcement is weak.

(23) Ownership disclosure rules (company ranking 4; country ranking 3*).*

The analysis here is much the same as for disclosure rules generally. A single company can list on the New York Stock Exchange and subject itself to US ownership disclosure rules. The company and its insiders still may not follow them as attentively as an American company, if the insiders have a reason to conceal their ownership. Hence the ranking of 4 instead of 5.

A country has to fit the rules into its overall legal framework and have some ability to enforce them. For example, if courts don't see immediately that if company A controls company B which controls company C, then A controls C, then disclosure rules that work just fine in a developed country will break down. Given this risk, a ranking of 3 seems appropriate.

(24) Securities or other laws banning insider trading (company ranking 3; country ranking 2*).*

Insider trading can be banned as a formal matter, but policing it is difficult everywhere, and perhaps almost impossible if local institutions are weak. Much of the proof (*A* is related to *B*, who knows *C*, who actually traded) will be local, and thus perhaps hard to come by. It helps a bit if a particular company is listed on a foreign exchange, with an active surveillance operation. But still, the exchange will usually hit a dead end when it investigated suspicious trading. These pervasive enforcement problems preclude a high ranking.

V. Strong and weak securities markets: a separating equilibrium?

Many of the institutions needed to support a strong securities market are endogenous to the existence of that market. For example, if there isn't an active market for public offerings of securities, there is less need and less opportunity for investment bankers to invest in the reputation needed to support these offerings; less need for a stock exchange to develop strong listing standards; less opportunity for a sophisticated securities regulatory agency, sophisticated accounting rules, and a sophisticated rule-writing body to develop; and so on.

Moreover, if securities markets are weak, companies and countries will develop other ways to finance businesses. Bank financing is the most obvious alternative, which means that banks will tend to become strong, both financially and politically. They will both provide financing to companies, and resist legal changes that might strengthen securities markets. Conglomerates are a second alternative that will tend to become strong. Once built, they reduce the need for a strong securities market, and their insiders will fight against strengthening of rules and institutions that would limit self-dealing transactions between group members.

The converse is also true. A country with a strong securities market will build supporting institutions, that will support the rules and official enforcement that are needed to maintain a strong market. It may build a venture capital industry that both depends on the possibility of exit from portfolio investments through an initial public offering and generates demand for the institutions that support these public offerings.

Thus, from both an economic and political point of view, there is the potential for two separate, stable equilibria to arise - a strong market equilibrium, in which the necessary endogenous institutions have been built, and a weak market equilibrium, in which many of the necessary institutions are absent.

I intend the concept of a separating equilibrium to be a qualitative one. Incremental improvements in a country's securities market are possible that will permit more companies to go public, at higher prices. Even in the weak market equilibrium, some companies will be able to develop reputations strong enough to obtain respectable prices when they sell shares to outside investors. The better a country's institutions, the more companies will be able to sell shares in reliance partly on their own and partly on the country's reputation.

Nonetheless, the concept of separating equilibria, both economically and politically, can capture both the difficulty a country will have in moving from a bank-centred capital market, where mature companies go public largely based on their own reputations built over time, to a stock-market-centred capital market, where new companies have access to public capital, because they can trade on the built-up reputations of others, especially reputational intermediaries, and on other factors - notably culture and enforcement that make fraud or self-dealing less likely even among companies that have yet to build a reputation of their own. Parts Two and Three of this article can be seen as an attempt to develop minimum conditions for achieving the "strong markets" equilibrium.

VI. Different types of monitoring: investor protection and firm performance

A major theme in comparative research on corporate governance over the past decade is the effort to assess the comparative strengths and weakness of bank-centred and stock-market-centred capital markets. The standard debate posits that bank-centred capital markets, such as Germany and Japan, have a potential advantage over stock-market-centred capital markets in the ability of investors to directly monitor managers, to make sure that the company is well-managed. Strong banks have greater ability to monitor than dispersed shareholders. That the insiders won't simply steal from the company through self-dealing transactions is taken for granted.[21]

The standard analysis also recognises that stock-market-centred capital markets also have potential advantages. For one thing, banks may discourage risk-taking, in order to protect their mostly fixed claims. They may monitor more strongly than dispersed shareholders, but in a skewed way. Stock-market-centred systems can also provide greater liquidity to investors, and greater capital-raising opportunities for companies with intangible assets, against which banks can't easily lend. Finally, they can develop an active market for corporate control that can provide indirect monitoring of performance and substitute in part for the weak direct monitoring that characterises capital-market-centred systems.

Still the debate proceeds from a central, widely accepted premise - that bank-centred capital markets potentially enjoy stronger monitoring than stock-market-centred systems. The analysis developed above suggests that this assumption may be misplaced, as applied to a less developed economy. Monitoring has two basic dimensions - monitoring management performance, to ensure that a company is well run, and monitoring insiders, to ensure that they don't steal the company's value from investors (whether shareholders or creditors). I have suggested above that strong securities markets develop only in countries that do a good job along the second dimension - protecting outside investors against insider self-dealing. That raises the question whether countries with stock-market-centred systems systematically have stronger monitoring along this dimension than countries with bank-centred systems, which could compensate for their (conceded, for purposes of this argument) weaker monitoring of management performance.

I do not propose to answer that question here, merely to raise it. Answering it is difficult, in part because bank-centred systems may do a good job of protecting creditors against insider theft, at the same time that they do a not-so-good job of protecting minority equity investors against transfer of value from those investors to insiders. Indeed, a strong bank-centred capital market almost *must* do a respectable job of protecting creditors, or bank finance won't be widely available either.

Still, it is at least plausible that, on the whole, stock-market-centred capital markets may be stronger than bank-centred capital markets in ensuring that companies are not only well-run, but *honestly* run. Indeed, a country's success along this dimension might be an important predictor of what kind of capital market it develops. If this were the case, then the two systems would have different monitoring strengths, with neither clearly dominating the other along an overall monitoring dimension.

Put differently, it is possible that the greater liquidity offered by stock-market-centred capital markets may not come at a cost in weaker monitoring, once monitoring is understood to include both controls against weak management (on which corporate governance scholarship usually focuses) and controls against self-dealing (which are often taken for granted in the United States, but loom large elsewhere). At the same time, this broader conception of "monitoring" suggests a reframing of the standard corporate governance debate over how to improve monitoring that gives greater weight to the dimensions of financial reporting and control over insider self-dealing.

VII. Conclusion: what steps to take first

The complex institutions needed to support a strong securities market can't be developed overnight, or all at once. Some, like honest courts and prosecutors, can precede market development. Others will grow only as the market itself grows. For example, a country can hardly develop a strong securities regulator before it has some publicly traded securities for the regulator to gain experience with.

Many transition economies have none, or almost none, of the needed institutions. Where should they start? There are two obvious places to start. The first area of emphasis should be on institutions that must be homegrown, including honest courts and prosecutors, and some experience in applying rules against fraud in complex white-collar crime cases. The second is good capital markets rules, which have the helpful feature that in important respects, they can be imported from outside. The importing country needs to understand that if it engages five sets of foreign advisors, they will propose five different laws, which will be inconsistent with each other and with the country's existing laws. Local draftsmen need to be closely involved in the drafting process, to ensure that the rules fit into an existing legal framework and that the rules build on existing terminology and practice to the extent possible.

Accounting rules are a central part of information disclosure. Here, fortunately, we are not far (perhaps 5 years) away from having a perfectly workable set of international accounting standards that a developing country can draw on in preparing its own rules, or even adopt wholesale.

Another important step, if professional intermediaries don't exist, is establishing or strengthening good professional schools in business (for investment bankers and accountants) and law (for securities lawyers and regulators). The payoff for this investment in training of young people will be measured in decades. But if the investment isn't made, the decades will go by, and the country still won't have the prerequisites it needs.

None of this will happen quickly. But some basic, early steps - honest courts, regulators and prosecutors - are critical whatever form a country's capital markets take. It is no harder to develop honest, sophisticated securities regulators than to develop honest, sophisticated bank regulators. One suspects also that government honesty has important externalities - one agency is unlikely to be an island of honesty in a sea of corruption.

In developed countries, scholars often think of good corporate governance as revolving around such matters as subtle variations in the independence of directors, or the constraints on the corporate control market. In developing countries, corporate governance can be much more basic. We need honest judges and regulators before it makes sense to start worrying too much about independent directors.

NOTES

1 Bernard Black & Reinier Kraakman, *A Self-Enforcing Model of Corporate Law*, 109: Harvard Law Review 1911-1981 (1996).

2 Bernard Black, *Information Asymmetry, the Internet, and Securities Offerings*, 2 Journal of Small and Emerging Business Law 91-99 (1998), also available from the Social Science Research Network electronic library at <http://papers.ssrn.com/paper.taf?abstract_id’84489>.

3 Florencio Lopez de Silanes, Andrei Shleifer & Robert Vishny, *Legal Determinants of External Finance*, 52 Journal of Finance 1131- (1997); Rafael La Porta, Florencio Lopez de Silanes, Andrei Shleifer & Robert Vishny, *Law And Finance*, 106 Journal of Political Economy 1113-1155 (1998a); Florencio Lopez de Silanes, Andrei Shleifer & Robert Vishny, *Agency Problems and Dividend Policies Around the World* (working paper 1998b), available from the Social Science Research Network Electronic Library at <http://papers.ssrn.com/paper.taf?abstract_id’52871>; Rafael La Porta, Florencio Lopez de Silanes and Andrei Shleifer, *Corporate Ownership Around the World*, 54 Journal of Finance 471-517 (1999).

4 Franco Modigliani & Enrico Perotti, *Security Versus Bank Finance: The Importance of a Proper Enforcement of Legal Rules* (working paper 1998), available from the Social Science Research Network Electronic Library at <http://papers.ssrn.com/paper.taf?abstract_id’157281>.

5 John Coffee, *The Future as History: The Prospects for Global Convergence in Corporate Governance and Its Implications* (Columbia Law School Law & Economics working paper No. 144, 1998, available from the Social Science Research Network electronic library at <http://papers.ssrn.com/paper.taf?abstract_id’142833>.

6 The subtitle of this article, ‘The Nontriviality of Securities Law,’ is a play on an earlier article of mine, Bernard Black, *Is Corporate Law Trivial? A Political and Economic Analysis*, 84 Northwestern University Law Review 542-597 (1990), in which I argue that American corporate law is mostly and perhaps entirely trivial, in the sense that it doesn’t significantly constrain any private contractual arrangements that a company's shareholders want to choose for themselves.

7 The obligatory citation here is to George Akerlof, *The Market for "Lemons": Quality Uncertainty and the Market Mechanism*, 84 Quarterly Journal of Economics 488-499 (1970).

8 On the pervasive role of reputational intermediaries in securities markets, see Ronald Gilson & Reinier Kraakman, *The Mechanisms of Market Efficiency*, 70 Virginia Law Review 549-644 (1984), at 595-607.

9 For evidence on the role of venture capital funds as reputational intermediaries, see Alon Brav & Paul Gompers, *Myth or Reality? The Long-Run Underperformance of Initial Public Offerings: Evidence from Venture and Nonventure Capital-Backed Companies*, 52 Journal of Finance 1791-1821 (1997); Paul Gompers & Josh Lerner, *Conflict of Interest and Reputation in the Issuance of Public Securities: Evidence from Venture Capital*, Journal of Law and Economics (1999).

10 See Bernard Black & Ronald Gilson, *Venture Capital and the Structure of Capital Markets: Banks versus Stock Markets*, 47 Journal of Financial Economics 243-277 (1998).

11 It is beyond the scope of this article to enter the debate over the extent to which audits and other disclosure practices must be mandated, or will appear voluntarily. Suffice it to say that the arguments

in favor of mandating disclosure become stronger, the weaker a country's securities markets, and the weaker the culture of disclosure that supports those markets. For pieces of this debate, see Anat R. Admati & Paul Pfleiderer, *Forcing Firms to Talk: Financial Disclosure Regulation and Externalities* (working paper 1998), available from the Social Science Research Network Electronic Library at <http://papers.ssrn.com/paper.taf?abstract_id'103968>; Paul G. Mahoney, *Mandatory Disclosure as a Solution to Agency Problems*, 62 University of Chicago Law Review 1047-1112 (1995); Frank Easterbrook & Daniel Fischel, The Economic Structure of Corporate Law ch. 11 (Harvard Univ. Press 1991); John C. Coffee, Jr., *Market Failure and the Economic Case for a Mandatory Disclosure System*, 70 Virginia Law Review 717-753 (1984).

12 See generally Louis Lowenstein, *Financial Transparency and Corporate Governance: You Manage What you Measure*, 96 Columbia Law Review 1335-1362 (1996).

13 For an overview of US and British practice in setting accounting rules, see Brian Cheffins, Company Law; Theory, Structure, and Operation 372-73, 376-77 (Oxford Univ. Press 1997).

14 See Cheffins (1997), *supra* note 11, at 378-420, for discussion of the advantages and disadvantages of self-regulation, both for accounting rules and other aspects of company and securities regulation, drawing largely on British experience.

15 See generally Robert Axelrod, *The Evolution of Cooperation* (1984).

16 For more general discussion of the reasons to believe that rules that can be privately enforced are likely to be more effective than rules that require public enforcement, see Black & Kraakman (1996), *supra* note 1.

17 This example is adapted from Coffee (1998), supra note 2.

18 For discussion of rules to control insider dealing in a transition economy, and the choice between *ex ante* and *ex post* controls, see Black & Kraakman (1996), *supra* note 1, at 1932-34, 1958-60.

19 See Bernard Black, Reinier Kraakman & Anna Tarassova, *Russian Privatization and Corporate Governance* (working paper 1999).

20 Coffee (1998), *supra* note 2.

21 For pieces of this extended debate, see Mark J. Roe, Strong Managers, Weak Owners: The Political Roots of American Corporate Finance (Princeton Univ. Press 1994); Black & Gilson (1998), *supra* note 9; John C. Coffee, Jr., *Liquidity Versus Control: The Institutional Investor as Corporate Monitor*, 91 Columbia Law Review 1277-1368 (1991); Ronald J. Gilson, *Corporate Governance and Economic Efficiency: When Do Institutions Matter?*, 74 Wash. U.L.Q. 327 (1996).

COMPARATIVE CORPORATE GOVERNANCE TRENDS IN ASIA

by
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I. Introduction

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

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

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

Another important aspect of the East Asian crisis was that the initial currency crisis quickly degenerated into a full economic crisis with massive corporate bankruptcies and soaring unemployment. In this regard, it is important to distinguish between the currency crisis and the subsequent collapse of corporate and financial sectors, although they are certainly related. It could be the case that a more astute policy response and/or better institutional arrangement in the international

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financial market may have averted a currency crisis which entailed an economic crisis of this magnitude.

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

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

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

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

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

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

Corporate governance and economic restructuring

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

Under these circumstances, it is likely that some of the funds newly provided by foreign investors were misallocated, lowering overall corporate profitability and raising vulnerability. To be sure, the relationship-based system can perform the task of resource allocation relatively well through inter-temporal cross-subsidies within a firm or inter-firm cross-subsidies within a business group, especially when legal and contractual infrastructures are not well developed and price signals are not informative. But the problem of resource misallocation can be significant under the relationship-based system since it does not use price signals and lacks monitoring and discipline from the market.[4] These deficiencies hurt most when abundant funds need to be allocated among new investment opportunities, which was the case in the East Asian countries after the liberalisation.

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

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

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

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

Corporate governance and economic growth

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

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

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

Third, better investment decisions and a mechanism to induce such decisions will be needed more than ever. As the economy places more emphasis on technological advancement and integrates itself more deeply into the global economy, production and investment decisions become more complex under the diverse market environments. For an efficient investment decision to be made, not only should all the relevant information be efficiently aggregated, but also the incentives of any given decision-maker need to be aligned as close to social efficiency as possible. This observation points to the importance of the signalling function of market price, and to the effectiveness and transparency of corporate governance systems.

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

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

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

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

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

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

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

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

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

II. Key aspects of the corporate governance system

As with any other economic institution, a successful corporate governance system must accomplish the tasks of co-ordination and motivation. The decisions and actions of the interested parties, i.e. shareholders, management, and creditors and potential investors in the financial market, need to be co-ordinated to protect the shareholders' interests and efficiently advance other corporate goals. At the same time, the relevant parties must be motivated to carry out their parts in the co-ordinated system through rewards for taking appropriate actions, and punishments for failing to do so.

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

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

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

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

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

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

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

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

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

First, we need to look beyond corporate governance at the individual firm level. It is well known that a small number of families dominated the corporate landscape in most East Asian countries.[6] Given this, the relationship among the firms within a business group controlled by a single family is necessary in order to gain insights into corporate governance in the real sector. A tight linkage among the firms under unified control could lead to better firm performance by pooling resources and information as well as by reducing transaction costs. However, there is also a clear danger that such singular control of several firms may facilitate the expropriation of non-controlling (outside) shareholders by the controlling shareholders.

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

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

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

A more important source of the failure in the financial sector governance can be found in governments' interventionist industrial policies. Governments' direct control of the allocation of financial resources has distorted the incentives of financial institutions, creating a severe moral hazard, and impeded the development of necessary corporate governance mechanisms. It also has adversely affected governance in the corporate sector. As governments provided subsidised credit to firms in the targeted industrial sector, and implicitly shared their investment risk, those firms, and more importantly the dominant shareholders of those firms, were excessively protected from market competition and discipline.

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

III. Corporate governance of East Asian Countries

Overview

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

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

The degree of leverage in the corporate sector, which was believed by many to have been closely linked to both the boom and the bust of the East Asian economies, varies widely across countries. Further, the profitability of firms and their ability to service their debt also vary significantly. The dominance of conglomerates and the impact they have on the performance of corporations and lending institutions also differ significantly throughout the region. While concentration of ownership and control of corporations (and banks in some countries) by families is a universal phenomenon in all seven economies, it is especially severe in Indonesia, the Philippines, and Thailand, where the largest ten families control half of the corporate sector in terms of market capitalisation, according to Claessens et al (1998b). Hong Kong and Korea are behind these in rank, but not by much as the largest ten families control about a third of the corporate sector according to the same study.

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

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

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

Corporate governance of corporations

Distribution of ownership and control

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

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

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

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

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

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

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

Table 3-1: Ownership Concentration of the Ten Largest Firms

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

Source: La Porta et al. (1998)

Table 3–2: Control of Publicly Traded Companies in East Asia
(Unweighted)

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

Source: Claessens et al. (1998b).

Table 3-3: Control of Publicly Traded Companies in East Asia
(Weighted by market capitalisation)

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

Source: Claessens et al. (1998b).

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

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

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

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

Governance structure within corporations and regulatory environments

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

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

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

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

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

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

Variables	Description/Effect	Korea	Indo-nesia	Malay-sia	Philip-pines	Thailand	Mexico	India
Right to call emergency shareholder meeting (percent of shareholders)	Facilitates shareholders control	YES 3	YES 10	YES 10	YES 10	YES 20	YES 33	YES 10
Right to make proposals at shareholder meeting	Facilitates shareholders control; increased opportunity to prevent biased decisions by insiders	YES	YES	YES		YES	NA	NA
Mandatory shareholder approval of interested transactions	Protects against abuse and squandering of company assets by insiders	YES	YES	YES	YES	YES	NA	NA
Preemptive rights on new stock issues	Protects against dilution of minority shareholders; prevents insiders altering ownership structure	YES	YES		YES	YES	NA	NA
Proxy voting	Facilitates shareholders control	YES	NO	YES	YES	YES	NO	YES
Penalties for insider trading	Protects against use of undisclosed information at the expense of current and potential shareholders	YES	YES	YES	YES	YES		
Provisions on takeovers legislation	Protects against violation of minority shareholders' rights	YES		YES	YES	YES		
Mandatory disclosure of non-financial information	Both financial and non-financial information data are important to assess a company's prospects	YES	YES	YES		YES		
Mandatory disclosure of connected interests	To protect against abuse by insiders	YES			YES	YES		
Mandatory shareholder approval of major transactions	Protects against abuse by insiders; protection can be enhanced through supra-majority voting	YES	YES	YES	YES	YES	YES	
One share-one vote	Basic right; some shareholders may waive their voting rights for other benefits such as higher dividends	YES	NO	YES	NO	NO	YES	NO
Allow proxy by mail	Facilitates shareholders control	YES	NO	NO	NO	NO	NO	NO

Source : World Bank (1998a).

Some countries have gone beyond the items covered by Table 3-4 and have introduced or already had in place additional measures designed to protect shareholders' rights. Appointment of independent directors is mandatory in Korea, Thailand, and Hong Kong. Korea recently even allowed cumulative voting to enable minority shareholders to better represent themselves on the board.[17] On the surface, corporate governance in East Asia generally appears quite satisfactory. However, having good laws is one thing, making them work is quite another in corporate governance as in most other areas.

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

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

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

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

Conglomerates

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

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

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

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

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

The above argument also has grave implications for the ownership of financial institutions in some East Asian countries. Some countries invited failure in their financial sector by barring the ownership of block shares and participation of shareholders in the governance structure of banks, for fear of undue influence by block shareholders who are related to the dominant families in the corporate sector. The recent crisis forced these governments to rethink the policies regarding the governance of banks. However, if they simply allow anyone to purchase shares of banks and take control, dominant families will probably be the only ones with the financial resources necessary to do so. Worse, the financial resources with which they purchase the equities of banks may mostly be derived from the money that firms under their control borrowed from financial institutions.[20]

Takeovers

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

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

Debtor and creditor relations

At the risk of over-simplification, the salient feature of East Asian corporate finance is bank dominance, except for Hong Kong and Singapore. The lack of a well-developed capital market was the major factor behind such an unbalanced financing pattern. Under this circumstance, the primary responsibilities for corporate monitoring rested on creditor banks. In reality, however, banks neglected monitoring and oversight, which ultimately was very costly as this culminated in the financial crisis. Indeed, even collusive connections between lenders and borrowers were not uncommon in many East Asian countries.

State control and moral hazard

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

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

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

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

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

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

Ownership structure and market discipline

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

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

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

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

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

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

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

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

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

Prudential supervision

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

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

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

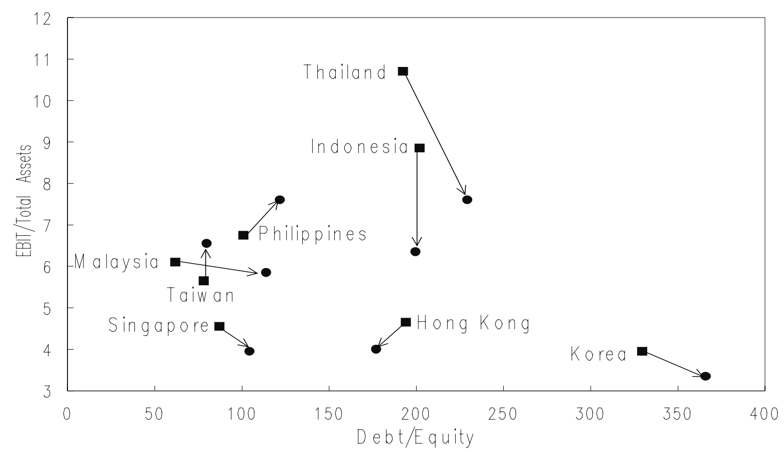
In sum, in most East Asian countries weak corporate governance has been developed largely by implicit government guarantees on bank lending, unhealthy connections between lenders and borrowers under the relationship-based system and poor bank supervision, the so-called "crony capitalism" argued by Krugman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

Financial structure and performance

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

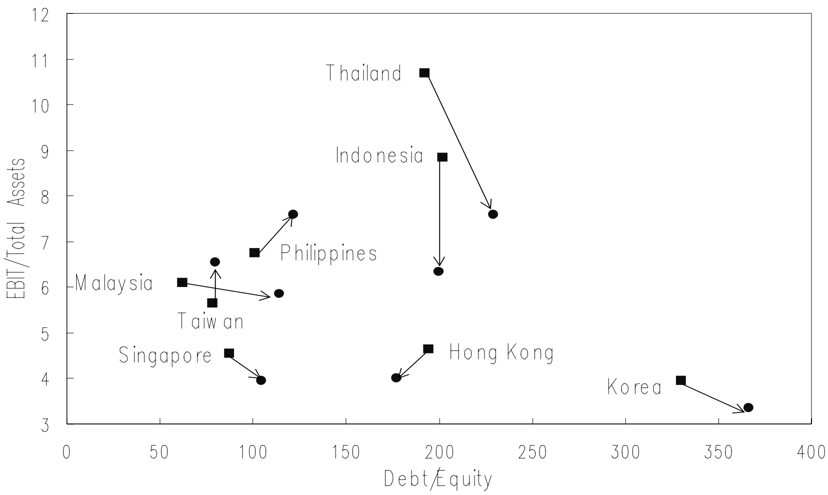
Meanwhile, before the financial crisis, there were signs of deterioration in corporate profitability in most East Asian countries (Chart 3-1).[27] This was most notable in Thailand and Indonesia: Thai and Indonesian corporations' profitability rate dipped from 10.7% and 8.9% in 1991-92 to 7.6% and 6.4%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

Chart 3-1 Debt Equity Ratio and EBIT/Total Assets for East Asian Countries (Unit: %)



Note: ■ denotes average for 1991-92, • denotes average for 1995-96.
Data Source: Claessens, Djankov and Lang (1998a). Recalculated by author.

Chart 3-2 Interest Coverage Ratio for East Asian Countries in 1996 (Unit: %)



Data : Claessens, Djankov and Lang (1998a)

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

Such vulnerable financial structures of many East Asian companies could not withstand the combined shocks of increased interest rates, depreciated currencies, and weak domestic demand since the onset of the financial crisis. Indeed, the number of bankruptcies surged, particularly in Korea and Thailand. In Korea, during the first quarter of 1998, the monthly average number of corporate bankruptcies exceeded 3,000, representing about a 200% increase compared to the same period of the previous year. Massive corporate bankruptcies immediately translated into a dramatic increase in non-performing loans (NPLs) of financial institutions. As of the end of June 1998, the estimated total of NPLs of all financial institutions, broadly defined to include loans classified as "precautionary", was about 136 trillion won (32% of GDP), a 58% increase from 86.4 trillion won at the end of 1997.

Insolvency mechanisms

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

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

Formal insolvency procedures

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

More importantly, what role and to what extent these formal insolvency procedures played in the Asian economies is hard to assess since complete data on the actual insolvency cases are not available, and the reports from the subject countries provide very little account of how they performed. It can nonetheless be inferred from a few observations that the insolvency law regime, as it was in most countries, was not effective in dealing with financially troubled firms, nor did it have a significant impact on the corporate governance structure.

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

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

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

Second, there were cases where the rules were not specific or thought out enough so that they left room for much discretion by judges and for abuse by debtor firms. In Malaysia, a debtor firm can seek and receive summary relief from creditor actions under the reorganisation procedure. The relief would last for a period of up to 9 months on a unilateral basis without the company being required to initiate a process of dialogue with its creditors and without the creditor being given a chance to present his case to the court before the relief is granted.[31] In Korea, as another example, a change in the Corporate Reorganisation Act in early 1998 made mandatory the wipeout of half of the existing shares if a firm is insolvent. Consequently the rest of 1998 saw a sharp rise in the number of cases of the composition procedure in which the management of the debtor firm is intact and such mandatory wipeout is not applied, as many controlling shareholders of failing firms scrambled to preserve their interests regardless of whether their firms' situation was suitable for the composition process or not.

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

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

Informal workouts

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

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

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

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

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

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

In summary, the reliance on bank loans and on ad-hoc informal procedures have left the formal insolvency procedures largely underutilised and underdeveloped in Asia while undermining the effectiveness of other mechanisms of corporate governance. However, there have recently been new amendments and reform efforts to improve the insolvency law regime in several countries including Indonesia, Thailand, Malaysia, and Korea. They are intended to further elaborate the rules for the purpose of speeding up the process and making its outcome generally more predictable and to make the reorganisation procedure assume a bigger role in the corporate restructuring process.

Transparency and disclosure

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

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

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

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

In short, inadequate standards and rules and lax enforcement have helped to grant a free rein to corporate insiders at the expense of outside shareholders and to hamper development of the securities market. The good news is, there are ample signs that policymakers have recognised the significance and long-term implication of the problems in this area, and have made their improvement a top priority. To the extent that the most immediate beneficiary of such improvements would be the investors in the securities market, it would help to get them involved in and contribute to the reform process.

IV. Challenges and future policy options for corporate governance in Asia

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

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

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

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

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

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

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

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

There is no instantaneous fix for these problems. Rather, governments must continue to improve their legal and institutional framework for corporate governance, and strengthen their enforcement by "biting the bullet". To this end, governments should scrutinise the regulatory framework and legal institutions, carefully analyse the incentive structure embodied in the framework, and eliminate any unclear provisions in laws and regulations. At the same time, an appropriate incentive structure needs to be established for regulators in order to ensure credible enforcement. After all, no laws or regulations can make a difference, no matter how well they are designed, unless they are properly enforced.

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

As corporate sector restructuring inevitably involves changes in ownership structure and corporate control, it has far-reaching implications not only for the business interests of financial institutions but also the governance structure of both financial and non-financial firms. There is little question that it is socially optimal to prevent financially troubled but economically viable firms from being liquidated.

The essential question is how to share the losses or benefits among involved parties, including creditors and shareholders. Currently, the most desirable option for loss/benefit sharing seems to be debt-for-equity swaps, and setting the right price for the exchange lies at the core of this option. If, under the right exchange price, shareholders are supposed to lose their interests completely or partially, they must be strictly enforced to do so.

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

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

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

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

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

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

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

NOTES

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

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

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

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

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

6 Korea, whose economy has been dominated by *chaebols* for decades, seems to be the best example in this regard. However, the dominance of family-controlled groups of firms is also pronounced in most other Asian countries, although the degree of their dominance may vary from country to country.

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

8 Our coverage of the East Asian region in this paper is generally limited to seven economies; Hong Kong, China; Indonesia; the Philippines; Thailand; Singapore; Malaysia; and Korea.

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

10 However, this is not unique to Asian countries. Latin American countries such as Argentina, Columbia and Mexico exhibit over 50% of ownership concentration as well. Such high concentration

might be related to the lack of proper protection for minority shareholders rights as suggested by La Porta et al. (1998).

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

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

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

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

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

16 The other East Asian countries not covered by the table seem to meet most of the standards used in the table, although no accurate report on all accounts is available. For instance, Hong Kong requires shareholder approval and disclosure of connected transactions. See the country reports for more detail.

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

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

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

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

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

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

23 World Bank (1993).

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

25 World Bank (1998).

26 World Bank (1998a).

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

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

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

30 ADB report (1999).

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

32 An alternative approach to systemic corporate bankruptcy problems in Korea is proposed in Nam and Kang (1998c).

33 ADB report (1999).

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

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Part II

COUNTRY DEVELOPMENTS IN CORPORATE GOVERNANCE

CORPORATE GOVERNANCE IN JAPAN

by
Takahiro Yasui*

I. Introduction

Today there are approximately 2.5 million corporations in Japan, most of which are limited liability companies. Among them, larger firms are usually organised as public-limited companies, which are required to have capital of JPY 10 million at the minimum, while a number of smaller enterprises are private-limited corporations. Out of 6,330 of the largest corporations that have sufficient capital for listing (JPY 1 billion or more), 6,249 or 98.7% are public-limited companies, of which approximately 38% are actually listed on the stock exchanges.[1] This note hereafter outlines Japanese corporate governance practices, focusing mainly upon the large, listed, public-limited corporations.

Section Two will sketch the features of three major players in corporate governance: the board, shareholders and main banks. The board – the highest management body – is legally responsible to the shareholders, but in practice cares as much about employees in Japan. This is because the directors are mostly promoted from the middle management level of the company and are regarded as leaders of all the employees. This feature of the board is supported by a stable and concentrated ownership structure in which cross-shareholdings are particularly prevalent. Key shareholders are mostly important business partners, especially creditors such as banks and insurance companies, who value mutual business expansion rather than short-term returns on shares and generally refrain from intervening in management. Discipline for the board is in many cases provided by the main bank, which is usually the largest lender and a significant shareholder. The main bank continuously monitors management but intervenes effectively only when company performance deteriorates significantly. This governance structure of Japanese corporations is often described as "contingent governance" in which the board enjoys a relatively high degree of autonomy in usual business situations but is subject to external control by the main bank when the company is in distress.[2]

Section Three will discuss the recent changes in Japanese corporate governance. First, it will be pointed out how the two key players – main banks and shareholders – have changed. The intensive monitoring by main banks over management has been weakened as a consequence of Japanese firms becoming less dependent on bank finance. It is expected to become even less effective in the future because of the eroded rents for monitoring and the weakened capital base of the banks. In contrast, shareholders have increased their influence on management. This has resulted from the shift in the

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ownership structure of Japanese firms in which cross-shareholdings have been reduced and foreign investors have increased their holdings, and also from the shareholders becoming more active in exercising their rights. Second, the recent or forthcoming changes in some basic rules for management and their influence on corporate governance practices will be surveyed. These changes include the recent amendments to the Commercial Code regarding share buybacks and stock options, forthcoming accounting reforms, and the legal changes associated with a holding company. Last, the discussion will show the recent movements in the reform of the board structure. More companies carried out or planned reforms of their boards by introducing an executive officer system and thereby streamlining the board. Moreover, in order to improve supervision over management, reinforcement of the functioning of statutory auditors is under consideration.

Finally, Section Four will identify some future prospects for changes in the governance structure of Japanese corporations. Structural changes in the business environment, such as slow trend economic growth and more unstable ownership structures, will continue to pressure Japanese companies to reform their governance structures. Fundamental changes may take time, however, as corporate governance practices do not stand alone but interact with various economic and social systems and practices.

II. Main features of corporate governance in Japan

The governance structure of Japanese corporations is often characterised as "contingent governance" in which company insiders retain effective control of management as long as the firm performs well, but once performance deteriorates, the control is taken away and they are subject to severe sanctions such as the forced liquidation of the corporation. This contingent structure is supported by three major features of the main players in corporate governance: the board, the shareholders and the main banks. This section describes these features and explores how the governance of Japanese corporations has worked.

Role of the board

Board structure

In legal terms, company directors are independently responsible to shareholders for management of the company. They are elected by the majority of the shareholders at a general shareholder meeting, and must work faithfully for the company in accordance with the law and the decisions of the general shareholder meetings. In order to oversee the affairs of each director, a board of directors is formed. The board is expected to make important managerial decisions to be carried out by directors in charge, and to supervise their performance. This "unitary" board structure is similar to that of the UK and the US, but different from the board structure of Germany, which has a "board of commissioners" to supervise the management, independent from a board of directors.

Though legal frameworks of boards of directors are similar in Japan and the US, the actual functioning of the boards is quite different. While in the US the boards tend to focus on appointment of the CEOs and other senior officers and supervising their affairs, those of Japanese firms centre on strategic and management decision making.

This difference in the functioning of the boards is reflected in the composition of the boards in both countries. In the US, many directors are appointed from outside of the company. They are required to have general expertise in corporate management in order to monitor the operation of the company on behalf of the shareholders. In Japanese companies, by comparison, the directors are usually promoted from the ranks of middle managers of the company and in many cases continue to be its employees. Having precise knowledge of how the company is operated, the directors are expected to make strategic decisions to guide the company. At the risk of oversimplification, it can be said that the directors of Japanese firms are typically leaders of the insiders, while those of US companies are usually outsiders representing the shareholders.

The board structure of Japanese companies has been considered to have various advantages, especially in the context of the life-time employment. The potential for promotion to the board creates an important incentive for the company's employees to be loyal and work hard for the company. The board, composed of directors with good knowledge of the company, can choose the most appropriate strategies for promoting steady growth of the company.

However, such a board structure also has deficiencies. First, it tends to create a hierarchical structure in the board, which can undermine the board's function to supervise the affairs of directors, especially the president. Promotion from within the company can establish seniority among directors, as in most cases such promotion is decided effectively by the chairman and the president as well as by a few other influential persons such as the ex-chairmen/presidents and the senior directors. The hierarchical structure is reinforced by the creation of vertical report lines between the president and the senior members and then between the senior and junior members, who are usually assigned responsibility for certain parts of the company's management. Second, under such board structures, the number of directors tends to increase over time in order to reward long-serving managers. As of July 1998, the average number of directors among listed companies was about 20, while 49 companies had 40 directors or more.[3] Because of this size of the boards, coupled with their hierarchical structure, it is common in large Japanese companies to form a committee consisting of the president and a small number of senior directors to make essential management decisions, which are almost automatically approved by the full board of directors afterwards. Thus, in spite of the legal responsibility, the role of the board of large Japanese corporations tends to be superficial as regards not only supervising the affairs of the directors, but also directing the management of the company.

Statutory auditors

In order to counterbalance the power of the directors being promoted from within, the Commercial Code requires statutory auditors to be appointed. Like directors, they have to be elected directly by shareholders, and are responsible for supervision of the affairs of the directors for the benefit of the shareholders. Statutory auditors have authority to demand reports on management from directors and employees, to examine the operational and financial situation of the company, to attend the board meetings, as well as to demand suspension of an action by a director when they believe it to be against the law or the articles of incorporation and likely to damage the firm seriously.

As statutory auditors are expected to provide supervision from outside the management and to reinforce the supervisory function of a board of directors, they cannot be the directors or the employees of the company concurrently. In addition, large companies that have capital of JPY 500 million or more or debts of JPY 20 billion or more, are required to have at least three statutory auditors, in addition to a financial auditor, who compose a board of auditors. Moreover, at least one of them has to be an "independent" individual who has not been a director or employee for the past five years.

It should be noted that the Commercial Code does not ban directors from being executives or employees concurrently nor require any "independent" directors. It can be said, therefore, that the legal framework expects statutory auditors to play the major role in supervising management on behalf of the shareholders, which may support the practice to appoint directors from within the company.[4] In reality, however, "independent" auditors are approximately half of the statutory auditors,[5] and they are often ex-employees or individuals coming from important business partners such as the group companies and the main banks, who may not be so unbiased in supervising the affairs of the directors (Table 1).

Table 1: Origins of Independent Auditors

Origins	Number	Share (%)
Group companies	1 509	30.3
Professionals	784	15.7
Banks, insurance companies	622	12.5
Ex-employees	584	11.7
Other large shareholders	557	11.2
Other business partners	246	4.9
Public sector	175	3.5
Others	506	10.2
Total	4 983	100.0

Source: Toyo Keizai, *Kigyo Keiretsu Souran* [1995] quoted by Fukao [1997].
Note: responses from 2,632 large companies having capital of JPY 0.5 billion or more or debts of JPY 20 billion or more.

Interests of directors

Despite the fact that the directors are legally responsible to the shareholders, they are not necessarily motivated to put much importance on maximising shareholder value. The simple way to induce directors to seek higher value for the shareholders is to associate their remuneration with the share price. The use of executive share options for this purpose is common in other OECD countries, especially in the US. It is common among Japanese companies to encourage the directors to buy and hold shares of the company, but granting executive share options has not been very popular thus far, perhaps partly because of unfavourable tax treatment.

Another mechanism to link the remuneration of directors with shareholder value, which is popular in the US, is to set up a remuneration committee composed of "independent" directors. The committee is expected to determine the managerial salaries of corporate executives based on its assessment of the performance of the executives with regard to the enhancement of shareholder value. Very few Japanese companies have so far adopted this kind of mechanism. Although the salaries of directors are subject to the approvals of shareholders at the general meetings in Japan, the approvals are usually asked on an aggregate basis, not on the salaries of respective directors. Moreover, the widespread practice of paying both an employee salary and a director's salary for a director who remains an employee may have eroded the supervision by shareholders.

It should also be pointed out that the promotion of a middle manager to director does not provide him with changes in remuneration and function salary significant enough to make him aware of the qualitative change in the role and responsibility associated with the promotion. While directors are often entitled to various fringe benefits such as a large office space, a secretary and a company car, the managerial salaries of Japanese directors are lower, on average, than those of other OECD countries.[6] Especially junior directors are still located in the middle of the company's hierarchy, though one step higher than middle managers, and may be discouraged to exercise fully their responsibility to the shareholders. The weak consciousness of directors of their duties to shareholders may also be associated with the consensus building, bottom-up decision making process, which is common in Japanese organisations.

Role of employees as stakeholders

In some OECD countries such as Germany, stakes of employees in a company are institutionalised in the corporate governance structure by granting employees representation on a board of directors or of commissioners. In contrast, in Japan there is no legal framework for corporate governance to require the board to consider the interests of employees. The employees of Japanese corporations, however, have played a significant role in actual corporate governance practices.

The most evident function of employees in the governance structure is to provide candidates from among themselves to be elected as director, as well as to monitor the incumbent directors. As seen above, the directors of Japanese firms have usually been selected from the middle management level of the company, and generally are expected to act as leaders of the employees. The selection itself is made by the top management level, but it should be acceptable, or at least not unacceptable, to the employees in general. The employees also monitor the activities of directors from their viewpoint. They have no legal power to dismiss the leaders deemed unsatisfactory, but their views could influence other members of the board to take action against them. The low level of managerial salaries of the directors may have partially resulted from the "peer" pressure exercised by employees on the "insider" directors. The influence of employees on management is obviously supported by the life employment system, in which management has to pay significant attention to maintaining a co-operative relationship with the employees, and the bottom-up decision making process, which is a feature of "Japanese management".

In addition, employee stock ownership plans have been common in Japan. For some companies, their fund is one of the largest shareholders of the company. In reality, employee stock ownership plans are often prepared by the management in order to create another "stable" shareholder. It is also true, however, that they can provide the employees with the legal authority to influence management directly.

Role of shareholders

Shareholder rights

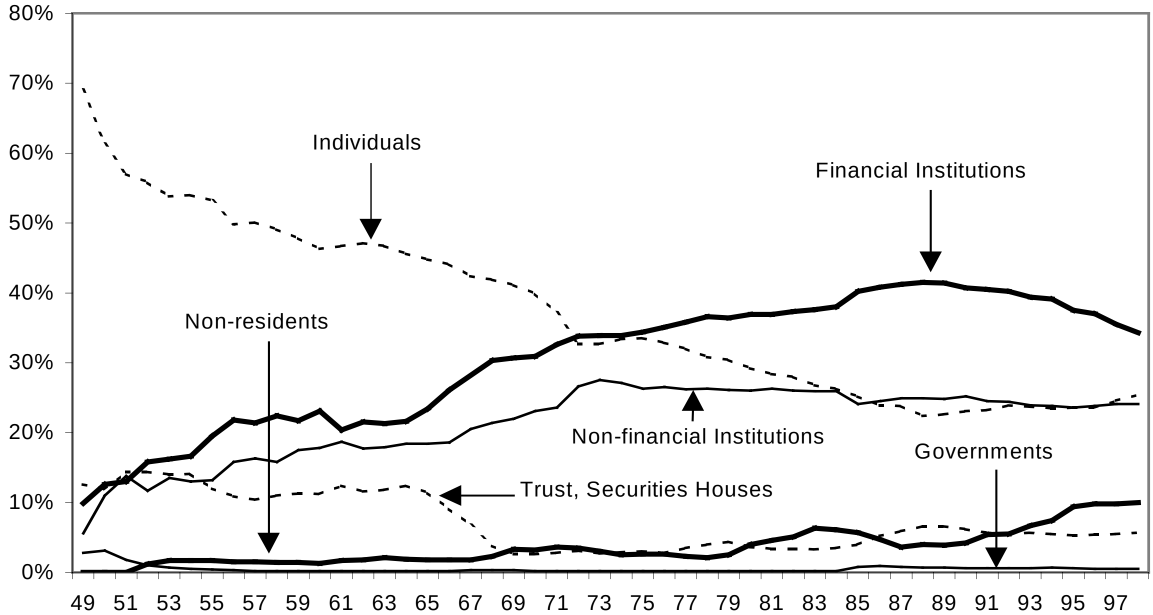
The primary right of shareholders is to appoint and, when necessary, dismiss the directors at general shareholder meetings. It is accompanied by the right to require the directors and the statutory auditors to report on the management at the general meetings. Shareholders also have the right to be informed of and participate in decisions which will result in fundamental changes in corporate structure, such as amendments of the articles of incorporation and extraordinary transactions. In addition, the Commercial Code stipulates that the salaries of the directors and statutory auditors should be decided by the general shareholder meeting. Moreover, though the board is responsible for the formulation and implementation of corporate strategy, it is legally possible for shareholders to limit the authority of the board by amending the articles of incorporation.

The Code also provides protection for minority shareholders. For example, the "one share one vote" principle is rather strictly established. Minority shareholders have the right to call a general shareholder meeting and to claim an inspector to be appointed by the court for checking the procedure of general meetings. One of the most important rights of minority shareholders stipulated in the Code is the one for shareholder litigation against misconduct of the directors. Since its introduction in 1950, lawsuits have been rarely filed, as a shareholder was initially required to pay a significant petition fee in accordance with the claimed damage of the company. However, this process has been significantly facilitated by the amendment of the Code in 1993, which dramatically reduced the fee to a fixed amount of JPY 8,200.

Ownership structure

The important merit of public-limited companies, especially those listed on the exchanges, is that they can acquire capital from a wide range of investors. As of March 1997, there were approximately 28.5 million shareholders for 2,339 listed companies, which means, on average, a listed company has more than 12,000 owners.[7] However, their distribution is not even, as shown by the fact that individual shareholders, amounting to more than 95% of the total number of shareholders, hold less than a quarter of the outstanding shares (*Figure 1*).

Figure 1: Distribution of Shareholders by Category

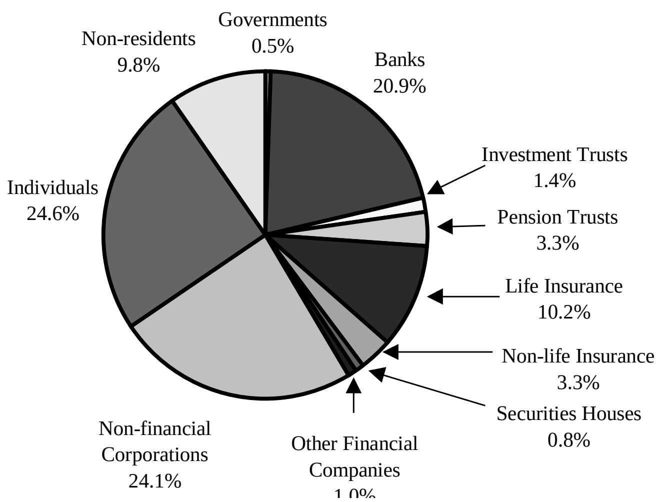


Source: Tokyo Stock Exchange

In other words, a large portion of shares is held by corporations, which distinguishes the ownership structure of Japanese corporations from that in most other OECD countries. Soon after the Second World War, outstanding stocks were mainly held by domestic individuals, but their share has steadily declined to less than 25%. Instead, domestic corporations have been increasing their share, which amounted to roughly 65% in March 1998.

Among domestic corporations, financial institutions hold a relatively large amount. Approximately 40% of the stocks belong to domestic financial institutions, while 24% are held by non-financial corporations. Among the financial institutions, banks have about half, amounting to 22% of all outstanding stocks, in aggregate (Figure 2). This implies that banks must keep the stocks of a wide range of companies, as they have been legally prohibited from owning more than 5% of any given company. The second largest portion, about 10% of all stocks, is owned by life insurance companies. Ownership shares of financial institutions are also high in the UK and the US, but mutual funds and pension funds hold the major portion among them and banks have few, if any.

Figure 2: Ownership Structure of Listed Companies
(Distribution of shares by types of shareholders)

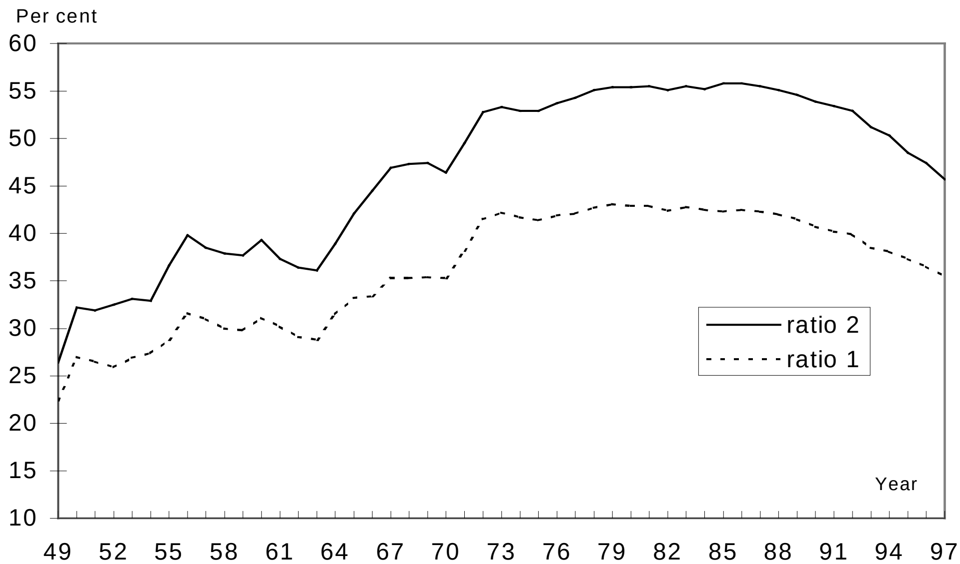


Note: Unit of share basis. As of March 1998
Source: Tokyo Stock Exchange

The significant holding of shares by domestic corporations has resulted from the prevalent cross-shareholding practices among Japanese corporations, which originated in the late 1940s or early 1950s with the aim of raising capital while preventing hostile take-overs.[8] Cross-shareholding became prevalent in the mid-1960s to mid-1970s (Figure 3). As stock prices soared in the late 1970s and early 1980s, the shares held by Japanese companies created considerable hidden profits for the companies, which strengthened their financial basis and contributed to the expansion of their business.

Cross-shareholding is arranged for strategic purposes. It is the symbol of a long-lasting relationship between the two parties, and consequently the shares in this arrangement are normally not sold off without the agreement of the issuer. As a result, the prevalent practice of cross-shareholding has created a relatively concentrated and considerably stable ownership structure of Japanese corporations. The top 10 shareholders of the companies listed on the Tokyo Stock Exchange (TSE) First Board have, on average, 44% of the outstanding stocks of a company.[9] These large shareholders are in most cases domestic banks and insurance companies as well as other group companies and important business partners. Research has shown that more than 90% of the listed companies considered the majority of their stock to be held by "stable" shareholders.[10]

Figure 3: Cross-shareholding Ratios



Source: Daiwa Research Institute
Note: The ratio 2 includes holdings by life insurance companies in addition to the ratio 1.

Control by shareholders

Shareholders can influence management in two ways: executing their rights as shareholders or trading the shares. As seen above, shareholder rights are well-protected in legal terms, but it has been rare to see shareholders in Japan influencing management directly by exercising their legal rights, except for the cases of abuses by "greenmailers." However, the concentrated ownership structure makes it possible for key shareholders to have considerable influence over management. As these shareholders are usually affiliated companies in the same corporate group (so-called *keiretsu*) or important business counterparts of the company, they have various occasions to communicate their demands to management informally. Furthermore, they sometimes send their personnel to the board as directors or statutory auditors, which provides a means to control management directly.

In this regard, it should be noted that the interests of these key shareholders are not necessarily identical to those of minority shareholders with pure investment purposes. In addition, these large shareholders may generally refrain from intervening in the management of the company, because they put more importance on maintaining or even expanding their business with the company rather than seeking the short-term returns on shares, and because the company in question is, in turn, often their large shareholder.

Shareholders may also influence management indirectly through their trading of the shares. In principle, when they are not satisfied with management, they may sell the shares in the market, which could lower the share price and eventually increase the risk of a hostile take-over for the management. However, unlike in the US, in practice this mechanism to discipline corporate managers through stock markets has not functioned well in Japan. This is not because of the legal framework, which is less restrictive than that of the US as it does not provide the incumbent management with various anti-take-over measures, but mainly because of the stable ownership structure supported by cross-shareholdings.

One may say that the legal restriction against hostile take-overs is not really necessary in Japan, as the ownership structure provides sufficient protection.

Moreover, the efficient functioning of the market for corporate control requires that share prices accurately reflect the performance of company management, which does not seem to be the case of the Japanese capital market, at least in the past few years. It is also pointed out that in Japan hostile take-overs may not pay in the end, as they could undermine the incentives and loyalty of the employees and hence their performance, especially when followed by lay-offs and/or salary reductions.

Role of main banks

Main bank system

In Japan, external control over management of a company is often supplied by its creditors. Among them, the bank that has a close business relationship with the firm, monitors its operation carefully and provides external corporate control in lieu of the take-over market by intervening in the management of the firm, especially when the firm is in financial distress. This so-called main bank system is one of the major characteristics of the Japanese corporate governance structure.

Table 2:The Roles of Main Banks (%)

	First Section listed	Second Section listed	OTC registered	Private
Underwriting of bond issues	100.0	100.0	96.9	76.6
Providing guaranty in bond issues abroad	88.9	96.6	100.0	88.9
Being the largest creditor	87.2	75.8	80.9	81.5
Having the largest deposits of the company	70.1	80.9	83.6	72.2
Having the longest history of transactions with the company	71.7	64.3	70.9	67.6
Holding a large amount of stock of the company	91.6	72.0	70.9	14.1
Having the largest share in handling the employee accounts for salary receipts	59.2	63.7	66.4	55.0
Acceptance of personnel as board members	45.2	35.0	28.2	16.8
Acceptance of personnel as employees	10.3	12.7	17.3	10.0

Source: Fuji Research Institute [1993] quoted by Fukao [1998].
Note: The result of the questionnaire research conducted in January 1993. The valid responses came from 321 firms listed on First Section, 157 on Second Section, 110 of OTC registered, and 518 not publicly traded firms, except for the first and second items for which the responses were 239, 69, 65 and 128 concerning the first item and 162, 29, 6 and 9 for the second one.

There is no strict definition of a main bank, but it is typically the largest creditor of the company. Main bank relations imply that the concerned company will ask the bank for credit when the company needs external finance for its operation and/or investment, and the bank will arrange the needed credit on favourable terms either by itself or by organising a syndicate. At the same time, the main bank is usually one of the major shareholders, in many cases as a result of the cross-shareholding arrangement, though it is not necessarily the largest one due to the regulation that prohibits banks from holding more than 5% of the stock of any particular company.

Moreover, in most cases, the main bank is the principal supplier to the company of various financial services, which include not only loan extensions, but also payment and settlement operations and underwriting and management of bond issues. The main bank sometimes provides management resources as well, for example by giving financial and investment advice and even sending its managers to the board of the company as directors or as statutory auditors (Table 2).

Monitoring by main banks

As the largest creditor and also a large shareholder, the main bank has a definite interest in assuring the sound management of the company. Through the functions mentioned above, the main bank can acquire considerable information on the financial and managerial situation of the company on a regular basis, which enables the bank to carry out effective monitoring of its management. According to Aoki [1996], the main bank can administer three types of monitoring: *ex-ante*, *interim*, and *ex-post*. *Ex-ante* monitoring is mainly related to investment decisions of the company. The main bank can monitor them by examining loan applications, as important investment normally requires external finance. *Interim* monitoring concerns performance of the on-going business and projects carried out by the company. The main bank is best situated to watch these by, for example, monitoring day-to-day cash flows at the company's settlement account. *Ex-post* monitoring involves evaluating the financial performance of the company and, when the company is in difficulty, intervening in the management decisively to take necessary corrective measures. Having considerable information on the company, the main bank is well-positioned to decide effectively whether to rescue or liquidate and how to restructure the company. Moreover, as a significant creditor and shareholder, the main bank not only can have determining influence on the management, but also can co-ordinate appropriately the claims of various stakeholders, sometimes by accepting a disproportionately larger burden to rescue the company.

Table 3: Expectations of Companies for Main Bank Support in Times of Crisis

(%)

	First Section listed	Second Section listed	OTC registered	Private
Will obviously help.	63.0 %	52.9 %	39.4 %	41.9 %
May not help depending on our situation, but we hope they will.	30.1 %	37.4 %	50.5 %	42.9 %
We used to think they would, but do not any more.	5.4 %	7.1 %	6.4 %	4.9 %
We have never expected them to.	1.6 %	2.6 %	3.7 %	10.2 %

Source: Fuji Research Institute [1993], quoted by Fukao [1998].
Note: Percentage of respondents choosing responses to the question, "Do you think your main bank will provide financial support and loans if you are in crisis?" The valid responses came from 315 firms listed on First Section, 115 on Second Section, 109 of OTC registered, and 508 not publicly traded firms.

Table 4: Contribution to the Main Banks (%)

	First Section listed	Second Section listed	OTC registered	Private
Contribution to deposits	27.9	22.2	21.8	21.0
Intensive orders for payments and employees-related transactions	21.3	15.8	13.6	14.9
Addition to interest rates	8.8	4.4	1.8	6.4
Purchase of bank stock	7.5	5.1	5.5	5.6
Borrowing of more than needed amounts	2.8	4.4	2.7	4.1
Payment of high bond underwriting fees	8.8	1.9	0.9	1.4
Acceptance of personnel	5.6	3.8	0.9	1.4
Others	0.3	1.3	0.0	0.4

Source: Fuji Research Institute [1993], quoted by Fukao [1998].
Note: Percentages of respondents choosing responses to the question, “If you pay costs for your main bank, in what way(s) do you do so?” The valid responses came from 319 firms listed on First Section, 158 on Second Section, 110 of OTC registered, and 618 not publicly traded firms.

The main bank system has been beneficial to Japanese banks, as it has enabled them to diversify their credit portfolios, while economising on the cost of information gathering by sharing the monitoring roles on corporate management among them. The banks could also earn sufficient rents through long-term relationships with the client companies, which often provided fees to the main banks in the forms of excessive deposits, monopolistic handling of employee’s salary accounts, high interest rates, etc., in the hope of getting help from the main bank when necessary (Tables 3 and 4).

Role of the government

The government has played an important role in supporting the main bank system. First, regulation has contributed to protecting the rents earned by main banks. Until the deregulation in the 1980s, there was stringent regulation on deposit rates, which had been kept at sufficiently low levels so that the banks could gain a fair amount of profits by extending loans. Competition among the banks had been therefore mainly related to lending volumes. In this context, being a main bank was quite profitable, as it assured the bank of the largest share of the lending to a client company on a long-term basis. The regulation that effectively restricted new entry to the banking industry had contributed as well to protecting the rents for the existing banks.

Second, the government has provided discipline to main banks. Through its regulatory and supervisory powers over banks, the government has played the monitoring role of a main bank for the banks. Once the government discovers that a bank is in difficulty, the government is expected to take appropriate corrective actions, including merging the bank with a healthy bank which operates its business soundly.

Contingent governance mechanism

The corporate governance structure with contingent control by main banks worked well in Japan in past years. The main bank system was quite efficient not only for the banks, but also for the other stakeholders, who could free-ride the intensive monitoring by a main bank. It was particularly important when financial experts were scarce in the society. Moreover, the monitoring by a main bank on corporate management, especially the *ex-post* monitoring, reduced the risk associated with the bankruptcy of the company, so that Japanese firms could get considerable finance from the main bank as well as other lending institutions. It enabled Japanese firms to be highly indebted, compared with those of the UK and the US, which has contributed to lowering their cost of capital and thereby encouraged them to invest in longer-term projects.[11]

It should also be pointed out that the contingent governance mechanism, heavily dependent on the monitoring role of main banks, has limitations. First, the monitoring is inevitably biased by the interest of main banks which are typically the largest creditor of their client companies. As suggested above, the agency problem between lenders and shareholders could be lessened by a main bank being a large shareholder concurrently. However, considering that shifts in effective corporate control were often triggered by the financial distress of the firms, the contingent governance mechanism functioned to protect the interests of the lenders rather than to lead to the maximisation of shareholder returns.

Second, the mechanism has the inherent tendency to lead to a lack of proper risk assessment by banks and by companies. The competition among banks for their lending volumes, supported by the rents protected by regulation, can induce banks to increase lending without sufficient risk assessment by free-riding on the main bank monitoring; the bank, in turn, is inclined to expand further its credit to the client company in order to protect the merits of being a main bank. As seen above, the higher the leverage of a company, the lower the cost of capital for the company becomes. The volume competition among banks could keep the interest rates for their lending at low levels, which encourages the company to invest in projects with lower expected returns. The lack of effective monitoring from the viewpoint of shareholders is likely to result in poor profitability of a firm and lower returns on equity.

Last, the monitoring role of a main bank has to be effectively supported, on the one hand, by the sufficient rents to be earned by the bank in association with its role, and on the other hand, by the sufficient capacity of the bank to exercise the effective monitoring, especially to bear a disproportionately large burden when the client company gets in distress.

Nevertheless, this contingent governance mechanism worked well in Japan for many years. It is probably because the key shareholders of a given company were mostly its affiliates or business partners, as seen above, which were more interested in continuing the business relationship with the company than in boosting returns on equity, and also because the returns were not excessively low, given the generally strong performance of Japanese firms in the growing economy. The economic expansion in the 1980s also helped to reduce the costs of main banks, as the risks of their clients being in trouble was relatively low and asset price increases created considerable hidden profits for the banks to strengthen their financial base.

III. Recent trends

Since the economic bubble in the latter half of the 1980s ended, the Japanese economy has been stagnating. In this economic climate where the performance of Japanese firms has also been disappointing, the traditional corporate governance practices as well as other characteristics of "Japanese management" have come under question. In response, various changes and reforms have recently been observed in the corporate governance structure. This section outlines these changes and reforms. First, it discusses a weakening of monitoring by main banks which played a key role in the traditional "contingent" governance structure. Second, increasing pressure from shareholders on management is described. The pressure has been intensified because of a shift in the ownership structure as well as a change in the attitudes of shareholders. Third, the section looks over recent or forthcoming changes in some basic rules for corporate management and their influence on corporate governance practices. Last, the recent efforts of Japanese firms to reform their boards are illustrated.

Weaker control by banks

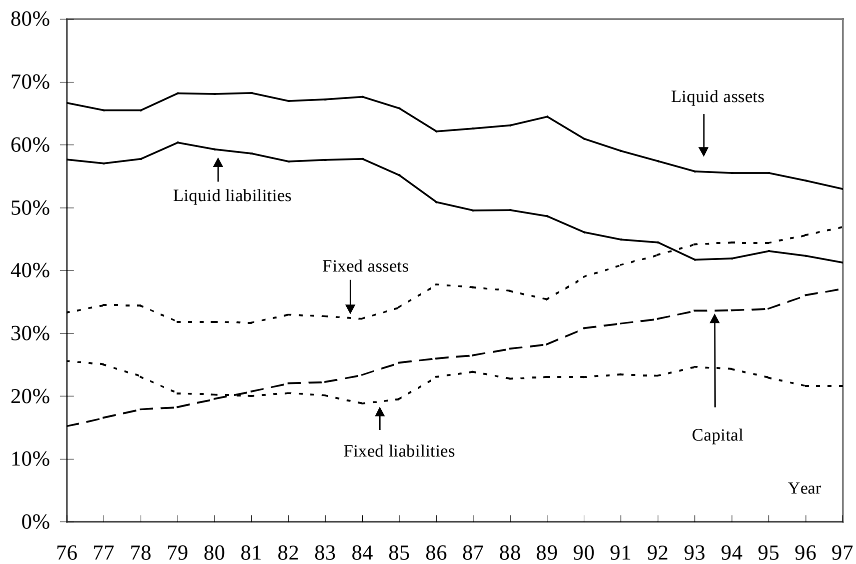
Shift in corporate finance

High economic growth during 1960-74 created significant cashflows for Japanese companies. As a result, in the following relatively slow growth period, their need for external funding decreased and internal sources of funding became more important in their financing for investment, making the firms less dependent on bank finance. Official statistics show that, in the aggregate balance sheet of listed companies, the ratio of capital to total assets has continuously increased for the last 20 years, while the ratio of fixed liability has stayed unchanged or even slightly decreased (Figure 4).

In addition, deregulation of the financial markets in the 1980s paved the way for Japanese corporations to raise funds in the market. Thanks to their strong financial positions in those days, many Japanese firms could earn high credit ratings, which enabled them to get finance in the markets at more favourable rates than banks offered. This further weakened their dependence on bank finance. This trend has continued in the 1990s (Figure 5).

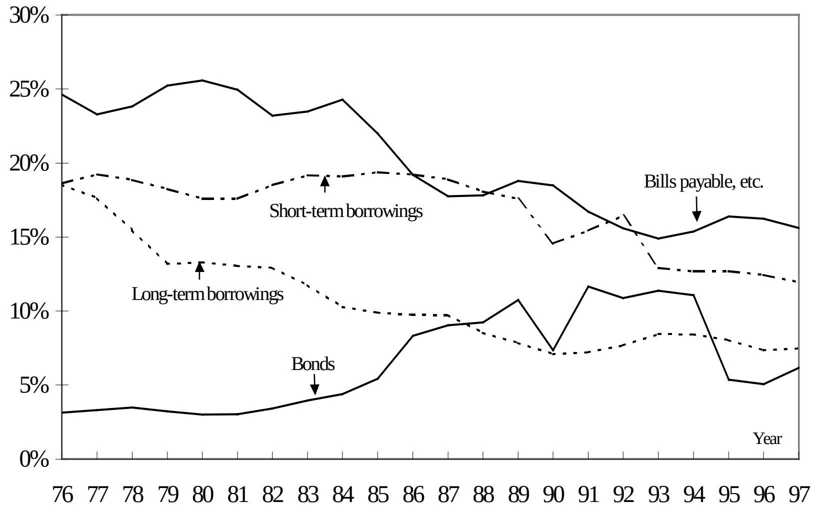
Decreasing dependence on bank finance does not necessarily mean a weakening of the relationship with the main banks. Research has shown that more than 80% of large Japanese firms do not plan to decrease their borrowing from the main banks (Table 5). However, another survey indicates that approximately 60% of the companies expect the role of the main banks in corporate governance to lessen in the next five years.[12]

Figure 4: Balance Sheet Compositions of Listed Companies
(Ratios to total assets)



Note: The companies listed on Tokyo Stock Exchange First and Second Boards, excluding financial institutions, utilities companies, etc.
Source: Tokyo Stock Exchange

Figure 5: Composition of Debt Financing
(Ratios to total assets)



Note: The companies listed on Tokyo Stock Exchange First and Second Boards, excluding financial institutions, utilities companies, etc.
Source: Tokyo Stock Exchange

Table 5: Projection of Financing by Sources
(159 firms with more than JPY 10 billion sales)

Financing sources	Current Ratio	Increase	No change	Decrease
Borrowing from main banks	14.5%	21.5%	65.1%	15.6%
Borrowing from other banks	33.4%	12.4%	57.0%	30.6%
Borrowing from group companies	0.4%	1.1%	97.7%	1.1%
Borrowing from business counterparts	1.2%	4.7%	88.4%	7.0%
Other borrowing	7.2%	9.7%	75.3%	15.1%
Domestic bond issue	24.1%	33.7%	51.5%	14.9%
Overseas bond issue	7.1%	20.9%	62.6%	16.5%
Domestic equity issue	7.0%	7.1%	87.1%	5.9%
Overseas equity issue	0.5%	4.9%	92.6%	2.5%

Source: Mitsubishi Research Institute, *Research on Japanese corporate system.*

Less incentive and capability of banks

By the 1990s, due to increased competition among banks and between banks and financial markets, the rents that banks can earn by being "main" banks have considerably diminished. First, financial market deregulation in the 1980s increased competition between banks and securities markets, which reduced dependence on bank finance of Japanese firms, as discussed above. Second, competition among banks for expansion of lending volumes has resulted in strengthening the bargaining power of the firms in loan negotiations. This eroded the profitability of the main banks which are expected to supply credit at the most favourable conditions to their client companies. Third, the regulation on deposit rates, which had effectively protected the rents of banks in increased lending, was gradually eased in the 1980s. This also contributed considerably to deterioration of the banks' profitability.

In the economic slowdown of the 1990s, the capacity of banks to perform the monitoring functions as main banks over their client firms weakened significantly. As a result of the collapse of the "bubble" economy in the 1980s, Japanese banks have suffered from accumulated problem assets, which have eroded their capital base significantly. Responding to such distressed capital situations, the banks have recently been squeezing their balance sheets while trying to increase capital. They have become much more cautious in extending new loans and reluctant to renew existing ones, which has created a serious credit crunch in the economy. The weakened capital base of the banks, coupled with the eroded rents, has discouraged them from performing the *ex-post* monitoring function. This has been attested to by some of the recent bankruptcy cases, in which, against general expectation, the main banks did not save the troubled companies by providing liquidity, nor did they agree to bear disproportionately large burdens in the liquidation of the companies.

The deterioration of their capital base also made it more difficult for the banks to keep a substantial amount of corporate shares, as discussed below. It is likely, therefore, that in the near future main banks will be obliged to decrease their holdings of client company shares, possibly weakening the relationship between the client companies and the main banks. The monitoring roles of the main banks would thus become less effective as there would be less insider information. Moreover, an agency problem between the main banks and the other shareholders of the client companies could emerge, which would result in the outside shareholders having to take actions by themselves to monitor the corporations.

Increasing pressure of shareholders

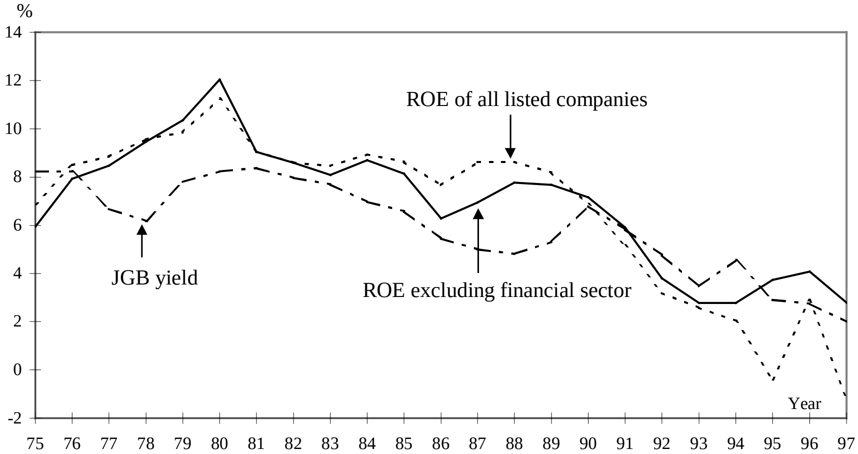
Dilution of cross-shareholding

Research shows that the ratio of cross-shareholdings (including holdings by life insurance companies) declined from the peak of 55.8% in 1986 to 45.7% in 1997. More recently, this trend has clearly accelerated from 0.5 percentage points annually between 1987 and 1992 to 1.4 percentage points annually between 1993 and 1997 (Figure 2).

The dilution of cross-shareholding has been induced by the successive deterioration in share prices and profits of Japanese companies since the bursting of the financial bubble towards the end of the 1980s (Figure 6). In contrast to providing various benefits - such as creating hidden assets to strengthen their financial base - to Japanese firms when their general performance was good, once economic performance worsened, cross-shareholding unveiled its negative effects on corporate management. First, long-term holdings of such shares deteriorate efficiency in asset management, as the shares pay low dividends and yield little or even negative capital gains. Second, the total asset value of a company as well as its profits are exposed significantly to share price volatility, which is intensified by low liquidity in the market resulting from relatively stable holdings of a large portion of the shares. These costs of cross-shareholding did not surface when a company made high profits in its own business and had sufficient hidden assets to cushion the volatility. The costs are now considered to be significant by many Japanese firms, as their own performance has weakened in the economic slowdown and their hidden assets have become eroded after a prolonged period of deterioration in share and land prices.

Fukao [1998] argued that this problem is particularly severe for banks, as well as domestic institutional investors such as life insurance companies, which currently hold a considerable amount of corporate shares. As a result of writing off huge problem assets accumulated in the aftermath of the financial "bubble", capital of many banks has been severely damaged so that the costs of holding such stock portfolios have become excessive. It is highly likely, therefore, that the banks will cut their shareholding to more appropriate levels, which will lead to a substantial unwinding of cross-shareholding.

Figure 6: Development of ROE of Japanese Corporations



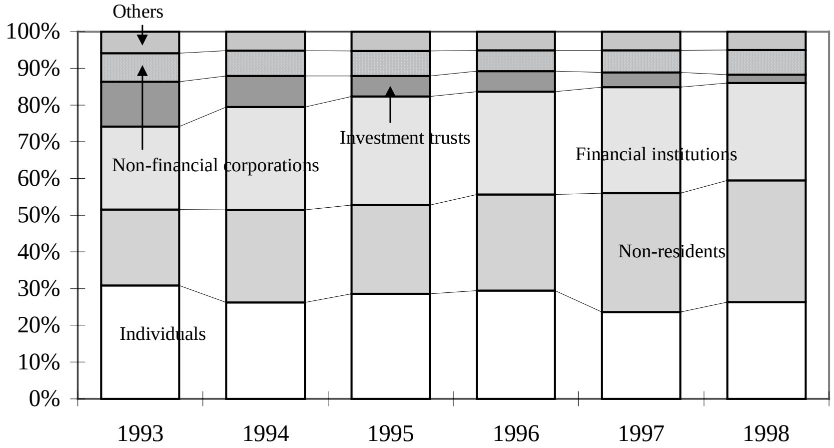
Note: JGB yields are the 10 year government bonds yields to subscribers.
Source: Tokyo Stock Exchange

Increasing share of foreign investors

The reduction of cross-shareholding inevitably results in a relative increase in shareholdings by investors other than non-financial corporations, banks and insurance companies. Among such investors, foreign investors have increased their share remarkably. They now hold approximately 10% of total stocks of listed companies (Figure 1). For approximately 12% of the companies listed on the TSE, foreign shareholders own more than 15% of the outstanding shares.[13]

The influence of foreign investors is much more significant in the market, since the liquidity of the market is thin as a result of a large portion of stocks held by "stable" shareholders. The share of foreign investors in the market turnover has increased constantly, reaching almost a third in 1998 (Figure 7).[14] The investment strategies of foreign investors have a substantial influence on the stock prices of the large, reputable companies in particular.

Figure 7: Shares in Market Turnover by Category



Note 1: The transactions by securities houses for their own sakes are excluded.
Note 2: "Others" includes non-bank financial institutions, non-corporate institutions, etc.
Source: Tokyo Stock Exchange

Domestic institutional investors could have played a much more important role in absorbing the shares placed to the market by strategic corporate shareholders, but the reality is that life insurance companies, the largest institutional investors in Japan, as well as non-life insurance companies and investment trusts, have been decreasing their portions in the ownership structure. Only pension funds have increased their share, but it was only 3.3% in 1997, as private pensions play only a limited role in the Japanese pension system.

This is likely because of the disappointing performance of corporate stocks, but also because, like banks, such institutional investors have lost their capacity to cushion the risk of price volatility of stocks from their clients whose risk profiles are very risk-averse. Fukao [1998] argued that Japanese institutional investors have essentially provided fixed-income financial assets for the household sector while investing in risky assets such as shares and long-term bonds. This risk mismatch was absorbed by their own capital and the unrealised profits on their stock and land portfolios, but these cushions have been eroded significantly by the continued deterioration of stock and land prices, as well as by the poor performance of their other investments after asset price bubbles burst towards the end of the 1980s.

Intensified demand of shareholders

In addition to the shift in ownership structure mentioned above, changes can also be observed in the attitudes of shareholders in two respects: first, more shareholders tend to demand higher returns on equity, and second, shareholders have started to influence the management directly in seeking higher returns.

The first is the direct consequence of the recent shift in the ownership structure described above. The higher the ratio of "outside" shareholders who seek pure economic returns on their investment in shares is, the more directors have to pay attention to their interests. Moreover, the extremely low levels of current returns on equity should urge traditional "insider" shareholders, who stress the importance of the long-term business relationship, to press directors to deliver higher returns, before disposing of them.

The second aspect is related to the recent tendency of institutional investors to become more active in using their legal rights in order to enhance the returns on shares, rather than simply selling the shares outright when they are not satisfied with low short-term returns. CalPERS (California Public Employees' Retirement System), which is active in executing its shareholder rights to require more effective corporate governance from the viewpoint of investors, has invested more than JPY 4 billion in Japanese firms, and proposed in March 1998 some concrete actions for Japanese corporations to strengthen their governance. Domestic institutional investors, such as life insurance companies and pension funds, also have come to voice their interests as investors. In 1998, reportedly, a pension fund managed by a trust bank decided to execute its voting rights against the proposals of the managements at the general shareholder meetings of the particular companies.[15] Other domestic institutional investors are likely to follow this movement, which would lead to strengthening the control that shareholders have over management.

Activism of shareholders in using their legal rights can be also seen in the increasing number of shareholder litigations against management misconduct, especially after the amendment of the Commercial Code in 1993 to reduce the burden to initiate such actions. This has created considerable pressure on the members of the boards who personally face the risk of enormous financial liability as the result of such litigation. Shareholder litigation clearly distinguishes the board members from the employees, which has a dramatic impact on the recent reform of the board discussed below. It is argued, however, that shareholder litigation may put excessive pressure on directors, impeding them to make material management decisions promptly since, unlike in the US, the rule to safeguard directors from lawsuits against their business judgements has not yet been established in Japan.

Changes in basic rules for management

Changes in practices and framework of management

The recent intensification of shareholder activism has pushed the management of Japanese corporations to modify their conduct to reflect more closely the interests of shareholders and maximise their value. An increasing number of firms has launched measures to improve the efficiency and transparency of management from the investors' viewpoint. These measures include a more efficient use of funds with share buybacks, introduction of incentive schemes to link compensations of corporate executives to their performance, improvement of disclosure, and adoption of the holding company structure.

These measures are supported, or sometimes induced, by various changes in the basic rules for corporate management which have been recently implemented or are expected to be implemented shortly. For example, the amendments of the Commercial Code to lift the restrictions on share buybacks and stock options were initiated by companies, while the forthcoming reforms of corporate accounting practices encourage them to improve their disclosure.

Efficient use of funds

In the traditional governance framework, the managers of Japanese firms tended to pay more attention to their employees and lenders and to pour available funds into the expansion of the business. This use of funds became quite inefficient, however, as the economy slowed and investment opportunities lessened. The increased influence of shareholders has recently forced management to revise such strategies and to seek a more efficient use of funds from the viewpoint of current and potential shareholders.

One remarkable response is the increasing implementation of share buybacks for redemption. When sufficiently profitable investment projects are scarce, to repurchase and redeem its own shares is an efficient use of funds for a company to meet the interest of its shareholders, as it reduces the number of outstanding shares and possibly leads to higher future returns on equity. Share buybacks were legally prohibited in Japan, but the amendment of the Commercial Code in 1995 lifted the ban in response to the strong request of the business sector. Since then, the number of companies which have implemented share buybacks for redemption has rapidly increased. The legal amendment in March 1998 to expand the funds available for buybacks has further facilitated their use. By September 1998, approximately 45% of publicly traded corporations had announced plans for share buybacks for redemption, though only 20% of those companies actually implemented them (Table 6).

Table 6: Share Buybacks by Japanese Firms

	1995	1996	1997	1998	**Total**
Companies announced	5	16	262	1179	1462
Companies implemented	5	16	78	186	285

Source: Life Insurance Association [1998]

Incentive scheme

Linking the personal interest of directors and employees to their performance is an effective way to increase the efficiency of management and operations. Traditionally the salary of a Japanese worker was connected to his seniority in the life-time employment practices, and reflected the performance of the industry and to lesser extent that of the company. In recent years, however, responding to their disappointing performance, Japanese firms are increasingly setting out to introduce incentive schemes, especially for company executives, that link compensation to the performance of the company, or, when applicable, to those parts of the company that the executives are responsible for.

In this context, some companies have adopted returns on equity or share prices as criteria to measure performance so as to make clear their desire to maximise shareholder value. This movement was encouraged by the amendment of the Commercial Code in May 1997, which removed the legal impediments to stock options. The amendment was strongly urged by the business sector, and was accomplished quite quickly in the hope of having a favourable influence on the weak stock market. By January 1999, 165 firms, of which 96 are listed, had decided to introduce stock option programs.[16] Modification of the current unfavourable tax treatment, which is now under discussion, would further accelerate the use of stock options.

Reforms of corporate accounting practices

Investors put importance not only on actual economic return but also on transparency in management, as the latter enables them to assess returns and risks associated with their investment appropriately. Especially in the current stagnated economic situation in which remarkable business performance is generally difficult, Japanese firms are obliged to put more emphasis on disclosure. Increasing importance of credit agencies in the market adds to the pressure on firms, as credit agencies are ready to downgrade a company lacking sufficient transparency, which usually leads to a decline in the share price and an increase in the interest rates paid for borrowing. Many companies have reinforced their activities for investor relations, and some of those which have significant ratios of foreign ownership have begun to hold investors meetings overseas.

In association with this trend, major reforms of corporate accounting standards are about to be implemented. Among various changes, those that should have a significant impact on corporate governance practices are the emphasis on consolidated accounting and the introduction of mark-to-market accounting on financial products. Even though these new practices have already been partly introduced, this reform was not necessarily driven by the business sector but rather by market forces. The recent bankruptcy cases of large corporations raised a question as to the effectiveness of the traditional accounting practices. The reforms also reflect intensified demand from foreign investors and the credit agencies which operate internationally for harmonising Japanese accounting practices with the internationally accepted ones. The new standards are mostly in line with the principles that the International Accounting Standard Committee expects to establish shortly.

First, in June 1997 the Business Accounting Council, a government advisory committee on corporate accounting standards, submitted its recommendation to reform disclosure required by the Securities and Exchange Act, so that corporate information is provided principally on a consolidated basis. Consolidated financial statements were introduced in 1977, and the number of companies that provide such reports has gradually increased, accounting for more than 60% (2,300 companies) of the domestic companies that submit financial reports to the authority.[17] However, consolidated accounting has played a relatively minor role in corporate disclosure where major accounting standards are still established on an individual company basis according to the principle of the Commercial Code. In order to respond to the demand of investors for better transparency in management, this reform intends to give the major role to consolidated accounting for the disclosure of companies whose securities are traded in a market. The new practices will be enforced in April 1999.[18]

Emphasis on consolidated accounting not only prevents large, listed companies from dressing up their financial statements by conducting transactions with the unlisted group firms, but also allows the executives to view their companies as a portfolio of businesses. This shift in attitude induces changes in the corporate structure and corporate governance practices of Japanese firms, as discussed below.

Second, the Council also published its recommendation on the introduction of market-based valuation of financial products in January 1999. Asset valuation has traditionally followed the lower-of-cost-or-market method in principle, reflecting the conservatism of the Commercial Code in corporate accounting. This practice resulted in accumulation of unrealised profits for Japanese companies, especially in the early 1980s, and allowed them to expand their balance sheets aggressively, which led to difficulties afterward. Drawing a lesson from this harsh experience, and also seeking harmonisation with international standards so as to appease foreign investors, it has been decided to introduce mark-to-market accounting on financial products in 2000.[19]

This accounting reform will sweep out unrealised profits and make firms that have a large amount of financial assets more exposed to price volatility in the markets. It will obviously increase the cost of keeping inefficient financial assets, which will inevitably accelerate the recent tendency of liquidating cross-shareholdings described above.

Introduction of a holding company structure

After years of operation and occasional business expansion, the corporate structure of large Japanese companies has become huge and complicated, with a number of divisions, subsidiaries and related companies. The deteriorated performance of Japanese companies, coupled with the intensified competition with other international firms, has urged them to streamline and reform their organisation by introducing a holding company structure. This movement induced the legal change to lift the ban on creating a pure holding company in December 1997 which, in turn, accelerated the movement toward reform. The first case after the legal change is Daiwa Securities Co., Ltd which decided in its extraordinary general meeting of shareholders on 5 February 1999 to create a pure holding company. Other large companies are also moving in this direction, either by establishing a similar holding company or by building a quasi-holding company structure through the creation of independent profit centres in the company which, together with the subsidiary companies, are supervised by the central management.

This movement eventually will be supported by expected legal changes. An amendment to the Commercial Code is expected to bring about a new method of exchanging shares which would enable existing companies to create a holding company smoothly and economically. The introduction of corporate taxation on a consolidated basis, which would facilitate considerably the creation of holding companies, is also under serious discussion. Moreover, though not a legal change, the forthcoming accounting reform for emphasising consolidated accounting will reinforce this momentum by changing the attitude of management in large companies.

The holding company structure will make it easier for management to trade its business units with other companies, and thereby facilitate mergers and acquisitions. It could possibly create a market for corporate control in Japan, leading to better disciplining of management by market forces.

Reform of the board

Board restructuring

More recently, efforts of Japanese firms to improve efficiency and transparency in corporate management tend to accompany the reform of the board of directors. Various measures have been carried out or discussed in order to strengthen the effective functioning of the boards which are legally responsible for management, and to increase their accountability for existing and potential shareholders.

The leading company in this respect is Sony Corporation. After introducing a quasi-holding company structure within the company in 1994, Sony decided in June 1997 to downsize the board from 38 directors to 10 by transforming most of the directors in charge of actual management of the "subsidiary companies" into executive officers. It also increased the number of independent directors from two to three, while the remaining 7 directors are concurrently the executives. An increasing number of companies have recently announced plans to downsize their boards by introducing the executive officer system, which usually accompanies the comprehensive streamlining and reorganising of the company with the introduction of a holding company structure.

One may distinguish two factors in this reform, which are in many cases closely interrelated. The first factor is downsizing of the board. This usually intends to improve the efficiency of the functioning of the board which has been criticised to be superficial particularly because of its size. The second relates to changes in the practical function of directors. The demand from investors for effective disclosure and the eventual reform of accounting standards urge the board to focus more on overall strategy and supervision of a group of companies than on management of individual companies. Creation of a holding company structure should clarify this change of the function of the board. More important, the increasing recent cases of shareholder litigation highlight the legal responsibility of individual board members for managerial decisions by the board. These factors require each director to be competent and fully accountable for management and supervision of the company and its subsidiaries. Obviously this change of the actual role of directors accelerates the significant downsizing of the traditional board structure in which many directors do not actually participate materially in managerial decision making.

Improvement of supervision

As was previously explained, one of the deficiencies of the traditional board structure is its weak supervisory function over the affairs of directors. In the context of reforming the board to be more accountable to shareholders, various measures to improve the supervisory function of the board are being implemented or considered. Roughly speaking, there are two types of measures: those to strengthen the existing mechanism and those to adopt a new mechanism which is widely used in the US.

The first type of measures mainly focuses on improving the function of statutory auditors, who are legally responsible for external supervision of management on behalf of the shareholders. The following three elements could reinforce their supervisory function in governance practice. First, their independence from management could be improved. The concrete measures proposed and seriously discussed include increasing the number of "independent" auditors required in a board of auditors, stipulating a more stringent definition of "independence", and lengthening the term of service for statutory auditors. Second, the actions that statutory auditors can take against management could be strengthened. Granting statutory auditors the authority to suspend or dismiss directors would increase the auditors' power significantly, but little discussion has taken place on this kind of drastic action. Finally, the capacity of statutory auditors to gather information on management could be reinforced. In this context, measures such as an increase in the budget and staff for the auditors, and closer co-operation of statutory auditors with the internal audit and legal section and/or outside professionals, have been implemented or planned in some companies.

The current policy discussion seems to focus on the measures to reinforce the functioning of statutory auditors, *inter alia* those to strengthen their independence from management. A committee in the ruling Liberal Democratic Party published in September 1997 its proposal to amend the Commercial Code, which contains the measures to improve the independence of statutory auditors enumerated above, as well as a review of the framework for shareholder litigation. Japan's Federation of Economic Organizations (Keidanren) has also issued a similar proposition.

The second type of measures to improve the supervisory function of the board are based on introducing new mechanisms that are popular in the US. These measures include appointing "independent" directors and establishing remuneration and appointment committees.

Referring to US corporations which strengthened the supervisory function of their boards by increasing the number of "independent" or "outside" directors who are not executives and who focus on supervising executives, some suggest that Japanese companies should also raise the number of such independent directors to a majority on their boards. Recent research shows that on average independent directors represent approximately a third of the directors for large, listed companies, but few companies plan to increase the number of independent directors on their boards, even though they recognise the importance of their role.[20] This is possibly because external supervision of management is seen as the principal role of statutory auditors, and not as the primary function of directors, who are themselves responsible for managing the company.

Establishing remuneration and/or appointment committees has also not been very popular among Japanese firms. There are some companies which have recently established a remuneration committee to determine the compensation for respective directors and/or an appointment committee to select candidates to become directors, as in US. companies. However, these committees in Japanese firms may differ from those in US firms, as they are sometimes composed of "independent" individuals who are neither directors nor statutory auditors elected by shareholder general meetings and therefore have no legal responsibilities to the shareholders. One may argue that the committees are necessary in the US to rationalise high managerial salaries and to choose objectively - both from inside and outside the company - competent candidates to become directors. But these issues have not been so relevant in Japan.

IV. Future prospects

As mentioned above, one can observe recently a remarkable shift in the corporate governance structure of Japanese corporations. Research shows that the number of listed companies that have implemented or plan to implement concrete measures to strengthen governance is rather limited (Table 7). However, there is now an accelerating trend toward the improvement of corporate governance practices. For example, half of 17 major banks in Japan have recently introduced or are determined to introduce the executive officer system coupled with downsizing the board.[21]

Table 7: Measures to Improve Corporate Governance[1)]

(%)

	Taken	*Will Take*	*Will Not*	*Not Know*[2)]
Appointing independent directors[3)]	35.6	4.0	37.9	22.5
Appointing executive officers	3.5	10.6	54.9	31.0
Downsizing the board of directors	28.6	9.9	31.9	29.6
Setting up a remuneration committee	0.4	2.0	74.6	23.0
Setting up an appointment committee	0.6	2.0	74.3	23.1
Setting up a body for legal compliance	25.8	10.0	38.8	25.4
Setting up an advisory body of outsiders	3.8	2.6	71.3	22.3

Note:

1) Percentages of 1,137 responding companies out of 1,822 companies listed on the Tokyo Stock Exchange.

2) Including "plan to take other measures for the same purpose".

3) Directors who have not been director or employee of the company and its subsidiaries for the last 5 years.

Source: Tokyo Stock Exchange [1998b].

The shift seems to be heading for a governance system based on the Anglo-Saxon model. This is not surprising, as these changes have been at least partly induced by the increasing influence of foreign shareholders, especially those from Anglo-Saxon countries. Indeed, these changes are becoming common for the large listed companies, which are expanding their business internationally, but, for the moment, less so for a number of relatively small Japanese corporations..

It is not likely, however, that the governance practices of Japanese corporations will become identical to those of the Anglo-Saxon model in the near future. Corporate governance practices do not stand alone, but are closely interrelated with various economic and social systems and practices, for example, legal and regulatory systems, financial market systems, employment practices, etc. These systems and practices cannot be completely converged with those in the Anglo-Saxon countries, even though they may move in that direction in the period of mega-competition. In response to the significant changes in business environments, Japanese corporations are now seeking their own model of corporate governance, suitable to them in their particular environments.

NOTES

1 The numbers of companies, except for that of listed ones, are as of 30 June 1998 (National Tax Administration, Kaisha Hyouhon Chosa). The number of companies listed on stock exchanges was 2,387 as of 7 December 1998.

2 Aoki [1996].

3 The Weekly Toyo Keizai, 20 September 1997.

4 In the past, a ban on directors being concurrently executives or employees of the company was discussed. It was not adopted due to the opposition of the business sector; instead, the supervisory function of statutory auditors was reinforced to cover not only financial reporting but also management of the company (Fukao [1997]).

5 Life Insurance Association [1998].

6 OECD [1995-1996] contains the data on the international comparison of CEO compensations, originally provided by Abowd and Bognanno (1995), "International Differences in Executive and Managerial Compensation", in Freedman and Katz (ed.), Differences and Changes in Wage Structure, Chicago, University of Chicago Press.

7 Tokyo Stock Exchange [1998a].

8 In the late 1940s, many large firms, especially ex-zaibatsu (the large financial holdings in the pre-war period) affiliated companies, faced the pressing need to raise capital under the reorganisation plan after the Second World War. However, the stock market collapsed in 1949 because of the serious recession induced by the severe anti-inflation policy implemented in 1949 as well as the excess supply of stocks resulting not only from rushing issues of stocks by the large companies, but also from market auctions of stocks of ex-zaibatsu affiliated companies, which began in 1948 in order to redistribute their ownership among the public and thereby "democratise" the Japanese economy. The market collapse brought two serious problems to the management of large companies: the difficulty in increasing capital and the real threat of hostile take-overs with high liquidity of shares and sharp declines in share prices. In order to survive this difficult circumstance, the companies asked their related firms, especially financial institutions, to hold their shares. As a result, cross-shareholding, especially among ex-zaibatsu companies, advanced significantly during 1949-55 (Miyajima [1995]).

9 As of December 1998. The ratio includes holdings by the executives of the companies in addition to the 10 largest shareholders.

10 Fukao [1997]

11 More detailed analysis was provided by OECD [1996] and Fukao [1997].

12 EPA [1997].

13 As of December 1998.

14 This is the share of the market turnover excluding the transactions conducted by securities houses for their own sake. The share of the total turnover, including these transactions, is 18.6%.

15 Nikkei Shinbun, 24 June 1998.

16 The numbers of companies are available at the web site of Daiwa Securities Co., Ltd (http://dvl.daiwa.co.jp/KOKAI/Stock/stock.html).

17 Business Accounting Council, Draft Recommendation concerning Review of Consolidated Financial Reporting, 7 February 1997.

18 More precisely, it will be applied to the business year of respective companies starting on, and after, April 1999.

19 Applied to the business year starting on and after April 2000, except for valuation on the securities whose holdings are not evident either for trading purpose or for holding until maturity purpose. The mark-to-market valuation of these securities which are considered to include the majority of stocks held by corporations with cross-shareholding arrangements, will be enforced for the business year starting on and after April 2001.

20 Life Insurance Association [1998].

21 Nikkei Shinbun, 27 May 1999.

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DISCLOSURE AND CORPORATE GOVERNANCE: A JAPANESE PERSPECTIVE

by
Hideki Kanda[*]

I. Introduction

I will limit my comments to disclosure in publicly held business firms. Also, by "disclosure" I mean disclosure required by law (unless otherwise indicated).

I would like to emphasise three points. First, it is easy to say that disclosure is a good thing. In fact, I am an advocate of disclosure. Disclosure enhances transparency. Disclosure helps "stakeholders" of the firm and other market participants act properly. With adequate information, investors can buy or sell stock, express their "voice" to the management, or even acquire control of the company. Also, disclosure might prevent fraud. Despite these benefits, however, costs accompany disclosure. These costs are carried by the firm which is required to make disclosure, and thus by the national economy. Therefore, when one wants to improve the disclosure system, one must have a clear idea of exactly what disclosure system to aim for. Indeed, it is extremely important to be aware of what information should be disclosed. Information being disclosed must be "useful," that is, understandable and verifiable. In this sense, what accounting rules should be adopted is particularly important. And audit by accounting professionals must be reliable.

Second, disclosure does not have an absolute value in isolation. The value, or the effectiveness, of disclosure depends very much on other (often non-legal or loosely legal) conditions, such as the style of finance and ownership structure. The value of disclosure is higher where there is a well-functioning capital market. It is also higher where investor ownership is dispersed rather than concentrated.

Third, from a corporate governance perspective, disclosure alone may not be enough, and other legal infrastructures are equally important for corporate governance to matter. For instance, even if a vast amount of information on public companies is available in the marketplace, if there are restrictive legal rules on corporate takeovers, the "market for corporate control" does not function as an effective corporate governance device. Therefore, when one considers improving the disclosure system, one must also prepare a comprehensive regime of securities regulation to take full advantage of the disclosure regime.

In Japan, the disclosure system is becoming more and more important. I believe that this trend is consistent with what I just said - first, Japan is adopting global accounting standards; second, Japan is moving from a bank-centred system to a capital market-based system, and from a system with concentrated investor ownership to a system with more dispersed investors; and third, Japan is comprehensively overhauling its legal and regulatory infrastructure of capital markets.[1]

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I will elaborate these points below. In Section Two, I will examine the role and limitation of disclosure required by law. In Section Three, I will provide an overview of the Japanese situation. Finally, Section Four is my brief conclusion.

II. The role and limitation of disclosure in corporate governance

The logic of mandatory disclosure: why and what to disclose?

Capital markets may be both well-developed and well-functioning markets when compared with product and other markets, but they operate in a highly regulated environment. Highly organised securities markets on stock exchanges also operate in a highly regulated environment. The reason why there is more, rather than less, regulation in capital markets - as compared with other ones - stems from the historical origin of securities regulation: protecting public investors against manipulative and deceptive activities by securities brokers and others. Thus, securities regulation in most jurisdictions emerged and is centred upon the idea of retail investor protection.[2] The two fundamental ways of protecting investors are found in mandatory disclosure and anti-fraud rules.

The value of disclosure has been well recognised, and the relationship between the amount of information available in the market place and the "efficiency" of the stock market has been well analysed.[3] Why the law must require a firm to disclose certain information, however, is not entirely clear. Nevertheless, most industrialised economies today have a legal system of mandatory disclosure. In fact, civil law countries have a register system of merchants, which provides specific information regarding the amount of stated capital, the names of officers and directors, and other pertinent information on business entities. In many jurisdictions, securities law provides a detailed and complex disclosure system for large public companies.

The value of disclosure depends on the value of information being disclosed. In general, information being disclosed comprises two kinds: accounting and non-accounting information. For accounting information to be useful, it must be based on proper accounting treatment. What is proper accounting, however, is not entirely clear, and is much debated today. The global trend is that the importance of market-value accounting is more and more recognised.

Disclosure and the depth of the capital market

Mandatory disclosure has both benefits and costs. Its value depends on other elements of corporate governance.

Among various determinants of corporate governance, or how companies are run, it is well-known that two are most important: the style of finance and ownership structure. First, for the style of finance, jurisdictions can be classified as either the bank-centred system or the capital market-centred system. Because capital markets function better when more information is available in the market place, disclosure is more important and more valuable in the capital market-centred system. In other words, in any given country’s policy, the increased emphasis on the disclosure system means increased emphasis on the capital market-based system. This suggests that Japan’s efforts to improve the disclosure system in recent years is an indication that it is moving from the bank-centred system to the capital market-based system.

Second, when ownership is concentrated, investors are able to collect necessary information about the firm by themselves, rather than through the mandatory disclosure system. When ownership is spread out, dispersed investors face the collective action problem, and may benefit more from mandatory disclosure. This suggests that where investors are more dispersed, the mandatory disclosure system is more valuable and more effective. This may also suggest that where disclosure is taken increasingly into account, an investor ownership structure may be changing to non-concentrated ownership.

Other legal infrastructures, however, are equally important for the capital market to function well and properly. One typical example is the rule for corporate takeovers. It is well-known that corporate takeovers discipline inefficient management, but restrictive legal rules on corporate takeovers often emerge for political reasons. When corporate takeovers are difficult, the value of capital markets - from a corporate governance perspective - would be reduced.

Disclosure as a legal rule: periodicity and enforcement

Disclosure mandated by law has inevitable weaknesses. For instance, the most typical mandatory disclosure system is to require public companies (known as "reporting companies") to make disclosure periodically. Disclosure is made quarterly in the US, and twice a year in Japan. The scope of information being disclosed is carefully delineated in law, and the key information being disclosed is accounting and financial data. Such periodic disclosure, however, has at least two flaws. First, there is a time lag between the date when disclosure documents (typically the firm's financial statements) are prepared and when they are actually disclosed. In Japan, the legal rule is that periodic disclosure is made semi-annually, and the financial statements must be prepared and become public within three months of the cut-off date. For instance, an annual report must be prepared and become public after the closing of the company's fiscal year. Thus, there is a three month lag. Second, there is no obligation for the company to update the information supplied in the financial statements, even if something happens after they are prepared and become public. There is an exception that certain important events must be disclosed in a special report (known as an "8-K" report in the US), but this exception is not comprehensive.

Therefore, to rectify these two flaws, there must be a supplemental scheme. In this vein, stock exchanges and other self-regulatory organisations usually require "timely disclosure", by which the company is required to disclose pertinent information more often (and sometimes in greater detail) than is required by law. For instance, the Tokyo Stock Exchange requires listed companies to file summary financial statements within two months of the closing of the fiscal year, and to file a special report for events that would materially affect investor decision-making.

Another problem with legal rules is that they must be enforced, and enforcement is often not costless. Fortunately, disclosure and accounting rules, particularly those for "hard" information such as data in the firm's financial statements, are often enforceable at low costs. For example, if a publicly held company keeps supplying false numbers in its financial statements, it is most likely to be found out and penalised in the market place. Thus, contrary to the rule on insider trading, rules on disclosure and accounting are often self-enforcing. This implies that it is the value of the substantive rule that matters, and not so much the cost or level of enforcement. And in this case there is reason to expect that various jurisdictions' disclosure and accounting rules could efficiently and increasingly converge.[4]

It might be added that there are disclosure rules which are not self-enforcing. Typically, rules on "soft" information, particularly non-financial or forward looking information, tend to be litigated. For example, claims concerning misleading projections about a firm's future profits have often been filed in US courts, and this has led to a legislative response constraining such litigation. This means that for this kind of disclosure enforcement matters. In sum, the value of any disclosure rule must be evaluated with its enforcement cost.

III. Disclosure System in Japan

Overview

Japan has adopted a dual system of disclosure: one by the Commercial Code (Law No. 48 of 1899, as amended) and the other by the Securities and Exchange Law or SEL (Law No. 25 of 1948, as amended).

Accounting

Among major industrial countries, Germany and Japan are distinct in that the company law provides detailed rules on accounting. In Japan, the Commercial Code provides accounting rules on recognition, measurement, and reporting of the assets and liabilities of a joint-stock company (*kabushikigaisha*) - the counterpart of a US business corporation, a UK public limited company, a German *Aktiengesellschaft* and a French *société anonyme*. For most assets, the Commercial Code adopts the principle of historical cost accounting, but when the market value declines below the historical cost, the company must adjust booking to the market value (known as the conservative accounting principle). As noted below, this accounting rule is expected to change soon.

The purpose of "company law accounting" is, for the most part, to measure a company's annual "profits" in connection with the Code's dividend regulation: dividend may only be paid out of the company's (accumulated) profits. Large companies must have their annual financial documents audited by accounting auditors (who must be CPAs) before submission to the annual shareholder meeting.

In addition, the SEL requires all "reporting companies" to prepare financial statements, both on unconsolidated and consolidated bases, twice a year. "Reporting companies" are (1) companies whose securities are listed on a stock exchange, traded "over the counter," or whose registered shareholders are 500 or more, and (2) companies which filed a registration statement with the Ministry of Finance (MOF) when it issued securities. The annual financial statements of reporting companies must be audited by CPAs. Accounting rules (for recognition, measurement, and reporting of assets and liabilities) are promulgated under the SEL. Accounting rules for recognition and measurement are known as the "Japanese GAAP". This dual accounting system of company law and securities law comes from Japanese history: company law has its origins in 19th century German law, and securities law was imported from the US after World War II. But the accounting standards of these two accounting systems have been harmonised over the decades, and today, this dual system does not put much burden on Japanese companies subject to both accounting requirements.

Disclosure

Accounting documents prepared in accordance with the rules in company law must be submitted to the company's shareholders before the annual shareholders' meeting. The Commercial Code requires "large companies" to make public the summaries of their annual balance sheet and profit and loss statement. A "large company" is defined under the statute as a joint-stock company having either capital in the amount of 500 million yen or more, or total (on balance sheet) debt in the amount of 20 billion yen or more. Under the SEL, all reporting companies must have their financial statements disclosed to the public at the MOF, stock exchanges and the company's principal office twice a year. In addition, reporting companies must file a disclosure statement when an unusual event occurs, such as a merger. Also, as noted above, stock exchanges require listed firms to provide "timely disclosure" of certain information.

Auditors

Under the Commercial Code, a joint-stock company must have *kansayaku*, often (somewhat misleadingly) translated as statutory auditors. Statutory auditors are elected at the shareholders' meeting, and do not have to be accountants or other professionals. A large company must have at least three statutory auditors, and at least one of them must be an "outside" statutory auditor. An auditor is "outside" when he has not served as a director or employee of the company or of its subsidiary for at least five years preceding his appointment as auditor. In a large company there must be at least one full-time auditor.

In addition, a large company must have an accounting auditor *(kaikeikansanin*), who is a certified public accountant or certified auditing firm. An accounting auditor is elected at the shareholders' meeting, and is responsible for auditing the company's financial documents annually before they are submitted to the annual shareholders' meeting, where the audit opinion is also submitted. In contrast, a statutory auditor is responsible for the oversight of management activities. This is understood to mean checking the legality of management's activities. The statute provides complex rules for the collaboration of accounting auditors and statutory auditors, but if an accounting auditor notices an illegal matter in the course of an accounting audit, for instance, he must report it to the statutory auditor. Thus, the role of accounting auditors in discovering fraud or the like is limited, as compared to the US, where a more active role by CPAs is recognised by law.

Six disclosure rules under Japanese securities regulation

The SEL provides six different sets of disclosure: (1) issuer disclosure of publicly placed securities in the primary market; (2) issuer periodic disclosure in the secondary market; (3) proxy rules (requiring public companies to send information to shareholders for mail voting at the shareholders' meeting); (4) reporting of "short swing" trades of stock by the "insiders" of public companies; (5) offeror disclosure in stock tender offer; and (6) ownership disclosure (requiring a shareholder who obtains 5% or more of the total issued shares of a public company to disclose the intent of stockholding, the source of finance, etc.). These sets of disclosure are already well recognised in US securities regulation.

Year 2000 accounting reform in Japan

As noted above, what information should be disclosed is the key issue of securities regulation. Japan is currently in the midst of an important reform, and plans to implement three important changes in accounting and disclosure rules around the year 2000: enhanced scope of consolidation, market-value accounting, and pension liability. First, the scope of consolidation of financial statements will be expanded. The current rule is to consolidate subsidiaries where the parent owns more than half of the shares issued by them. The new rule is that the parent must consolidate all subsidiaries when it "controls" them even if its stockholding does not amount to more than 50%. This consolidation standard of "control" is well-known in the US. Second, the new rule is that financial assets must be measured at their fair market value, rather than at historical cost. This is consistent with the current rule in the American GAAP and the position of the International Accounting Standards Committee. Finally, the new rule requires public companies to recognise pension liability on its balance sheet. This, too, is already recognised by the American GAAP.

IV. Conclusion

Any disclosure system is contingent. From a corporate governance perspective, the value and effectiveness of enhanced disclosure and transparency depend very much on other elements of corporate governance.[5] In any given country, in order to judge the role and function of the disclosure system properly, one must evaluate the entire system of corporate governance. Any reform of the disclosure system often accompanies or leads to reform of the entire system of corporate governance.

NOTES

1 Japan is currently undergoing a comprehensive reform of banking, capital market, and insurance regulation, known as "Japan's Big Bang." See e.g.Valentine V. Craig, "Financial Deregulation in Japan", *FDIC Banking Review*, Volume 11, No. 3, at 1 (1998).

2 In theory, protection of public investors alone does not justify regulation. This fundamental question of why we need regulation in capital markets is not discussed here. See Merritt B. Fox, "Required Disclosure and Corporate Governance", in Klaus J. Hopt et al. (eds.), *Comparative Corporate Governance* 701 (1998) (arguing that corporate governance, not investor protection, is the justification for mandatory disclosure).

3 See Ronald J. Gilson and Reinier H. Kraakman, "The Mechanisms of Market Efficiency", 70 *Virginia Law Review* 549 (1994). For the "Efficient Market Theory," see, e.g., Burton G. Malkiel, *A Random Walk Down Wall Street* (6th ed. 1996).

4 On this point, see Gérard Hertig and Hideki Kanda, Rules, Enforcement, and Corporate Governance (draft, 1998).

5 For substitutabilities and complementarities among various elements of a corporate governance system, see Hideki Kanda, *Notes in Corporate Governance in Japan*, in Klaus J. Hopt et al. (eds.), supra, at 891.

CORPORATE GOVERNANCE IN KOREA

by
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I. The Korean economy before and after the crisis

Economic performance before the crisis

Korea's rapid growth during the past four decades has been cited as an exemplary model of successful economic development and termed an "economic miracle."[1] Indeed, Korea's growth performance was remarkable as shown by the fact that its per capita income increased by more than 120 times, from a mere US$ 80 in 1960 to US$ 10,543 in 1996.

Remarkable economic growth was accompanied by equally dramatic change in economic structure. International trade, including both exports and imports, as a share of GDP, increased from 12.9% in 1960 to 88.7% in 1996 (Table I-1). Total investment accounted for only 8.6% of GDP in 1960, but dramatically rose to 39.1% in 1996. On the production side, the manufacturing sector also underwent significant structural change as indicated by the increased share of heavy and chemical industry (HCI) within the sector from less than 20% to more than 70% during 1960-1996.

The major thrust for economic take-off was made at the beginning of the 1960s when the newly established government adopted an outward-looking development strategy based on export promotion. Such a development strategy led to increases in employment, income, and savings by enabling Korea to benefit from economies of scale in production and technology transfer as well as to make the best use of its available resources. In particular, the promotion of HCIs as strategic export industries during the 1970s expanded the spectrum of the product mix of the economy and provided domestic producers with a good opportunity to benefit from scale economies.

The so-called HCI drive in the 1970s set the stage for the emergence of large conglomerates – known as c*haebols* in Korea – which has been the core engine of growth since then. The government provided c*haebols* in the targeted sectors with massive financial support in the form of policy loans that carried low interest rates. To this end, the government directed more than half of the bank credit through state-owned banks. More important was the government's implicit risk sharing with private firms in making investments. These measures significantly contributed to rapid growth which was largely driven by the factor-input expansion.

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High economic growth and rapid industrialisation, however, were not free of problems. The government's financial support to and risk sharing with c*haebols* resulted in a serious problem of moral hazard not only in the corporate sector but also financial institutions. Implicit risk-sharing by the government encouraged c*haebols* to make reckless investments based on heavy debt financing, while discouraging financial institutions to properly monitor the soundness of borrowers and manage risk in their loan portfolios.

Table I-1: Changes in the Economic Structure by GDP
(Unit: %)

	1960	1970	1980	1990	1996
Trade and investment					
Trade/GDP	12.9	21.7	51.5	60.1	88.7
Investment/GDP	8.6	20.0	28.6	36.9	39.1
Construction	5.7	13.3	16.8	22.1	21.2
Equipment	2.9	4.3	11.7	15.0	16.8
Industrial structure					
Manufacturing/GDP					
Light Industry	10.9	10.6	22.1	29.2	30.1
HCI	8.8	7.2	11.7	9.9	6.4
Agriculture/GDP	2.1	3.4	10.4	19.2	23.6
Service/GDP	41.6	28.4	15.1	8.7	6.4
	43.2	50.5	48.7	47.6	49.0

Source: National Statistical Office, Major Statistics of the Korean Economy.

The impact of the crisis

The impact of the financial crisis that occurred at the end of 1997 was immediately reflected in the currency market. Upon the onset of the crisis, the exchange rate of the won *vis-à-vis* the US dollar soared to a 1,950 level in December 1997, from the pre-crisis level of about 900. In order to stabilise the currency market quickly, the IMF imposed a high interest rate policy during the initial stage of crisis management. Accordingly, the call rate jumped from 14% to 25% and the rise in market interest rates soon followed. Such a drastic rise in interest rates, coupled with severe credit crunch, caused massive corporate bankruptcies. During the first quarter of 1998, the monthly average number of corporate bankruptcies exceeded 3,000, representing about a 200% increase compared to the same period of the previous year.

Massive corporate bankruptcies immediately translated into a dramatic increase in non-performing loans (NPLs) of financial institutions, seriously undermining the soundness of the financial system as a whole. As of the end of June 1998, the estimated total of NPLs of all financial institutions, broadly defined to include loans classified as "precautionary," was about 136 trillion won (32% of GDP), a 58% increase from 86.4 trillion won at the end of 1997 (Table I-2).

The financial crisis quickly degenerated into a full economic crisis. Real GDP growth plunged since the fourth quarter of 1997, and remained negative throughout 1998 (Table I-3). In particular, private consumption and fixed investment declined drastically, mainly due to the severe credit crunch as well as increased market uncertainty. Reflecting the dire growth performance as well as fallouts from economic restructuring, the rate of unemployment sharply rose to over 7% in 1998, up from the pre-crisis level of 2 to 3%. Stagnated domestic demand, however, worked as the major contributing factor behind the improved external current account as it reduced import demand dramatically. The current account registered a record-high level surplus of more than US$ 40 billion in 1998, while imports declined by more than 20%. Large devaluation of the domestic currency after the crisis pushed up consumer price inflation to 7.5% in 1998, from 4.5% in 1997.

Table I-2: Non-performing Loans (end of period)
(Unit: trillion won)

	Dec. 1997	Mar. 1998	June. 1998
Non-performing Loans (A)	86.4	117.3	136.0
Precautionary	42.8	57.7	72.5
Substandard or below	43.6	59.6	63.5
Bank	31.6	38.8	40.0
NBFI	12.0	20.8	23.5
Total Loan (B)	647.4	668.7	624.8
A/B (%)	13.3	17.5	21.7

Source: Financial Supervisory Commission.

Table I-3: Recent Trends in Key Macro Indicators
(year on year growth rates, %)

	1994	1995	1996	1997	1998			
					1Q	2Q	3Q	4Q
Gross Domestic Product	8.6	8.9	7.1	5.5	-3.9	-6.8	-6.8	-
Private Consumption	7.6	8.3	6.8	3.1	-10.6	-13.0	-12.0	-
Fixed Investment	11.8	11.7	7.1	-3.5	-23.0	-29.8	-29.3	-
(Facility)	23.6	15.8	8.3	-11.3	-40.7	-52.4	-46.3	-
(Construction)	4.5	8.7	6.1	2.7	-7.7	-13.2	-15.8	-
Exports	16.5	24.0	13.0	23.6	26.4	14.4	8.9	-
Imports	21.7	22.0	14.8	3.8	- 25.3	-23.1	-20.9	-
Current account (US$ 100 mil)	-39	-85	-230	-82	108	109	97	-
Consumer Price	6.2	4.5	4.9	4.5	8.9	8.2	7.0	6.0
Unemployment[1)]	2.4	2.0	2.0	2.6	5.7	6.9	7.4	7.4
Dishonoured Bill Ratio[1)]	0.17	0.20	0.17	0.52	0.72	0.59	0.55	0.23
Fiscal Budget surplus/GDP[1)]	0.45	0.35	0.28	-1.65	0.002	-2.42	-5.36	-

Note: 1) In level.

Causes of the economic crisis

A myriad of factors have been cited to date as the causes of Korea's financial crisis. To get a clear picture of the unfolding drama of the crisis, however, it is necessary to identify the essential characteristics of the crisis. For Korea, the financial crisis was initiated by a series of large-scale corporate failures, starting with Hanbo Steel Co. in early 1997. The string of major bankruptcies was soon followed by unbearable burden of NPLs in the financial sector, which, in turn, greatly undermined international confidence and hence caused massive pull-out by foreign investors from Korea. In sum, the corporate insolvency problem translated into domestic financial crisis, and ultimately caused the external liquidity crisis. Of course, many factors, such as poor corporate governance, heavy exposure to short-term external debt, lax supervision and contagion effect, magnified and/or triggered Korea's economic crisis.

At the risk of over-simplification, large corporate failures in 1997 can be attributed mainly to two factors. The first factor is an adverse shock in terms of trade occurring in the first half of 1996, particularly in the semi-conductor manufacturing industry and other HCIs. The terms of trade deteriorated about 20% in 1996, the largest drop since the first oil shock of 1974 (Chart I-1). The unit export price of semi-conductors fell by more than 70% during 1996. Such a negative shock significantly constrained cash flows of *chaebols*, which were the major exporters. The second is structural in nature, namely the heavy exposure to debt financing of large corporations. The weak capital structure of *chaebols* was the core source of their financial vulnerability. According to the flow of funds statistics, at the end of 1997, gross corporate debt amounted to 811 trillion won, equivalent to about 190% of GDP (Chart I-2).[2] In fact, the ratio of corporate debt to GDP has risen rapidly since the late 1980s, when the current account balance turned into a deficit. Given the large share of international trade, the continued current account deficits have significantly strained corporate cash flows and forced firms to rely more on borrowings to finance operational loss.

The financial vulnerability of Korean corporations can also be seen in the high debt/equity ratios. The corporate debt/equity ratio in Korea is about five times higher than that of Chinese Taipei or the United Kingdom (Chart I-3).[3] In particular, by the end of 1997, the debt/equity ratio of the 30 largest *chaebols* reached 519%, about 130 percentage points higher than a year earlier. Owing to the high leverage, the ratio of financial expenses to sales in Korea is three times as large as in Japan or in Chinese Taipei (Chart I-4). Furthermore, the corporate sector's asset-liability composition was quite fragile as evidenced by low liquidity ratios defined as a ratio of liquid assets over short-term liabilities. For Korea, the ratio remains barely above 90%, far below that in the US, Japan, and Chinese Taipei (Chart I-5).

Due to high financial leverage and illiquid asset-liability structure, the corporate sector was faced with high default risk over the business cycle. Such inherent vulnerability was further compounded by large negative shock in terms of trade and weak domestic demand in 1996-97. As a result, 13 out of the top 30 Korean *chaebols* recorded negative net profit in 1996, and 7 of them went bankrupt in 1997, which in turn devastated the banking sector and created an unbearable systemic risk in the financial system.

Chart I-1: Terms of Trade (Index)

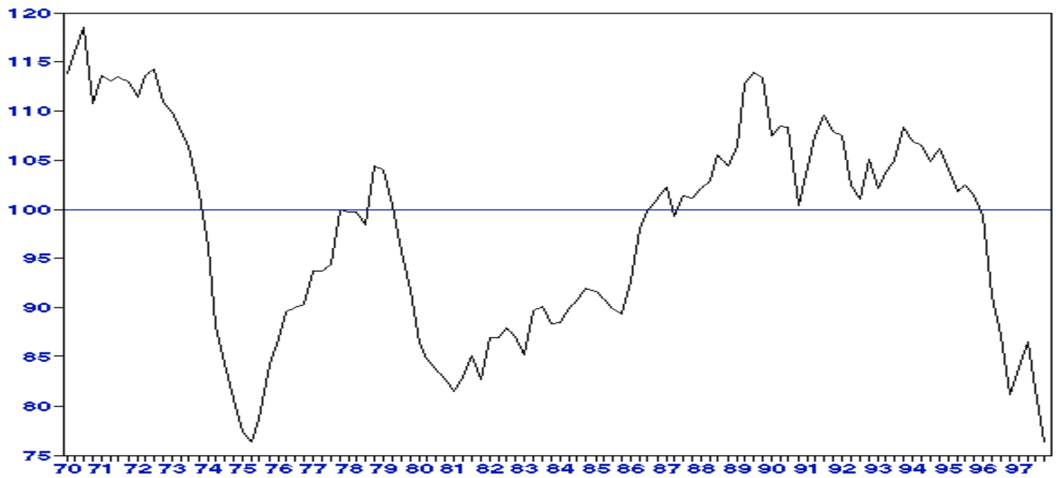
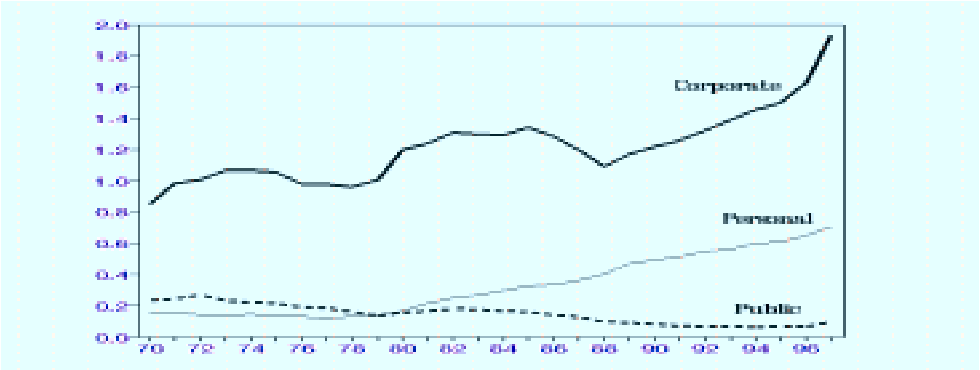
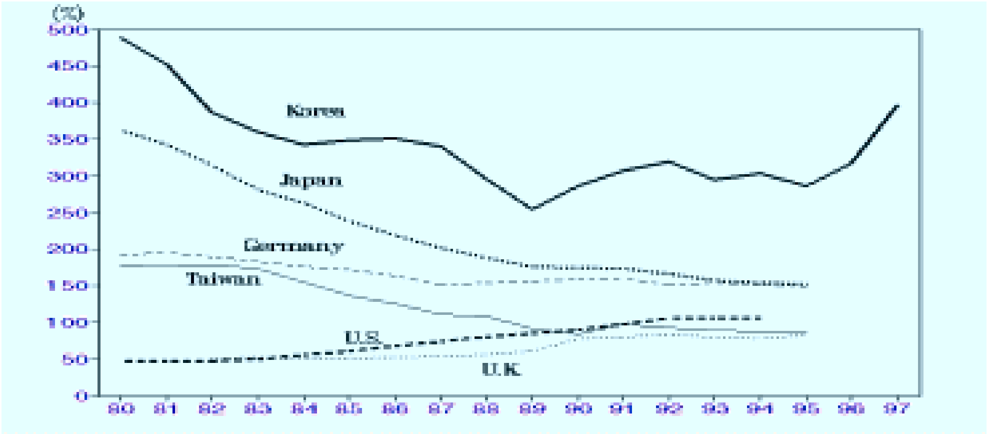


Chart I-2: Debt/GDP Ratios by Sector - Korea



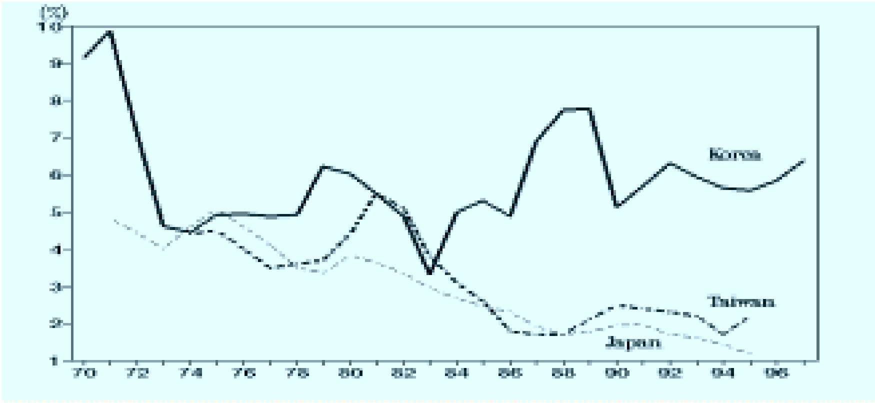
Source : Bank of Korea.

Chart I-3: International Comparison of Debt/Equity Ratio[1)]



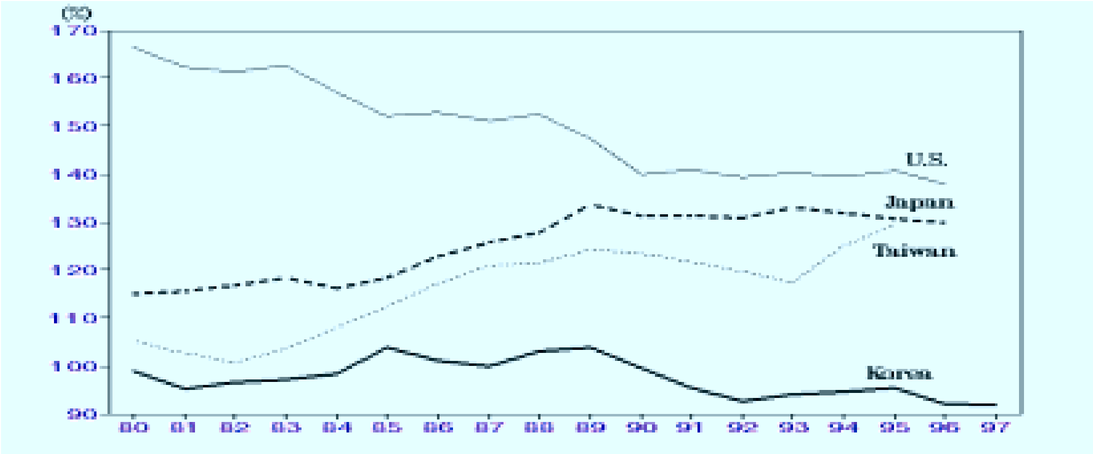
Note: 1) For the manufacturing sector in Korea, Japan and Taiwan (Chinese Taipei).
Source : Bank of Korea, Financial Statement Analysis. OECD, Financial Statistics Part 3: Financial Statements of Non-financial Enterprises.

Chart I-4: International Comparison of Financial Expenses to Sales[1)]



Note : 1) Manufacturing sector.
Source : Bank of Korea, Financial Statement Analysis.

Chart I-5: International Comparison of Liquidity Ratio[1)]



Note : 1) Manufacturing sector.
Source : Bank of Korea, Financial Statement Analysis.

Increased systemic risk in the domestic financial market immediately affected foreign investor confidence. Especially, foreign lenders started to reduce their exposure to Korea as part of their pull out from emerging markets. Subsequent massive and abrupt capital outflow in the face of falling international confidence was a direct triggering point of Korea's external liquidity crisis. However, the fundamental aspect of the crisis lies at the excessive exposure to short-term external debt and maturity mismatch in the asset-liability portfolios of Korean financial institutions and corporations. At the end of 1996, the share of short-term debt out of total external debt peaked at 58%. The significance of maturity mismatch problems faced by Korean banks is well reflected in low liquidity ratios of less than 80%, which is far lower than the international standard of 100% (Table I-4).[4]

The inherent risk associated with a disproportionately large share of short-term debt and maturity mismatch was inadequately covered by foreign reserves. The ratio of short-term external debt to foreign reserves exceeded 200% at the end of 1996, and invariably, all of the crisis-hit countries had high short-term debt to foreign reserves ratios (Table I-5).

Korea's excessive exposure to the short-term debt and maturity mismatch problem are the outcomes of a disastrous combination of ill-sequenced capital account liberalisation and lax supervision. Over the course of capital account liberalisation since the early 1990s, short-term capital inflows were liberalised in advance of long-term inflows. Consequently, Korean banks borrowed from abroad in the short-term, and lent funds in the long-term, causing a serious maturity mismatch. For example, in 1993, the Korean government relaxed restrictions on the usage for long-term foreign currency-denominated loans, while maintaining restrictions on long-term borrowing, including foreign commercial loans, so as to limit total capital inflows in the face of liberalised short-term borrowing.

Another development related to capital account liberalisation was the deregulation of foreign exchange transactions. The number of financial institutions licensed for foreign exchange businesses jumped since 1994. During 1994-1996, Korean banks opened 28 foreign branches while 24 finance companies were newly licensed for foreign exchange businesses upon their conversion to merchant banking corporations (MBCs). These institutional changes in the midst of a strong investment boom during 1994-95 triggered a dramatic increase in short-term foreign debt of financial institutions and severe maturity mismatch problems.

However, financial supervision of banks and the newly licensed MBCs was lax, or simply absent. The Office of Bank Supervision introduced a belated guideline for the liquidity ratio of banks only in June of 1997 and the Ministry of Finance and Economy (MOFE), a supervisory authority for MBCs until the eruption of the crisis, had not taken appropriate measures to deal with the problem. In particular, the lack of prudential regulations on MBCs' operations was not confined to the realm of supervision on liquidity conditions. Basic regulations such as capital adequacy ratio requirements had not been applied to MBCs.

The importance of the contagion effect as one of the causes of Korea's financial crisis seems to be modest and indirect. Although the Korean economy had a relatively strong trade linkage with the South East Asian region, its financial linkage was not tight despite the modest exposure of domestic financial institutions to that region at the time of financial crisis. Indeed, there is about a five-month time difference between the crises in Thailand and Korea. Nonetheless, the blanket state of uncertainty in the international financial market triggered by the turmoil in Thailand affected foreign investor confidence in the emerging markets, including Korea. The speculative attack on Hong Kong, China in October 1997 further increased instability in the international financial market, and indirectly affected Korea in terms of foreign investor confidence. In light of this, the observed correlation between Korea's exchange rate movements and the timing of crises in South East Asia and Hong Kong seems to reflect such an indirect contagion effect (Chart I-6).

Table I-4: Liquidity Ratios[1)] of the 10 Largest Banks – Distribution

(Number of banks)

	1995	1996	1997. 3	1997. 9
80~90%	1	3	2	2
70~80%	2	2	1	1
60~70%	4	2	4	5
below 60%	3	3	3	2
Average	59.9%	61.7%	62.0%	63.2%

Note : 1) Three-month liquidity ratio defined as a ratio of liquid assets over liquid liabilities, where the period of three-months is a criterion for being 'liquid'.
Source : Shin and Hahm (1998).

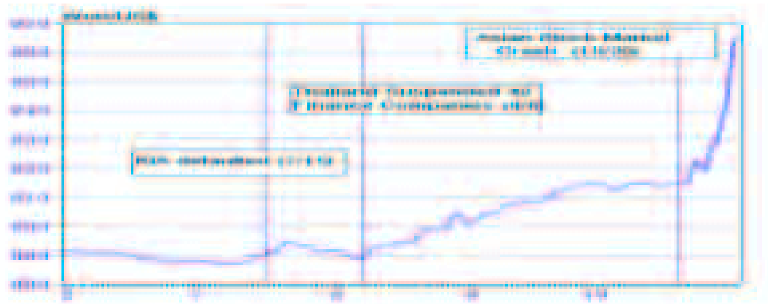
Table I-5: Short-term Debt/Foreign Exchange Reserves

(Unit: %)

	1995	1996
Korea	171.5	203.2
Indonesia	189.4	176.6
Thailand	114.3	99.7
Malaysia	30.6	40.9
Philippines	82.9	79.5
Singapore	1.8	2.6
Hong Kong	14.2	22.4
China	29.7	23.7
Taiwan	21.6	21.3

Source : BIS, The Maturity, Sectoral and Nationality Distribution of International Bank Lending. IMF, International Financial Statistics.

Chart I-6: Movement of Daily Won/Dollar Exchange Rate



Policy responses to the crisis

Korea's crisis management over the past year or so is comprised of three stages. Chronologically, the first stage of crisis management covered the period between the onset of the crisis and April 1998. The first policy priority in the first stage was to overcome the immediate liquidity crisis and stabilise the currency market. Financial assistance from the IMF, the World Bank and the ADB was of great help in resolving the liquidity shortage problem. In tandem with this, the successful debt exchange program negotiated with international lenders as well as the sovereign global bond issues of US$ 4 billion provided an important momentum in crisis resolution. Furthermore, large and sustained surplus in the current account allowed Korea to quickly regain its currency stability. At the same time, high interest policy was instituted as a supplementary measure for currency stability. Thanks to these factors, Korea's usable foreign reserves surpassed US$ 30 billion by the end of April 1998, while the won-dollar rate stabilised at around the 1,400 level, down from 1,950 in December 1997.

Several institutional reforms were also made in the first stage. Legal standards related to corporate governance were strengthened to ensure transparency and accountability in corporate management. On the labour front, labour market flexibility was legally instituted in February 1998, allowing for layoffs due to managerial difficulties. In tandem with this, a Tripartite Commission was established for an open dialogue among labour, business and government in order to ensure fair burden sharing.

Having achieved such positive results, the Korean government - as the second stage of crisis management that continued until September 1998 - shifted its policy focus on economic restructuring. During that period, non-viable financial institutions were either closed or suspended, while corporate workout programs were applied to medium-sized *chaebols* who ranked 6th and below. By September, the first round of financial sector restructuring was completed with the help of the government. In total, 94 financial institutions had their operations suspended or were closed down as of the end of September. In the restructuring process, the government provided fiscal support of 41 trillion won (10% of GDP) for the disposal of NPLs, recapitalisation of banks, and depositor protection. As a result, most Korean banks obtained BIS capital adequacy ratios of 10-13%. Such improvement in the bank capital structure contributed significantly to the alleviation of the credit crunch.

Another important policy measure taken in the second stage of crisis management was the stabilisation of domestic interest rates. Given the visible progress in currency stability, the Korean government and the IMF agreed upon the gradual downward adjustment in interest rates. The call rate sharply dropped from more than 20% in the first quarter to less than 9% by the end of September. Such a decline in interest rates, coupled with financial sector restructuring, contributed to the alleviation of the credit crunch by reducing corporate default risk and, consequently, prevented the over-kill of the industrial sector. Indeed, in 1998, monthly figures of corporate bankruptcies fell from more than 3,000 in the first quarter to about 1,400 in the third quarter.

The second stage also witnessed a dramatic liberalisation of the capital market. Restrictions on foreign equity ownership and foreign portfolio investment in the short-term money market were completely eliminated, while hostile M&As by foreigners were fully liberalised. In August 1998, the Foreign Investment Promotion Act was legislated as an institutional basis for attracting foreign direct investment.

In the third stage, which began in October 1998, corporate sector restructuring with a special focus on the 5 largest *chaebols*, was intensified on the basis of the visible progress in financial sector restructuring. In the absence of a well-developed capital market, creditor banks were needed to play a major role in corporate sector restructuring, particularly *chaebol* restructuring. Indeed, this was the main rationale behind the Korean government’s strategy to tackle the financial sector restructuring first. For the 5 largest *chaebols*, not only debt reduction but also business restructuring was pursued in order to address over-capacity problems. Business mergers and swaps, referred to as the so-called "big deals" were negotiated among the top 5 *chaebols*, and the concrete plans were formulated by the end of 1998.

In conjunction with an effort for *chaebol* restructuring, the Korean government implemented an expansionary macroeconomic policy to support economic recovery and supplement the on-going structural reform. In accordance with further stability in the currency market, interest rate reduction was accelerated. Fiscal policy was also expanded to not only finance economic restructuring and the expanded social safety net, but also stimulate domestic demand. To this end, the consolidated budget deficit was allowed to rise up to 5% of GDP in 1998, and this stance will continue in 1999.

The visible progress in financial sector restructuring and economic stimulus from expansionary macroeconomic policies has already been reflected in Korea’s brightened macroeconomic picture. Since November 1998, industrial production has been showing an upward trend, while business operation ratios hovered around 70% in January 1999. Various indicators related to consumption are also exhibiting signs of rapid recovery. These developments in private consumption are partly affected by the wealth effect stemming from rebounded stock prices. More important is the recent upgrade of Korea’s sovereign credit standing to investment grade by all major international credit rating agencies. Accordingly, capital inflows have been strong as can be seen in the inward foreign direct investment of about US$ 9 billion in 1998, which far surpassed the annual figures during the previous several years before the crisis.

Table I-5: Recent Trends in Business Conditions

(Unit: %)

	1998						Jan 1999
	1Q	2Q	3Q	Oct	Nov	Dec	
Production Index[1]	-6.2	-12.2	-9.5	-9.3	0.3	4.8	14.7
Operation ratio in MFG	68.8	67.0	66.7	69.1	69.6	70.9	69.2
Wholesale and retail index[1]	-11.2	-16.0	-15.1	-13.2	–8.1	-3.6	2.8
Call rate	23.7	18.7	10.2	7.34	7.26	7.00	6.35
Stock price index	507.8	371.3	317.6	358.8	429.2	524.7	597.6
Wages[1]	0.1	-1.2	-8.2	-1.4	-1.5	1.3	-
Won/dollar exchange rate	1,613.2	1,394.6	1,325.1	1,335.1	1,292.7	1,212.8	1,174.8
Foreign direct investment[2]	0.6	1.9	2.2	0.9	1.4	1.9	500.9
Usable foreign reserve[2]	241.5	370.4	433.7	452.7	464.7	485.1	

Notes: 1) year on year growth rates. 2) In billion US$.

II. Ownership and control in the Korean corporate sector

Distribution of corporate ownership

Ownership composition

The number of investors has been declining from over 5% of the population in 1990 to 2.9% in 1997. The decline of shareholders is correlated to the weak financial market. After the boom period of the stock market from 1987 to 1989, the Korean stock market has been declining except for a few years of transient recovery. The composition of ownership has also changed. While individual ownership has been declining the most followed by government ownership, both non-financial corporation investors and foreign investors have increased their shareholdings (Table II-1).

Most of the changes in the number of investors come from the individual investors as they amount to over 99% of total investors. The number of individual investors has been declining from 2.5 million in 1990 to around 1.35 million in 1997. Their ownership has been also decreasing from around 60% in the 1980s to less than 40% in 1997. In terms of market value, individual shareholders owned less than 30% in 1997, indicating that their ownership is relatively more concentrated in inexpensive small stocks.

Non-financial institutions represent a huge block of shares through interlocking ownership. Non-financial institutions hold around 20% of shares, most of which are through cross-holding or interlocking ownership. Although some firms are *de facto* holding companies, there are no laws that recognise holding companies in Korea. In many cases, these institutional owners are the largest shareholders. Recently, their ownership has been increasing in part to protect the incumbent managers from outside takeovers. On average, when the largest shareholder is an institutional investor, his holding is greater than when the largest shareholder is an individual.

Table II-1: Share Ownership by Investor Type (Unit: %)

End of Year	Government	Banks	NBFIs	Corporations	Individuals	Foreigners	Total
1983	0.20	6.05	4.64	28.96	57.91	2.24	100
1984	0.21	6.61	6.10	31.14	53.74	2.20	100
1985	0.41	7.09	7.35	30.00	52.48	2.63	100
1986	0.15	7.04	12.83	24.53	52.43	3.01	100
1987	0.12	5.61	8.2	20.41	62.35	3.31	100
1988	1.40	6.52	7.8	18.63	62.96	2.69	100
1989	11.84	3.15	10.43	17.85	54.62	2.13	100
1990	10.25	7.34	19.13	15.60	45.99	1.69	100
1991	9.96	8.92	18.67	15.49	44.47	2.49	100
1992	9.20	8.75	19.22	18.77	39.94	4.13	100
1993	8.58	10.72	17.24	17.16	37.57	8.74	100
1994	8.62	10.47	16.74	18.18	36.87	9.11	100
1995	8.03	11.17	15.61	18.65	36.42	10.12	100
1996	7.40	10.55	15.54	20.65	34.29	11.58	100
1997	6.59	9.42	12.27	22.81	39.79	9.11	100

Note : The number of shareholders has been calculated by totalling the shareholders on a record book basis until 1989 and by counting the shareholders since 1990 owning various stocks as one shareholder to prevent duplication.
Source: Korea Stock Exchange, Stock, 1998. 4.

After reaching its highest ownership percentage of 11.9% in 1989, when large state-controlled enterprises such as POSCO were listed, government ownership has also declined to 6.6% in 1997. Most government ownership is concentrated in large firms that were completely owned by the state. In the process of privatisation of state-controlled firms, the ownership concentration by government has been declining.

Financial institutions hold around 20% of total shares, with banks holding around 10%. Other financial institutions including security firms, investment trust companies and insurance firms own more than 10%. Non-Bank Financial Institution (NBFI) ownership has been declining. Among NBFIs, insurance firms have the largest ownership.

Foreign investors have increased their shares from 2% to 9.1% by the end of 1997, and constitute almost 13.7% of the total market value (Table II-2). After the crisis, foreign ownership has been increasing fast. By the end of 1998, the value of shares owned by foreigners reached almost 18.6% of total market share. Compared to other countries, foreign investors' ownership in Korea is high.

Table II-2: Stock Distribution by Type of Investors
(Unit: %)

	1996		1997	
	Market Value	Number of Shares	Market Value	Number of Shares
Public sector	10.8	7.4	10.9	6.6
NBFIs	15.2	15.6	12.7	12.2
Banks	10.6	10.5	10.2	9.4
Corporations	19.6	20.6	22.8	22.8
Individual	30.8	34.3	29.6	39.8
Foreigner	13.0	11.6	13.7	9.1
Sum	100.0	100.0	100.0	100.0

Source: Korea Stock Exchange, Stock, 1998. 4.

Size Distribution of Ownership

Most shareholders invest on a small scale holding less than 500 shares. In 1997, 68% of investors owned less than 500 shares. All together the market value of shares owned by these small shareholders is less than 3% of total market value. Less than 5% of investors own 5000 shares or more. These large shareholders represent more than 82% of the total market value. As shown in Table II-4, the largest shareholder owns over 20% of total shares. Since 1996, ownership by the largest shareholder has increased by more than 5%. Some argue that such increase in ownership is related to an increase in foreign ownership. As foreign ownership reaches a significant level, the existing controlling shareholders are under pressure to defend their control by increasing their ownership stake.

Table II-3: Share Ownership by Size of Portfolio

(Unit: %)

	1996		1997	
	Number of Shareholders	Number of Shares[1)]	Number of Shareholders	Number of Shares[1)]
10,000 shares and above	1.85	81.55	2.23	76.22
5,000 ~ 10,000	2.00	4.38	2.67	6.37
1,000 ~ 5,000	13.81	9.14	16.17	11.99
500 ~ 1,000	10.21	2.28	10.60	2.58
100 ~ 500	26.35	2.03	26.05	2.20
50 ~ 100	15.58	0.36	14.94	0.37
10 ~ 50	30.20	0.27	27.34	0.27
Sum	100.0	100.0	100.0	100.0

Note : 1) In market values. *Source*: Korea Stock Exchange, *Stock*, 1998. 4.

Table II-4 Ownership Distribution by Size of Investors

(Unit: %)

	1996		1997	
	Number of Shareholders	Number of Shares	Number of Shareholders	Number of Shares
Small shareholders	98.1	73.0	98.5	66.0
(institutional)	(1.2)	(46.9)	(1.1)	(33.3)
(individual)	(96.8)	(26.1)	(97.5)	(32.7)
Large shareholders	0.3	21.6	0.2	26.8
(institutional)	(0.0)	(15.7)	(0.0)	(18.7)
(individual)	(0.2)	(5.8)	(0.2)	(8.1)
Other shareholders	1.7	5.4	1.3	7.2
(institutional)	(0.3)	(3.1)	(0.3)	(4.9)
(individual)	(1.4)	(2.3)	(1.0)	(2.3)
Sum	100.0	100.0	100.0	100.0

Note: Small shareholders mean investors with less than 1% of ownership.
Source: Korea Stock Exchange, Stock, 1998. 4.

Since cross-holdings make ownership patterns complicated, it is necessary to estimate the magnitude of ultimate ownership of an investor. By tracing the ultimate ownership of investors using the method in La Porta et al. (1998) and Claessens et al. (1998), we can examine the ultimate corporate ownership concentration. Table II-5 shows the number of firms that are under the ultimate control of a family or government, and how many firms are widely held. At the 10% cut off rate for ownership concentration necessary for control, more than two-thirds of corporations are under the control of family shareholders. When the cut-off rate increases from 10 % to 20%, there is a huge jump in the number of firms described as widely held. This is mainly due to the fact that many family shareholders have ownership between 10% and 20%. When the cut-off rate for the ownership level necessary for controlling a firm increases, more firms can be described as widely held.

Table II-5: Control of Publicly Traded Companies in Korea

Cut-off rate	Widely held	Family controlled	State controlled
10%	14.3	67.9	5.1
20%	43.2	48.4	1.6
30%	76.2	20.1	1.2
40%	94.8	3.5	0.9

Note: Number of corporations is 350 including the largest 100 firms
Source: Claessens, Djankov and Lang (1998).

Distribution of control

In Korea, where business groups (*chaebols*) are prevalent in the economy, direct control by the largest individual shareholder is relatively limited as the ownership concentration is around 10% for large *chaebol*-affiliated firms. However, cross-shareholding by other affiliated firms that own an additional 30% of shares enables the largest shareholder to control the firms (Table II-6). Even though banks and other financial institutions hold more than 20% of shares, they have not engaged in corporate governance because until recently their voting was regulated so as not to affect other shareholders' votes.

Table II-6: In-group Shareholding Ratio of 30 Largest Chaebols
(Unit: %)

	1987. 4	1990. 4	1992. 4	1993. 4	1994. 4	1997. 4
In-group shareholding ratio	56.2	45.4	46.2	43.4	42.7	43.0
Largest holder and related parties	15.8	13.7	12.8	10.2	9.6	9.3
Subsidiaries	40.4	31.7	33.4	33.2	33.1	33.7

Source: Korea Fair Trade Commission.

In-group shareholding ratios for 34 *chaebol* groups are summarised in Table II-7. The figures in the table confirm that dominant shareholders of *chaebol* companies depended heavily on cross-shareholdings of the affiliated companies. For instance, the dominant shareholder of the Samsung group, one of the largest *chaebols* in Korea, controls more than 46% of the shares of the companies even though his personal shares are around 4%. Many of the *chaebols* in the table went bankrupt or technically bankrupt or fell into financial trouble in 1997 or 1998. They include Kia, Ssangyong, Hanwha, Halla, Dongah, Donggul, Haitai, Newcore, Anam, Hanil, Keopyung, and Shinho. Table II-8 describes cross-shareholdings of Samsung group companies.

Table II-7: In-Group Ownership Concentration

(Unit: %)

	1995	1996	1997
1. Hyundai	60.4(15.8)	61.40(15.60)	56.2(14.6)
2. Samsung	49.3(3.1)	49.01(3.29)	46.7(4.2)
3. LG	41.4(6.7)	39.88(6.73)	40.1(6.1)
4. Daewoo	39.7(6.8)	41.69(6.80)	38.3(7.1)
5. SK	51.2(17.7)	48.64(16.53)	44.7(14.6)
6. Ssangyong	33.1(4.2)	37.03(4.36)	42.0(4.5)
7. Hanjin	40.3(22.1)	41.19(21.06)	41.4(21.1)
8. Kia	21.9(17.7)	25.59(4.55)	30.6(21.0)
9. Hanwha	36.7(5.5)	32.83(6.63)	33.0(6.3)
10. Lotte	22.3(3.5)	22.20(3.39)	22.8(3.4)
11. Kumho	40.3(2.6)	41.86(2.45)	40.1(2.3)
12. Halla	57.8(30.5)	55.56(22.74)	49.5(19.0)
13. Dongah	40.1(20.1)	42.38(16.54)	54.2(12.0)
14. Doosan	51.6(14.6)	48.99(14.30)	49.7(13.8)
15. Daelim	37.6(9.3)	33.90(9.35)	34.2(9.1)
16. Hansol		54.27(8.97)	37.3(4.1)
17. Hyosung	43.6(14.3)	44.01(14.56)	44.9(14.2)
18. Dongkuk	46.6(15.5)	50.30(17.95)	51.0(18.5)
19. Jinro	47.2(15.5)	45.58(15.67)	45.8(17.5)
20. Kolon	47.6(12.1)	49.66(11.62)	45.1(8.6)
21. Kohap	46.7(6.0)	46.05(10.01)	39.4(8.6)
22. Dongbue	40.4(15.5)	43.83(13.33)	47.8(14.6)
23. Tongyang	46.1(7.9)	53.06(3.53)	50.1(6.1)
24. Haitai	34.0(5.3)	30.48(3.91)	30.9(6.0)
25. Newcore		99.38(35.55)	98.7(36.4)
26. Anam			42.0(10.0)
27. Hanil	43.1(16.2)	36.29(11.10)	37.4(12.2)
28. Keopyung			59.0(17.5)
29. Miwon	49.8(18.9)		52.5(16.3)
30. Shinho			36.9(13.6)
* Sammi	30.9(13.7)	28.36(15.59)	
* Kukdong	25.0(8.8)	26.48(8.95)	
* Byucksan	41.3(15.1)	36.19(14.98)	
* Hanbo	88.3(88.2)		
Avg.	43.3(10.9)	44.14(10.82)	43.0(9.3)

Notes:
1) 'In-Group Ownership' is a weighted average (where the weight is the size of capital) for each business group of the family ownership shares plus those of subsidiaries.
2) The rank was as of 1997.
3) ( ) is the sum of the ownership by controlling shareholder and family members.
4) For Kia, the largest shareholder is Kia motors.
Source: Korea Fair Trade Commission, Press Release.

III. Corporate governance for firms

A high concentration of corporate ownership and control of corporations by families in Korea have led to governance structures that enable the dominant shareholding families to make key decisions on their own. Appointments of board members are almost entirely in the hands of the families controlling the firms. Thus, there is a possibility of conflicts of interest between dominant shareholders/managers and minority shareholders.

Episodes of expropriation are abundant. Even the biggest and most successful corporations that also have significant foreign ownership were engaged in scandalous practices. Considering that foreign investors have a much louder voice than domestic investors in Korea, we expect higher incidences of expropriation by dominant shareholders in corporations with smaller foreign ownership. Table III-1 below summarises several key features of the measures aimed at protecting shareholder rights, before and after the crisis.

Table III-1: Key Items of Minority Shareholders' Rights

	Former Commercial Code	Amendments	Securities and Exchange Act**
Removal of a Director	5%	3% (Art.385?)	0.5%(0.25%) (Art.191/13?)
Right to Injunction	5%	1% (Art.402)	0.5%(0.25%) (Art.191/13?)
Derivative Suit	5%	1% (Art.403)	0.01% (Art.191/13?)
Shareholder's Proposal	-	3% (Art.363?)	1%(0.5%) (Art.191/14?)
Demand for Convocation	5%	3% (Art.366?)	3%(1.5%) (Art.191/13?)
Right to Inspect Account Books	5%	3% (Art.466?)	1%(0.5%) (Art.191/13?)
Right to Inspect Affairs and Company Property	5%	3% (Art.467?)	3%(1.5%) (Art.191/13?)
Removal of Liquidation	5%	3% (Art.539?)	0.5%(0.25%) (Art.191/13?)

Notes: Appraisal rights of the convocation of the shareholders general meeting and shareholder proposals estimated on the base of voting stocks.

** Percentages in parentheses show the case of corporations with more than 100 billion won, paid-in capital in the end of the recent business year.

In principle, the convening of a shareholders' meeting shall be determined by the board of directors. However, shareholders who hold no less than five hundredths of the total number of the issued shares may demand the convening of a shareholders meeting to prevent majority shareholders' oppression (Commercial Code; CC Art. 366 [1]). In the case of listed corporations, the rights to convene a shareholders meeting is vested in shareholders who hold no less than three hundredths of the total number of issued shares. However, in the case of listed corporations where capital stock is more than 100 billion won, the rights to convene a shareholders meeting is vested in shareholders who hold no less than fifteen thousandths of the total number of the issued shares (Security and Exchange Act; SEA, Art. 191. 13. [4]).

The right to make proposals is vested in the shareholders who hold no less than three hundredths of the total number of issued shares and who are entitled to vote for more than six months (CC Art. 363. 2 [1]). While listed corporations approve the right of shareholders who hold no less than one hundredths of the total to make proposals, listed corporations whose paid-in capital is more than 100 billion won require five thousandths of the total shares issued (Enforcement Decree of SEA Art. 84. 21). Shareholders should file a written application with the board of directors, which shall state the matters concerning the proposal, at least six weeks prior to a shareholders' meeting to exercise the right of proposals.

To facilitate the exercise of shareholder voting rights and the acquirement of the needed quorum of those large companies with dispersed shareholders, proxy voting is duly recognised under the commercial code (CC Article 368. 3). A proxy who wishes to exercise delegated voting rights must present proper documentation certifying his proxy voting right at the shareholders' meeting. Accordingly, a legal proxy must present sufficient documents to certify the effectiveness of his proxy vote and the shareholder that is delegating his voting right must present a document indicating his willingness to delegate his vote.

Shareholders can have as many voting rights as the number of directors to be elected with every share and cast their vote cumulatively for a candidate. For cumulative voting, shareholders with no less than 3% of outstanding stocks shall make the claim for cumulative voting 7 days before a shareholder's general meeting. Cumulative voting aims to enable minority shareholders to elect a director who represents their interests (CC Art. 382-2).

Shadow voting regulation required financial institutions to vote with other investors except on some important corporate issues like M&As. Under this rule, financial institutions could not credibly control and monitor the existing management, as their 'voice' was limited. Until now, although banks held almost 10% of shares in terms of value, they have not played a major role in corporate governance. Although the regulation was not the sole cause of their inactivity, it may have been an obstacle to financial institutions fulfilling their role of corporate governance agents. With the lifting of this regulation in September 1998, financial institutions now are able to take a more active role in corporate governance. As it is expected that the ownership stake of financial institutional investors will increase because investors, including foreigners, can now establish mutual funds, these institutional investors are expected to more effectively monitor and discipline firm managers.

Cumulative voting, which was not available before, is now allowed. However, it is not mandatory. Some large firms are said to be changing their articles of association to exclude the employment of cumulative voting.

As a fiduciary duty of CC Art. 382-3, directors shall perform their duties in accordance with the laws and articles of incorporation. Fiduciary duty was introduced to encourage sound management by reinforcing directors' liabilities. The Commercial Code already has some provisions on directors' duties and liabilities like duty of care (CC Art. 382, Civil Code 681) and direct liabilities to the corporation or the third parties in case of their malperformance (CC Art. 399, 401).

The amendment to the Commercial Code treats the person who instructs directors on management matters or executes managerial power with influence on a corporation as a legal director as far as director's liability issues are concerned (CC Art. 401-2).

Listed corporations are required to appoint outside directors, whose number is no less than a quarter of total directors (Listing Rules: Art. 48-5). And listed corporations are recommended to have an outside auditor. The Korea Stock Exchange may also publicise listed corporations which do not have an outside auditor (Listing Rules: Art. 48-6).

It should be noted that remedies for violations of shareholder rights are not sufficient and well enforced. Even though many believe that self-dealings that reduce the value accruing to minority shareholders are continuing, criminal cases involving breach of trust by managers or dominant shareholders are rare. Further, derivative suits are also rare. The existing few cases have been initiated by an activist group, the *Chamyoyundai*, and not by minority shareholders or lawyers interested in financial rewards from the suits. Financial rewards that each minority shareholder is expected to receive from a class action suit, in the event that he wins, are too small to provide him with enough monetary incentive to initiate a suit. The Supreme Court regulation on legal fees appears to limit the incentives of lawyers to initiate such suits.

Data on performance management contracts are generally not available, although *chaebol* families are believed to have been using compensation schemes for top managers of the firms under their control that are not fixed-sum payment types. We expect that incentive bonuses received by top managers of *chaebol* affiliated firms are based more on their contribution to dominant shareholders rather than their contribution to the value of the firm to which they belong. Recently, a *chaebol* announced a plan to apply stock options to the compensation scheme of top managers of affiliated firms. It is important that the plan was announced by the *chaebol* headquarters, and not by individual firms. Four state-owned enterprises covered by a special law on commercial public enterprises, KOGAS, Korea Telecom, Korea Ginseng and Tobacco, and Korea Heavy Industries, are known to use performance based payment schemes for their chief executives. The base salary is around 100 million won, and incentive bonuses are capped by about 200% of the base salaries. In addition, a few banks announced stock option plans for their top executives.

IV. Problems with *chaebols* and relevant regulations

In Korea, *chaebol* families control many firms that cut across multiple industries. Virtually all large firms are controlled by *chaebols*, except for state-owned enterprises and those owned by foreigners. Thus, a handful of families control a big chunk of the assets available in the economy. Table IV-1 summarises key features regarding dominance of the economy by *chaebol* families. They control nearly 52% of the total assets (818 trillion won) available in the economy.

Dominance of *chaebols* combined with strong controls by a family over affiliated corporations raises the possibility of a type of expropriation that utilises transactions between the firms belonging to a *chaebol* in diverting resources from one firm to another. For instance, the dominant family could force Firm A, in which it has a 30% interest, to sign a preferential contract with Firm B, which is 100% owned by it. The most popular types of observed preferential contracts are transactions of goods and services as well as assets at terms that are more favourable to Firm B than prevailing market prices, loans made by Firm A to Firm B at below market interest rates, and loan guarantees.

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

Table IV-1 30: Largest *Chaebols* - July 1997
(Unit: billion won)

	Total Assets	Total Sales[a]	Number of Subsidiaries	Number of Listed Subsidiaries
1.Hyundai	59,325(7.25%)	69,798	57	20
2.Samsung	82,438(10.08%)	75,605	80	16
3.LG	45,482(5.56%)	48,635	49	11
4.Daewoo	37,497(4.58%)	38,620	30	10
5.SK	23,998(2.93%)	26,797	46	6
6.Ssangyong	18,305(2.24%)	20,157	25	11
7.Hanjin	17,594(2.15%)	9,972	24	9
8.Kia	14,508(1.77%)	12,038	28	6
9.Hanwha	14,388(1.76%)	10,088	31	7
10.Lotte	7,925(0.97%)	7,209	30	4
11.Kumho	8,551(1.05%)	4,834	26	4
12.Halla	6,657(0.81%)	5,297	18	4
13.Dongah	8,873(1.08%)	5,416	19	4
14.Doosan	6,402(0.78%)	4,046	25	8
15.Daelim	6,810(0.83%)	4,970	21	5
16.Hansol	6,431(0.79%)	2,700	23	7
17.Hyosung	6,131(0.75%)	5,478	18	2
18.Dongkuk	6,764(0.83%)	3,487	17	7
19.Jinro	3,881(0.47%)	1,391	24	4
20.Kolon	4,638(0.57%)	4,471	24	4
21.Kohap	3,810(0.47%)	2,563	13	3
22.Dongbu	6,233(0.76%)	4,856	34	6
23.Tongyang	9,558(1.17%)	3,602	24	4
24.Haitai	3,398(0.42%)	2,716	15	3
25.Newcore	2,803(0.34%)	2,279	18	0
26.Anam	2,792(0.34%)	1,995	21	2
27.Hanil	2,599(0.32%)	1,277	7	2
28.Kupyung	4,963(0.61%)	1,387	22	5
29.Miwon	2,235(0.27%)	2,116	25	5
30.Shinho	2,237(0.27%)	1,223	25	6
	425,226(51.98%)	385,023	819	185

Note: Figures in parentheses are the share of total assets of the corporate sector in Korea (818 billion won). 1996.
Source: Fair Trade Commission. Quoted from Yoo (1998).

Simple diversion of funds by a dominant shareholder from a firm under his control was not uncommon in Korea. As long as the diversion does not involve transactions between firms under unified control, it is not a problem that relates to *chaebols*. However, concentrated ownership by families of the firm in question seems to be a significant factor leading to such diversion. This type of diversion differs from a diversion by an executive who is not a member of the dominant family in that it has to pass the eyes of the dominant shareholder and the other employees. Diversion by dominant shareholders is a result of organised efforts by top employees of the firms, because active and intentional participation by some employees and acquiescences by some others are necessary. This suggests that job security, rewards, and in fact whole careers of most managers are determined by the *chaebol* families. Professional managers in Korea face an incentive structure that forces them to serve the interests of *chaebol* families and not the interests of the firm or the shareholders.

Another key feature is the widespread use of loan guarantees. The following two tables summarise the extent of loan guarantees among the top 30 *chaebols*. Many firms affiliated with the top 30 *chaebols* saw their loan guarantees turned into their own debts as many of the firms whose debts had been guaranteed by them defaulted on debt payments.

Table IV-2: Trend of Cross-payment Guarantee of the 30 Largest Chaebols
(Loan guarantee/ equity capital : %)

1993	1994	1995	1996	1997
469.9	258.1	161.9	105.3	91.3

Source: Fair Trade Commission and the Federation of Korean Industries

Table IV-3: Status of Cross-payment Guarantees of the 30 Largest *Chaebols*
April 1997

(Loan guarantee/equity capital: %)

5 largest *Chaebols*	6-10 largest *Chaebols*	11-30 largest *Chaebols*
58.9 (64.7)	153.9 (150.3)	207.1 (200.0)

Parentheses: April 1996.
Source: The Federation of Korean Industries.

In Korea, controlling families were in a position to control huge amounts of financial resources that the firms under their control borrowed. Inefficient investment of the borrowed money in large risky projects, as well as other more onerous uses, led many of the large corporations to become insolvent or bankrupt and eventually cost the lending institutions and taxpayers an unprecedented amount.

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

It is widely suspected that *chaebol* companies could relatively easily transfer financial resources to and from one another as the needs for such transfers arise from the standpoint of the dominant shareholders, and they have actually done so frequently. No accurate figure is available on the amount of money involved in such transfers. Many of the transactions between firms under the single control of a *chaebol* family that result in large scale transfers of wealth may be found to be acts of breach of trust if they are brought to the court and sufficient evidence is presented to the court. For some reason that is not clear to us, there are few cases of breach of trust involving large listed companies, even while almost everybody appears to believe that self-dealings among the companies controlled by the same *chaebol* family have been prevailing.

Under such circumstances, the Fair Trade Commission has been the main regulator of self-dealings by *chaebol* families. Article 23 of the KFTC Act includes a clause that declares illegal "undue provision of money, assets, labour, and other transactions involving significant preferential treatment, that are likely to distort competition." In 1998, KFTC twice investigated the top five *chaebols* and found illegal self-dealings that entailed transactions amounting to more than 5.5 trillion won, and subsequently handed down administrative fines amounting 93.1 billion won to the involved companies under the control of the five largest families.

Almost all of the cases are restricted to preferential financial deals between companies under the control of the same family, such as exorbitant prices paid for CPs, loans made at below market rates, and delay of payment for assets sold to affiliated firms. The move by KFTC was interpreted by many as a response by the government to the efforts of *chaebol* families who were trying to keep under their control the firms that were in deep trouble and should have declared bankruptcy.

The following three tables provide detailed information on self-dealing cases. It is worth mentioning that of the 33 firms found to have provided subsidies in the first round of investigation, 27 (81.8% of the total) had recorded profits for the previous three consecutive years. Of the 21 beneficiaries, 17 (81.0%) experienced losses in at least one of the three previous years. Four of the beneficiaries showed negative net values. Results from the second round of investigation included nine firms among the beneficiaries that were insolvent and generally showed a similar pattern to that of the first round. This seems to strongly support the suspicion that *chaebol* families were indeed trying to keep ailing firms under their control by cross subsidising them with the financial resources of the other affiliated firms.

Table IV-4: Summary of the Results from the 1st Round of Investigation

Chaebol	Number of Subsidy Providers	Number of Beneficiaries	Estimated Amount of Subsidies (in 100 million won)
Hyundai	35	11	7,706
Samsung	7	9	7,200
Daewoo	6	7	4,229
LG	20	6	10,573
SK	12	2	10,555
Total	80	35	40,263

Source: Fair Trade Commission, 1998.

Table IV-5: Summary of the Results from the 2nd Round of Investigation

Chaebol	Number of Subsidy Providers	Number of Beneficiaries	Estimated Amount of Subsidies (in 100 million won)
Hyundai	13	7	3,485
Samgsung	2	3	2,000
Daewoo	11	3	415
LG	3	2	682
SK	4	6	8,345
Total	33	21	14,927

Source: Fair Trade Commission, 1998.

Table IV-6 Summary of Surcharge Imposition on 5 Largest *Chaebols*

(Units: 100 million won)

Chaebol	1st Round of Investigation	2nd Round of Investigation
Hyundai	226	92
Samgsung	114	30
Daewoo	89	44
LG	102	22
SK	191	21
Total	722	209

Source: Fair Trade Commission, 1998.

While KFTC regulation on self-dealings between *chaebol* companies seems to be the only working mechanism that could check self-dealings by *chaebol* families, it has several shortcomings. First, the logic behind Article 23 of the KFTC Act is basically a predation argument, and is not per se related to expropriation of minority shareholders. Transactions between two firms under the control of a single family that divert resources from one firm to another may at the same time have elements of predation in intents as well as effects. In such cases, KFTC should pursue predatory act cases. But, this should not limit other branches of the government from pursuing breach of trust, or other more onerous acts.

Second, from the perspective of corporate governance, the current regulation may be pointing fingers at the wrong parties. Currently, it is the firm that pays the fines, which is consistent with the predation logic of the regulation. However, the firm and minority shareholders will doubly suffer from self-dealings that are detrimental to them in the first place, and from fines that further aggravate their interests. From the perspective of corporate governance, it is the members of the *chaebol* families involved who should pay the fines. Last, KFTC regulation on self-dealing does seem to cover only a small part of the potential violations. As the result of the investigations that occurred in 1998 suggest, KFTC may have focused upon only the financial transactions.

Other measures that the Korean government has taken include reduction in debts held by *chaebol* companies, reduction in loan guarantees, and consolidated financial statements. *Chaebol* companies are required to reduce their debts to 200% of their equity or below by the end of 1999. *Chaebols* are also required to submit combined financial statements, which show transactions between affiliated firms, starting from the 1999 fiscal year. Although the government also required *chaebol* affiliated firms to eliminate existing loan guarantees, there is room for extension of the loan guarantees.

There also has been a relaxation of regulations on *chaebols*. Holding companies are now allowed. However, we see little potential benefits *chaebols* could reap by establishing holding companies to control affiliated firms that are already under their control. In addition, the limits on cross-holdings have also been lifted.

V. Foreign investment and takeovers

In May 1998, the investment ceiling imposed on foreign ownership of listed companies was abolished. For state controlled enterprises, the aggregate ceiling has been raised from 25% to 30%, while the individual ceiling remains at 3%. Over 60% of investors are institutional investors and almost 50% of the investors are from the US or UK (Tables V-1 and V-2). Around 15% of foreign ownership is through direct investment rather than portfolio investment (Table V-3).

Table V-1: Foreign Investment Registration by Country
(As of 31 Dec. 1998)

US	UK	Chinese Taipei	Japan	Others
3,225	859	514	677	3,205

Source: Korea Stock Exchange.

Table V-2: Type of Foreign Investors
(As of 31 Dec. 1998)

Institutional Investors							Individual Investors	Total
Fund	Pension Fund	Banks	Securities	Insurance	Others	Sub Total		
3,763	522	282	285	159	318	5,329	3,151	8,480

Source : Korea Stock Exchange.

Table V-3: Foreign Investment in Stocks

	Amount (billion won)	Ratios
Portfolio Investment	22,536.8	16.35%
Direct Investment	3,103.1	2.25%
Total	25,639.9	18.60%

Source : Korea Stock Exchange.

The Commercial Code allows a company to require transfer of shares to be approved by the board of directors as long as such requirement is specified in the articles of association of the company. However, for listed companies, such requirement is prohibited. Thus, transfer of shares do not have to be approved by the board of directors for listed companies.

The old stock exchange act required that anyone whose proportion of shares was expected to exceed 25% as a result of a purchase of shares, should acquire more than 50% of the shares of the company. While this restriction was advocated to give shareholders equal treatment, it was used as a barrier to takeovers. A revision of the act in February, 1998 removed the restriction. The dominant shareholding family of the SK group purchased more than 25% of the SK Securities after the revision took effect.

The most important existing restriction on takeovers is a restriction called the “5% rule” (Securities Exchange Act Article 21), whereby anyone whose shares in a company reaches 5% or more as a result of a new purchase of shares in OTC should purchase them through tender offers in OTC.

In addition, all the mergers and acquisitions are subject to the Fair Trade Act, which forbids mergers and acquisitions that would substantially reduce competition in the affected markets. FTA also requires that large companies or dominant shareholders of the companies inform the Fair Trade Commission if either the company or the dominant shareholder purchases 20% or more shares of other companies.

Tender offers and hostile takeovers are very rare in Korea and have never been used for large firms. Only a handful attempts at hostile takeovers have taken place. The best known cases involve two merchant banking companies.

VI. Corporate governance of public enterprise in Korea

There are many public enterprises in diverse forms in Korea. This report covers only the public enterprises that are subject to the Framework Act on the Management of Government-Invested Institutions and the other large commercial companies in which the government maintains controlling shares and plays an active role. Among the commercial public enterprises that are not subject to the Framework Act, Korea Telecom (KT), Kogas, Korea Ginseng and Tobacco (KT & G), and Korea Heavy Industry (KHI), which used to be a monopoly in the electricity generating equipment manufacturing industry, are subject to the Act on Privatization and Management Reform of Public Enterprises (special act henceforth), as well as company laws. The rest of the large commercial public enterprises that are not subject to either act are subject only to company laws. Most of the important public enterprises, such as the monopolistic firms in the network industries of electricity, telecommunications and gas, as well as in other industries such as tobacco, steel, and electricity generating equipment, are covered. Large commercial public enterprises that are not subject to either act include Posco and KBS.

Before the fall 1997, most of the public enterprises were subject to the Framework Act, run virtually as instruments of the policies of the line ministries and generally considered as parts of the line ministries. In addition to the Framework Act, most of the public enterprises were also subject to a special act that explicitly specified the objectives of the public enterprise as the promotion of public goals in the relevant industry and allowed the line ministry full control of the public enterprise. Appointments of chief executives were almost entirely restricted to career bureaucrats and career politicians with little or no experience in commercial business. Thus, there was little room for utilising commercial potential of public enterprises. The main objective of the Framework Act was to prevent inefficiency within public enterprises by letting the Ministry of Finance and Economy, apart from the line ministry, take part in the management of public enterprises. However, since the Ministry of Finance and Economy was not staffed with experts in the relevant industries, its role was restricted. In essence, the idea behind the Framework Act was to minimise expenditures needed to supply the services of public enterprises, just as the budgetary agency wanted to minimise the cost of supplying government services such as defence. The Framework Act required that the board of directors of a public enterprise subject to the act include one representative from the line ministry, and another from the Ministry of Finance and Economy. The rest were selected from mostly academics. But, the director from the line ministry dominated, and the others did not play significant roles.

A comprehensive study of public enterprises conducted in 1994 and 1995 concluded that privatisation was needed for some of the large public enterprises including Korea Telecom and Korea Tobacco and Ginseng. However, the government did not privatise them and instead introduced the special act in the fall of 1997. The act identified four public enterprises mentioned above as the targets for privatisation and allowed profit oriented management for them. Specifically, the act exempted KT, KT & G, and Kogas from the Framework Act and required that their boards consist of executive directors and outside directors who were not government officials, thus excluding the presence of the line ministries as well as the Ministry of Finance and Economy. At the same time, the government abolished the KT act and KT & G act, freeing them from the intervention by the line ministries. Outside directors have been subsequently appointed and were given the tasks of formulating management contracts with the chief executives that were partially based upon the commercial performance of the companies. The act is believed to lead to substantial improvement in the internal efficiency of the four public enterprises. However, its effect has been limited mainly because realignment of industrial policies and the regulatory policies have not been followed. For instance, while the act nominally gave profit incentives to KT, no independent regulatory authority, scheme for rates or access changes for the telecommunications have been established. The line ministries were able to continue to influence the management of public enterprises because they were allowed to appoint outside directors.

In late 1998, the Framework Act was modified to resemble the special act. On the surface, the public enterprises that are subject to the Framework Act have similar corporate governance structures as the four companies covered by the special act. However, because the public enterprises that are subject to the Framework Act are considered as instruments of promoting policies rather than commercial entities, there remains confusion over how to separate policy functions from the commercial functions of the public enterprises. This confusion is compounded by the fact that the Framework Act covers many public enterprises which are vastly different in nature. For instance, the nature of the business of Kepco is as commercial as that of Kogas or KT, while the Farming and Fishing Promotion Corp. supplies services that are essentially government services with little commercial potential.

Overall, corporate governance in public enterprises in Korea has not changed fundamentally from the old regime that was based on the view that public enterprises are instruments of the line ministries in their pursuit of public policies. Policy objectives have not been clearly separated from commercial businesses and still influence the operation of public enterprises significantly. In network industries, no independent regulatory framework has been established, even though the government identified KT, Kepco, and Kogas as targets of privatisation and introduced competition in the telecommunications industry and parts of the electricity industry. Consequently, public enterprises are still run as tools to achieve the goals set by the line ministries and are not allowed to maximise shareholders' value, even when sizeable shares are in private hands. Lack of separation between public objectives and commercial operation of public enterprises has in the past, and still is, hindering privatisation.

VI. Debtor and creditor relations

Corporate finance in Korea is characterised largely by the bank dominance as is the case in most East Asian (EA) countries. The lack of a well-developed capital market was the major factor behind such an unbalanced financing pattern. Under this circumstance, the primary responsibilities for corporate monitoring rested on creditor banks. In reality, however, monitoring and oversight by banks was neglected, the high price of which culminated in the financial crisis. These deficiencies in debtor and creditor relations are closely intertwined with prolonged state control in the financial sector and the resultant problem of moral hazard. The ownership structure of financial institutions, which varied significantly across the segments of the financial sector, also was as an important ground for improper debtor and creditor relations.

State control and moral hazard

Neglected monitoring and oversight of corporate finance by creditor banks in Korea were the natural outcome of the distorted incentive structure which was largely affected by the policy environment, characterised by undue state influence in credit allocations, as well as lax financial supervision and a lax regulatory framework. In Korea, unhealthy links between government and banks were a legacy of government-led economic development.

Since the early 1960s, the Korean government has played a pervasive role in financing industrial development.[5] The Korean government directly owned all major banks in 1961, directed policy loans to priority sectors such as export industries and HCIs. Policy loans were indeed substantial during the HCI drive in the 1970s: they constituted about 50% of total domestic credit (Table VII-1).

Table VII-1: Share of Policy Loans by DMBs and NBFIs (Unit: %)

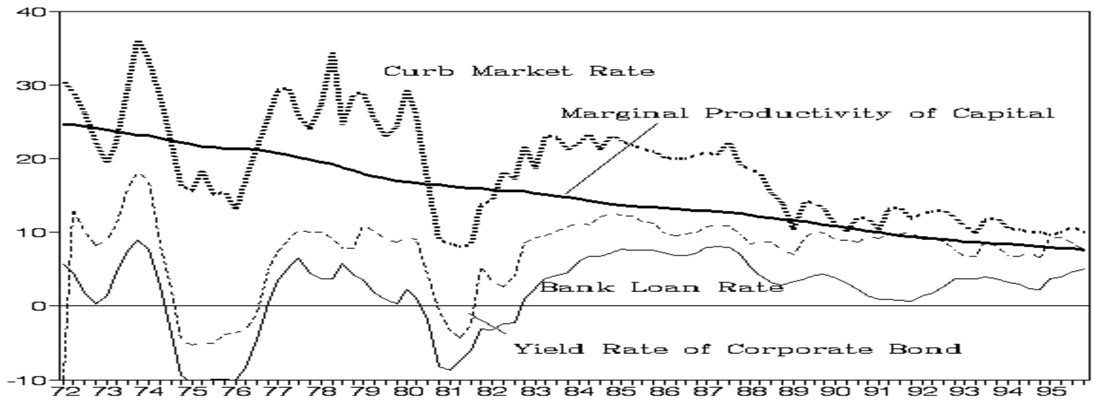
	1973~81	1982~86	1987~91	Average during period 1973~91
DMB loans (A)				
Government funds	7.5	7.4	8.0	7.6
National Investment Fund	4.3*	5.1	3.0	4.2
Foreign currency loans	21.1	19.7	19.4	20.3
Export loans	21.3	16.9	5.2	16.2
Commercial bills discounted	8.0	13.9	16.5	11.6
Special funds for SMCs	5.9	5.6	6.5	6.0
Loans for AFL	6.1	5.3	7.4	6.2
Housing loans	8.0	13.1	14.1	10.8
Other[1)]	17.7	13.1	20.0	17.1
Policy Loans Total	100.0	100.0	100.0	100.0
NBFI loans(B)				
KDB loans	91.9	71.7	83.7	84.8
(National Investment Fund)	(25.7)*	(18.5)	(7.9)	(19.5)
EXIM loans	8.1	28.3	16.3	15.2
(National Investment Fund)	(2.5)*	(4.7)	(2.3)	(3.0)
Policy Loans Total	100.0	100.0	100.0	100.0
(A)/DMB loans	63.0	59.4	59.5	61.2
(B)/NBFI loans	48.0	32.3	15.3	35.9
((A) + (B))/domestic credit	48.9	40.8	30.9	42.4

Notes : Figures in the table are annual averages.
* Annual average during 1974~81.
1) Includes loans for imports of key raw materials, loans on mutual instalment, loans for machinery, equipment loans to the export industry, special equipment funds, and special long-term loans.
Source : National Statistical Office, *Korean Economic Indicators*, various issues: Bank of Korea, *Monthly Bulletin*, various issues. Quoted from Y.J. Cho and J.K. Kim (1995).

State influence over the banking sector has waned along with the progress in financial liberalisation, particularly the privatisation of commercial banks. Nonetheless, it has remained substantial until recently. In fact, the share of policy loans out of total loans extended by deposit money banks (DMBs) remained about 60% in 1987-91.

The provision of subsidised credit, coupled with interest rate control, encouraged the corporate sector to rely more on borrowings than equity financing. Since real interest rates have remained below the marginal productivity of capital, overseas borrowing has taken place, and the subsequent increases in financial expenses induced further borrowing (Chart VII-1). Such a vicious cycle ultimately led to an unbearably high leverage and reckless capacity expansion in the corporate sector.

Chart VII-1: Real Interest Rate, Marginal Productivity of Capital[1] (Unit: %)



Note: 1) We estimate the marginal product to capital using the Cobb-Douglas production function approach in Cho and Oh (1996). We assume a capital-output ratio of 1/3 and depreciation rate of 0.065. We also estimate the potential GDP and capital stock derived from the KDI quarterly model.

The Korean government had to provide an implicit guarantee on bank lending as it played a major role in credit allocation. Also, given the tight linkage between the banking and corporate sectors, corporate failures had an immediate impact on the soundness and viability of banks. For these reasons, the government undertook major corporate bailout exercises on numerous occasions, including the August 1972 Emergency Measure, industrial restructuring in major HCIs (1979-81), and industrial rationalisation measures in overseas construction and shipping industries (1984-88).[6]

The first and prime example of corporate bailout by the government is the August 1972 Emergency Measure that included not only corporate debt rescheduling by creditor banks but also a temporary moratorium on the payments of corporate debt owed to curb market lenders (Box 1). Such a measure was deemed inevitable at that time in the face of unbearable default risk of the corporate sector stemming from high leverage. In addition, it signalled to private firms the government's implicit commitment to becoming a risk-sharing partner with them. Indeed, since then, Korean entrepreneurs were able to undertake risky ventures and attach a long-term perspective to their investment decisions.

As the August 1972 Emergency Measure set the precedent for corporate bailout, similar rescue operations by the government followed on several occasions.[7] Such recurrent government bailouts, however, were not free of costs. The government bailouts exacerbated the already weak market discipline and caused serious moral hazard problems. Excessive corporate leverage based on implicit risk-sharing by the government created the so-called "too-big-to-fail" hypothesis, which worked as an important exit barrier and often overshadowed the voices for financial market liberalisation. Given the preponderance of the *chaebols*' market share and the vertically integrated industrial structure, the social costs of *chaebol* bankruptcy would be enormous. In such an environment, the *chaebols*' incentive structure with regard to corporate financing was seriously distorted: the more *chaebols* borrow, the safer *chaebols* are. Given the implicit state guarantees on bank lending, banks had little incentive to monitor the client firms' investment decisions. Strict prudential regulation and supervision were hardly applied to banks given the fact that the government and banks were in the same boat in the sense that both acted as a risk-sharing partner of business firms. Indeed, in the course of a bailout, managements of a rescued financial institution and corporation were not replaced, further undermining incentives for prudent behaviour.

These fault lines, left as a legacy in Korea, have made the business sector vulnerable to unfavourable cyclical shocks and increased systemic risk in a globalising financial market. Indeed, a series of corporate bankruptcies in 1997, which constituted a starting point of Korea's financial crisis, were not immune to the large terms of trade shocks that occurred in 1996 and 1997 and the subsequent squeeze in corporate cash flows.

After the August 1972 Emergency Measure, credit control on *chaebols* was introduced in order to check or reduce the banks' exposure to *chaebols*, and improve the capital structure of *chaebols*. To this end, various financing restrictions, including the basket control of credit supply, were imposed on *chaebols* and the main bank system was established to implement those restrictions. To some extent, these policies have produced positive results as can be seen in the declining share of bank loans to *chaebols* in total bank lending (Table VII-2).[8] In addition, under the main bank system, the power balance between banks and *chaebols* was improved in favour of banks.

Table VII- 2: Share of Loans to the 30 Largest C*haebols* by Financial Institutions(Unit: %)

	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995
Banks[1)]	28.6	26.3	24.2	20.7	19.0	18.9	17.9	15.6	15.0	13.9
NBFIs	-	-	32.4	36.6	37.8	38.5	40.5	-	-	-

Note: 1) include deposit money banks only.
Source : The Bank Supervisory Board, the Korea Investors Service, Inc., quoted from S.M. Yoo and J.K. Kim (1993) and D.H. Lee et. al (1998).

Unfortunately, the credit control system under the leadership of the main banks was ill-focused and, as a result, distorted debtor-creditor relations. Main banks acted more as a regulator on *chaebols'* business activities than as a risk-sharing partner in terms of financing. Since the early 1980s, *chaebols* were required to get pre-approval from the main banks on their business decisions regarding market entry, investments, acquisitions of assets and real estate holdings, among others, which are not principal activities of banks. In short, the main banks acted as *de facto* government agents in terms of regulation and monitoring.[9] Furthermore, the main banks were designated by the government on the basis of the bank's exposure to *chaebols*: for each *chaebol*, the government designated a bank with the largest exposure to that *chaebol* as its main bank. Once designated, however, the main bank was not changed even if it lost its status as the principal source of credit to the *chaebol*. In retrospect, these features of the main bank system distorted the commercially oriented links between creditor banks and *chaebols* as well as incurred substantial costs and administrative burdens to banks. Thus, it is clear that the relationship between the main banks and their *chaebol* clients is in sharp contrast to that of Germany and Japan.[10]

Box: August 1972 Emergency Measure

High economic growth after the first five-year economic plan period (1962-66) made Korean industrialists optimistic about the future of the economy. Their optimism combined with rapid growth of domestic credit and increase in foreign borrowing fuelled the investment boom of the second half of the 1960s. During 1963-71, the debt/equity ratio of the manufacturing sector increased by more than four times, from 92% to 394%.

As the economy showed signs of over-expansion with a swelling current account deficit, the IMF stepped in. The IMF recommended the currency devaluation, abolition of export subsidies and tight monetary control (an orthodox IMF program). The Korean government did not accept these recommendations, which could thwart the second five-year economic plan and jeopardise rapid growth. But the pressure was intense: the US made the consideration of additional PL 480 and developmental loan funding conditional on the acceptance of the IMF program. The government then agreed to the IMF program in 1970, with the exception of the demand to end export subsidies - the incentive that the government viewed as the pillar of its export-led growth strategy. Consequently, monetary expansion dropped and economic growth also fell from 13.8% in 1969 to 7.6% in 1970. This drop was followed by a currency devaluation of 18% in 1971.

Devaluation and tight credit control hit domestic firms hard, especially those that borrowed from abroad. The world economic recession made things worse. The net profit ratio of the manufacturing sector fell sharply and NPLs of banks started to pile up. Under tight credit control, domestic banks could not help firms finance the increased foreign loan payments. Business turned to the last available resort: the curb market. By 1971, the number of bankrupt enterprises that had received foreign loans climbed to 200; Korea faced its first debt crisis.

Business was in an uproar. The Korean Federation of Industrialists urged immediate remedies - something short of declaring national bankruptcy to the international financial community to bail out firms. The government originally considered mobilising special funds of ten billion won (about 3.3% of the total money supply). Business responded that the amount was far short of what was required. After consultation with leading businessmen, the government concluded that some extraordinary measures were necessary to cushion the financial burden of the debt-ridden firms, and eventually issued its Emergency Decree in August 1972.

It included an immediate moratorium on the payment of all corporate debt to the curb lenders and extensive rescheduling of bank loans. All corporate loans from the curb market were converted to long-term loans, at a maximum interest rate of 16.2%, when the prevailing curb-market rate was over 40% per annum. About 30% of the short-term bank loans to business were converted into long-term loans at a reduced interest rate. This conversion was ultimately backed by the central bank, which accepted the special debentures issued by the commercial banks (C.Y. Kim 1990 and 1994, and Y.J. Cho and J.K. Kim 1995).

Ownership and governance structure of financial institutions

Ownership structure of financial institutions is also a critical element in the fabric of corporate governance as it is directly related to the issue of conflicts of interest. Strong governance usually emerges in response to predictable pressures from shareholders, supervisors and market competition.

Commercial banks

In Korea, the social concern about the strong economic influence of *chaebols* translated into strict restrictions on bank ownership structure. In 1982, when privatisation of the banking sector was pursued, a ceiling of 8% on individual ownership of nationwide commercial banks was imposed, in order to prevent any single shareholder from exerting excessive influence and control over a bank's management. This restriction was further strengthened as the ceiling was lowered to 4% in 1994, as financial liberalisation made progress[11]. It has been allegedly argued that the resulting fragmented ownership structure significantly reduced the room for potential influence of large shareholders.

As of the end of 1996, the average number of shareholders who own more than 1% of the total voting stocks was 10 for the nationwide commercial banks, and their combined shares accounted for 39.3% of the total. The number of shareholders with ownership of 4% or more averaged at 3, accounting for 24.3 percent of the total shares (Table VII-3). If similar statistics are calculated for all DMBs including local banks whose ownership structure is much more concentrated than nationwide banks due to a higher ceiling, the combined shares of the largest 12 shareholders accounts for more than 40% of the total.

This figure indicates that the ownership distribution of Korean banks is no less concentrated than in advanced countries such as the US. Therefore, the long-time advocated argument that "there is no accountable owner in individual Korean banks due to fragmented ownership structure" seems to be unfounded. Theoretically, it only refers to the absence of a *single* dominant shareholder, and should not be interpreted as the non-existence of shareholders with a potential for management control power.

Despite Korea's bank ownership structure comparable to that of advanced countries, large shareholders of most banks have remained passive in exercising their voting rights and monitoring bank management. Such behaviour of large shareholders has been attributed in large part to government intervention in bank management. Despite financial liberalisation and deregulation, strong inertia due government intervention continued as the government appointed CEOs of banks. Under these circumstances, bank management tended to reflect the government's intention in their decisions, rather than being accountable to their shareholders. *The continued government control or influence on banks seems to be a rather unique feature of the Korean banking sector, given the fact that the government did not have ownership in commercial banks after privatisation*.

Accordingly, internal governance of banks has remained ineffective and poor. The boards of directors of banks have not been in a position to check management in an independent manner. Typically, the board of directors was comprised mostly of insiders and the CEO and they, not the shareholders, exercised virtually full power in nominating directors. In addition, inside directors were actually in charge of carrying out the business plans rather than continuously monitoring the CEO. Although there were 6 to 8 non-executive directors in large nationwide banks, they were not assigned a clearly defined role, nor provided with necessary information for monitoring.

To correct this problem, the government revised the General Banking Act at the end of 1996 to introduce a non-executive director-led board system for banks without dominant shareholders.[12] Due to this change, the number of non-executive directors at large nationwide banks increased to 13, while 5-8 non-executive directors were newly appointed at regional banks (Tables VII-5 and VII-6). However, the renewal of the board system itself did not appear to contribute much to improving bank management. In fact, for the 6 largest banks, 10 non-executive directors, who were representatives of shareholders, only held 2.64-9.25 percent of total stocks and many non-executive directors seemed to have a favourable relationship with top management. More importantly, at the outset, bank managers did not have strong incentives for improving transparency standards and being accountable to shareholders and outside stakeholders because of weak prudential regulation and moral hazard.

Table VII-3: Large Shareholders' Ownership of Banks

(As of the end of 1996)

Classification	Large Shareholders Over 1%		Large Shareholders over 4%		Ownership Share by 5 Largest Shareholders (%) (by 3 Largest Industrial Capital)
	Number	Ownership Share (%)	Number	Ownership Share (%)	
Chohung	11(4)	45.7(14.7)	5(2)	32.4 (10.0)	32.4(12.8)
Commercial	10(3)	35.1(9.3)	5(1)	27.4 (7.0)	27.4(9.3)
Korea First	13(5)	35.6(15.7)	2(1)	12.5 (5.5)	22.4(12.5)
Hanil	14(5)	45.5(15.8)	4(1)	20.8 (4.8)	24.6(11.4)
Seoul	12(6)	30.6(14.2)	2(1)	12.0 (4.6)	20.3(10.3)
5 Largest Nationwide Banks, Average	12(5)	38.7(13.9)	4(1)	21.3(6.5)	25.6
Korea	9(2)	59.0(2.1)	1(-)	47.9(-)	54.6(n.a.)
exchange	9(1)	48.5(2.0)	3(-)	37.2(-)	43.4(n.a.)
Kookmin	6(2)	16.4(4.5)	!(-)	- (-)	15.3(n.a.)
Shinhan	9(6)	70.4(45.6)	5(3)	64.4 (41.1)	79.9(41.1)
KorAm	16(5)	54.6(19.4)	5(2)	28.5 (11.0)	28.5(14.5)
Hana	17(5)	52.9(26.0)	5(3)	31.4 (20.8)	31.4(20.8)
Boram	10(2)	14.9(2.3)	- (-)	- (-)	8.7(n.a.)
Donghwa	3(-)	17.1(-)	2(-)	15.2 (-)	n.a.(n.a.)
Daedong	7(-)	20.0(-)	2(-)	13.8 (-)	17.8(n.a.)
Dongnam	9(1)	49.0(1.3)	6(-)	42.2 (-)	37.0(n.a.)
Peace					
Nationwide Banks, Average	10(2)	39.3(10.7)	3(1)	24.3(5.4)	-
Daegu	15(3)	40.6(8.6)	4(1)	22.9(5.7)	25.6(8.6)
Pusan	14(3)	52.0(28.8)	2(1)	31.8(23.9)	40.4(28.8)
Chungchong	14(5)	63.9(27.7)	3(1)	36.2(16.5)	43.0(23.3)
Kwangju	13(2)	41.7(9.5)	3(1)	21.7(7.9)	28.6(n.a.)
Cheju	10(4)	51.8(31.7)	3(1)	36.6(26.5)	42.1(30.6)
Kyonggi	13(5)	42.6(20.6)	3(2)	21.6(14.3)	28.7(17.7)
Jeonbook	15(4)	59.4(24.3)	6(3)	41.8(23.1)	37.3(23.1)
Kangwon	17(3)	57.0(14.5)	4(1)	31.2(11.9)	34.9(14.5)
Kyungnam	16(4)	50.4(20.5)	2(1)	19.4(11.6)	29.7(18.2)
Chungbuk	16(5)	54.1(11.3)	4(1)	29.7(4.7)	33.4(9.3)
Local Banks, Average	14(4)	49.7(18.5)	3(1)	27.6(13.5)	33.0
Commercial Banks, Average	12(3)	40.9(11.9)	3(1)	24.8(6.6)	-

Note : Figures in parentheses indicate the number and ownership share by private industrial capital (including affiliated financial institutions).

Source : The Bank Supervisory Board.

Table VII-4: Share of Banks Owned by Top 30 *Chaebols*

(As of the end of 1996, Unit: %)

Conglomerates	Ownership Share
1. Hyundai	Korea First bank(2.20), Hanil bank(2.00), Seoul bank(1.99), Kangwon bank(11.89)
2. Samsung	Chohung bank(2.81), Commercial bank(7.03), Korea First bank(3.96), Hanil bank(4.76), Seoul bank(3.77), Korea exchange bank(1.05), Shinhan bank(3.36), KorAm bank(18.56), Hana bank(3.42), Peace bank(1.28), Daegu bank(5.65), Pusan bank(1.02), Kyonggi bank(1.57), Jeonbook bank(1.20), Kangwon bank(1.22), Kyung nam bank(2.38)
3. LG	Korea First bank(3.03), Hanil bank(2.47), Boram bank(7.58), Cheju bank(1.80)
4. Daewoo	KorAm bank(18.56)
5. SK	Kyonggi bank(3.42)
6. Ssangyong	Chohung bank(1.98), Korea exchange bank(1.04), Hana bank(1.52), Kookmin bank(1.96)
7. Hanjin	Kyonggi bank(5.63)
8. Kia	Korea First bank(1.04)
9. Hanwha	Chungchong bank(16.49)
10. Lotte	Pusan bank(23.93)
11. Kumho	Kwangju bank(7.87)
12. Doosan	Boram bank(11.34)
13. Daelim	Hanil bank(3.57)
14. Hanbo	
15. DongAh	Seoul bank(1.50), Cheju bank(2.31)
16. Halla	
17. Hyosung	Hank bank(5.16), Kyungnam bank(11.57)
18. Dongkuk Steel	Seoul bank(1.27), Pusan bank(3.85), Kyungnam bank(3.92)
19. Jinro	Hana bank(3.51)
20. Kolon	Boram bank(5.80)
21. Tongyang	Donghwa bank(1.03)
22. Hansol	
23. Dongbu	Cheju bank(1.06), Chungbuk bank(1.74)
24. Kohab	
25. Haitai	
26. Sammi	
27. Hanil	
28. Kukdong-Construction	
29. New Core	
30. Byucksan	

Source: The Bank Supervisory Board.

Table VII-5: Board of Directors of Banks

(As of March 11, 1997, Unit: person)

	Chair-man	Managing Director	Execu-tive Director	Director	Auditor	Total	Non-Executive Board Member			
							President	Vice-president	Director	Auditor
Chohung	1	1	10	-	1	13			13	
Commercial	1	2	9	-	1	13			13	
Korea First	1	2	5	4	1	13			13	
Hanil	1	2	9	-	1	13			13	
Seoul	1	1	6	4	1	13			13	
Korea Exchange	1	2	9	-	1	13			13	
Kookmin	1	1	10	-	1	13			13	
Shinhan	1	2	3	3	1	10	1	1	30	2
KorAm	1	2[1)]	3	1	1	8			9	
Dongwha	1	1	5	-	1	8	1		14	
Dongnam	1	1	5	-	1	8			8	
Daedong	1	1	3	2	1	8			8	
Hana	1	1	3	2	1	8	1		9	1
Boram	1	1	4	2	1	9	1		8	
Peace	1	1	2	-	1	5	1		7	
Nationwide Banks Subtotal	15	21	86	18	15	155	5	1	184	3
Daegu	1	1	5	-	1	8			8	
Pusan	1	1	5	-	1	8			8	
Chungchong	1	1	3	-	1	6			8	
Kangwon	1	1	5	-	1	8			8	
Cheju	1	1	2	1	1	6			6	
Kyonggi	1	1	4	-	1	7			8	
Jeonbook	1	1	4	-	1	7			8	
Kangwon	1	1	3	-	1	6			7	
Kyungnam	1	1	5	-	1	8			8	
Chungbuk	1	-	3	-	1	5			5	
Local Banks Subtotal	10	9	39	1	10	69			74	
Total	25	30	125	19	25	224	5	1	258	3

Note : 1) Including one first vice-president.

Source : The Bank Supervisory Board.

Table VII-6 Newly Employed Non-Executive Directors of Banks
(Unit: person, %)

	Classification	Large Shareholders	Minor Shareholders	Recommended by Board of Directors	Total
Nationwide Bank	Corporate	41(38.3)	28(26.2)	8(7.5)	77(72.0)
	Academic circles	1(0.9)	-	7(6.5)	8(7.5)
	All sorts of	6(5.6)	4(3.7)	1(0.9)	11(10.3)
	organisations	-	-	3(2.8)	3(2.8)
	Lawyer/Accountant	2(1.9)	-	1(0.9)	3(2.8)
	The Press	-	-	3(2.8)	3(2.8)
	Government/Others	-	-	2(1.9)	2(1.9)
	Financial circles				
	Subtotal	50(46.7)	32(29.9)	25(23.4)	107(100.0)
Local Bank	Corporate	35(47.3)	14(18.9)	8(10.8)	57(77.0)
	Academic circles	1(1.4)	1(1.4)	5(6.8)	7(9.5)
	All sorts of	2(2.7)	4(5.4)	1(1.4)	7(9.5)
	organisations	-	-	2(2.7)	2(2.7)
	Lawyer/Accountant	-	-	-	-
	The Press	-	-	-	-
	Government/Others	-	-	1(1.4)	1(1.4)
	Financial circles				
	Subtotal	38(51.4)	19(25.7)	17(23.0)	74(100.0)

Note: Figures in parenthesis indicate shares of total non-executive directors in commercial banks.
Source: The Bank Supervisory Board.

In fact, the supervisory authorities had never allowed any financial institution to fail before the crisis, for fear of impairing public confidence toward the financial system and their being responsible for inappropriate supervision. At the time of financial distress, the government almost surely rescued ailing institutions. In addition, the information disclosure system fell short of the International Accounting Standards (IAS). As a result, bank managers, recognising that they would not be forced out of the market even when they were failing, did not actively search long-term development plans to survive in deteriorating environments or carry out restructuring through mergers or strategic alliances. Instead, they relied on high charter value of their banks resulting from various entry barriers, and often appealed to supervisory authorities for relaxing regulatory standards and corrective measures when the business environment worsened.

Various factors virtually prevented market discipline from operating properly in the domestic financial markets. High entry barriers restricted fair competition among financial institutions and induced bank managers to maintain a passive management attitude, seeking rents from the imperfect competition. Moreover, exiting management improvement measures were often not taken by supervisory authorities or were delayed because of unclear standards for taking action. Also, the capital market could not check the bank management, since accounting data on the financial situations of banks were quite inaccurate,[13] and public disclosure of financial information on banks was hardly sufficient. The market for corporate control in which failing institutions could be resolved through M&As was non-existent.

For these reasons, bank management was accountable to no one, except the government, even after privatisation in the early 1980s. Within banks, lending decisions tended to be centralised in senior management, while internal risk control as well as credit analysis skills and procedures were underdeveloped. Given the high corporate leverage and opaque ownership and control linkages, many corporate borrowers were not creditworthy by traditional criteria. As a result, credit decisions tended to rely on collateral and cross debt guarantees among affiliates of business groups rather than projected cash flows. Loan review processes and managerial information systems were rudimentary. In sum, the financial liberalisation expanded the controlling power of bank managers, but at the same time, the lack of proper governance structure, both internal and external, increased the possibility of exploitation and misuse of the expanded power. In light of this, Korean banks not only suffered from greater agency costs, but also played an inactive role as an external governance device for the non-financial corporate sector.

Weak external governance by financial institutions of the corporate sector can also be partly explained by the regulations with respect to banks' equity participation in non-financial firms. Korean banks had been regulated in their equity shares in non-financial businesses with a ceiling of 10%. In 1998, the ceiling was relaxed to 15%, and commercial banks increased shareholdings of non-financial firms in their portfolios.[14] However, the underlying motivation for banks to increase their shareholdings in non-financial businesses seems to have been capital gains rather than management control or influence. In fact, a bank's equity share hardly represents a threat of potential control as it is quite low compared to other shareholders. Furthermore, a bank's control of firms as a shareholder was severely limited due to regulations mandating "shadow voting", an obligation for financial intermediaries to vote with the management which is also the major shareholder. Therefore, we might say that Korean commercial banks generally had not been in a position to play a leading role in corporate governance matters.

Table VII-7: Nationwide Commercial Banks' Stock Holdings
(%, of total assets, year-end)

	1989	1990	1991	1992	1993	1994	1995	1996	1997
On-balance sheet account	1.8	1.6.	1.6	1.8	2.3	3.3	3.2	2.8	2.1
Trust account	9.1	8.8	6.5	5.2	4.7	5.6	4.7	3.7	3.2

NBFIs

Unlike banks, NBFIs were free of ownership restrictions except for life insurance companies and investment trust companies.[15] As a result, many NBFIs are currently owned or actually controlled by *chaebols* (Table VII-8). As of 1997, the 70 largest *chaebols* owned a total of 109 financial affiliates – an average of five financial affiliates in the case of the 5 largest *chaebols* - mostly in securities companies, MBCs, non-life insurance firms, and instalment credit companies.

Table VII-8: Number of NBFIs Owned by the Top 70 *Chaebols*[1]
(Unit: number of firms, the end of 1997)

	Top 5 *Chaebols*	Top 6-30 *Chaebols*	Top 31-70 *Chaebols*	Non-*Chaebols*
Merchant Bank (29)[2]	3	7	4	14
Securities (26)	6	5	1	12
Investment Trust Company (14)	2	2	1	5
Life Insurance (31)	2	4	8	14
Fire & Marine Insurance (13)	2	3	0	5
Installment Credit (26)	2	7	3	12
Mutual Saving & Finance (219)	1	5	12	18
Venture Investment (56)	3	4	6	13
Card (7)	3	1	0	4
Finance & Factoring (46)	3	4	5	12
Total (477)[3]	27	42	40	109

Notes:
1) The rank of *chaebol* is based on total borrowings.
2) The figure in parentheses represents the total number of financial institutions at each financial sector.
3) Leasing companies (a total of 39) are excluded because they are owned by banks

Source: National Information and Credit Evaluation Inc.

The close links between NBFIs and *chaebols* have created scope for conflicts of interest. In fact, it appears that *chaebols* have been using their affiliated NBFIs to finance the activities of other subsidiaries within their group in various ways: direct provision of funds, priority underwriting of securities issued by related subsidiaries, provision of preferential financial services and information on competing firms, management of related firms' shares and their prices, exercise of control of other firms via stock holdings, and other forms of unfair inter-group transactions. For example, *chaebols* have been using their affiliated MBCs, especially their overseas branches, and to a lesser extent their insurance companies, to finance the activities of other subsidiaries within their groups. In this situation, it is hard to expect prudent corporate monitoring by NBFIs.

Although many NBFIs are owned by large industrial groups, financial supervision of NBFIs has been lax as can be seen from the fact that basic prudential regulations such as capital adequacy requirements were absent until the onset of the crisis. The principal regulator and supervisor of NBFIs has been the Ministry of Finance and Economy. However, only a small working-level unit has been assigned the supervisory role within the Ministry, making effective monitoring almost impossible. *In short, the NBFIs have been under the strong influence of* chaebols *while government supervision was almost absent.* Such a combination was a disaster in waiting as can be seen from the fact that the financial trouble of MBCs acted as a triggering point for the financial crisis in 1997.

Policy responses to the crisis: financial sector governance system

The establishment of market principles, thereby preventing moral hazard problems, and enhancement of accountability and transparency of management, are essential to improve a poor financial sector governance system. As of the end of September 1998, the first round of financial sector restructuring had been completed, and since the onset of the financial crisis, various measures have been taken to improve both the financial sector's internal and external governance structures. Although not complete, it is quite a dramatic improvement, considering the pre-crisis situation.

Internal governance structure

- Rules for bank ownership were eased so that investors can acquire strategic stakes in financial institutions. As large owners reach the thresholds of 10%, 25% and 33% of the total equity, they will be subject to increasingly strong review by the Financial Supervisory Commission (FSC). It is expected that, in addition to injections of capital, foreign banks and investors can provide monitoring and managerial skills, and apply international profitability standards.

- Since January 1998, under the Act Concerning the Structural Improvement of the Financial Industry, the supervisory authority is able to order the write-off of equity of shareholders deemed to bear responsibility for the insolvency of banks which the government has recapitalised or decided to recapitalise.

- In February 1998, in order to activate the function of shareholders and internal auditors in monitoring management, the requirements for exercising the minority shareholder's right to initiate a class action were eased.

- The FSC has established and executed an efficient sanction system in which the FSC, can impose civil and criminal liabilities on the directors. Also, the FSC can impose the claim for financial damage of financial institutions on the executives and employees having responsibilities for the insolvency, and can impose the equivalent sanction on the external auditors and examiners of supervisory authorities for neglect of duties.

External governance structure

- Closure of insolvent financial institutions opened a new chapter in the history of Korea's financial sector, where no single commercial bank had been closed before. As of September 1998, five banks, sixteen MBCs, two securities companies and one investment trust company had been permanently closed. In addition, four securities companies, four insurance companies and one investment trust company had been suspended. If including mutual savings, finance companies and credit unions, the total number of financial institutions either closed or suspended was 94. Another 115 financial institutions are currently pursuing mandatory restructuring by the order of the FSC.

- The prompt corrective action system and management evaluation system have been introduced. Three-step corrective measures, composed of recommendations, measures and orders to improve management, will be imposed on unsound financial institutions according to the degree of their unsoundness. To this end, the capital adequacy standards for deciding whether financial institutions are sound have been simplified.[16]

- To strengthen the bank disclosure system, in April 1998 the FSC increased the regular disclosure items to the scope requested by the IAS, which include asset classification, off-balance sheet transactions including derivatives, and special disclosure items such as those related to financial mishaps. Also, the FSC has increased the frequency of regular disclosure from once to twice a year.

- To upgrade prudential regulation standards, loan classification standards as well as provisioning requirements were strengthened in accordance with international practices in July 1998. Under the new classification standards, loans overdue for 3 months or more are categorised as "substandard" and those in arrears for 1-3 months as "precautionary". Forward-looking asset quality classification standards will also be introduced in 1999. The required provisioning rate for "precautionary" loans was raised from 1% to 2%. Commercial papers, guaranteed bills and privately-placed bonds in trust accounts have been included in the asset category subject to loan loss provisions, and the requirement of 100% of loan loss provisions for trust accounts with guarantees of the principals has been added to those with guarantees of the interests. In addition, the evaluation standard for marketable and investment securities held by banks has been changed from the "lower-of-cost-or-market" to the "mark-to-market" method.

Table VII-9: Financial Institutions Suspended or Closed
(As of September, 1998)

	Total Number of Institutions (end-1997)			
		License Revoked	Suspended	Subtotal
Banks	33	5	-	5
Merchant Banks	30	16	-	16
Securities Companies	34	2	4	6
Insurance Companies	50	-	4	4
Investment Trust Companies	8	1	1	2
Mutual Savings and Finance Companies	230	1	21	22
Credit Unions	1,653	12[1)]	27	39
Leasing Companies	25	-	-	-
Total	2,063	32	62	94

Note: 1) bankruptcy.

Corporate financing patterns and performance in recent years

As discussed before, the absence of well-developed equity markets, and the provision of subsidised credits coupled with weak corporate governance, have altogether resulted in *chaebols'* excess leverage without due consideration to default risk. By the end of 1997, the debt/equity ratio of the 30 largest *chaebols* reached 519% (Table VII-10). More surprising was that such extremely high debt/equity ratios had prevailed for several years before the crisis. For example, in 1995, the debt/equity ratios of several *chaebols* were already at unimaginable levels: Hanbo Steel Co. (675%), New Core Group (924%), Hanil Group (836%), Jinro Group (2,441%), Halla Group (2,855%), and Sammi Group (3,245%). During the period of 1997-98, all of them either went bankrupt or were subject to legal procedures related to composition or reorganisation.

An important observation can be made from this example. Clearly, many *chaebols* have shown signs of rapidly deteriorating financial health and remained vulnerable to unfavourable cyclical shocks, such as the terms of trade shock in 1996 and business downturn since the end of 1995. Nonetheless, they were able to survive at least for two years before they collapsed at the time of the financial crisis, even with such an unbearable burden of debt. At this juncture, key questions are: 1) how could *chaebols* borrow to the point of unthinkable leverage in the first place, and 2) how could they survive for several years with such a heavy burden of debt at the time of economic downturn? Answers to both of these questions critically hinge upon poor internal governance of both the corporate and financial sectors, as well as lax financial supervision.

Table VII-10: Top 30 *Chaebols*' Debt/Equity Ratios
(Unit: %)

1995		1996		1997	
Chaebols	Debt/equity ratio	*Chaebols*	Debt/equity ratio	*Chaebols*	Debt/equity ratio
1. Hyundai	376.4	1. Hyundai	436.7	1. Hyundai	578.7
2. Samsung	205.8	2. Samsung	267.2	2. Samsung	370.9
3. LG	312.8	3. LG	346.5	3. Daewoo	472.0
4. Daewoo	336.5	4. Daewoo	337.5	4. LG	505.8
5. Sunkyung	343.3	5. Sunkyung	383.6	5. SK	468.0
6. Ssangyong	297.7	6. Ssangyong	409.4	6. Hanjin	907.8
7. Hanjin	621.7	7. Hanjin	556.6	7. Ssangyong	399.7
8. Kia	416.7	8. Kia	516.9	8. Hanwha	1,214.7
9. Hanwha	620.4	9. Hanwha	751.4	9. Kumho	944.1
10. Lotte	175.5	10. Lotte	192.1	10. DongAh	359.9
11. Kumho	464.4	11. Kumho	477.6	11. Lotte	216.5
12. Doosan	622.1	12. Halla	2,065.7	12. Halla	-1,600.4
13. Daelim	385.1	13. DongAh	354.7	13. Daelim	513.6
14. Hanbo	674.9	14. Doosan	688.2	14. Doosan	590.3
15. DongAh Construction	321.5	15. Daelim	423.2	15. Hansol	399.9
16. Halla	2,855.3	16. Hansol	292.0	16. Hyosung	465.1
17. Hyosung	315.1	17. Hyosung	370.0	17. Kohab	472.1
18. Dongkuk Steel	190.2	18. Dongkuk Steel	218.5	18. Kolon	433.5
19. Jinro	2,441.2	19. Jinro	3,764.6	19. Dongkuk Steel	323.8
20. Kolon	328.1	20. Kolon	317.8	10. Dongbu	338.4
21. Tongyang	278.8	21. Kohab	590.5	21. Anam	1,498.5
22. Hansol	313.3	22. Dongbu	261.8	22. Jinro	-893.5
23. Dongbu	328.3	23. Tongyang	307.8	23. Tongyang	404.3
24. Kohab	572.0	24. Haitai	658.5	24. Haitai	1,501.3
25. Haitai	506.1	25. New Core	1,225.6	25. Shinho	676.8
26. Sammi	3,244.6	26. Anam	478.5	26. Daesang	647.9
27. Hanil	936.2	27. Hanil	576.8	27. New Core	1,784.1
28. Kukdong Construction	471.2	28. Keopyong	347.6	28. Keopyong	438.1
29. New Core	924.0	29. Miwon	416.9	29. Kangwon Industrial	375.0
30. Byucksan	486.0	30. Shinho	490.9	30. Saehan	419.3
Total	347.5		386.5		519.0

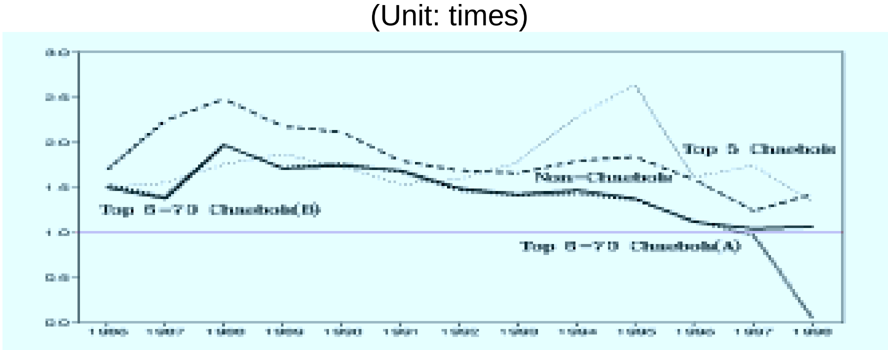
Source : Fair Trade Commission.

As a basis for discussions on the relationship between the issue of corporate governance and financial soundness and performance of firms, it would be desirable to document the financial landscape of the corporate sector, particularly *chaebols*, in greater detail. Given the high debt leverage of the corporate sector, a large share of operating earnings went to servicing their debts. Chart VII-2 shows the trend of the interest payment coverage ratio, calculated as operating earnings over interest expenses, of the listed companies during the period of 1986 and 1998. Operating earnings used in this paper are EBITDA (Earnings Before Interest payment and Taxes plus Depreciation and Amortization). Therefore, those firms whose interest payment coverage ratio is below 1 are likely to go bankrupt. The total number of listed companies covered by the sample is 504, and these companies are classified into two categories: *chaebol* affiliates and non-*chaebol* independent companies. At the end of the first half of 1998, the top 6th-70th *chaebols*' interest payment coverage ratio (weighted average) was merely 0.04 (1.06, if Kia and Asia automobile companies are excluded), far below the level of the top 5 *chaebols* (1.35) and non-*chaebol* independent companies (1.42).

Such financial vulnerability of the top 6th-70th *chaebols* has been attributed to weak business performance and high leverage. By the end of the first half of 1998, the top 6th-70th *chaebols*' business performance, calculated as the EBITDA over total assets, sharply deteriorated while their financial leverages continued to rise. Consequently, the top 6th-70th *chaebols*' net profits to total assets plunged to -9.9% (-1.2%, if Kia and Asia automobile are excluded) from -1.8% in 1997 (-1.3%, if Kia and Asia automobile are excluded). Unfortunately, both poor business performance and high debt leverage are not recent phenomena as these conditions have been present since the mid-1990s.

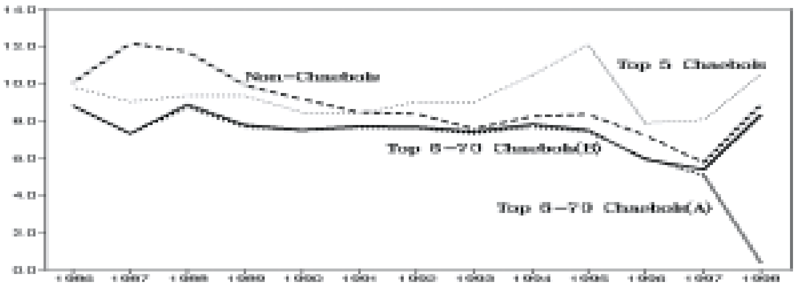
For the top 5 *chaebols*, by the end of the first half of 1998 the operating earnings have increased, apparently due to sharp reduction in wage costs and robust exports. Despite the increased earnings, however, they have also experienced difficulty in servicing debt as their debt continued to grow. As a result, the top 5 *chaebols*' net profit rate fell to -0.4% in the first half of this year from -0.1% in 1997. In contrast, non-*chaebol* independent corporations showed visible improvement during the first half of 1998 with substantial progress in restructuring. Their interest payment coverage ratios have risen due to a combined effect of debt reduction and increased earnings. Consequently, their net profit rates turned positive, 0.4%, in the first half of 1998.

Chart VII-2: Interest Payment Coverage Ratios for Listed Firms
(Unit: times)



Notes:
1) Figures for 1998 are those for the first half of 1998.
2) (A) includes all subsidiaries of the top 6-70 chaebols,
(B) excludes Kia and Asia automobile companies among the top 6-70 chaebols
Data Source: National Information and Credit Evaluation Inc.

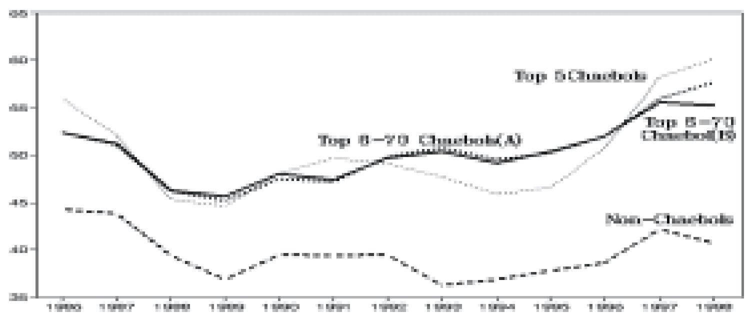
Chart VII-3: EBITDA/Total Assets for Listed Firms (Unit: %)



Notes:
1) Figures for 1998 are those for the first half of 1998.
2) (A) includes all subsidiaries of the top 6-70 *chaebols*,
(B) excludes Kia and Asia automobile companies among the top 6-70 *chaebols*

Data Source: National Information and Credit Evaluation Inc.

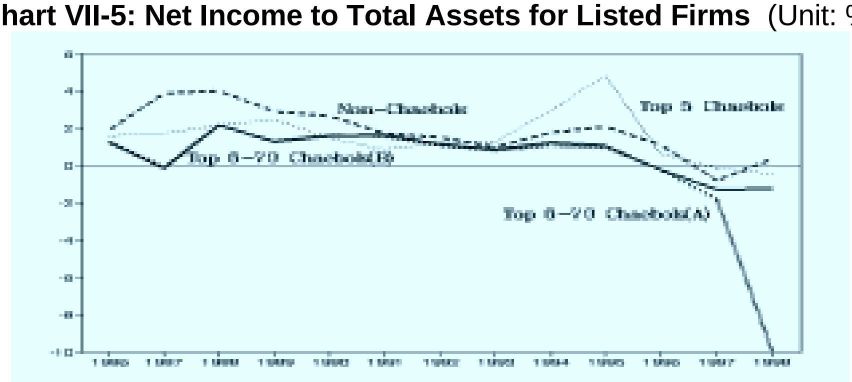
Chart VII-4: Total Borrowings to Total Assets for Listed Firms (Unit: %)



Notes:
1) Figures for 1998 are those for the first half of 1998.
2) (A) includes all subsidiaries of the top 6-70 *chaebols*,
(B) excludes Kia and Asia automobile companies among the top 6-70 *chaebols*

Data Source: National Information and Credit Evaluation Inc.

Chart VII-5: Net Income to Total Assets for Listed Firms (Unit: %)



Notes:
1) Figures for 1998 are those for the first half of 1998.
2) (A) includes all subsidiaries of the top 6-70 *chaebols*,
(B) excludes Kia and Asia automobile companies among the top 6-70 *chaebols*

Data Source: National Information and Credit Evaluation Inc.

Table VII 11 also shows the significance of financial trouble in the corporate sector before and after the financial crisis in terms of the interest coverage ratios. In 1995, when the Korean economy was in a boom cycle, there already existed signs of financial weakness to some degree in both corporate performance and financial structure: the number of firms with interest payment coverage ratio below 1 was already 61, which amounts to 11% of total listed firms. This number increased to 158 (31% of total listed firms) in the first half of 1998, which is 2.6 times as high as the figures in 1995, largely due to a drastic rise in interest rates and sharp reduction in profitability since the onset of financial crisis. The situation is particularly pressing for the top 6th-70th *chaebols*.

Table VII-11 Deteriorating Corporate Performance

		Interest Payment Coverage Ratio							
		1995		1996		1997		1998	
		≥ 1	< 1	≥ 1	< 1	≥ 1	< 1	≥ 1	< 1
Top 5 ***Chaebols***	Number Of firms	56	4 (7%)	52	8 (13%)	52	9 (15%)	46	14 (23%)
Top 6~70 ***Chaebols***	Number Of firms	127	15 (11%)	114	28 (20%)	96	46 (32%)	67	58 (46%)
Non-***Chaebols***	Number Of firms	288	42 (13%)	288	61 (18%)	279	87 (24%)	233	86 (27%)
Total	Number Of firms	497	61 (11%)	454	97 (18%)	427	142 (25%)	346	158 (31%)

Note: Figures in parentheses indicate the share of firms in each categorised group.
Data Source: National Information and Credit Evaluation Inc.

At this juncture, it should be noted that factor costs have stabilised considerably since the second half of 1998: not only have interest rates dropped significantly, but nominal wages have also fallen as firms struggled to survive and workers preferred pay cuts to reductions in employment. Such reductions in factor costs are significantly improving firms' balance sheets and lowering interest coverage ratios. These developments will contribute to the reduction of the corporate default risk. Nonetheless, considering the heavy debt service burden of *chaebols* and the weak domestic demand, the potential of large business failures cannot be ruled out. Unless debt reduction measures, including debt-equity swaps, are carried out up-front, debt overhang would persist and the process of rehabilitation of troubled firms would be delayed.

VIII. Insolvency mechanisms

There are usually two types of formal insolvency procedure in a corporate insolvency law regime. One is *liquidation* (or winding-up) in which the commercial activities of an insolvent firm are terminated and its assets are sold either on a piece-meal basis or as a whole. In Korea, the Bankruptcy Act administers liquidation procedure. The other is *reorganisation* (or rescue) which provides for the continuation of an insolvent corporate debtor with restructuring of the financial claims of its creditors and shareholders, and entails a change in the management and the ownership structure. The Company Reorganization Act and the Composition Act provide for reorganisation procedure in Korea.

Informal workouts can be used as an alternative to the formal procedures of the insolvency law regime when the debtor firm and its creditors would prefer to conduct negotiation of rescheduling or restructuring with more flexibility. They can be less costly and speedier than the formal procedures which involve the courts. Other than informal rescheduling of loans between a debtor firm and its banks, an informal workout program has recently been introduced since the economic crisis by the Corporate Restructuring Agreement among the financial institutions in Korea.

M&A markets can play the role of an insolvency mechanism in that an insolvent firm can be bought by private investors, or be acquired by or merged into another firm, and the financial claims are repaid or rearranged in the process. However, the *M&A market* has played only a minimal role as an insolvency mechanism in Korea since it has almost been non-existent due to the concentrated ownership structure and the regulations in the stock market.

Formal insolvency procedures

The liquidation procedure under the Bankruptcy Act may be initiated by the insolvent debtor, creditors or other interested parties. Once the application is filed and accepted, the court may issue an order to preserve the debtor's assets. Then a bankruptcy administrator is appointed to oversee the process, which will eventually distribute the remaining assets to the creditors in an equitable manner.

The reorganisation procedure under the Company Reorganization Act may be initiated by the debtor firm, its creditors or shareholders. Once a petition is filed, a temporary order to preserve the debtor firm's assets may be issued. Only when the petition is accepted by the court, the formal proceeding is commenced. The most important criterion for acceptance is whether the firm's going-concerns value is greater than its liquidation value. Once the formal proceeding is under way, a receiver is appointed by the court; investigation of the firm's assets and debts is conducted by the receiver, and meetings of creditors and shareholders are convened. A reorganisation plan is prepared[17] and, once confirmed, can change the financial and ownership structure of the debtor firm. The receiver plays a central role since he/she not only oversees the process but also makes all the important decisions on the firm's operation with the court's approval.

The Composition Procedure is similar to that of the Corporate Reorganization Act, except for a few important differences. First, the Composition Procedure can by initiated only by the debtor firm, and its management is still in charge of its operation during the process. Second, a composition plan is proposed solely by the debtor firm, whereas the receiver, creditors and shareholders can also propose a reorganisation plan under the Company Reorganization Act. Third, the composition plan can only reschedule or modify the terms of the existing unsecured debts.

These formal insolvency procedures were not used very often in Korea until the crisis drove many of the highly-indebted firms into deep financial trouble or bankruptcy, as shown in Table VIII-1 and Table VIII-2 for cases under the Bankruptcy Act and the Company Reorganization Act, respectively. The composition has been used even less often. For the first 34 years since the Act was introduced in 1962, there were only 26 petitions (2 cases in 1985, 2 in 1989, 13 in 1995, and 9 in 1996). But 322 firms filed for the Composition procedure in 1997.

In addition, the formal procedures have not been very effective in restructuring and rehabilitating debtor firms in trouble. For example, under the reorganisation procedure only slightly over 20% of the firms which had filed emerged successfully from the process in recent years.

Table VIII-1: Number of Cases under the Bankruptcy Act

Year	1990	1991	1992	1993	1994	1995	1996	1997	98.1~6
# of cases	27	16	17	26	18	12	18	38	201

Source: Court Administration Agency.

Table VIII-2: Number of Cases under the Corporate Reorganization Act

Year	1990	1991	1992	1993	1994	1995	1996	1997	98.1~8
# of cases	15	64	89	45	68	79	52	132	24[18]

Source: Court Administration Agency.

Table VIII-3: Period of Time between Commencement and Conclusion/Termination and the Number of Cases (1993-95)

	Within 3 yrs	4-5 yrs	6-7 yrs	8-10 yrs	11-15 yrs	16-20 yrs	Total
Successful turnaround, conclusion	1	1	2	6	7	1	18
Failure, termination	17	12	10	8	5	0	52

Source: Court Administration Agency.

There are several reasons for the under-utilisation and ineffectiveness of the formal insolvency procedures in Korea.

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

Second, sometimes the rules were not specific or thought out enough so that they left room for much discretion by judges and for abuse by debtor firms. For example, under the old Company Reorganization Act before the 1998 amendment, the criteria for proceeding commencement included the possibility of a firm's rehabilitation and the public interest. These rules were often used in favour of debtor firms for the protection of reorganisation proceeding at the expense of the creditors' interests. For another example, a change in the Company Reorganization Act in early 1998 made mandatory the wipeout of half of the existing shares if the firm is insolvent. Then the rest of 1998 saw a sharp rise in the number of cases of the Composition procedure in which the management of the debtor firm is intact and such a mandatory wipeout is not applied. This came about as many controlling shareholders of failing firms scrambled to preserve their interests, *regardless of* whether their firms' situation was suitable for the Composition Process or not.

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

Informal workout

The Corporate Restructuring Agreement was signed by all the financial institutions in Korea in 1998 as an attempt to prevent a systemic corporate bankruptcy in the aftermath of the economic crisis and to facilitate an economic recovery. The process can be initiated by the consent of the lending financial institution of a debtor firm. After due diligence, the main bank proposes a debt restructuring plan. If the creditors representing more than 75% of the firm's debt vote for the plan, it becomes binding to all the institutions. If the creditors cannot reach an agreement after two attempts, the case is referred to the Corporate Restructuring Committee, whose decision becomes binding.

Currently 79 firms are undergoing debt restructuring under the Corporate Restructuring Agreement, while 63 of them now have their restructuring plan confirmed.[19] The total amount of their borrowing from credit institutions is estimated at 13 trillion won. Even though there are variations, most restructuring plans feature the following elements: about 10% of unsecured credit to be converted into equity or convertible bonds; a combination of repayment extension, interest exemption and interest reduction for the rest of unsecured credit; and retention of the current controlling shareholders and management on conditions of asset sales or additional capital inflow.[20] It should be noted that a super-majority voting in the shareholders' meeting is required for the debt-equity conversion to be actually executed, since the Corporate Restructuring Agreement is a contract among the financial institutions and, consequently, in itself does not bind the shareholders of the debtor firms.

To the extent that a systemic bankruptcy of the corporate sector should be avoided and that the existing formal insolvency procedures are not well developed and efficient enough, the Agreement can be thought of as an appropriate response by the financial institutions and the government. In this context, three main tasks that the procedure should address can be identified: 1) preventing bankruptcy of economically viable, though heavily indebted, firms; 2) preventing banks and other financial institutions from being unfairly expropriated to "save" the corporate sector; and 3) disciplining the incompetent management and reckless controlling shareholders.

However, there are several obstacles: 1) the lack of experience and commercial knowledge of bank personnel who are involved in the process; 2) the reluctance to supply new money to the debtor firm on the part of financial institutions other than the main bank; 3) the ineffectiveness of the formal procedure as a threat to the creditors and the debtor firm in case of failure of the informal one; 4) the lack of effective corporate governance of institutional creditors such as banks could fail to provide incentives for bank employees to actively strive for a successful workout. Especially given the nature of the Corporate Restructuring Agreement as a private contract, the last two obstacles may give the current controlling shareholders of the debtor firms some incentive to hold out in the hope of exacting a bigger concession from the creditors.

One important instrument to achieve a successful workout is the judicious use of debt-equity conversion. It can relieve the debtor firm from the immediate pressure of debt service, reward the creditors with a rising stock price if the conversion price has been set properly, and perform a disciplinary function with the change in ownership structure and in management. Most of the workout programs approved so far under the Corporate Restructuring Agreement contain a debt-equity conversion provision. One curious feature in many of the cases, though, is that the incumbent management or controlling shareholders remain in control even after their shares have been almost wiped out. It is not clear whether this reflects the competence of the incumbents, the perverse incentive problem as mentioned above, or the aversion of the banks to exercise control over their client firms, which may have something to do with the lack of effective corporate governance in the banks.

Recent developments

The Korean government had begun the amendment project of bankruptcy-related statutes in 1996, which was concluded in early 1998 (1998 amendments to the Company Reorganization Act and the Composition Act). The following are important elements in the 1998 amendment:

- *Economic Test:* Instead of the possibility of rehabilitation and public interest, an economic test was adopted as a criterion for the commencement of the reorganisation process which compares the liquidated value of the company's assets and the going-concern value of the reorganised company.
- *Administrative Committee:* An administrative committee is established to provide the courts with administrative service and experts' advice. It is composed of accountants and lawyers who have experience in corporate reorganisation.
- *Time Limitation:* To expedite a reorganisation process, time limitations are stipulated: a reorganisation plan should be submitted within 4 months after filing a petition; there should be a vote on a reorganisation plan within a year from the commencement of reorganisation proceedings (extensible by up to 6 months in case of unavoidable causes); there should be a provisional order of stay within 14 days after the filing of a petition, the order of a commencement of a composition proceeding within 3 months from the filing of a petition (extensible by up to 1 month). The duration of restructuring in a reorganisation plan is limited to 10 years.[21]
- *Amortisation of Shares and Mandatory Assessment:* The 1996 Supreme Court Rule provided that the court should amortise the shares that were owned by majority shareholders who were in charge of management. The rule was criticised because of the lack of statutory foundation. The 1998 amendment enumerates that more than half of stocks should be amortised in case that debts exceed assets, and more than two-thirds of stocks which are owned by dominating shareholders who are liable for bankruptcy. The Assessment is a summary procedure to examine the liability of directors and auditors for bankruptcy and order them to pay damages. This was stipulated in the 1996 Rule, but never applied. The 1998 amendment adopts the assessment provision to induce a sound practice in management.
- *Creditors' Conference:* Creditors had complained that not enough information was given to them both before and after the commencement of a reorganisation process. A Creditors' Conference is organised as an information channel to creditors from the receiver and the company. It is also expected to function as a forum for creditors.

After the final draft was completed in February 1999, a new set of amendments to those statutes is under public review. The 1999 Amendment Draft (the Draft) is a response to the criticism that reorganisation proceedings in Korea are still slow and inefficient. The order of commencement of a reorganisation proceeding is rendered at least after five months from a filing and there is no time limit from a filing to the order of commencement. A company's financial status is examined twice: by an investigative committee before the order of commencement and by the receiver after the order.

The Draft provides that the order of commencement of a proceeding should be within a month after a filing. It means that the courts should decide the commencement according to formal requirements without reviewing the possibility of rehabilitation or comparing liquidation and reorganisation value. Following the order of commencement, a receiver examines the company's financial statutes with or without the help of an investigative committee.

The Draft allows for an easy and quick commencement of rehabilitation procedures on the one hand, but it adds a restriction on the other. When the process is repealed or the reorganisation/composition plan is rejected, the courts should adjudge the debtor company to be bankrupt.

The voting requirement for confirmation of a reorganisation plan has been reduced from 3/4 to 2/3 for secured creditors whose credit repayment is to be extended, and from 4/5 to 3/4 for those secured creditors whose interests are to be impaired in other ways than repayment extension.

IX. Transparency and disclosure

The lack of transparency and inadequate disclosure have been recognised to be an important contributing factor in the failure of corporate governance in Korea, to the extent that the periodical financial statements and public disclosure in the securities market are the major source of corporate information for outside shareholders and other investors, and the means to protect their interests.

One major problem has been the failure of financial statements to accurately represent a firm's operating activities and financial health. According to the Security and Futures Commission (SFC), 36 out of the 122 listed companies whose financial statements were reviewed by the SFC were found to have violated the accounting rules for 55 cases in 1997, up from 15 companies for 42 cases in 1996. This figure amounted to roughly 1 out of 3 listed companies being in violation with respect to their financial statements. For another, 66 CPAs were subject to disciplinary action for inadequate audit of financial statements of listed and public companies in 1998, up 25% from 53 in 1997.

Several factors can be identified. First, the lack of effective governance within a firm has allowed the controlling shareholders and incumbent management to tamper with the firm's financial data to their advantage. Second, the current system for independent auditing has failed to establish the independence of outside auditors from the incumbent management. Since the outside auditors must compete with others for their business with a firm, they are susceptible to pressure to cater to the needs or demands of the controlling shareholders. Third, the government has often changed the financial accounting rules for the purpose of making the firms' financial statements "look better" than their actual condition warrants.[22] Last but not least, the government has been passive in enforcing the accounting and disclosure rules and in punishing violators.

In recent months, the government has introduced significant changes in the financial accounting standards. The SFC and FSC approved amendments to the corporate accounting standards prepared by the Financial Accounting Standard Council (FASC) in December 1998 to make the Korean accounting standards conform more closely to internationally accepted accounting principles, including those of the US. The major elements in the amendment are:

- Loss/gain from foreign currency-denominated asset/liability due to foreign exchange fluctuation is now reported as a loss/gain on the current income statement, instead of deferred asset/liability on the balance sheet.

- Financial claims or liabilities are to be reported at present value reflecting changes in repayment schedule, interest rate, etc., for example, when those claims/liabilities are subject to a reorganisation or workout plan, and the corresponding loss/gain is to be reported on the current income statement. They used to be reported at book value even after the relevant contract terms were modified.
- It is now mandatory to apply the equity method to valuation of securities when they represent a significant control (usually 20% of equity). In the past, firms were given a choice between the equity method and cost method.
- Derivatives are to be marked to market on the balance sheet as assets or liabilities, and loss/gain from their transactions is to be reported on the income statement. In the past, information on derivatives was only required to be provided in the footnotes.
- Bonds and debentures are to be marked to market on the balance sheet, and the corresponding loss/gain is to be reported. However, those that are certain to be held to their maturity are still to be valued according to the cost method.

With respect to the dominance of the *chaebols* in the Korean economy and the actual and potential abuse by the insiders against outside shareholders, the government has established separate Standards for the Combined Financial Statements for the 30 largest *chaebols* designated by the Fair Trade Commission (FTC). The major elements are:

- The combined financial statements consist of combined balance sheet, combined income statement, and combined cash flow statements. The statement of changes in equity is disclosed in a footnote.
- The combined financial statements are prepared under the assumption that *chaebol* affiliates under the common control constitute a single economic entity. Therefore intragroup balances, intragroup transactions, and resulting unrealised profits and losses are eliminated in preparation of the combined financial statements, unless they are immaterial. The principle of "substance over form" is used in identifying intragroup transactions.
- The Standards require footnote disclosure of intragroup transactions, including intragroup ownership interests, cross guarantees, cross pledging, intragroup borrowings and intragroup sales. Especially, information useful for estimating the overall risk of a given *chaebol* is provided in a matrix form showing relevant parties and amounts of intragroup transactions.
- The Standards for the Combined Financial Statements become operative for the fiscal year beginning on or after 1 January 1999.

The government has also strengthened the penalties for auditors and management in violation of the Independent Audit Act. An auditor who receives or demands monetary rewards in return for a wrongful request can be punished by a jail term of up to 3 years, or by fines of up to 5 times the relevant economic gains from the audit. In the past, the limit was 3 years or 20 million won. The management or an employee in charge of accounting can be punished for failing to prepare financial statements or for preparing them in violation of the accounting standards by a jail term of up to 2 years (up from 1 year) or by fines of up to 20 million won (up from 5 million won)..

Another major area of improvement is disclosure in the securities market. Listed companies in the Korea Stock Exchange (KSE) are required to submit specific periodic reports to the FSC and the KSE, and to disclose necessary corporate information through the KSE in three major categories:

- Disclosure in the primary market includes the registration statement which should be filed with the FSC and the prospectus which should be provided to investors before the issue. The issuer also has to file with the FSC a report of public offering results.
- Disclosure in the secondary market includes periodic disclosure in the form of annual and semi-annual reports (the annual report must be accompanied by a CPA's audit opinion),[23] and ongoing disclosure of material information which may have a bearing on the company's future performance or its asset value.
- Special disclosures, covering tender offer, merger, divestiture, stock repurchase and sale of the company's own shares, acquisition of block shares (5% rule), share ownership of directors and majority shareholders, and proxy solicitation.

These formal rules of disclosure have been developed over time, so that they conform more or less to the international standards *in form*. However, it is widely recognised that the *quality and substance* of disclosure leave a lot to be desired, especially from the investors' viewpoint. The financial statements often did not accurately represent a company's business and financial health, and important corporate information was sometimes not disclosed in time and in full, or not at all. The problem largely stems from three factors: (a) the corporate insiders did not feel the pressure or need for more adequate disclosure because of the lack of effective governance within and market discipline without; (b) the outside shareholders and investors did not have effective means to redress damages due to inadequate disclosure, since derivative lawsuit was not practically useful and class action lawsuit was not allowed; (c) the penalties for violation of disclose rules were mild,[24] and the regulatory authorities were not aggressive in going after violators.

Since the economic crisis highlighted the deficiencies in disclosure in the securities market, the government has introduced, or is preparing to introduce, several improvements on the disclosure system: [25]

- Quarterly report: From the year 2000, listed companies will be required to submit quarterly reports to the FSC and the KSE. The quarterly reports are not required to be subject to external audit.
- Combined Financial Statements: The 30 largest *chaebols* will be required to report combined financial statements starting from the fiscal year 1999, as described above.
- Electronic Filing System: The FSC is planning to introduce an electronic filing system to lessen the burden on companies for preparing and submitting required reports, and to provide easier access to corporate information for the general public. In the first stage, annual reports and audited financial statements are to be processed through the electronic system. A complete system processing all the required documents is expected to be launched in March, 2000.
- Class Action Lawsuit: The ruling party has recently proposed a bill to introduce the class action lawsuit in the securities market, specifically in cases of untruthful registration statements and annual or semiannual reports, and untruthful tender offer statements.
- Severer Penalties: It has been recently proposed that those who make an untruthful statement of, or omit, material facts will be fined up to 1 billion won, up from the current 5 million won.

NOTES

1 Lucas (1993) even constructed a model for the occurrence of economic miracles based on the Korean growth example.

2 This figure of domestic corporate debt dwarfs the external debt of the corporate sector of 101.6 trillion won, which accounts for only 12.5% of its total debt. In this context, Korea's debt overhang problem, if realised, is more likely to be caused by excessive domestic debt rather than external debt (J.K. Kim, 1999).

3 <Chart I-3> also shows a clear distinction between corporate sectors with low gearing in Anglo-Saxon countries such as the UK and US, and those with high gearing in continental Europe (Germany) and Japan. The relatively high leverage in Germany and Japan can be related to their main bank systems which can help establish risk sharing between creditors and borrowers.

4 In fact, maturity mismatch had been a chronic problem at least since 1995 (Shin and Hahm, 1998).

5 J.K. Kim (1993), and J.K. Kim et al.(1993), Y.J. Cho and J.K. Kim (1995) provide more details on the directed credit programs in Korea.

6 J.K. Kim (1991), Y.J. Cho and J.K. Kim (1995), and K.S. Kim and J.K. Kim (1997) provide more details on the bailout policies in the past.

7 As discussed below, following the August 1972 Emergency Measure, the Korean government introduced various policy measures geared toward reducing debt leverage and improving corporate governance through tightened credit control on large industrialists and incentives for public offering of firms. These measures, however, turned out to have only limited results as the HCI drive was initiated after 1974 with the provision of massive financial support.

8 In contrast, concentration of loans to the top 30 *chaebols* extended from NBFIs is greater than that from DMBs, and has been intensified as NBFIs were subject to less stringent regulations.

9 S.M. Yoo and J.K. Kim (1993).

10 J.K. An (1995).

11 For local banks, there had been no restrictions with respect to ownership structure until 1992 when a 15% ceiling was introduced and has remained at that level up to date.

12 In the system, more than half of board members should be non-executive directors, consisting of representatives of large shareholders (50%), representatives of minor shareholders (30%), and financial specialists (20%). Any person related to one of the 5 largest *chaebols* or institutional investors were not eligible for directorship.

13 Until now, financial institutions in Korea have not adopted mark-to-market accounting for securities, though it is in common use internationally and even in use by domestic corporations.

14 For nationwide commercial banks, the ratio of stocks relative to total assets on-balance sheet accounts rose from 1.8% in 1989 to 3.3% in 1994 when the stock market was quite bullish, but declined to 2.1% in 1997. For the trust account, the ratio, which is carried off-balance sheet, decreased continuously from 9.1% to 3.2% during the same period (Table VII-7).

15 For life-insurance companies, the 5 largest conglomerates were prohibited from newly entering the market and the 6th-10th largest conglomerates were allowed to hold only less than 50% of the equity

since 1996. The restrictions were repealed in February 1997, except the condition that the 5 largest conglomerates wishing to enter the market should acquire 1-2 unsound institutions. For investment trust companies, the 30 largest conglomerates cannot own more than 15% (30% for local trust companies).

16 These standards are the BIS capital adequacy ratio for banks and MBCs, the operational net capital ratio for the securities companies and payment capacity insufficiency ratio for the insurance companies.

17 A reorganisation plan can be proposed by the receiver, creditors, shareholders and debtor firm under the Company Reorganization Act. In practice, however, it is usually prepared by the receiver.

18 The number of cases filed at the Seoul District Court.

19 Three cases (Tong-il group, Kyung-ki Chemical, and Anam Electronics) were filed under the agreement, and all three firms filed for the Company Reorganization procedure.

20 There have been only three cases where the current controlling shareholders or management were stripped of their control of their firm: Dong-A Construction, Keo-pyung, and Dong-Kook Trading.

21 However, these limitations tend to be interpreted not as mandatory, but recommended, provisions by judges.

22 The latest example was the change in the accounting standards in late 1997 for losses in foreign currency-denominated debt due to exchange rate fluctuation.

23 If a company has an affiliate, consolidated financial statements must also be submitted with a CPA's audit opinion.

24 Violation of periodic and ongoing disclosure requirements can be punished by fines up to 5 million won, for example. Also, in no case of violation can the violating company be punished by de-listing.

25 This list is summarised from Choi and Woo (1998).

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CORPORATE RESTRUCTURING IN THAILAND AND KOREA

by
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I. Thailand

Thailand's approach to corporate restructuring has emphasised positive incentives to encourage corporate restructuring. These include the following:

- *Provision of an option for court-supervised reorganisation.* Until mid-1998, Thailand's 1940 Bankruptcy Act had provided only for court-supervised liquidation.
- *Temporary tax relief for debt restructuring.* For a two-year period – from 1 January 1998 until 31 December 1999 – losses from debt restructuring could be deducted by financial institution creditors and gains to the debtor would not represent taxable income.
- *Financial sector regulation and re-capitalisation.* In early 1998, Bank of Thailand (BOT) regulations gave financial institutions until year-end 2000 to recognise all losses from corporate debt restructuring. Moreover, a restructured loan classified as non-performing could be re-classified as performing once the debtor successfully services the restructured loan for 3 successive months. Subsequently, in its 14 August financial sector reform programme, the government committed Baht 300 billion for re-capitalisation of the financial sector and linked the provision of public funds for Tier 2 re-capitalisation to successful corporate restructuring and increased business lending.
- Liberalisation of rules on foreign investment and property ownership.
- Adoption of the "Bangkok rules" for voluntary corporate restructuring.

Negative incentives – i.e., punishment for failure to service debt or co-operate with voluntary workout efforts – remain weak. Court-supervised liquidations are not being pursued. Foreclosure procedures are uncertain and can take 5+ years to conclude. While replacement of management's proposed planner as part of a court-supervised reorganisation might encourage voluntary out-of-court co-operation, two-thirds of creditors would need to agree on replacing the insolvency planner proposed by management. Weak negative incentives have given rise to "strategic defaulters" – those who have the liquidity to service debts but refuse to do so. Their refusal may reflect debtor desires to enhance their bargaining position, hopes of driving the creditor out of business, or concern about their competitive position and future access to working capital.

Process responses in Thailand have focused on monitoring, facilitation, and efforts at arbitration. The Bank of Thailand is upgrading its capacity to monitor non-performing loans (NPLs), monitor progress in high-priority cases, and respond proactively (e.g., by instructing major creditors to convene

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debtor/creditors meetings) to insufficient progress. Associations representing creditors and debtors have formed a Corporate Debt Restructuring Advisory Committee (CDRAC) under the BOT auspices to liaise with debtors and creditors in order to encourage progress and to identify legal, regulatory or procedural impediments to progress on corporate restructuring.[1] Recognising that agreement among major creditors is a prerequisite for voluntary corporate restructuring, financial institution creditors and their trade associations are exploring avenues for arbitrating or otherwise resolving differences among themselves in particular workout cases. Foreign banks, which have substantial exposure to Thai corporates, may differ from Thai institutions in their willingness to take losses. Nevertheless, there is some agreement among financial institutions that 75% is a reasonable threshold for creditor agreement on a voluntary workout and that cases where there is 50-75% agreement could be submitted to a three-person arbitration panel – at least on a case-by-case basis.[2]

By year-end 1998, non-performing loans at 13 Thai banks had reached Baht 2.4 trillion – or 54 % of outstanding loans.[3] A large number of smaller loans to businesses and individuals account for about half of these NPLs, as indicated in Table 1.

Table 1: 1998 NPLs at Thai Banks

Loan Size	Number of Cases	Percent of NPLs
Over Baht 500 million	300	25%
Baht 100-500 million	1300	25%
Under Baht 100 million	Almost 500,000 (including 40,000 firms)	50%

Source: BOT

Recent developments suggest that Thailand is beginning to make progress on corporate restructuring. On February 2nd, creditors approved the first court-supervised reorganisation – for Alphatec, which will be taken over by AIG and Investor (Sweden). By late February, voluntary restructurings had been announced for UCOM (US$570 million in debt) and negotiations were complete (or nearly so) for TPI (US$3 billion in debt) and Sri Thai (US$120 million in debt). Box 1 summarises key terms of the UCOM deal. According to the BOT, negotiations have been completed on 53 of 200 high-priority cases. It is also noteworthy that Thailand attracted US$7.6 billion in foreign direct investment in 1998, including US$5.5 billion for industry and US$2.1 billion as part of bank recapitalisations. This substantially exceeds the 1997 total of US$3.6 billion. While the progress on larger cases is encouraging, the composition of NPLs indicates a greater need for Thai banks to address SME indebtedness.

Box 1. Voluntary Restructuring of UCOM

Twenty-eight major creditors have agreed with UCOM management to restructure US$570 million in debt. US$120 million in convertible bonds will be converted into equity. As a result, these creditors will hold 43% of UCOM's shares while current controlling shareholders will be diluted from 40% to 22%. The remaining US$450 million in debt is to be paid off by year-end 2003. The agreement contains additional covenants limiting the liabilities/equity ratios of affiliated companies (including the local participant in the Iridium consortium); requiring operating cash flows to equal or exceed interest expense after 31 December 2001; and limiting dividend payouts until this restructuring has been fully implemented.

Source: Bangkok Post

II. Korea

Corporate restructuring in Korea

Reform bills passed by the National Assembly in February 1998 included many positive incentives to promote corporate restructuring:

- *Tax Exemption and Reduction Control Act* – provides tax breaks for company restructuring, including exemption of SMEs from capital gains on the sale of real estate used to repay debt to financial institutions and for real estate transfers through M&A transactions.

- *Bank Act* – increases the limit on bank ownership of a corporation's equity from 10% to 15%, or higher, with approval of the Financial Supervisory Commission (FSC).

- *Corporation Tax Act* – advances non-deductibility of interest on "excessive" debt by two years (from 2002 to 2000).

- *Foreign Direct Investment and Foreign Capital Inducement Act* – permits takeovers of non-strategic companies by foreign investors without government approval and raises from 10% to 33% the shares that a foreign investor can acquire without board approval (subsequently further liberalised).

- *Antitrust and Fair Trade Act* – prohibits any new cross guarantees and eliminates existing cross guarantees by March 2000.

In addition, the FSC has maintained relatively relaxed rules on accounting for restructured debt. These have made it easier for Korean banks to negotiate substantial rate reductions and conversions of debt into equity or low-yield convertible bonds.

Negative incentives punishing failure to service debt or co-operate with voluntary restructuring include a credible threat of bankruptcy/foreclosure and Fair Trade Commission (FTC) investigations of intra-*chaebol* transactions. In February 1998, the National Assembly passed three measures to reform Korea's insolvency regime:

- *Bankruptcy Act* – concentrates authority over insolvency cases in district courts.

- *Composition Act* – introduces an administrator for asset preservation, requires debtors to report on implementation, and requires creditors to evaluate debtor implementation.

- *Reorganization Act* – establishes expedited deadlines, promotes specialisation within the courts, and strengthens creditors by recognising creditors' committees.

Even prior to these reforms, the deterrent effect of bankruptcy/foreclosure was established as a result of 13 *chaebol* insolvencies which occurred in 1997. Including such large cases as Kia and Halla, these 13 cases cumulatively involved about 47 trillion won in assets and 28 trillion won in debt. In at least ten of the cases listed in Table 2, the *chaebol* was placed under court receivership which typically involves replacing management with a court-appointed administrator. Such examples involving loss of control and ownership can provide a powerful example and incentive for other companies to co-operate with voluntary workout efforts.

Table 2: Insolvent *Chaebol*
(in billion won)

Chaebol	Assets	Debt	Status
Hanbo	4,470	4,091	Court receivership; sale underway
Sammi	2,515	875	Court receivership
Jinro	3,898	1,917	Composition
Daenong	1,759	1,172	Court receivership
Hanshin Construction	1,326	502	Court receivership
Kia	14,186	6,624	Sold to Hyundai
Ssangbangwool	1,420	595	Court receivership
Taeil Media	1,102	588	Composition
Haitai	3,397	3,046	Court receivership; sale underway
New Core	2,803	1,215	Applied for court receivership
Soosan Heavy	1,267	639	Court receivership
Halla	6,627	6,453	Court receivership
Chunggu	1,897	728	Court receivership
Total	**46,667**	**28,445**	

Source: Goldman Sachs, YS Jung

In addition, the FTC has conducted two rounds of investigating transactions among the affiliates of the top 5 *chaebols*: 80 affiliates in the first round and 40 in the second. The FTC imposed penalties of 72 billion won in the first round and 21 billion won in the second. In the first round, the FTC found over 4 trillion won in improper transactions. According to the FTC, these included unfair support to affiliates through the purchase of commercial paper and subordinated debt at below-market rates (i.e., above-market prices) and payment of above-market prices for rent and real estate.

The government has used or supported a number of processes to promote corporate restructuring. While Lead Banks are responsible for leading voluntary workout efforts, the FSC indirectly drives corporate restructuring through its powers to regulate and supervise Korean financial institutions. At the FSC's encouragement, 210 financial institutions entered into a Corporate Restructuring Agreement (CRA) in July 1998, which requires the following:

- Conclusion of voluntary workout agreements within 3-6 months after an initial standstill;
- Selection by CRA signatories of a 7-person Corporate Restructuring Coordination Committee to arbitrate inter-creditor disagreements;
- Establishment of a 75% threshold for creditor approval of any voluntary workout;
- Submission of proposed workouts that lack 75% approval to the CRCC for arbitration; and
- Significant penalties for violation of the CRA, including failure to honour CRCC arbitration decisions.

Additional examples of indirect promotion by the government of corporate restructuring include the FSC requirements for each *chaebol* seeking a new loan or a loan roll-over to develop and implement a capital structure improvement programme (CSIP), for banks to identify and exit from non-viable *chaebol* affiliates,[4] and for financial institutions to limit their holdings of *chaebol* debentures and commercial paper. Government proposals for the sale or merger of the top 5 *chaebol* affiliates in sectors suffering from over-capacity (i.e., the "Big Deals") represent an attempt at more directly influencing corporate restructuring.[5]

Table 3 summarises identifiable large corporate restructuring as of end 1998. Over US$61 billion in *chaebol* restructuring transactions were completed or – in the case of insolvent *chaebols* still under court supervision – underway as of end 1998. This total excludes labour reductions and other cost savings that would subsequently appear on income statements. Of the US$61 billion, about one-third represents the debt of insolvent *chaebols*, which has been resolved (e.g., the sale of Kia to Hyundai) or is proceeding under court supervision, while the remaining two-thirds has occurred as a result of voluntary restructuring. Although the 6-64 *chaebols* held only 43% of 1997 assets, the 6-64 *chaebols* account for three-quarters of corporate restructuring transactions. All 13 *chaebol* insolvencies, representing 28.4 trillion won (US$20.3 billion) in debt, have occurred among the 6-64 *chaebols*. The 6-64 *chaebols* accounted for 66% of business/asset sales for the first 9 months of 1998 and all of the troubled debt restructuring agreed under the CRA procedures. Thus it appears that the top 5 *chaebols* have managed to float over Korea's corporate distress. Indeed, the top 5 *chaebols*' ability to absorb 80% of the proceeds from bond and equity offerings during the first – respectively – 6 and 9 months of 1998 suggest that the top 5 *chaebols* will emerge from the crisis in a stronger position *vis-à-vis* the 6-64 *chaebols*.

Table 3: Summary of Selected *Chaebol* Restructuring
(in US$ billions)

Chaebol #	Share of YE97 Assets	Debt in Court-Supervised Insolvencies (1997)	Voluntary Restructuring			Total
			Business & Asset Sales (9 mos. 98)	Equity & Bond Issues (6-9 mos. 98)	Troubled Debt Restructuring (Oct-Dec 98)	
Top 5	57%	0.0	2.6	12.8	0.0	15.4
6-64	43%	20.3	5.0	3.2	17.5	46.0
Total	100%	20.3	7.6	16.0	17.5	61.4

Source: Goldman Sachs and author's estimates

Troubled debt restructuring under the CRA provisions represents about 45% of voluntary restructuring in 1998. Almost all of the CRA workouts have been concluded since October. Approximately 24.5 trillion won (US$17.5 billion) in the debt of 31 affiliates from 12 *chaebol*s plus 19 other companies was restructured in these deals. Table 4 summarises the application of alternative debt restructuring methods in these deals to the different types of pre-workout debt.

Table 4: Troubled Debt Restructuring Through End 1998

Method	Portion of Total Debt Restructured	Application
Rate Reduction	69%	Secured Debt
Debt/Equity Conversion	5%	Unsecured Debt
Conversion to Convertible Bonds	7%	Unsecured Debt
Interest Exemption	15%	Cross Guaranteed Debt
Forgiveness of Principal	2%	Cross Guaranteed Debt
Term Extension	2%	Various
	100%	

Source: Author's estimates

As indicated above, just over two-thirds of the CRA debt restructuring involves rate reductions – typically from about 16.5% to prime – along with deferrals on principal repayment and deferral/capitalisation of interest payments. Another 12% represents conversion of debt into equity or into low-yielding convertible bonds (CBs). Only 2% of the troubled debt has been forgiven. Thus, it appears that debt forgiveness has been the last resort while conversion of debt into equity or CBs has been the next-to-last resort.

Debt/equity swaps are expected to significantly dilute controlling shareholders. At one *chaebol,* the equity interest of controlling shareholders may be cut from 30% to 2-3%. At another, the equity interest of controlling shareholders in two remaining affiliates could be reduced from 50-58% to 25%.[6]

In many or all of these debt/equity swaps, it appears that all new financial institution shareholders would have to agree before any could sell converted equity. It is argued that this is necessary to protect the controlling equity interests acquired by banks and to preserve a share block for potential sale to a strategic investor. But this practice also serves to obscure the value of non-tradable converted equity and insulate management from potentially activist investors. Banks seem inclined not to interfere so long as the current managements meet quarterly business targets.

A final issue has to do with accounting for restructured debt. Lenient provisioning regulations have encouraged banks to undertake initial debt restructuring. Especially now that initial debt restructuring deals have been completed, it would be appropriate to tighten regulations on accounting for restructured debt.

Inevitability of debt/equity swaps

While operational restructuring (e.g., business and asset sales) and equity-raising efforts have been significant, the corporate debt overhang and the saturation of asset and equity markets have made debt/equity swaps inevitable. It is simply not feasible to reduce leverage to sustainable levels in a timely manner through business/asset sales and new equity issues alone. Table 5 summarises one set of projections on the challenges the top 30 *chaebols* would face in climbing down from mid-1998 leverage to a liabilities/equity ratio of 200 % by end 1999.

Assuming the projections in Table 5 represent the maximum amounts that can be raised from asset sales and new equity issues, substantial debt/equity conversions and/or debt forgiveness would be required to reach liabilities/equity ratios of 200%.

Table 5. Projected Change in Top 30 Leverage
(amounts in trillion won)

	Assets	Liabilities	Equity	Leverage
At 6.30.98	***435***	***360***	***75***	***478%***
Incremental effects:				
Asset/business sales	(26)	(26)		
New equity issues		(10)	10	
FX effects	(6)	(6)		
Big Deals and exits	(34)	(34)		
Remaining at 12.31.99	***369***	***284***	***85***	***334%***

Source: Goldman Sachs

Mechanisms to exit or manage converted equity

Whether or not debt/equity swaps are inevitable, Korean financial institutions are in fact becoming major corporate shareholders. Debt/equity swaps feature prominently in the 12 *chaebol* restructurings negotiated under the CRA auspices as of Year-End 1998.

Financial institutions in the region are stressed enough without having also to manage the follow-on operational restructuring of corporations in which they hold shares and to exercise effective corporate governance. This suggests a need for mechanisms by which financial institution shareholders in distressed corporates can exit from or more effectively manage converted equity. Exit/management options include the following:

- Pre-conversion sale of distressed debt;
- Sale of converted equity;
- "Warehousing" of converted equity in a vehicle (e.g., trust or partnership) managed by professionals appropriately compensated on an incentive basis; or
- Retention by Standing Ex-Creditors Committee of advisors to maximise the value of converted shares and to oversee corporate management.

The apparent inevitability of debt/equity swaps and the fact that swaps are underway heighten the urgency of developing effective exit/management mechanisms.

It is also important to develop norms and regulations for financial institution accounting for converted equity and for related-party transactions (e.g., lending) between financial institutions and corporations in which these financial institutions hold shares.

III. General conclusions

- Realignments of ownership structures are occurring as a result of insolvencies, business sales, foreign investment, new equity issues, debt/equity swaps, and spin-offs.
- The volume of corporate distress necessitates heavy reliance on voluntary workouts. Reliance solely on court-supervised insolvencies would otherwise overwhelm existing institutional capacity (e.g., courts, administrators, insolvency professionals).
- Positive incentives (e.g., tax breaks, liberalisation of foreign investment) are not enough to induce an adequate volume of voluntary corporate restructuring on a timely basis.
- A credible threat of court-supervised insolvency (including ready replacement of management) and foreclosure encourages debtors to co-operate with voluntary restructuring.
- Direct government pressure on debtors (e.g., investigations of related-party transactions for violating the rights of public shareholders) and indirect pressure by supervisors via financial institutions (e.g., Capital Structure Improvement Plans and mandated exits) can encourage voluntary restructuring.

– Substantial debt/equity swaps are inevitable given the magnitude of corporate indebtedness and the saturation of asset and equity markets. Such next-to-last resort transactions can buy time to do more fundamental operational restructuring and more "up market" corporate finance transactions.

– Ongoing debt/equity swaps are creating an immediate need for exit/management mechanisms for the financial institutions that are becoming holders of converted equity. In addition, debt/equity swaps raise accounting and other prudential regulatory issues for financial institutions. These issues should be addressed in a timely manner so as to support ongoing corporate restructuring, enhanced corporate governance and competitiveness, and avoidance of future corporate crises.

NOTES

1 CDRAC is chaired by the BOT Governor and includes representatives from the Board of Trade, Federation of Thai Industries, Thai Bankers' Association, Association of Finance Companies, and Foreign Bankers' Association.

2 Arbitration procedures are still under consideration. A financial institution creditor could agree, for instance, to allow an arbitration option for all cases or for specified cases.

3 Bangkok Post, 26 February 1999.

4 In June 1998, banks identified 55 chaebol affiliates as non-viable and designated for exit.

5 These sectors are: oil refining, petrochemicals, aircraft, rolling stock, marine engines, power generation facilities, semiconductors, automobiles, and electronics.

6 Actual dilution will depend on market prices for these shares at the time of conversion.

CHAEBOL REFORM: THE MISSING AGENDA IN CORPORATE GOVERNANCE

by
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Introduction

A comparative perspective is important not only for bringing together the views and experiences of different countries, but also for presenting the perspectives of different actors who have a role or stake in a given issue. It can reveal different experiences, approaches, achievements and shortcomings that are vital in building the foundation of a successful outcome. That is why it is important to bring together the voices and perspectives of many diverse actors. This means that discussions about and reaching decisions on corporate governance should not be limited to 'technical' or 'expert' practitioners, but should also involve the various political and social actors who are not only affected by the outcome, but also have a legitimate stake in shaping and validating the outcome.

Why the concern about corporate governance?

Why are we or should we be concerned about corporate governance? Why should a government be concerned about corporate governance? Why should a society be concerned about it? Shouldn't this be a matter for business or firms – and those people who run them? Even if corporate governance should be of their concern, workers have a natural right and responsibility to be also concerned about it. Who would be more closely involved in this issue concerning the health of companies than the workers whose livelihood is linked to them?

Corporate governance is an issue that is vital for the welfare of not only the owners and shareholders of companies, but also of workers and people in society as a whole. This may be well noted, but all of us need to be reminded that some crucial facets of corporate governance are determined by laws enacted by the legislature representing the sovereign and democratic will of the people of the land. Why corporate governance is and should be a concern of the people is demonstrated most amply and painfully by the crisis that has wreaked disastrous damage upon the economy and society – and the people.

The issue of corporate governance in the context of the currency, financial and economic crisis in Korea – which has brought about a massive social crisis, as highlighted by the five-fold increase in unemployment – can only be understood in the context of overall reform needs. The issue of corporate governance in Korea is part of the agenda for reform of the *chaebol* structure and system. Furthermore, debates and efforts on this front cannot be effective without a comprehensive "attack" on the system that has sustained the malpractice of *chaebols*. Without reforming the system of corruption

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and ‘insider’ dealings that link the government and its various bureaucratic agencies, personnel, politicians, banks, and *chaebol* firms, all the talk of "corporate governance" is meaningless.

Furthermore, the discussion and efforts for reform of corporate governance cannot turn a blind eye to the global economic reality in which massive financial capital moves around the globe - second by second or minute by minute - in search of transaction profits without any regard for the long-term development needs of a national economy. A debate and effort dedicated to corporate governance that fail to address the "political" dimension and issue of international financial capital can only, at best, result in temporary band-aid measures. It is nevertheless necessary to identify some issues specific to the corporate governance agenda.

The three aspects of *chaebol* reform

- Internal structural reform - modernising task;

- External structural reform - dismantling the dictatorial monopoly over the national economy; confronting unfair competition and monopoly dominance; and

- Resolving problem of "over-investment".

Korean *chaebols* are characterised by dynastic control obtained and exercised by the chief owner. In themselves, "owner-manager" systems may not be necessarily bad, but as *chaebols* have grown in size and scope and have become actors in a globalised environment, and as the power of the founder-owners is passed on to their children, they have come to represent something totally different from the early days. A *chaebol* owner is different from owners of SMEs: a *chaebol* owner-chief exercises unchallenged and unaccountable control over a network of companies whose total asset is 40 to 50 times the capital he has actually invested. This is not just a problem for the vast pool of minority shareholders who have no say in what the owner-chief (controlling single largest shareholder) does. The *chaebol* owner-chiefs are in fact "trustees" of the wealth and assets of the whole nation and its people, and the inability and corruption of a *chaebol* chief are not just a personal problem or a problem for his company, but a problem for all the people. Therefore, a *chaebol* firm must be endowed with structures and mechanisms of transparency, responsibility, accountability, and participation. The agenda of dismantling the dynastic control calls for employee participation in the management decision making process, expansion of employee shareholdership, outside members in the board of directors, and auditors-inspectors who represent the interest of the stakeholders.

The dominance of *chaebol* firms has suffocated the development of SMEs and brought on a gross imbalance in the national economy. This was exasperated by recent developments where the power of *chaebols* has surpassed the capacity of the government and banks, resulting in weaker institutional control and influence.

In the earlier period - from the 1960s to mid-1980s - *chaebol* firms were confined by external governmental control exercised through a network of government-banks-*chaebols* that had been built up to meet the imperative of export-led development. Since the mid-1980s, the government was progressively out-manoeuvred and out-paced in terms of capacity and will by *chaebols.* They became more powerful and had greater access to opportunities that lay beyond government control. At the same time, the government – in the course of transition towards more democracy -- failed to obtain or build a new basis of legitimacy and regulatory regime with effective democratic procedural instruments. Banks – nurtured by state directives and sponsorship – also failed to meet the challenge posed by newly empowered *chaebols.*

This new situation saw the rapid expansion and unchallenged consolidation of *chaebols*. The commodity and capital markets – for a long time shaped by protection and regulation mandated by the export-led development network and consensus – were not in a position to exercise a check on the *chaebols* going out of control.

The combination of one-man rule typical of the *chaebol* structure and the absence of control mechanisms gave rise, on one hand, to irrational expansion, diversification and over-stretching, and on the other, to deep-rooted unfair competition, insider trading and corruption. The result is an economy and people held hostage by *chaebols* – which are too big and explosive to be allowed to fall out of the system or die. The dominance of the economy by *chaebols* is dangerous not only for the economy but also for the nation. This has to be checked and a new healthy balance must be restored to the system. Internal reform of the *chaebol* structure – removing the dynastic control exercised by the owners-managers – lies at the heart of any effort to redress the problem as a whole. This will also pave the way for restoring the balance in the government-bank-firm relationship. In the new configuration, however, the government cannot base its relationship with banks and firms on military-dictatorial power, aided by bureaucratic-technocratic rationalism, as before, but on democratic and societal consensus, principles, and participatory processes.

The reform of the *chaebol* system and structure must also address the problem of over-investment. This problem has arisen from the internal logic of the *chaebol* system, spurred on by some of its defining characteristics: the pursuit of "profit of control" and the second-generation complex (a syndrome created by the ambition of the founder-chiefs' children, who have inherited total control, to demonstrate their "worth"); moral hazard; and competition for self-aggrandisement.

The problem of natural or cyclical over-investment – accentuated by capital-intensive activities – has taken on colossal dimensions as *chaebols* have become dinosaur monopolies with a will and power to hold the entire system hostage for their own survival. Over-investment results in over-capacity and a declining rate of profit. While efforts to deal with the problem of over-capacity focus on the size of the workforce and facilities, a declining rate of profit may require value destruction, such as selling firms at below the rate or debt forgiveness. Any of these efforts naturally gives rise to tension and conflict among firms, banks, workers, shareholders, and citizens, each of them endeavouring to minimise the loss that may be incurred in the process. The question is how the burden is to be shared.

The outcome: no progress

The Korean government’s efforts – propelled by the prescription and close monitoring of the IMF and World Bank - to bring about a reform of the *chaebol* structure and system has been a mixed bag of classical liberal and neo-liberal measures, as well as measures typical of developmental dictatorships. Globally, on one hand, the government has failed to institute a new mode of regulations and processes to realise reform and support corporate governance, and on the other, in actually obtaining the necessary outcomes.

In order to address the internal aspects of the *chaebol* problem, the government has introduced a number of measures, including: the adoption of a consolidated accounting system *(kyulhapjaemujepyo* system) and international accounting principles; establishing auditing committees and strengthening the accountability of directors; the appointment of outside-the-company members for the board of directors; lifting the limitation on the voting rights of institutional investors and strengthening the rights of minority shareholders; and the introduction of a system of class action. As for the external aspects of the *chaebol* problem, strengthening the power of the Fair Trade Commission is seen as one mechanism for controlling the outward behaviour of *chaebol* firms.

As part of the prescriptions for diffusing the over-investment problem of the *chaebol* system, the IMF/WB demanded the liberalisation of mergers and acquisitions, and foreign investment, the prohibition of cross loan guarantees, as well as measures for greater labour market flexibility (making it easier to dismiss workers on the ground of redundancy).

The measures aimed at the internal aspects of *chaebol* reform are limited to inducing responsible and transparent management. The government has made some efforts to remove "dictatorial" aspects, but without addressing the issue of "dynasty" that characterises the Korean *chaebol* system. As long as the dynastic power remains intact, it will be difficult to institute a process and mechanism for selecting qualified, or replacing discredited, management.

Government efforts have not penetrated the core problem of the *chaebol* system. While the government allowed creditors to seize the governance rights of smaller *chaebol* firms that were allowed to undertake debt-equity swap, bringing about cases where the existing owner-chiefs lost the managerial rights or were permitted to hold on to them conditionally, the "big five" were made immune from this process. For the "big five", debt-equity swap did not loosen the owner-chiefs' grip; instead, the various measures, including the new capitalisation programmes, have in fact turned into special privileges, allowing the existing chiefs to strengthen their hold.

Furthermore, the *chaebol* reform pursued by the government has not encouraged employee participation in ownership and management, as the debt-equity swap did not provide a priority option for employees or citizens in general, or any other special arrangement for employee participation.

An assertive effort to address the "moral" or "political" aspects of diluting the owner-chiefs' power would have enhanced the spirit of pain sharing and responsibility sharing. In addition, this could have created a better environment for stimulus measures. As for external reform – reforming the mechanisms to control the outward behaviour of *chaebol* firms – the government has focused on the independent management of individual member firms of *chaebol* groups. However, the Financial Supervisory Commission insists that its three-stage measure aiming for *chaebols* to become an alliance of independent companies is not a project to "dismember" the *chaebol* system.

It would be difficult to expect real independence of individual companies in a *chaebol* group while the power of the owner-chief remains intact. Furthermore, legislation allowing the formation of holding companies – while the power of "owner-chiefs" is untouched – is tantamount to giving a blessing to the power and position of the owner-chiefs.

The dominant position of *chaebols* in the economy is likely to be further strengthened due to the unhindered transfer of burden to the SMEs or their sub-contractors. In addition, *chaebols* are expected to come out as the biggest winners in the restructuring and reform of public corporations and utilities that will be brought to market to be sold.

The effort to redress over-investment focuses on establishing internationally capable "national champions". It calls on *chaebols* to get rid of non-performing member companies to be able to concentrate their energies on core firms.

However, many of the IMF/WB prescriptions were informed by the need to guarantee the repayment of debt and removing some of the obstacles for the takeover of Korean firms. It is not difficult to imagine that the measures for the retrenchment of domestic production facilities were, in part, designed to bring about a localised adjustment of global production over-capacity at Korea’s expense.

In the days before the crisis, the term *chaebol* referred to the top 30 *chaebol* groups. But, in the course of the various adjustment processes prompted by the crisis and the IMF/WB-prescribed measures, the ranks of *chaebol* were stratified into two categories: the "big five" and the rest. It does not take much analysis to find differences in how the government has treated the two classes of *chaebols.*

The reform efforts have had little or no effect on the major five *chaebol*s. The companies belonging to the five largest *chaebols* listed on the stock exchange make up some 40% of the total assets of all listed companies. A total of 343 cases of restructuring took place among listed companies in 1998. This involved some 111 trillion won in assets. However, restructuring of members of the "big five" was limited to 38 cases representing 3.5 trillion won – 3.2% of the total assets involved.

In December 1999, the owner-chiefs of the "big five" agreed with President Kim Dae Jung to reduce the number of member companies. The total contribution of these targeted companies to the total revenue of each of the *chaebol* families ranges between 0.2% to 10.4%. Furthermore, a reduction of debt-equity ratio to 200% is expected either to die out, or to be undertaken through asset re-evaluation or issuing new stocks (which will be swooped up by member companies to keep control within the family). Five companies from the "big five" were made subject to debt-equity swap, but the government allowed the existing owner-chiefs to maintain management rights.

The austerity measures also contributed to the concentration and greater dominance of the "big five". This is evident in the fact that more than 80% of new equity issues and 70-80% of new CP issues were undertaken by the "big five", monopolising the available funds at a time when all companies were suffocating in the credit squeeze. The predilection for macro-economic financial austerity rather than micro-level credit rationing as an instrument to enforce restructuring has, in fact, brought about the reverse of the desired effect.

In addition, the big five *chaebol* groups refused resolutely to make any effort, such as abolishing or selling excess facilities, that could result in loss of capital. Instead, they insisted on reducing the workforce, increasing work intensity, and cutting wages. This resistance blocked all hopes for genuine reform and restructuring of the *chaebol* system and diffusion of over-investment, and at the same time aggravated the suffering of workers and the credit crunch for all other companies.

The government’s inability or unwillingness to address the issue of the ownership-governance structure has pressured it to opt for "big deal" neo-developmental dictatorship measures – forcing the swap of companies. This has had the effect of distorting whole parameters of corporate restructuring and causing unnecessary problems. Furthermore, the "big deal" will be assisted by various facilitating privileges, such as debt-equity swap, debt forgiveness and, perhaps, the first option for future privatisation of large public corporations. The whole process does not consider the responsibility of the owner-chiefs to inject their personal wealth to settle debt incurred by their "companies" nor their withdrawal from management, and leaves the question of moral hazard untouched.

The whole process fails to satisfy the criteria of fairness and burden sharing. In addition, the “big deal” measures may not be effective in diffusing the whole problem of over-investment.

Concluding remarks: changing the matrix of interaction

The government-promoted corporate restructuring fails to embrace employee participation as an integral part of ownership and management. Furthermore, workers are excluded from the whole decision making process of restructuring and are severely disadvantaged in the burden sharing matrix. Workers are not allowed any kind of "ownership" of the process. They are asked just to bear with it and shoulder all the burden generated by the process and its outcome. They have been placed in a situation where they are forced to act purely in reaction - as "unavoidably affected victims - to the process that was created and undertaken without their participation; it is their natural and just response to resist a change which has ill-effects on their welfare and rights.

This distortion of the reform process has brought an unfortunate shift in the parameters of interactions surrounding the reform of the economic system, precipitating the economic crisis.

The government's legal action in 1998 against some 500 trade unionists – including some 280 workers actually imprisoned – is the outcome of reform that has gone wrong. The situation may not change in the near future, as the government continues to warn and threaten labour with "punishment" for any form of resistance or actions to assert its just place in the reform process.

Labour is aware of the need for a radical overhaul of the Korean economic system. As its biggest victim, the one with most at stake, and not being able to move freely about to find better pastures, labour is the most ardent proponent of genuine reform. Labour's aim is to readjust the parameters of the change and reform so that it gains just and fair ownership in the process and the outcome. What needs to change first is the attitude which seeks to exclude labour because, among other things, of a fear that its participation may have possible disruptive effects. As history has shown, this is the most dangerous kind of self-fulfilling prophecy.

CORPORATE GOVERNANCE IN THE SPECIAL ADMINISTRATIVE REGION OF HONG KONG

The Securities and Futures Commission of Hong Kong, China

I. Introduction and summary

Impact of South East Asian financial crisis

As a small open economy and a financial centre in the region, it is not surprising that the Hong Kong economy slackened in 1998 upon the profound repercussions of the regional financial turmoil. While exports of goods and services were hit by the sharp shrinkage in regional import demand, local consumer and investment demand both fell amidst a tighter liquidity and marked correction in the asset markets. GDP thus showed a contraction in 1998. Yet the Hong Kong economy has been adjusting to these shocks expeditiously, with the internal cost and prices coming down promptly, and the combined visible and invisible trade account reverting to surplus in the latter part of the year.

There are other positive signs emerging in the Hong Kong economy since late 1998, including improved liquidity from the earlier tight situation, and rebound in share .prices and flat prices. Externally, the regional financial markets also seemed to have stabilised, upon the easing in US interest rates and the rebound in yen. An improved sentiment should yield some beneficial effect on local demand over the course of 1999.

Corporate governance characteristics of Hong Kong

Over 80% of listed companies in Hong Kong are controlled by a single or family shareholder with a stake of 35% or more of the equity share capital. The banking sector is independent and is neither controlled by nor controls other sectors.

Over the five years to 1997, the Hong Kong stock market raised more equity capital than any other market in Asia. Between 1993 and 1998 the market raised HK$564 billion (US$73 billion). The total market capitalisation of the Hong Kong stock market at 31 December 1998 was HK$2,662 billion (US$341 billion). The 33 companies that comprise the Hang Seng Index made up 79% of this value.

Corporate behaviour, finance and restructuring

The market correction following the South East Asian financial crisis has reduced price earnings ratio. However, the correction was not as severe as that seen in the region generally.

Hong Kong companies do not have significant levels of debt. Levels of non-performing loans as reported to the Monetary Authority are significantly higher than in previous periods and are expected to increase. However, the amounts are particularly low in comparison with other Asian countries. At 30 September 1998, the level of overdue and rescheduled loans of local banks was less than 4%.

Equitable treatment of shareholders

The high incidence of companies controlled by a family raises concerns about the absence of checks and balances found in companies where shareholders are distinct from management. In a number of cases these shareholders also have other business interests and there are concerns that business dealings between listed companies and their controlling shareholders may not be in the best interest of all shareholders. These concerns have been recognised for some time and are covered by the SEHK rules. Many companies listed in Hong Kong are incorporated offshore. Hence the burden of protecting minority shareholders falls on non-statutory rules such as Listing Rules and the Takeovers Code.

The Listing Rules oblige directors of a listed company to fulfil fiduciary duties of skill and diligence to standard at least commensurate with the standards established by Hong Kong law. The Listing Rules includes the Code of Best Practice for listed companies.

Transparency

Hong Kong accounting standards are based on the International Accounting Standards. Independent audits have been required for many years. Requirements for independence are based on those of the UK, and auditing standards are based on International Standards on Auditing.

In response to the recent crisis, the Exchange has issued a public consultation paper proposing enhancements to financial disclosure.

II. The corporate governance environment in Hong Kong and its impact on corporate performance and finance

General economic context

Background

Over the past two decades, the Hong Kong economy has more than tripled in scale. Hong Kong's GDP has been growing at an average annual rate of about 7% in real terms, twice as fast as the world economy. Per capita GDP in Hong Kong reached US$26,700 in 1997, next only to that of Japan and Singapore within Asia.

Over that period, the Hong Kong economy has undergone a profound structural change from manufacturing to services, along with the open-door policy and economic reforms in the Mainland, which have not only provided a huge production hinterland for local manufacturers, but have also created an abundance of business opportunities for a wide range of service activities in Hong Kong. Indicative of this development, the contribution of the service sector as a whole to GDP rose steadily, from around 67% in 1980 to 84% in 1996.

Hong Kong is now the world's 8th largest trading entity in terms of trade in goods, and the 11th largest in terms of trade in services. Its total trade in goods reached HK$3,075 billion (US$397 billion) in 1997, or 229% of the GDP. With service trade also taken into account, the ratio is even higher, at 263% in 1997 (see Annex I).

Impact of the South East Asian financial crisis on the Hong Kong economy

The Hong Kong economy, however, suffered a downturn in 1998, overshadowed by the profound contagion effect that arose from the volatility in the regional financial markets causing a surge in local interest rates. The tighter liquidity and the sharp corrections in the asset markets that ensued led to the contraction in both consumer and investment demand that year .Export performance was also hit by the sharp shrinkage in import demand in Japan and East Asia. Hong Kong's GDP thus contracted by around 5% in real terms in the first three quarters of 1998 compared with 1997 (see Annex II).

Yet the Hong Kong economy adjusted to these shocks promptly. Office and flat rentals fell sharply. Wages and salaries eased. With flexibility in the internal cost and price structure, the cost of doing business was able to come down at a remarkably rapid pace during the year. The adjustment process also brought about a significant improvement in external balance, with the visible and invisible trade account reverting to surplus in the third quarter of 1998. In June 1998, the government announced a package of special relief measures, including a moratorium on land sales, a rates refund, a cut in diesel duty, a reduction in export declaration charges and the introduction of a special finance scheme for small and medium enterprises. This package was estimated to cost HK$32 billion and was expected to turn the originally budgeted surplus for the year of HK$11 billion to a deficit of HK$21 billion.

Main causes of the economic downturn in Hong Kong

It is not difficult to see that the abrupt downturn in the economy was mainly a result of the contagion effect from the regional financial turmoil.

The increased volatility in the regional financial markets caused a higher regional risk premium, resulting in a surge in local interest rates which in turn severely hit the asset markets, and hence overall domestic demand.

As a small open economy heavily dependent on external trade, with total trade in goods and services accounting for 263% of its GDP, the Hong Kong economy is inevitably dampened by the sharp shrinkage in regional trade flows in both goods and services following the outbreak of regional financial turmoil.

As one of the major financial centres in the world, and particularly in the region, Hong Kong cannot be immune from the shocks and volatilities in the financial market emanating from the region and beyond. The impact on financial market related service industries was particularly pronounced.

Impact of the financial crisis on the banking sector

The banking sector in Hong Kong has demonstrated resilience against the backdrop of the Asian financial crisis. Banks have remained fundamentally strong, notwithstanding an increase in overdue loans, lower profitability and intense competition for deposits. Local banks continued to make profits although at a lower level as compared with 1997. Despite expectations of further deterioration in asset quality and profitability in the short term, this should not be a cause for concern in terms of systemic stability because banks remain highly capitalised and liquid. The average capital adequacy ratio of local banks was 18.6% and their problem loans ratio was 4.9% as of September 1998. While banks will face a tough year ahead in 1999, this is more an issue of profitability than solvency. There are positive signs that local market conditions have begun to stabilise. The interbank market is now less susceptible to manipulation and interest rates have come down significantly in recent months.

As Hong Kong's banking supervisory system compares well with international standards and has a high standard of transparency in terms of financial disclosure, this has contributed to a stable banking sector and minimised market uncertainty and contagion.

The government's response to the crisis and recent economic developments

The several packages of relief measures put out by the government in May and June 1998 helped alleviate the pressures faced during the economic adjustment process. The packages of seven technical measures announced by HKMA and 30 regulatory measures by FSB in early September 1998 helped enhance the robustness of the linked exchange rate system, reduce volatility in local interest rates, and strengthen the local stock and futures markets. Indeed, local interest rates eased steadily in the ensuing months, further aided by the cut in US interest rates. Reflecting the improvement in market sentiment, the rate differentials between 1-month and 3-month HIBOR and their US dollar counterparts narrowed significantly, down from around 690 bps in early September to 7 bps and 19 bps respectively at end-1998.

Apart from the easing in local interest rates, there are other positive signs emerging in the Hong Kong economy since late 1998, including improved liquidity from the earlier tight situation, and rebound in share prices and flat prices. Externally, the regional financial markets also seem to have stabilised upon the easing in US interest rates and the rebound in yen. An improved sentiment should yield some beneficial effect on local demand over the course of 1999.

The corporate governance characteristics of Hong Kong

Ownership of listed companies

In Hong Kong, companies listed on the Exchange tend to be controlled by a family. Where the family does not retain a majority of the shares, the family will usually hold the senior executive director positions and retain executive control over the company.

A survey in 1996 of all listed companies based on disclosure in 1995 annual accounts showed the following concentration of ownership:

Percentage holding of a single shareholder or family	% of all listed companies
0 to 10%	4%
10 to 25%	8%
25 to 35%	11%
35 to 50%	24%
50% +	53%

Brokers' estimates of current ownership of the market indicate this current profile of corporate ownership of the Hang Seng index companies:

	%
Controlling family	42
Hong Kong Government	7
Other investors -individual and institutional	
- Local	31
- Foreign	20
Total	100

A review of ownership of 63 small listed issuers with market capitalisation below HK$50 million as at 30th September 1998, confirmed this pattern, with directors and substantial shareholders holding in aggregate an average of 55% of the shares.

Role of controlling family shareholders

The majority of Hong Kong listed companies continue to be dominated by families and often by the individual responsible for the establishment of the business. The holdings of these controlling families vary, nearly 80% of the listed companies disclose a family shareholding of over 35%, and over 50% have a family shareholding of over 50%. The existence of a controlling shareholder is not generally seen as a disadvantage by investors. Where family shareholdings are less than 50%, control is generally retained as the senior executive directors position and usually the post of chairman are filled by family members. In many cases, the founder of the company is still actively involved in the running of the company. As company success is often seen to be the result of the efforts of the founder, his continuing involvement is perceived by many investors as a key requirement for retaining their investments. For this reason contested takeover bids are very rare.

Most companies have only one class of shareholder with all shareholders receiving equal treatment. The principal weakness of the system is the potential for conflict between the interest of the controlling family and the minority shareholders. This is the main focus of corporate governance regulation. As company insiders have significant investments in their companies, there is a potential for abuse of insider information.

Role of the banking sector in corporate governance

The banking sector, as one of the major components of the corporate sector in Hong Kong, has an important role in corporate governance. While banks cannot directly influence the corporate governance of firms, they are a conduit for influencing the corporate culture of borrowers. In particular, banks can selectively lend to borrowers who provide reliable financial information and exhibit prudent risk management, adequate internal controls, and a strong financial position. These characteristics are to a large extent a reflection of the proper and responsible corporate governance on the part of the borrowers.

Banks in Hong Kong do not own a considerable part of the corporate sector. Under the Banking Ordinance, the aggregate holdings in shares of companies (listed and non-listed) by a locally incorporated bank are restricted to 25% of its capital base. This has restricted banks from owning a significant part of the corporate sector.

Hong Kong's economy operates on an open and free market philosophy, and there is no "main bank" arrangement through which corporate control is exercised.

Ownership and governance of banks

The banking sector in Hong Kong maintains a high standard of corporate governance, which is an integral part of the HKMA's banking supervisory approach. A consultancy study published by the HKMA at the end of 1998 on the banking sector in Hong Kong indicated that the level of corporate governance of banks in Hong Kong was largely in line with that of other major financial centres.

In terms of the corporate governance of banks in Hong Kong, there are various related legislative provisions and policy guidelines that have been introduced by the HKMA and they are continuously being updated to incorporate international best practices. These legislative provisions and guidelines cover the major elements of good corporate governance for banks, including ownership, management, internal control, independent audit and financial disclosure, and ensure that banks maintain high standards in these areas.

The principal control agents of banks in Hong Kong are banking and financial corporates. Most banks belong to part of a financial group, but some banking groups do have other lines of business. In such cases, banks are required to deal with their sister companies on an arms-length basis, in addition to the statutory limits referred to above.

Role of the equities market

Funds raised in the Stock Exchange of Hong Kong (SEHK) over the past six years are summarised in Annex IV. 38% of the new capital was raised in respect of companies related to the People's Republic of China. The total new equity raised on the SEHK in the four years to 1997 (the last year FIBV statistics are available for other years- see Annex V) was US$55.7 billion and exceeds the capital raised in any other Asian markets in this period. The South East Asian financial crisis greatly reduced the ability of the companies to raise new equity in the last quarter of 1997. Despite this, a total of US$31.7 billion of new equity capital was raised on the SEHK in 1997. Only the NYSE (US$177.6 billion) and NASDAQ (US$36.2 billion) raised more new equity capital in 1997. The full effects of the crisis were felt in 1998, but companies still raised a total of US$4.6 billion of new equity capital on the SEHK.

At 31 December 1998, 680 companies were listed on the SEHK with a market capitalisation of HK$2,662 billion (US$341 billion). The most quoted index for the Hong Kong market is the Hang Seng. This consists of 33 companies. At 31 December 1998, the market capitalisation of these 33 companies was HK$2,106 billion (US$270 billion), 79.12% of the total market. Market capitalisation at 31 December 1998 for the last five years was:

(HK$ billion)

	1998	**1997**	**1996**	**1995**	**1994**
Total market capitalisation	2,662	3,203	3,476	2,348	2,085
annual change	*-17%*	*-8%*	*48%*	*12%*	
Hang Seng index companies					
market capitalisation	2,106	2,103	2,436	1,750	1,434
percentage	*79%*	*67%*	*70%*	*74%*	*69%*

Role of institutional investors

The Hong Kong Investment Funds Association represents the investment management industry in Hong Kong. At the end of 1997, its 46 fund management company members managed total assets of some US$53 billion worldwide, and included many of the world's leading investment management organisations. Whilst the association's members do not seek to directly influence the corporate governance of individual firms, their preference is to invest in companies that provide reliable and timely financial information and demonstrate a commitment to appropriate standards of corporate governance. In a number of cases, institutional investors have provided sufficient opposition to halt proposals made by controlling shareholders.

Role of life insurers

An analysis of the asset composition of the top 10 life insurers in terms of premium incomes shows that, on average, about 20% of their assets were invested in listed shares. The analysis was based on their latest returns and relates to the listed shares held by the company or the Hong Kong branch, where appropriate.

It is a statutory requirement that there should be a prudent and satisfactory relationship between the nature and term of the assets and the nature and term of the liabilities of long-term business (including the life insurance and retirement scheme management business). This prudential rule apparently will constrain the ability of a long-term business insurer to :invest in equity .Although assets held in this respect are for the purposes of matching long-term business liabilities, they are likely to be managed in an active way in order to maximise the returns.

Role of pension funds

Hong Kong retirement funds, who in aggregate hold about HK$50 billion in Hong Kong shares, are too small to have any material influence on corporate ownership of governance of the locally listed companies. However, they do exercise their rights as minority shareholders.

According to industry surveys, Hong Kong retirement funds have on average for the past 15 years about 70% holdings in equities, half of which in Hong Kong shares (mostly in blue chips). In other words, about one-third of retirement funds are held in Hong Kong shares.

For Mandatory Provident Fund (MPF) schemes to be introduced in the near future, regulations on equity investments require shares to be fully paid up and listed on recognised stock exchanges (with a 10% exception for shares listed on unrecognised exchanges). Short selling of shares is prohibited. Not more than 10% of the funds of an MPF scheme may be invested in any single share issue. An MPF scheme may not hold more than 10% of the shares issued by any single company. The regulations are made on prudential grounds, having regard to existing market practice for the protection of scheme member interests.

The investment portfolios of current retirement funds are managed actively on commercial criteria. MPF scheme assets will also be under private management, operating on the basis of commercial criteria.

Pension fund investors in Hong Kong are less active than other institutional investors in the area of corporate governance. However, with MPF funds growing to be the dominant institutional investors in the very long term (10 to 15 years), they may have a significant role to play in the future.

Role of the government as holder of equities

In August 1998, in its operations in the stock and futures markets to put an end to the manipulative double play that was threatening system stability, the government acquired through the Exchange Fund a portfolio of Hang Seng Index constituent stocks.

The government subsequently set up a separate company, namely the Exchange Fund Investment Limited (EFIL), which has its own board of directors to manage these shares. EFIL's role is not to conduct active stock trading, but to manage and safeguard the assets in the Hong Kong equity portfolio and identify value-added opportunities for the eventual disposal of the shares with minimal disruption to the market.

In view of the concerns over potential conflicts of interest arising from the government's holding of these shares, the board of directors of EFIL is chaired by a non-official and the majority of the directors are drawn from distinguished members of the community, including members of the Legislative Council. Both EFIL and its staff are subject to the full regulation of the Securities and Futures Commission. To enhance transparency, the Government has disclosed in full the stocks acquired.

In regard to EFIL's role as a minority shareholder of the companies held, EFIL directors feel that the government should not interfere with the day-to-day management and operations. On the other hand, the directors consider that it may not be advisable for the government to refrain from exercising its voting rights in all circumstances. The crucial point is to strike the right balance between non-interference with the commercial activities of the companies and the need to safeguard the government's interest in these companies as a responsible shareholder.

Role of foreign direct investment in Hong Kong

Hong Kong is a major recipient of foreign direct investment (FDI) in the region, owing in part to its status as a major regional trade, financial and business services centre. Currently, Hong Kong is the second largest recipient of FDI from the US in Asia, and the third largest recipient of FDI from Japan in Asia.

The latest statistics are available up to end-1997 only. The overall stock of inward direct investments at end-1997 increased by 17% over a year earlier. Analysed by country of origin, the UK, Mainland China, the US and Japan were the leading external investors in Hong Kong in 1997, accounting for about three-quarters of FDI in Hong Kong (see Annex III).

Recent changes

EFIL is a new corporate governance agent. The present profile of significant family control of listed - companies is not likely to change radically in the medium term. Factors such as the introduction of MPF and demands for diversification of savings is likely to bring Hong Kong's profile of corporate ownership more in line with that of stock markets in the US and Europe.

Corporate behaviour, finance and restructuring

Diversified corporate groups

Whilst a few of Hong Kong's listed companies are conglomerates covering a number of diverse industries, Hong Kong does not have diversified groups that are similar to Korean *chaebols* or loosely affiliated groups such as Japanese *keiretsu*.

Performance of Hong Kong companies

The average rates of return on equity of major categories of listed companies are as follows:

	Average rate of return on equity				
	1997	**1996**	**1995**	**1994**	**1993**
Hang Seng Index constituent stocks (excluding banks)	13%	15%	14%	15%	15%
Banks	17%	18%	18%	20%	21%

The return on equity is defined as net income (losses) less cash preferred dividends divided by the average of total common equity and expressed in percentage.

The average price earning ratios of Hong Kong listed companies in the last five years were:

1998	1997	1996	1995	1994
10.7	12.1	16.7	11.4	11.7

The mid-1997 South East Asian financial crisis returned the average price earnings ratio to the levels seen before 1996. In contrast, other South East Asian markets (see Annex V) saw a significant correction in 1997. Other than Chinese Taipei, price earnings ratios for 1997 were significantly down, generally to less than half the ratios seen in 1994, 1995 and 1996.

Debt/equity ratio

The average debt to equity ratios of major categories of listed companies are as follows:

	Average debt to equity ratio				
	1997	**1996**	**1995**	**1994**	**1993**
Hang Seng Index constituent stocks	36%	35%	37%	34%	29%
Red Chip companies	68%	56%	86%	70%	88%
H-share companies	45%	94%	49%	56%	51%

There is no ready information on the profile of corporate debt (bonds/bank, short/long term) or the extent of direct exposure to foreign exchange debt of issuers.

Non-performing loans in the corporate sector

The statistics on non-performing loans collected by the HKMA from authorised institutions are not analysed by corporate and non-corporate sectors. The Asian financial crisis and the slowdown of the local economy resulted in a deterioration in the asset quality of banks in Hong Kong. For local banks, the overdue and rescheduled loans as a percentage of total loans increased from 1.80% at end-1997 to 3.81% at end-September 1998 (latest available figure). A broader definition of non-performing loans is "classified loans" (i.e. loans classified as substandard, doubtful and loss under the HKMA loan classification system). This takes account of not only the period that loans are overdue, but also more forward-looking and qualitative factors such as the business prospects of the borrower, cash flow and payment capability .The classification of individual loans is also influenced by the extent to which they are covered by collateral since this will affect the collectability of such loans (by contrast, the figures for overdue loans do not take account of the existence of collateral). Classified loans for local banks increased from 2.08% at end-1997 to 4.92% at end-September 1998. The figures are higher than overdue and rescheduled loans, suggesting that banks are adopting a prudent approach by not simply relying on the period overdue as the criteria for classifying loans.

Although these figures are quite low, particularly in comparison with other Asian countries, non-performing loans are expected to continue to increase. Banks are much more cautious and selective in their lending, thus reducing the overall availability of credits. Domestic loans fell by 3.8% in the first 10 months of 1998. It is likely that these factors together will continue to have an adverse impact on the solvency of corporate enterprises generally. However, there is no evidence of any fundamental structural weaknesses in the Hong Kong economy nor of excessive risk taking.

Despite expectations of further deterioration in asset quality and profitability in the short term, Hong Kong banks remain highly capitalised and liquid. The capital strength of banks continues to be strong. The average consolidated capital adequacy ratio of locally incorporated institutions stood at 18.6% as at end-September. In respect of the banking sector, the concern is profitability , not solvency.

The South East Asia financial crisis resulted in liquidation of only one major listed company in Hong Kong, Peregrine Investment Holdings. Although a high profile company, Peregrine represented less than one quarter of a percent of the total of SEHK's market capitalisation. The main cause of Peregrine's failure is considered to be excessive risk-taking. It remains to be seen if this provides any new insights on corporate governance. However, the isolated nature of this case confirms that corporate Hong Kong is generally prudent.

Special policies that address the interface between the corporate and financial sector

For the banking sector in Hong Kong, no special policies that address the interface between the corporate and financial sector have been adopted. Banks, however, play a major role in corporate restructuring as creditors. In this regard, the Hong Kong Association of Banks (HKAB) issued a guideline in April 1998 covering how institutions should deal with corporate customers encountering financial difficulties. The HKMA, in appropriate circumstances, stands ready to help resolve differences of views which could threaten the ultimate feasibility of a workout and achieving an acceptable compromise. In this respect, the HKMA would be prepared to act as a mediator between any involved parties, irrespective of size or national affiliation. The underlying principles and objectives of the HKAB's guideline are as follows:

- When it becomes public knowledge that a debtor company may be experiencing financial problems and the borrower has approached its banks, the banks' initial attitude should be one of support. They should not withdraw facilities or hastily put the company into receivership, or issue Supreme Court writs demanding payment.
- Further decisions should only be made based on information that is reliable and shared fully with all creditor banks (after obtaining debtor's permission).
- The decision to offer the company financial assistance -or not -should be a collective one by creditor banks.
- The objectives of any workout should be to obtain for creditor banks the best possible deals.

Incentives to force conflicting interests (creditors/debtor) to converge

Since Hong Kong adopts a free market philosophy, corporate restructuring is largely decided on a commercial basis. Naturally, debtors (i.e. the corporates under restructuring) are interested in restructuring programmes that will provide them with the chance to continue operating and recover from financial difficulties. However, corporate restructuring would probably involve debt restructuring under which creditors (normally the banks) would be required to delay taking actions against the debtors. This means that creditors would be exposed to a risk of suffering greater loss. Obviously, this will only be acceptable to creditors if the restructuring plan is a credible one. The conflict of interests will converge only when the risk of loss is greater if all creditors were to "rush for the exit" at the same time.

Insolvency mechanisms

The legal machinery for ensuring that the estate of insolvent companies is wound up and distributed to creditors in an orderly manner has continued to be adequate. The number of new compulsory liquidations of companies in 1998 was 723, an increase of 44% over 1997. However, the number of new compulsory liquidations is still relatively low, being only about 0.15% of all companies or 2.4% of companies incorporated in the year. There is no evidence that the rate of corporate winding-up does not correspond to the "actual" insolvency levels of the corporate sector.

III. The regulatory framework and the role of policy

Equitable treatment of shareholders and other stakeholders

Shareholder protection

The high incidence of companies controlled by a single shareholder or family clearly raises concerns about the absence of checks and balances found in companies where the shareholders are distinct from management. In a number of cases, these shareholders also have other business interests and there are concerns that business dealings between the listed companies and the controlling shareholder may not be in the best interest of all the shareholders of the listed companies. These concerns have been recognised for some time and the SEHK' s rules specify in some detail transactions where independent shareholders' approval is required. The South East Asia financial turmoil has not provided any new insights in this area, and no rule changes are anticipated in response to the crisis.

The incidence of family control over many listed companies represents also a strength for the market. Many commentators of the US and UK financial markets criticise the short-term view taken both by investors and management. The market's fixation on short-term results and the relatively short period of tenure for management provide a significant hurdle to long-term growth plans. Management by a controlling family provides a long-term perspective to act as a counter-weight to the stock market's emphasis on the latest results.

Information on shareholdings of listed companies

Any person or entity acquiring an interest in 10% or more of the share capital of a company listed on the SEHK is required by law to inform the company and the SEHK of this interest. Where an interest subsequently changes by one percentage point the company and the SEHK must be informed.

In addition, any director or chief executive is required by law to inform the listed company and the SEHK of any interest in the company's, or in an associated company's, share capital or debentures, and of any changes in these interests. Director's interests include stock options. The listed company is required by law to keep a register of this information. The SEHK rules require that the annual report of each listed company sets out the holdings of each director and of any shareholder whose interest is 10% or more. The SEHK publishes on its information system the information it receives under this legislation in respect of interests of directors and shareholders. Any shareholder or other person is entitled to inspect the register maintained by the listed company.

Failure to inform a listed company and/or the SEHK of interests or changes in interest is a criminal offence.

Voting rights and attendance at shareholder meetings

The SEHK will not allow listed companies to issue a new class of shares whose voting power does not bear a reasonable relationship to the equity interest of such shares. Where a class of shares already exists that carry a disproportionate share of votes, new issues of such shares are restricted. There are only a few examples of such classes of shares.

To facilitate the electronic transfer of shares, a large portion of the shares of listed companies are legally registered in the name of the clearing company Hong Kong Securities Clearing Company Limited. At 31 December 1998, the clearing company was the registered owner of 948 different securities. Other than insignificant exceptions, this includes ordinary shares of all Hong Kong listed companies as well as other types of securities. The clearing company's holdings represent 51% in number and 29% in value of these securities.

Voting at general meetings may be by proxy. When the clearing company receives instructions from the owners of the shares, it votes in accordance with these instructions. Shareholders may attend meetings and raise questions. Under Hong Kong law, shareholders are defined as those persons, or corporations, whose name is entered in the shareholders register. To cater for shares through the clearing house, Hong Kong legislation allows the clearing house - as the registered shareholder - to be represented by more than one person at a meeting. This allows shareholders, who hold shares through the clearing house, to attend meetings, vote their shares and put questions directly to directors. There are no structural factors that prevent shareholders from voicing their views, such as the practice of all listed companies holding annual general meetings on the same day.

There is no legal or practical difference in the treatment of foreign and domestic shareholders.

Shareholder approval of transactions

Any acquisition or realisation of assets (including securities) by a listed issuer or any of its subsidiaries, where the transaction amount accounts for more than 50% of the net assets, or net profit of issuer, is defined by the SEHK's Listing Rules as a major transaction. A major transaction must be made conditional on approval by shareholders. Such approval may be obtained either by convening a general meeting of the issuer or by means of a written approval of the transaction by shareholders who together hold more than 50% in nominal value of the securities, giving them the right to attend and vote at such a general meeting.

The shareholders have pre-emptive rights when new equity is issued. Shareholders must approve any issue of shares or equities that may materially dilute the percentage equity interest of its shareholders.

Where a transaction will result in a change in a listed issuer such that assets and profits will increase by 100%, the transaction may be treated as an application for a new listing. In such cases, the company must prepare information to prospectus standard and seek shareholder approval.

Connected transactions

Under the SEHK's rules, any director, chief executive or major shareholder of a listed company is regarded as a connected person. The SEHK' rules include provisions governing the disclosure and approval procedures for connected transactions (i.e. transactions between connected persons and the listed company). Where there is a conflict of interest between managers (directors) or major shareholders and the company, the listed company must call a general meeting to get independent shareholders' approval of the connected transaction. In addition, the listed company must appoint an independent expert acceptable to the SEHK to express an opinion as to whether the connected transaction is fair and reasonable so far as the shareholders of the issuer are concerned.

Takeovers

The Hong Kong Takeovers Code is modelled on the London Code with an Executive responsible for day to day matters and a Panel to deal with disciplinary matters, reviews of decisions of the Executive and to determine novel, important or difficult cases referred to it by the Executive. The Code's primary purpose is to ensure that all shareholders affected by takeover and merger transactions are treated fairly and equally, and that they are given sufficient information, advice and time to make an informed decision on an offer.

The key requirements of the Code are that offers must be made to all shareholders once:

- a person's holding exceeds 35% or more of the voting rights in a company; or

- a person, whose holding is between 35% and 50%, acquires a further 5% within a 12-months period; or

- there is a change in the group of persons associated with a controlling shareholder.

If an offeror holds 50% or less of the voting rights of the target company, he must obtain more than 50% of the shares. If this happens while the offer remains open, it becomes unconditional and stays open for 14 more days. If the offeror does not get at least 50% of the shares, the offer lapses and he cannot make another offer for the next 12 months. If an offeror already holds 50% of the shares, the offer is unconditional.

As most companies are controlled by a person or family hostile, takeovers are very unusual.

Insider trading regulations

Revised insider dealing legislation was passed in 1990, setting up a tribunal to inquire into possible cases of insider dealing, determine whether insider dealing has taken place, identify insider dealers and the amount of profit gained or loss avoided. The tribunal has the power to:

- disbar an insider dealer from acting as a director of a listed company for up to 5 years;

- order the insider dealer to pay to the government any profit gained or loss avoided; and

- order the insider dealer to pay to the government a penalty equivalent to three times the amount of any profit gained or loss avoided.

In the seven years since the introduction of the legislation, the tribunal has completed its inquiries in 10 cases and determined that 8 of these cases involved insider dealing. In number and percentage this level of successful cases compares favourably with all major financial markets other than the US. This is particularly true when compared with markets that deal with insider dealing via the standard criminal courts.

Protection of shareholder rights

Hong Kong's law in relation to corporate governance is similar to that of other common law countries. Corporate governance in Hong Kong is, however, far less driven by fear of civil liability on the part of directors than in the US, Australia or, increasingly, the UK. The SEHK's rules are particularly concerned with related party transactions and the protection of the interests of minority shareholders.

Most Hong Kong listed companies are incorporated offshore, which constrains the degree to which the conduct of the companies' internal affairs can be regulated through Hong Kong courts.. Hence, in practice, a greater burden of regulating such matters falls on non-statutory rules, such as the Listing Rules and the Takeovers Code.

The SEHK and the SFC stress the importance of educating directors of listed companies.

As in other Commonwealth common law jurisdictions, there is no general legislation or judicial practice on disregarding limited liability. It is only in the most exceptional circumstances (e.g. fraud) that the courts would be prepared to lift the "corporate veil".

Front-line regulatory functions of the SEHK

The SEHK is the front-line regulatory organisation responsible in the first instance for the day-to-day supervision and regulation of listed companies, their directors and controlling shareholders. The SFC becomes involved in novel, complex or controversial matters, or if the exercise of statutory powers, including powers of investigation, is necessary or desirable in a particular case.

The Listing Rules are the main source of authority for regulating the conduct of directors and controlling shareholders of listed companies.

Provision of information to shareholders

In addition to annual and interim reports, listed companies are required to keep its shareholders and the SEHK informed, as soon as practical, of any information that:

- is necessary to enable them and the public to appraise the position of the group;

- is necessary to avoid the establishment of a false market in its securities; and

- might be reasonably expected to materially affect market activity in, and the price of, its securities.

The SEHK reviews such information before it is released and may request further information or clarification.

In the case of a company registered in Hong Kong, shareholders who hold 10% or more of the company's share capital may requisition the directors to call a meeting of the company's shareholders, and if the directors do not proceed to convene a meeting, these shareholders may do so.

Role of the board of directors

Directors are appointed by majority voting at shareholders meetings. Based on their latest annual reports, the 33 constituent stocks of Hang Seng Index have an average of 7.2 executive directors and 6.5 non-executive directors. It is important to note that the number of non-executive directors is high when compared with smaller listed companies. Smaller listed .companies usually only appoint the minimum of 2 independent non-executive directors required under the SEHK's rules. In determining whether a director is independent, the Exchange will consider the following:

- a holding of less than 1% of the share capital will not normally act as a bar to independence unless the shares were received as a gift or by means of other financial assistance from a person connected with the listed company;

- the director should normally have no past or present connection with the listed company or with persons connected with the listed company; and

- the director should not have any management function in the listed company or its subsidiaries.

Director's duties

The Listing Rules more or less codify directors' duties under the common law and by so doing, give the SEHK and/or SFC jurisdiction to regulate the conduct of directors of listed companies in Hong Kong.

Chapter 3 of the Listing Rules requires a director of a listed company to fulfil fiduciary duties of skill, care and diligence to a standard at least commensurate with the standard established by Hong Kong law. The Listing Rules set out specifically a director's duties to:

- act honestly and in good faith in the interest of the company as a whole;
- act for proper purpose;
- be answerable to the issuer for the application or misapplication of its assets;
- avoid actual and potential conflicts of interest and duties;
- disclose fully and fairly his interests in contracts with the listed company; and
- apply such degree of skill, care and diligence as may reasonably be expected of a person of his knowledge and experience and holding his office within the listed company.

Interlocking directorates between companies that are not part of the same group are not a feature of Hong Kong.

Stock options and directors' compensation

As an incentive, listed companies usually include stock options in the compensation of directors and/or senior management. Share option schemes must be approved by shareholders in general meetings, with any person to whom, or for the benefit of whom, securities may be issued under the scheme abstaining from voting. The total amount of the securities subject to the scheme is limited to 10% of the relevant class of securities in issue from time to time, and the fixed maximum entitlement for any one participant cannot exceed 25% of the aggregate of all securities subject to the scheme. The life of the scheme is limited to 10 years while the option price must not be more than 20% below the average closing price of the securities for the five business days immediately preceding the date of grant.

In addition to disclosure of directors' interests, companies are required to disclose any option held by a person giving details of the number of shares, the period of the option and the exercise price. Also, listed companies need to disclose directors' fees and the band analysis in their annual reports.

Code of Best Practice

The main guidance on corporate governance practices is set out in a Code of Best Practice included in the SEHK's Listing Rules.

History of the Code of Best Practice

The Code of Best Practice (the "Code") was introduced in late 1993 to improve the standard of corporate governance among listed companies in Hong Kong.

The Code initially contained 12 guidelines concerning the board of directors which listed issuers should follow. The SEHK added two new guidelines in May 1998. Beginning with all interim and annual reports for periods ended on or after 31 December 1995, all listed issuers are required to include in their interim and annual reports a statement affirming compliance with the Code, or to explain the reasons for any non-compliance.

The Code sets out a number of guidelines relating to board meetings, notices and minutes, provisions of board papers and agendas, etc. It provides that where a matter to be considered by the board involves a conflict of interest for a substantial shareholder or director, a full board meeting should be held.

The Code also provides guidance relating to the role of independent non-executive directors, and affirms their rights as full members of the boards. For example, non-executive directors should be appointed for a specific term, which should be disclosed in annual reports and accounts; the minutes should reflect contrary views held by independent non-executive directors during any board meeting; independent non- executive directors may seek separate professional advice at the expense of issuers; both executive and non-executive directors are entitled to have access to board papers and materials, and any queries raised by non-executive directors in relation thereto must be responded to promptly; fees and emoluments of independent non-executive directors should be disclosed in annual reports and accounts; non-executive directors must ensure that they can give sufficient time and attention to the affairs of issuers; and the Exchange should be notified of the reasons when independent non-executive directors resign or are removed from office.

Recent amendments

The Exchange introduced two new guidelines into the Code in May 1998. The first one, which relates to director's education (Guideline 13), provides that every; director is expected to keep abreast of his responsibilities as a director. Newly appointed directors should receive appropriate briefings 'on the issuers' affairs and be provided by the company secretaries with relevant corporate governance materials published by the Exchange on an ongoing basis.

The other new addition is a guideline on audit committees (Guideline 14). Every board should establish an audit committee consisting of a minimum of two members appointed from amongst the non-executive directors, the majority of whom should be independent. The audit committees should have written terms of reference which deal clearly with their authority and duties, and their principal duties should be the review and supervision of the issuer's financial reporting process and internal controls. All listed issuers should report in both their interim and annual reports their compliance with the guideline and the reasons for any non-compliance for accounting periods commencing on or after 1 January 1999.

Compliance with the Code of Best Practice

The Exchange advocates self-regulation among listed companies and aims to provide issuers with broad guidelines of corporate governance. Listed issuers are encouraged to devise their own codes of practice in the interests of the board of directors as a whole. The Exchange places great importance on increasing disclosure and transparency.

Set out below are some available statistics on corporate governance.

- Independent Non-Executive Directors:

- there are 13 listed companies (about 1.9% of the total listed companies) with outstanding independent non-executive directors to be appointed as at 23 October 1998.

- Compliance with the Code of Best Practice:

- Listed companies reported in their latest interim or annual reports their non-compliance with certain Guidelines in the Code of 'Best Practice.

- Guideline 7, which deals with the appointment of non-executive directors for a specific term, is the area where companies report non-compliance. Many Hong Kong companies require a portion of their directors to retire by rotation each year. Thus the term of appointment for their non-executive directors cannot be for a specific term.

- Audit Committees:

- According to the latest available annual reports of the listed companies, there are 16 listed companies with audit committees which represents some 2.4% (16 out of 676 listed companies) of the listed companies as at 31 October 1998.

Transparency and disclosure

Hong Kong accounting standards

Companies listed on the SEHK are required to prepare accounts in accordance with Hong Kong Accounting Standards or International Accounting Standards. Hong Kong accounting standards are issued by the Hong Kong Society of Accountants. In 1993, the Society of Accountants decided to bring its accounting standards in line with International Accounting Standards. Hong Kong accounting standards currently cover the topics covered by International Accounting Standards that are relevant in Hong Kong. The recent spate of new International Accounting Standards has increased the areas of difference between Hong Kong and international standards. In a number of these areas of difference, new Hong Kong accounting standards are in progress. The principle areas of difference that remain and are not being addressed are:

- IAS 12 Income Taxes: Hong Kong accounting standards retain the concept of recognising timing difference to the extent that it is probable a liability will crystallise.
- IAS 19 Retirement benefit costs: few Hong Kong companies have defined benefit pension plans that raise the main issues when accounting for retirement benefit costs. Companies with such funds are required by the SEHK rules to explain their accounting policies.
- IAS 30 Disclosure in Financial Statements of Banks and similar Financial Institutions: reporting by banks is governed by rules issued by the Hong Kong Monetary Authority.

The Hong Kong Monetary Authority guidelines are substantially in line with the International Accounting Standards and in many areas require greater disclosure.

- IAS 32 Financial Instruments - Disclosure and Presentation: the HKSA has issued a draft accounting standard that deals with accounting for investments. This is not as extensive as the International Accounting Standards. Investments not held for an identified purpose and investments held for trading must be marked-to-market with gains or losses recorded in the profit and loss account. Where the carrying value of listed securities is different from their market value, the market value must be shown in the notes to the financial statement.

Most properties held by listed companies are carried in their financial statements at valuation. Under accounting standards, these valuations are performed by professionally qualified valuers each year and at least every three years by independent external professionally qualified valuers.

Except for goodwill arising on consolidation, few listed companies include intangible assets in their balance sheets. There are no specific accounting rules for intangible assets.

As with Hong Kong laws, accounting practices and principles were originally based on those in the UK. Hong Kong legislation has included a requirement to prepare group accounts for many years. The principles of consolidated accounts have been used and understood in Hong Kong for many years. As many business ventures are conducted by separate entities coming together for particular projects, the accounting standards on "Accounting for associated companies" (1985, about to be revised) and "Accounting for interests in joint ventures" (1998) are particularly relevant for listed companies in Hong Kong. These standards are based on the International Accounting Standards.

SEHK financial reporting requirements

Hong Kong accounting standards provide a suitable base for reporting financial performance to shareholders. Building on this base, the SEHK Listing Rules specify additional disclosures relevant to listed companies. The SEHK recently issued a public consultation paper on updating SEHK rules on the frequency of reporting and contents of interim reports. The proposals in the consultation paper included provisions for interim reports to include full financial statements and to accelerate the current reporting timetable for interim reports (currently 3 months) and annual reports (currently 5 months).

Off-balance sheet transactions

Except for the accounting standard on contingencies, Hong Kong accounting standards do not deal with disclosure of off-balance sheet transactions. Listed banks are required by the HKMA to provide extensive information on off-balance sheet risks, including contingent liabilities and commitments and derivatives. Material banks must provide an analysis of the aggregate notional amounts of each significant class of derivative, detailing those entered into for hedging and trading purposes. In addition, information must be provided on risk exposure, detailing credit risk weighted amounts and replacement costs for off-balance sheet items.

The SEHK consultation paper on financial disclosure includes proposals to apply the above requirements for banks to any listed financial conglomerates.

External auditor

The role of the external auditor has been enshrined in Hong Kong legislation for many years. The first formal examinations for auditors in Hong Kong were carried out in 1913. Hong Kong companies legislation, being based on UK law, requires that .every company appoints an auditor. A person cannot be appointed as an auditor unless qualified as such under the Professional Accountants Ordinance. The Hong Kong Society of Accountants was set up under the Professional Accountants Ordinance in 1973. The Society of Accountants is responsible for regulation of the accountancy profession, and in particular for registration and regulation of auditors. All persons licensed to act as auditors must first satisfy the requirements of the Society of Accountants and be registered as a certified public accountant. The Society of Accountants' code of ethic for auditors is closely modelled on that of the Institute of Chartered Accountants in England and Wales, and includes strict rules on independence. These rules require professional accountants to be, and to be seen to be, free of any interest that might prevent the accountant from adopting an objective approach to an engagement.

Except for local topics, such as taxation and law, the UK's Association of Chartered Certified Accountants sets the professional examinations used by the Society of Accountants. From December 1999 the Society of Accountants will set all the examinations.

The Society of Accountants monitors auditing performance of its members in two ways. First it has a programme of regular practice reviews, including examination of audit files. Second, it examines all published financial statements and raises any points noted with the auditors.

Auditing standards issued by the Society of Accountants are closely modelled on the International Standards of Auditing that were codified in 1994.

Prudential regulation over affiliated lending

With regard to affiliated lending, section 83 of the Banking Ordinance places limits on unsecured lending to persons connected with a lending institution. Such persons include any director, controller or any employee who is responsible for approving loan applications, relatives of these persons and companies which are controlled by them. The maximum unsecured lending to such persons, who are individuals, should not exceed HK$lmn per person and 5% of the capital base in aggregate. The aggregate unsecured lending to all connected persons should not exceed 10% of the capital base of the lending institution. The HKMA closely monitors connected lending by requiring institutions to submit information on loans to connected parties and by requiring the chief executive to certify their compliance with the above-mentioned section of the Banking Ordinance. Affiliated lending is not a major issue in the banking sector in Hong Kong.

Response to South East Asian financial crisis

In December 1998 the SEHK released a consultation paper on proposed enhancements to some rules regarding financial reporting. The principle behind the SEHK's rules require issuers to provide appropriate and timely information to enable market participants to reach informed investment decisions. The South East Asian financial crisis had highlighted some areas where existing financial reporting criteria ought to be improved. These areas were:

- contents and timeliness of interim financial reporting;

- disclosure requirements for financial conglomerates;
- contents of Management Discussion and Analysis section of annual reports; and
- circumstances that may give rise to a general disclosure obligation of price sensitive information.

The need for these enhancements was highlighted by the South East Asian financial crisis. However, they do not represent a change in direction for the regulatory environment relating to transparency. They are designed to ensure that Hong Kong's financial disclosure rules remain in line with international best practice. Indeed, the proposals for contents of interim reporting, being a full set of consolidated financial statements, go far beyond the existing regulations and practices of the London Stock Exchange.

IV. Conclusions

The South East Asian financial crisis has had no significant impact on the corporate governance environment of Hong Kong. This reveals that there is no significant weakness in the existing approach to corporate governance. Nevertheless, the government and the regulators in the financial sector continue to share experiences with overseas counterparts and endeavour to keep up with international best practices.

Hong Kong is an open free market economy with no restrictions on capital flows. The regulatory approach appropriate for such a market is disclosure based. It is important that disclosure standards continue to be adjusted to reflect changes in international best practice. The policy of the Hong Kong Society of Accountants to base its accounting standards on International Accounting Standards is an important factor for the standards of corporate governance in Hong Kong.

Over the past years, the SEHK has revised its rules to require disclosure above what is required by accounting standards. The recent public consultation paper on financial disclosure is the latest improvement of financial disclosures by listed companies. It is important that the SEHK continues to enhance its regulations in line with developments in the leading financial markets.

The Code of Best Practice for listed companies incorporates the key elements of the recommendations of the Cadbury report relevant to Hong Kong's market. Continued enhancement of the Code is important for maintaining high standards of corporate governance.

In the medium term, a main focus of corporate governance regulation will continue to be the protection minority shareholder rights in cases where there is a potential for conflict between their interests and those of the controlling family.

Annex I

Hong Kong's external sector, 1994-98

	1994	1995	1996	1997	Q1/1998	Q2/1998	Q3/1998
							(In HKSMn)
Total exports (f.o.b.)	1,170,013	1,344,127	1,397,917	1,455,949	310,964	345,841	352,354
Domestic exports	222,092	231,657	212,160	211,410	41,368	49,326	51,805
Re-exports	947,921	1,112,470	1,185,758	1,244,539	269,596	296,514	300,548
Total imports (c.i.f)	1,254,427	1,495,706	1,539,851	1,619,468	344,429	381,435	359,238
Trade balance	-84,414	-151,579	-141,934	-163,519	-33,465	-35,594	-6,884
Total trade in goods	2,424,440	2,839,833	2,937,768	3,075,417	655,393	727,276	711,592
Services exports	240,668	265,635	292,757	293,373	65,333	63,290	67,362
Services imports	144,067	160,877	167,761	176,683	45,294	41,762	44,458
Invisible trade balance	96,601	104,758	124,996	116,690	20,039	21,528	22,904
Total trade in services	384,735	426,512	460,518	470,056	110,627	105,052	111,820
Total Trade in goods and services	2,809,175	3,266,345	3,398,286	3,545,473	766,020	832,328	823,412
Visible and invisible trade balance	12,187	-46,821	-16,938	-46,829	-13,426	-14,066	16,020
Foreign exchange reserves*	381,233	428,547	493,802	719,255	750,174	747,764	684,919
Total exports (f.o.b.)	151,399	173,750	180,750	188,059	40,161	44,636	45,489
Domestic exports	28,739	29,945	27,432	27,307	5,343	6,366	6,688
Re-exports	122,661	143,804	153,318	160,752	34,818	38,270	38,800
Total imports (c.i.f)	162,322	193,344	199,101	209,180	44,483	49,230	46,377
Trade balance	-10,923	-19,594	-18,352	-21,121	-4,322	-4,594	-889
Total trade in goods	313,722	367,093	379,851	397,238	84,643	93,866	91,866
Services exports	31,142	34,338	37,853	37,894	8,438	8,169	8,696
Services imports	18,642	20,796	21,691	22,821	5,850	5,390	5,739
Invisible trade balance	12,500	13,542	16,162	15,072	2,588	2,779	2,957
Total trade in services	49,785	55,133	59,545	60,715	14,287	13,559	14,436
Total Trade in goods and services	363,506	422,227	439,396	457,953	98,931	107,425	106,302
Visible and invisible trade balance	1,577	-6,052	-2,190	-6,049	-1,734	-1,815	2,068
Foreign exchange reserves*	49,274	55,424	63,840	92,823	96,820	96,503	88,394

Annex II

Performance of Hong Kong's economy, 1994-98

	1994	1995	1996	1997	Q1/1998	Q2/1998	Q3/1998
							(Year-on-year rate of change
Real GDP	5.4	3.9	4.6	5.3	-2.6	-5.1	-7.1
Private consumption	6.7	1.6	4.7	6.7	-2.6	-5.1	-10.0
Public consumption	3.9	3.2	4.0	2.4	2.1	-5.3	3.7
Private investment	15.5	8.8	9.6	20.0	-0.9	6.3	-6.6
Public investment	17.1	22.0	17.1	-5.5	-2.7	0.8	-24.7
Export of goods	10.4	12.0	4.8	6.1	1.4	-0.5	-7.0
Domestic exports of goods	-2.3	2.0	-8.4	2.1	-4.7	-0.6	-9.4
Re-exports of goods	13.8	14.3	7.5	6.8	2.5	-0.5	-6.6
Exports of services	6.5	4.8	8.5	-0.6	-9.0	-11.0	-3.7
Imports of goods	14.0	13.8	4.3	7.2	-1.7	-1.8	-10.5
Imports of services	8.8	2.1	2.5	4.1	1.9	3.0	-1.2
Real GDP per capita	3.1	1.9	2.0	2.2	N.A	N.A	N.A
							(Index 1990 = 100)
Terms of trade (I)	100.3	98.7	99.7	100.4	101.5	101.7	101.7
							(Index November 1983 = 100)
Effective exchange rate (end of period) (II)	123.5	122.7	125.3	137.9	136.6	138.8	136.7
							(Percent)
Unemployment rate	1.9	3.2	2.8	2.2	3.5	4.4	5.0
Interest rate (short-term) (III)	4.8	6.2	5.5	7.1	8.7	7.8	9.8
							(Year-on-year rate of change)
Monetary expansion M2 (end of period)	12.9	14.6	10.9	8.3	7.3	2.8	7.4
Inflation (consumer prices)	8.8	9.1	6.3	5.8	5.0	4.4	2.8

Notes: (I) Ration of the unit value index of total exports (including re-exports) to that of imports

(II) Trade-weighted average of the nominal exchange rate of the HKS based on a new series released since 1 April 1995.

(III) Three-month HKS interbank-offered rates (HIBOR)

Annex III

Stock of inward direct investment in Hong Kong

	1995			1996			1997		
	$Bn	Share (%)	Change (%)	$Bn	Share (%)	Change (%)	$Bn	Share (%)	Change (%)
Non-manufacturing sector	503.3	100.0	6.0	575.9	100.0	14.4	681.8	100.0	18.4
UK	146.6	29.1	1.7	166.3	28.9	13.4	181.3	26.6	9.0
Mainland China	104.6	20.8	13.2	111.6	19.4	6.7	138.9	20.4	24.5
US	58.8	11.7	10.7	98.0	17.0	66.5	118.2	17.3	20.6
Japan	69.9	13.9	-5.0	76.3	13.2	9.1	77.0	11.3	1.0
Netherlands	9.2	1.8	19.2	17.5	3.0	89.6	24.6	3.6	40.8
Singapore	9.3	1.9	5.6	9.7	1.7	4.0	14.1	2.1	45.4
France	8.4	1.7	-11.9	6.5	1.1	-22.6	14.1	2.1	115.9
Germany	11.0	2.2	27.9	8.5	1.5	-22.3	10.8	1.6	27.5
Switzerland	15.7	3.1	50.2	7.6	1.3	-51.3	8.6	1.3	12.8
Others	69.6	13.8	4.8	74.0	12.8	6.2	94.2	13.8	27.4
Manufacturing sector	45.3	100.0	14.5	48.0	100.0	5.8	50.6	100.0	5.5
UK	17.6	38.9	32.5	18.1	37.8	2.7	20.9	41.2	15.1
Mainland China	12.9	28.4	13.8	12.9	26.8	-0.3	10.5	20.7	-18.5
US	3.0	6.5	-17.9	2.6	5.5	-11.0	3.5	6.8	31.6
Japan	2.3	5.0	-14.1	2.4	5.0	5.9	3.0	5.9	23.7
Netherlands	1.8	3.9	17.9	2.2	4.6	23.8	2.8	5.6	28.6
Singapore	1.1	2.4	40.4	1.0	2.1	-4.1	1.4	2.8	38.8
France	1.1	2.4	-17.1	1.2	2.6	10.2	1.0	2.0	-16.3
Germany	0.5	1.1	-20.0	0.6	1.3	30.8	0.5	10.	-19.4
Switzerland	0.4	0.8	-9.5	0.6	1.3	68.7	0.4	0.9	-26.3
Others	4.8	10.6	15.9	6.3	13.1	31.1	6.6	13.1	5.5
All sectors	548.6	100.0	6.6	623.9	100.0	137.	732.4	100.0	17.4
UK	148.9	27.1	1.4	168.7	27.0	13.3	184.3	25.2	9.2
Mainland China	107.5	19.6	12.1	114.2	18.3	6.2	142.4	19.4	24.7
US	71.7	13.1	11.3	110.8	17.8	54.5	128.6	17.6	16.1
Japan	87.6	16.0	0.7	94.4	15.1	7.8	97.9	13.4	3.7
Netherlands	11.0	2.0	19.0	19.7	3.1	79.0	27.4	3.7	39.5
Singapore	10.4	1.9	8.4	10.7	1.7	3.2	15.5	2.1	44.8
France	8.8	1.6	-11.8	7.1	1.1	-18.9	14.5	2.0	103.9
Germany	11.4	2.1	24.7	9.1	1.5	-20.0	11.4	1.6	24.2
Switzerland	16.8	3.1	42.5	8.9	1.4	-47.3	9.7	1.3	8.8
Others	74.4	13.6	5.5	80.2	12.9	7.8	100.9	13.8	25.7

Notes: Figures may not add up exactly to the total due to rounding.

*: The stock of inward direct investment measures the cumulative amount of funds (including equity capital, reinvested earnings, and loan capital, if any) provided by external investors.

Annex IV

Equity funds raised on the SEHK

(HK$ million)

Type	1993	1994	1995	1996	1997	1998
H shares						
IPOs	8,141.52	9,879.81	2,011.35	6,834.16	32,037.52	2,072.36
Rights	-	-	-	-	-	-
Placing	-	-	980.00	1,037.50	1,046.70	1.480.16
Others**	-	-	-	-	-	-
Total	8,141.52	9,879.81	2,991.35	7.871.66	33,084.23	3,552.52
Red chips						
IPOs	950.52	1,541.37	1,569.75	3,427.30	39,394.82	142.38
Rights	4,485.41	1,316.64	202.74	287.25	2,058.47	381.77
Placing	9,506.73	6,165.48	313.10	10,841.05	27,966.00	9,031.16
Others**	136.57	4,203.36	4,588.02	4,452.37	11,445.89	5,869.63
Total	15,079.23	13,226.85	6,673.61	19,007.96	80,865.18	15,424.95
Other Equities						
IPOs	20,289.02	5,939.16	4,529.36	20,954.32	10,221.27	3,739.11
Rights	4,780.66	4,326.48	1,087.00	4,365.76	14,453.04	5,003.36
Placing	21,092.54	5,521.08	10,217.03	34,233.38	49,161.11	3,939.44
Others**	20,827.33	12,967.77	13,703.55	13,585.17	59,792.43	4,221.81
Total	66,789.54	28,754.48	29,536.94	73,138.63	133,627.86	16,903.72
All Equities						
IPOs	29,181.05	17,360.34	8,110.46	31,215.77	81,653.62	5,953.85
Rights	9,266.07	5,643.12	1,289.73	4,653.02	16,511.52	5,385.13
Placing	30,599.27	11,686.55	11,510.13	46,111.93	78,173.82	14,450.77
Others**	20,963.90	17,171.13	18,291.58	18,037.54	71,238.32	10,091.44
Total	90,010.29	51,861.14	39,201.90	100,018.25	247,577.27	35,881.18

** including warrants exercised, consideration issue and share option scheme

* provisional figure up to the end of December 1998

Funds raised by classification

Equities						
IPOs	29,181.05	17,360.34	8,110.46	31,215.77	81,653.62	5,953.85
Placing	30,599.27	11,686.55	11,510.13	46,111.93	78,173.82	14,450.77
Rights	9,266.07	5,643.12	1,289.73	4,653.02	16,297.97	5,301.50
Open offer	-	-	-	-	213.54	83.62
Consideration issue	4,683.88	5,026.71	9,225.17	10,51.03	58,859.90	9,337.08
Warrants exercised	14,246.49	10,835.09	8,192.61	5,568.57	8,322.09	278.99
Share options	2,033.52	1,309.34	873.79	2,317.94	4,056.33	475.37
Equities funds raised	90.010.29	51,861.14	39,201.90	100,018.25	247,577.27	35,881.18
Debt securities #	4.640.00	1.930.00	4.990.61	448.50	-	1,12.48

Amount raised by Hong Kong stocks only

CORPORATE GOVERNANCE IN INDIA

by
Pratip Kar[*]

I. Introduction and summary

The corporate governance regimes in developed economies have broadly followed two models – the "insider model" found generally in continental Europe and in many OECD countries, and the "outsider model" found for example in the United States and the United Kingdom. The systems of corporate governance have evolved in these countries over a considerable period of time. Several recent studies conducted by the OECD have also shown that the pressure of globalisation, bringing in its wake the borderless corporation, is leading to a gradual convergence of these systems. East Asian countries and the transitional economies, on the contrary, have been marked by weak corporate governance regimes and fragility of the financial systems. Indeed, the failure of these systems has been indicated as one of the sundry causes of the East Asian crisis. The policy debate on the establishment of a framework for corporate governance in some countries in the region, and on the revamping of the existing channels of corporate governance in others, is therefore of recent origin in these countries.

India, on the other hand, has had a hybrid system of corporate governance – a mix of the "insider model" and the "outsider model" - for a considerable period of time. The legal framework for regulating all corporate activities including governance and administration of companies, disclosures, shareholders' rights, has been in place since the enactment of the Companies Act in 1956 and has been fairly stable. The listing agreements of stock exchanges have also been prescribing on-going conditions and continuous obligations for companies. By Aoki's classification (1995)[1], "India could be considered to be in the 'post-transition regime' with well defined and stable corporate governance structure, and where the management of enterprises is chosen through due process defined by the corporate law. India is also representative of many developing countries in terms of its reliance on external sources of finance as well as the prevalence of insider-dominated family business". [2]

But the perceptible change that has taken place in the past few years in India is that *greater attention* is now being focused on the subject of corporate governance, and there has been a growing awareness that good corporate governance forms an intrinsic part of a company's best practices and its obligations to the outside world, and hence is crucial to its competitive strategy and long term growth. Lack, or inadequacy, of corporate governance mechanisms in companies has been featuring in the media, in board room discussions of financial institutions who are the block holders in many companies, and in academic and policy debates, and has been cited as one of the reasons for the "present disenchantment" of small investors. The boards of enlightened companies - even those belonging to business families, financial institutions and other large institutional shareholders - investors and regulators are increasingly becoming aware of the need for open and transparent management policies, transparency of operations within business and industry, disseminating material

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information as quickly as possible, adopting international standards of accounting and disclosure of information by the corporate sector and setting out standards of best practices for directors, managers and employees of companies. With increasing reliance placed by companies on external financing sources for debt and equity, public concerns have become more focused on the effective protection of investor interests, especially those of the small investors, and on the preservation and enhancement of shareholder value and wealth.

Several factors have helped drive this change. *First, the economic reforms* which have allowed the growth of free enterprise and freed private investment opportunities; *second, exposure* of domestic private and public sector companies *to greater domestic and foreign competition* which has multiplied choices for consumers and compelled increases in efficiency; *third, the growing reliance placed by private and public sector companies on capital markets,* underpinning the need for better disclosures and better investor service; *fourth, the consequential changes in the shareholding pattern of private and public sector companies; fifth, the growing awareness of investors and investor groups* of their rights; *sixth, the growing importance of institutional investors and public financial institutions* gradually asserting and transforming themselves in their new role as active shareholders rather than as lenders; *seventh, the stock exchanges becoming increasingly conscious of their roles as self-regulatory organisations* and exploring the possibility of using the listing agreement as a tool for raising the standards of corporate governance; *eighth, the establishment of a comprehensive regulatory framework for the securities markets* with the setting up of the Securities and Exchange Board of India (SEBI) as the statutory regulatory body for the securities markets to protect the rights of investors and to regulate the markets.

The objective of this paper is to present an overview of the present state of corporate governance in India and the steps that are being taken towards raising corporate governance standards. It is organised in four parts. Part One is the introduction and summary. It introduces the subject and summarises the paper. Part Two discusses the corporate governance environment in the country and its impact on corporate performance and finance. It provides *the general economic context* - the economic perspective - by briefly describing the historic macroeconomic and structural characteristics and trends in the Indian economy since the introduction of economic reform, which has been the driving force for corporate governance. *The characteristics of corporate governance* are then reviewed by discussing: the patterns of corporate ownership and finance, emerging trends and reasons for the evolution of these patterns, especially for the listed companies; the roles of major shareholders, both insiders and outsiders, including banks and financial institutions; the role of other institutional investors, such as mutual funds and pension funds; the role of non-bank intermediaries, such as merchant banks, securities companies; the role of the state in state-controlled enterprises; and the role of foreign direct investment. *Corporate behavioural patterns, finance and restructuring,* are discussed in terms of returns to shareholders, patterns of diversification of investment, trends in investment, financing patterns and the incidence of non-performing assets and restructuring. Part Three discusses the regulatory framework and the role of policy, covering areas such as *equitable treatment of shareholders and other stakeholders, the role of the board of directors, and the importance of transparency and disclosures;* the instruments of shareholder protection and their adequacy; issues related to the level playing field between foreign and domestic shareholders; takeovers, insider trading regulations, accounting standards and disclosure standards; and the role of outside directors, boardroom procedures and remuneration policies of directors. The concluding Part Four discusses the policy issues and responses in the medium and long-term, recent steps toward improving the standards in various areas, and the initiatives taken by the SEBI.

Studies analysing the patterns of Indian corporate governance, ownership structure of companies, and impact of ownership structure on governance are very few, and the limited number of studies that are available, are very recent. I have drawn extensively on these studies for the analytical portion of the paper.

II. The corporate governance environment and its impact on corporate performance

Any discussion on corporate governance regimes in India must take note of at least four basic differences in the historic macroeconomic, legal and structural characteristics and trends between India and other Asian countries. First, at no time has India faced the kind of on-going financial crisis which has affected the economies of East Asia in terms of exchange rates, large current account deficits, fiscal imprudence, disproportionate external financial exposure, imbalance between short-term and long-term liabilities, and lax financial supervision. India had even by and large escaped the "contagion effect" of the East Asian crisis which impacted the Indian economy in a limited way, only through loss of export competitiveness and declining export performance. The financial crisis faced by India in 1990-91 was of a different nature, as discussed later in this section. Second, the current debate on corporate governance in India is sponsored by the economic reforms and their consequences on the relationships between the firms and the environment in which they are now required to function, and not by the weakness of the financial system or its lax supervision. Third, India has had a well-established regulatory framework for more than four decades, which forms the foundation of the corporate governance system in the country. Fourth, although the Indian corporate sector is a mix of government firms and private enterprises (which are again a mix of independent firms and those owned by business groups families, and multinationals), it has not suffered from the cronyism that has dominated some of the Asian economies, nor does the Indian corporate sector possess the characteristics of the Korean *chaebols*. The banking and the financial systems in India have also never been vulnerable to the cronyism, which afflicted some of the Asian economies and vitiated fair assessment of credit risk. However, the East Asian crisis did provide a timely warning signal on the vulnerability of a financial system if certain important support systems and controls are absent. The crisis also helped focus the immediate attention of the government, the Reserve Bank of India (RBI), the SEBI, the banking system, the industry and the market forces on these issues.

The general economic context [3]

The economic policies in India have undergone much change over the last few years, especially since 1991, and more changes are being implemented. An unprecedented economic crisis and social turmoil had engulfed the country during 1990-91. India faced the prospect of defaulting on international contractual commitments for the first time in its history. International credit rating was down-graded and access to external commercial credit was completely denied. India could only borrow from international markets by offering the security of its gold reserves and physically transporting gold abroad. There were severe inflationary pressures and a near complete breakdown of fiscal discipline. It was under these conditions that the government embarked on a wide-ranging programme of economic reforms.

The central approach underlying these reforms involved a greater reliance on market mechanisms, and this translated into a class of public policies including deregulation and reduction in government controls, greater autonomy of private investment, less use of the public sector, more opening of the economy to international trade, and less restrictions on the convertibility of the rupee. The reforms made a complete break with the established conventions of Indian planning and policy making. It was significant that despite the multi-party democratic system of Indian politics, there was broad political consensus and acceptability on the economic reform programme across all political parties. This is evidenced by the continuity of government policies despite several changes of government in the last few years and multi-party coalitions coming into power. Successive governments have continued the major thrust and direction of the reforms. While opinions may differ on the speed and sequencing of implementation of the reforms, there can be little doubt on the growing force and reach of the reforms.

A critical element of the reforms was the reversal of the trend of growing fiscal imbalance which had by then built up in the economy. In the medium term, the government strategy was to bring down the fiscal deficit of the central government from the high of 8.4% in 1991. Reforms in industrial policy was a priority area. It was recognised that over the years the industrial policy framework had become over burdened with extensive bureaucratic control over choices. Even if such control might have served a purpose in the initial post-independent years of development, they had over time become dysfunctional resulting in delays in decision making and inefficiencies. Several changes were made, such as abolishing industrial licensing, repealing the restrictive provisions of the Monopolies and Restrictive Trade Practices Act, enabling private sector to freely expand capacity, throwing open for private investment new and strategic areas, which were hitherto the sole preserve of the public sector. Private enterprise was also given the freedom to expand without the need for prior governmental approval. Access to foreign technology was freed to bring in foreign direct investment. In short, the role of the government was reduced and the outdated control structure was dismantled. Extensive reforms were also made in the regimes of direct and indirect taxation and in the trade and exchange rate policies. Import control restrictions were removed and fresh impetus and incentives were given to exports, including service exports and remittances. The exchange rate of the rupee was left to be determined by the demand and supply conditions in the market.

Performance of the public sector is critical to any reform process, and in the case of India it was even more so because of the scarcity of resources. While the public sector was given the key role in a command economy, there was a substantial decline in its overall profitability and performance. Economic restructuring was therefore necessary in the public sector to improve efficiency. As part of that restructuring, a programme of divestment of government holdings in key public sector enterprises in the industrial and services sector was initiated. Though retaining majority control, the government divested its shareholding in the financial institutions for development which, for two decades, were the sole purveyors of long-term credit. Besides, these institutions began to meet their own resource requirement from the market through issues of debit and equity to the public.

An efficient banking system and a well functioning capital market capable of mobilising savings and channelling them to productive uses are essential for successful economic restructuring. While both the banking system and the capital market in India had by 1990-91 recorded impressive growth in the volume of operation, they suffered from several deficiencies in regard to their efficiency and quality. The major planks for reforms in the banking system were the introduction of new accounting and prudential norms relating to income recognition; provisioning and capital adequacy in line with accepted international standards; reduction of the proportion of bank funds pre-empted through the requirement of statutory liquidity ratio; divesting governments' holding in public sector banks and allowing them to access the securities market for mobilising resources and reduction in the percentage of government holdings to 51%; freedom of private sector banks to expand and allowing new banks to be set up in the private sector; de-regulation of interest rate structure, giving banks the freedom to levy the rates; and, finally, setting up the supervisory system of the Reserve Bank of India (see Box 1).

The economic reforms soon bore results. The annual rate of inflation, which had peaked at nearly 17% in August, came down steadily to 7% by 1992-93, and is currently down to a low of 3.6%. Foreign currency reserves recovered steadily to US$29 billion. Overall economic growth, which had dipped to 1.2%, showed significant recovery, increasing to 4% in 1992-93 and consistently remaining over 7.5% during three consecutive years (1994-95 and 1996-97). It has been around 5.8% for 1998-99, which was a difficult year for the country and the world economy. The current account deficit, which was as high as 2.6% in 1991, was around 1.4% in 1998-99. Agricultural production had witnessed consistent growth during the period, except for two years. Industrial production also showed a distinct improvement. It had increased to 12.8% in 1995-96, though it declined thereafter (see Tables 1-3).

Box 1: Banking Reforms in India (1992-99)

- Cash Reserve Ratio (CRR) was reduced from 15% in 1990-91 to 10% on 18 January 1997 in relation to net demand and time liabilities.
- Statutory Liquidity Ratio (SLR) which was at 38.5% as on 3 April 1992 has been reduced to 25% on net demand and time liabilities.
- Interest rates on deposits have been decontrolled, except for the savings deposits. Now banks themselves determine interest rates. The RBI regulates only lending above Rs.25000. In regard to term loans, banks are free to fix prime term lending rates.
- RBI is using the bank rate actively to influence the money market and liquidity in the market.
- Banks have been observing prudential norms, which include capital adequacy, income recognition, provision for non-performing assets.
- Non–performing assets (NPA) stood at Rs.45653 billion at end March 1998 and formed 7% of the total assets.
- Capital adequacy ratio of public sector banks was 11.53% in 1997-98.

Capital Restructuring of Banks

- Following asset classification norms, banks consider non-performing assets to be an advance that has not been serviced as a result of past dues for 180 days and over, and under capital adequacy norms, banks are required to mobilise capital. In the beginning, this capital was contributed by the government in the form of equity and, later on, banks issued equity capital to the market. They also mobilised resources through subordinate debt instruments qualifying for Tier –2 capital. Capital restructuring has been completed in all banks.
- Banks in relation to government: Prior to financial reforms, banks were to invest in government securities a certain amount of the deposits on fixed and controlled interest rates. Now government securities are sold to banks through auctions on the basis of market determined interest rates.

Other points

- The financial reforms have been focusing on alignment between the structures of assets and liabilities of banks.
- Financial reforms have introduced automation, efficient payment systems, better customer services, and transparency in the functioning and accountability of banks.
- Banks are now free to take up other activities, such as opening different subsidiaries in the areas of merchant banking, housing finance, primary dealership in government securities, credit card business, mutual fund activities, etc.
- Foreign banks have been encouraged to open branches in India or have joint ventures with domestic Indian banks.
- Banks are now free to finance 5% of their deposits in equities.

Table 1: Key Economic Indicators

	1998-99	1997-98	1996-97	1995-96
GDP (Rs bn)	110099.83(A)	10491.91 (Q)	9990.00 (P)	9264.00
GDP Growth	5.8%	5.0%	7.8%	7.6%
Sectoral real growth rate a) agriculture and allied activities b) industry c) services	 5.3% (A) 4.7% (A) 6.7% (A)	 (1.0%) Q 5.9% Q 8.2% Q	 9.4% (P) 6.0% (P) 8.0% (P)	 0.2% 12.2% 9.8%
Net fixed capital stock (Rs bn)	N.A.	N.A.	7566.79	6786.29
Percentage change in index of industrial production	3.5% (April – Dec '98)	6.6%	5.6%	12.8%
Agricultural production (Index) 1981-82	171.3	164.9	175.4	160.7
Percentage change in index	3.9%	-6.0%	9.1%	-2.7%
Inflation index 1981-82	353.9	337.1	320.1	299.5
Percentage change in WPI	4.6% (As on 1.1.99)	5.3%	6.9%	4.4%
Fiscal deficit	5.1%	5.5% (RE)	4.7%	4.9%
Current account deficit	1.0 %	1.6 %	1.1%	1.6%
Forex Reserves (US$ bn)	32.49	29.367	22.4	-
Gross Domestic Savings (as percentage of GDP at current market price)	N.A.	23.1% (Q)	24.4% (P)	24.1%
Household		18.3% (Q)	18.8% (P)	17.4%
1. Physical		8.0% (Q)	9.0% (P)	9.3%
2. Financial		10.3% (Q)	9.8% (P)	8.2%
2a. Claims on govt.		1.0 % (Q)	0.9% (P)	0.8%
2b. Investment in shares and debentures		0.2% (Q)	0.8% (P)	0.8%
2c. contractual savings (LIC, PF)		3.7% (Q)	3.3% (P)	3.2%
Mid-year Population growth	N.A.	1.68%	1.60%	1.95%
Percentage share of major exports a. Agriculture and allied items	 17.5% (April –Oct)	 18.8%	 20.4%	
b. Ores and Minerals	2.4%			

A : advance estimates; P : provisional estimates; Q : quick estimates; RE : revised estimates.

Table 2: Key Banking Indicators

	1998-99	1997-98	1996-97	1995-96
No of banks a) Indian b) private c) public d) foreign	 61 34 27 42	 61 34 27 42		
Total deposits (Rs bn)	6798.94	6170.27	5148.98	4347.86
Total advances (Rs bn)	3389.53 (Dec 18, 98)	2911.11 (Dec 12,97)	2755.50	2319.27
Profit (ROE)		34.54%	24.61%	
Profit ratio (ROA)		0.86%	0.65%	
Net profit (Rs bn)		64.99	65.04	

Table 3: Gross and Net NPAs of Public Sector Banks in India

End-March	**Gross NPAs** (Rs 10 mil)	**% to Gross Adv.**	**% to Total Assets**	**Net NPAs** (Rs 10 mil)	**% to Net Adv.**	**% to Total Assets**
1993	39,253	23.2	11.8			
1994	41,041	24.8	10.8			
1995	38,385	19.5	8.7	17,567	10.7	4.0
1996	41,661	18.0	8.2	18,297	8.9	3.6
1997	43,577	17.8	7.8	20,285	9.2	3.6
1998 (p)	45,653	16.0	7.0	21,232	8.2	3.3

Note: Total assets consist predominantly of loans and advances and SLR investments in addition to other assets. Net NPAs is derived from gross NPAs by excluding (i) balance in interest suspense account i.e. interest due but not received (ii) DICGC / ECGC claim received and kept in suspense account pending adjustment (for final settlement), (iii) part payment received and kept in suspense account, and (iv) total provisions held.

In the area of the securities market, the reforms were as pervasive as in other areas. As the first step, a statutory body was set up to regulate the securities market. The Securities and Exchange Board of India (SEBI) became the independent authority to regulate the securities market and to protect investors' interest. The SEBI was empowered to regulate the issuance of securities, the Stock exchanges, any financial intermediary dealing in securities, credit rating agencies, depositories, custodians, mutual funds, and takeovers, and to prohibit insider trading and market manipulation. An elaborate framework, comprising the Rules and Regulations covering each of these areas, was notified by the SEBI, thus providing for the first time a comprehensive regulatory framework for the securities market. The reforms gave freedom to the companies to access the capital market and also removed control over timing, amount and pricing of issues. Companies were allowed to tap the foreign equity and debt markets through the issue of GDRs and convertible bonds. Consequently, there was a sudden increase in the number of public issues made by companies in the public and private sectors and in the amount of capital raised in the domestic and international markets. The total resources mobilised through the market rose to over Rs 200 billion between 1994-95 and 1996-97, but declined thereafter to around Rs 50 billion due to various factors.

To better protect the interest of investors, the SEBI laid down the initial and ongoing disclosure requirements and entry point norms for companies accessing the market, such as the requirement of a minimum track record of at least three years of profitability. Firms were required to publish half-yearly and quarterly financial results and increase disclosures to investors and shareholders.

Institutional investors, who are important corporate governance agents, became important players in the market. Mutual funds, which were hitherto the sole preserve of the public sector, were opened to the domestic private sector and foreign asset management firms. The new regulatory framework for mutual funds allowed mutual funds managed by domestic and foreign asset management companies to garner larger resources from the Indian household sector. These mutual funds today are able to raise resources to the order of Rs 180 billion annually from the market, and the total of investible funds is around 16% of overall market capitalisation.

Foreign portfolio investment was permitted in India since 1992 and foreign institutional investors also began to play an important role in the institutionalisation of the market. The regulatory regime for foreign portfolio investment allows foreign institutional investors to invest freely in listed or unlisted Indian securities, and to freely repatriate profits subject to payment of short-term and long-term capital gains tax. More than 400 foreign institutional investors are registered with the SEBI, of which about

100 actively manage their portfolios in India. The foreign portfolios were steady between 1994-97 to around US$1.5–2 billion annually, but weakened during most of 1998 due to the East Asian crisis. The portfolio flows improved thereafter, and there has been a noticeable surge in recent months. The net portfolio investment is to the order of US$9 billion.

In the secondary market, automated trading replaced the prevalent open outcry systems in all 23 stock exchanges in the country, which increased transparency and efficiency. The governance of the stock exchanges was improved significantly so that they could function effectively as self regulatory organisations. A wide variety of risk containment measures were put in place in the stock exchanges to protect the integrity of the securities markets. Surveillance and monitoring activity at the stock exchanges and by the SEBI were stepped up resulting in wide spread action against violations of the securities laws, insider trading and market manipulation. All these helped in providing for a modern, efficient and transparent market which can afford better protection of investors' interests and rights. These steps also had important bearing on corporate governance.

Dematerialisation of securities and electronic book entry transfer were speedily introduced with the setting up of the National Securities Depository Limited as the country’s first depository, followed by the setting up of the second depository, the Central Depository Services Limited. The setting up of the depository helped remove the inefficiencies and risks associated with a paper-based system. Apart from the depository, other service providers for the market, such as credit rating institutions, were set up as credit rating was made mandatory by the SEBI and RBI for various debt instruments issued by the companies to the public. International credit rating agencies have now taken equity stake in these institutions.

The freedom given to private enterprise resulted not only in private firms freely accessing the market for resources, but also to embark upon restructuring programmes through mergers, amalgamations and takeovers. The Companies Act, which governs mergers and amalgamations, and the Takeover Regulations of the SEBI, provided protection to investor interests (see Table 4).

Table 4: Key Statistics for Securities Market

	1998-99	**1997-98**	**1996-97**	**1995-96**
No. Stock Exchanges	23	22	22	22
Automated trading in stock exchanges	23	20	16	5
Average daily trading volumes (Rs bn)	41.60	37.86	26.92	9.89
Annual volumes (Rs bn)	10233.81	9086.91	6461.16	2373.75
Market capitalisation. (Rs bn)	5908.00*	6302.21	5051.37	5637.48
Capital issues (Rs bn)	55.86	45.69	142.76	208.04
Cumulative no. of listed companies	9877	9833	9890	9100
No. of mutual funds	41	35	32	24
No. of mutual fund schemes	320	259	228	197
Cumulative amount raised by mutual funds (Rs bn)				
UTI	940.67	808.74	717.73	674.92
Others	258.72	163.54	140.50	135.35
Total	1199.39	972.28	858.22	810.27
Foreign institutional investors				
a) No. regd. with SEBI	543	496	439	367
b) Net cumulative investment (US$ mn)	9517.3	8650.0	8998.20	7241.6
Takeovers				
a) No. of offer documents filed with SEBI	63	41	43	26
b) Exemptions granted	4	5	32	29

* Market capitalisation of the Stock Exchange Mumbai.

The reforms in the economy and in the banking sector, the laying down of a prudential and provisioning norms, the reforms in the securities market, automation of trading system, greater reliance of the corporate sector on the securities market, greater disclosure regime, electronic book entry transfer, institutionalisation of the market, establishment of a regulatory framework by SEBI to protect investors, laws against insider dealing – all happening within the short span of six years – were bound to have a significant impact on corporate governance.

The changes in the economic, monetary and securities market policies implemented by the government, the RBI and the SEBI constituted a major effort at redirecting policy to respond continuously to varying domestic and international situations. Investors and shareholders are now more confident than before as their rights and interests are protected. However, it would be quite wrong to conclude that the task of economic reform is over. There is a need to continuously supplement actions already taken through new initiatives that go beyond the policies that have already been announced.

Corporate governance characteristics

The corporate governance agents

An understanding of the place of the corporate sector in Indian economy is relevant as a preface to the present discussions. The Indian corporate sector is large by developing country standards and has historically played a significant role in the country's economic growth. As of 1995, value added by the industrial sector stood at 29% of GDP, and that by the manufacturing sector at 19%. Comparable figures for the US are 26% and 18%, and those for the UK are 32% and 21% respectively. Public, private domestic and multinational enterprises co-exist in the country. Among domestic private enterprises are the large business houses and independent companies. The number of listed companies in India has grown significantly over the years, especially with the adoption of economic and capital market reforms in 1991-92. As of 1999, there were 8,800 companies listed in the two major stock exchanges in the country, namely the Bombay Stock Exchange (BSE) and the National Stock Exchange.

As always, economic liberalisation and reliance on capital markets, as in India's case, underpin the need for reforming and strengthening corporate governance systems to better protect the interest of investors and other interested parties. For the success of any corporate governance system, certain issues are particularly important and relevant, such as transparency in generating and using information, equity for protecting legal and contractual rights of interested parties, and accountability for providing adequate incentives and discipline for management of companies.

Thus, as India became more integrated with the world market, and more and more companies accessed external sources of finance through the domestic and international debt and equity markets, public concerns became more focused on the effective protection of investor interests, especially those of small investors, on the promotion of transparency of operations within business and industry, and on the need to move towards international standards for disclosure of information and accounting by the corporate sector. Most important, the role of large blockholders, such as banks and institutional investors, also came under increasing scrutiny in view of the passive role they had played in the past in corporate governance of companies. For the institutions, financial risk management and credit evaluation mechanisms became important for internal governance, and their own prudent regulation and supervision became crucial to the soundness of the financial system. The steps taken by the RBI through capital adequacy requirements, prudential norms and norms for the banking sector and financial institutions ensured the maintenance of the integrity of the financial system. A Banking Supervisory Board was also set up by the RBI for banking supervision.

Ownership structure

The ownership structure of companies has an important bearing on corporate governance. Historically, there are several factors which contributed to the ownership structure of companies in India, and the reforms described earlier have had an impact. Prior to the reforms, governmental restrictions on ownership, freedom to expand and inter-corporate holdings, and the high tax regime resulted in private companies seeking to retain control less through direct holdings and more through indirect holdings, by way of an elaborate network of small investment and finance companies that were loosely or remotely connected to the parent company. The financial institutions, which were the sole providers of long-term finance, acquired equity holding through the convertibility covenant in the loan agreements, which allowed for conversion of a part of the loan into equity, and also through underwriting development and direct subscription in public issues of the borrower companies. Thus there were companies belonging to a large, well established business house where the promoter's controlling block was less than 10%. As few shareholders could attend the annual or extraordinary general meetings (which were held in remote places), it was easy for the promoters to move resolutions with the support of financial institutions.

The economic reforms which gave freedom to the private sector to expand, the reforms in the tax requirement, the institutionalisation of the market, greater reliance in the securities market, the activation of the takeover market and institutional investors, i.e. the financial institutions themselves having private ownership, all these brought about increased direct ownership of companies by promoters, increased the stake of the public, and reduced the stake of financial institutions on relative terms.

Comprehensive studies on the changing patterns of ownership structure of companies, based on representative and statistically meaningful samples of companies, with ownership data over a long period of time, are not readily available. In Table 5 data and analysis on the subject, based on studies conducted by various agencies at different times, have been compiled in an attempt to portray the changing pattern of ownership structure in India over a 35-year period. As methodologies, definitions, classifications and samples in the different studies may not be consistent, the results presented in Table 5 should only serve the limited purpose of providing a broad indication of the changing pattern of ownership structure of companies. It can be seen that the ownership pattern of financial institutions and the public has gradually declined over a period of time and that the ownership of corporate directors and top 50 shareholders has consistently increased in the corresponding period. There appears to be an apparent consolidation by insiders to the extent of 40% – 43%. These results contradict the expectations and prevalent beliefs in the country.

Table 6[4] shows another analysis, based on equity ownership data as of 1995-1996 for a sample of 1,613 non-public listed manufacturing companies. The equity ownership pattern of these 1,613 firms has been classified into broad ownership groups: domestic private companies belonging to business houses; domestic private stand-alone companies; foreign companies belonging to business houses; and foreign stand-alone companies. It is evident from this Table that the principal blockholders of corporate equity are: the term lending institutions in India, primarily comprising the three government controlled/promoted development financial institutions (DFIs), and the State Finance Corporations; institutional investors, namely the government-owned mutual fund, the Unit Trust Fund, and three government owned insurance companies; corporate bodies; directors and their relatives, i.e. a measure of family holdings; and foreign investors. Apart from these blockholdings, there is sizeable equity holding by small investors. The criticism of the role of the financial institutions referred to earlier is therefore understandable.

Table 5: Changing Pattern of Shareholdings in the Indian Private Corporate Sector (%)

Category of owners	1959 (1)	1965 (1)	1978 (1)	1982 (2)	1989 (2)	1989 (3)	1991 (4)	1996 (3)	This study
Individuals/public	52.1	44.1	37.3	44	36	36	26	31	33.33
Trustee and charitable institutions	1.2	1.3	1.2	2	1.5	n.a.	n.a.	n.a.	n.a.
Nominee companies, promoters & directors	39.6	13	13.8	24	26	21	30	35 (4)	41.79 (4)
Financial institutions and others	7.1	20.3	27.4	30	36.5	23	32	21	14.25
Overseas (individuals and institutions)	n.a	21.3	20.3	n.a.	n.a.	20	12	13	10.67
Total	100	100	100	100	100	100	100	100	100

Note: (1) RBI (Reserve Bank of India) study.
(2) IDBI (Industrial Development Bank of India) study.
(3) ETRB (The Economic Times Research Bureau) study.
(4) Includes top 50 shareholders.
n.a. Not available.

Table 6: Pattern of Equity Ownership in Different Types of Companies

Type of Company	Mean Equity Holding (in %) by					
	Directors and relatives	Corporate bodies	Foreign	Financial institutions	Institutional investors	Public
Private companies belonging to business houses	8.1	33.8	9.2	4.2	10.2	34.5
Private stand-alone companies	21.6	18.5	7.2	3.1	3.1	46.5
Foreign companies belonging to business houses	0.8	18.3	42.0	4.3	12.2	22.4
Foreign stand-alone companies	2.8	13.8	43.3	1.7	8.4	30.0
ALL	15.7	23.8	9.9	3.5	6.1	41.0

Certain broad differences in the equity structure across the groups is also revealed by Table 6. Companies belonging to private business houses have significantly higher equity participation by financial institutions and institutional investors than stand-alone companies. This difference is particularly pronounced with respect to institutional investors. Second, domestic companies have a much higher holding by directors and relatives compared to foreign companies. Within domestic companies, the share of directors and relatives in stand-alone companies (22%) is almost three times the share in companies belonging to business houses (8%). However, companies belonging to the latter group have a significantly higher holding by corporate bodies (34%) compared to stand-alone companies (19%). As mentioned previously, the controlling block of shareholding is often owned through a string of corporate bodies. Taking the sum of holdings by directors and relatives and by corporate bodies into account, this share is remarkably similar in domestic stand-alone companies and group companies. Since for group companies, a significant proportion of the holdings by corporate bodies may be holdings by other group companies, the extent of total insider control in these companies may be very similar to that in domestic stand-alone companies. The relatively low holdings by directors and relatives, but higher corporate holdings as compared to the overall average, probably reflects the fact that most business houses had developed complex webs of private companies and cross-shareholdings to take advantage of various government incentives to encourage industrial growth. This has left them with small, direct controlling stakes in group companies. For foreign companies, both stand-alone and group companies, the share of foreign bodies is less than 10%, being slightly higher in group companies (9%) compared to that in stand-alone companies (7%). Finally, ownership of equity of stand-alone companies, both Indian and foreign, are much more diffused than that of the business houses.

The above analysis of the equity holding pattern of the Indian corporates reveals that the nature of equity holding, as well as the identity of the largest equity holder, varies significantly across the different groups. For domestic group companies, corporate bodies that include finance and investment companies which control the indirect holdings of promoters in companies, emerge as the single most dominant group, followed by holdings by institutional investors. For domestic stand-alone companies, directors and relatives appear to be the most dominant group, followed by holdings by corporate bodies. For foreign companies, foreign bodies obviously emerge as the single most dominant group followed by holdings by corporate bodies.

While cross-country comparisons are somewhat difficult, given that the reporting of equity ownership data is not uniform, some broad comparisons with other countries suggest that the Indian corporate governance system can by and large be considered as a hybrid of the 'outsider' system of the US and UK, characterised by diversified equity ownership and less involvement of lending institutions, and the 'insider' systems of continental Europe and Japan, characterised by a greater concentration of shareholder power residing with banks, families and other corporations (see Table 7).

Table 7: Distribution of Outstanding Corporate Equity for Selected Countries (%)

Percentage of equity held by	India[1] (1996)	China (1995)	US (1993)	UK (1993)	Germany (1993)	Japan (1993)	Czech Rep. (1995)
All corporations	36.3	28.7	46	64	68	69	45.5
Financial institutions	12.7		46	62	29	45	
Banks/lending inst.	6.6[2]			1	14	22	15.5[5]
Insurance companies	4.0		5	17	7	17	
Pension/inv. funds	-		26	34	-	1	
Mutual funds	2.1		11	7	8	3	
Others	-		4	3	-	1	30[6]
Nonfinancial corps.	23.6		-	2	39	24	
Individuals	40.8[3]	31.5	49	18	17	24	49[7]
Foreign	9.8	6.1	5	16	12	7	3.4
Government	--	30.9	-	1	4	1	3.2
Others	15.3[4]	-	-	2	-	-	-
Total	100.0	100.0	100	100	100	100	100.0

Source: Jayati Sarkar and Subrata Sarkar, ibid.

Sources: Data for US, UK, Germany and Japan from OECD, 1995. Data for China from Xu and Wang (1997). Data for Czech Republic from Claessens et al. 1996.

Note: The columns on India, China and Czech Republic are not directly comparable to the other four countries.
1) Data is based on the study sample of 1613 companies.
2) Includes commercial banks, government owned/promoted term-lending institutions and financial corporations.
3) Individuals include top 50 as given in Table 2.
4) Others include shares held by directors and relatives given in Table 2.
5) Bank-sponsored investment funds.
6) Non-bank sponsored investment funds.
7) Include both individuals and local strategic investors.

The Table shows that equity holding by non-financial corporations in India, which are primarily inter-corporate cross-holdings, are much higher than in the UK and US, and are more comparable to Germany and Japan. However, at the same time, the participation of small investors in corporate equity in India is at comparable levels with the US. Different types of financial institutions in India separately hold much smaller blocks than those in other countries but, given that nearly all of these institutions are government controlled and fall under the aegis of the Ministry of Finance, they form a much more homogeneous block than elsewhere. Another significant homogeneous institutional presence in companies is made up of institutional investors such as mutual funds, chief among which is the Unit Trust of India that controls more than 80% of the investible resources of the mutual fund sector; other mutual funds in the public sector (private sector mutual funds are comparatively still small in size); and insurance companies having a common owner, i.e. the government. This presence is comparable to what is found in Japan and Germany, but much less than what is in the US and UK. However, in the past, these institutions were not known to be active shareholders in board rooms. Now they have become active, and among themselves have drawn up a code of corporate governance for companies. The government is also encouraging them to take a proactive role as shareholders.

Another study on the distribution of ownership stakes by various categories of owners, based on financial and ownership data for a sample of 1060 companies during January to December 1998, signals a change in corporate ownership[5]. Management ownership appears to be clustered in the range of 25% – 75%, and public ownership and financial institutions appear to be clustered in the range of 10% - 40% and 5% - 40% respectively. Management appears to prefer holding more than 30% and would like to increase its holdings to 70%. Financial institutions appear to be gradually divesting their stake after keeping a minimum stake in the range of 5% - 15%. The study also shows that management of smaller firms is quite conservative and holds more than 40% of the ownership. Financial institutions, which on an average hold 14%, appear to be concentrating on bigger firms. Public shareholding also follows the same pattern of management ownership. Public shareholders hold a larger stake in smaller companies than in bigger firms.

Role of non-banking intermediaries

Among the non-banking intermediaries, such as merchant banks, finance companies and securities companies, the merchant banks and securities companies have traditionally played an active role in issue management, as underwriters, brokers and financial advisors. They do not usually hold equity status in a company, except up to 5% to demonstrate their commitment to those companies for which they provide advice and underwriting support. The shareholding of securities companies in other firms is also very low. The case of finance and investment companies is somewhat different, as has been discussed previously.

Role of equity markets

The role of equity markets in financing companies, especially in the post-reform period, has already been discussed. It is important to note that as is typical of many developing countries, but not of developed countries, Indian corporations rely dominantly on external sources of finance, and this reliance has increased significantly since the institution of financial sector reforms. As of 1996, more than three-quarters of total funds raised by Indian corporations were from external sources via the capital market and through bank borrowings. Hence, the onus of proper corporate governance automatically falls disproportionately on the external financiers. Among these, financial institutions, like those in developed countries, have remained a significant source of external finance as compared to the equity market, although the latter's share in overall financing has considerably increased since liberalisation. As of 1996, funds raised from the capital market constituted 17.4% of total funds, and bank borrowings (commercial banks and development financial institutions) constituted 33.1% of total funds. The debt-equity ratio for the sample of corporations stood at around 1.9 in 1995-96, which shows that Indian corporations, like their counterparts in developed countries, are substantially leveraged.

The economic reforms which helped unleash entrepreneurial skills and private enterprise have also paved the way for corporate restructuring through mergers, amalgamation and takeovers. The market for corporate takeovers has yet to mature, hostile takeovers are few in number, and anti-takeover devices are not yet prominent, but it must be mentioned that corporate takeovers have become an important mode of corporate growth. In takeovers, the stock markets have been providing exit options to shareholders in a transparent manner, enabling them to realise the value of their wealth. The Regulation for Takeovers framed by the SEBI provides adequate protection to investors. Over the last 18 months, corporate takeovers in the value Rs 30 billion have taken place.

Institutional investors

It has already been discussed earlier that there is a growing trend towards institutionalisation of the market. About 60% of the funds of institutional investors, such as the government-controlled Unit Trust of India (UTI), as well as public and private sector mutual funds, are invested in equity. All 36 mutual funds are managed by asset management companies, of which 9 belong to the public sector, 14 are set up as joint ventures with foreign asset management companies, and the remaining are set up as domestic private financial services firms. The asset management companies manage the equity portfolio of the mutual funds actively and, indeed, the buying and selling by these funds, especially by the UTI, significantly influence market movements. The SEBI regulation for mutual funds lays down prudential investment norms which include ceilings of mutual fund holdings as a percentage of a company's equity and also as a percentage of net assets.

The government-owned insurance companies have a sizeable equity portfolio but do not usually play an active role in portfolio management. Besides, there are government restrictions on investments by these companies in the equity market. The banks are allowed to invest 5% of the incremental deposits in stocks, but they are reluctant to take risks by investing in equity markets for fear of suffering the penalty of making wrong investment decisions. The provident and pension funds, which are also pre-empted by the government, are prohibited from investing in equity. Thus, a large amount of capital which is patient in nature is restricted from entering into the equity market.

It has been observed that financial institutions and mutual funds are becoming active in the board rooms. They have therefore an important role to play in corporate governance. Privatisation, at least partial, of the insurance sector and removal of investment restrictions on provident funds could help increase the supply of long-term capital to equity markets and help institutionalisation of the market, which can in turn build up pressure for corporate governance. In the absence of these institutions, foreign institutional investors play a dominant role in the Indian securities market and often are able to influence market movements. There is a need for counterbalancing their impact by encouraging large, active domestic institutional investors. It would then be possible for these investors to play a larger monitoring role in the board rooms, and supplement the steps that are now being taken by financial institutions.

Voting rights

As far as voting rights are concerned, the present laws do not make a distinction in voting rights of shareholders based on their origin. While restrictions exist on maximum foreign holdings in Indian companies, varying between 51%-75%, through foreign direct investments and portfolio investments, there is no distinction in the rights of the foreign shareholder and domestic shareholder. This implies that a foreign institutional investor, who has made a portfolio investment, has equal voting rights and can participate in takeovers or in AGMs as any other shareholder.

Diversification of business

As mentioned before, there are four types of Indian corporations – firms with dominant ownership of business houses, stand-alone professionally managed companies, government-controlled firms in the public sector, and multinationals. The business houses are fairly diversified across the manufacturing and service sectors, including commodity companies such as cement, steel, fertilisers, oil and petrochemicals, pharmaceuticals, automobiles, and financial services. The government-controlled firms are not as diversified across industry sectors, although as a whole the public sector is diversified over core industries in the manufacturing, banking and service sectors. The diversification of private corporate sectors has increased since the economic reforms that removed investment restrictions on the private sector and allowed industries, which were the sole preserve of public sector investment, to be set up by private sector companies. The ownership structure of these companies has already been discussed in the previous paragraphs.

Corporate behaviour, finance and restructuring

Funding pattern

The funding pattern of the corporate sector has important implications on corporate governance. This is shown by a study on the financial performance of 550 sample companies in the private corporate sector assisted by the Industrial Development Bank of India (IDBI) during 1997-98. Internal resources at Rs 137 billion met 29.3% of the total requirement of funds in 1997-98, as against 35% in the previous year. Of the external sources, long-term borrowing increased by 23% in 1997-98, on top of an increase of 84% in 1996-97. Funds borrowed from financial institutions increased by 8%, and funds raised by debentures increased by 44%. The long-term borrowings of commercial banks increased by a whopping 138% in 1997-98, as against 32.5% in the previous year (see Table 8). The debt equity ratio and current ratio of the sample companies was around 1.1 and 1.5 respectively in 1997-98, and this ratio has more or less remained steady for the last 5 years. The profit after tax, as percentage of net worth, has been showing a declining trend in the last 5 years, and was around 11.2 in 1997-98 (see Table 9).

Effects of ownership structure on value

The effects of the ownership structure on a company's value have been studied[6] with regard to performance and governance, using data from a sample of 1613 listed manufacturing companies, comprising private companies, foreign companies, and stand-alone companies. The analysis focuses on the role of different equity and debt holders in influencing company value. Using the Market to Book Value Ratio (MBVR) as a measure of company value and the return on net worth ratio as a measure of company performance, the study shows that the correlation between the two ratios is very low for domestic private companies and is actually negative for companies belonging to business houses. For foreign companies belonging to business houses, the correlation is high irrespective of the measure of profit that is used. The correlation suggests that the largest distortion between market and accounting indicators occur due to tax and depreciation provisions.

Table 8: Sources of Funds for 550 Sample Companies

(Rs. billion)

Sources	All companies (550)			Profit-making companies (410)		
	1995-96	1996-97	1997-98	1995-96	1996-97	1997-98
A Internal sources	19707.5	15012.2	13717.7	17610.3	14220.1	14788.9
1 Paid-up capital	335.0	153.7	542.8	292.6	150.5	496.3
2 Reserves and surplus	14512.3	7426.4	4814.5	13098.6	7610.7	7209.3
3 Provisions						
Depreciation	4785.5	7366.5	8547.2	4105.8	6388.1	7246.7
Tax (net of advance income tax)	74.7	65.6	-186.8	113.3	70.8	-163.3
B External sources	24228.6	28001.6	33029.5	18078.3	21961.2	24745.5
4 Paid-up capital	1866.7	660.2	1189.6	1328.0	249.2	862.6
5 Long-term borrowings	10356.7	19043.4	23474.4	7316.4	14282.0	17312.5
Debentures	752.6	4533.3	6546.6	541.7	2871.9	4931.7
From financial institutions	3342.4	6125.5	6614.7	2086.7	5166.6	3585.5
From banks	2283.1	1540.3	3673.0	1788.7	1257.5	2594.7
From long-term deposits	154.0	481.0	586.8	101.4	369.6	455.7
From others	3824.7	6363.3	6053.4	2797.9	4616.5	5745.1
6 Other receipts/bank borrowings for working capital	12005.1	8297.9	8365.5	9434.0	7430.0	6570.4
6.1 Short -term borrowings	4798.5	2592.9	3048.7	3698.5	2069.3	2475.0
6.2 Sundry creditors	4924.0	3267.9	2841.4	3937.5	2678.6	2017.3
6.3 Other current liabilities	2282.6	2437.2	2475.5	1797.9	2682.1	2078.2
Total (A+B)	43936.0	43013.7	46747.2	35688.6	36181.3	39534.4

Source: Financial Performance of IDBI Assisted Companies in the Private Corporate Sector, 1997-98.

Table 9: Important Ratios for 550 Sample Companies

	All Companies (550)			Profit-making companies (410)		
	1995-96	1996-97	1997-98	1995-96	1996-97	1997-98
Asset-liabilities ratios						
Debt-equity ratio	0.81	0.95	1.14	0.74	0.85	0.97
Current ratio	1.46	1.42	1.40	1.50	1.45	1.47
Quick asset ratio	0.94	0.92	0.90	0.97	0.94	0.94
Total borrowings to net worth	1.56	1.73	1.96	1.46	1.59	1.72
Net worth as % of total net assets	39.06	36.60	33.80	40.70	38.55	36.76
Long-term borrowings from financial institutions as % of net fixed assets	23.68	24.21	24.64	21.77	23.07	22.41
Profitability ratios						
Profit before tax as % of net worth	17.36	12.92	10.55	18.31	15.42	14.56
Profit after tax as % of net worth	15.58	11.00	8.87	10.03	7.89	7.57
Dividend ratios						
Total dividends as % of net worth	3.75	3.70	3.36	3.92	4.05	3.69
Ordinary dividends as % of ordinary paid up capital	20.19	20.70	18.74	24.27	26.91	25.15

Source: Financial Performance of IDBI Assisted Companies in the Private Corporate Sector, 1997-98.

Does the performance of companies also vary across different groups of companies? The study clearly illustrates that foreign companies have a higher market valuation than domestic private sector companies. Based on MBVR, the pecking order for performance of different groups is: foreign companies; domestic companies belonging to business groups; and domestic stand-alone companies. There is a wide divergence in the performance of the three groups of companies. An increase in holdings by directors and relatives, commonly known as insider holdings, reduces company value in India as long as the holding does not exceed 25%. After that, an increase in holdings by directors and relatives has a positive effect on company value. The authors of the study conclude that directors and relatives may have an interest in maximising their own private interests at the expense of other shareholders when they have less stake in the company, but as their stakes increase, the interest of directors and managers coincide with the interest of shareholders. The same pattern of behaviour is seen between corporate bodies and company value. As far as the financial institutions are concerned, the study shows that an increase in holdings by financial institutions reduces company value for holdings below 15%, but increases it thereafter. As far as institutional investors are concerned, an increase in their holdings has a uniformly positive effect on company value for low levels of holdings, but the sharp increase noticed in higher levels of holdings, as in the case of financial institutions, is absent for institutional investors.

The authors of the study suggest that the reason for the above results could be that, in India, financial institutions, rather than institutional investors, are more effective in influencing company value at high levels of equity ownership. This is because the financial institutions, which have gone to the capital market - in which government has divested substantial portions of equity - are now under pressure from the market (i.e. from the shareholders) to perform. In contrast, the mutual fund industry has remained government-controlled and does not have full voting rights since mutual funds are set up as public trusts with the voting rights vested in the public trustee. Another important factor is that because of significant debt holdings by financial institutions, they have more incentive to monitor and exercise their voting rights effectively than institutional investors. This also implies that under present Indian conditions, debt holding vis-à-vis equity holding is more effective in monitoring company performance.

III. The regulatory framework and the role of policy

Equitable treatment of shareholders and other stakeholders

Shareholder protection

The regulatory framework and its effective enforcement play a vital role in corporate governance and influencing corporate behaviour. Enlightened shareholders, supported by a legal or institutional framework, can provide the necessary bulwark against discretionary behaviour of management. In India there are primarily four avenues which ensure that debt holders and equity holders can exercise exit or voice options to make company management accountable. These are the Companies Act 1956; the SEBI Act 1992, and various regulations prescribed by the SEBI; a market for corporate control; and active participation by financial institutions and institutional investors.

The Companies Act 1956, which is by far the largest legislation enacted by Parliament, comprising 658 sections and 14 schedules, regulates the activities of Indian companies. The main objective of the Companies Act is to ensure that the interests of creditors and shareholders are adequately protected and that the shareholders are adequately represented in the management of a company. The Companies Act sets down the requirements that must be fulfilled and the disclosures that must be made before and after making public issues.

The Companies Act is administered by the Department of Company Affairs in the Ministry of Industries. The central government has also constituted the Board of Company Law Administration which comprises members appointed by the government by notification. This Board in turn forms one or more Benches from among its members, and every Bench has powers vested in a court under the Code of Civil Procedures. Every Bench is also deemed to be a Civil Code, and the proceedings before the Bench are deemed to be judicial procedures. The Companies Act sets down the circumstances under which a company or a shareholder may appeal to the Board.

The Companies Act has provisions for: the registration and incorporation of companies; the issue and reduction of capital; disclosure requirements, including disclosures through issue of prospectus; civil and criminal liabilities for misstatement in prospectuses; the allotment of shares and debentures, and time limit within which shares and debentures are to be allotted; penalties for violating the time limits; rights of shareholders for change in capital; and the transferability of shares. General provisions relating to the management and administration of companies include: registration of membership and a register of members; requirement to file annual returns in a specific format; and inspection of registers and annual returns of any member or debenture holder, or any other person on payment. There are also provisions and procedures for: holding statutory meetings; submission of annual reports in a specific format; holding annual general meetings within a specified period from the date of the closing of annual accounts; disclosures by way of notices for the meetings; and proxies, manner of voting, manner of passing various types of resolutions. There are specific provisions for maximum managerial remuneration, the calculation of commissions, and the payment of remuneration in the case of absence or inadequacy of profit. There is also a requirement for: auditing company accounts, and the remuneration of auditors; the right of auditors to attend general meetings; and the approval of the annual accounts, as well as the AGM, by the board of directors. The Companies Act also lays down provisions for: the constitution of the board of directors; appointment, qualifications and remuneration of directors; meetings of the board; and the powers and restrictions of the board. Furthermore, the Act lays down elaborate procedures for winding up companies.

Important are also the provisions in the Companies Act for preventing oppression and mismanagement. Under these provisions, no fewer than 100 members of a company, or 10% of the total members (whichever is less or if any member holds 10% of the issue and paid-up capital of the company) can apply to the Company Law Board for relief of oppression or mismanagement. The central government may apply to the Company Law Board under the same provisions. The Company Law Board has specific powers to *inter alia* regulate the conduct of company affairs, terminate, set aside or modify any agreement, and set aside any transfer or delivery of goods. The Act lays down civil and criminal liabilities against officers in default for violating various provisions of the Companies Act, and also provides for circumstances under which the central government can order an investigation into the affairs of a company. After receiving a report of misconduct, the central government is also empowered to prosecute any person found criminally liable.

The key provisions of the Companies Act are given in Box 2. Some of these provisions are discussed in the following paragraphs:

- *Voting rights*: the important legal right that shareholders have to ensure management accountability. This right is guaranteed. Every member of a company limited by shares, and holding part of the equity share capital, has a right to vote. The Act does not make any distinction between shareholders with respect to their origin or any other parameter. All shares carry proportional voting rights. Voting through proxy is also allowed.

- *Board of directors*: the day-to-day-business of a company is controlled by the board of directors. The board of a company is the focal point of any decision making process. The quality of the board determines the level of corporate governance. It is therefore important that corporate boards can influence how well a company is run and functions.

Usually the board of a company is single-tiered, with the company being governed by the chairman or managing director. The Companies Act does not have a requirement to appoint non-executive directors to the board. As in the UK, the Companies Act has no provision for the number of executive and non-executive members. There are restrictions on the maximum number of companies to which a person can be appointed as director. The Companies Act stipulates that no individual can act as the director in more than 20 companies. The directors are subject to detail disclosure requirements with respect to the financial interest in the company.

There is, however, no provision in the Companies Act to facilitate free competition on corporate boards which is vital for improving how the board functions. There is no mechanism in the regulatory framework to provide for exit pressure on existing board members. There is also no specific provision in the Companies Act for appointing independent directors. Hence the Companies Act does not make any distinction between independent and non-independent directors of the company.

The Companies Act provides broad guidelines on how the board should function. But, it is not legal compliance alone that ensures better corporate governance. For example: the Companies Act does not have any provision for appointing non-executive directors to the board. The provisions of the Companies Act restrict the number of directorships, conditions of disqualification, remuneration and compensation. The appointment and retirement of the members of the board are regulated through the Act. The frequency of board meetings, appointment and removal of directors, and requirement of disclosure of interest are regulated by the board of the company.

- Remuneration *of directors*: the Companies Act provides for remuneration of executive directors either through monthly payment or a specified percentage of net profits or a combination of both. There is, however, a ceiling for such remuneration - up to a maximum of 5% of net profits for one such director, and 10% in case there is more than one director. The non-executive directors may be paid monthly, quarterly or annually, or by way of a commission provided that the remuneration is paid to one or several of them does not exceed 1% of the net profits of the company in certain cases, and 3% in others.

- *Appointing committees*: the Companies Act does not provide for any regulation which can compel the board to appoint certain committees, such as an audit committee, and delegate powers to the committees. The board also cannot be compelled to obtain independent advice on any matter.

- *Annual general meeting*: the Companies Act provides for the holding of annual general meetings, quorums for such meetings and the circumstances under which extraordinary general meetings could be called. The Companies Act also gives the notice period to be given to members for the attendance of meetings. Sec 219 of the Companies Act requires a copy of every balance sheet (including the profit and loss account, the auditors' report and every other document required by law to be annexed or attached to the balance sheet), to be sent to every member of the company not less than 21 days before the date of the meeting.

- *Shareholder rights*: shareholder rights provide an important benchmark on the quality of corporate governance. There are several provisions in the Act which empower the shareholders to voice their opinion. For example, the Act provides for various types of voting procedures and requirements of ordinary and special majority for passing various resolutions. Since the majorities are determined on the basis of members present at the meetings, it is possible for management to abuse these provisions. The provisions for postal ballot are still absent.

- There are rules that allow minority shareholders to take certain remedial action if they believe that they are being oppressed by the majority shareholders, and that the company is indulging in mismanagement of resources in a way that causes prejudice to the interest of the company and the public. Shareholders have a right to request the Company Law Board to investigate into the affairs of the company and request it to freeze the voting rights on certain shares. Members also have the right to ask for the register of members, inspect proxies in case of a proxy war between shareholders, and to call for an extraordinary general shareholder meeting.

- *Role of the institutional shareholders*: the financial institutions for development, as well as insurance institutions and mutual funds, are the substantial block holders in large Indian companies. These institutions are also major debt holders. And, as already mentioned before, they exhibit a certain degree of homogeneity in ownership. There are now three public financial institutions listed on the stock exchanges, but with majority control exercised by government. The insurance companies and the UTI are still government-owned.

As in the case of certain countries like Germany and Japan, financial institutions in India have nominees on the boards of companies to which they have made loans. The financial institutions therefore have the potential to act as a single blockholder and collectively block resolutions detrimental to their interests. In the past financial institutions have been perceived to be extremely passive in corporate governance, but in certain cases their role has come under sharp criticism. The Supreme Court has held in one such case that on corporate boards they have to serve as guardians of the public interest, even if they have the rights of ordinary shareholders. With public financial institutions being partly owned by the securities market, they are now increasingly playing their role in corporate governance. They have not only evolved certain codes of behaviour, but they have also taken action by voting with their feet and defeating resolutions moved by the company that were in the interest of a part of the management.

The regulatory framework for the securities market and SEBI

The SEBI has directed the stock exchanges to amend the listing agreement to incorporate provisions for enhanced disclosures and for strengthening corporate governance (see Box 2).

Market for corporate control

There is a growing trend in the post economic reform scenario towards consolidation of market shares and diversification into new areas through takeovers, mergers and amalgamations. The removal of the restrictions on companies placed in the Monopolies and Restrictive Trade Practices Act have made mergers and amalgamations relatively easy. Friendly takeovers, however, are more pronounced. In the last two years, a large number of companies in the pharmaceutical, cement, infotech and consumer goods sectors have focused on core competence by either divesting product line divisions and group companies, or acquiring these businesses.

The important point about the market for corporate control is that the regulation for substantial acquisition of shares ensures transparency in operations, equity and disclosure of material information to all parties concerned. The regulations allow shareholders to participate freely in the takeovers and realise the value of their investments. Similarly, provisions in the Companies Act allow for the free transferability of shares, although under certain sections the target companies can shelter and not transfer shares, if such transfers affect the interest of the company. The Companies Act ensures that shareholders' interests are protected in the case of mergers and amalgamations where company valuation and merger ratios require the approval of the courts.

The importance of transparency and disclosure

The importance of transparency and disclosure in corporate governance has been described in various sections of the report. The SEBI has brought about significant improvements in the standards of disclosures in offer documents of companies issuing securities and in mutual funds, and also in frequency and quality of continuing disclosures through the listing agreement. The contents of the annual report prescribed in the Companies Act have been supplemented through the listing agreement. The listing agreement has also required companies to publish unaudited quarterly results. Besides, both issuer companies and mutual funds have the option of publishing half-yearly unaudited results in newspapers. Abridged results must also reach every shareholder. Box 3 describes the type of information about material events affecting the performance of a company and which needs to be disclosed.

An important development, which can play an important role in corporate governance, is the introduction of the facility for buying back shares. Recently, the Companies Act has been amended and the SEBI has issued guidelines to companies for buy back of shares.

Box 2: Key Provision of Companies Act, 1956	
Sec 39	Copies of memorandum and articles, etc., to be given to members.
Sec 40	Alteration of memorandum or articles, etc., to be noted in every copy.
Sec 55	Dating of prospectus.
Sec 56	Matters to be stated and reports to be set out in prospectus.
Sec 57	Expert to be unconnected with formation or management of company.
Sec 58	Expert's consent to issue of prospectus containing statement by him.
Sec 61	Terms of contract mentioned in prospectus or statement in lieu of prospectus, not to be varied.
Sec 62, 63	Civil, criminal liability for mis-statement in the prospectus.
Sec 87	Voting rights.
Sec 108	Transfer not to be registered except on production of instrument of transfer.
Sec 165	Statutory meeting and statutory report of company.
Sec 166	Annual general meeting.
Sec 171	Length of notice for calling meetings.
Sec 172	Contents and manner of service of notice and persons on whom it is to be served.
Sec 173	Explanatory statement to be annexed to notice.
Sec 176	Rules for the appointment of proxies.
Sec 177, 178	Voting by show of hands and the declaration of the result by the Chairman.
Sec 179-186	Rules for taking a poll.
Sec 189	Different types of resolutions at meetings. In the general meetings of companies, the major decisions are on the agenda as resolutions, which are decided by the shareholders.
Sec 197A	Prohibition of simultaneous appointment of certain different categories of management personnel.
Sec 198-204A	Managerial remuneration.
Sec 205-207	Manner of and time of payment of dividends.
Sec 209-223	Accounts, manner of maintenance, inspection boards report & penalty for improper issue of b/s & p&l a/c.
Sec 224-233B	Eligibility, appointment, remuneration of auditors, right of auditor to attend the general meeting.
Sec 235-237	Investigation into the affairs of the company
Sec 252	Provisions for minimum number of directors
Sec 253.	Only individuals to be directors.
Sec 254	Subscribers of memorandum deemed to be directors.
Sec 255	Appt. of directors and proportion of those who are to retire by rotation.
Sec 256	Ascertainment of directors retiring by rotation and filling of vacancies.
Sec 257	Right of person, other than retiring directors, to stand for directorship.
Sec 258	Right of company to increase or reduce the number of directors.
Sec 259	Increase in number of directors to require Government sanction.
Sec 260	Additional directors.
Sec 262	Filling of casual vacancies among directors.
Sec 263	Appointment of directors to be voted on individually.

Box 2: Key Provision of Companies Act, 1956	
Sec 264	Consent of candidate for directorship to be filed with the company and consent to act as director to be filed with the Registrar.
Sec 267	Certain persons not to be appointed managing directors.
Sec 268	Amendment of provision relating to managing, whole-time or non-rotational directors to require Government approval.
Sec 269	Appt. of managing or whole-time director or manager to require Government approval only in certain cases.
Sec 274	Disqualification of directors.
Sec 275	No person to be a director of more than 20 companies.
Sec 276	Exclusion of directorships for the purpose of the acts.
Sec 280-282	Retiring age of directors.
Sec 283	Vacation of office by directors.
Sec 284	Removal of directors.
Sec 285	Board to meet at least once in every 3 calendar months.
Sec 286	Notice of meetings.
Sec 287	Quorums of meetings.
Sec 299	Disclosure of interest by director.
Sec 300	Interested director not to participate or vote in Board's proceedings.
Sec 301	Register of contracts, companies and firms in which directors are interested.
Sec 302	Disclosure to members of directors' interest in contract
Sec 305	Duty of directors, etc., to make disclosure.
Sec 309	Remuneration of directors.
Sec 310	Provisions for increase in remuneration to require Government sanction.
Sec 311	Increase in remuneration of MD on reappt. or appt. after Act to require Government sanction.

The SEBI regulations for Substantial Acquisitions and Takeovers have also increased the transparency in takeover operations and made information available to shareholders in a timely manner. A takeover offer is announced through a public announcement in the newspapers, followed by the compulsory mailing of a detailed offer document within a stipulated time so as to reach every shareholder. This enables every shareholder to participate in takeovers.

The disclosure of financial information relates to accounting standards. The auditors in India are members of the Institute of Chartered Accountants of India which has laid down the accounting standards. There are already specific norms for evaluation of assets and securities. As regards banks, the RBI has laid down strict guidelines for the evaluation of assets and criteria for determining non-performing assets, provisioning and norms for capital adequacy. As is mentioned in Box 3, the SEBI has appointed a committee to further strengthen and consolidate accounting norms and disclosures. It should be mentioned that Indian companies are now moving towards international accounting standards. Three market leaders - one among financial institutions, one in the manufacturing sector and one in services and software - have already disclosed modified accounts under GAAP. This step is likely to put competitive pressure on other companies to voluntarily raise their accounting standards.

Box 3: Steps Taken by SEBI for Corporate Governance

SEBI advised the stock exchanges to make an amendment in the listing agreement, whereby every household will be sent a copy of the complete balance sheet, whereas abridged balance sheets will be sent to every member to save on costs.

SEBI has introduced various disclosure norms for offer documents in a public or rights offer of a company.

In order to address changing scenarios in market conditions, SEBI, from time to time, has suggested changes/amendments in the listing agreements for better disclosures by companies.

To ensure that utilisation of funds and projected profitability are in accordance with disclosures made in the prospectus of the companies, stock exchanges have been advised to make an amendment to the listing agreement that the companies should furnish on a yearly basis a statement to the exchange showing the variations between projected utilisation of funds and/or projected profitability statement and the actual utilisation of funds and/or actual profitability. If there are material variations between the actual and projections, the company shall furnish an explanation. This comparison is also to be provided in the Director's Report.

SEBI has also provided that a company will supply a copy of the complete and full Balance Sheet, Profit & Loss Account and Director's Report to each shareholder, though the Companies Act contains provisions for providing abridged accounts only. SEBI has also mandated that the company should also give the Cash Flow Statement along with the Balance Sheet and Profit & Loss Account. The Cash Flow Statement will help investors to get better quality information about the performance of the company.

It has been made mandatory for companies to appoint a senior officer to act as Compliance Officer who will be responsible for monitoring the share transfer process and report to the company's board in each meeting, to directly liaise with the authorities such as SEBI, Stock Exchanges, Registrar of Companies, and investors with respect to implementation of various clauses, rules, regulations and other directives of such authorities and investor services and complaints related matters as per the recommendations of the Chandrasekaran Committee.

With the purpose of ensuring continual disclosure standards by corporations and timely dissemination of price sensitive information to the public, companies have been advised to provide the details pertaining to all material events having a bearing on the performance of the operation of the company and which would be price sensitive information. These could be pertaining to: change in the general character or nature of business; disruption of operations due to natural calamity; commencement of commercial production/commercial operation; developments with respect to pricing/realisation arising out of change in the regulatory framework; litigation/dispute with a material impact; revision in ratings; and any other information having bearing on the operation/performance of the company as well as price sensitive information.

The listing conditionalities, among other things, mandate companies to declare unaudited quarterly results.

A committee for accounting standards has been appointed by SEBI to evolve disclosures on the lines of international standard practices to bridge the gap between Indian accounting standards and international accounting standards. The committee would be recommending accounting standards in respect of the following:

1. Standard norms for NAV of mutual funds, uniform accounting policy and valuation methods.
2. Accounting norms for brokers and maintenance of standard books.
3. Business combinations and consolidated financial statements of issuer/listed companies.
4. Review of continuous disclosure requirement of listed companies.
5. Valuation of soft assets, derivatives.
6. Special accounting norms where no accounting standards have been set up.

IV. Conclusions

Given the ownership structure and the macro-economic environment prevailing till 1991-92, in which private enterprise was allowed restrictive growth, corporate governance was not of critical importance to most companies. While the capital market was growing, and companies were increasingly relying on it for long-term capital, the full potential of the market was yet to be realised. The regulatory framework for the securities market was also fragmented as there was no single body charged with protecting the interest of investors. Thus, even though the Companies Act provided the basic foundation of corporate governance, the companies adhered at best to the letter of law. For example, while the Companies Act required the issue of prospectus for every public offer or securities, the disclosure of information under each head in the statutory format of the prospectus was kept to a bare minimum. Besides, prospectuses were printed in small fonts so as to be almost illegible and also were not available to all investors. The disclosures in the annual reports were kept to the bare minimum by merely adhering to the prescribed format. Transfer of shares took time and investors had to wait for a long while to receive share certificates in public issues. Although the annual general meetings and extraordinary general meetings were held as legally provided for, the information disclosures in the notices were scant. Investors therefore did not have sufficient material information to make informed decisions. The frequency of disclosures was also annual. The takeovers took place in a non-transparent manner and investors did not have sufficient opportunity to participate. These are some examples to demonstrate the absence of corporate governance systems. On the whole, the shareholders themselves were also not conscious of their rights. There were, however, several companies, including multinationals and those belonging to business houses, which did demonstrate and adhere to high standards of corporate governance that include disclosures, respect for shareholder rights, speedy redresses of grievances, and transparent board practices. As has already been discussed in the previous pages, then there were economic reforms that changed the whole situation.

The industry, as well as the regulatory authority and government, have realised the significance of corporate governance. Industry associations are also realising that if companies are to raise resources from the capital markets both in India and abroad, investors have to be drawn to the capital markets, and the companies must adopt internationally accepted norms for corporate governance. Some of the chambers of commerce, in particular the Confederation of Indian Industry, have prepared a code of corporate governance. Some of the companies in the private sector have already significantly increased financial and material disclosures in the annual reports and in various communications to the shareholders. They have also been appointing independent directors on their boards, as well as improving the practices in board rooms and the manner in which meetings are conducted. The financial institutions are setting their own houses in order, while requiring their borrowers to adhere to corporate governance practices. The stock exchanges are acting as self regulatory organisations in disciplining the listed companies. The mutual funds have already been required to adopt high standards of corporate governance and transparency in their investment operations, and trustees and asset management companies are also required to conduct their businesses according to certain standards. As reliance and external finance increases, the financial institutions, institutional shareholders, as well as individuals, will begin to play a greater role as is common in the “outsider" model of corporate governance. Furthermore, investor associations have become active and are contemplating class action suits.

Keeping in view the above changes and the importance of corporate governance as a tool for investor protection, the SEBI has appointed a committee to draw up a code of corporate governance. Under the chairmanship of a reputed industrialist, it comprises a widely represented cross-section from industry, the securities market, financial intermediaries, financial institutions, investors and noted international experts. The committee will draw extensively upon international experience through the OECD code, the combined London Code, and the recommendations of the Blue Ribbon Committee in the US. It is expected that when submitted the report of the committee will set out new standards of corporate governance which will be internationally comparable. The SEBI will be implementing the recommendations largely through amendments of the listing agreement and also recommend to the government that the Companies Act be amended, if necessary.

NOTES

1 Hyung-Ki Kim Masahiko Aoki, 1995 *Corporate Governance In Transitional Economies*, EDI, World Bank.

2 Jayati Sarkar and Subrata Sarkar 1999 *Large Shareholder Activism in Corporate Governance in Developing Countries: Evidence from India*. I G I D R.

3 Discussion Paper on "Economic Reforms –Two Years and After and the Task Ahead", Economic Survey 1998-99, Budget speech of the Finance Minister and SEBI Market Review.

4 Jayati Sarkar and Subrata Sarkar, 1999 ibid.

5 UTI Institute of Capital Markets, 1998.

6 Jayanti Sarkar and Subrata Sarkar, 1999, *ibid.*

CORPORATE GOVERNANCE AND RESTRUCTURING IN MALAYSIA:

A Review of Markets, Mechanisms, Agents and the Legal Infrastructure

by
R. Thillainathan*

I. Introduction

Unlike the dispersed shareholding of the Anglo-Saxon world, Malaysia and Asia ex-Japan is characterised by concentrated shareholding. Non-competitive product markets or weak legal protection have made for concentrated shareholding, for governance by large controlling shareholders and not by managers, for reduced opportunities of specialisation by management and for lack of diversification of one's investments as well as for an increased risk of expropriation of outside shareholders by controlling shareholders. Banks or institutional investors have not to date played a role as corporate governance agents to check the power of the controlling shareholders or to offset or minimise the potential loss of value from inadequate monitoring and control by small shareholders.

In a company with concentrated ownership, there is a better matching of the control rights of the dominant shareholder with its cashflow rights. There will therefore be a greater incentive for that control to be exercised in maximising shareholder value. Thus the incentive of the controlling shareholder is more likely to be aligned to the interest of other shareholders. However, given that in an environment of concentrated shareholding, the board of directors and the market for corporate control are likely to be weak, there is a higher probability of expropriation of minority shareholders.

In Asia the more serious problem arises not from large shareholdings but from the more widespread practice of pyramiding and cross-holdings. This causes a major divergence between the control and cashflow rights of insiders. Therefore, the incentive is for the insiders in such companies to maximise their private benefits of control and not necessarily that of shareholder value. There is thus a higher probability that minority shareholders run the risk of being expropriated the more pronounced this divergence.

The dominant voting rights of the controlling shareholders in Asia can make for a weak board and for a weak market in corporate control. As such, external financiers require more rights to protect their interest. Thus shareholders in Malaysia have been given, for many years now, more powers to limit the discretion of insiders on key corporate matters. There are also restrictions placed by the Kuala Lumpur Stock Exchange (KLSE) on the voting rights of controlling shareholders to vote on related or interested party transactions. In this regard, it is interesting to note that the powers of the KLSE have

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been substantially embellished by the recent amendments in 1998 to the Securities Industry Act (SIA) which now strengthen KLSE's ability to take action against directors and anybody concerned by its listing rules, whereas it was previously confined to the listed entity. With this increase in its powers, more reliance on the KLSE has been advocated to enforce the rule on large and related party transactions. As a self-regulatory organisation, KLSE is likely to be more flexible in adapting its rules to the changing conditions in the business world. There is great merit in this argument provided that KLSE's rule that restricts an interested shareholder's voting rights is binding, as is now the case with the recent amendments to the SIA.

Apart from the basic voting rights based on the one-share-one-vote rule, shareholders require certain "anti-director rights" that support the voting mechanism against interference by the insiders. Malaysian shareholders only enjoy three of the six anti-director rights identified by La Porta et al, namely that shareholders are not required to deposit their shares prior to a general meeting (GM), that an oppressed minorities mechanism is in place and that the minimum percentage of share capital that entitles a shareholder to call a GM is only 10%. If shareholders are accorded full pre-emptive rights to new stock issues, this will improve minority rights. If cumulative voting is permitted, this will increase the probability of outside directors. If proxy by mail is permitted, as recommended by the high-level Finance Committee (FC) on Corporate Governance, then this can reduce the cost of shareholder voting and enhance the ability of outside shareholders to limit the discretion of owner-managers. Recent amendments to insider trading rules and the takeover code have strengthened the position of minority shareholders.

To strengthen the role of the board as a check and balance on the owner-manager, the new code of best practice on corporate governance proposed by the FC recommends that one-third of the board be made up of independent directors and that independent board committees be set up for audit, remuneration and nomination of directors. Rather than decreeing this, it is best to increase the presence of independent directors by allowing shareholders to mail their proxy vote and to cast their votes for one candidate (through cumulative voting) thereby increasing the probability of outside directors.

The Finance Committee has called for more codification as well as for the introduction of statutory derivative action to strengthen civil enforcement action. Aside from codification of a director's fiduciary duties, it also recommends codification of the minimum functions of boards of public limited companies (PLCs). This move towards codification has been motivated by a desire to clarify the law or (as some speculate) to make judgements more consistent, reliable and predictable. It is impossible for the law to be written up to cover all contingencies. Some element of discretion should always be preserved. However, any reform in the law should not be at the cost of the time-honoured business judgement rule that keeps the courts out of corporate decisions. The rule of law requires an efficient, independent and impartial judiciary as well as an independent bar. There has been a growing perception of a decline in the standards to which the rule of law has been upheld in recent years. As the rule of law is a critical determinant of economic growth and as justice must be seen to be done, there is a need for the government to address what has led to this adverse trend or perception.

Banks in Malaysia are poor governance agents because they are weak or have distorted incentives. Domestic and foreign institutional investors have a sizeable presence. They can be encouraged to be more vigilant especially in checking abuses by owner-managers. Institutional investors who choose to exercise their voting rights on related party transactions can have a marked effect as only non-interested parties are allowed to vote on such matters. These institutional investors can also have a significant impact on the election of directors who are independent of the controlling shareholders, provided cumulative voting is permitted, the number of directors is below 10 and that their election is not on a staggered basis. Minimising conflicting objectives or perverse incentives will always remain a major challenge in the exercise of such voting rights by the institutional investors.

An outside investor can vote with his feet if the insider is not maximising shareholder value. But this requires good disclosure rules and an efficient market infrastructure. There is still a great deal of room for improving disclosures on risk exposures and mark-to-market rules. We must not compound the problem by imposing unnecessary controls on trading, as happened in the second half of 1997.

Equally important, restrictive practices on licensing and imports have made for monopolistic tendencies in certain industries and hence for concentrated shareholding. The continued opening up of markets is essential to increase incentives for dispersed shareholding and hence for improved governance practices.

In the Anglo-Saxon world competitive markets have reduced the incentive for concentrated shareholding. But in an environment of dispersed shareholding governance is exercised by the manager. The separation of ownership from management gives rise to the agency problem. We cannot rely on shareholder voting to limit managers' discretion because of the collective action and free-rider problems. And yet there is a heavy reliance on external financing from outside shareholders as attested to by the well-developed public markets in equities. The outsiders have been prepared to provide the finance because the corporate governance mechanisms in place have enabled them to maximise the return on their investments by hiring the best managers (i.e. through a separation of management from financing), to minimise their risk through diversification and to minimise the potential loss in value due to inadequate monitoring.

The corporate governance mechanisms which have enabled heavy reliance on external financing in the Anglo-Saxon world are as follows:

<u>First</u>, there are good disclosure rules and an efficient market infrastructure for an active and liquid financial market and hence for the outside investor to monitor and vote with his feet if the insider is not maximising shareholder value;

<u>Second</u>, there is a satisfactory legal framework and enforcement machinery. This machinery supports an internal corporate governance mechanism that minimises abuses by the insiders but maximises business flexibility;[1]

<u>Third</u>, the board of directors, who are elected by shareholders, monitor and exercise management oversight and hence act as a check and balance on managers on behalf of shareholders with the assistance of the auditor; and

<u>Fourth</u>, there is a well-developed market for control of corporate assets, through contested takeovers, mergers and acquisitions, restructurings and bankruptcies, which throws out entrenched insiders who have captured the boards of directors and who are maximising their private benefits of control and not shareholder value. It also throws out incompetent managers who are misusing corporate resources.[2]

Given the well-developed infrastructure on disclosure and market for corporate control as well as a well-functioning legal enforcement machinery and judicial system in the Anglo-Saxon world, the rights that shareholders require are voting rights and the rights that support the voting mechanism against interference by the insiders. These rights dubbed as anti-director rights by La Porta et al (1998a) are as follows:

- that shareholders are allowed to mail their proxy vote;
- that shareholders are not required to deposit their shares prior to the general shareholders meeting;

- that cumulative voting is allowed;
- that an oppressed minorities mechanism is in place;
- that shareholders have pre-emptive rights to new stock issues; and
- that the minimum percentage of share capital that entitles a shareholder to call for an extraordinary general meeting is reasonable, i.e. 10% or less.

In an environment of dispersed shareholding, if the board and the market for corporate control are weak, then the potential loss of value from inadequate monitoring and control by small shareholders will not be minimised. By concentrating shareholding, the problem can be minimised as a large shareholder will have the incentive and the power to monitor and limit managers discretion. And in a bank-centred system of corporate governance such as that in Germany and Japan, the monitoring of managers by the bank as a large and informed investor encourages investments by the outsiders. An institutional investor also has the incentive to take on the task of monitoring managers to minimise the agency problem and this can also encourage investments by outsiders. Monitoring the monitor and conflicts of interest that distort incentives are the problems which face these approaches to governance. These problems can be minimised by promoting competition. And by developing the market for corporate control as an alternative governance mechanism (but which is a costly one for preventing abuses), we can rely on it to check extreme abuses which are not held in check by the other governance mechanisms.

This country study on corporate governance and restructuring will review the extent to which the markets and mechanisms which have enabled heavy reliance on external financing in the Anglo-Saxon world are present in Malaysia. It will also explore the opportunities and risks that an outside investor faces in an environment of concentrated shareholding where governance is exercised by an owner-manager. There is also an assessment of the role played by banks, domestic institutional investors and foreign fund managers as governance agents, and of the reforms required for increasing reliance on external financing.

The focus of the country study is on the structures and practices of corporate governance of major listed companies. A peculiarity of some Asian economies is that many major companies rely more on debt markets than on equity markets in corporate financing (so as not to dilute control), which has resulted in stock markets that are relatively small compared with those of mature western economies. Accordingly, there is a brief review of the role of debt markets and debt-holders in enforcing financial discipline and in having a “voice” in corporate governance in Malaysia.

To give a better appreciation of the corporate governance practices in the country, there is an extensive discussion of the corporate governance environment in Malaysia and its impact on corporate performance and finance in Part One. In this regard, Part One also provides certain salient information on the financial system in Malaysia, the development of markets as well as trends in corporate financing, and serves as a backdrop to the discussion of corporate governance issues in the country. In the discussion on the equity and credit markets, there is a quick review as to whether these markets perform any “disciplinary” functions over listed firms. There is also a review as to whether there is a cosy relationship between banks, big firms and the government to determine the ways and extent to which financial constraints on big firms may be weak due to overt and covert “policy of directed lending” or creditor passivity.

I. Corporate governance environment in Malaysia and its impact on corporate performance and finance

The general economic context

A review of the economy before and after the Asian crisis

At the outbreak of the Asian financial crisis in mid-1997, the Malaysian economy had been registering high growth for a decade of 8.5% p.a. There was over full employment, with the unemployment rate at 2.6% (versus 8.8% in 1986) and with continued upward pressure on wage rates (and this in spite of the huge pool of foreign labour). The economy was over-invested with a massive over-supply in properties[3] and even in infrastructure facilities, and this had exposed the economy to the risk of a boom-bust cycle. The inflation rate was around 2.5% p.a. (and under 4% for the ten-year period). The external current account deficit had been persistently high throughout the nineties (above 6% of nominal GNP with a high of 10% in 1995). The service sector was over-regulated and over-protected causing its GDP share to be still below 45%.[4] The economy had become more open, with international trade at twice the size of GNP, whereas it had been about the size of GNP in the early 80s. The exchange rate in USD terms had appreciated from the 2.70 level in the late 80s to the 2.50 level in the mid 90s.

At the outbreak of the crisis the government was running a fiscal surplus (and the stance of fiscal policy had been prudent from the late 80s). But the stance of monetary and exchange rate policy in the mid 90s was in fact unsound (with a near-pegged exchange rate regime and excessive growth in money supply and credit). Growth was generally prioritised over distribution. But over-reliance on privatisation to achieve a distributional goal undermined efficiency and increased macroeconomic vulnerabilities.

Excessive risk-taking had also caused the regional financial crisis. Asia, including Malaysia, had taken too much credit risk. There were also huge mismatches between the assets and liabilities of the banks, which had led them to assume excessive liquidity risk, interest rate risk or currency risk. This excessive risk-taking was caused partly because the Asians loved to take risk and partly because there were not enough opportunities to hedge risk. Given the love of Asians to take risk, the problem should have been addressed by requiring mandatory disclosures to forewarn investors and depositors, but the disclosure regime was underdeveloped. To provide adequate opportunities to price and hedge risk, active and liquid markets are necessary, but markets were not allowed to develop because of the over-regulation of markets and the over-protection of the banking industry.[5]

The initial response to the crisis was to tighten the stance of macro policies to restore market confidence. And judging by the stringent credit control introduced, this led to an overkill. These policies and the contagion plunged the economy into a deep recession. Anti-market pronouncements and an unwillingness to consider a market solution aggravated the crisis. These policies were replaced by a new regime of capital controls in September 1998 and a limited easing in macro policies.

Before we end this sub-section by a quick review of how the economy has performed since then, it is useful to look at the state of the economy and the stance of policy at the time of the imposition of the new regime.

The economy was then in deep recession with rising unemployment[6] and a deterioration in government finances into negative territory.[7] But inflation had peaked (though still in single digit) and was moderating. And there was a rapid build-up in external current account surplus. The interest rate was high but falling (with the 3-month inter-bank rate declining to 9.5%). The RM was weak, trading between 4.00 and 4.20 against the USD, but the stock market composite index had slipped below 300.[8] There was a banking crisis with mounting non-performing loans (NPLs), with the optimists projecting them at 15% and the pessimists at 30% by end 1999. There was also a corporate crisis with many businessmen (and in particular several prominent bumiputra businessmen) driven into bankruptcy. But more controlling shareholders were broke than companies. The economy was still facing a liquidity crisis and was getting into the grip of a credit crunch.[9]

The stance of policy at imposition of the new regime of capital controls was mildly reflationary from mid-98 but the stance of monetary policy was still contractionary. The government was prepared to liberalise and deregulate the economy but only within limits. It was not prepared to open up the service sector which may have provided for a more efficient utilisation of surplus capacity (especially in property and infrastructure sectors). Corporate restructuring was slow.[10]

For 1998 as a whole the Malaysian economy contracted by 6.7%, inflation was registered at 5.3%, the unemployment rate climbed marginally to 3.9%, the 3-month inter-bank rate declined to 6.5%, and the external current account recorded a surplus of 13.7% in terms of GNP. The stance of fiscal policy was mildly expansionary, with the federal government running a deficit of 1.9% of GNP in 1998, compared to the surplus of 2.5% in 1997. The stance of monetary policy was contractionary with the growth rate in broad money (i.e. M3) declining from 18.5% in 1997 to 2.7% in 1998. Credit growth registered an equally steep decline from 26.5% in 1997 to 1.8% in 1998. And the exchange rate was pegged at 3.80 to the USD and has remained at that level from September 1998.[11]

With the aggressive buying of NPLs by the Asset Management Company and the prompt recapitalisation of financial institutions by the Bank Recapitalization Agency, the threat of a credit crunch from the lack of bank capital has been significantly reduced in Malaysia. However, the continued slow growth in credit suggests that bankers are still suffering from risk aversion, that loan demand is weak, or that the stance of monetary policy is still tight as may have been the case until recently. Corporate restructuring, however, has been slow, probably because it is not entirely market-driven.

Many observers had expected the imposition of the new regime of capital control to be accompanied by an aggressive easing in macro policies. If this had happened and had continued for any length of time, it could have bankrupted the economy. This has in fact not happened. The out-turn of macro policies has continued to be tight, partly because of the anti-inflation bias of policy makers in the conduct of monetary policy and partly because the government machinery was not geared up to cope with the increased spending that had been envisaged in the 1999 Budget unfolded in October last year.

The increased domestic liquidity from the imposition of capital controls, as well as weak demand, has led to significantly lower interest rates, and to a marked uptick in activity in the stock market and, to an extent, in the property market. The perception that the exchange rate is undervalued and that capital controls are temporary (fostered at least partly by the country's history and the flexible manner in which the controls have been imposed) has not led to any serious flight in capital through such activities as re-invoicing. However, this is not likely to remain so if there is a risk of capital controls becoming more permanent, or if re-pegging the currency or unexpected shocks cause the currency to become over-valued.

An overview of the financial system and development of markets

Malaysia boasted the largest debt market and the largest equity market in ASEAN in the mid 90s. Nonetheless, banks in Malaysia have become even more dominant. The share of domestic debt of the banking system increased from 62% in 1986 to 75% in 1997, whereas that of the debt market decreased from 38% to 25% over the same period.

To gauge the reliance of firms on the debt and equity markets, the only data that is available is on the supply of funds. In terms of net funds raised, the share of the banking system increased from 50% to 58% between 1986 and 1997, that from the domestic debt market declined from 33% to 11%, that from the equity market increased from 13% to 14% and that sourced from external borrowings increased from 3% to 16%.

The over-dependence on banks in Asia has been caused by the over-protection of banks (in particular of locally owned banks) and the over-regulation of capital markets. This has led to the under-development of non-bank financial institutions, of capital markets, of risk management products, of risk intermediaries as well as of trading and market making.

An over-dependence on banks can become catastrophic when the high-risk banking industry operates under a regime of pegged exchange rate and open capital flows or under inconsistent macro-economic policies. Asia's experience during the 1990s provides ample evidence to substantiate this conclusion.

The high-risk nature of banking (versus for instance the fund management industry) arises from implicit government guarantee of bank deposits. Consequently, its high gearing, and massive asset-liability mismatches create an incentive for risky or imprudent banking.

Dynamics of the Equity Market

The ratio of market capitalisation (of the Malaysian equity market) to money GDP was 2.59 in 1995, 3.23 in 1996 and only 1.36 in 1997. On the other hand, the ratio of total market turnover to market capitalisation was 0.59 in 1996 and 1.13 in 1997.[12]

The listing requirements for an IPO include minimum thresholds regarding the number of shareholders and the value and volume of public shares, earnings and balance sheet criteria over a number of years; an assessment of the potential of the firm and industry it belongs to; qualitative criteria regarding corporate governance; and credible documentation of compliance with the above criteria.

From the mid-1990s, a disclosure-based regulatory regime has been gradually replacing a merit-based system in deciding on which companies be permitted for listing. Merit reviews are judgements by regulatory bodies on IPOs, on the merit of the prospective investment, but not on the quality of the disclosure. Under a merit system, the regulatory authorities replace investors in the investment decisions. Merit-type systems usually also include a strong role for the regulatory institution in setting prices and allocating rights for IPOs. Under the phased implementation of the disclosure-based regime, the pricing of corporate offers in Malaysia was to be fully determined by market forces from the beginning of 1998. As a result of the regional financial crisis, there has been a shift of the target date to 1 January 2001.

The requirements for continued listing are not clearly spelt out in Malaysia. The authorities are now working on the criteria for a company to qualify for continued listing with reference to such considerations as the adequacy of its scale of operations, the satisfactoriness of its financial condition, the public shareholding spread, as well as its corporate governance practices.

Unlike in the Anglo-Saxon world, there is concentration of ownership in Malaysia (as elsewhere in Asia). For instance, the three largest shareholders owned some 54% of the shares of the ten largest non-financial private firms, and 46% of the shares of the ten largest firms in Malaysia. The average for the Asian countries (i.e. India, Indonesia, Malaysia, Pakistan, Philippines, Sri Lanka and Thailand) was 50% and 46% respectively (see Table 1).

The concentration of shareholding in Malaysia imposes a severe constraint on the market for corporate control. Thus there is little or no room for hostile takeovers to play a disciplinary role on insiders who are not working towards the maximisation of shareholder value. However, share price movements exercised through the exit route or a sell-down of shares do provide an avenue for disenchanted or aggrieved shareholders to discipline errant insiders. This is evident from an examination of foreign shareholding in and share price movements of UEM and KFC, companies which had been viewed by the market as blue chip companies before the announcement of the major breakdown in their corporate governance practices in 1997. The foreign shareholding in UEM (represented by some of the top names from the world of institutional investors), amounted to 54.2% at year-end 1996 versus Renong's shareholding (which was the controlling shareholder) of 32.6%. The announcement of the corporate governance irregularities in November 1997 led to a 48.2% decline in the UEM share price (versus a decline in the KLCI index of 14.5% over the corresponding period)[13], and foreign shareholding in UEM contracted to 35.1% by year-end 1997. The disclosure of the corporate governance irregularity by KFC in June 1998 also led to a sharp fall in its share price of 47.6% (versus a decline in the KLCI index of 6.1%).[14] Foreign shareholding had fallen from 34.3% to 15% between 1996 and 1997, and the corresponding number for 1998 is still not available. It is not clear what caused the sharp fall even before the public disclosure of the irregularity – the perceived problem of insiders or under performance. For a sample of 75 public listed companies (see Annex 1), the weighted average of foreign shareholding had in fact increased marginally from 24% to 24.2% over the 1996-1997 period.

Table 1: Ownership Concentration in Ten Largest Firms [1)]

	All Firms [2)]	Private [3)]		All Firms [2)]	Private [3)]
ASIA			LATIN AMERICA		
India	38%	40%	Argentina	50%	53%
Indonesia	53%	58%	Brazil	31%	57%
Korea	23%	20%	Chile	41%	45%
Malaysia	46%	54%	Colombia	63%	63%
Pakistan	26%	37%	Mexico	64%	64%
Philippines	56%	57%	Venezuela	Na	51%
Sri Lanka	60%	60%			
Thailand	44%	47%			

Source: La Porta et. al. (1998).
Notes: 1) The average percentage of common shares owned by the three largest shareholders in the ten largest non-financial firms. 2) Excluding the public share. (3) Largest 10 firms with no public ownership.

Credit Market Dynamics

Banking is relationship-based and not transaction-driven. But governance is exercised by large shareholders and not large creditors. And banks are prohibited from lending to related parties. There are no Chapter 11 provisions.[15] Therefore, creditors have been able to pursue their rights without serious handicaps or bias but, in recent years, the courts have become slower in resolving disputes between creditors and debtors.

In contrast to this, the prevalent government view that economic and corporate hardships have been caused by currency speculators and stock market raiders has enabled the problem borrowers to bargain for more time from their bankers to settle their loans. The relaxation of rules with respect to recognition of interest income and loan provisioning has encouraged this tendency. There is no evidence that more loans are being pumped in (on an indiscriminate or imprudent basis) to "rescue" financially weak borrowers. However, loan restructuring is being permitted a little more liberally. Under the old rules, even if the borrower services the restructured loan without default, it will continue to be classified as a non-performing loan for a period of 12 months before it is reclassified. It appears that now a more liberal approach has been adopted and the period for reclassification has been reduced to 6 months.

There has been a great deal of talk on the need to introduce Chapter 11 provisions in Malaysia. Apparently, such provisions are in a Bill which is being reconsidered by the government.

Under the current law, creditors have a variety of legal protections, including the right to seize assets that serve as collateral for the loans, the right to liquidate the company when it does not pay its debts, the right to vote in the decision to reorganise the company, and the right to remove managers in reorganisation.

If Chapter 11 provisions are introduced, they will allow companies unimpeded petition for reorganisation, give companies the right of automatic stay of creditors, and let managers keep their jobs in reorganisation, thus enabling managers to keep creditors at bay even after having defaulted, as in the US, which is deemed as one of the most anti-creditor common law countries. Protection of creditor rights is necessary for ensuring a steady flow of external finance in the form of bank and other credit to businesses and households. More complete bankruptcy laws are necessary in countries such as Malaysia where courts may not be as reliable as in the developed countries. Monitoring by large creditors may encourage minority shareholders to invest even in companies with concentrated shareholding.

The relationship between banks, big companies and the government

Foreign-owned banks have a 20% market share. Government-owned or controlled banks (which include the largest bank in the country, a public limited company), account for 30% of the market share. Many of the leading locally-owned banks are public listed companies (PLCs), but each with a dominant shareholder, either a government institution or a private family interest. All the other local banks are not PLCs and are directly or indirectly controlled by private family interests.

Of the 37 commercial banks only a few are part of a conglomerate. But prohibition on loans to related parties and the stringent enforcement by the central bank have greatly reduced opportunities for business groups to avail themselves of easy loans through their tie-ups with banks.

The relationship between firms, the government and banks cannot be described as cozy as in certain other Asian countries. There was no overt "policy of directed lending" to big firms and to that extent one cannot say that the financial constraints on big firms were weak.

Nonetheless, there were certain discernible weaknesses. The government's commitment to a high growth policy based on a high ratio of investments to GDP led eventually to the promotion and support of certain mega projects, with the implicit assumption by lenders that the government would not let these projects fail, and to lending decisions by bankers based on collaterals and implied government support and not just on project cashflows. Such over-investment led aggregate demand to outstrip aggregate supply and to mounting or persistent external deficit. It also led to lower returns, poorer cashflows and to more problem loans.

The government's active pursuit of privatisation during the period enabled Malaysia to emerge as a leader in privatisation within the developing world with some brilliant success stories. Privatisation reduced the role of government and increased reliance on markets. But the apparent use of privatisation to attain certain non-economic goals (e.g. the promotion of bumiputra businessmen) has caused problems. This led to more reliance on negotiated tenders and hence to lower efficiency. The desire to control output prices and to minimise subsidies led, in some cases, to government support of privatisation deals via approvals for special property development projects. This has led to an over-supply of properties. And reliance on management or leveraged-buyouts to attain the government's distribution goal biased government policy towards supporting the stock market. Hence, it compromised the conduct of monetary policy. It also made the stock market as well as the banking industry, with its over-exposure to share financing, vulnerable to the regional financial crisis.

The corporate governance characteristics in Malaysia and their relevance to the financial crisis

The corporate governance agents

The Malaysian corporate sector's attempts to access the external market in equities have an early history, as witnessed by the formation of a formal stock brokers association in the 1930s and the setting up of a formal stock exchange in 1960. During that period, the country was dominated by its plantation and mining industries. The large British-controlled companies engaged in plantation, mining and/or trading were listed on the London Stock Exchange. Some of these companies went for a secondary listing on the Malaysian or Singapore stock exchange in the 60s given the increasing interest of Malaysian and Singapore investors in these companies. Acquisition of the controlling interest in such companies, first by Malaysian private sector interests and later by the government agencies, led to the transfer of their domicile to Malaysia from the 70s.

The initial public offerings by home-grown family-controlled companies as well as domestic market-oriented foreign-controlled companies in manufacturing, trading, construction and services, led to the significant growth of the Malaysian stock market from the 60s. This growth in market capitalisation was further boosted from the 80s by the privatisation of key state enterprises in the transport, gaming and utilities sectors. These newly listed entities continued to be characterised by concentrated shareholding either by family interests or the state.

The concentrated shareholding in public listed companies (PLCs), which are not state-controlled, has been attributed to weaknesses in shareholder rights or the poor enforcement of these rights. In certain activities, restriction on competition has led to higher returns or lower risk thus reducing the incentive of the controlling shareholders to share these benefits with other shareholders.[16]

Shareholding in Malaysian PLCs is concentrated and not dispersed, but the shareholding is not as concentrated as believed by many. Stijn Claessens et al have analysed the distribution of ultimate control among five broad ownership groups and by the size of ultimate control of each owner at four cut-off levels as set out in Table 2. At the 20% cut-off level of ultimate shareholding for a block shareholder - the benchmark used both by Berle and Means (1932), La Porta et al (1998), and Stijn Claessens et al (1999) - 10.3% of the PLCs are widely-held in that none of these PLCs has a shareholder whose ultimate holding is 20% or more. At the cut-off levels of 30% and 40%, the percentage of widely-held companies of course increases and quite dramatically to 41.2% and 77.3% respectively. As is to be expected, at the 10% cut-off level, only 1% of the PLCs are widely-held.[17]

The dominant shareholder in PLCs with concentrated shareholding is the family. At the benchmark 20% cut-off level, 67.2% of the PLCs are in family hands. The percentage of family-controlled PLCs is 45.6% at the 30% cut-off level and 57.7% at the 10% cut-off level, but it drops to 14.7% at the 40% cut-off level.

The next important category of dominant shareholder is the state. The number of state-controlled PLCs is highest at the 10% cut-off level and declines to 13.4% at the 20% cut-off level. It drops further to 8.2% and 4.2% at the 30% and 40% cut-off levels, respectively.

Widely-held financial institutions exercise control over 12.5% of the PLCs at the 10% cut-off level and 2.3% of the PLCs at the 20% cut-off level. There are no PLCs which are controlled by widely-held financial institutions at the 30% and 40% cut-off levels.

Widely-held corporations are a more important category of block shareholders than widely-held financial institutions. Widely-held corporations exercise control over 11% of the PLCs at the 10% cut-off level, 6.7% of the PLCs at the 20% cut-off level, 5% of the PLCs at the 30% cut-off level and 3.8% of the PLCs at the 40% cut-off level.

There is an increase in the importance both of widely-held PLCs and state-controlled PLCs if the distribution of ultimate control is measured on a weighted basis in terms of market capitalisation of the PLCs and not just on a unweighted basis, that is, by accounting for the PLCs only in terms of their numbers. At the benchmark 20% cut-off level, the percentage of PLCs which are widely-held in terms of market capitalisation has increased from 10.3% to 16.2%, the state-controlled companies have increased even more dramatically from 13.4% to 34.8%, whereas the family-controlled companies have decreased from 67.2% to 42.6% (see Table 3).

The average number of firms per controlling family, as set out in Table 5, is 1.97. In terms of market capitalisation that families control at the 20% cut-off level, market capitalisation control is 7.4% for the top one family, 17.3% for the top five families, 24.8% for the top ten families and 28.3% for the top fifteen families.

Concentration of shareholding varies significantly with firm size, as shown in Table 4, for the benchmark 20% cut-off level. 30% of the largest 20 PLCs are widely-held whereas this is so only for 10.3% of all firms. Similarly, 30% of the largest 20 PLCs are state-controlled compared to 13.4% of all firms. Accordingly, the family is the dominant shareholder only amongst 35% of the largest 20 PLCs compared to 67.2% for all firms. The pattern of ownership for the middle 50 PLCs is not significantly different from that for all firms. However, amongst the smallest 50 PLCs, 84% of the firms are in family hands and 5% under state-control. Although none of the smallest 50 PLCs are widely-held, 11% are controlled by widely-held corporations or financial institutions. We had noted that shareholding in PLCs is concentrated. At the benchmark 20% cut-off level, it has been found that 37.4% of the PLCs have only one dominant shareholder with the individual shareholding of all other shareholders falling below the 10% level. More interestingly, 85% of the PLCs have owner-managers in that the post of the CEO, Board Chairman or Vice-Chairman has been filled by a member of the controlling family or an employee drawn from the ranks of the controlling shareholder.

The concentration of ownership, and hence of votes, leverages up legal protection of the large shareholder.[18] Voting rights, which are the principal rights of shareholders, are of limited value unless they are concentrated. And the large shareholder can enforce his rights by relying on relatively simple legal interventions, which are suitable even for poorly informed and motivated courts. Therefore, large investors with a direct interest in a company do not need any special arrangements to establish effective corporate control. But there are investors without large direct shareholding interests who can enhance their control through the use of dual-class shares with different voting rights (i.e. shares which are not based on the one-share-one-vote rule), pyramid structures[19] or cross-holdings.[20]

Table 2: Control of Publicly Traded Companies by Type of Shareholder & Level of Ultimate Shareholding of a Substantial or the Controlling Shareholder
(Unweighted)

Level/Type	Widely-Held	Family	State	Widely-Held Financial	Widely-Held Corporation
10%	1.0	57.7	17.8	12.5	11.0
20%	10.3	67.2	13.4	2.3	6.7
30%	41.2	45.6	8.2	0.0	5.0
40%	77.3	14.7	4.2	0.0	3.8

Table 3: Control of Publicly Traded Companies by Type of Shareholder for Base Case
(Where an Ultimate Shareholder Controls Over 20% of the Shares)

	Widely-Held	Family	State	Widely-Held Financial	Widely-Held Corporation
Unweighted	10.3	67.2	13.4	2.3	6.7
Weighted by Market Capitalisation	16.2	42.6	34.8	1.1	5.3

Table 4: Control of Publicly Traded Companies by Type of Shareholder & Size of Firm
(Based on Market Capitalisation) for Base Case

	Widely-Held	Family	State	Widely-Held Financial	Widely-Held Corporation
All Firms	10.3	67.2	13.4	2.3	6.7
Largest 20	30.0	35.0	30.0	0.0	5.0
Middle 50	12.0	69.0	10.0	4.0	5.0
Smallest 50	0.0	84.0	5.0	2.0	9.0

Source: Stijn Claessens et al (1999a).
Notes: Stijn Claessens et al analyse the control pattern of companies by studying ultimate shareholdings. In the majority of cases, the principal shareholders are themselves corporate entities, not-for-profit foundations or financial institutions. The authors then identify the owners of these entities, the owners of their owners, etc. and use the family group as the unit of analysis but do not distinguish among individual family members. Corporations are divided into those with ultimate owners and those which are widely-held, i.e. those which do not have any owners who have significant control rights. Ultimate owners are further divided into four categories: families including individuals who have large stakes, the state, widely-held financial institutions, such as banks and insurance companies, and widely-held corporations.

The distribution of ultimate control among the five ownership groups identified has been computed by studying all ultimate shareholders who control over 20% of the shares or votes – the benchmark cut-off level used both by Berle and Means (1932) and La Porta, Lopez-de-Silanes, and Shleifer (1998) – as well as at alternative cut-off levels of 10%, 30% and 40%. The distribution of ultimate control has been computed by reference to a simple average as well as a weighted average where the weights are based on market capitalisation.

Given the above definition of ultimate control, a firm can have more than one significant owner at a given cut-off level and the ultimate owner can change at a different cut-off level. For example, if a firm has three owners – a family which controls 20%, a bank which controls 10% and a widely-held corporation which controls 10% - it is only 1/3 controlled by the family at the 10% level, but is fully controlled by the family at the 20% level. The firm is widely-held at higher cut-off levels.

Table 5: How Concentrated is Family Control?

1. Number of companies listed on KLSE	621
2. Number of companies in sample	238
3. Share of total market capitalisation	74%
4. Average number of firms per family	1.97
5. % of total market cap that families control	
a. Top 1 family	7.4%
b. Top 5 families	17.3%
c. Top 10 families	24.8%
d. Top 15 families	28.3%

Source: Stijn Claessens et al (1999a).
Notes: The average number of firms per family refers only to firms in the sample.

The use of these devices will enable these shareholders to exercise control or voting rights which are in excess of their cashflow rights. The study by Stijn Claessens el al (1999b) shows that there are shareholders or corporate groups in Malaysia which have resorted to such devices. Their study has shown that the average minimum share of the book value of common equity that is required to control 20% of the vote in Malaysia is 18.11% (versus the average of 19.91% for Singapore and 19.23% for the nine East Asian countries that their study had covered).[21] In 39.3% of the PLCs (versus 55.0% for Singapore and 40.8% for the East Asian Nine as a whole), the controlling shareholder exercised effective control through a pyramid structure. In 14.9% of the companies (versus 15.7% for Singapore and 8.7% for the East Asian Nine), control was exercised through cross-holdings.

As a result of the use of these control devices, the ratio of cashflow rights to ultimate control rights in Malaysia (see Table 7) was 0.853 (versus 0.794 in Singapore and 0.746 for the East Asian Nine).[22] The standard deviation of this ratio measure was 0.215 for Malaysia (versus 0.211 and 0.321 for Singapore and the East Asian Nine respectively).

Table 6: Means of Enhancing Control (Full Sample, % of Total)

1.	Cap = 20% V[a]	18.11
2.	Pyramids with ultimate owners[b]	39.30
3.	Cross -holdings[c]	14.90
4.	Controlling alone[d]	37.40
5.	Owner management[e]	85.00

Source: Stijn Claessens et al (1999a)
Notes: a. Cap = 20% V is the average minimum % of the book value of common equity required to control 20% of the vote;
b. Pyramids with ultimate owners (when companies are not widely held) equals 1 if the controlling owner exercises control through at least one publicly-traded company, 0 otherwise;
c. Cross-holdings equals 1 if the company has a controlling shareholder and owns any amount of shares in its controlling shareholder or in another company in its chain of control, 0 otherwise;
d. Controlling Owner Alone equals 1 if there does not exist a second owner who holds at least 10% of the stock, 0 otherwise;
e. Management equals 1 if the CEO, Board Chairman or Vice-Chairman are from the controlling family, 0 otherwise.

Table 7: Concentration of Cashflow Rights and Ultimate Control by Largest Control Holder

	Mean	Std. Deviation	Medium	1st Quartile	3rd Quartile
Cashflow Rights	23.89	11.68	19.68	14.00	30.00
Control Rights	28.32	11.42	30.00	20.00	30.42
Ratio of Cashflow to Control Rights	0.853	0.215	1.000	0.733	1.000

Source: Stijn Claessens et al (1999b).
Note: The study by Stijn Claessens et al also distinguishes between control (or voting) rights and cashflow rights. Suppose, for example, that the family owns 11% of the stock of publicly-traded Firm A, which in turn has 21% of the stock of Firm B. We would say that the family controls 11% of Firm B – the weakest link in the chain of voting rights. In contrast, we would say that the family owns about 2% of the cash flow rights of Firm B, the product of the two ownership stakes along the chain. To make the distinction between cashflow and control rights, the authors document pyramiding structures for each firm, cross-holdings among firms, and deviations from one-share-one-vote rule.

There are many public-quoted companies (PLCs) in Malaysia and elsewhere in Asia which are family-dominated. In meeting the interest of the small or outside shareholders they have been viewed unfavourably in relation to the management-controlled companies in many OECD countries. Large shareholders are certainly in a position to expropriate the small shareholders given their control rights. But the managers in companies with dispersed shareholding also have similar powers given the effective control rights they exercise. Whether an expropriation or squandering of a company's resources will take place will depend on shareholder rights including the rights of large shareholders *vis-à-vis* small shareholders and how these rights are enforced in practice.

It is useful to explore, on an *a priori* basis, the incentive for the maximisation of shareholder value in a company which is controlled by a large shareholder compared to one which is controlled by a manager with dispersed shareholding. In a company with concentrated ownership, as there is a better matching of the control rights of the dominant shareholder with his cashflow rights, there will be a greater incentive for that control to be exercised in maximising shareholder value. Therefore, the incentive of the controlling shareholder is more likely to be aligned with the interest of other shareholders. On the other hand, as a manager has control rights with little or no cashflow rights, he has less incentive to maximise shareholder value. In order to deal with this problem a manager is given an incentive contract in the form of share ownership or a stock option to align his interests with those of investors. Even with such incentive contracts the mismatch between control and cashflow rights will still be large in a management-controlled company.[23] Therefore, a company with concentrated ownership, where the mismatch between control and cashflow rights are much less, is likely to promote shareholder value much more than a management-controlled company. In this context, it is useful to note that the use of incentive contracts has been limited by difficulties in the optimal design of incentives, by fear of self-dealing or by distributive politics.

As for a company where the controlling interest is indirectly exercised through a pyramid structure or cross-holdings, there will be a mismatch between the control and cashflow rights of the controlling shareholder. Therefore, the incentive of this controlling shareholder with an indirect stake will be less aligned with the interest of the other shareholders. Even then, other things remaining equal, there is likely to be a greater coincidence of interest between the incentive of such a controlling shareholder and his fellow shareholders than between the incentive of the manager and his shareholders (in a management-controlled company).

As in Germany and Japan, banks in Malaysia play a dominant role in lending. But Malaysian banks do not play a role in governance (with respect to the appointment of managers or directors, or in the choice of investments or on any corporate matters) because they do not or are not permitted to control or vote significant block of shares or sit on boards of directors.[24] As a rule, they vote the equity of other investors, namely of their clients, but only under their express instruction.

The banks in the country do play a major governance role in insolvencies. They appoint receivers or liquidators. However, as for companies which are not insolvent but illiquid and which require restructuring or rehabilitation, the procedures for turning control over to the banks (including the rules for changing managers and directors) are not well established. And in the absence of well-established rules for the rehabilitation of companies, this may have caused firms suffering from illiquidity to be driven into insolvency.[25]

Banks may not play a role in governance, save in bankruptcies, but there are some who - as an alternative to our current arrangements - are in favour of promoting in Malaysia governance based on banks as large shareholders.

This recommendation is flawed. Banks in Malaysia, as well as in Asia, are hardly able to take care of themselves. Therefore, it is not advisable to entrust them with a key role in the governance of listed companies. The loss of focus is likely to make matters even worse. Furthermore, the incentive of a bank in governance is likely to be severely distorted, as its primary interest is in lending. Where it is a significant minority shareholder and exercises control over a company by voting these shares and the shares of others for which it acts as a proxy, its main interest is in enhancing its own income from its lending and other related activities and not in enhancing shareholder value. Empirical findings in Japan and Germany attest to this and are highlighted by Shleifer and Vishny (1997) in their survey article.

Within a period of about 10 years the country has faced two banking crises. This is only partly due to weak supervision. At least part of the blame has to be attributed to the ambitious promotion of local banks and local managers (often at the expense of local corporates and tax payers) as well as the aggressive pursuit of economic growth and distributional goals. Implicit government guarantee of deposits and high gearing compounded the problem by creating an incentive for risky or imprudent banking.

The central bank attempts to maintain a tight control over both local and foreign banks. Appointment of directors as well as chief executives requires its approval. Given the central bank's multiple goals in economic management and in supervising banks, and given the constraints it faces in its hiring and firing policy as well as in setting compensation, the central bank has a lot of room for improving its performance as an economic manager or as a bank supervisor.

Provident and pension funds, insurance funds and unit trusts are emerging as a significant force in the Malaysian financial markets. As at end 1998, the size of the provident and pension funds was RM173 billion, of which 86% was accounted for by the Employees Provident Fund (EPF). About 20% of the provident and pension funds was invested in equities, accounting for 9% of market capitalisation. The corresponding size of the insurance funds was RM39.4, of which about 20% would have been invested in equities (equivalent to 2% of market capitalisation). The net asset value of the unit trusts, predominantly invested in equities, was RM38.7 billion accounting for 10.3% of market capitalisation. Of this the government-sponsored funds, controlled primarily by Permodalan Nasional Berhad (PNB), had a net asset value to KLSE market capitalisation of 8.6% versus that for private funds of 1.7%.

The insurance companies are permitted to invest 20% of their funds in equities. The corresponding ratio for EPF is 25% but only 18% of its total funds were invested in equities at year-end 1998.

EPF had an equity interest concentrated in the 5-15% range in many blue chip companies on the 1st Board of the KLSE (See Table 8). PNB is also invested in many blue chip companies both on the 1st and 2nd Boards with an equity interest concentrated in the 5 to 20% range. There are also other major local institutional investors whose pattern of investments is shown in the same Table.

Table 8: Substantial Shareholding of Key Domestic Institutional Investors in Public Companies Listed on the Kuala Lumpur Stock Exchange (%)

% of Shareholding	1st Board					2nd Board				
	EPF	KH	LTAT	LUTH	PNB	EPF	KH	LTAT	LUTH	PNB
5 – 10	40	4	9	16	22	-	-	1	4	28
10 – 15	10	-	3	6	10	-	-	-	-	5
15 – 20	2	1	-	4	3	-	-	-	-	12
20 – 30	2	-	4	2	2	-	-	1	-	4
30 – 50	-	1	1	-	5	-	-	-	-	1
> 50	-	1	2	-	2	-	-	-	-	-

Source: Data extracted from SBC Warburg Dillon Read, Malaysia Connections, January 1998.
Note: EPF: Employees Provident Fund KH: Khazanah Holdings
LTAT: Armed Forces Fund LUTH: Pilgrims' Fund
PNB: Perbadanan Nasional Berhad (National Investment Corporation)

Local institutional investors, including EPF, play only a passive role in corporate governance and rely on third party research, primarily that by brokerage houses. However, this does not apply to PNB and LTAT which often have sizeable minority or even controlling interests, are represented on boards, and are therefore often insiders who tend to play a more active role in performance monitoring and even in corporate governance.

In an environment of dispersed shareholding with no large institutional investors, we cannot rely on shareholder voting to limit managers' discretion because of the collective action problem and the free rider problem. In an environment of concentrated shareholding, we cannot rely on the market for corporate control (whether it is through hostile takeovers, mergers or acquisitions), to limit managers' discretion because no such market may exist given the existence of large controlling shareholders. However, where there are large institutional investors, proxy by mail is allowed and cumulative voting for directors is also allowed, we may be able to rely on shareholder voting to limit managers discretion, provided the institutional investors do not suffer from conflicts of interest.

Most institutional investors (e.g. corporate pension funds, bank trust funds and insurance funds), will suffer from conflicts of interest between their desire to maximise shareholder value (which may require them, where necessary, to vote against corporate managers) and their desire to retain or solicit business from corporate managers (which may induce them to vote with the managers).[26]

On the other hand, public pension funds (and this would include EPF), and mutual funds (to an extent), do not solicit business from corporate managers and therefore face no constraints on how they can vote. Their incentives for maximum effort on their beneficiaries' behalf are still limited, since the beneficiaries get the upside,[27] but at least those incentives are not perverted by direct conflicts. However, public fund managers do have conflicting incentives between the need to be good political operators and good money managers, and can be subject to public pressure to support social responsibility proposals or invest in local enterprises at the expense of investment returns. Such conflicts will be minimised to the extent that these funds are accountable to individual contributors but will be enhanced to the extent that their returns are government-guaranteed.

In Malaysia we have noted that EPF is a large domestic institutional investor. However, EPF has captured a large chunk of national savings and its investment management is centralised. Conflicts and perverse incentives from its fund management and corporate governance activities can be minimised not by breaking up EPF but by parcelling its funds for management on a passive and active basis, with the passive portfolio managed in-house and the active portfolio managed (largely if not wholly) by external fund managers. It should be readily apparent why passive management will minimise conflicts and perverse incentives. The operation of its externally managed funds will not cause any conflicts or perverse incentives only if the mandate for such management is based strictly on commercial considerations. This is more likely if the external funds are managed for the account of individual contributors.

Presently, EPF's decision to invest its funds is on a portfolio basis and it does not seek any board positions. This stance cannot be faulted. If it actively seeks a position on the boards of companies in which it invests and monitors its nominees, then it runs the risk of becoming an insider thus adversely affecting its short-term trading opportunities in these companies.

EPF can of course choose to exercise its voting rights on related party transactions. This can have a telling effect where only non-interested parties are allowed to vote. It can also have a significant impact on the election of directors who are independent of the controlling shareholders, provided cumulative voting is permitted. Minimising on conflicting objectives or perverse incentives will always remain a major challenge in the exercise of such voting rights.

EPF has to be ever vigilant against abuses of minority shareholder rights by the insiders. Although it held 10% of the shares in UEM and 14% in KFC, it failed to initiate any actions against the insiders in these companies whose apparent disregard of minority interests led to a steep fall in the shareholder value of these companies.

A case can be made for the setting up of a Minority Shareholder Watchdog Group to monitor and combat abuses by insiders against minority shareholders. Initially EPF as the major institutional investor can take the initiative to set up and organise such a Watchdog Group with the technical assistance of the World Bank or the Asian Development Bank. Representatives from the Malaysian Institute of Corporate Governance, the Malaysian Association of Investors and the Malaysian Association of Asset Managers should be invited to participate in the Group. As the growth of the fund management industry in Malaysia gathers momentum through a decentralisation of EPF's investment activities, these fund managers can then play a more active role in this Watchdog Group.

If institutional investors take actions against insiders who have violated the trust that ought to be accorded to minority shareholders, then this will send a clear signal and insiders are likely to engage less in dealings which are detrimental to minority shareholders.

Foreign investors are an important force on the KLSE. We have examined (see Annex 1) the situation with respect to 75 out of the 383 (or 19.6%) of the public listed companies (PLCs) in the non-financial sector on the Main Board of the KLSE. The PLCs examined are the larger or more reputable ones accounting for 68.0% of the market capitalisation of the sector in 1996 and for 74.4% in 1997. Out of the 75 non-financial enterprises, 10 were foreign-controlled with a share in market capitalisation of 8.0% (1996: 4.8%). The weighted average of foreign shareholding in these companies, including that by foreign institutional investors or fund managers, in fact increased marginally from 24% to 24.2% over the 1996-1997 period.

The foreign fund managers like certain domestic institutional investors have opted to play a passive role in corporate governance. But foreign fund managers are more active in monitoring firm performance through research and client visits.

A large investor may be rich enough to prefer maximising his private benefits of control (including investments in unrelated activities, whether for diversification or for the purpose of empire building), rather than maximising his wealth. Unless he owns the entire firm, the large investor will not internalise the cost of these control benefits to the other investors. This will then be reflected in the failures of large investors to force their managers or companies to maximise profits and pay out the profits in the form of dividends.

An examination of the foreign controlled companies, especially those which have a clear majority shareholder, shows that these companies have been paying out a high proportion of their profits in the form of dividends (and not reinvesting the profits in diversified or empire-building activities). Such high dividend payout ratios may have been facilitated by the healthier relationship between the control rights of the majority shareholder and his cashflow rights. In the case of locally-controlled companies, the control rights were usually well in excess of the cashflow rights of the controlling shareholder, usually because of the pyramid structure of companies in the same group. This could explain their much lower dividend payout ratios and their greater propensity to reinvest their profits even in unrelated activities, at least in part to maximise the insider's private benefits of control.

An examination of the financials of EON and Proton *vis-à-vis* Gadek and DRB shows that the operating entities of the Yahya Group had better dividend-payout ratios. This was however, not the case with respect to UEM. The higher dividend payout ratios of the Yahya Group should not come as a surprise. In the operating entities we are reviewing, the Yahya Group was in joint venture with a foreign or a local party or both. These joint venture partners could have acted as a check and balance. In UEM there were only institutional investors and no joint venture partners.

We have noted from Tables 2 to 4 that there are many state-controlled companies, especially among the largest entities. Where the state, through its shareholdings in the listed companies, plays a role in governance, the incentive to maximise shareholder value will be distorted because of the complete divergence between the control and cashflow rights of state enterprise managers.

Corporate behaviour, finance and restructuring[28]

A study of nine East Asian countries on corporate diversification and efficiency at the company level by Stijn Claessens et al (1998b) revealed that 70% of the firms in Malaysia were multi-segment firms in that they operate in more than one two-digit SIC code industries. This number was second only to that of Singapore whose share was 72% as compared with an average figure of 65% for all nine countries. There is no comparable study at the level of the corporate group, but the setting up of different companies at a group level can be taken as further evidence of diversification. Corporate groups are, within the private sector, among the most prominent business houses in Malaysia. They often operate across a diversified range of activities within a sector, as well as across many sectors, as diverse as plantation, manufacturing, trading, services, construction and property development. As stated in the preceding section, control within a corporate group is exercised either through cross-holdings or a pyramid structure. While the incidence of cross-holdings is high according to the measure used by Stijn Claessens et al (1999a), the extent of inter-locking ownership is not as pronounced or complicated as in Japan or Korea. The exercise of control through the use of a pyramid structure is more widespread. Usually the controlling shareholder exercises control over a listed operating subsidiary through a listed intermediate holding company. The divergence between control and cashflow rights is more pronounced the greater the number of layers of listed companies between the controlling shareholder and a listed subsidiary. Amongst the prominent corporate groups, Yahya Ahmad, Lim Thian Kiat, Khoo Kay Peng and Vincent Tan use a pyramid structure consisting of two layers of listed companies to control a third layer of listed companies. The divergence between their control and cashflow rights is given in Table 9. Yahya Ahmad, Lim Thian Kiat, Khoo Kay Peng, William Cheng and Kuok Brothers had used cross-holdings to exercise control over certain listed companies. The divergence between their control and cashflow rights is also given in Table 9.

Table 9: Control and Cashflow Rights of Selected Malaysian Corporates[1]

		Control Rights	Cashflow Rights
I	Khoo Kay Peng		
	MUI	0.29	0.13
II	Kuok Brothers		
	Perlis Plantations	0.39	0.39
	Shangri-La Hotels (M)	0.70	0.55
	Federal Flour Mills	0.53	0.34
III	Lim Thian Kiat [2]		
	Multi-Purpose Holdings	0.09	0.03
	Magnum Corporation	0.09	0.01
IV	Vincent Tan		
	Berjaya Group	0.41	0.41
	Berjaya Sports Toto	0.41	0.20
	Berjaya Singer	0.41	0.30
V	Yahya Ahmad Estate		
	Diversified Resources	0.66	0.66
	Gadek Malaysia	0.65	0.54
	Hicom	0.32	0.17
	EON	0.32	0.06
	Proton	0.26	0.05
VI	William Cheng		
	Amsteel Corp	0.70	0.58
	Lion Corp	0.59	0.59

Source: Data extracted from SBC Warburg Dillon Read: Malaysia Connections, January 1998.
Notes: 1. Methodology used in computing control rights are as laid down in Stijn Claessens (1999a).
2. T K Lim's family company owned 8.8% of Kamunting Corporation and Malaysian Plantations owned 37.2%. In turn, Kamunting owned 25.2% of Malaysian Plantations. Therefore, actual control rights of T K Lim in Kamunting is probably above 8.8%. Kamunting held a 30.5% stake in Multipurpose Holdings which in turn held a 23% stake in Magnum Corporation.

According to the study by Stijn Claessens et al (1998b), the extensive diversification of corporates has led to the misallocation of capital investment, possibly even in Malaysia, towards less profitable and more risky business segments. And this in spite of the fact that the diversified groups may have emerged to provide an internal capital market (to compensate for weaknesses in external financial markets) as well as to capture scarcity rents arising from practices such as restrictive licensing that usually characterise a hybrid economy (with transactions based partly on markets and partly on relationships).

Michael Pomerleano (1998) has examined, based on data for the period 1992-96, the corporate roots of the financial crisis in East Asia. For some Asian economies, especially Indonesia, Korea and Thailand, clear evidence emerged of a rapid and unsustainable build up of investment in fixed assets financed by excessive borrowing. The East Asian investment spending spree resulted in poor profitability, reflected in low and declining returns on equity and on capital employed. The study concluded that at the core of the corporate crisis were financial excesses that inevitably led to financial distress.

In the case of Malaysia, the debt-equity ratio was on a rising trend and the level of profitability had started to decline but these variables were still at reasonable levels. However, the rapid build up of investment in fixed assets and weak risk management practices had made the corporate balance sheet vulnerable to the crisis as a result of the sharp depreciation in currency value, escalation in interest rate and collapse in demand.

The pre-tax return on capital employed or on assets (ROCE)[29] was 12% in 1992 and declined to 10% in 1996 to give an average return of 11% over the period. ROCE captures the efficiency with which a company uses all its capital resources. By comparing this number against the cost of capital, defined as the interest rate, and taking the difference as the economic value added (EVA), Pomerleano assessed the extent to which Asian corporates had created shareholder value. The EVA reading for Malaysia over the period was 3%, compared to 12% for Hong Kong, China; 2% for Singapore; 4% for the US; -9% for Indonesia; -2% for Korea; and –8% for Thailand (but the reading generally showed a deterioration over the period across the board with the exception of the US).

Pomerleano's study pointed to a rapid build up of fixed assets in Asia. The average change in tangible fixed assets during 1992-96 was 20% in Malaysia, versus 33% in Indonesia, 29% in Thailand and 17% each in Hong Kong and Korea. The risk of rapid business growth is that it can overwhelm managerial capacity as well as distribution and marketing channels.

A study by JD Abendroth (1997) on Malaysian Corporate Capital Structure covering 272 non-financial public listed companies gives the pattern of corporate finance flows over the period 1992-96. Of the total funds used, 28.1% was derived from retained earnings, 27.3% was mobilised from new equity issues and 44.6% from borrowings (of which 26.6% was short-term debt and 18.0% was long-term debt). The author drew attention to the resemblance of Malaysia's debt financing levels during this period with those of the US during the 1970s of 45%, of which 24% represented short-term debt and 21% long-term debt. However, of the balance, retained earnings accounted for 52% of the funds mobilised compared to 3% from new equity issues. No data is available for corporate financing levels during the post-crisis period. External financing, whether in the form of debt or new equity issues, dried up in 1998 and the first quarter of 1999.

An estimate of the domestic and foreign currency borrowings of the Malaysian corporate sector, including of private limited companies, is given in Table 10. The capital expenditure of all limited companies financed by foreign borrowing was 17.8% in 1995, 6.8% in 1996, 12.7% in 1997 and 8.9% in 1998.

Table 10: Sources of Funding of Capital Expenditures of Limited Companies

(RM Million)

	1995		1996		1997		1998*	
Total	12,725	100%	12,344	100%	25,915	100%	25,896	100%
Financed from own funds	8,412	66.11%	9,050	73.31%	15,733	60.71%	15,891	61.36%
Financed from local borrowing	2,053	16.13%	2,455	19.89%	6,893	26.60%	7,705	29.75%
Financed from foreign borrowing	2,261	17.77%	839	6.80%	3,290	12.70%	2,299	8.88%

Source: Department of Statistics, Business Expectation Survey of Limited Companies, various years.
Note: *Estimated.

Malaysia's debt-equity ratio – which indicates how much borrowed money the corporate sector is using relative to its equity, rose from 31% in 1992 to 62% in 1996, whereas that for Indonesia had risen from 59% to 92%, that for Thailand from 71% to 155%, and that for Korea had risen from 123% to 132% (in 1995).

To analyse debt sustainability, Pomerleano had calculated the interest cover – that is the ratio of companies' operating cashflows (operating income before interest, taxes and depreciation) to their annual interest payment on loans. For Malaysia the interest cover had declined from 9.1 to 6.7 whereas that for Indonesia had increased from 0.03 to 2.44, that for Korea had declined from 1.42 to 1.07 and that for Thailand had deteriorated from 4.6 to 1.9.

Based on its own data base for the actual financial information of non-financial listed companies for 1996 and the first-half 1997, Goldman Sachs (as quoted in Pomerleano) had projected the operating results and financial position of these companies for 1997 and 1998 under certain assumptions about average interest rates, sales growth etc. The interest cover for Malaysian corporates, according to these estimates, was expected to fall from 6.7 in 1996 to 4.0 in 1998.

From the same data base, Goldman Sachs also estimated the number of companies with EBITDA/Interest expenses under 1. Assuming a close correspondence between the percentage of non-performing loans and distressed corporates, Goldman Sachs estimated a rapid increase in the percentage of loans (and companies) in distress in Malaysia from 8.3% in 1996 to 11.2% in 1997 and 18.5% in 1998.[30] The percentage of insolvent or distressed corporates in 1998 in Indonesia was estimated by Goldman Sachs at 45.6% and that in Korea at 31.5%.

Malaysia has registered significant progress in restructuring its banking system but progress is still limited in corporate restructuring. Danaharta, the government's asset management company (AMC) which was set up in July 1998, had acquired or was managing (in terms of gross value) RM14.7 billion of non-performing loans (NPLs) of the banking system and had acquired an additional RM5.0 billion from Malaysian-owned or controlled offshore banks and development finance institutions.[31] With the removal of these NPLs from the banking system, (accounting for 20% of its NPLs), the net NPL ratio of the banking system based on the 6-month classification (which includes all loans whose interest is in arrears for more than 6 months) declined from 8.1% as at end September 1998 to 7.6% as at end December 1998.[32]

Banking institutions with gross NPL ratio exceeding 10% or which required recapitalisation from Danamodal (the Bank Recapitalisation Agency, BRA, set up in August 1998 by the government to ensure that banks were well-capitalised), are obligated to sell all their eligible NPLs (of RM5 million and above) to Danaharta. Burden sharing in the recapitalisation exercise is based on the "first-loss" principle where existing shareholders are required to absorb all losses to insulate Danamodal's capital against past and existing losses. Both Danaharta and Danamodal have brought forward their bank restructuring plans by six months to be complete by mid 1999.

The Corporate Debt Restructuring Committee (CDRC), which was set up in July 1998 to enable creditors and debtors to arrive at schemes of compromise and reorganisation on a voluntary basis without resorting to legal processes, had received by 15 March 1999, 48 applications for debt restructuring, involving debt of RM22.7 billion. Two restructuring plans are under implementation thus far and 26 Creditor Committees have been formed to oversee the restructuring efforts.

With the setting up of Danaharta, Danamodal and CDRC, the full menu of restructuring options are now available in Malaysia – market-based, government facilitated and government financed.

Part X (Section 212 through 318) of the Companies Act provides for a purely private and market-based arrangement for creditors to recover their monies through a winding-up of the company and by liquidating its assets. The Act, which provides for the appointment of a liquidator or receiver, defines their powers and establishes the priority and ranking of debt between and within different classes of creditors, is extensive and lays a clear basis for winding-up.

Part VII (Sections 176 through 181) of the Act provides a market-based approach for the preservation of the company as a going concern and for recovery of loans which have the legal sanction of the courts. However, there are no well-defined judicial management procedures for managing schemes of compromise and reconstruction. There are no guidelines, the process is cumbersome and the courts have limited experience in supervising reorganisation plans. Some 32 companies had misused these provisions in 1998 to obtain temporary relief from their creditors on a unilateral basis without following up with a well-defined reorganisation plan. This had unsettled creditors, given the risk of asset stripping to which they were exposed. To restore the credibility of this option, Section 176 of the Act was amended in late 1998 requiring that a company need the consent of creditors representing at least 50% of its debts before it can apply for court protection and requiring that it submit a list of its assets and liabilities with the application. Since then no relief orders have been obtained.

Repossessing assets in bankruptcy is often very hard even for the secured creditors. With multiple, diverse creditors who have conflicting interests, the difficulties of collecting are even greater, and bankruptcy proceedings often take years to complete. Because bankruptcy procedures are so complicated, creditors often renegotiate outside of formal bankruptcy proceedings both in the US and Europe. The situation is worse in developing countries, where courts are even less reliable and bankruptcy laws are even less complete.

Hence, in mid-August 1998, the CDRC was established under the aegis and with the secretarial support of Bank Negara Malaysia (BNM), to provide a framework to enable creditors and debtors to arrive at schemes of compromise and reorganisation on a voluntary basis without resorting to legal processes. The aim of this scheme, based on the 'London Approach' is to tackle the complex cases of indebtedness with outstanding debt of at least RM50 million and with more than three creditors. Even in these voluntary restructuring exercises Danaharta is expected to use public funds to buy out debts, in a strategic manner, with the aim of facilitating agreements between creditors and debtors.

The CDRC process depends on co-operation between lenders, and while the onshore banks may have an incentive to cooperage, it is not clear if the offshore banks and smaller creditors have a similar incentive. There is therefore, a risk that local banks may end up bearing a higher burden of the restructuring cost. Given the key role the central bank is playing in this government facilitated restructuring process, and given the potential conflicts of interest between its supervisory role and its role in the work-out-process, the central bank has to bend backward to ensure that the process remains a voluntary one.

The government-financed restructuring option revolves around Danaharta and Danamodal. Danaharta was established in 1998 to acquire non-performing loans from banks and assets from distressed companies to minimise the problem of a credit crunch as well as to facilitate an orderly payment/write-down of debts. It will have the same claims as the original creditors and will rely on a number of asset disposal methods (including private placements, public auctions and public tender offers) to recover its claims.

The legal process to be followed by Danaharta aims to compensate for the absence of a well-defined scheme of the judicial management of corporate restructuring under the Companies Act.[33] The goal is to expedite and shorten the legal procedures and to bring to bear professional expertise in design and implementation of reorganisation plans. The operations of Danaharta are covered under a special act that confers on it broad ranging powers to acquire and manage assets.

For corporate borrowers with total outstanding debt of less than RM50 million, the Loan Monitoring Unit at Bank Negara Malaysia provides assistance in enabling these borrowers to continue to receive financial support while restructuring their operations. In addition, these borrowers could also use the Danaharta route.

With the amendment to Section 176 of the Companies Act, the incentives for market-based restructuring have increased. But the government has taken the initiative to intervene or guide the restructuring of banks as well as of large companies. As the government owns the only AMC and as large financial resources are available to it and to the BRA, and as an exit strategy is yet to be articulated, this may diminish pressures for the operational and management restructuring of the ailing companies. A strong case can therefore be made for greater reliance on the market-based approach to restructuring and on banks or other private parties to establish AMCs.

To increase reliance on the market-based approach, the remedies available under the Companies Act should be used for resolving the more straightforward cases of corporate distress than those entailed in bilateral creditor-debtor relationships. Greater use should also be made of the secondary markets for quick disposal of assets. In fact, it should be easy to dispose of individual properties or pools of real estate given that there is a good and well-functioning secondary market in properties backed by a well-developed land and property registry system. In such cases, the restructuring could be left to banks to be carried out under existing laws governing enforcement of security measures.

The overwhelming role of Danaharta and the inadequate reliance on the market-based approach will be a cause for concern so long as Danaharta's asset warehousing and disposal strategy is not clearly articulated. According to the 1998 Central Bank Annual Report, Danaharta is expected to have a life span of 7 to 10 years. Further, all the bonds Danaharta has issued to date have a five year tenor and it has an option to extend the tenor of these bonds by another five years. This gives the impression that the assets acquired by Danaharta may remain in its warehouse for an indefinitely long period, as has been the case with the Mexican AMC.

Danaharta has given the assurance that it will not function as a warehousing agency and that in fact it will start on its assets disposal programme from the second half of 1999. This is indeed a key issue for the government. The slower the pace at which the assets are disposed of, the greater the overhang in the market place. And so long as there is this overhang, and so long as asset prices are above their market clearing levels, this can severely hamper new development activities and hence the pace of economic growth. Danaharta should also be cautious in the use of its funds in supporting partially completed projects. It is best for Danaharta, by relying on the auction process, to let the market decide on the fate of these projects.

A comprehensive restructuring exercise would require the judicious use of debt-equity conversions. The resulting change in ownership structure and management can create the right incentives for efficient behaviour by all stakeholders. To date there have been few corporate restructurings and hence few ownership and management changes at the corporate level.[34] The bank restructuring has led to the purging of NPLs, the recapitalisation of banks and some new appointees as directors or managers but without necessarily removing the old directors or managers. This is unlike what happened in the aftermath of the last banking crisis in the mid 80s. There were then no Danaharta or Danamodal. The Central Bank sacked the board and management of the ailing banks, appointed a new board and management, wrote down the loans and recapitalised the banks so that they could start all over again. To the extent that the old directors and managers are not removed and to the extent that bank deposits continue to be government-guaranteed, the right incentives are not being created to rid the banking industry of the moral hazard problem and of a future banking crisis.

As for the corporate sector, if Danaharta ends up as a warehousing agency or if it does not impose proper burden sharing on stakeholders of the corporations that are restructured through its intervention, then the right incentives will not be created to rid the corporate sector of the moral hazard problem.

II. The regulatory framework and the role of policy

Equitable treatment of shareholders and other stakeholders

Shareholder protection

The adequacy of investor protection in Malaysia can be examined in relation to the rights of shareholders, the protection that shareholders enjoy against abuses and expropriation by insiders as well as the quality of law enforcement.

Ownership of shares in a company confers on a shareholder several basic rights which include the following – the right to a secure method of ownership registration, the right to convey or transfer shares, the right to obtain relevant information on the corporation on a regular basis, the right to participate and vote at general shareholders meetings on key corporate matters, the right to elect members of the board and the right to share in the residual interest in the profits of the corporation (see Annex 2 for more details).

The principal right that shareholders have is the right to vote on the election of directors, on amendments to the corporate charter as well as on key corporate matters, such as the sale of all or a substantial part of the company's assets, mergers and liquidations, thus limiting the discretion of insiders on these key matters.

In determining how well Malaysia fares as regards this principal right of shareholders, we have to examine the voting rights attached to shares as well as the rights that support the voting mechanism against interference by the insiders (dubbed anti-director rights by La Porta et al [1998a] in their cross-country study of Law and Finance in 49 countries).

The one-share-one-vote rule with dividend rights linked directly to voting rights is taken as a basic right in corporate governance. This rule obtains when the law prohibits the existence of both multiple-voting and non-voting ordinary shares and does not allow firms to set a maximum number of votes per shareholder irrespective of the number of shares owned. The idea behind this basic right is that, when votes are tied to dividends, insiders cannot appropriate cashflows to themselves by owning a small share of the company's share capital but by maintaining a high share of voting control. In La Porta's cross-country study, Malaysia was found to be one of only 11 countries out of the 49 which impose genuine one-share-one-vote rule.

La Porta et al have identified six anti-director rights which essentially describe how easy it is for shareholders to exercise their voting rights. These rights and the findings, as set out in Table 11, are as follows:

- that shareholders are allowed to mail their proxy vote;
- that shareholders are not required to deposit their shares prior to the general shareholders meeting;
- that cumulative voting is allowed (whereby shareholders are allowed to cast their votes for one candidate thereby increasing the probability of outside directors);
- that an oppressed minorities mechanism is in place (whereby minority shareholders are granted either a judicial avenue to challenge the management decisions or the right to

step out of the company by requiring the company to purchase their shares when they object to certain fundamental changes, e.g. mergers);

– that shareholders have pre-emptive rights to new stock issues; and

– that the minimum percentage of share capital that entitles a shareholder to call for an extraordinary general meeting is reasonable, i.e. 10% or less.

In their cross-country study, La Porta et al found that the average score for the sample as a whole was 3.0, whereas it was 4.0 for the English common law countries, 2.33 for the French and German civil law countries, and 3.0 for the Scandinavian civil law countries. This index aggregating shareholder rights was formed by adding 1 to each of the anti-director rights as specified above and 0 otherwise (with the index ranging from 0 to 6). Malaysia was scored at 4 as proxy by mail and cumulative voting are not allowed.[35] The score was 4 for Singapore, 3 for Philippines and 2 for Thailand and Indonesia.

In Malaysia, as in many other common law countries, shareholder voting rights are supplemented by an affirmative duty of loyalty of managers to shareholders, i.e. managers have a duty to act in the shareholders' interest. The most commonly accepted elements of the duty of loyalty are the legal restrictions on managerial self-dealing, such as outright theft from the firm, excessive compensation or issues of additional securities (such as equity) to the management and its relatives. The courts would interfere in cases of management theft and asset diversion, and they would surely interfere if managers diluted existing shareholders through an issue of equity to themselves. However, courts are less likely to interfere in cases of excessive pay, and in line with the business judgement rule (that keeps the courts out of corporate decisions), and are very unlikely to second guess managers' business decisions, including the decisions that hurt shareholders (e.g. empire-building). Shareholders in Malaysia, as in the US, have the right to sue the corporation using class action suits that get around the free rider problem, if they believe that the managers have violated the duty of loyalty. However, civil procedure in Malaysia is less facilitative of class actions and contingent fees are prohibited.[36]

In addition to measures of investors' legal rights, the La Porta study examined the measures or proxies for the quality of enforcement of these rights, namely estimates of "law and order" in different countries compiled by credit risk agencies. Of the five measures studied, namely efficiency of the judicial system, rule of law, corruption, risk of expropriation and likelihood of contract repudiation, the authors noted that only the first two pertain to law enforcement proper and the last three deal more generally with the government's stance toward business.

The study emphasised the role accounting plays in corporate governance.[37] Accordingly, in addition to the rule of law variables, the study used an estimate of the quality of a country's accounting standards. Like the rule of law measures, the study used a privately constructed index based on examination of company reports from different countries as a measure of accounting standards.

The specification in the study of the indices for the two law enforcement variables and for accounting standards are set out in Table 12. For the variable "efficiency of judicial system", Malaysia was scored at 9 (which is surprisingly high). The average score for countries with a legal system of English origin was 8.15; of French origin 6.56; of German origin 8.54; and of Scandinavian origin 10.00. Australia; Hong Kong, China; New Zealand; Singapore; the UK and US, which are all common law countries, registered a perfect score of 10 each; whereas Thailand was scored at 3.25; Indonesia at 2.50; and Philippines at 4.75.

With respect to the "rule of law" variable, Malaysia was scored at 6.78 as against an average of 6.46 for countries with a legal system of English origin; 6.05 for French origin; 8.68 for German origin; and 10 for Scandinavian origin. Australia, New Zealand and the US had a perfect score of 10 with the scores for Hong Kong, China at 8.22, Singapore at 8.57 and the UK at 8.57. The scores for Thailand, Indonesia and Philippines were 6.25, 3.98 and 2.73 respectively.

For the rating on accounting standards (see Table 12), Malaysia was scored at 76, as compared to the average of only 69.62 for countries of English origin; 51.17 for French origin; 62.67 for German origin; and 74.00 for Scandinavian origin. Malaysia was behind Singapore and the UK which had a score of 78 whereas it was ahead of Australia at 75; Hong Kong, China at 69; New Zealand at 70; and the US at 71. Malaysia was way ahead of Thailand's 64 and Philippines' 65. Indonesia was not scored.

From the preceding discussion, it is clear that Malaysia was one of only 11 countries out of a sample of 49 countries which impose a genuine one-share-one-vote rule. However, in respect of the exercise and enforcement of these voting rights, there is still significant room for improvement in Malaysia. The authorities should actively consider allowing proxy by mail and cumulative voting for directors to strengthen the position of minority investors *vis-à-vis* the controlling shareholders.

Table 11: Rights that Support Voting Mechanism against Interference by Insiders

	VARIABLE	DESCRIPTION
i)	Proxy by mail	9 countries from the sample allowed voting by mail whereas others allowed voting only by the shareholder in person or his authorised representative. Malaysia does not allow proxy by mail.
ii)	Blocking of shares before meeting	14 countries required that shareholders deposit their shares prior to a general meeting of shareholders thus preventing them from selling those shares for a number of days. Malaysia is not one of them.
iii)	Cumulative voting for directors	13 countries allowed shareholders to cast all of their votes for one candidate thus increasing the probability of outside directors but Malaysia is not one of them.
iv)	Percentage of share capital to call an emergency shareholders meeting	38 of the countries required 10% or less thus facilitating better shareholders' control. Malaysia's requirement is 10%.
v)	Oppressed minorities mechanisms	26 of the countries granted minority shareholders either a judicial venue to challenge the management decisions or the right to step out of the company by requiring the company to purchase their shares when they object to certain fundamental changes, such as mergers, assets disposition and changes in the articles of incorporation. Malaysia is one of them.
vi)	Preemptive rights on new stock issues	26 countries required preemptive rights which protect against dilution of minority shareholders and prevent insiders altering ownership structure. Malaysia is one of them. [1]

Source: R.L Porta et al (1998).
Note: [1] The directors may make a special issue of shares of up to 10% of a company's paid-up capital to the general public or to any class of investors if they have obtained the general authority of the shareholders to do the same at a general meeting. Special issues to Bumiputras may also be required during new listings. This can pose a serious problem when the new issue prices differ from the market prices. With the recent move to a disclosure-based regulatory regime and the concomitant freeing of the new issue prices, this is less of a problem. On a strict interpretation, given special issues to Bumiputras, existing shareholders do not enjoy pre-emptive rights in Malaysia.

Table 12: Specification of Variables for Law Enforcement & Accounting Standards

Variable	Description	Sources
Efficiency of judicial system	Assessment of the "efficiency and integrity of the legal environment as it affects business, particularly foreign firms" produced by the country-risk rating agency *Business International Corporation*. It "may be taken to represent investors' assessments of conditions in the country in question". Average between 1980 – 1995. Scale from 0 to 10, with lower scores for lower efficiency levels.	Business International Corporation.
Rule of law	Assessment of the law and order tradition in the country produced by the country-risk rating agency *International Country Risk* (ICR). Average of the months of April and October of the monthly index between 1982 and 1995. Scale from 0 to 10, with lower scores for less tradition for law and order.	International Country Risk Guide
Accounting Standards	Index created by examining and rating companies' 1990 annual reports on their inclusion or omission of 90 items. These items fall into 7 categories (general information, income statements, balance sheets, funds flow statement, accounting standards, stock data and special items). A minimum of 3 companies in each country were studied. The companies represent a cross-section of various industry groups where industrial companies numbered 70% while financial companies represented the remaining 30%.	International Accounting and Auditing Trends, Center for International Financial Analysis & Research, Inc.

Source: La Porta et al (1998).

The La Porta study did not examine the laws in place for the protection of minority shareholders against insider expropriation or abuses. But this has been attempted in a recent joint study of the Asian Development Bank and the World Bank (1998) for certain selected Asian countries. (Table 13 sets out the findings of the study.)

From a review of the table, one can infer that Malaysia stands out on the positive side in respect of safeguards against insider abuses. Shareholder approval of major as well as interested transactions is mandatory. Reporting by large shareholders and connected interests is also mandatory. Loans to directors or shareholders are prohibited. Stiff penalties against insider trading, provisions on takeovers and a mandatory independent audit committee minimises abuses by insiders and protects minority interests. However, a close review of existing legislation reveals several weaknesses:

First, there are outright prohibitions on certain related party transactions. On efficiency grounds, such transactions should be made subject to shareholder approval with the interested parties required to abstain from voting.[38]

Second, Section 132E of the Companies Act as presently drafted, only embraces transactions with directors or persons connected with directors. It does not embrace transactions between a company and a substantial shareholder or persons connected with a substantial shareholder. Only Section 132G (see Footnote 38) recognises the concept of a substantial shareholder in related party transactions. Therefore, the ambit of Section 132E should be extended to cover substantial shareholders and persons connected to substantial shareholders.

Third, Section 132E only requires the related party transactions to be disclosed and approved by shareholders, but it does not prohibit the related party from exercising its voting rights on such transactions. Amendments should be considered to require the related parties (and in particular when the ambit of the section is expanded to cover substantial shareholders) to abstain from voting on interested party transactions.

Table 13: Safeguards against Insider Abuses in Selected ASEAN Countries[1)]

	Variables	Description/Effect	Malaysia	Thailand	Philippines	Indonesia
1.	Mandatory shareholder approval of major transactions	Protects against abuse by insiders. Protection can be enhanced through supra-majority voting.	Yes	Yes	Yes	Yes
2.	Mandatory independent board committees	If composed of independent directors, audit and remuneration committees protect against insider abuse.	Yes	Yes		
3.	Mandatory disclosure of non-financial information	Both financial and non-financial information data are important to assess a company's prospects.	Yes	Yes		Yes
4.	Mandatory reporting by large shareholders	Disclosure of transactions by large shareholders protects against abuse by insiders.	Yes	Yes	Yes	
5.	Mandatory disclosure of connected interests	To protect against abuse by insiders.	Yes	Yes	Yes	
6.	Mandatory shareholder approval of interested transactions	Protects against abuse and squandering of company assets by insiders.	Yes	Yes	Yes	Yes
7.	Prohibition of loans to directors [2)]	Protects against abuse by insiders; prevents squandering of company assets.	Yes	Yes	Yes	
8.	Penalties for insider trading	Protects against use of undisclosed information at the expense of current and potential shareholders.	Yes	Yes	Yes	Yes
9.	Provisions on takeovers legislation	Protects against violation of minority shareholders' rights.	Yes	Yes	Yes	

Sources: 1. Asian Development Bank & World Bank (1998), Managing Global Financial Integration in Malaysia: Emerging Lessons and Prospective Challenges.
2. World Bank 1998.
Notes: 1) A blank means that it was not possible to establish whether the legal/regulatory framework included the shareholder protection variable in question. This has been rectified for Malaysia. 2) Loans to Directors are prohibited unless the loans are part of the standard benefit package for employees.

Fourth, there are also weaknesses in existing legal provisions with respect to a substantial acquisition or disposal which requires shareholders approval.[39] The KLSE Rule on a substantial transaction and, in particular, the new rule which came into force from July 1998, define this more clearly. It makes sense for the relevant provisions in the Companies Act to be redefined in a similar manner with respect to such tests as the assets test, profits test, consideration test, consideration to market capitalisation test and the equity or capital outlay test.

Fifth, there were also some serious weaknesses in insider trading rules in Malaysia. With the recent amendments to the Securities Industry Act (SIA), which came into effect in 1999, the law against insider trading has been greatly improved. Insiders are no longer defined as persons with fiduciary duty or duty of confidentiality, namely directors, managers, advisors and agents, but include all persons who have in their possession material non-public information. A tippee who uses such information will also fall into this group. The law which only provided for criminal action has now been expanded to enable the regulator or any person who has suffered loss or damage from insider trading (or market manipulation) to institute civil action against the offenders, thus heralding a new era in Malaysian securities industry regulation. Penalties for insider trading have also been increased to include civil penalties with provision for the regulator to recover three times the insider's gain or loss avoided. The new civil penalties also allow investors to seek full compensation for loss or damages from the offenders.

Last, there was a serious weakness in the Takeover Code. There are provisions in the Code for the protection of shareholders, such as special disclosure thresholds and the obligations to extend a tender offer to all shareholders. However, parties who are involved in an acquisition or a takeover were allowed to apply to the Foreign Investment Committee (FIC) of the Economic Planning Unit for a waiver from making a general offer on "national interest" grounds or to the Securities Commission (SC) if they meet its criteria with respect to the restructuring of a group of companies. Since 29 August 1997, the FIC has granted, subject to certain specific conditions, exemptions to several trust agencies, majority shareholders, individuals and public companies from the obligation to extend a mandatory general offer (MGO) so as to facilitate the acquisition of shares in certain identified companies in order for them to stabilise share prices. These exemptions were poorly received by the market. The market reception became more violent when UEM, one of the entities given the waiver, was given a further exemption, and this despite the MGO being triggered by a breach of the initial approval conditions.

In response to the adverse reaction, the SIA was amended in December 1998 to make the SC the sole authority to grant exemptions from provisions of the Code. The amendments now subject the discretionary exemptive powers to a clear and transparent criteria as stipulated in statute so that the authority that exercises such discretionary power can be checked by investors who have recourse to courts if the power is arbitrarily exercised.

Unlike the weaknesses in the Companies Act on a related party transaction, the listing rules of the Kuala Lumpur Stock Exchange (KLSE) require that a circular be sent to shareholders on a material transaction affecting a director or a substantial shareholder and that their prior approval of the transaction be sought in general meeting, and further may require that the interested party abstain from voting.[40]

Reliance on the KLSE Rules, however, was not adequate as the KLSE had powers only to penalise or punish the listed companies and not the insiders committing the offence. Doubts had been expressed as to the extent to which the rules restrict a shareholder from voting his shares in respect of a transaction that he is directly interested in. The KLSE Rules, it was felt, cannot deny a shareholder that fundamental property right. In this regard, it is interesting to note that the powers of the KLSE have been substantially embellished by the recent amendments in 1998 to the SIA which now strengthen the KLSE's ability to take action against directors and anybody concerned by its listing rules, whereas the KLSE was previously confined to the listed entities.

With this increase in its power, more reliance on the KLSE to enforce the rules on related party transactions has been advocated. This is on the ground that the KLSE, as a self-regulatory organisation, is likely to be more flexible in adapting the rules to changing conditions in the business world. There is great merit in this argument provided that it can be established that a shareholder, with the recent amendments to the SIA, cannot in fact challenge the KLSE Rules that restrict his voting rights. However, it is important to note that the KLSE still does not have the enforcement infrastructure of a statutory regulator (which includes the statutory right to require information as well as the rights of search and seizure).

The purchase by UEM, a blue chip company with a strong balance sheet, of a one-third interest in a related company with a weaker balance sheet, namely Renong Berhad, without proper disclosure or prior shareholder approval, as well as controversy over the waiver granted to UEM from making a mandatory general offer under the Takeover Code, led to a big shakeout in investor confidence in the Malaysian stock market in late 1997 and early 1998. This had come soon after the market had succumbed to the regional financial crisis in mid-97 and the attempt of the government to regulate trading which had unsettled the market further. While UEM was penalised for its non-disclosure, its directors were not. The fine imposed was the maximum but it was a paltry sum in relation to the billions that were lost in market capitalisation. As noted earlier, the waiver from the MGO unsettled the market a great deal. On a strict interpretation of the law then, the transaction might have required the approval of shareholders only as a large transaction but not as a related party transaction. With the changes to the law made since then, such a transaction, if it were to happen now, would require the prior approval of disinterested shareholders.

Apart from the quality of legal protection, the quality of law enforcement also matters for a system of good corporate governance. The La Porta study adopted the rule of law variable as a proxy for the quality of law enforcement. Going by this measure, Malaysia only ranked 9th amongst the 17 common law countries which were covered by the study. Of the 11 German and Scandinavian civil law countries, only one, namely Korea, registered a lower score than Malaysia for this variable. Even amongst the French civil law countries, there were 7 countries which had a better quality of law enforcement than Malaysia. In the light of the UEM-Renong debacle, Malaysia's record on the quality of enforcement may in fact be worse than what is suggested in the La Porta study. Therefore, it is clear that there is considerable room for Malaysia to improve its record on matters related to law enforcement.

Prior to 1965, minority shareholders had to rely on common law doctrines to check abuse of power by directors or majority shareholders. There are several difficulties with the common law doctrines.[41] Responding to these inadequacies, the legislature in 1965 introduced Section 181 of the Companies Act 1965 providing for relief against oppressive conduct or conduct in disregard of interests and unfairly discriminatory or prejudicial conduct.

Section 181, according to Loh Siew Cheang, "is a superior course of law for checking the abuse of power and in providing remedies when compared with the common law doctrines. Under this section, the rule in *Foss V Harbottle* has no application and the courts are free of common law precedents developed under the doctrine of fraud on the minority when interpreting the scope of the section. Further, once the court is satisfied that the conduct complained of is established, the court has a wide discretion as to the relief which it may grant, such relief including an option to wind up the company".[42]

Section 218 of the Companies Act 1965, the second statutory remedy for shareholders, gives the holder of fully paid up shares in a company the right to petition the court for a winding up order. The court would grant the order in a specified range of circumstances, including:

- where the company is insolvent;
- when the directors have acted in their own interests instead of the interests of the members, or acted unfairly or unjustly to other members in the company; and
- if the court is of the opinion that it is just and equitable for the company to be dissolved.

Creditor protection

A measure of creditor rights and the efficacy of the judicial system in protecting creditor rights, as computed by Claessens et al (1999c), is set out in Table 14.

In constructing the index of creditor rights, Claessens et al have used the methodology in La Porta et al (1997). This index is an average of four indicators of creditor strength. First, the timeliness of rendering a judgement whether to liquidate or restructure once a bankruptcy petition has been filed. For example, the bankruptcy codes in Indonesia, the Philippines and Thailand do not have a specified timetable for rendering a judgement.[43] The remaining six countries impose a timetable, such as 60 working days in Japan and Hong Kong, China; and 180 working days in Malaysia. Second, whether the incumbent management remains in control of the company during reorganisation or bankruptcy. This is the case only in Indonesia and the Philippines. Third, whether the creditor is barred by an "automatic stay" from taking action against the debtor's assets while the bankruptcy proceedings are pending. This is the case only in Indonesia, Japan and the Philippines. Fourth, whether secured creditors have the first priority of claims to the debtor's assets. This is the case in Hong Kong China, Japan, Korea, Malaysia, Singapore and Chinese Taipei. Based on these indicators of creditor rights, Hong Kong, China; Singapore and Chinese Taipei were scored at the maximum of 4; Japan, Korea and Malaysia were scored at 3; Thailand at 2; and Indonesia and Philippines at 0.

Claessens et al have constructed their index of the efficacy of the judicial system based on data from a 1999 Asian Development Bank study of Insolvency Law Reform in selected Asian countries. The study reports the expense, difficulty, efficiency and speed of liquidating or restructuring an insolvent corporate borrower. As shown in Table 14, Singapore had the highest ranking at 7 based on the average of the scores of its liquidation and restructuring processes, as against the maximum of 8. Korea was scored at 6.5; Hong Kong, China was scored at 5.5 as were Japan and Thailand (a surprise); Malaysia was scored at 4.5, Indonesia and Chinese Taipei at 3.5, and the Philippines at 2.0.

Table 14: Legal Origin, Creditor Rights and Efficacy of the Judicial System

Country	Legal Origin	Creditor Rights	Judicial Efficacy
Hong Kong	Anglo-Saxon	4	5.5
Indonesia	French	0	3.5
Japan	Germanic	3	5.5
Korea	Germanic	3	6.5
Malaysia	Anglo-Saxon	3	4.5
Philippines	French	0	2.0
Singapore	Anglo-Saxon	4	7.0
Taiwan	Germanic	4	3.5
Thailand	Anglo-Saxon	2	5.5

Sources: Claessens et al (1999c). Creditor Rights and Efficacy of Judicial System are constructed by the authors based on data from a Asian Development Bank study of Insolvency Law Reform (1999).
Note: The Creditor Rights index is the summation of four dummy variables, where the highest possible score is 4: TIME, equal to 1 if the timetable for rendering a judgement is less than 90 days, 0 otherwise. MANAGER, equal to 1 if incumbent management does not stay during a restructuring or bankruptcy, 0 otherwise. STAY, equal to 1 if there is no Automatic Stay on assets, 0 otherwise, CREDITOR, equal to 1 if secured creditors have the highest priority in payment, 0 otherwise.
The Judicial Efficiency index is the average of 8 variables, the ranking (0-2) of expense, ease, efficiency, and speed for RESTRUCTURING and LIQUIDATION. For Example, we assign 0 points if Restructuring is Very Slow, 1 if Slow, 2 if Quick. Similar ranking is constructed for expense, easy and efficiency. The maximum score is 8 each for Restructuring and Liquidation. We take the average of those scores.

Claessens et al state that the individual country surveys on which the above computations are based use similar methodology and were conducted by teams of legal experts in each country, and reviewed by a regional team to ensure the comparability of results. Nonetheless, based on casual empiricism, it is my considered view that the score for Malaysia *vis-à-vis* that of Thailand appears to be low. There has been a reform of the Thai bankruptcy law no doubt, but this has been more than compensated by the establishment in Malaysia of Danaharta whose operations are covered under a special act. This act confers on Danaharta broad ranging powers to acquire, manage and dispose assets. It also compensates for the absence of a well-defined scheme of judicial management of corporate restructuring under the Companies Act.

The role of the board of directors[44]

Malaysian boards are unitary in nature. The average size of the board of Malaysian PLCs is 8. Of this, 2.6 members are made of independent non-executive directors, 2.6 are non-executive directors and 2.8 are executive directors. (KLSE/PriceWaterhouseCoopers 1999). There is no requirement or practice to represent stakeholders (other than shareholders) on boards, such as employees, creditors or major clients or suppliers. Interlocking directorships occur in companies belonging to the same corporate group. No limit has been placed on this practice except for restrictions (with effect from 1999) on the number of directorships an individual director of a PLC can hold in other PLCs as well as in private limited companies. As a rule, individuals belonging to a particular corporate group (whether they are owners, directors or managers) do not sit on boards of companies belonging to other groups. But there are directors who are independent of significant shareholders or management who sit on boards of different corporate groups or companies, provided these companies are not competing with each other.

There has been minimal regulation of the structure and composition of boards. The Companies Act requires every company to have at least two directors. The KLSE listing rules require two independent directors on boards who are neither related to its officers nor represent concentrated or family holdings of its shares. The KLSE is currently considering a proposal to expand the definition of independence to exclude substantial shareholders. A substantial shareholder is now defined (i.e. wef 1998) as a person who has interests in 2% of the voting shares. This is a source of concern given that the new Malaysian Code on Corporate Governance, which was adopted in early 1999,[45] requires that one-third of the board should comprise independent directors. To fulfil this requirement, the Code simply states that the board should include a number of directors, which fairly reflects the investment in the company by the shareholders other than the significant shareholder. The proposed KLSE rule and the new Code, taken together, may have the unintended effect of disenfranchising the very group of people who have the most incentive (because of their large shareholdings) to ensure that their rights are not abused.

There is, therefore, an urgent need for the KLSE to reconsider its proposal. Otherwise, given concentrated shareholding, the two or three largest shareholders in a company (see Table 8) may end up accounting for two-thirds of the appointees on boards with the balance one-third representing the retail investors without any representation from intermediate groups such as institutional investors who have, by virtue of their large shareholding, an incentive to monitor the managers or owner-managers of the companies in which they have invested.

Presently cumulative voting is not permitted in that a shareholder is not allowed to concentrate and cast his votes on behalf of a single candidate. Also, appointment to the board is on a staggered basis, with approximately one-third of the directors coming up for re-election once in three years. If there is cumulative voting with non-staggered boards and the number of directors is in the single digit, then this is likely to see the election of large shareholders as directors who are independent of managers or owner-managers, such as institutional investors. This is a more market-friendly and effective way of ensuring independent directors on boards than what is envisaged even by the new Code. In the absence of cumulative voting and given concentrated shareholding, it will be more difficult to ensure a board which is not a captive of the owner-managers.

The new Code attempts to strengthen the selection process somewhat by recommending that non-executive directors should be selected through a formal and transparent process. The suggested formal process would involve a nomination committee, with the responsibility for proposing to the board any new appointments, whether of executive or non-executive directors. The nomination committee is to comprise a majority of independent non-executive directors and is to be chaired by such a director. The executive summary of the KLSE/PriceWaterhouseCoopers corporate governance survey indicates that only about 20% of companies that responded to the survey had a structured process for selecting independent non-executive directors, and amongst them, the majority (81%) involved the board as a whole. Again, it is not clear if this process is superior to cumulative voting for ensuring the election of independent directors.

The boards are essentially free to set up whatever committees they see fit to facilitate the management and supervision of the company. The only committee that is mandated is the audit committee. The listing rules of the KLSE currently require all listed companies to have audit committees comprising 3 members of whom a majority shall be independent. The rules also set out the minimum functions of the audit committee.[46]

The new Code sets out an additional function of the audit committee, i.e. to consider, and where it deems necessary, to investigate any matter referred to it or that it has come across in respect of a transaction, procedure or course of conduct that raises questions of management integrity, possible conflicts of interest or abuse by a significant or controlling shareholder. The Code further recommends that when its findings have been reported to the board and the board fails to take action, the directors of the committee should be required under the listing rules of the Exchange to report the matter directly to the Exchange.

In addition to the audit committee, typical issues to be delegated to committees of larger public companies include nominating directors (alluded to above) and the compensation and remuneration of directors and senior management. While the concept of a remuneration committee is said to be relatively new in Malaysia, the results of the KLSE/PriceWaterhouseCoopers survey on corporate governance indicates that one in five companies already has remuneration committees in Malaysia. No data is provided on the membership of these committees. The Malaysian Code on Corporate Governance stresses the need for companies to establish a formal and transparent procedure for developing policy on executive remuneration and suggests in this respect the setting up of remuneration committees, comprising wholly or mainly non-executive directors to recommend to the board the remuneration of executive directors in all its form drawing from outside advice if necessary. The membership of the remuneration committee has to be disclosed in the director's report. The Code also requires companies to disclose in the annual report the details of remuneration of each director. Presently the remuneration of directors is disclosed on an aggregate basis.[47]

The law imposes on directors certain "trustee–like" duties. These can be broadly classified into the duties to act in the best interests of the company, the duty to avoid conflicts of interest with the company and the duty to act for a proper purpose.

Duty to act in the best interests of the company – Section 132 of the Companies Act 1965 (CA) sets out the director's duty to act honestly. This has been interpreted through case law to mean the "best interests of the company". A crucial aspect of the duty of the nominee is that he is not entitled to sacrifice the interests of the company in favour of that of his principal.

There is also a well established body of common law to say that the interests of a company may at times include the "interests of creditors", especially when a company is insolvent or approaching insolvency. With respect to employees, unlike the English Companies Act 1985 or the Singapore Companies Act, the Malaysian Act does not expressly provide that the performance of directors' functions include the interests of the company's employees.

No conflict rule - As fiduciaries, directors must not, as a matter of general rule, put themselves in a position where their duties to the company conflict with that of their personal interest. A company has a right to the services of its directors as an entire board. A director who has entered into a contract with his company in breach of his fiduciary duty still remains accountable to the company for any profit that he may have realised by the deal.

The application of the no-conflict rule may be modified by statute. The provisions of Section 131 of the CA are designed to achieve such a modification by allowing a company to enter into transactions with directors provided that the interest is first disclosed to the board

Duty to act for a proper purpose - directors are under a duty to act *bona fide* in the interest of the company as a whole and not for any collateral purpose. Where directors are conferred with discretion, the particular purpose for which the discretion is being exercised must be one of those purposes for which it was conferred. The majority of the cases in this area involved the directors issuing new additional shares in an attempt to defeat take-over bids. But the power of the directors to issue new shares is qualified under Section 132D of the CA which provides that, notwithstanding any provisions in the company's charter, directors must not issue new shares without the prior approval of members in general meeting.

There is a striking contrast between directors heavy fiduciary duties and their relatively light obligations of skill and diligence. Unlike the robust approach when adjudicating on questions of loyalty and good faith, courts display a reluctance to interfere with a director's business judgement and take a lenient view of their duties of care, skill and diligence. Courts are perhaps conscious of substituting their hindsight for a director's foresight. Section 132(1) of the CA sets out the duty of the director to "use reasonable diligence in the discharge of the duties of his office." The common law spreads the requirement wider with its duty of skill and care.

Directors are also subject to various disclosure obligations under the law. Section 135 of the CA sets out the general duty of directors to make disclosure. These include disclosure with respect to the directors interests in the company or a related company, and any changes in those interests. The consequences for breach of this provision is criminal and the penalty is imprisonment for a term of three years or a fine of fifteen thousand ringgit. Section 99B of the Securities Industry Act similarly provides that a chief executive and a director of a listed company must disclose to the Securities Commission their interest in the securities of the listed entity or any related corporation of the entity. This provision carries much stiffer penalties – imprisonment for a term of up to 10 years and a fine of up to one million ringgit.

While directors are subject to all of these duties, there is room for strengthening and clarifying on these duties. Critical areas in this connection would include:

- *Clarification of the duty to act honestly*. The duty to act "honestly" should, according to the FC, be reformulated to require a director to act *bona fide* in the best interests of the company." The problem with the existing formulation of the duty to act honestly is that it could be misconstrued by some to require some element of wrong doing or fraud.

- *Clarification of the position of nominee directors*. Essentially a person who has a major stake in a company will appoint someone whom he trusts onto the board to keep an eye on his investments. There are some directors who erroneously believe that if a particular shareholder is responsible for their election, the director should represent the best interests of that shareholder. The FC Report has suggested that there should be legislative clarification that a nominee's duty to his principal is always subject to his duty to act in the best interests of the company.

- *Codification of the fiduciary duty of directors to avoid conflicts of interest*. There have been numerous criticisms levelled against the practices of directors that give rise to conflict. And while there are fiduciary principles under common law to deal with these abuses, the problem with common law, according to the FC, is that it is difficult to distil a clear set of rules for directors to operate by. The rules operate by reference to the particular facts of the case in question. There are several provisions in the CA which reinforce the common law obligations, but these do not cover the full range of common law duties and obligations. Accordingly, the FC argues for the codification of this duty, setting out minimum procedures that directors should adopt in conflict situations, which should include full disclosure of the conflict, the interested director abstaining from voting, and the ability of the court to enquire into the fairness of a transaction.

- *Strengthening enforcement of fiduciary duties*. As a general rule, directors do not owe fiduciary duties to shareholders. For this reason a member cannot sue to enforce a company's right against the directors. The power to institute action in the company's name generally lies with the board. It is practically very difficult for a shareholder to cause the company to commence an action against a defaulting director, especially where he controls the board and the company. So typically a company commences action against such a director where there has been a change in management or where he has left the company, which in most instances is unlikely. There is an avenue for minority shareholders to initiate action in the company's name, but the practical realities such as the legal costs of funding the transaction, as well as the substantive and procedural requirement to institute such an action, are generally insurmountable for the minority shareholder. Accordingly the FC has opined that codification of the fiduciary duties coupled with stringent penalties would go some way towards addressing this problem; provisions could be made, as in Australia, for the regulator to institute civil action on behalf of an investor to recover damages suffered by the investor as a result of transgressions, and that statutory derivative action be introduced to strengthen the avenue for civil enforcement action by shareholders. Sections 90 and 90A of the Securities Industry Act, with the recent amendment, now provide for the recovery of losses caused by insider trading, by way of civil actions instituted either by the Securities Commission or the investor.

- In Malaysia it is clear that a company is a separate legal entity from its membership but the corporate veil can be lifted (and hence limited liability can be disregarded) in appropriate circumstances. However, according to Chan and Koh (1998), the instances where the court has disregarded the doctrine follow no consistent principles. The court has a discretion to lift the corporate veil for the purpose of discovering any illegal or improper purpose and has indeed pierced it when a fraud has been committed. The court has also not allowed the doctrine to be used by a contracting party to circumvent its contractual obligations lawfully owed to a counter party. The court has denied the existence of a general principle that a parent company and a subsidiary are to be regarded as one. This means that a parent company may not sue to enforce the rights belonging to its subsidiary company and the holding company is not liable for the debt of its subsidiary company.[48] An exception is to establish the agency rule, but in the absence of an explicit agency contract between a parent and a subsidiary, one cannot be said to be an agent of the other. And in the present state of the law, it is difficult to ascertain when a court will imply such an agency. If liability is to be fixed as principal, evidence of agency has to be established substantially and cannot be inferred from the holding of a director's office and by the control of shares alone. It appears that piercing of the corporate veil on agency grounds has not been fully considered by the Malaysian courts.

The exceptions to be found in common law to the doctrine of independent legal entity and limited liability have been supplemented by certain provisions in the written law of the country. These are as follows:

- If the number of members of a company falls below the statutory minimum of two, then a sole remaining member, where it is not a holding company, may be liable for the payment of the company's debts if it carries on business for more than six months.

- The privilege of a member's limited liability may be lost if he is convicted of providing financial assistance for purchasing, dealing in or lending money on its own shares.[49]

- If any officer of a company signs, issues or authorises any negotiable instrument wherein the name of the company is not so mentioned, he is liable to the holder for the amount due thereon.

- Section 132D prohibits the directors to issue shares without the prior approval of the shareholders. A director who contravenes this provision is liable to pay compensation to any adversely affected party.

- An officer who is a party to the contracting of a debt by a company which is subject to any proceedings such as a winding up action (and which debt the company is unable to repay), may be required to repay the debt without any limitation of liability.

- The privilege of limited liability is lost if any business of the company has been carried on with intent to defraud creditors.

- Where any dividend is paid out of share capital and not out of profits, every director or manager of the company who pays the dividend will be liable to the creditors up to the extent of the difference.

- Where companies are related to each other, the law sets aside the independent legal entity doctrine by requiring a consolidated profit and loss account of the holding company and of its subsidiaries.

The importance of transparency and disclosure

An investor in a publicly quoted company always has the option to quit by selling his shares. Given the availability of this exit route, the business judgement rule that governs the attitude of courts on the separation of management and financing (and hence towards the agency problem), keeps the courts out of corporate decisions except on matters of executive pay, self-dealing and protection of shareholders against expropriation by an insider.[50] If equity markets are active and liquid, then a shareholder can rely on the exit route to protect himself against managerial inefficiencies or abuses which are not kept down by the courts. These abuses include the consumption by managers of perquisites, such as plush carpets and company airplanes, as well as managers expanding the firm beyond what is rational (where they are engaging in empire-building or pursuing pet projects). For a shareholder to rely on the exit route to protect himself and to recover his investments, the regulatory regime must ensure that all material information that investors need to make decisions are disclosed on a full and timely basis, that there are safeguards against anti-competitive behaviour and other forms of abusive behaviour by market participants (who may play a key role in regulation and enforcement), that investors are protected from the insolvency of financial intermediaries, and that there are adequate controls for systemic risk.

Until 1995, Malaysia had used a merit-based regulatory regime in deciding on the suitability of a company for listing and the pricing of new issues was usually based on the need to protect the interest of minority shareholders.[51] From 1995, a disclosure-based regulatory regime is being implemented on a phased basis. This will require firms to disclose all material information at the time of new listings, as well as on a periodic or continuing basis thereafter depending on the nature of the information to be disclosed. In countries with more developed capital markets, firms rely on market practice and due diligence obligations to ensure the disclosure of all material information. In Malaysia, as the markets are less developed, the regulators are playing a more active role in recent years in defining and enforcing specific accounting, financial reporting and disclosure standards. To reinforce market incentives, the regulators are strengthening due diligence and fiduciary obligations both of financial intermediaries as well as of directors, managers, accountants and auditors.[52]

Good corporate governance based on transparency and the exit route is critically dependent on a country's accounting, auditing, financial reporting and disclosure standards and practices. These standards and practices are examined at some length in this section.

To increase transparency, the Malaysian regulatory framework mandates disclosure and dissemination to potential and existing investors timely, accurate and material information on corporate performance, affairs and events. Such disclosure is mandated at the initial public offering (IPO) of the securities and thereafter on a periodic or continuous basis depending on the information disseminated.

An enterprise is mandated to disclose two types of information at the IPO phase. First, information that allows the prospective investors to assess the underlying state of the offeror (e.g. its risk characteristics) and second, more specific information about the IPO (e.g. the size of the offering).

With respect to the periodic disclosure and reporting requirements, a public listed company (PLC) is now required to publish quarterly financial statements within two months after the end of each financial quarter starting from the third quarter of 1999 (versus half-yearly reports within three months previously), and annual audited accounts, auditors' and directors' reports within four months (versus six months previously) from the close of each financial year. Unlike the half year reports which focused only on the financial performance of a PLC and not on its financial position, the new quarterly reporting requirement will be more stringent entailing the release of a balance sheet, income statement and explanatory notes. The annual reports will continue to report on a PLC's financial performance, financial position as well as its cashflows. These reports are also required to disclose the extent of compliance of the company with the Malaysian Code on Corporate Governance, which has the backing of KLSE's listing rules.

Under the continuous disclosure requirements, a PLC is required to make immediate public disclosure of all material information (including non-financial information) concerning its affairs, except in exceptional circumstances. Companies are required to release the information to the public in a manner designed to ensure the fullest possible public dissemination.[53]

Malaysia has been adopting, starting from the late 1970s, accounting standards that are generally consistent with the standards issued by the International Accounting Standards Committee (IASC). This process had been spearheaded and supervised by the Malaysian Institute of Accountants (MIA) and the Malaysian Association of Certified Public Accountants (MACPA), the two professional accountancy bodies in the country.

By the beginning of 1998, Malaysia had adopted 25 of the 31 extant International Accounting Standards (IASs). Only six of the remaining IASs had not been adopted in Malaysia but these can be accounted for. Of these six IASs, two deal with the accounting treatment of inflation, which is not material in the current economic environment, a third is on accounting for business combinations for which local standards exist. The fourth is on computing Earnings Per Share for which a local standard has been available from 1984. For the fifth, on accounting for financial institutions, the central bank (BNM) has drawn up its own standard format of financial reports. The sixth is on disclosure and presentation of financial instruments for which the standard is to come into force from 1 January 1999.

Malaysia has been somewhat slow in adopting some of the revised IASs and to that extent accounting practice in Malaysia has not kept pace with the international best practices. This has become a little more marked after the Malaysian Accounting Standards Board (MASB) was established in 1997 under the Financial Reporting Act (FRA) as the sole authority to set up accounting standards for Malaysia. This is no doubt because the MASB has embarked on its own due process as a pre-condition to the establishment of its financial reporting regime for the country. In the interim the MASB adopted, in January 1998, 24 of the extant accounting standards as approved accounting standards for purposes of the Act. The remaining eight accounting standards issued by the professional bodies were not adopted by the MASB. But the MASB announced that these eight standards will continue to be promulgated by the professional bodies as applicable standards in the preparation of financial statements until each of these accounting standards is reviewed and adopted as approved accounting standards, or relevant new accounting standards are issued. Based on its current work programme, the MASB's standards are expected to differ from the IASs primarily to reflect the statutory and regulatory reporting requirements in Malaysia. Seven of the MASB's new standards are expected to come into force in July 1999.

Malaysia has not only been adopting good standards but, according to the World Bank, it has also been trying to strengthen actual accounting and auditing practices. The professional accounting bodies in the country review the published financial statements annually on a random basis to ensure compliance by their members with the accounting standards and statutory disclosure requirements. The professional accounting bodies have the power to reprimand only their own members for any non-compliance. However, under the FRA, the PLCs themselves are now liable to prosecution for non-compliance with approved accounting standards. And the power of enforcement rests with the Securities Commission for PLCs, with the Central Bank for licensed financial institutions and the Register of Companies (ROC) for non listed companies

The major differences between Malaysian approved accounting standards, which are currently in force, and the IASs are as follows:[54]

- Current asset investments have to be carried at the lower of cost and market value and not at market value as in IAS25.

- Goodwill arising on acquisition can be immediately written-off to reserves in the year of acquisition, retained as a permanent item on the balance sheet subject to provision for permanent diminution in value, or recognised as an intangible asset on the balance sheet and amortised over its estimated useful life. On the other hand, IAS22 requires goodwill to be recognised as an intangible asset and amortised to zero over its useful life but not exceeding 25 years.

- IAS32 on the Disclosure and Presentation of Financial Instruments which became operational in 1996 has not been adopted in Malaysia.[55] This means that there is currently no disclosure of terms, conditions and accounting policies for financial instruments (including derivatives), interest rate risk and credit risk data, and the fair value of on-and-off balance sheet financial instruments.

- There is a reporting requirement to consolidate financial statements in Malaysia which is consistent with IAS27 in all material respects but classifies a subsidiary not by using the criterion of control as in IAS27 but by ownership interest (of more than 50%).[56]

- On accounting for investment in associates, under current practices in Malaysia, some reporting enterprises recognise associates on the basis of ownership interests of between 20% to 50%, and not on the criterion of "significant influence" as per IAS28.

The MASB has adopted (but only with effect from 1 July 2001) the revised standard on the effects of changes in foreign exchange rates (i.e. IAS21) which requires all exchange gains or losses arising on translation of long-term monetary items to be recognised as income or as expenses in the period they arise. The MASB's transitional provisions permit the deferral of unrealised exchange gains or losses on long-term monetary items provided no recurring exchange losses on the items are expected in the future.

IAS10 on Contingencies and Post Balance Sheet Events which was adopted in 1980 became operational in Malaysia on the same date. The accounting treatment of research and development costs in Malaysia is consistent with IAS9. IAS24 on Related Party Disclosures, which came into force in 1988, became operational in Malaysia only in 1997.[57]

We have noted the existence of corporate groups and ownership links where a controlling shareholder exercises control via pyramid structures and cross-holdings, and where the divergence between control and cashflow rights can lead to the potential expropriation of minority shareholders. The threshold for substantial shareholding reporting has been lowered from 5% to 2% and the period of reporting has also been shortened from 14 to 7 days. The penalties for failure to make the required disclosure have been increased from a fine of 5,000 ringgit to a fine of 500,000 ringgit or imprisonment for a term not exceeding 5 years or both. With these changes, the data base on substantial shareholders will be much better for the analysis of control and cashflow rights and of their implications for violations of minority shareholder rights.

Steps have also been taken to achieve transparency of ownership. Amendments to the Securities Industry Central Depositories Act in October 1998 now prohibit persons from hiding behind their nominees. This introduces the concept of an authorised nominee, prohibits global accounts (an authorised nominee may only hold securities for one beneficial owner in respect of each account), and requires a beneficial owner of securities to make a declaration that he is the beneficial owner of the securities. This new restrictive rule, which prohibits global accounts and requires a fund manager to open accounts and maintain records in the name of each and every one of his individual clients (apparently for improving transparency), has increased the cost and decreased the level of private fund management activity and hence aggravated the problem of concentrated shareholding in Malaysia. Given the reporting requirement on substantial shareholders with its reduced threshold, it is not necessary to prohibit the operation of global accounts for the alleged purpose of improving transparency.

The Companies Act requires the financial statements of a company to be duly audited before they are laid before the company at its annual general meeting (AGM). A company is required under the Act to appoint, at each AGM, an approved auditor to hold office for the ensuing financial year. The auditor is to audit the accounts and issue a report to the shareholders (for deliberations at the next AGM) on the company financial statements, other records and its registers.

The responsibilities of an auditor in Malaysia under the reporting framework of the MIA's approved auditing standards and the Companies Act require the auditor to conduct his audit in accordance with international best practices and to clearly state whether the accounts have been drawn up to give a true and fair view (or are presented fairly, in all material aspects), in accordance with applicable approved accounting standards and whether the accounts comply with statutory requirements. Where the accounts have not been drawn up in accordance with a particular applicable approved accounting standard, the auditor is required to quantify the financial effects on the accounts of the failure to so draw up. If, in his opinion, the accounts would not, if so drawn up, give a true and fair view, he is to state the reasons for holding that opinion, state if the directors have quantified the financial effects on the accounts and further give his opinion on the quantification.

Unlike the UK Companies Act, the Malaysian Companies Act does not require an auditor to give an opinion as to whether the information given in the Directors' Report is consistent with the audited accounts. And unlike the listing rules of the London Stock Exchange, there are no KLSE rules requiring directors to agree with auditors on the content of preliminary announcement of financial results. There are now moves to bring about these changes.

Under the Companies Act, an auditor of a company has a right of access at all reasonable times to the accounting and other records (including registers) of the company, and is entitled to require from any officer of the company and any auditor of a related company such information and explanation as he desires for the purposes of audit. An officer of a corporation who hinders, obstructs or delays an auditor in the performance of his duties is guilty of an offence under the Act. The penalty for this breach is imprisonment for two years or thirty thousand ringgit or both.

The external auditor is appointed and may only be removed by shareholders. The auditor is given the right to make representations by circulars and be heard orally at a meeting of shareholders convened for the purpose of considering his removal. Once removed, the company must notify the ROC in writing of the removal. As the provisions of the Act do not require the company to furnish to the ROC a copy of the written representations made by the auditor, a suggestion has been made for amending the Act to require the company to forward a copy of the written representations to aid the ROC in its enforcement activities and not for reinstating the auditor.

Where an auditor desires to resign, the Companies Act provides for the convening of a meeting to appoint another auditor, but there is no requirement that the circumstances surrounding the auditor's decision to resign are disclosed. It has been suggested that the law be amended requiring an auditor to inform the ROC and the KLSE of the reasons for his resignation or for declining to seek reappointment, and that a rule be introduced into the KLSE Listing Manual requiring a company to circulate to shareholders the auditor's representations on the matter.

The primary responsibility for prevention and detection of fraud or other illegal acts on the part of the company rests with the board as part of its fiduciary responsibility for protecting the assets of the company. The auditor's responsibility is essentially to properly plan, perform and evaluate his audit work so as to have reasonable expectation of detecting material misstatements in financial statements. The Companies Act places a statutory duty on an auditor to report in writing to the ROC, where in the course of performance of his duties an auditor of a company is satisfied that there has been a breach or non-observance of any of the provisions of the Act.

The obligation to report is triggered when the auditor is satisfied that a breach of the Act has occurred and where he has no confidence that the directors will deal adequately with the matter. This introduces a subjective element to the duty to report. There is now a move to amend the section to enable an auditor to report matters that in "his professional opinion" constitute a breach of the Companies Act thus providing the auditor an objective standard on which to base his decision to or not to report. The amendment should be such as to protect auditors from defamation suits in respect of this reporting obligation.

Auditors are required to observe approved Standards on Auditing as promulgated by the MIA and an audit report has to contain a positive statement to the effect that the audit has been conducted in accordance with these standards. The MIA has adopted the International Standards on Auditing issued by the International Auditing Practices Committee of the International Federation of Accountants (IFAC) as the basis for its approved standards on auditing. Any failure to observe the standards can expose a member to the risk of disciplinary action by the MIA. To date the accounting profession has not directed as much attention to strengthening auditing practices. This is changing now that the MASB is the sole authority to issue accounting standards and government regulatory agencies have been entrusted with the responsibility for enforcing these standards against companies which are not observing them. Members of the MIA have also been advised that a court of law may, when considering the adequacy of the work of an auditor, take into account the approved standards on auditing as indicative of good auditing practice.

III. Conclusions

At the outbreak of the Asian crisis, there were certain weaknesses in the corporate governance mechanisms for protecting investors *vis-à-vis* the insiders. And yet on a relative basis, the public equity market was very sizeable. This is partly because Malaysia, with its common law tradition (which it had inherited from Britain), had a satisfactory reputation for the protection of minority shareholder rights, partly because investors were optimistic about prospects, partly because the shareholders could count on the managers to be concerned about reputation and therefore could expect the owner-managers to work in the larger interest of all shareholders, and partly because a good market infrastructure that facilitated active trading provided the shareholders with the option to exit by selling their shares. The crisis exposed certain glaring cases of corporate governance breakdowns arising from related party transactions which had worked against the interest of minority shareholders. There were only a few cases of such breakdowns among bluechip companies in which the foreign and local funds or institutions had invested. But these breakdowns became very glaring not only because of certain weaknesses in the law but more because (perceived or otherwise) of the weak enforcement of minority shareholder rights, as well as the failure of the regulators to take strong actions or impose the required penalties against the violators. Inadequate disclosure of risk exposures (because of weaknesses in the disclosure regime), some shortcomings in the accounting and financial reporting standards (because of non-adherence to international best practices on the mark-to-market rules) and the imposition of restrictions on trading at the height of the crisis had compounded the problem.

In response to the crisis, the most comprehensive corporate governance reform exercise in Malaysia was announced by the Minister of Finance in March 1998 which saw the establishment of a high level Finance Committee (FC) comprising both government and industry representatives. The FC was established to provide a comprehensive report on measures to improve corporate governance. After consultation with selected industry bodies (namely those bodies not represented on the FC), a revised report was re-submitted to the government in February 1999. The recommendations of the FC essentially seek to strengthen the statutory and regulatory framework for corporate governance, enhance the checks and balances and self regulatory mechanisms towards good governance and identify training and education programmes to ensure success in the implementation of its recommendations.

Key recommendations of the FC in the context of law or rule reform proposals include recommendations for restrictions in voting rights of controlling shareholders in related or connected party transactions to be codified in the Companies Act, codification of the fiduciary duties of directors, strengthening the position of nominee directors, introduction of a statutory derivative action, voting by mail (to name a few). The FC's Code on Corporate Governance, to be incorporated into the KLSE's Listing Manual, sets out the extent of independent director participation on boards, use of board committees, and includes proposals for the setting up of remuneration and nominating committees, etc. A key proposal in the context of training and education is to subject all directors of companies seeking listing on the Exchange to undergo mandatory training.

In spite of these comprehensive reforms, minority shareholders are still exposed to considerable risk so long as they operate in an environment of concentrated shareholding. This is so because the independent directors, who are to exercise oversight over the owner-managers, are liable to be captured by these owner-managers. These reforms may prove to be futile unless they are effectively enforced. Too narrow an interpretation or too rigid an enforcement of the reforms may have the unintended effect of curbing business flexibility. What is probably more important is to ensure an efficient and impartial judiciary to which aggrieved parties can turn to redress their grievances. In spite of the country's good heritage in this direction, there is a growing perception in recent years of a decline in the standards of the judiciary. There is of course a need to arrest this trend so as to ensure that the independence, impartiality and integrity of the judiciary is maintained beyond doubt at all times. Equally important, the presence of restrictive licensing practices have made for monopolistic tendencies in certain industries and hence for concentrated shareholding. The continued opening up of markets to competition is essential to reduce the incentives for ownership concentration and therefore to increase the incentives for dispersed shareholding, risk diversification at the level of individual or family wealth holders, and hence for improved governance practices.

NOTES

1 For instance, the legal and judicial system in the Anglo-Saxon world recognises that outside shareholders need stronger protections in the form of shareholder voting rights supplemented by an affirmative duty of loyalty of the managers to shareholders. The business judgement rule that governs the attitude of courts on the separation of management and financing (and hence towards the agency problem), keeps the courts out of corporate decisions except on matters of executive pay, self-dealing and protection of shareholders against expropriation by the insider.

2 Where the boards are captured, the internal control mechanisms of corporate governance do not provide the necessary check and balance on insider excesses.

3 According to the 1998 Bank Negara Annual Report, the average occupancy rate in the Klang Valley in the office space market continued to decline to around 79% at end-1998 from 95% at end-1997, and that in retail centres fell to 65.7% from 90.5%. The situation will deteriorate further given the new supply coming into the market and weak demand. More telling rentals have fallen at least by 50% from their recent peaks.

4 The prolonged rapid growth of the economy over long periods should have made for a higher GDP share of services but, in fact, it had declined form 43.9% in 1985 to 42.7% in 1995. Over the corresponding period the share of primary production in GDP had declined from 31.2% to 21.0%, whereas the share of manufacturing had increased from 19.7% to 33.1%.

5 For an alternative explanation see Raghuram et al 1998. According to Raghuram, transactions in a market-based model are based on market generated price signals and require an infrastructure that facilitates private contracting.

On the other hand, in a relationship-based model, markets are under-developed or over-regulated. The prices thrown up by these shallow or illiquid markets serve as poor indicators for coordinating economic activities. Invariably transactions (e.g. borrowing-lending) are based on relationship considerations, with the rights and obligations of the parties based on the membership norms of the "family" or "group" to which they belong and not on private contracting (because of poor and weak enforcement of laws).

In an environment where the infrastructure for contracting is weak, investment decisions based on the relationship model need not go sour so long as the supply of capital relative to investment opportunities is limited. This will mean that the investments undertaken are more likely to be productive and profitable. However, the investment decisions are likely to go wrong where there is a plentiful supply of capital relative to investment opportunities. And given the weak contracting infrastructure, lenders will face difficulties if they try to recover their loans and minority shareholders run the risk of being expropriated by the controlling shareholders.

East Asia was characterised by a weak contracting infrastructure and massive capital inflows in the 1990s. To protect their interest, the foreign lenders invariably made short-term loans and relied on the threat of not rolling over the loans to ensure that the borrowers serviced their loans. When the Asian crisis struck, the decision of some lenders to call back the loans or of some investors to pull out their investments made others do the same thus causing a stampede of capital outflows. This was a rational response and not a panic. It did not make sense for the lenders or investors to take their time in going to the courts to enforce their rights given the poor laws and weak enforcement.

6 The initial situation of over full employment and opportunities for repatriating guest workers made the problem of unemployment less acute.

7 Although the government deficit was still small, the government's expected contingent liabilities were escalating on account of its implicit guarantee of bank deposits and infrastructure projects as well as the explicit guarantee of the principal (and of a minimal return) to investors/contributors of the large unit trusts and providend funds.

For the infrastructure projects for which the government had guaranteed traffic volumes, this had ceased to be a problem. But for others it had step-in rights if the concessionaires ran into financial difficulties. But these were not obligations. As the government was not prepared to let the projects be auctioned off to the highest bidders, these step-in-rights became obligations.

8 There was a difference of opinion whether RM was stabilising or still vulnerable. My considered view was that it was significantly under-valued *vis-à-vis* the key currencies. It was unclear when the correction would take place but RM was probably stabilising as it was trading close to 4.00 inspite of mounting political uncertainties, falling interest rate and the Prime Minister's call to be prepared for shocks. These factors had more impact on the stock market, but even then it is inconceivable that it could have continued its free fall given the lows it had reached. The shock of the sacking of the then Deputy Prime Minister had the potential to depress the markets further. But this may have been discounted given the early warning by the Prime Minister.

9 In the first half of 1998, 782 winding-up petitions were filed under the Companies Act – nearly equal to the number of cases filed during all of 1997 – and courts issued 248 winding-up orders.

10 For banks and infrastructure projects, renationalisation may have been preferred to liquidation or auction to the highest bidder. The government was not prepared to contemplate even this. Rescue of the captains and corporates may have been its preferred option then, for instance through the issue of government guarantees, to save the government's distributional programme. But as at mid 1999 that has not happened.

11 In its 1998 Annual Report, Bank Negara had projected the economy to grow at 1% in 1999 with government deficit at 6% of GNP, inflation at under 4%, but with the external current account surplus at 11% of GNP. By May 1999, the 3-month inter-bank interest rate had fallen below 4% and many analysts have revised the growth rate upward to 3%. So long as capital controls remain, the long-term growth rate, however, is not likely to exceed ¾ th of its potential even if conduct of macro policies remains prudent.

12 Stock market capitalisation to GDP is as follows for the various periods: 1975-79 – 45.2%, 1980-84 – 89.5%, 1985-89 – 101.1% and 1990-94 – 198.8%. The ratio was 114% in 1990, 122% in 1991, 166% in 1992, 375% in 1993 and declined to 261% in 1994.

13 The period referred to is 17-24 November 1997.

14 The period referred to is 8-19 June 1998.

15 But there are now proposals for introducing the US style anti-creditor rights into the Malaysian bankruptcy code.

16 There are several manufacturing industries in Malaysia with just a few producers accounting for the bulk of the output in the country. Even if there is only one domestic producer in an industry, so long as there are no restrictions on imports or on the entry of new players, the industry cannot be said to be non-competitive as it is exposed to the threat of actual or potential competition. It is restrictive import or licensing arrangements that make for monopolistic tendencies and hence profiteering.

In industries such as iron and steel and cement, which historically had been subject to restrictive imports and licensing in Malaysia, a quick research by the Federation of Malaysian Manufacturers shows that the number of domestic producers has increased over time as can be ascertained from reading [4]. In the rolling of iron and steel, the number of players in the market has increased from three in the 1960s to ten by 1993, and the largest producer in the 60s had dropped to third position in terms of market share in 1993. In the steel making industry, the number of players had also increased from one in the 1960s to six in 1993. Malayawata, which was the leading steel maker until 1976, had dropped to the fifth position by 1993. In the pipe making industry, the number of players in the industry had increased from a single producer in the 1960s to seven in 1993. For the hydraulic cement industry, the number of producers had increased from two in the sixties to five by 1993.

These data clearly show that the concentration of market power has declined over time in Malaysia. Further liberalisation of licensing as well as of imports is required to improve the competitive environment even more and thus reduce the opportunities for profiteering.

17 A company which has a block shareholder with an ultimate shareholding of close to 30% cannot be viewed as a widely-held company. This will apply even more forcefully to companies where the blockholder has close to 40%.

18 Small shareholders as well as the courts do not become actively involved in corporate matters. Voting rights, which are the principal rights of shareholders, are of limited value unless they are concentrated. The free rider problem faced by individual investors makes it uninteresting for them to learn about the firms they have financed or even to participate in governance. And further contacting and persuading a large group of small shareholders through the proxy mechanism is difficult and expensive. In line with the business judgement rule that keeps the courts out of corporate decisions, the courts are very unlikely to second guess managers' business decisions. And even in the Anglo-Saxon world with its excellent infrastructure for private contracting, courts would interfere only in cases of management theft and asset diversion and if managers diluted existing shareholders through an issue of equity to themselves, but are less likely to interfere in cases of excessive pay (given the difficulties involved in detailed contract enforcement). The principal advantage of large investors is that they rely on relatively simple legal interventions, which are suitable for even poorly informed and motivated courts.

19 A pyramid structure has been defined in Berle and Means (1932) as an ownership pattern which involves the owner "owning a majority of the stock of one corporation which in turn holds a majority of the stock of another – a process that can be repeated a number of times".

20 A pattern of cross-holdings is said to occur "where a company down the chain of control has some shares in another company in its chain of control".

21 Stijn Claessens et al (1999b) note that they may have actually exaggerated the extent of deviations from the one-share-one-vote rule as their findings (because of lack of access to company charters) were not based on company-specific voting caps. See p 11.

22 Stijn Claessens et al (1999b), Table 7, p 29.

23 In this regard it is interesting to note that "legal protection of creditors is … more effective than that of the shareholders since default is a reasonably straightforward violation of a debt contract that a court can verify" (Stijn Claessens et al, 1999). On the other hand, to make incentive contracts for managers feasible, "some measure of performance that is highly correlated with the quality of the manager's decision must be verifiable in court" (Stijn Claessens et al, 1999).

24 The Banking and Financial Institutions Act permits FIs only to make portfolio investments in non-financial businesses up to a maximum of 20% of an FI's shareholders funds and up to 10% of the issued share capital of a company in which the investment is made. The FI is not allowed to assume any management role or take up a board position. The shareholders funds so invested must be excluded from an FI's capital for purposes of computing its required capital ratio for conducting its banking business.

25 The banks as large creditors combine substantial cashflow rights with the ability to interfere in major decisions of the firm. This is because of a variety of control rights they receive when firms default or violate debt covenants, and in part because they typically lend short term, so borrowers have to come back at regular, short intervals for more funds.

26 The institutional investors are managed by money managers who are themselves imperfectly monitored agents, that is, who have imperfect incentives at best and significant conflicts of interest at worst.

27 "Institutional fiduciaries have strong incentives to avoid legal risks, because they face personal exposure if the risk comes to pass, while their beneficiaries get most of the upside. They care less

about the conduct that legal rules, read narrowly, might permit, than about what those rules, read broadly, might prohibit." (JD Abendroth, 1997.)

28 I wish to acknowledge my debt of gratitude to Arun Gupta of the World Bank for educating me on the basics of corporate debt restructuring, which is dealt with later in this sub-section.

29 ROCE is defined as Operating Profit divided by Capital Employed, where operating profit = revenues – cost of sales – selling expenses – general administration expenses – research and development expenses – restructuring expenses +/- Other income/expenses and where Capital Exmployed represents the necessary operating capital derived from the balance sheet assets, i.e. balance sheet total minus financial items and fiscal items which are not considered as necessary operating capital. ROCE gives a comprehensive information about the economic performance of the business, since both operating and non-operating results (e.g. proceeds from sale of property) are accounted for. An added advantage is that it permits a comparison between businesses, without regard to accounting convention (e.g. depreciation), and different capital mobilisation and financing strategies, since the operating profit is viewed in relation to the total funds employed. ROCE shows the rate of return on capital employed for the period, and captures the efficiency in the total use of capital resources.

30 Based on the sharp fall in the market value debt-equity ratio, Dr Gan Wee Beng (1998) has estimated that the proportion of listed companies falling into the insolvent category rose from 19.5% (valued at year-end 1996 prices) to 47% (valued at year-end 1997 prices). The proportion of companies regarded as healthy declined from 58% to 34%.

31 The corresponding numbers as at March 15, 1999 was RM15.1 billion and RM6.6 billion respectively.

32 Based on the 3-month classification, the net NPL ratio as at end 1998 was 13.2%. The net NPL ratio is the ratio of NPL less interest-in-suspense (IIS) and specific provisions (SP) to gross loans less IIS and SP.

33 Danaharta can appoint Special Administrators (SA) with a legal mandate to manage and oversee all operations of the distressed enterprise. On the appointment of the SA a moratorium for a period of 12 months (can be extended if necessary) will take effect over winding-up petitions, enforcement of judgements, proceedings against guarantors, re-possession of assets, applications under Section 176 of the Companies Act.

During this period the SA will prepare a plan for disposal of assets. The plan is presented to Danaharta who seeks the opinion of an independent advisor as regards the reasonableness of the proposal and the manner in which the proposal safeguards the interest of creditors. Once the approval of the corporation has been received, the SA convenes a secured creditors meeting, seeks a majority approval vote and then implement the plan. Plan options could range from restructuring of debts and reorganisation of the borrower as an ongoing concern to disposal of assets through liquidation.

34 Liberalisation of ownership conditions led to two major foreign equity investments in 1998 – a 30% investment by British Telecoms which increased the capitalisation of Bina Riang and an outright acquisition by Blue Circle of Kedah Cement. These deals, which were market-driven, greatly improved the competitive position of the two enterprises. To date there are no companies in corporate distress which have attracted outside equity investments in any significant quantity. The liberalisation also enabled two cellular phone companies to attract majors from Europe to take a sizeable minority stake after the outbreak of the crisis.

35 Shareholders in Malaysia do not enjoy pre-emptive rights on new stock issues given that companies may be required to make special issues to Bumiputras. If this is so then Malaysia’s score on anti-director rights is 3 and not 4.

36 Civil procedure in the US is much more facilitative of class actions. Notably there is no procedural bar against recovery of damages. The general rule is that differences in the amount of damages claimed by the class member would not defeat class certification so long as damages are readily calculable on a class-wide basis. Each member of the class is entitled to a pro-rata share of damages recovered in the action. In Malaysia, on the other hand, once a plaintiff in his representative capacity has established his claim to the damages, each member of the class has to bring his own action to establish damage suffered by him within the limitation period.

37 “For investors to know anything about the companies they invest in, some basic accounting standards are needed to render company disclosures interpretable. Even more important, contracts between managers and investors typically rely on some measures of firms’ income or assets being verifiable in court. If a bond convenant stipulates immediate repayment when income falls below a certain level, this level of income must be verifiable for the bond contract to be even in principle enforceable in court. Accounting standards might then be necessary for financial contracting, especially if investor rights are weak.” (Stijn Claessens et al, 1998.)

38 Many observers would agree that the outright prohibition in 132G of the Companies Act on the acquisition of shares or assets in a shareholder or director-related company should be revised but not Section 133 and 133A which deal with loans to directors or persons connected with directors. There is a fairly widely held view that the section should be widened to embrace quasi-loans or other financial benefits or arrangements, gifts or quasi-gifts received or receivable. Also outright prohibitions against loans to directors are not uncommon (unlike the prohibition in 132G which is peculiar to Malaysia) and may be found both in the UK and Australia.

39 See Philip T N Koh (1997), who contends that "Section 132C has given rise to uncertainty as to the scope of the meaning of "undertaking", "property", and "substantial value", leading to doubts as to whether in any one transaction approval of a general meeting is needed. Furthermore, it is arguable that only acquisition/disposal which materially and adversely affects the performance or financial position of the company would require the approval of the general meeting. It can be debated in any one case whether the transaction is adverse to the company performance or financial position.

40 The old Rule 118 only covered transactions involving the interests of directors and substantial shareholders, direct or indirect. The new rule also covers transactions involving the interests, direct or indirect, of persons connected with directors or substantial shareholders.

41 Foremost, according to Loh Siew Cheang (1996), aggrieved shareholders have first to overcome the rule in *Foss V Harbottle*. Second, the difficulty involved in trying to bring the impugned conduct within certain categories of conduct which the courts would readily recognise as being culpable or wrongful. Third, the range of remedies available to aggrieved minority shareholders is limited, p 124.

42 In a decision by the Privy Council in *Re Kong Thai Sawmill (Miri Sdn Bhd* (1978) 2 MLJ 227 (see Thillainathan et al 1999), it was judicially recognised that the Section 181 provision is wider than its equivalent in the United Kingdom. Conduct caught under Section 181 encompasses autocratic conduct by the board, the appropriation of business, property or corporate opportunity at the expense of the company or its minority shareholders, unjustifiable failure to pay dividends, or the director’s neglect of the duty of care, skill and diligence. The case also recognises that the court has unfettered discretion to give relief and to safeguard the rights of minority that may have been trampled upon. The court’s discretion to choose from a wide range of remedies may include the following: prohibiting, cancelling, varying a transaction or resolution; regulating the conduct of affairs of the company in future; providing for the purchase of the shares of the company by other members of the company or the company; altering the articles or the memorandum of the company; and providing for the winding-up of the company.

43 For Indonesia, Claessens et al refer to the law before the bankruptcy reform in August 1998.

44 This section is based largely on the study of Thillainathan et al (1999).

45 This Code was drawn up by a joint-working group of the public and private sectors referred to as the Finance Committee and was incorporated into its Report on Corporate Governance. See Government of Malaysia (1999). The listing rules of the KLSE are to be amended to incorporate the key provision of the Code.

46 These are as follows:

- review with the auditor, the audit plan, the auditor’s evaluation of the system of internal accounting control, the audit report;

- review the assistance given by company officers to the auditors;

- review the scope and results of internal audit procedures;

- review the balance sheet and profit and loss account of the company;

- review any related party transactions that may arise within the group;

- and nominate the auditors of the company.

Some listed companies in Malaysia have an internal audit function though law does not mandate this. The PriceWaterhouseCoopers/KLSE survey suggests that about 68% of companies that responded to the survey have internal audit functions and 33% out of those have outsourced this function.

47 The compensation of executive directors and managers includes stock options. The rules require disclosure by directors of the shares and options they hold and of the trading in such instruments on an annual basis in the company's annual report.

48 This is partly because each company in a group may not have identical creditors with identical claims.

49 Under a recent amendment, PLCs are now allowed to buy back their own shares in certain prescribed circumstances.

50 Given that this exit option is not available to minority shareholders of private companies, the burden placed on the courts to protect the interest of such shareholders will be much greater. If the courts are not able to meet this demand, then there will be few or no such minority shareholders.

51 The need to promote certain special interests also led to the use of this regime. The fixing of new issue prices often at levels well below market prices led to massive over-subscription, harmed issuers and in fact restricted the size of new issue activity.

52 Under the KLSE regulations, listed companies are required to make timely disclosure of material financial and corporate information. From 1 January 1998 to 18 February 1999, based on data supplied by the KLSE,

sanctions ranging from a private reprimand to a fine of 100,000 ringgit were imposed on 7 public listed companies for breaches of the listing requirements relating to non-disclosure of material transactions; and

sanctions ranging from a private reprimand to a fine of 100,000 ringgit were imposed in 27 instances on public listed companies for the failure to submit financial statements within the periods prescribed in the listing requirements.

53 Other regulatory initiatives are supportive of this orientation for immediate public disclosure and thorough public dissemination of material information. For instance, whenever a PLC becomes aware of a rumour or report, albeit true or false, that contains information that is likely to have, or has had, an effect on the trading of the company's securities or would be likely to have a bearing on investment decision, the company is required to publicly clarify the rumour or report as promptly as possible. Further, whenever unusual market action takes place in a PLC's securities, the company is expected to make inquiry to determine whether rumours or other conditions requiring corrective action exist and, if so, to take whatever action is appropriate. A PLC is to refrain from promotional disclosure exceeding what is necessary for the public to make informed investment decisions.

54 The standards chosen for comparison are as per the OECD questionnaire.

55 IAS32 has been adopted by the MIA to come into force w.e.f. 1 January 1999. The MASB is expected to issue the standard as an exposure draft in 1999.

56 In countries where there was no reporting requirement to consolidate financial statements, this had allowed some firms to hide debts on the books of affiliates, preventing lenders and shareholders from discovering the firm's real exposure to high levels of debt.

57 The following are examples of the situation where related party transactions may lead to disclosure: purchase or sale of goods, property and other assets, rendering or receiving of services, agency, leasing and license agreements, finance (including loans and equity contributions), guarantees and collateral as well as management contracts.

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ANNEX I

COMPANY PROFILE - WEIGHTAGE OF FOREIGN SHAREHOLDING

	Company Name	Market Capitalisation (1997)		Share of Foreign Shareholding	Weightage of Foreign Shareholding	Market Capitalisation (1996)		Share of Foreign Shareholding	Weightage of Foreign Shareholding
		(RM 'Bil)	(%)			(RM 'Bil)	(%)		
Non-financial Corporations									
1.	Telekom Malaysia Berhad	34.48	11.77%	14.82%	2.34%	44.98	7.65%	13.70%	1.54%
2.	Tenaga Nasional Berhad	25.73	8.78%	1.26%	0.15%	37.27	6.34%	4.30%	0.40%
3.	Sime Darby Berhad	8.70	2.97%	41.94%	1.67%	23.13	3.94%	45.25%	2.62%
4.	Petronas Gas Berhad	15.96	5.44%	8.24%	0.60%	18.92	3.22%	2.09%	0.10%
5.	United Engineers Malaysia	2.57	0.88%	35.12%	0.41%	17.19	2.92%	54.23%	2.33%
6.	Resorts World Berhad	7.15	2.44%	28.16%	0.92%	12.56	2.14%	15.82%	0.50%
7.	Genting Berhad	6.85	2.34%	40.14%	1.26%	12.22	2.08%	26.93%	0.82%
8.	Renong Berhad	4.00	1.36%	22.11%	0.41%	9.73	1.66%	14.27%	0.35%
9.	Perusahaan Otomabil Nasional	2.06	0.70%	34.56%	0.33%	8.66	1.47%	28.17%	0.61%
10.	YTL Corporation Berhad	8.63	2.94%	24.37%	0.96%	8.19	1.39%	30.64%	0.63%
11.	Rothmans of Pall Mall Berhad	8.64	2.95%	63.46%	2.51%	7.57	1.29%	62.58%	1.18%
12.	HICOM Holdings Bhd	2.33	0.79%	15.05%	0.16%	7.48	1.27%	12.18%	0.23%
13.	Malaysian International Shipping Corporation Berhad	4.98	1.70%	27.06%	0.62%	7.47	1.27%	27.62%	0.52%
14.	Magnum Corporation Berhad	3.51	1.20%	2.93%	0.05%	7.34	1.25%	8.07%	0.15%
15.	Berjaya Sports Toto Berhad	5.72	1.95%	43.72%	1.15%	7.13	1.21%	37.93%	0.68%
16.	Edaran Otomobil Nasional Berhad	1.80	0.62%	34.25%	0.28%	5.72	0.97%	22.01%	0.32%
17.	Malaysia Resources Corporation Berhad	0.87	0.30%	27.80%	0.11%	5.25	0.89%	51.89%	0.68%
18.	Malaysian Airlines System Berhad	2.40	0.82%	28.80%	0.32%	5.04	0.86%	28.12%	0.35%
19.	Sarawak Enterprise Corporation Berhad	1.91	0.65%	1.82%	0.02%	4.87	0.83%	3.69%	0.04%
20.	Nestle (Malaysia) Berhad	4.22	1.44%	72.03%	1.39%	4.76	0.81%	58.04%	0.69%
21.	Kuala Lumpur Kepong Berhad	5.95	2.03%	27.64%	0.75%	4.56	0.78%	22.97%	0.26%

	Company Name	Market Capitalisation (1997)		Share of Foreign Shareholding	Weightage of Foreign Shareholding	Market Capitalisation (1996)		Share of Foreign Shareholding	Weightage of Foreign Shareholding
		(RM 'Bil)	(%)			(RM 'Bil)	(%)		
22.	Kumpulan Guthrie Berhad	2.50	0.85%	4.49%	0.05%	4.48	0.76%	5.93%	0.07%
23.	Golden Hope Plantations Berhad	4.52	1.54%	2.95%	0.06%	4.32	0.73%	7.15%	0.08%
24.	HUME Industries (M) Berhad	1.01	0.34%	46.08%	0.21%	3.94	0.67%	41.79%	0.41%
25.	Tanjong PLC	2.42	0.83%	37.31%	0.41%	3.79	0.65%	36.16%	0.34%
26.	Multi Purpose Holdings Berhad	0.80	0.27%	4.71%	0.02%	3.76	0.64%	19.12%	0.18%
27.	TR Industries Berhad	1.74	0.59%	23.32%	0.19%	3.76	0.64%	56.49%	0.53%
28.	OYL Industries Berhad	1.23	0.42%	20.63%	0.12%	3.59	0.61%	21.59%	0.19%
29.	Cahya Mata Sarawak Berhad	0.76	0.26%	26.30%	0.09%	3.55	0.60%	19.82%	0.18%
30.	Oriental Holdings Berhad	1.54	0.52%	17.60%	0.12%	3.47	0.59%	19.33%	0.17%
31.	Jaya Tiasa Holdings Berhad	1.81	0.62%	38.67%	0.32%	3.40	0.58%	4.81%	0.04%
32.	IOI Corporation Berhad	1.06	0.36%	45.53%	0.22%	3.27	0.56%	24.65%	0.20%
33.	UMW Holdings Berhad	0.78	0.27%	30.83%	0.11%	3.11	0.53%	50.83%	0.40%
34.	Land & General Berhad	0.36	0.12%	6.71%	0.01%	3.01	0.51%	11.26%	0.08%
35.	Innovest Berhad	0.20	0.07%	36.51%	0.03%	2.99	0.51%	28.88%	0.22%
36.	New Straits Times Press (M) Berhad	0.96	0.33%	34.16%	0.15%	2.90	0.49%	46.80%	0.34%
37.	Perlis Plantation Berhad	2.02	0.69%	37.99%	0.35%	2.89	0.49%	34.58%	0.25%
38.	Tan Chong Motors Berhad	1.14	0.39%	24.43%	0.13%	2.88	0.49%	30.08%	0.22%
39.	Malakoff Berhad	1.90	0.65%	30.64%	0.27%	2.80	0.48%	25.62%	0.18%
40.	Konsortium Perkapalan Berhad	0.35	0.12%	18.08%	0.03%	2.74	0.47%	5.12%	0.04%
41.	Ekran Berhad	1.41	0.48%	14.58%	0.09%	2.73	0.46%	27.23%	0.19%
42.	Sime UEP Properties Berhad	0.84	0.29%	11.55%	0.04%	2.63	0.45%	12.82%	0.08%
43.	Petronas Dagangan Berhad	1.32	0.45%	10.10%	0.06%	2.57	0.44%	4.20%	0.03%
44.	Highlands & Lowlands Berhad	2.41	0.82%	16.31%	0.18%	2.55	0.43%	10.65%	0.07%
45.	Metroplex Berhad	0.21	0.07%	8.91%	0.01%	2.49	0.42%	24.99%	0.16%
46.	Diversified Resources Berhad	0.29	0.10%	12.49%	0.02%	2.46	0.42%	11.15%	0.07%

	Company Name	Market Capitalisation (1997)		Share of Foreign Shareholding	Weightage of Foreign Shareholding	Market Capitalisation (1996)		Share of Foreign Shareholding	Weightage of Foreign Shareholding
		(RM 'Bil)	(%)			(RM 'Bil)	(%)		
47.	Malaysian Mining Corporation Berhad	1.28	0.44%	1.45%	0.01%	2.44	0.42%	1.79%	0.01%
48.	Malayan United Industries Berhad	1.32	0.45%	5.69%	0.03%	2.44	0.41%	23.78%	0.15%
49.	Amsteel Corporation Berhad	0.86	0.29%	2.11%	0.01%	2.37	0.40%	16.35%	0.10%
50.	Time Engineering Berhad	0.99	0.34%	31.70%	0.14%	2.34	0.40%	11.17%	0.07%
51.	Hong Leong Properties Berhad	0.50	0.17%	37.73%	0.09%	2.34	0.40%	37.63%	0.22%
52.	Leader Universal Holdings Berhad	0.52	0.18%	52.28%	0.13%	2.31	0.39%	16.86%	0.10%
53.	F & N Holdings Berhad	0.70	0.24%	60.43%	0.19%	2.24	0.38%	61.13%	0.34%
54.	Shell Refining Company (F.O.M.) Berhad	1.83	0.62%	86.78%	0.73%	2.22	0.38%	82.33%	0.46%
55.	Gadek Berhad	0.18	0.06%	21.40%	0.02%	2.11	0.36%	25.72%	0.14%
56.	Lingui Developments Berhad	0.12	0.04%	32.41%	0.02%	2.11	0.36%	31.18%	0.16%
57.	Berjaya Land	1.64	0.56%	8.97%	0.07%	2.09	0.36%	19.98%	0.10%
58.	Ramatex Berhad	1.28	0.44%	60.39%	0.35%	2.08	0.35%	44.13%	0.23%
59.	Kedah Cement Holdings Berhad	0.30	0.10%	14.61%	0.02%	2.07	0.35%	17.07%	0.09%
60.	Naluri Berhad	0.35	0.12%	1.32%	0.00%	2.07	0.35%	13.06%	0.07%
61.	Malaysian Pacific Industries Berhad	1.96	0.67%	29.64%	0.27%	2.05	0.35%	21.68%	0.11%
62.	KFC Holdings	1.18	0.40%	15.01%	0.08%	1.94	0.33%	34.30%	0.17%
63.	ESSO Malaysia Berhad	1.17	0.40%	76.77%	0.41%	1.93	0.33%	74.87%	0.36%
64.	Hock Seng Lee Berhad	0.31	0.10%	6.71%	0.01%	1.93	0.33%	6.60%	0.03%
65.	Pernas International Holdings Berhad	0.67	0.23%	12.32%	0.04%	1.92	0.33%	3.94%	0.02%
66.	Malayan Cement Berhad	1.10	0.37%	78.76%	0.40%	1.92	0.33%	66.68%	0.32%
67.	Carlsberg Brewery Malaysia Berhad	1.91	0.65%	57.06%	0.50%	1.91	0.32%	53.61%	0.26%
68.	Pan Malaysia Cement Work Berhad	1.11	0.38%	3.29%	0.02%	1.89	0.32%	9.49%	0.04%
69.	Guinness Anchor (M) Berhad	1.45	0.49%	74.19%	0.49%	1.87	0.32%	79.62%	0.37%
70.	Tradewinds (M) Berhad	0.52	0.18%	4.02%	0.01%	1.87	0.32%	2.69%	0.01%
71.	Intria Berhad	0.31	0.11%	9.14%	0.01%	1.85	0.32%	4.31%	0.02%

	Company Name	Market Capitalisation (1997)		Share of Foreign Shareholding	Weightage of Foreign Shareholding	Market Capitalisation (1996)		Share of Foreign Shareholding	Weightage of Foreign Shareholding
		(RM 'Bil)	(%)			(RM 'Bil)	(%)		
72.	IJM Corporation Berhad	0.48	0.16%	1.50%	0.00%	1.83	0.31%	12.63%	0.06%
73.	Sunway City Berhad	0.21	0.07%	2.09%	0.00%	1.83	0.31%	2.34%	0.01%
74.	Berjaya Group Berhad	0.70	0.24%	12.63%	0.04%	1.82	0.31%	23.54%	0.11%
75.	Malaysian Oxygen Berhad	1.20	0.41%	67.81%	0.37%	1.80	0.31%	49.45%	0.22%
	TOTAL	218.17	74.44%		24.18%	399.66	68.02%		24.04%
	TOTAL (All Main Board Non-financial Cos)	*293.10*				*587.56*			
Financial Institutions									
1	Malayan Banking Berhad	12.92	25.17%	28.09%	12.19%	32.02	24.04%	43.53%	14.57%
2	AMMB Holdings Berhad	1.02	1.98%	34.51%	1.18%	8.40	6.31%	41.89%	3.68%
3	RHB Capital Berhad	3.14	6.11%	8.13%	0.86%	7.00	5.26%	18.28%	1.34%
4	Public Bank Berhad	2.00	3.90%	35.04%	2.35%	6.70	5.03%	33.10%	2.32%
5	Rashid Hussain Berhad	1.17	2.27%	13.91%	0.54%	5.80	4.35%	7.61%	0.46%
6	Hong Leong Credit Berhad	1.93	3.75%	54.28%	3.51%	5.47	4.11%	45.15%	2.58%
7	Commerce Assets Holding Berhad	1.46	2.83%	35.06%	1.71%	5.32	3.99%	19.65%	1.09%
8	Hong Leong Bank Berhad	1.64	3.20%	10.77%	0.59%	4.51	3.39%	21.72%	1.03%
9	Affin Holdings Berhad	0.75	1.45%	0.86%	0.02%	3.75	2.82%	1.05%	0.04%
10	Malaysian National Insurance Holdings Berhad	1.45	0.49%	0.89%	0.01%	3.58	0.61%	0.56%	0.01%
11	Pacific Bank Berhad	1.36	2.64%	33.32%	1.52%	3.53	2.65%	34.04%	1.26%
12	Arab Malaysian Corporation	0.33	0.63%	20.26%	0.22%	3.37	2.53%	48.19%	1.70%
13	MBf Capital Berhad	0.71	1.38%	58.79%	1.40%	3.20	2.40%	28.88%	0.97%
14	MIDF Berhad	0.70	1.36%	8.58%	0.20%	2.98	2.24%	5.85%	0.18%
15	Arab Malaysian Finance Berhad	0.42	0.81%	7.59%	0.11%	2.79	2.10%	28.23%	0.82%
	TOTAL	30.96	57.99%		26.42%	98.42	71.82%		32.04%
	TOTAL (All Main Board Financial Institutions)	*51.33*				*133.17*			
	Total Market Capitalisation for Main Board	*344.43*				*720.73*			

ANNEX II BASIC RIGHTS OF SHAREHOLDERS IN MALAYSIA

1.	Right to a secure method of ownership	The Malaysian law sets out a comprehensive body of provisions on how shares are to be registered, the identity of member(s), the amount, date of entry and cessation, date of allotment, location of register, register of index of members, openness for inspection, and entitlement for copy upon request. Section 358 Companies Act 1965 provides that if there is default in compliance with the keeping, closing or allowing inspection of the register, the company and every officer in default is guilty of an offence. With effect from 1st November 1998 it became mandatory for securities of companies listed on the KLSE to be deposited with the Central depository. Under section 107B of the Companies Act 1965, any name that appears on the record of depositors maintained by the central depository under section 34 of the Securities Industry Central Depositories Act 1991 shall be deemed to be a member of the company. A depositor will not be regarded as a member of a company entitled to attend, speak or vote at the general meeting unless his name appears on the record of depositors not less than three market days before the general meeting. Crucially any rectification of the register of depositors must be made to the Court and the Court's discretion to rectify is limited to the circumstances set out in subsection 107D (2) Companies Act 1965.
2.	Right to freely transfer shares	The nature of shares as personal property is recognised in Malaysia. Shares may be freely transferable as provided by the Articles of Association and are also capable of being inherited or transmitted by operation of law. Section 98 Companies Act 1965 provides that shares are subject to the general law relating to ownership and dealing in property. The principle of free transferability of shares is fundamental to listed shares. The Listing requirements of the KLSE are clear that the Articles contain no restriction on the transfer of fully paid securities, which are quoted on it. The Malaysian Central depository has been operating starting in 1992, a system that enables securities transactions to be effected electronically without the need for physical delivery of shares scripts. This is done through a system that effects the transfer of ownership of securities through computerised book entries rather than by physical delivery and execution of instruments of transfer.
3.	Right to information	The Act makes provision for members to have access to various records and registers that the company must maintain in order to enable the shareholders of a company to be kept fully informed of what is happening in the company. These include: – the register of members; – register of directors, secretaries, managers and auditors; – the register of directors' shareholdings; – the register of substantial shareholdings; – the register of debenture holders; – the register of charges; – the register of holders of participatory interest. – A copy of the last audited profit and loss accounts, the auditor's report and the directors' report on the accounts.

4.	Right to vote at shareholders meetings	The right to vote is one of a member's fundamental rights. It is recognised in Malaysia as a proprietary right and every member has an unfettered right to exercise his votes as attached to the shares. The principal right of shareholders in respect of their right to vote is their right on the election of directors, on amendments to the constitutional documents of the company, and on key corporate transactions which include transactions where an insider has an interest in the transaction, sale of all or a substantial part of a company's assets, mergers and liquidations. This limits the discretion of the insiders on these key matters.
5.	Right to make proposals at shareholders meetings	Section 151 Companies Act 1965 sets out the right of shareholders wishing to submit proposals to the general meeting. Under this section, shareholders holding in aggregate of not less than 1/20th of the total voting rights, or 100 shareholders holding shares in a company on which there has been paid an average sum per member of not less than RM500, may requisition the company to give to the members entitled to receive notice of the next annual general meeting, notice of any resolution which may properly be moved and circulate a statement of not more than 1000 words on any matter referred to in the resolution on any business to be transacted. Shareholder resolutions are not popular. The biggest deterrent to circulation of shareholder resolutions is that all expenses involved would have to be borne by the shareholder. There is also the 1000 word limit, the difficulty in obtaining sufficient requisitionists and the inability of shareholders to accompany these circulars with proxies in their own favour. Also from a tactical point of view, the board will obtain advance information about the dissenting shareholder's case and be able to send out at the same time a circular in reply.

Source: R Thillainathan et al (1999).

ANNEX III:

ABBREVIATIONS

BNM	Bank Negara Malaysia
CA	Companies Act (1965)
DRB	Diversified Resources Berhad, a PLC
EON	Edaran Otomobil Nasional Berhad, a PLC
EPF	Employees Provident Fund
FRA	Financial Reporting Act
IAS	International Accounting Standards
IASC	International Accounting Standards Committee
IFAC	International Federation of Accountants
IPO	Initial Public Offering
KFC	Kentucky Fried Chicken Berhad, a PLC
KLCI	Kuala Lumpur Composite Index
KLSE	Kuala Lumpur Stock Exchange
LTAT	Lembaga Tabung Angkatan Tentera (Armed Forces Fund)
MACPA	Malaysian Association of Certified Public Accountants
MASB	Malaysian Accounting Standards Board
MGO	Mandated General Offer
MIA	Malaysian Institute of Accountants
PLC	Public Listed Company
PNB	Permodalan Nasional Berhad (National Investment Corpn)
ROC	Registrar of Companies
SC	Securities Commission
SIA	Security Industries Act (1983)
UEM	United Engineers Malaysia Berhad, a PLC

CORPORATE GOVERNANCE ENVIRONMENT AND POLICY: THEIR IMPACT ON CORPORATE PERFORMANCE AND FINANCE IN THE PHILIPPINES

by
Cesar G. Saldana*

I. Introduction

The Philippine corporate sector has become the focus of government efforts to cope with the 1997 Asian crisis and get back on track toward sustainable economic development. This came about after the Philippines underwent a political and economic upheaval in the 1980s, a full decade ahead of the recent Asian crisis. During that period, the Philippine corporate sector dealt with issues like the state ownership of business, "crony capitalism", and state-sanctioned monopolies and subsidies to business. With a change in government in 1986, the country resolved to let government set the rules and private sector to conduct business. Part of the adjustments was a settlement of losses from "crony capitalism" and the failure of public corporations under the previous government. The unilateral debt moratorium declared by the government in the early 1980s lasted up to 1991. Only at about that time did the financial sector get back on solid footing and the private sector began to access the foreign debt markets to finance its investments and restructuring for growth.

The corporate sector and the government emerged from the country's crisis in 1991 clearly stronger because of valuable lessons learned on managing under crisis and on prudent investing and financing. The country later exerted efforts to join the rest of the Asian countries in the "Asian Economic Miracle" but did so in small, measured steps. When the Asian crisis came in 1997, the government was in an advantageous fiscal position, the financial system was strong and the corporate sector had accumulated internal funds from three years of robust profits. More importantly, the Asian crisis did not catch the corporate sector investing, and financing it by debt, into a recession. The Asian financial crisis revealed that the Philippine non-financial corporate sector has been a relatively efficient user of funds of Philippine savers, although there were indications of over-expansion using leverage a few years before the Asian crisis in 1997.

While the sector avoided the full impact of the Asian financial crisis, the corporate sector still needs to address structural weaknesses that constrained its growth in the past. A number of these key structural weaknesses are identified in this Study. The large shareholder, family-based ownership of corporate groups results in a governance structure that depends entirely on internal control systems. It has led to investment and financing policies that are based on trading-on-equity, a strategy that makes the corporate sector vulnerable to deep economic shocks as already evident in the steep decline in its 1997 performance. Another structural weakness concerns the significant presence in the corporate sector of

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* Principal, PSR Development Consulting. This Study used data and results of analysis of a previous Study conducted by the author for the Asian Development Bank, RETA 5802: A Study of Corporate Governance and Financing in Selected Developing Member Countries.

affiliated groups that include large commercial banks. Banks represent an important external control agent for large shareholders-based corporate governance systems. Common ownership of banks and non-financial companies in affiliated groups weakens the role of banks as external control agents because they become part of corporate groups and may be smaller than the groups of companies that they serve.

This Study reviews the historical development of the corporate sector in the Philippines, examines its performance, investment and financing structures and examines the sector's corporate governance framework and key regulations. The Study conducts an empirical assessment of the financial structure and performance of the corporate sector in the period 1988 to 1997. Using data from the SEC-*Business World* annual survey of the largest 1,000 Philippine corporations and the databank of the Philippine Stock Exchange (PSE), this Study analyses the financial performance and structures of companies in relation to their ownership corporations and their accessibility to capital market investors. The Study identifies and analyses large corporate groups, estimates their significance relative to the entire corporate sector and assesses their influence on the corporate sector's financing structure and investment performance. Based on the results of these analyses, the Study recommends reforms in corporate governance.

This paper presents the results of the Study in three parts. Part Two covers the corporate governance environment in the Philippines and its impact on corporate performance and finance. Containing the main findings of the Study, this part is divided in three sections. The first section reviews the general economic context of the country, the impact of the Asian financial crisis on the corporate sector and the responses of government and the corporate sector to the crisis. The second section profiles the attributes of Philippine corporate governance and their relevance to the financial crisis. It reviews the historical development of the corporate sector and the patterns and composition of Philippine corporate ownership. The third section analyses the financial performance of the corporate sector in relation to corporate ownership and governance variables. Part Three reports on the Philippine regulatory framework and policy as a limiting factor for corporate governance. The first section of this part reviews the scope of shareholder rights in law and in practice, while the second section is a parallel review of the role of the board of directors. Part Four presents the key conclusions and recommends reforms to improve the governance structure of the Philippine corporate sector.

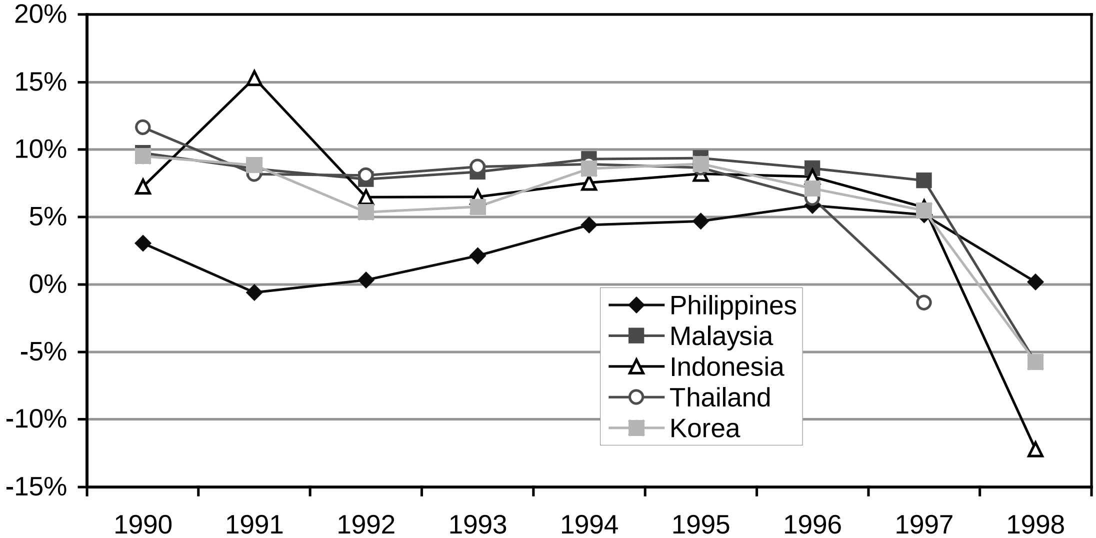
II. A profile of the corporate governance environment and policy, and their impact on corporate performance and finance

The general economic context

The Philippine economy lagged behind the "tiger economies" in Southeast Asia because it faced a major political and economic crisis in the 1980s. The economy achieved a turning point after the turnover of government from the strongman rule of President Marcos to traditional democratic institutions under President Aquino. Economic recovery accelerated after the Middle East crisis in 1990 to 1991. Real GDP grew by an average of 4.5% per year from 1992 to 1997 with the highest real GDP growth of 5.9% achieved in 1996. Real GDP growth rates during the five-year period were considerably lower than those of Thailand, Malaysia, Indonesia and Korea. Figure 1 shows comparative GDP growth rate performance over 1990 to 1998 of the Philippines relative to these countries.

Figure 1: Comparative Real GDP Growth Rates

(Selected Asian Countries, 1990-1998)



Source: Bangko Sentral ng Pilipinas

The largest component of GDP was the services sector with about 43% share and growing at 5.3% per year from 1993 to 1997. The industrial and agriculture sectors contributed about 34% and 21% of GDP in 1997 with annual growth rates of 4.7% and 2.6%, respectively. Exports had been growing at about 20% per year from 1995 to 1997. Manufactured products accounted for 80% to 85% of exports and grew at about 25% per year during the period. Commodities exports accounted for the balance of 15% to 20% of exports and grew at a much slower rate of 2% per year. In 1997, semiconductors accounted for about 52% of manufactured exports with growth rate of about 33% per year. The second largest export, garments, accounted for about 9% of manufactured exports but had been declining by 4% per year from 1995 to 1997. In sum, 60 % of manufactured exports were in two products, one of which was clearly declining in international competitiveness. Most commercial, industrial and service activities in the economy are oriented to the domestic market.

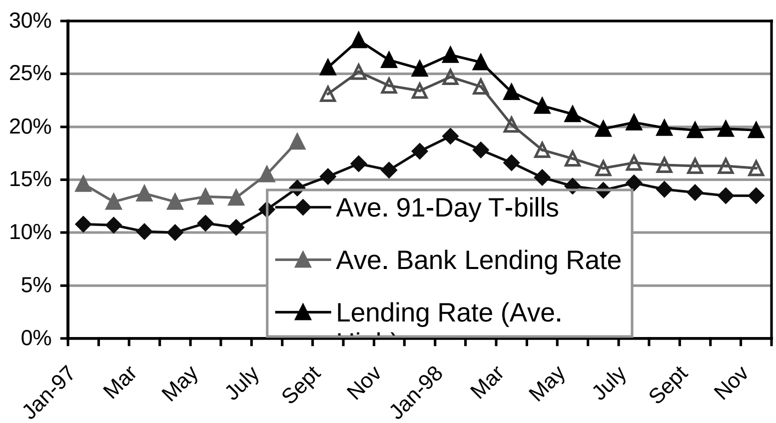
About 80% of the country's imports were capital goods, raw materials and intermediate goods. The largest imports, power generating and telecommunications equipment, grew at an annual rate of 30% from 1995 to 1997. Average deficit in net trade in goods and services was about 5.7% in the same three-year period. Net investment flows were growing by an average of about 48% per year from 1992 to 1996, to about US$3.5 billion in 1996. Gross new foreign investments grew from US$0.74 billion in 1992 to US$3.6 billion in 1996, or a rate of 40% per year. Foreign investment flows were much lower than in comparable Asian countries, but they gathered momentum in the years preceding the Asian crisis in 1997. The growth in foreign investments appeared to have fuelled the high growth of the manufacturing and services sectors during the years prior to the Asian crisis.

It seems that the Asian crisis visited the Philippines only through "contagion" because the Philippines was not heavily dependent on foreign capital flows and its corporate sector was focused on domestic markets. For these reasons, the effects of the crisis were relatively mild. The Bangko Sentral ng Pilipinas (or BSP, the Philippine Central Bank) initially responded to the crisis by selling foreign exchange and increasing the key overnight interest rates. On 11 July 1997, it allowed a relatively moderate depreciation of the peso compared to other Asian countries, from P27.67 in July 1997 to P35.13 to the US dollar in December 1997. After the devaluation of the local currency, relatively mild government measures turned out to be sufficient to stabilise the economy. The crisis came at a time when the government was in surplus fiscal position with the highest surplus of US$6.3 billion (0.3% of GNP) achieved in 1996. Even in the crisis year 1997, the government still had a budget surplus of US$1.6 billion. A 7.8% drop in net foreign investments marked the height of the Asian crisis' impact. The economy sustained the effect because net capital outflows amounted to only US$200 million a month at their highest levels in May and June 1997. By August 1998, net foreign investments were still below 1997 levels. By August 1998, the economy generated a surplus with a 20% increase in exports and a 15% decrease in imports compared to 1997. In 1998, the Philippines was the only country in its group that had avoided an economic recession. It expects to show a GNP growth rate of 2.5% in 1999.

The longer-term impact of the Asian crisis on the financial system and corporate sector is evident in interest rates, bank lending rates, loan demand, non-performing loans and new investments. Bellwether government Treasury bill rates were between 11% to 13% from 1993 to July 1997. These rates rose to a high of 22.7% in January 1998, sparking a rise in interest rates on corporate loans. Average bank lending rates increased to the highest range of 25.2% to 28.2% in November 1997. Lending rates ranged beyond 20% during the height of the Asian crisis, from July 1997 to March 1998. Figure 2 shows Treasury bill rates and bank lending rates before and after the start of the Asian crisis.

The combined effect of shrinking demand and high interest rates reduced the demand for corporate loans. Loans outstanding of commercial banks started decreasing by the first quarter of 1998, in varying degrees depending on industry sector. In October 1998, the top three borrower industry sectors had reduced their credit exposures. Compared to 1997 levels, manufacturing reduced its loan outstanding by 11%, wholesale and retail trade by 12%, and real estate remained at the same levels. Figure 3 shows the loan outstanding of commercial banks with the three largest borrower sectors the year before and after the start of the Asian crisis.

Figure 2: Average 91-day T-bill and Bank Lending Rates
(1997 - Nov. 1998)



Source: Bangko Sentral ng Pilipinas

Figure 3: Loans Outstanding of Commercial Banks in Three Leading Sectors
(1996 - Oct. 1998)

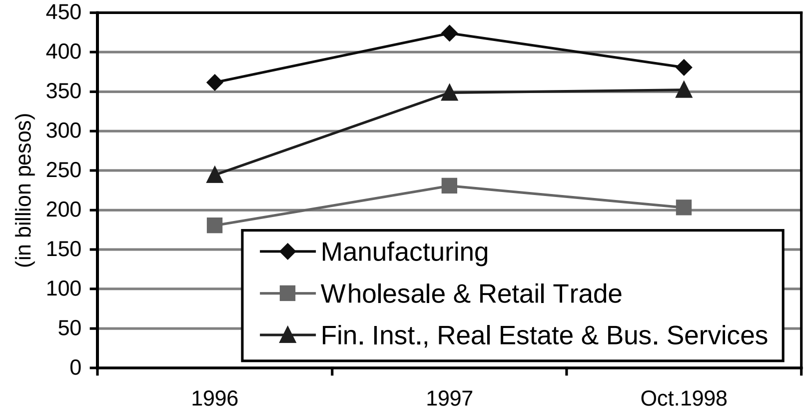
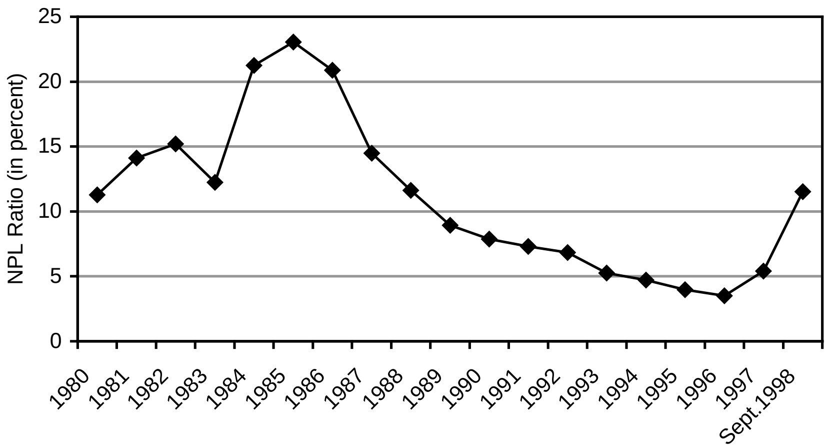


Figure 4: Non-performing Loans of the Banking System
(1980 - Sept. 1998)



Loan loss provisions and non-performing loans (NPL) increased to a high of 11.5% by September 1998. It should be noted, however, that Philippine banking had gone through a worse crisis in the past, one that ended only in 1988. Figure 4 shows that the low, single-digit NPL ratio prevailed only in 1994-96, and the NPL effects of the crisis (thus far) are less severe compared to the country's last major banking crisis in the mid-1980s. Net capital increases by businesses reached a peak of 145.7 billion pesos in 1995 and abruptly declined to 121.7 billion pesos in 1997 or by 8.4% per year. Some 82% of capital increases in 1995 came from the real estate sector. Capital increases in the real estate sector went down by about 20% from 1995 to 1997.

The government policy responded to the crisis by managing the monetary system to control inflation, ensuring a market-oriented foreign exchange system, building up a fiscal position and strengthening the banking system. The country's policy and regulatory responses to the Asian financial crisis focused on the monetary and credit systems, fiscal position, and financial system. BSP rationalised foreign exchange trading to control speculative activities. It acted to control non-deliverable forward contracts, monitored the foreign exchange positions of banks, regulated banks and their subsidiaries on a consolidated basis and introduced a hedging facility for borrowers with foreign currency-denominated loans. BSP managed the system's liquidity by adjusting key interest rates, liquidity reserve requirements and the statutory reserve ratio for banks. BSP aimed to control inflation and to bring down domestic interest rates. After reducing bank reserve requirements, BSP got the banks to reduce their lending spreads from 3% - 8% over the 91-day Treasury bill rates to 1.5%-6%. Finally, BSP actively regulated problem loans levels by prescribing a limit on banks' loans to the real estate sector; reducing the period for classifying unpaid loans as past due loans; requiring fixed loan loss provisions based on gross amount of portfolio; increasing bank capital requirement by 20% for universal banks (40% for ordinary commercial banks); and improving the disclosure requirements on the financial position of banks.

The policy directions and measures taken by government appeared to have effected a recovery of the economy from the crisis. The country avoided a recession in 1998 attaining a barely positive GNP growth in 1998 and expects a 2.5% growth in 1999. With prudent monetary management and favourable fiscal position, the government expects to control inflation to a level below 10%. Average T-bill rates have come down since mid-1998. Responding to the measures to reduce bank intermediation costs, bank lending rates have also come down (see Figure 2). NPL levels are stabilising and improving because of the decline in lending rates (see Figure 4). Banks' real estate portfolios are declining and remain well below BSP's regulatory ceiling.

Corporate governance characteristics in the Philippines: relevance to the financial crisis

Historical development and overview of the corporate sector

The Philippine corporate sector contributes significantly to the country's economic activity. While there is a greater number of small- and medium-scale businesses, the larger companies account for a large proportion of business activities in each industry. There is a high degree of concentration in most Philippine industries. From 1946 to the early 1980s, the government adopted policies of protecting domestic industries from foreign competition. It set up high barriers to entry and assured the continued survival of inefficient businesses. During that period the banking sector was itself tied to the same protectionism policies that hampered its own growth. The financial system was not competitive because of restrictions on entry of foreign banks, licensing of new banks and branching by local banks. Government gradually reformed trade and financial sector policies beginning in the early 1980s. The political crisis from 1983 to 1986 delayed economic growth and reforms. A change of government in 1986 and the transition to an elected government under President Fidel Ramos assured continuity of the process of economic reforms. The government of President Ramos relied on the corporate sector to implement market-based reforms and liberalisation of trade and investments as the basis for its industrial development policy. The Ramos Government gauged the success of its economic policies from the corporate sector's performance and responses to its policies, ushering in the beginning of a closer relationship between the government and the corporate sector on policy matters.

Size of the corporate sector

The corporate sector contributes to the growth and stability of the Philippine economy. The GNP of the Philippines in 1997 was about 934 billion pesos in constant 1995 prices and grew at a compound annual rate of 4.5% per year. The Study used the *Business World* and the Securities and Exchange

Commission (SEC) list of the largest 1,000 corporations of the Philippines as proxy for the corporate sector. Table 1[1] lists the number of companies and gross sales of the corporate sector by industry sector. Gross sales of the corporate sector amounted to about 1.64 trillion pesos. Assuming that companies generated about 50% of their revenues in value-added, the corporate sector contributed about 42% of the 1995 GNP. The corporate sector contributes significantly to the country's economic activities. In 1997, the main industry sectors, in terms of share in total revenues, were manufacturing (46.7%), financial services (20%) and trading (14.4%). Interestingly, industry sectors that figured in the 1997 crisis, like the utilities, real estate and construction sectors, were not among the top three most important subsectors in terms of contribution to corporate sector revenues.

Multinationals and public companies in the corporate sector

Multinational companies and publicly listed companies contribute to the stability and growth of the corporate sector. Multinational companies operate with established technologies and practice internationally-proven governance systems. These advantages underlie their sustained growth and dynamic positions in their industries. Publicly listed companies have proven track records and management competence. These companies have better access to financing sources than privately owned local companies. Public companies are subject to rules and regulations that promote transparency and protection for investors.

Multinational companies have a significant presence in the Philippine corporate sector. Table 2 presents the number and gross sales of multinational companies in the corporate sector from 1986 to 1997. The number of companies increased from 233 companies in 1986 to 272 in 1997, or by only 1.4% per year. Sales grew from about 297 billion pesos in 1986 to about 807 billion pesos in 1997, or a growth rate of 9.5% per year. Before the crisis, gross sales of multinational companies were even higher at 1,072 billion pesos with an average growth rate of 43.4% per year for the period 1990-95. In 1997, multinational companies accounted for about 27% of the number and about 33.5% of the gross sales of the corporate sector.

Table 3 presents the number and gross sales of publicly listed companies in the corporate sector. Publicly listed companies increased from 68 companies to 97 companies from 1986 to 1997 or a growth rate of 3.3% per year. Publicly listed companies are not necessarily large companies. Among the 219 companies listed in the stock exchange as of yearend 1998, only 97 had sales revenues that allowed them to join to the list of the largest 1,000 corporations. In fact, the share of publicly listed companies in the gross sales of the corporate sector for 1997 amounted to only 21.6%. Considering that the largest private corporations and privatised government corporations are publicly listed, the small share of publicly listed companies among the corporate sector's revenues is surprising. Multinational companies have a more significant presence in the corporate sector than publicly listed companies. However, publicly listed companies are larger, with average annual gross sales of about 5.36 billion pesos per company, while multi-nationals averaged about 3.0 billion pesos in annual sales per company. Together, multinational companies and publicly-traded companies accounted for about 55% of sales in 1997, although they accounted for only 37% of the number in the top 1,000 companies. This suggests a high concentration of corporate activities among these two groups.

Corporate governance agents: historical review of patterns of Philippine corporate ownership

Three historical factors shaped Philippine corporate ownership, namely, the country's colonial past, the changing industrialisation policies of the government, and the emergence of industrialists from a

1. Tables 1-14 are at the end of this chapter.

growing middle class. During the Spanish and American periods of the country's history, a number of families owned land and large businesses. These families built and preserved their businesses over several generations under the leadership of patriarchs who ran their businesses as an "extended family."[1] During the early decades of the country as an independent nation, the government adopted import-substitution policies to develop industries and trade. Government gave local investors preferential treatment and imposed quantitative restrictions and high tariffs on imported products that competed with locally produced goods. Government granted incentives to "infant" industries. Government subsidised credit to companies in industries considered by government as priority development areas. An unintended result of these government policies was the creation of an entire class of industrialists, businessmen and bankers who accumulated profits and capital. Former traders took more advantage of incentives and subsidised credit offered by the government than those who responded to its call to set up "pioneer" industries in the country. The early years of the country's industrialisation in the 1950s up to the 1970s also gave rise to well-known personalities of Chinese descent, some of them emigrants from China, who dominated certain industries. Their dominating presence ensured that their families would continue to own these businesses for the next several generations.

With the emergence of a growing middle class in the 1980s and 1990s, the government called upon leading managers and businessmen from its ranks to become "captains of industry" and help in pursuing industrial development through vigorous growth of the corporate sector. Government sought to forge a partnership between the government and industry in a pattern similar to Singapore's and Korea's. Industrialists helped the government formulate industrial development policy. Some of them turned over their businesses to their trusted family members and business partners to enable them to occupy advisory or cabinet positions in the government. Through their business sense and management ability, they became major owners of new large companies and influenced growth, development and government policy in their industries. Because large shareholders tend to allocate their investments in several businesses, they typically control these investments by forming groups of companies. In sum, large shareholders that dominate ownership of the Philippine corporate sector are families whose wealth dates back to the colonial era, early industrialists and ethnic Chinese emigrants, and entrepreneurs and professionals from the middle class. Large shareholders manage their investments through corporate group structures.

Groups of companies commonly include commercial banks and other financial institutions like insurance and finance companies. Large shareholders either directly owned these banks or controlled them through companies that they owned. Commercial banks hold the largest share of financial resources in the country. Past government policies sought to ensure stability in the financial system through regulations at the expense of growth and competition. Past government policies restricted entry, set up minimum capital requirements and limited the number of local branches and foreign bank operations in the Philippines. With the capital markets still underdeveloped, commercial banks came to control the financial resources of the system and to capture excess profits in the process. Corporate financing depended on intermediation by commercial banks. Large groups responded by acquiring significant ownership of commercial banks. Once banks became part of corporate groups, member companies of the groups improved their prospects for accessing loans at favourable interest rates and terms. BSP introduced major reforms to strengthen the banking system and increase competition. Some of these reforms were the liberalisation of interest rates and foreign exchange in the 1980s, entry of foreign banks in the 1990s, and as a response to the Asian crisis, increased capital requirements.

BSP's reforms are probably changing the conduct but not necessarily the structure of banks. In particular, banks' ownership remains large shareholder and family-based. Through common ownership, ties of commercial banks with corporate groups of companies remain strong. Concentration of ownership in banks weakens the regulatory capacities of BSP. To accelerate recovery from the crisis, BSP sought to reduce the lending rates by bringing down Treasury bill rates, the bellwether for lending rates. This did not get the expected response from banks. Foreign banks increased in number, but local banks still dominated domestic credit and deposit markets. By raising capital requirements, BSP wants to strengthen the capital base and increase the size and stability of banks as a safeguard against future financial crises. However, capital build-up demonstrates the advantage of corporate groups in raising capital from their own internal capital market. Increasing capital shall heighten the concentration of ownership and expand the scope of own-group lending by these larger banks in the future. Several banks merged after the Asian crisis in a process that involved divestments by a large shareholder group and increased ownership by another.

Composition of ownership

Ownership is the key element in corporate control and governance. Of the four central forces that resolve problems regarding the compatibility of corporate decisions and social good, two – external control through the capital market and the corporate internal control system – depend on the degree of shareholding.[2] Companies that are publicly listed *and* widely held enable dissatisfied shareholders to exit by selling their shares. Capital market investors control these companies and discipline management of companies toward broad, market standards of efficiency. In under-developed capital markets, publicly listed companies may not be widely held by public investors. In that case, external control is not present. In the Philippines, public listing rules require public issuance of only 10% to 20% of outstanding shares. Ownership by large shareholders of publicly listed companies limits the trading of those shares. Public investors could not readily influence the price of shares through their trading activities. The growth and survival of those companies then depend on the effectiveness of control systems within the company's organisation. Because large shareholders manage these internal control systems, any disciplining force generated by such systems is about equal to that coming from self-control.

The composition of ownership of publicly listed companies according to shareholder type by industry sector is shown in Table 4. Because of limitations in shareholder ownership data, Table 4 describes the composition only of the largest five shareholders of publicly listed companies[3]. The largest shareholder type is the non-financial company, controlling an average of 52.1% of non-financial and 33.5% of financial companies in 1997. Non-financial companies include pure holding companies. In four out of nine commercial and industrial sectors, non-financial companies held majority ownership. Large shareholders set up pure holding companies to own operating companies to gain central control over many companies in a group. Pure holding companies are a means of pooling ownership of family members over many companies to enable family members to share the risks and profits of the group. They can also better manage their income taxes because family incomes pass through a holding company. The importance of these advantages is evident in the popularity of holding companies among publicly listed companies. The majority ownership by *privately* owned companies of publicly owned companies suggests that the corporate governance structure is based on internal controls.

Ownership by financial institutions suggests the presence of external controls. The fiduciary responsibilities of financial institutions call for protection of their investments by monitoring management performance and actions. Table 5 identifies financial institutions in the top five shareholders with their corresponding average ownership shares. These are investment trust funds (4.7%), commercial banks (1.3%), securities brokers (1.1%) and insurance companies (0.1%). As a group, they owned an insignificant 7.2% of non-financial companies in 1997. Regulators limit investments by banks and insurance companies in the stock market. Investment trust funds are the most important institutional investors. These are mainly contributions to provident and retirement funds of government and private sector employees that are managed by two separate institutions[4]. These institutions mainly invest in shares of large capitalisation and liquid companies in the communication, power and energy, and food and beverage industries. Investment funds have a significant presence in these sectors, ranging in 1997 from 8.5% to 12.6% of market capitalisation in communications and power/energy sectors respectively. Because of limited ownership by institutional investors, there is no real market for investment information. The Philippine capital market does not have an active analyst community similar to that in more developed capital markets.

Ownership concentration

The average ownership of the top 1, 5 and 20 largest shareholders of publicly listed companies is shown in Table 6. The largest shareholder owned an average of 40.8% of the market value of the non-financial companies in 1997. The counterpart figure for the financial sector is 27.2%. The ownership by one shareholder was highest and constituted majority ownership for companies in the property sector (54.8%) and for holding companies (53%). Other non-financial sectors with a high (more than 25%) degree of one-shareholder control in 1997 were construction, manufacturing/trading and communication. Average ownership by a single shareholder was lower than 25% only for industry sectors with large capitalisation such as power and energy and transportation, and industry sectors with high risk like oil exploration and mining. Even for publicly listed companies, a single shareholder had strong or even dominant control.

The largest five shareholders owned about 65.3% for the non-financial sector and 59.2% for the financial sector in 1997. On average, only five shareholders held majority control over Philippine publicly listed financial and non-financial companies. The highest degrees of ownership by the five largest shareholders were holding companies (78.4%), construction (74%), property/real estate (69.8%), manufacturing and trading (68.4%) and communication (67.3%). Five shareholders controlled, to a degree equal to about a two-thirds majority, five out of 13 industry sectors. Except for the transportation, food and beverage and tobacco, hotel and recreation, and oil exploration sectors, the top five shareholders held majority ownership of publicly listed companies.

The largest 20 shareholders owned 75.9% of companies in the non-financial sector and 76.2% for the financial sector. Except for the manufacturing/trading sector, the largest 20 shareholders held majority control over companies in all sectors. In 10 out of 13 industry sectors, the top 20 shareholders exceeded two-thirds majority ownership. Of the three exceptions, two - mining and oil explorations - are industry sectors of insignificant market capitalisation. Excluding these three sectors, the largest 20 shareholders held a commanding share ownership and management control in the average publicly listed company in every Philippine industry sector.

The degree of ownership defines management control. The Philippine Corporation Code requires approval of management decisions by a majority vote of the board of directors. Strategic decisions, because of their major impact on a company, require a two-thirds majority. On average, the largest five shareholders held sufficient majority ownership to approve operating and strategic management decisions of companies. Minority shareholders could not achieve majority without the support of one or more of the five largest shareholders. Well-organised minority shareholders can probably elect only one member of the board of directors and even then only with effective use of cumulative voting privileges. Concentration of ownership at these high levels reveal that publicly listed Philippine companies are not truly publicly owned. Many companies listed in the Philippine stock exchange have issued only the minimum number of shares needed to gain public listing. By limiting the ownership shares issued to public investors, controlling shareholders reduce minority shareholders to passive roles in corporate governance.

Corporate behaviour and performance

External control systems

Governance of Philippine corporations depends on three external control factors, namely, regulation, the capital market and control by group or affiliate structures. The SEC enforces regulations on conduct and disclosure according to the country's US-based Corporation Code. Publicly listed companies have to meet conduct and disclosure requirements by the SEC and the PSE. The stock market features some of the leading corporations. Public investors could enforce external discipline on these companies by trading their shares. The financial media monitors management practices and performance of publicly listed companies. The common affiliate structures in the Philippine corporate sector are the corporate groups and industry alliances or associations. Corporate groups have family-based ownership structures. Industry alliances based on advantageous sharing of information and policy lobbying activities are emerging. Many industries have organised industry associations where larger companies play prominent roles.

To determine the impact of these three external control factors on corporate sector performance, the Study classified companies by ownership and by external control structures. Ownership structures classify companies into the categories of publicly listed, multi-national and privately owned companies. Public investors partly own publicly listed companies and are assisted in their external control roles by two local regulators (SEC and PSE). Foreign investors and central headquarters own branches of multinational corporations. Family-based owners own and control privately held companies. Conglomerate control structures refer to membership in corporate groups. Independent companies are those that are not affiliated with conglomerates.

Impact of external control on corporate performance and financing

Ownership structures, working through their influence on corporate governance, have an impact on corporate performance as follows:

- Publicly listed companies, being the large, top-tier players in their industries, have good access to external financing of their investments. They require a larger asset base to sell at lower profit margins to support their goal of market share leadership. They need to meet expectations of returns by investors in the local capital market. These expectations shape these companies' performance characteristics like high leverage, higher than average return on equity, low efficiency in asset use and low net profit margins.

- Multinational companies enjoy mobility in capital. They invest only if sufficiently assured of returns. Many are global companies that must meet expectations of high returns by investors in foreign capital markets. They are willing to borrow more if funds can be employed to increase returns to shareholders. Multinationals exhibit high return on equity, efficient asset utilisation and high leverage.

- Privately held companies have limited access to external financing and are not competitive with larger companies. They cannot expand their investments because of limited capital and the presence of large competitors. They have lower leverage and returns but efficiently use their limited asset base.

The Study selected a sample of companies and classified them according to the above external control categories. To be included in the sample, a company had to have a complete time series of financial statements information from 1988 (or their start-up years, if later) up to 1997.[5] This requirement ensures the validity of the time series of financial performance ratios computed from the sample. Financial ratios include standard profitability ratios like return on capital, return on assets, operating profit margin, net profit margin, leverage and asset turnover ratios like total asset turnover and fixed assets turnover. The resulting ratios, summarised in Table 7, confirm the above-mentioned characteristics of the three groups, in particular:

- Publicly listed companies had a high average ROE (17.2%), and leverage 2.79 times equity. They had the lowest total asset turnover of 0.3 and lowest net income margin at 6.6%.

- Multinationals had the highest average ROE (20.5%), and efficiency of asset use in terms of total asset turnover of 0.86, total fixed asset turnover of 4.46, and average ROA (5.6%). Its leverage was relatively high, especially by developed country standards, at 2.53 times equity.

- Privately owned companies had the lowest average ROE (10%), and average ROA (3.3%). Their advantages were their lower leverage, 2.14 times equity, and higher efficiency than publicly listed companies in use of total assets, 0.43.

- The Asian financial crisis caused a steep decline in rates of return and net profit margins for the entire corporate sector in 1997. Average leverage in 1997 increased notably for privately held companies to 2.2 times capital. However, that level is still lower than the level of 3 to 3.4 times capital experienced in 1988 to 1990. Leverage of publicly listed companies was high at almost 2.8 and comparable to the leverage of Thai companies of 2.9 in 1997.[6]

The Study identified main patterns of corporate financing from aggregate corporate sector funds flows from 1988 to 1997.[7] The indicators of investing and financing patterns are: a) net investment in fixed asset relative to total asset growth (measured by the change in fixed assets over the change in total assets); b) the capacity for self-financing of new fixed assets from income (NIC to change in fixed assets); c) equity financing rate (ratio of change in SE to change in total assets); and d) net equity financing rate for assets except fixed assets (ratio of change in stockholders equity less change in fixed assets to change in total assets excluding fixed assets). The results of these financing ratios are shown in Table 8 with the following emerging patterns:

- Fixed assets were a small component of total asset growth, averaging only about 18%. The corporate sector consisted primarily of light industry, trading and holding companies.

- Net income, without considering dividends, was an important internal source of funds but for local companies, it was insufficient to meet new investments in fixed assets. Only multinational companies could finance their fixed assets growth entirely from contemporaneous income.

- Equity, including retention of earnings, financed only a small part of growth in investments, an average of 33% for the past decade. Multinational companies used a higher percentage of equity to finance asset growth, at an average of 43%.

- The effects of the Asian crisis are evident in the funds flows for 1997. Net income was lowest across all categories of companies in the preceding four years. The average increase in total liabilities for the corporate sector was more than twice the highest level experienced in 1995, causing an immediate increase in leverage and a decline in profitability due to higher financing costs.

– Equity, after deducting the amount to cover fixed assets growth, financed only a small proportion, or an average of 18%, of assets growth. The corporate sector heavily used external debts to finance growth in investments and working capital. Because sales have been growing by about 19% per year, debt partly financed permanent or fixed working capital requirements. The resulting mismatch of tenors between short-term financing and long-term investment exposed the corporate sector to refinancing risk and made it vulnerable to sudden rises in interest rates as happened during the crisis. This explains why many companies who worked down their investments to pay off debts suffered substantial losses and reduction of capital. Weakly capitalised companies could not absorb these losses and had to declare bankruptcy.

Importance of corporate groups

In many Asian countries, large shareholders controlling corporate groups emerged from development policies of the government and historical circumstances that enabled certain entrepreneur groups to accumulate capital. When capital markets and legal structures are weak, shareholders deal with the problem of moral hazard in governance by accumulating controlling ownership shares. The Study investigates the importance of these shareholder groups and the characteristics of this control structure. Based on publicly available shareholder information and published reports, 39 corporate groups were identified from the annual SEC-*BW* list of top 1000 corporations in the Philippines. Table 9 shows these groups, their main companies and industries, the total number of companies, total sales in 1997, and their affiliate banks.[8] The Study estimates sales of these groups at 746 billion pesos or 31% of the total sales of the corporate sector in 1997, although they constituted only 25.6% of the number of companies. Twenty financial institutions were affiliated with these groups, including 16 commercial banks. Significantly, corporate groups control a majority - 16 of only 31 - local commercial banks in the country.

Current rankings of companies in the Philippines refer only to corporate entities and do not make any reference to controlling owners. By grouping sales of all companies belonging to the major shareholder groups and comparing them with the sales of independent (non-group) companies, one can generate a list of top corporate "entities." In case where two groups control one company, the company's sales were allocated to the groups in proportion to their percentage ownership. Only 12 such companies were involved in the 1997 sample, indicating that groups do not co-operate by jointly owning companies. The results for 1997 data are presented in Table 10. It shows how the profile of the corporate sector would change if one focused on ownership rather than on the legal personality of companies. The top three corporate entities are corporate groups and are far bigger than the largest independent company, the government-owned National Power Corporation. A total of 25 out of 39 corporate groups entered the list of 50 largest corporate entities in 1997. Together, sales of the 25 groups contributed 57% of the total sales of the top 50 entities in 1997. The overall picture reveals the importance of the 39 corporate groups in the corporate sector and in the economy.

Members of corporate groups tend to dominate or become major players in industries where they participate. It is interesting to find out how groups choose to invest in certain industries. Table 11 presents the different industries in the corporate sector, the sales of the corporate groups per industry, the share of the market, the identity of the corporate groups involved in the industry and the percentage share in the industry of each company. The market influence and competitiveness of the 39 groups are evident at the industry level based on Table 9. Corporate groups dominated or were major players in industries that are capital intensive (i.e. power, cement airlines, telecommunications); difficult to enter due to start-up barriers and economies of scale (i.e. real estate, car manufacturing, shipping); regulated (i.e. power generation and distribution, mass communications, retail trade, banking, mining and agriculture); and subject to government restrictions. Examples of industries under government restrictions that seem to attract (or at least, not deter) groups of companies are food and automotive (restrictions on imports); telecommunications; cement (regulations on quarry rights, anti-pollution guidelines); real estate (zoning and land use restrictions); and coconut/agribusiness (development requirements and restrictions). Corporate groups held dominant shares of industry sales in 1997. They had more than a 30% share in 33 industries (3-digit SIC). In many industries, a group member company accounted for over 30% of total industry sales. Dominant companies held 80% to 98% of the industries sales (examples are mining, pipelines, and beer and cola industries).

In sum, the conduct and structure of corporate groups were moulded by the government's past industrial and infrastructure development policies and the recent emergence of new industry leaders. There was a high concentration of industry sales in a few leading companies. Large shareholders owned dominant companies. To leverage their holdings, large shareholders organised their companies into conglomerate groups. These corporate groups gathered capital and allocated it to an internal market of affiliates. To ensure a continuing flow of external financing, they acquired active minority or majority ownership of a large commercial bank. Due to social benefits generated by their businesses (e.g., employment, tax payment, etc.) their leading shareholders gained influence in society and government. Large shareholders leveraged this influence by entering industries that have high entry barriers. Dominant ownership shares and assurance of bank financing for the corporate group were the means whereby large shareholders achieved control of corporate groups.

Impact of large shareholder-based group structure on corporate performance and financing

Groups of companies in the Philippines operate at varying degrees of effective central control. Some members of the groups have autonomous operations. They separate operating management from central control and allow them to raise their own financing without gross guarantees. Other corporate groups have a central management that makes all major investment and financing decisions for the group. Philippine corporate groups are characterised by the presence of a large family-based shareholder group, majority or active minority ownership of affiliate companies, and a CEO who is a large shareholder. Philippine groups of companies tend to diversify toward industries related to the flagship company's business. This strategic direction ensures availability of competent management within the group and scale economies from central purchasing, logistics and financing. To illustrate the diversification pattern of corporate groups, Table 12 shows the number of industries on three-digit SIC for four of the six largest Philippine groups of companies. As shown for these four corporate groups, many of the companies in their respective corporate groups were in related businesses that accounted for a large share of their total group revenues.

Corporate governance depends on ownership type and control by corporate groups. Owners with greater control are more likely to avoid management inefficiencies (i.e. the moral hazard problem of management-controlled companies), but may tend to over-borrow, knowing they could pass on any loss from credit-financed projects to creditors (i.e. the moral hazard problem of creditors). Stated another way, corporate groups can be expected to show good profitability but may have higher leverage risks. Using individual company data from 1988 to 1997, the Study analysed returns (on equity and assets) and leverage relative to two corporate government variables, owner type and corporate control structure while controlling for industry effects. The methodology involved alternately regressing ROE and ROA and leverage on group membership and ownership type dummy variables along with industry dummy variables.

The results of regression analysis for profit performance using ROA are shown in Table 13(a). Return on assets is positively related to the foreign owned dummy and negatively related with leverage. The negative relationship of ROA with leverage suggests that companies were inefficient in expanding their assets, a result consistent with the hypothesis of over-expansion using borrowed funds. The coefficient for group member dummy is not significant. ROA's significant positive relationship to foreign owned company dummy variable supports previous observations on the superior profitability of foreign owned companies.

Leverage is regressed on profit performance as measured by ROE and ROA and the two corporate governance factors. The regression results are presented in Table 13(b). Leverage is significantly and positively related to ROE and negatively related to ROA. Companies successfully used borrowed funds to generate returns for shareholders but appear to be investing them inefficiently at the margin. Leverage is significantly and negatively related to the group member dummy, the publicly listed dummy and foreign owned dummy variables. The negative sign of the coefficient of group member dummy suggests that conglomerates did not have a tendency to over-borrow in the period 1988 to 1997. There are various explanations for a tendency of groups toward lower leverage. Some possible explanations are the relative efficiency of internal capital markets of groups, the support by affiliate commercial banks in these groups, the stock market boom in 1992 to early 1997 that enabled groups of companies to let their affiliates go public and the country's debt moratorium up to 1991 that prevented companies from tapping foreign debt markets. Leverage is significantly and negatively related to publicly listed and foreign owned dummies. Companies in these two corporate control types are subject to external controls from the capital market. The tendency for lower leverage justifies the importance of external control mechanisms to regulate corporate governance.

III. The regulatory framework and the role of policy

Shareholder rights

The Philippine Corporation Code and the main agency enforcing it, the SEC, are patterned after their US counterparts. The SEC requires all securities to be registered with the registry open for inspection to the public. Corporate stock and transfer books are open for inspection by the company's stockholders. Basic rights of shareholders are adequately protected. Shareholders enjoy one-share-one-vote rule, with proxy voting legally allowed and practised. The Corporation Code requires the annual general shareholder meeting (AGSM) to confirm decisions of management. A shareholder can voice out his/her concern during the AGSM without any required minimum shareholdings for such privilege. However, the minority shareholders cannot influence the vote, since there is no real discussion of board decisions during such meetings. Major transactions of the company require approval by two-thirds majority vote of shareholders. Examples of such transactions are amendment of the articles, bonded indebtedness, sale of major corporate assets, investments in other companies and mergers.

Shareholders have preemptive rights under the law but these rights can be denied or waived in a company's articles of incorporation. Given the large shareholder groups in the Philippine corporate sector, an important concern is the possible conflicts of interest on transactions by managers or large shareholders. There are provisions addressing dealings by the company with directors or officers, contracts between corporations with interlocking directors and for cases where directors are in businesses that compete with the company. These explicitly identified cases require approval by the board of directors. There is no requirement of disclosure to shareholders unless transactions are presented to them for approval. A special case of conflicts of interest is insider trading. The Revised Securities Act specifically prohibits insider trading and provides for strict liability by presuming violation of insider trading rules when directors, officers and principal shareholders conduct trades around the insider information dates. Insider trading regulations are important because most publicly listed companies have a high degree of owner concentration and are thinly traded. However, enforcement has always been a question. Nobody has been successfully prosecuted for insider trading although the SEC and the media have discussed various possible insider trading cases.

In sum, the legal framework for shareholder rights is generally adequate. However, in practice, shareholder protection is eroded by the dominance of large shareholders in corporations even for major decisions involving two-thirds vote. A serious limitation of the legal framework is its incapacity to protect minority investors from management dominated by large shareholders in areas involving conflicts of interest and insider trading. There is very little to deter management from conflicts of interest because, at worst, the Corporation Code only requires special approval by two-thirds vote in AGSMs which can be reached due to dominant control by large shareholders. Insider trading regulations have been poorly enforced in the past although there is hope in the current revision of the law.

Role of the board of directors

The board of a typical Philippine large public company is composed of between 7 to 11 members representing the largest shareholders of the company. There is no requirement in law or in practice of representing stakeholders on boards. The board of directors is not explicitly mandated by the Corporation Code to consider the interest of minority shareholders. The Corporation Code prohibits the removal of a director without cause only if minority shareholders shall lose their representation in the board of directors as a result of such action. Interlocking directorships are common and extensive, especially for corporate groups. Directors are elected during the AGSM by shareholders. Outside directors are not common and not mandatory. Outside directors, if present, are brought in by controlling shareholders. Having an "independent" director is not acceptable for most companies because family members and close associates prefer to discuss business issues of highly confidential nature within the family.

Boards of directors may create sub-committees. However, most companies do not have sub-committees of the board of directors. A few have management remuneration and audit committees. Companies can provide in the bylaws or approve by majority of outstanding stock the compensation of senior management including stock options. In practice, only few publicly listed companies provide stock options to management and by minimal amount (for example, 1% of outstanding shares). Directors' fees are publicly disclosed by the SEC reporting requirement. However, the amounts are shown as a lump sum for the directors and another for officers. There are provisions for disregarding the limited liability of the corporation and protection by shareholders against infringement of their rights. A stockholder can file a derivative suit against its directors. The SEC is the special body that handles conflicts involving corporations and their shareholders. Although intended to speed up resolutions of intra-corporate conflicts, SEC proceedings are known to be costly and take a very long time to resolve. In effect, enforcing the protection of minority shareholders through the courts is costly and not effective.

IV. Conclusions and recommendations

Conclusions

The dominating factor in Philippine corporate governance is the large, family-based ownership structure of companies. By itself, this is not an unusual characteristic because most Asian businesses and those in developed countries like Germany and Japan also have family-based owners. However, the country's history of economic, policy, and legal environment, and the relatively weak external control agents, suggest that highly concentrated ownership constitutes a structural weakness that limits future growth and leads to inefficiencies in investments and financing in the corporate sector. The following conclusions were derived from the results of the analysis in this Study:

First, large shareholders that dominate ownership of companies pursue a financing policy characterised as trading-on-equity, resulting in further dominance by these companies in their industries.

The five largest shareholders hold about two-thirds ownership of publicly listed companies. Returns to shareholders increase while return on assets decrease with leverage. This suggests that companies expand their investments using borrowed funds although the returns on those investments are declining. Because larger companies have superior access to debt financing entailed in this strategy, the result is further concentration of industry sales in these larger companies.

Second, corporate groups with affiliate banks enjoy advantages in terms of access to financing and economies of investments and operation in related industries.

Companies that operate as part of corporate groups are able to get adequate debt financing for their projects because affiliate banks leave the task of "picking winners" to the group management. Philippine corporate groups appear to have been successful in investing debt funds over the past 10 years.[9] However, ownership of banks by corporate groups diminishes the capacity of banks to be effective external control agents. This is a serious weakness in the governance structure of Philippine corporate groups because as providers of mostly short-term loans, banks would have been in the best position to appraise the efficiency of the corporate group's investment and financing activities. They could have been the most suitable external control agents for corporate borrowers that are owned by large shareholders.

Third, most publicly listed Philippine companies are not widely held by public investors.

Most publicly listed companies actively float shares that represent only the minimum number of shares required to be considered a public corporation. The absence of a wide shareholder base in most Philippine public corporations weakens corporate governance. There is a resulting lack of active shareholder discussions of major management actions and weak signals from investors regarding their judgement on a company's performance.

Fourth, the regulatory framework for corporate governance is inadequate in the context of Philippine conditions like large shareholder-dominated companies, corporate groups and ownership of banks by groups of companies.

The modified US-based Corporation Code that prevails in the Philippines does not address the structural weaknesses that were revealed in the Study's analysis of the integrated relationship between governance agents and performance, and corporate investment and financing. The presence of large shareholders in most Philippine companies precludes the effectiveness of legal provisions preventing resource transfers that are adverse to small shareholders. Ownership of banks by non-financial companies may diminish the due diligence role of banks when evaluating loans to a member of its own corporate group. The Philippine Corporation Code does not adequately address adverse actions by large shareholders involving potential conflicts of interest and expropriation of minority shareholder's wealth.

Recommendations

The Study offers the following recommended actions that the government should take to introduce reforms to address weaknesses in corporate governance identified by the Study.

First, review the regulatory framework for corporate governance to strengthen the rights of minority shareholders and to improve disclosure of actions by the board and large shareholders.

The SEC, PSE and BSP should formulate a sound and proactive corporate governance framework. The Study showed that the degree of control by a few large shareholders is pervasive even among public companies. It exceeds the level that is consistent with any reasonable standard of equitable distribution in society of ownership of the corporate sector. In practice, controlling shareholders can further erode the rights of small shareholders by preventing discussions of management actions during AGSMs. The currently prevailing regulatory framework appears to merely achieve parity with similar corporate regulatory standards like in the US. This is not enough. Without the conditions that prevail in those other countries such as broad-based ownership, a strong business information media and a highly competent financial analyst community, it will not be possible to impose strong external control, in the form of a proactive corporation law, on large shareholders.

Second, formulate and reform the legal and regulatory basis for the establishment and operation of investment funds and venture capital funds.

Investors in publicly listed companies are mainly individuals, non-financial companies and stockbrokers who hold shares in nominee accounts. These are either large shareholders that are long-term holders or portfolio investors who hold short-term trading portfolios. The PSE's investor profile clearly has a "missing middle" category of investors, namely institutions that intend to hold shares long enough to participate in the profits and growth of a company and still trade heavily when fundamental conditions and business prospects of the company change. Investment and venture capital funds meet this description.

The conspicuous absence of institutional investors in the PSE is an indication of the quality of shares traded in the PSE and the weakness of the legal and regulatory basics for their operations. By supporting the establishment and operation of institutional investors, the SEC and PSE will help ensure that publicly listed companies are exposed to market discipline. The effectiveness of external investors as governance agents was illustrated in the recent acquisition of Philippine Long Distance Co. (PLDT) by First Pacific. It became feasible only after the government investment fund (SSS) and a foreign fund (First Philippine Capital) offered to sell their holdings in block to First Pacific.

Institutional investors use their checkbook to vote their agreement or disagreement with corporate management. However, to do so, they must have fairly good information about investee companies. With institutional investors in action, an active financial analyst community begins to form. Other investors benefit from the information that analysts produce for these institutional investors as information technology soon makes their output a public good. In this process, the investee companies eventually measure their performance according to their stock price. Eventually they find that their conduct, like their investing and financing decisions, affect stock price. Only at that stage do investee companies achieve market discipline and control of corporate governance based on the capital market. A legal structure that promotes the establishment and efficient operation of investment funds should be formulated as a first step in this direction.

Third, adopt policies and regulations to broaden the supply of securities in the stock market.

To promote the capital markets as an external control agent in corporate governance, the SEC and PSE should increase the supply of quality securities from top-tier local companies in the Philippine stock market. The Study found that PSE companies, on average, float barely the minimum number of shares to be considered public. The lack of liquidity deters investors who want to participate in the future success of the business. The resulting absence of a reliable and fair price makes the prices of shares of these companies vulnerable to temporary business shocks and to manipulation or insider trading by large shareholders. In short, the price of a stock that is thinly traded relative to total outstanding shares becomes subject to many influences besides the corporate management's business performance. Prices of thinly traded stocks are not fairly set. To the extent that most companies in the PSE publicly list and float only a small proportion of their outstanding shares, the entire Philippine market is not inherently a fair market. Regional fund managers appear to have this consensus because they largely bypass the Philippine stock market when they want to take a large position in the Asian markets.

The road to a stock price-efficient market is one for the PSE and SEC to traverse. The PSE needs to convince listed companies to expand their share offerings to the public. The SEC has a task similar to the BSP's periodic call for banks to expand their capitalisation. By regulating to increase the proportion of public issues, the SEC and PSE will be requiring publicly listed companies to increase the share of public investors in their total capitalisation. Large shareholders are likely to oppose these actions because they do not want their control diminished nor wish to handle activism by an active minority of shareholders in AGSMs.

Fourth, improve external audit standards and information disclosure for all corporate businesses.

Effective external control systems in corporate governance require accurate and timely information about the company. Audited financial statements contain the basic independent information about a company's financial position and performance. The SEC requires all corporations to submit audited financial statements. The Philippine Institute of Public Accountants (PICPA) has a clear set of guidelines for ethical and technical practice of external audits. The country has some of the best-trained audit professionals in the Asian region. The top audit companies in the world operate in Manila. Yet the consensus of investors is that current audit standards and information disclosure requirements do not sufficiently protect stock market investors. Recent cases of failures of external audits involved leading public corporate names in their industries, for example, Victorias Milling Corporation and PLDT. Victorias Milling Corporation, a leading sugar miller received loans from banks partly on the strength of clean audit opinions on its financial statements. VMC suddenly went into troubled debt restructuring without indicative signals from those audited financial statements. PLDT was acquired by First Pacific but later questions about the audited financial statements of one of its subsidiaries raised doubts about the fair value of the purchase.

Much of the problem of adequate audit and disclosure stems from the tendency of the SEC and the PICPA to be satisfied with replicating the audit standards and disclosure requirements of their counterparts in the US. Very little attention is given to the conditions, not necessarily present in the Philippines, that make those US regulations effective. Disclosure requirements of the SEC and of external auditors are stated but are not very specific in many instances. Consequently, investors get very low quality information. In practice, auditors have a wide scope of disclosure styles. Penalties for poor conduct or non-compliance are weak and poorly implemented. In spite of many well-known cases of the poor quality of audited financial statements associated with investors' losses, no auditor has been sanctioned by the SEC or PICPA. Companies that ignore requirements of audited financial statements are subject to small penalties for the offence. The SEC and PICPA need to act for better standards because of the costs of these problems to investors. The longer-term cost is the resulting inability of investors and creditors to discipline companies because of the absence of quality information on their performance and conduct.

NOTES

1 Business World, Anniversary Report: "Who Owns the Philippines?", July 1994.

2 The other two are legal/regulatory systems and product/factor markets. Legal/regulatory systems are covered in this Study. Product/factor markets provide the ultimate discipline because a firm cannot survive if it does not provide products and services competitively (Jensen, 1993).

3 The analysis therefore understates the true share of shareholder types in the ownership of publicly listed companies. The percentages shown in Table 4 are the minimum levels of ownership of those ownership types for the indicated groups of publicly listed companies.

4 The Social Security System manages provident funds of private company employees while the Government Service Insurance System assumes the same function for government employees.

5 The SEC-Business World annual survey of top 1000 largest corporations does not have the same set of corporate names on a year-to-year basis.

6 Alba et al, 1998.

7 The data from SEC-BW survey of top 1000 corporations is suitable for describing the aggregate investing and financing flows of the corporate sector.

8 The analysis excluded government companies.

9 Since the Study uses the financial reports of the 1000 largest companies, only survivors are represented, clearly a bias in the sample companies.

Table 1: The Corporate Sector by Industry Subsector

Industry Sector	Number of Companies				Gross Sales (in Billion Pesos)			
	1986	1990	1995	1997	1986	1990	1995	1997
Manufacturing	461	463	436	407	165.1	378.1	772.6	1,125.1
Financing, Insurance, Real Estate and Business Services	114	138	190	198	50.4	118.8	307.1	482.0
Wholesale and Retail Trade	238	244	213	232	68.0	117.3	240.1	346.5
Electricity, Gas and Water	13	9	24	23	39.9	55.4	132.2	179.9
Transportation, Storage and Communication	71	42	42	39	29.1	30.3	95.0	128.3
Community, Social and Related Services	29	41	39	43	3.6	20.0	41.8	69.0
Construction	22	25	37	42	6.2	8.9	27.9	56.7
Mining and Quarrying	22	18	9	8	11.8	19.5	11.7	10.7
Agriculture, Fishery and Forestry	30	20	10	8	4.9	6.1	8.3	8.7
Total	1,000	1,000	1,000	1,000	378.9	754.5	1,636.6	2,406.8

Source: Bangko Sentral ng Pilipinas

Table 2: Number and Sales of Multinational Companies by Industry Subsector

Industry Sector	Number of Companies				Gross Sales (in Billion Pesos)			
	1986	1990	1995	1997	1986	1990	1995	1997
Manufacturing	151	135	184	181	266.8	144.7	452.0	659.2
Financing, Insurance, Real Estate and Business Services	34	24	28	29	14.9	17.3	33.6	62.2
Wholesale and Retail Trade	28	26	19	23	7.1	8.0	16.8	34.7
Transportation, Storage and Communication	9	6	14	11	3.3	3.6	11.3	18.3
Construction	3	3	14	12	1.8	1.0	8.5	14.2
Community, Social and Related Services	2	1	10	9	0.4	0.4	542.2	10.9
Electricity, Gas and Water	0	1	7	5	0.0	1.8	5.3	5.6
Mining and Quarrying	5	1	2	2	3.0	0.4	1.9	1.6
Agriculture, Fishery and Forestry	1	1	1	0	0.2	0.3	0.4	0.0
Total	233	198	279	272	297.6	177.5	1,072.0	806.8

Source: Bangko Sentral ng Pilipinas

Table 3: Number and Sales of Publicly Listed Companies by Industry Subsector

Industry Sector	Number of Companies				Gross Sales (in Billion Pesos)			
	1986	1990	1995	1997	1986	1990	1995	1997
Financing, Insurance, Real Estate and Business Services	21	22	55	41	14.3	47.8	127.0	203.9
Electricity, Gas and Water	0	0	2	2	0.0	0.0	93.0	130.2
Manufacturing	23	24	33	30	23.4	52.1	109.9	97.4
Transportation, Storage and Communication	4	8	15	14	6.6	17.7	48.0	66.9
Construction	3	0	2	2	2.4	0.0	5.3	8.1
Mining and Quarrying	13	12	5	4	10.2	15.2	422.5	6.8
Community, Social and Related Services	2	3	5	4	0.1	37.4	3.3	6.6
Wholesale and Retail Trade	2	3	0	0	0.6	5.9	0.0	0.0
Total	68	72	117	97	57.7	176.0	808.8	520.0

Source: Bangko Sentral ng Pilipinas

Table 4: Top Five Shareholders of Publicly Listed Companies by Shareholder Type and by Industry Subsector (1997)

Industry Sector	Total Market Capitalization[1] (Million Pesos)	Percent Share by Type of Largest Five Shareholders							
		Non-financial Institution	Investment Trust Fund	Nominee Company	Individual	Commercial Bank	Government	Securities Broker	Insurance Company
A. Financial									
Banks	239,654	33.9%	1.3%	3.0%		5.4%	2.3%	2.6%	1.7%
Financial Services	3,751	6.6%	0.0%	10.2%	7.6%	19.3%	1.0%	18.6%	0.0%
Total	243,406								
Average Ownership[2]		33.5%	1.2%	3.1%	9.0%	5.6%	2.3%	2.8%	1.6%
B. Non-financial									
Communication	133,789	53.5%	8.5%	3.9%	0.0%	0.0%	0.2%	0.6%	0.6%
Power and Energy	117,718	26.3%	12.6%	0.2%	0.0%	5.7%	10.7%	0.0%	0.0%
Transportation Services	12,243	37.2%	0.0%	3.2%	5.1%	0.0%	0.0%	2.6%	0.2%
Construction and Other Related Products	19,830	59.4%	1.3%	3.0%	6.6%	0.6%	1.2%	1.5%	0.1%
Food, Beverage and Tobacco	147,254	29.8%	12.3%	1.5%	0.4%	0.0%	0.0%	0.0%	0.0%
Holding Firms	258,613	66.0%	0.2%	4.2%	5.5%	1.7%	0.0%	0.8%	0.1%
Manufacturing, Distribution and Trading	20,857	45.9%	0.8%	5.6%	4.3%	0.3%	0.3%	11.0%	0.2%
Hotel, Recreation and Other Services	12,026	36.7%	0.0%	5.7%	5.3%	0.0%	0.0%	7.6%	0.0%
Property	225,635	67.3%	0.2%	0.7%	1.0%	0.1%	0.0%	0.6%	0.0%
Mining	13,387	26.8%	1.7%	3.9%	0.4%	5.8%	5.0%	12.5%	0.0%
Oil	7,711	21.9%	0.0%	0.4%	8.5%	0.0%	0.0%	13.7%	0.5%
Total	969,063								
Average Ownership[2]		52.1%	4.7%	2.4%	2.2%	1.3%	1.4%	1.1%	0.1%

Source of Basic Data: PSE databank

Note: 1) Total market capitalization of the companies with ownership data

2) weighted by market capitalisation

Table 5: Percent of Institutional Holdings in the Top Five: Banks and Non-Bank Intermediaries (1997)

PSE Industry	Commercial Banks	Non-Bank Intermediaries			Total
		Insurance Companies	Investment Trust Funds	Securities Firms	
Banking	5.4%	1.7%	1.3%	2.6%	10.8%
Financial Services	19.3%	0.98%		18.6%	38.8%
Communication	0.01%	0.19%	8.6%	0.57%	9.3%
Power and Energy	5.7%		12.6%		18.3%
Transportation Services		0.23%		1.02%	1.3%
Construction and Other Related Products		0.11%	0.24%	1.4%	1.8%
Food, Beverage and Tobacco		0.04%	12.3%	0.02%	12.4%
Holding Firms	0.02%	0.22%	1.6%	1.6%	3.4%
Manufacturing, Distribution and Trading	0.69%	0.18%	1.4%	8.0%	10.2%
Hotel, Recreation and Other Services				12.2%	12.2%
Property	0.13%		0.7%	0.9%	1.8%
Mining	5.8%		1.7%	12.5%	19.9%
Oil		0.49%		13.7%	14.2%

Source of Basic Data: PSE database

Table 6: Average Percentage Share Ownership of Largest Shareholders in Publicly Listed Companies by Industry Subsector (1997)

Industry Sector	Number of Publicly listed Companies		Market Capitalization of Companies. with Ownership Data (Million Pesos)	Average Ownership Percentage of Largest Shareholders (Market Capitalization Weights)		
	Total	With Owner ship Data		Top 1	Top 5	Top 20
A. Financial						
Banking	22	18	239,654	26.9%	59.2%	76.4%
Financial Services	7	7	3,751	41.3%	63.2%	65.8%
Total	29	25	243,406			
Average Ownership [1]				27.2%	59.2%	76.2%
B. Non-financial						
Communication	10	10	133,789	35.4%	67.3%	76.9%
Power & Energy	2	2	117,718	21.5%	55.4%	72.1%
Transportation Services	7	7	12,243	23.8%	48.4%	69.2%
Construction & Other Related Products	15	13	19,830	47.7%	74.0%	86.2%
Food, Beverage & Tobacco	14	13	147,254	22.7%	44.1%	69.7%
Holding Firms	51	49	258,613	53.0%	78.4%	86.0% [2]
Manufacturing, Distribution & Trading	25	19	20,857	37.4%	68.4%	42.6% [2]
Hotel, Recreation & Other Services	8	8	12,026	28.9%	55.3%	68.0%
Property	25	23	225,635	54.8%	69.8%	74.5% [2]
Mining	19	15	13,387	23.4%	56.0%	51.9%
Oil	14	10	7,711	19.9%	45.1%	64.3%
Total	190	169	969,063			
Average Ownership [1]				40.8%	65.3%	75.9%

Source of Basic Data: PSE databank

Note: 1) Weighted by market capitalization. 2) Data on Top 20 shareholders are not available for 5 companies in holding firms sector, 10 manufacturing companies and 2 property companies. Subsequently, these figures consider only the data available on 44 holding firms, 9 manufacturing companies and 22 property companies.

Table 7: Profitability, Leverage and Asset Use Efficiency of the Philippine Corporate Sector by Ownership Type
(Average 1988 to 1997)

	Publicly-listed	Multinational	Privately-held	Total
Profitability				
Return on Equity	17.2%	20.5%	10.0%	13.9%
Return on Assets	4.5%	5.6%	3.3%	4.1%
Net Income Margin	6.6%	7.8%	9.4%	16.1%
Leverage				
Leverage	2.79	2.53	2.14	2.43
Efficiency of Asset Use				
Total Asset Turnover	0.30	0.86	0.43	0.43
Fixed Asset Turnover	1.73	4.46	1.37	1.81

Source of Basic Data: SEC-BW Annual Survey of Top 1000 Corporations

Table 8: Funds Flow of the Corporate Sector (1989 - 1997)

SELECTED FUNDS FLOW RATIOS	88-89	89-90	90-91	91-92	92-93	93-94	94-95	95-96	96-97	**Average**
Corporate Sector										
1. Change in Fixed Assets (FA) / Change in Total Assets (TA)	0.15	0.33	0.24	0.25	0.27	0.28	0.17	0.04	0.16	0.18
2. Net Income / Change in FA	1.54	0.73	1.22	1.28	0.73	0.91	1.06	6.12	0.55	1.05
3. (Change in Stockholders' Equity - Change in FA) / (Change in TA- Change in FA)	0.22	(0.06)	0.35	0.38	0.19	0.11	0.14	0.41	0.04	0.18
4. Change in SE/Change in TA	0.33	0.29	0.50	0.54	0.41	0.36	0.29	0.43	0.20	0.33
Publicly Listed Companies										
1. Change in Fixed Assets (FA) / Change in Total Assets (TA)	0.07	0.21	0.26	0.21	0.14	0.17	0.13	(0.04)	0.01	0.08
2. Net Income / Change in FA	1.43	0.95	1.01	1.97	1.72	1.32	1.63	(5.23)	19.44	2.44
3. (Change in Stockholders' Equity - Change in FA) / (Change in TA- Change in FA)	0.11	(0.01)	0.22	0.51	0.20	0.30	0.23	0.08	0.41	0.23
4. Change in SE/Change in TA	0.17	0.20	0.43	0.61	0.31	0.41	0.33	0.04	0.42	0.30
Foreign-owned Companies										
1. Change in Fixed Assets (FA) / Change in Total Assets (TA)	0.18	(0.19)	0.20	0.37	0.23	0.94	0.35	0.04	0.15	0.23
2. Net Income / Change in FA	2.39	2.42	1.62	1.46	0.78	0.96	1.29	7.72	0.39	1.26
3. (Change in Stockholders' Equity - Change in FA) / (Change in TA- Change in FA)	0.20	(0.01)	0.09	0.56	0.70	(52.62)	0.99	0.40	0.17	0.27
4. Change in SE/Change in TA	0.34	(0.21)	0.27	0.72	0.77	(2.23)	1.00	0.42	0.29	0.43
Privately-held Companies										
1. Change in Fixed Assets (FA) / Change in Total Assets (TA)	(0.45)	0.35	0.23	0.24	0.42	0.34	0.18	0.12	0.25	0.25
2. Net Income / Change in FA	1.27	0.41	1.31	0.91	0.43	0.70	0.67	1.53	0.24	0.59
3. (Change in Stockholders' Equity - Change in FA) / (Change in TA- Change in FA)	(0.32)	(0.10)	0.71	0.28	(0.27)	0.25	(0.04)	0.68	(0.19)	0.10
4. Change in SE/Change in TA	(0.91)	0.28	0.77	0.45	0.26	0.50	0.15	0.72	0.11	0.33

Source of Basic Data: SEC-BW Annual Survey of Top 1000 Corporations

Table 9: Aggregate Sales of Identified Group of Companies in the Corporate Sector with Industry Category, Main Firm and Affiliate Banks (1997)

	Groupings	Main Nonfinancial Industries	Estimated No. of Affiliated Companies	Aggregate Sales 1997 (Bil. Pesos)	Main Firm	Affiliate Bank
1	Eduardo Cojuangco	beverages, food, coco-oil, and packaging	20	123.7	San Miguel Corp.	UCPB
2	Lopez Family Group	power distribution and mass communications	15	87.6	ABS-CBN	PCIBank
3	Ayala Corp. Group	real estate, food and car manufacturing	29	82.4	Ayala Corporation	BPI
4	George Ty	car manufacturing and real estate	12	49.4	Toyota Motors	Metrobank/Global Bank
5	Lucio Tan	airlines, beverages, agri and tobacco	4	46.5	Fortune Tobacco	Allied Bank
6	Ramon Cojuangco Family Group	telecommunications	6	44.0	PLDT	Bank of Commerce
7	Henry Sy.	department store and real estate	10	34.4	SM	Banco de Oro
8	John Gokongwei	food and telecommunications	14	27.9	Robinson	PCIBank
9	Zuellig Group	pharmaceutical & distribution	5	26.0	Zuellig Pharma	
10	Del Rosario/Phinma Group	cement and construction materials	11	25.3	Phinma	Asian Bank
11	First Pacific/Metro Pacific Group	real estate, telecom & personal care products	9	16.7	Metro Pacific	PDCP Bank
12	Jose Concepcion/RFM Group	food, beverages and dairy products	5	16.3	Swift Foods/RFM	Consumer Bank
13	Alfonso Yuchengco	investments, construction and mining	6	15.5	House of Investment	RCBC
14	Aboitiz Family Group	shipping, power and food	9	13.6	William Gothong & Aboitiz	Union Bank
15	Andres Soriano Family Group	management, real estate and tourism	8	11.7	Anscor	Asian Bank
16	George Go	credit card	6	11.7	Equitable Card Network Inc.	Equitable Banking Corp.
17	Wilfred Uytengsu/General Milling Group	food and dairy products	4	10.4	Alaska Milk Corporation	
18	David M. Consunji	construction and mining	4	10.1	DM Consunji Inc.	
19	Jollibee Foods	fast food	4	8.5	Jollibee	
20	Alcantara Family Group	cement & wood products	5	7.9	Alson Cement	
21	Bienvenido Tantoco	retail merchandising	2	7.8	Rustans	
22	Luis Lorenzo Family Group	beverages and distribution of agro-ind'l prod.	7	6.9	Pepsi Coca Products	

	Groupings	Main Nonfinancial Industries	Estimated No. of Affiliated Companies	Aggregate Sales 1997 (Bil. Pesos)	Main Firm	Affiliate Bank
23	Elena Lim	electronic appliances	4	6.9	Solid Group	
24	Brimo Family Group	mining	4	5.9	Philex Mining	International Exchange Bank
25	Andrew Tan	real estate	2	5.6	Megaworld Properties	
26	J. P. Enrile/JAKA Group	telecom, distribution and real estate	5	5.4	Jaka Investment Corporation	
27	Jaime Gow	retail merchandising	7	5.2	Uniwide Corporation	Ecology Bank
28	Guoco Group	ceramics and real estates	5	4.7	Guoco Ceramics	Dao Heng Bank
29	Andrew Gotianum	real estate	4	4.7	Filinvest	East-West Bank
30	Jose Go	department store and real estate	5	4.4	Ever Gotesco	Orient Bank
31	Gerardo Lanuza	real estate and securities trading	4	3.3	PhilRealty	International Exchange Bank
32	Alfredo C. Ramos	bookstore, mining and real estate	3	3.3	National Bookstore	International Exchange Bank
33	Gaisano Family Group	department store	3	2.5	Gaisano Department Store	Philbanking Corp.
34	Jardine Davies	cement and sugar central	3	2.3	Republic Cement	
35	Felipe Yap	mining	2	2.0	Lepanto Consolidated Mining	
36	Felipe F. Cruz	construction	2	1.8	F.F. Cruz & Co. Inc.	
37	Jose Luis Santiago	telecommunication	2	1.4	PT&T Corp.	
38	Robert John Sobrepeña/Fil-Estate Group	real estate	4	1.1	Fil-Estate Development Inc.	
39	Keppel Group	shipyard, power	2	1.1	Kepphil Shipyard Inc.	Keppel-Monte Bank
	Total		**256**	**745.9**		
	Ratio of Group to Corporate Sector		***25.6%***	***31.0%***		

Source of Basic Financial Data: PSE Databank and SEC-BW Survey of Top 1000 Corporations (1997), Annual Report.

Table 10: Top 50 Companies or Group of Companies According to Sales (1997)

	Group/Companies	Sales 1997 (Bil. Pesos)	Main Industries
1	EDUARDO COJUANGCO	123.7	beverages, food, coco-oil, & packaging
2	LOPEZ FAMILY GROUP	87.6	power distribution, mass communications, and bank
3	AYALA CORP. GROUP	82.4	real estate, bank, food & car manufacturing
4	National Power Corp.	77.1	power
5	Petron Corporation	60.8	refined petroleum products
6	Pilipinas Shell Petroleum Corporation	53.2	refined petroleum products
7	GEORGE TY	49.4	banking, car manufacturing and real estate
8	LUCIO TAN	46.5	airlines, beverages, agri and tobacco
9	RAMON COJUANGCO FAMILY GROUP	44.0	telecommunications, banking
10	Caltex (Philippines) Inc.	38.0	refined petroleum products
11	Texas Instruments (Phils.) Inc.	37.6	radar equipment, radio remote control apparatus
12	HENRY SY	34.4	department store and banking
13	JOHN GOKONGWEI	27.9	banking, food, telecommunications
14	ZUELLIG GROUP	26.0	pharmaceutical & distribution
15	DEL ROSARIO/PHINMA GROUP	25.3	cement, construction materials
16	Toshiba Information Equipment (Phils.), Inc.	24.8	electronic data processing equip. and accessories
17	Fujitsu Computer Products Corp. of the Phils.	22.4	electronic data processing equip. and accessories
18	Philippine National Bank	19.6	bank
19	Mercury Drug Corp.	18.1	drugs & pharmaceuticals goods retailing
20	FIRST PACIFIC/METRO PACIFIC GROUP	16.7	real estate, telecom, personal care products
21	JOSE CONCEPCION/RFM GROUP	16.3	food, beverages and dairy products
22	ALFONSO YUCHENGCO	15.5	investments, banking, construction and mining
23	Philiipine Associated Smelting & Refining Corp.	15.2	gold and other precious metal refining
24	La Suerte Cigar and Cigarette Factory	14.9	cigarettes
25	Land Bank of the Philippines	14.7	bank
26	ABOITIZ FAMILY GROUP	13.6	shipping, power and food
27	Procter and Gamble Philippines	13.3	soap and detergents
28	Hitachi Computer Products (Asia) Corp.	12.6	radar equipment, radio remote control apparatus
29	National Steel Corporation	12.0	operation of rolling mills

	Group/Companies	Sales 1997 (Bil. Pesos)	Main Industries
30	ANDRES SORIANO FAMILY GROUP	11.7	management, real estate, tourism
31	GEORGE GO	11.7	banking
32	National Food Authority	11.5	palay, corn (unmilled) and other grains wholesaling
33	Phil. Amusement and Gaming Corporation	10.7	other amusement and recreational activities
34	Mitsubishi Motors Phils. Corp.	10.7	motor vehicles
35	WILFRED UYTENGSU/GENERAL MILLING GROUP	10.4	food and dairy products
36	DAVID M. CONSUNJI	10.1	construction and mining
37	Uniden Philippines Laguna Inc.	9.8	television & radio transmitters and apparatus for line telephony and line telegraphy
38	EAC Distributors Inc.	9.8	tobacco products wholesaling
39	Philip Moris Philippines Inc.	9.6	cigarettes
40	Philips Semiconductors Phils., Inc.	9.5	radar equipment, radio remote control apparatus
41	JOLLIBEE FOODS	8.5	fast food
42	Citibank N.A.	8.4	bank
43	United Laboratories	8.2	drugs & medicines, including biological products
44	Development Bank of the Philippines	7.9	bank
45	ALCANTARA FAMILY GROUP	7.9	cement & wood products
46	BIENVENIDO TANTOCO	7.8	retail merchandising
47	LUIS LORENZO FAMILY GROUP	6.9	beverages, distribution of agro-ind'l prod.
48	ELENA LIM	6.9	electronic appliances
49	BRIMO FAMILY GROUP	5.9	mining
50	ANDREW TAN	5.6	real estate

Source of Basic Financial Data: PSE Databank and SEC-BW Survey of Top 1000 Corporations (1997), Annual Report

Table 11: Diversification Patterns of Four of the Largest Corporate Groups in the Philippines (1997)

Group	Total Number of Company in Top 1000	Companies in Core Businesses & Related Industries			Companies in NonCore/Unrelated Industries		
		Business (Number)	1997 Sales (Bil. Pesos)	No. of 3-digit SIC	Total No.	1997 Sales (Bil. Pesos)	No. of 3-digit SIC
1 AYALA CORPORATION	29	Banking & Finance (9)	30.8	4			
		Car Manufacturing (10)	27.2	3			
		Real Estate (5)	7.7	2			
		Total	***65.7***	***9***	***5***	***16.7***	***5***
2 JOHN GOKONGWEI	14	Banking & Finance (4)	31.1	2			
		Food Manufacturing (4)	12.8	4			
		Total	***43.9***	***6***	***6***	***4.6***	***6***
3 LOPEZ FAMILY	15	Power Gen. & Dist. (5)	70.4	3			
		Banking & Finance (4)	18.1	2			
		Total	***88.5***	***5***	***6***	***10.3***	***6***
4 HENRY SY	10	Banking & Finance (6)	29.1	2			
		Retail (3)	21.4	1			
		Total	***50.5***	***3***	***1***	***1.5***	***1***

Note: 1) PCI Bank Revenues is considered in both John Gokongwei and Lopez Family Group.
2) Far East Bank & Trust Company Sales is considered in both John Gokongwei and in Henry Sy Group.
Source of Basic Financial Data: PSE Databank and SEC-BW Survey of Top 1000 Corporations (1997), Annual Report.

Table 12: Market Share of Group of Companies in Selected Industries
(1997, with Key Companies, Ownership Group and Market Share Per Company)

Industry	Group Sales (million)	Market Share (%)	Name of Group	Leading Companies	% Share of Industry
A Food and Other Food Products					
1 Alcoholic Beverages, Malt Liquor	72,831	89.5	Eduardo Cojuangco	San Miguel Corp./Coca-Cola Bottlers	70.2
2 Chocolate, other food Products	32,422	69.3	Eduardo Cojuangco	Nestle Philippines	64.4
3 Meat & Vegetable Oil	32,365	56.4	Jose Concepcion/RFM Group	Swift Foods/RFM Corp.	19.6
			Ayala Corporation Group	Purefoods Corp.	15.3
			John Gokongwei	Universal Robina	15.2
4 Flour Milling & Animal Feeds	14,848	35.4	Eduardo Cojuangco	San Miguel Foods Inc.	19.6
			Wilfredo Uytengsu/Gen. Milling Group	General Milling Corp.	11.5
5 Milk & Dairy Products	6,214	51.8	Wilfredo Uytengsu/Gen. Milling Group	Alaska Milk Corporation	19.8
			Eduardo Cojuangco	Philippine Dairy Products	16.6
			Jose Concepcion/RFM Group	Selecta Dairy Products	15.4
6 Coconut Oil	4,838	34.3	Eduardo Cojuangco	Legaspi Oil/San Pablo/Cagayan de Oro Oil	34.3
B Electricity, Gas and Water					
1 Generation and distribution of electricity	69,729	38.7	Lopez Family Group	Manila Electric Co./Bauang Private Power Corp/First Private power	38.4
C Transport, Storage and Communication					
1 Telecommunication	53,818	86.3	Ramon Cojuangco Family	PLDT/Piltel	64.5
2 Air Transport	32,678	81.6	Lucio Tan	Philippine Airlines	81.6
3 Inter-island water transport	4,915	29.7	Aboitiz Family Group	WGA/Universal Aboitiz Inc.	29.7
4 Pipelines	477	96.5	Lopez Family Group	First Philippine Ind'l Corporation	96.5
D Wholesale and Retail					
1 Retail Selling in Supermarkets	35,801	45.7	Henry Sy	Shoe Mart Inc. / SuperValue	21.5
			Bienvenido Tantoco	Rustans Commercial Corp.	9
2 Passenger Motor Vehicle Retailing	20,805	45.6	George Ty	Toyota Motors Phils.	24.4
			Ayala Corporation Group	Honda Cars / Izusu Manila	21.2
3 Construction Materials	15,999	53.9	Del Rosario/Phinma Group	Atlas Cement Mktg./ Davao Union Mktg. Corp	35.3
			Alcantara Family Group	Market Developers Inc.	13.3
4 Medicinal, Pharmaceutical Products	4,253	13.5	Zuellig Group	Zuellig Pharma Corp.	13.5

Industry	Group Sales (million)	Market Share (%)	Name of Group	Leading Companies	% Share of Industry
E Financial Intermediation					
1 Investment House	35,554	65.4	Ayala Corporation Group	Ayala Corp/BPI Family Savings/Mermac	24.9
			Lopez Family Group	Benpres Holdings/Lopez Inc./First Phil. Holdings	9.5
			Henry Sy	SM Prime Holdings Inc/SM Investment	9.4
2 Financing Company	2,663	35.2	Ayala Corporation Group	Ayala Life/BPI-Leasing/Card/Capital Corp.	23.2
			George Go	Equitable Card Network Inc.	12.0
F Real Estate, Renting and Business Activities					
1 Real Estate	29,095	41.3	First Pacific/Metro Pacific Group	Fort Bonifacio Dev./Bonifacio Land/Landco Pacific	14.3
2 Real Estate Renting	2,571	84.0	Lopez Family Group	Rockwell Land Corporation	54.4
			Robert John Sobrepeña/Fil-Estate Group	Fil-Estate network Inc/Fil-Estate Ecocentric	29.6
3 Architectural Eng'r Services	894	12.1	Lopez Family Group	Meralco Ind'l Engineering Services	12.1
G Motor Vehicles					
1 Motor Vehicles	24,558	47.9	Ayala Corporation Group	Honda Cars Phils./ Isuzu Phils.	25
			George Ty	Toyota Motor Phils. Corp	22.9
2 Motorcycles	3,358	31.2	Ayala Corporation Group	Honda Phils. Inc.	31.2
3 Parts and Accessories	2,947	20.9	George Ty	Toyota Autoparts Phils. Inc.	11.3
			Ayala Corporation Group	Honda Engine Mfg. Phils. Inc.	9.5
4 Shipbuilding	1,085	38.5	Keppel Group	Subic Shipyard & Eng'g./Kepphil Shipyard	38.5
H Construction					
1 General Engineering	22,313	39.4	David M. Consunji	DMCI/ AG&P/ Bachy Soletanche Phils	17.8
I Construction Materials					
1 Cement	16,375	56.9	Del Rosario/Phinma Group	Hi-cement/Davao Union/Bacnotan	36.3
2 Glass Products	3,046	84	J.P. Enrile/JAKA Group	Republic Asahi Glass Corp.	57.3
			Eduardo Cojuangco	San Miguel Yamamura Asia Co.	26.8
3 Ceramic & other Concrete Products	1,433	43.8	Alfonso Yuchengco	Philrock, Inc	28.6
			Guoco Group/George Go	Guoco Ceramics	15.2
J Hotels and Restaurants					
1 Rest., Cafes, & Fast Food Centers	7,977	51.4	Jollibee Foods	Jollibee/ Greenwich Pizza/Freemart Foods	51.4

Industry	Group Sales (million)	Market Share (%)	Name of Group	Leading Companies	% Share of Industry
K Mining and Quarrying					
1 Gold Mining	7,200	97.7	Brimo Family Group	Philex Mining/Philex Gold	64.6
			Felipe Yap	Lepanto Consolidated Mining/Manila Mining	26.9
2 Coal Mining	971	34.8	Del Rosario/Phinma Group	Asia Coal Corporation	34.8
L Textile, Wood & Paper Products					
1 Paper Products	6,018	35.8	Eduardo Cojuangco	Rightpak Int'l/Premium Packaging/ SM Rengo	13.5
			Guoco Group	PICOP Resources	13.4
2 Textile	1,577	18.9	John Gokongwei	Litton Mills	18.9
3 Shoes	815	13.7	Gerardo Lanuza	A. Brown	13.7
M Other Commercial, Social and Personal Services					
1 Radio and TV Broadcasting	5,645	57.8	Lopez Family Group	ABS-CBN Broadcasting Corp.	57.8
N Electrical Materials					
1 Electronic Appliances	4,671	16	Elena Lim	Solid Corp.	16
2 Insulated Wires & Cables	2,773	40.4	Andres Soriano Family Group	Phelps Dodge Phils. Inc.	40.4
3 Electrical Transformers	1,775	78.9	Jose Concepcion/RFM Group	PSI Technologies, Inc	41.9
			Lopez Family Group	Phil. Electric, Inc.	37
O Agriculture, Hunting and Forestry					
1 Hog Farming	3,384	52.1	Eduardo Cojuangco	Monterey Farms Corp	33.3
			Lucio Tan	Foremost Farm Inc.	18.8
P Petrochemcials					
1 Organic Chemicals	3,010	32.4	Eduardo Cojuangco	United Coconut Chemicals	23.5
Q Metal Products					
1 Forge, packaging other fabricated metal	1,321	16.9	Eduardo Cojuangco	San Miguel Yamamura Ball Corp.	11.2
2 White Line Domestic Appliances	875	16.8	Elena Lim	SSEC, Inc	16.8

Source of Basic Financial Data: PSE Databank and SEC-BW Survey of Top 1000 Corporations (1997), Annual Report.

Table 13: Profitability Relative to Leverage and Corporate Governance Factors

Regression Variables	Coefficient	Standard Error	t-value	Significance Level
1. Dependent Variable: Profitability (ROA)[1]				
2. Independent Variables[2]:				
a. Performance Variable Leverage (Total Debt/Total Assets)	-0.137	0.0125	-10.913	<0.001
b. Governance/Control Variables:				
Group member dummy	-0.123	0.011	-1.174	0.241
Foreign-owned dummy	0.338	0.011	3.063	0.002
3. Overall regression statistics:				
a. Adjusted R				0.184
b. F			11.426	<0.011
c. Observations: n = 647				

Note: 1) Return on asset defined as the ratio of net income to total assets
2) The regression controlled for industry effects by introducing dummy variables for 11 industry categories.
Source of Basic Data: SEC-Business World Annual Survey of Corporations and PSE Data Bank

Table 14: Leverage Relative to Profitability and Corporate Governance Factors

Regression Variables	Coefficient	Standard Error	t-value	Significance Level
1. Dependent Variable: Leverage (TLTA)[1)]				
2. Independent Variables[2)]:				
a. Performance Variable				
ROE (Net Income/Stockholders' Equity)	0.032	0.011	2.763	0.006
ROA (Net Income/Total Assets	-1.161	0.105	-11.037	<0.001
b. Governance/Control Variables				
Group member dummy	-0.096	0.03	-3.194	0.0015
Ownership Type:				
Publicly-listed dummy	-0.26	0.116	-2.233	0.026
Foreign-owned dummy	-0.189	0.114	-1.651	0.099
Privately-held dummy	-0.103	0.112	-0.922	0.357
3. Overall regression statistics:				
a. Adjusted R				0.24
b. F			13.0	0.001
c. Observations: n = 647				

Note: 1) Leverage defined as the ratio of total liabilities to total assets
2) The regression controlled for industry effects by introducing dummy variables for 11 industry categories.
Source of Basic Data: SEC-Business World Annual Survey of Corporations and PSE Data Bank

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CORPORATE GOVERNANCE IN SINGAPORE: CURRENT PRACTICE AND FUTURE DEVELOPMENTS

by
Mak Yuen Teen and Phillip H. Phan*

I. Introduction

Singapore's small size and lack of natural resources have necessitated an open trade policy. Total trade amounts to more than two-and-a-half times GDP, while data from the 1990 input-output tables show that imports comprised 55% of total expenditure and 60% of exports. In addition, Singapore has virtually no exchange controls on inflows and outflows of foreign currency funds by residents and foreigners, whether in amount or destination. Singapore also has a very liberal policy towards foreign direct investment (FDI), with no limitation on the extent of foreign ownership, except in the onshore banking sector. Other than a 40% maximum limit for foreigners in the onshore banks and 3% maximum limit on foreign shareholders in a local media company, there are no other restrictions on share ownership. In many aspects, ownership policies in key sectors are more liberal than in more developed nations. For example, there are more restrictions on the ownership of financial institutions and media companies in Canada.

In such an environment, it would be expected that corporate governance would evolve along the lines similar to those of the US and UK[1]. However, this is not what we see in Singapore. Corporate governance in practice and philosophy is still relatively underdeveloped when compared to those of the US and UK. In addition, the high concentration of ownership combined with a weak takeover market appears to work in favour of owner-managers who can consume at the expense of minority shareholders. Further, without the strong bank-centred monitoring mechanisms common in Japan and Germany, there appears to be a lack of either market or structural governance mechanisms to discipline errant managers.

This paper is divided into five parts. Part Two provides a description of the historic macroeconomic and structural characteristics of the Singapore economy. It also discusses the impact of the economic crisis on Singapore and the initiatives taken by the government in response to the crisis. Part Three discusses the institutional environment as it relates to corporate governance in Singapore. It includes descriptive data on various aspects of corporate governance, such as ownership structure, board structure, disclosure and the use of stock option plans. It also reports results of recent empirical tests of factors that influence corporate governance in Singapore companies. Part Four discusses the likely future developments in corporate governance in Singapore in light of the economic crisis and the government's response to the crisis. Part Five concludes the paper.

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II. The Singapore economic environment before and after the crisis[2]

Singapore is a small country (582 square kilometres) with no natural resources. It achieved independence in 1965, at which time it had a population of 1.9 million, and was growing at a rate of 2.5% per year, with an unemployment rate estimated at 10%. The economy was highly dependent on entrepot trade and the provision of services to British military bases in Singapore. There was a small manufacturing base, limited industrial know-how and local entrepreneurial capital. In order to develop Singapore, the government adopted the following strategies:

- Industrialisation to solve the unemployment problem and diversification away from regional entrepot trade.

- Internationalisation by attracting foreign investors to develop the manufacturing and financial sectors.

- Improving the investment environment by introducing employment and industrial relations legislation and investing in key infrastructure, such as the development of the Jurong Industrial Estate and Port of Singapore.

- Establishing new companies such as Singapore Airlines, Neptune Orient Lines, Development Bank of Singapore and Sembawang Shipyard in areas where the private sector lacked capital or expertise.

During the 1980s, the government adopted strategies to restructure the economy towards higher value-added activities in light of the tight labour market. These strategies included ensuring that wage increases reflect the tight labour market, increasing emphasis on education and training, encouraging the use of technology, adopting a more selective investment promotion policy, increasing emphasis on research and development, and developing higher value-added services.

Growth in the 1980s was interrupted by a recession in 1985. At that time, a parliamentary designated committee was set up to review the reasons for the recession and measures to cut costs were swiftly implemented. The economy recovered in 1986, due in large part to expanded trade. Despite the recession, average GDP growth in the 1980s averaged 7.1% and unemployment fell to its lowest level of 1.7% in 1990.

By 1990, Singapore was classified a Newly Industrialised Economy (NIE) by the United Nations. The economy had become more mature and was enjoying rapid growth, as were many other economies in the region. Then, the Strategic Economic Plan was formulated to transform Singapore into a developed country. In the 1990s, the aims of Singapore are to become a globally-oriented city, a centre for high-tech manufacturing industries and an international business hub. Singapore hoped to achieve this by being the hub of an Asia Pacific economic community through active participation in regional economic initiatives, and investing in other rapidly growing economies in the Asia Pacific.

Table 1 provides a summary of key annual indicators for Singapore in 1997.[3]

Table 1: Key Annual Indicators in 1997

Indicator	Value
Mid-year Population ('000)	3,736.7
Annual Population Growth (%)	3.5
GDP (S$m)	143,014.0
Per Capital GDP (S$)	38,272.8
Per Capital GNP (S$)	39,310
Annual Growth at 1990 Market Prices (%)	7.8
Unemployment Rate (%, seasonally adjusted)	1.7
Annual Growth in Productivity (%)	1.6
Annual Inflation Rate (%)	2.0
Foreign Investments (S$m)	5,908.1
Official Foreign Reserves (S$m)	119,616.8
Average Exchange Rate (per US$)	1.4848
Total Trade (S$m)	382,217.7
Exports (S$m)	185,612.5
Domestic Exports (S$m)	107,535.2
Imports (S$m)	196,605.2

Economic growth

Singapore's economic growth averaged 10% per year during the period 1965-1980, with the unemployment rate falling to 3% in 1980, and the development of a strong manufacturing sector accounting for 28% of GDP in 1980 compared to 15% in 1965. Figure 1 shows the real GDP growth for Singapore from 1980 to 1997. Figure 2 shows the composition of nominal GDP at 1980, 1990 and 1997.

Trade and investment

In 1997, total exports were S$185.61 billion, up from S$95.21 billion in 1990. Over the same period, total imports were up from S$109.81 to S$196.61 billion. In 1997, the five largest export markets were US (S$34.1b), Malaysia (S$32.4b), Europe (S$28.6b), Hong Kong, China (S$17.8b) and Japan (S$13.1b). In 1997, the three largest sources of exports were office machines (S$50.7b), telecommunications equipment (S$13.1b), and petroleum products (S$12.7b).[4]

Figure 1: Real GDP Growth from 1980 to 1997

Figure 2: Composition of Nominal GDP for 1980, 1990, and 1997

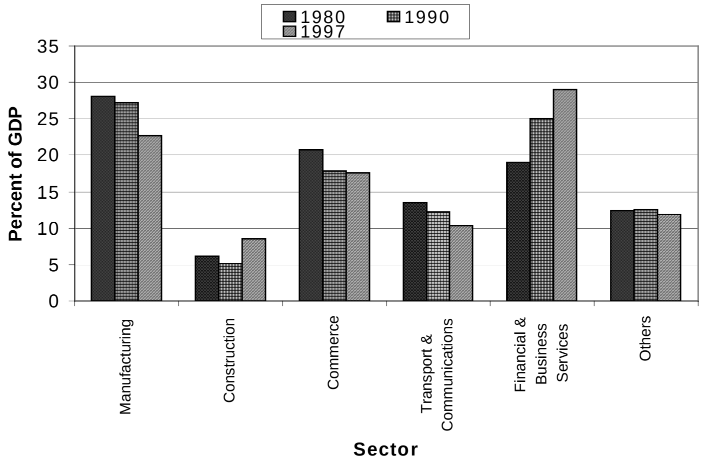

Figure 3: Trend in Incoming and Outgoing Direct Foreign Equity Investment
(1986-1995)

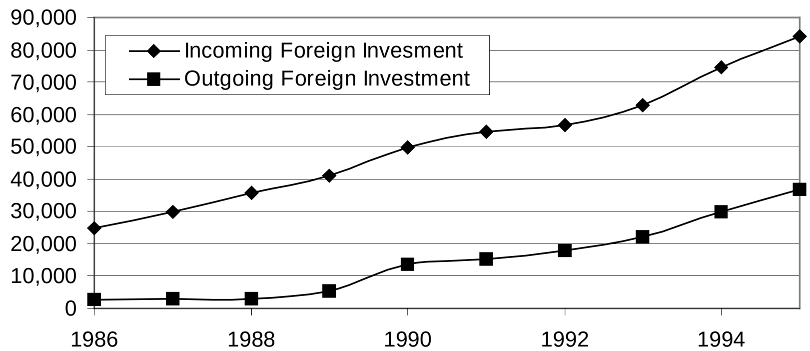

Table 2: Composition of Foreign Direct Equity Investment in Singapore (1986-1995)

		Industry (%)			Investor Country (%)				
Year	Total (S$m)	Manufacturing	Financial Services	Others	US	Japan	UK	Netherlands	Others
1986	24,703	49.4	38.2	12.4	27.8	14.8	14.6	4.5	38.3
1987	29,947	48.6	39.6	11.8	26.6	15.3	12.2	5.0	40.9
1988	35,799	44.2	42.5	13.3	21.4	18.1	11.0	5.5	44.0
1989	41,063	43.3	41.1	15.6	20.3	20.5	9.4	6.7	43.1
1990	49,831	39.7	43.2	17.1	17.2	21.4	9.3	8.2	43.9
1991	54,563	37.9	42.2	19.9	17.5	21.5	11.3	8.0	41.7
1992	56,661	35.4	46.4	18.2	17.0	23.3	10.6	7.2	41.9
1993	62,767	35.7	45.6	18.7	17.9	21.5	9.8	6.5	44.3
1994	74,605	36.4	44.0	19.6	16.2	21.2	8.9	5.6	48.1
1995	84,267	36.3	45.4	18.3	16.9	20.1	7.9	5.2	49.9

Table 3: Composition of Singapore's Direct Equity Investment Abroad (1986-1995)

		Industry (%)			Host Country (%)				
Year	Total (S$m)	Manufacturing	Financial Services	Others	Malaysia	Hong Kong	US	New Zealand	Others
1986	2,598	NA	NA	NA	37.9	19.2	2.5	0.3	40.1
1987	2,962	NA	NA	NA	34.1	18.2	2.3	0.2	45.2
1988	2,994	NA	NA	NA	34.4	18.2	3.6	0.6	43.2
1989	5,289	NA	NA	NA	26.9	15.8	5.5	15.7	36.1
1990	13,622	17.6	66.3	16.1	20.5	16.6	5.1	10.0	47.8
1991	15,184	19.1	66.6	14.3	20.6	15.6	8.6	9.1	46.1
1992	17,741	21.2	63.8	15.0	22.1	17.2	9.0	7.5	44.2
1993	22,181	20.5	65.0	14.5	20.8	17.3	8.0	8.2	45.7
1994	29,765	21.6	62.0	16.4	21.8	16.6	5.6	7.0	49.0
1995	36,866	25.6	60.3	14.1	19.8	13.8	5.5	5.3	55.6

The impact of the economic crisis

Although Singapore was less affected by the economic crisis than most other Asian economies, the effect was still severe relative to its previous growth patterns. The strategy of increasing regionalisation adopted in the early 1990s meant that the health of the Singapore economy was closely linked to that of other regional economies. For example, many Singapore banks have reported significant non-performing loans made to other Association of South East Asian Nations (ASEAN) countries although there were no bank failures resulting from the crisis. Contagion was also widely seen as contributing significantly to the effects of the crisis on Singapore.

The effects of the crisis included significant declines in stock and property prices, a large fall in demand in the local property market, an average decline of 20% in the value of the Singapore dollar relative the US dollar, increasing unemployment and bankruptcies, and a significant decline in GDP growth.[5]

Economic growth

In the third quarter of 1998, the economy contracted by 0.7%, following a growth of 6.2% in the first quarter and 1.8% in the second quarter. Overall, growth was 2.3% in the first three quarters of 1998, compared to 7.8% for the whole of 1997. The official GDP growth forecast for 1998 is 0.5% to 1.0%, taking into consideration further contractions in the fourth quarter, while the forecast for 1999 is between -1.0% to 1.0%. All sectors of the economy experienced deterioration in growth, with the manufacturing, distribution, and financial services sectors registering negative growth in the third quarter of 1998.

Asset prices

Consumer prices fell by 0.8% in the third quarter of 1998, the first such decline since March 1987. For the first 9 months of 1998, the change in CPI averaged 0.2%, compared to 2.0% for the whole of 1997. Both private residential prices and resale prices of government flats (the latter comprise 70% of total housing units in Singapore) continued to fall by an annual rate of 31% and 20% respectively in the third quarter of 1998. Between the second quarter of 1996 and the third quarter of 1998, private residential property prices fell by 40%, while resale prices of government flats had fallen by 24% since the fourth quarter of 1996. In addition, the stock of unsold housing units tripled between the first quarter of 1996 and the third quarter of 1998 to 19,627. In sum, the regional crisis has aggravated an ongoing consolidation in the property market.

The stock market has also fallen considerably. In 1997, the Stock Exchange of Singapore (SES) All-Singapore Share Price Index fell by 12.2%, with the last three quarters showing declines. For the first three quarters of 1998, the index fell by 6.7%, 12.8% and 18.0%, respectively.

Interest rates

Interest rates have declined steadily since their peak in January 1998. The 3-month domestic interbank rate rose from 3.31% in the first half of 1997 to 9.00% in January 1998, before falling back to 3.38% at the end of October 1998.

Balance of Payments

The current account surplus continued to increase, rising to S$8.8 billion in the third quarter of 1998, compared to S$7.2b in the second quarter and S$4.7b in the first quarter. This is due to the faster decline in imports relative to exports. The capital and financial account had a deficit of S$6.8b in the third quarter. The overall balance of payments recorded an S$865 million surplus, increasing Singapore's official foreign reserves to S$122b by the end of September 1998.

Labour market

Total employment fell in the second and third quarters of 1998. In the second quarter, the decline was mainly in the manufacturing sector; while the third quarter decline was more broad-based and also affected the services sector. A net loss of 18,000 jobs was recorded in the third quarter of 1998, which is the highest quarterly number of jobs lost since the recession in the mid-80s. The seasonally adjusted unemployment rate rose from 2.3% in the second quarter of 1998, to 4.5% in the third quarter.

Nominal growth in wages eased from 5.7% in 1997 to 4.5% in the first half of 1998, and is expected to ease further with the cut in wage costs recommended by the Committee on Singapore's Competitiveness and the National Wages Council, and which has since been adopted by the government.

In summary, the impact of the crisis on the Singapore economy, while not crippling, has been severe. More important, what started out to be a localised impact on manufacturing has spread to the services, real property, and financial sectors engendering a sharp decline in consumer and investor confidence. In order to deal quickly with the situation, the government initiated a series of budgetary and off-budgetary measures to lower the cost of business, encourage greater mobility in the labour market to growth, high-valued added sectors, and minimise the social costs associated with declining asset values and job displacements.

The government's response

Economic initiatives

In June 1998, the government announced a S$2 billion package of off-budget measures to cut business costs and enhance the economic infrastructure as well as to help stabilise specific sectors of the Singapore economy. Major cost containment measures included additional property tax rebates on commercial and industrial properties, and rebates on electricity tariffs. Infrastructure spending is to be accelerated through the year 2002. Measures to support the property and financial sectors were also introduced.

In November 1996, a parliamentary designated Committee on Singapore's Competitiveness was formed to review Singapore's competitiveness over the next 10 years. The Asian financial crisis caused a re-examination of Singapore's competitive position. In November 1998, the Committee recommended a series of short-term measures to help alleviate the effects of the crisis and long-term strategies to improve Singapore's competitiveness over the next decade. These recommendations included reducing total wage costs by up to 20%, which included trimming employer pension fund contributions from 20% to 10%, and reducing foreign worker levies in the manufacturing and services sectors. The Committee also recommended reducing land and factory rental rates, government charges for a wide range of services, vehicle use-related costs, extending property tax rebates, suspending stamp duties on share transactions, and reducing or extending income tax rebates for fiscal year 1999. The total package was estimated to reduce business costs by S$10 billion a year, which is equivalent to about 7% of GDP.

Financial sector reforms

In late 1997, the Monetary Authority of Singapore (MAS), Singapore's Central Bank, embarked on a fundamental review of its policies in regulating and developing Singapore's financial sector. This review was undertaken by the Financial Sector Review Group, chaired by the Chairman of the MAS and Deputy Prime Minister Brigadier-General Lee Hsien Loong. In February 1998, the MAS unveiled a series of sector reforms aimed at making Singapore the dominant financial centre in South East Asia. The MAS' new strategy involved the creation of an investor friendly regulatory environment that had, as its primary objectives, transparent supervision, product innovation, and aggressive advocacy for the industry.

The Financial Sector Review Group also formed various committees to make recommendations concerning different aspects of the financial sector. The major committees are the Committee on Banking Disclosure, the Corporate Finance Committee, and the SES Review Committee.[6] Annex 1 shows the key financial sector reforms that have been implemented to date and the proposed reforms that are currently being considered. More recently, the Corporate Finance Committee formed by the Financial Sector Review Group released its final report in which it called for a move from the current philosophy of regulation that is somewhere between merit and disclosure, towards a predominantly disclosure-based regulatory regime. Annex 2 reproduces the key recommendations of the Corporate Finance Committee. In Part Four of the paper we discuss the implications of these reforms for corporate governance in Singapore.

III. Corporate governance in Singapore: past and present

Regulatory environment

The Singapore corporate governance system is loosely based on the Anglo-American model.[7] However, because the capital market in Singapore is thin (there are only about 300 listed companies on the mainboard of the Singapore Stock Exchange), and equity is tightly held among the investors (including government, corporations, individuals and financial institutions), takeovers tend to be friendly rather than hostile. Furthermore, the lack of strict accounting standards (Singapore adheres to International Accounting Standards rather than FASB standards) and the lack of legal backing and enforcement of these standards means that the quality of publicly available corporate information is generally lower than in the US. More important, the high concentration of ownership among company management and large shareholders potentially violates the principle of decision management and decision ratification[8], and may result in the expropriation of wealth from minority shareholders to large shareholders.[9]

Companies legislation and shareholders rights

In Singapore, the Companies Act of 1990 governs the registration of companies and is the primary source of law protecting the rights of shareholders. Most of the rights of shareholders are specified in Articles of Association that companies are required to adopt. A model set of Articles of Association is contained in the Fourth Schedule of the Act. The model Articles apply to companies that have not adopted their own Articles, or where the companies' Articles are silent on particular matters. Under the model Articles of Association, companies are allowed to issue shares with different rights pertaining to dividends, voting or return of capital. However, Section 64 of the Act requires all ordinary shares to carry one vote per share.[10] Other major features of company legislation relating to shareholders' rights include voting by proxies must be in person and not by mail, and cumulative voting for directors is not permitted.

Regulation of takeovers

The major source of guidance on the conduct and procedures to be followed in takeover and merger transactions is the Singapore Code on Takeovers and Mergers (hereafter, "the Code"). The Code is non-statutory and supplements and expands on the statutory provisions on takeovers found in sections 213 and 214, and the Tenth Schedule of the Companies Act. Companies listed on the SES that are parties to a takeover or merger also have to comply with the provisions in the Listing Manual of the SES.

The Securities Industry Council administers the Code, which is divided into General Principles, Rules and Practice Notes. It was developed to aid directors and officers in the discharge of their duties in the event of a merger or takeover of a listed company. In general, the Code was set up as a way to protect the minority shareholder from possible adverse impact. As the concentration of stockholdings is very high in Singapore, the likelihood of minority oppression is very real because many takeover resolutions require only majority, rather than super-majority assent by the shareholders. For example, a principle in the Code states that at no time after a *bona fide* offer has been made can the board of a target firm take action to prevent the shareholders of the target from assessing the merit of the offer. In effect, such a principle prevents the *ex-post* adoption of poison pills as a method of entrenching management by frustrating the takeover. The Code reinforces the principle that directors have a duty to all shareholders with preference given to none, including and especially to those with personal relationships to the board. In this regard, the Code imposes a rule that there can be no termination of directors' service contracts within a 12-month period if the contract has more than 12 months to go prior to an impending takeover. This is to prevent directors from taking their own interests into consideration during a tender offer, such interests being to prevent the loss of a position or to capitalise on a golden parachute.

Unlike generally accepted practices in North America, the Code makes no mention of or give encouragement for boards to hold auctions. In North America, the initiation of an auction by the board is seen as a way to maximise the shareholder value. In Singapore, the Code promulgates a principle that all parties to a transaction must take special care to prevent the creation of a 'false market', which, while left undefined, implies a proscription on auctions. While the Code states that information on the takeover must be made available to all shareholders, it holds the target company responsible for unusual movements in the price of its stock. Rule 7 emphasises the "vital importance of absolute secrecy before an announcement". Thus, it appears that the Code is primarily concerned with friendly mergers and not hostile takeovers, in which the very real possibility of an auction may exist[11]. In large part, this is due to the fact that hostile takeovers are rare in Singapore because the concentration of stockholdings in family trusts, related institutions, and government linked corporations renders hostile takeovers very difficult if not impossible.

Disclosure regulation

Regulation in the public sector is effected primarily by the Registry of Companies and Businesses (RCB), which administers the Companies Act of 1990, and the MAS, which administers the Security Industry Act of 1986. The Companies Act requires financial statements to comply with the detailed disclosure requirements in the Ninth Schedule and to present a true and fair view. There are some differences in accounting and auditing requirements for private companies, public companies and listed companies. For example, the Act includes provisions for maintaining adequate internal accounting controls for public companies, and for listed companies to have an audit committee made up of at least 3 directors, a majority of which must be independent directors.

The regulation of accounting in Singapore involves a combination of private sector and public sector regulation. The Statements of Accounting Standards (SASs), together with the rules contained in the Stock Exchange Listing Manual (administered by the SES) and the Companies Act, determine how accounting is practised in Singapore. The two major institutions involved in private sector regulation are the professional accounting body, the Institute of Certified Public Accountants of Singapore (ICPAS), and the Singapore Stock Exchange (SES).[12] The ICPAS has the sole responsibility for developing and maintaining Statements of Accounting Standard (SAS) and issuing Statements of Recommended Accounting Practice (RAP) which specify how to account for certain business transactions. Standards setting is done through the Accounting Standards Committee appointed by the Council of the ICPAS. Each new Standard becomes part of GAAP, the "accounting law of the land." There is also the Financial Statements Review Committee of the ICPAS which reviews published financial statements for compliance with statutory requirements. Since the SAS issued by the ICPAS does not have legal backing and the ICPAS only has the authority to require members to follow its standards and guidelines, compliance with these standards depends largely on general acceptance by the business community. The SAS is based on the International Accounting Standards (IAS) issued by the International Accounting Standards Committee (IASC). In most cases, the SAS is identical to IAS, although there are occasional deviations and omissions.[13]

Financial sector regulation

Understanding the institutional environment in which corporate governance is played out in Singapore would be incomplete without understanding the role and importance of the financial services sector. The Singapore government, as part of its industrial policy, targeted the financial services sector 15 years ago for development into one of the three linchpins of the local economy (information technology and distribution being the other two). At this time, the regulation of disclosure standards in financial institutions is spread over a number of institutions, namely the SES, MAS, Securities Industry Council, Registrar of Companies and Commercial Affairs Department of the Ministry of Finance. Thus, there is no single point of reference both for companies and stockholders, which contributes to a lack of transparency in the governance process.

For example, the Banking Act of 1970 limits the investments of banks in other commercial enterprises to a specified percentage of its capital funds, the most recent of which is 20%. They are more severely limited in their ability to take large positions in a singular company even though it may be less than the 20% limit. The exception to this rule is when a bank invests in companies set up to promote development in Singapore, which has to be approved by the regulatory authorities (MAS). In order to take high levels of ownership positions, banks have to undergo a judicial review process by the MAS. In addition to enforcing legislation, the MAS also performs regulatory oversight by direct intervention in matters of corporate governance. For example, it maintains the right to approve the appointment of directors on the boards of financial institutions.

In 1998, a consultative paper on the securities market, put out by the Corporate Finance Committee of the Financial Sector Review Group, concluded in their review of the securities market situation in Singapore that the SES was not the right place in which to place board monitoring responsibilities. Instead, they recommended that the Monetary Authority of Singapore, with existing jurisdiction over the governance of the financial services industry and oversight of the regulatory work of the SES, take on the role of monitoring disclosure more fully.

Structural environment

Equity markets

As at the end of 1997, there were 241 Singapore companies and 53 foreign companies listed on the mainboard of the SES, with a total market capitalisation of S$329 billion. In addition, there were a total of 62 companies listed on the second board (SESDAQ), with a market capitalisation of S$3 billion. Prior to the economic crisis, IPOs in Singapore tended to be heavily over-subscribed, with retail investors actively participating in IPOs. The interest of retail investors can be attributed to the high savings rate, low interest rates, and the liberalisation of rules concerning the use of Central Provident Fund (a national pension fund) monies for equity investments. The economic crisis has slowed IPO activity considerably, with some issues being cancelled or deferred, and some companies making IPOs without the support of underwriters.

Ownership concentration

Table 4 summarises the ownership structures of a sample of SES-listed companies. The median stock ownership by the CEO is 0.3%, and the median ownership by all inside directors is 4.3%. The median proportion of shares owned by blockholders is more than 60%, which is very high relative to many developed Western economies. However, there are some important differences between blockholders in Singapore companies compared to other countries. Unlike in Japan and Germany, banks do not directly own significant proportions of shares in Singapore companies because they are not permitted to do so under the Banking Act of 1970. Further, unlike in the US and UK, mutual funds (or unit trusts) are not significant blockholders. This is partly due to the undeveloped funds management industry in Singapore and to the likely lack of interest of large international mutual funds in Singapore's small economy companies. Efforts by the government to encourage the further development of the funds management industry, described in the next part of the paper, are likely to increase the ownership of companies by mutual funds and therefore increase the monitoring provided by these large institutional investors.[14]

At the present time, blockholders in Singapore companies consist mostly of individuals, the government (through government controlled investment vehicles), corporations and government statutory boards (e.g. the Central Provident Fund). Because of the heavy concentration of stock ownership, the practice of using nominee (or representative) directors is common. This often contributes to the problem of conflicts of interest, as directors are required by the law to represent all shareholders. In addition, nominee directors can potentially obscure the decision-making process in the boardroom because of their own agendas.[15]

Table 4: Ownership Structures of SES-Listed Companies (1995, n=158)

Percentage of total voting shares equity	Min	Max	Mean	Median
CEO ownership	0	0.875	0.143	0.003
Inside directors' ownership	0	0.875	0.229	0.043
Blockholder ownership (5% or more)				
All blockholders	0.200	0.981	0.617	0.627
Individual blockholders	0	0.662	0.053	0
Institutional/corporate blockholders (non-nominees)	0	0.943	0.363	0.383
Nominee blockholders	0	0.875	0.203	0.143

As Shleifer and Vishny (1997) note, while large shareholders can potentially improve the monitoring of managers because of the alignment of cash flow and control rights, large shareholders represent their own interests. Where corporate governance is weak, large shareholders may expropriate wealth from minority investors and other stakeholders. Large shareholdings may also result in a loss of diversification and inefficient risk-sharing. Thus, due to the presence of a weak takeover market, lack of disclosure, and weak protection of minority shareholders' rights, the high concentration of shareholdings in Singapore may actually result in a weak corporate governance environment by Anglo-American standards. Recent moves to improve transparency in corporate governance in Singapore may see shareholdings, and thus the incidence of nominee directors, in private companies becoming less concentrated in the future.

Government ownership

A major feature of the Singapore economic landscape is the dominance of government linked corporations (GLCs). The government invests in corporations through three vehicles: MND Holdings, Singapore Technology Holdings, and Temasek Holdings. From here, up to 70% of some GLCs are directly and indirectly controlled by the government while a smaller percentage of major non-GLCs in the banking, shipping, and technology sectors are controlled indirectly through inter-corporate equity shares between the GLCs and non-GLCs. At the end of the 1980s, GLCs comprised 69% of total assets and 75% of profits of all domestically controlled companies in Singapore. In the 1990s, through a program of privatisation, which dispersed the equity of these companies, those numbers have been reduced. However, the government continues to hold majority ownership, through its holding companies (Temasek Holdings, MND Holdings, and Singapore Technologies) in these GLCs. Thus, a study of corporate governance in Singapore would not be complete without understanding the role and governance structures of the GLCs. In many ways, these companies form the bulwark of the domestic economy and are often seen as opinion leaders in the practice of management.

Singh and Siah (1998) suggest that inter-firm competition in Singapore is tempered by co-operation and co-ordinated action in ventures that represent unrelated diversification strategies. This is particularly true for the GLCs, which have a social as well as economic objective, i.e., that of promoting the development of Singapore. For example, the regionalisation of such GLCs as Keppel Corporation has often been achieved in concert with other companies and, in many cases, competitors. This is also reflected in the distribution of interlocking directorates. A high percentage of interlocks occur between listed subsidiaries and the parents but also between competitors in the same industry.[16] One effect of this is the moderation of competitive intensity. In addition, because many directors of GLCs are also senior government officials, it is an indirect method for controlling and monitoring corporate activities and business policies by the government.

While the government appears to facilitate governance through GLCs, there are some problems associated with this approach. The appointment of government officers to senior management and board positions within GLCs raises the question as to whether the best managers are running corporations that form an important part of the economy.[17] In addition, according to Vernon and Aharoni (1981), GLCs must respond to a “set of signals from the government to which private managers are less alert. These signals are not related to profits but to goals associated with the well-being of the nation. These goals may sometimes be in conflict with the commercial objectives of the enterprise”. Because of other superordinate goals, GLCs may also face less pressure in paying dividends.

In addition, unlike other blockholders, who may play an important third-party role in facilitating the takeovers of poorly-performing firms, the government is expected to play the role of the long-term investor in these GLCs. Therefore, GLCs are even more protected from an already weak market for corporate control. GLCs are also likely to have easier access to different sources of capital when compared to non-GLCs. Often, the government is perceived by the lenders to have a moral and legal responsibility for their liabilities and this tacit backing of the state implies that the enterprise is guaranteed solvency.[18] This results in a greater willingness by banks and non-bank financial institutions such as insurance companies to lend money liberally to these enterprises. Accordingly, “the fact that [GLCs] are part-owned (or managed) by the Singapore government enables them to raise funds much more cheaply – by up to four percentage points lower – than others” (*Business Times*, 4 March, 1997). The Minister of Finance noted that GLCs, being largely cash-rich, usually do not need to resort to raising bonds or bank borrowings.[19] This of course reduces the potential discipline to which a GLC will be exposed in a competitive capital market. In a recent interview, Ho Kwon Ping, Chairman of Singapore Power (the Singapore utility) criticised GLCs for excessive diversification.[20] In a competitive market, one would expect any wealth-decreasing diversification to be penalised by investors. However, the reduced exposure to market disciplines caused by a reduced exposure to takeovers, and access to cheap capital because of implicit government guarantee, may allow GLCs to be less efficient than other private companies.

Foreign share ownership limits

As at 30 June 1998, there were a total of 31 companies on the Singapore Stock Exchange (SES) that had imposed restrictions on foreign ownership. Foreign ownership limits range from 20% to 49%. As noted earlier, foreign ownership limits are imposed by statute in the banking and news media industries. In other cases, these restrictions are adopted voluntarily by the firms themselves through amendments to their Memorandum and Articles of Association (M&A). The justification given for imposing foreign ownership limits include strategic (i.e. defence) and national interests. Where foreign shareholdings have reached the statutory or self-imposed limit, shares are traded in separate local and foreign tranches. In general, foreign tranche shares trade at a significant premium over local shares provoking a debate over whether firms should remove foreign shareholding limits. According to Lam (1997), overseas evidence suggests that the use of foreign shareholding limits to prevent companies from falling into foreign control imposes capital costs on the company. Recently, however, some companies, such as those within the Singapore Technologies (ST) Group, have responded to this debate by increasing their foreign shareholding limits. In addition, companies such as the ST units and Singapore Press Holdings, have merged their foreign and local shares.

The adoption of foreign ownership limits, whether statutory or self-imposed, can facilitate managerial entrenchment. The imposition of a foreign ownership limit prevents control of the firm from passing into the hands of foreign investors. It also reduces the ability of foreign investors to acquire large stakes in these firms, thereby reducing potential monitoring by large foreign investors. Where the firm has dual listings of foreign and local stocks, the foreign stocks tend to trade at a substantial premium over the local stocks. This reduces the vulnerability of the firm to takeovers. This is because the law requires the mandatory takeover (triggered when an investor acquires more than 25% of the voting stocks) to be conducted at the highest price paid by the acquirer for the stocks over the last 12 months. If the acquisition is done solely through the purchase of local stocks, then the highest price paid is unlikely to be higher than the prevailing foreign price. This means that foreign stockholders are unlikely to sell their stocks to the acquirer. To the extent that foreign stockholders have some control over the firm's voting rights, and that transfers of restricted stocks have to be approved by the firm, a takeover of the firm is essentially precluded.[21]

Market for corporate control

The takeover market, as might be surmised from earlier discussions, is not active in Singapore. This is due, in large part, to the concentration of stockholdings, the pervasive presence of interlocks, the government investment vehicles, and tight controls by the SES (for example, secrecy rules are in place and strictly enforced in order to reduce speculative buying on rumours). Further, according to Chandrasegar (1995), the Asian way of doing business is marked by an avoidance of aggression, confrontation and bitterness, which usually precludes the use of tender offers. This cultural bias suggests that flamboyant corporate raiders such as T. Boone Pickens, James Gulliver, Ernest Saunders, and the late Robert Maxwell are out of place in Singapore. In addition, unlike their counterparts in London and New York, who are inclined to test the limits of the takeover laws and regulations, merchant bankers in Singapore generally do not act without prior clearance with the Securities Industry Council (SIC), the government agency charged with administering the Takeover Code in Singapore. Consequently, hostile takeovers are almost unheard of and when they do happen, auctions seldom take place because of the secrecy rules just described. Thus, the discipline of a takeover market on director behaviour envisioned by Jensen and Ruback (1983) simply does not exist or is very weak in the Singapore context.

Board structure

Table 5 shows the board structures of a sample of SES-listed companies. The average board size is about 8, with a range of 4 to 14 board members. The average board has a majority of outside directors (57%), with a range of 10% to 100%. Forty-six percent of companies have a dual leadership structure, defined as the situation where there is a separate CEO and non-executive chairman on the board. Therefore, on average, boards of Singapore companies exhibit the three features of boards that are considered to be indicative of effective boards.[22] In spite of this, a number of factors attenuate the effectiveness of a Singapore board. These factors include the difficulty of removing ineffective directors and appointing new ones due to the large stakes held by directors, family members and passive shareholders; the lack of cumulative voting, which may help minority shareholders appoint their own directors; and the weak market for corporate control, which results in few board upheavals even when corporate performance is poor. As an indication of the weakness of Singapore boards, there is some evidence that the relationship between firm performance and directors' pay is very weak.

Table 5: Board Structures of SES-Listed Companies (1995, n=158)

Variable	Min	Max	Mean	Median
1. Board size	4	14	8.030	8.000
2. Proportion of outsiders	0.100	1.000	0.571	0.570
3. Leadership structure [a]	0	1	0.462	/

a Leadership structure is measured by a dummy variable, with 1 for a company having separate CEO and non-executive chairman, and 0 otherwise. The mean represents the proportion of companies having separate CEO and non-executive chairman.

Disclosure

Since IAS requirements tend to be less detailed than American FASB standards, and IAS tends to allow more discretion in adopting accounting policies, the quality of financial disclosure in Singapore is weaker than in more developed Western economies, such as the US, UK, and Australia. A study by Goodwin and Seow (1998), in which they examined the annual reports of 94 Singaporean companies from 1994 to 1996, concluded that the disclosure practices of Singapore corporations fell short of the recommended levels in the Best Practices Guide. They also concluded that, compared to US firms, disclosure practices were poor, although they were better when compared to their South Asian counterparts.

Stock options

In recent years, many Singapore corporations have adopted stock option plans as a means of compensating managers and directors. There is no explicit regulation on the maximum term of the options. The SES Listing Manual contains a number of rules governing the use of stock options. Among others, these are:

- The total number of shares which can be issued under the scheme should not exceed 5% of the issued share capital. If the applicant is listed on SESDAQ, the number of shares available under the scheme should not exceed 15% of the issued share capital. In the case of an applicant which has a foreign currency listing under Chapter 5, the Exchange may vary the requirement on the maximum number of shares that is permitted to be issued under the scheme and any other requirement if the Exchange is satisfied that the applicant has good reasons for it.

- Not more than 50% of the shares available under the scheme should be issued to directors, chief executive officers, general managers and officers of equivalent rank.

- The maximum entitlement of each participant should be fixed and not exceed 25% of the total shares available under the scheme.

- The exercise price of options shall be pegged at the average market price prevailing during the price-fixing period immediately before the options are granted.

- Any offer of securities under the scheme may only be made within a period of forty-two days commencing after the fifth market day following the date of announcement of the applicant's interim and final results provided always that in the event that an announcement of any matter of an exceptional nature involving unpublished price-sensitive information is made during the aforesaid forty-two day period, offers may only be made after the fifth market day from the date on which the aforesaid announcement is released. The aforesaid forty-two day period may be extended with the approval of the Exchange.

- Options granted under the scheme may not be exercised within one year of the date of offer, except:

- Where options are granted to employees who have served less than one year's service, such options may not be exercisable within two years of the date of offer.

- The applicant may provide for staggered exercise of options if the Exchange considers that the purpose is consistent with the objective of this item.

In a survey of 158 companies listed on the SES, 51% had stock option plans in place. However, shares issued to directors and executives under these plans constitute only a small fraction of the total share capital of companies, the maximum percentage being 2.7%, and the mean (median) percentage being 0.2% (0.1%). Of the 80 companies that have option plans, 68.4% (55) only required the options to be held for a minimum period of one year. For these companies, options can be viewed as a mechanism primarily for rewarding short-term performance.

Financial profiles

Table 6 shows the financial profile of a sample of SES-listed companies. Equity financing is the primary source of long-term financing for most Singapore companies. Equity finance is widely available because the high savings rate in Singapore, coupled with low interest rates, has encouraged many retail investors to participate in equity markets. Where long-term debt financing is used, they tend to be in the form of bank borrowings or term loans, rather than bonds.

Table 6: Financial Profile of Sample of SES-Listed Companies (1997, n=265)

Variable	Min	Max	Mean	Median
1. Market-to-book value of equity	0.14	10.44	1.12	0.71
2. Price-earnings ratio	6.4	197.5	27.8	20.4
3. Long-term debt to total assets	0	0.84	0.21	0.21
4. Total debt to total assets	0.02	0.95	0.46	0.44
5. Dividend payout	-0.27	33.64	0.42	0.22
7. Return on equity	-2.19	0.48	0.06	0.06
8. Return on assets	-0.36	0.45	0.05	0.04

Are corporate governance practices related to firm value?

To determine whether corporate governance practices are related to firm value, we collected data on corporate governance structure, financial structure and firm performance for a sample of listed Singapore corporations. We then regressed the market to book value of equity against the following types of corporate governance mechanisms: adoption of option plans, disclosure, managerial ownership, blockholder ownership and board characteristics. We also controlled for the following: firm size, leverage, industry (financial versus non-financial firms), and government ownership (GLC versus non-GLC).

The results are presented in Table 7 and they show evidence of the relationship between board structure and firm value, but no significant relationship between the use of option plans or disclosure and firm value. Interestingly, firms with more outside directors tend to report lower firm value. Also of interest is the finding that GLCs have lower firm value than their non-GLC counterparts.

However, caution should be exercised in interpreting the results. First, relationships between corporate governance practices and firm performance, such as return on equity or return on assets (not reported) were considerably weaker.

Table 7: Regression of Market-to-Book Value of Equity Against Corporate Governance Mechanisms

Variable	Parameter Estimate	Standard Error	T for H0: Parameter=0	Prob > |T|
INTERCEP	-12.231257	5.67054424	-2.157	0.0327
Option Plan	-0.235798	0.74059599	-0.318	0.7507
Disclosure	0.015793	0.04349942	0.363	0.7171
Outside Directors	-3.484262	1.85815794	-1.875	0.0628
Board Leadership	1.982975	0.86651108	2.288	0.0236
Board Size	0.392707	0.18245378	2.152	0.0330
Inside Ownership	-0.390374	1.65956861	-0.235	0.8144
Block Ownership	2.276423	2.41793909	0.941	0.3481
Govt Ownership	-1.893277	1.03746447	-1.825	0.0701
Industry	-1.159315	1.12959143	-1.026	0.3065
Firm Size	0.561851	0.26730512	2.102	0.0373
Leverage	0.881684	1.88872580	0.467	0.6413

R-squared = 0.1707 Model F-value = 2.676 (p<.0037)

Second, the analysis does not consider the endogeneity of corporate governance mechanisms. That is, it can be argued that corporate governance mechanisms adopted by a particular firm depend on the contracting problems faced by the firm.[23] Therefore, if contracting problems vary across firms, so will their corporate governance mechanisms. This suggests that we cannot assume *a priori* an ideal corporate governance mechanism for all firms, and that its employment will increase firm value.

What explains cross-sectional variation in corporate governance practices?

A number of studies have analysed the factors that affect the propensity of Singapore companies to use particular governance practices, including board structure, disclosure, and stock option plans. These studies are based on the argument that, given competitive capital markets, companies have incentives to align their corporate governance practices to reflect the degree of agency problems faced by a firm and the presence of other mechanisms to control these agency problems. For example, where managers own a significant proportion of the firm's shares, their interests are closely aligned with the interests of outside shareholders, reducing their propensity to make decisions that reduce shareholders' wealth.

Based on a sample of 155 SES-listed companies, Mak and Li (1998) found that companies with limits on foreign ownership, higher growth and that are in the financial sector tend to have larger boards. The use of independent outside directors is lower for companies that have higher ownership by the CEO and other inside directors (managerial ownership), significant government ownership, higher growth, lower blockholder ownership, no limit on foreign ownership, and that are in the financial sector. Finally, companies that have a separate CEO and chairperson (where the chairperson is not an executive director) tend to have lower managerial ownership, lower government ownership, higher growth, and are generally in the non-financial sector. Eng and Mak (1999) examined the factors that explain the disclosure of strategic, non-financial and financial information by SES-listed non-financial companies and found that those that disclose more information tend to be those that have lower managerial ownership, lower debt, larger size, and higher government ownership. Finally, based on a sample of 158 SES-listed companies, Ching and Mak (1999) found that companies adopting option plans tend to have lower managerial and blockholder (individual and institutional) ownership, and higher government ownership. Therefore, there is evidence that cross-sectional variation in corporate governance practices is related to the type of the ownership structure, industry and other characteristics of companies.

IV. Corporate governance: future developments

In Part Two of the paper we indicated that the Financial Sector Review Group, formed by the government, has unveiled a number of initiatives in its review of the financial sector. These are summarised in Appendices 1 and 2. Perhaps the two reports that have the greatest implications for corporate governance in Singapore are the "Report on Banking Disclosure" (May 1998) and the "Report of the Corporate Finance Committee" (October 1998). In terms of banking disclosure and the impact on corporate governance, the more salient measures that have been adopted include:

- discontinuing the practice of maintaining hidden reserves;
- providing details on loan loss provisions;
- disclosing off-balance sheet items in notes to accounts;
- disclosing significant exposures; and

- improving the ability of foreign regulators to inspect the Singapore branches of their banks.

Some notable recommendations in the "Report of the Corporate Finance Committee" that have implications for corporate governance include:

- moving towards a predominantly disclosure-based philosophy of regulation with a high standard of prospectus and continuous disclosure;

- more timely release of annual reports and interim results;

- encouraging listed issuers to report their results on a quarterly basis;

- consolidating securities legislation into a unified code;

- moving to a single securities regulator responsible for enforcing all aspects of securities law and regulation (including disclosure obligations) and prescribing accounting rules;

- allowing shareholders civil right of action for insider trading and compensation for losses from insider trading;

- adopting best practice principles in corporate governance for all listed issuers of stock;

- disclosing corporate governance practices and procedures adopted by listed issuers in their annual reports;

- allowing controlling shareholders who are executives of the company to participate in employee share ownership schemes (ESOPs), subject to approval by minority shareholders;

- encouraging a wider participation in ESOPs;

- easing, and eventually removing, the current 5% limit on the maximum size of ESOPs; and

- allowing greater flexibility in the setting of exercise price for options with specified vesting periods.

Another important development in corporate governance in Singapore is the legalising of share buybacks. Share buybacks provide an additional mechanism for company management to return excess cash to shareholders and can therefore reduce the free cash flow problem described by Jensen (1990). Some companies such as Singapore Press Holdings have announced plans to reduce their share capital by buying back shares. The development of the bond market and the fund management industry can also enhance corporate governance. To help develop the bond market, the government has encouraged GLCs and statutory boards to raise funds through bond issues, and several have either done so or have announced plans to do so. This is likely to have positive implications for the corporate governance of GLCs and statutory boards, as borrowing through bond issues subject them to the discipline of the capital markets and can reduce moral hazard problems. Finally, the government has committed to place S$25 billion of Government Investment Corporation (GIC) funds and S$10 billion of MAS funds to external (international) fund managers to manage. The entry of external fund managers may alter the ownership structure of Singapore companies, with a shift towards greater ownership by fund management companies. Fund managers owning significant blocks of shares in companies have both the incentives and ability to monitor management, and are therefore likely to play a more important role in the corporate governance of Singapore companies in the future.

Finally, in recognition of the importance of corporate governance, the Singapore Stock Exchange, with support from the Monetary Authority, instigated the formation of the Singapore Institute of Directors (SID) in May, 1998. The Institute, governed by a Council comprising industry leaders and government representatives, is a voluntary association registered under the Companies Act. It is modelled after the British Institute of Directors and is chartered to improve and professionalise the practice of directing in Singapore companies. With the help of experts from industry and academia, the Institute has developed a director certification program modelled after the British and Australian IODs. Directors of newly listed companies and those wishing to obtain membership in the Institute may participate in this program in order to enhance their directing skills and knowledge. The objective of the SID is to eventually require all directors of mainboard listed companies (as is now the case with London Stock Exchange listed companies) to be certified by coursework. If similar experiences in the UK and US can be generalised, the institutionalisation of directing in Singapore will raise the level of awareness of directors' legal and moral responsibilities, professional conduct in the boardroom, and standardise the implementation of legal remedies for shareholders seeking redress for fraud and other corporate malpractices.

V. Concluding comments

The financial crisis has led the government to implement a number of initiatives to improve Singapore's competitiveness, and to strengthen its financial sector. Significant proposals have been made to improve corporate governance in Singapore. These include the improvement of disclosures by banks and other listed issuers, the creation of a single securities regulator with wide powers, the improved ability of investors to take civil action against insider trading, and the greater flexibility of using stock option plans to align the interests of shareholders and management of companies. Other financial sector developments such as the development of the funds management industry and the bond markets are likely to further improve corporate governance in the future.

However, a number of concerns remain. First, there remains doubt as to whether current and proposed securities and company legislation, and the general legal framework in Singapore accord adequate protection to the rights of minority shareholders to encourage them to increase their participation in share ownership. In the absence of such protection, ownership in Singapore is likely to remain heavily concentrated with significant ownership by executives (and their families), which violates the separation of decision management and decision control, and leads to the inefficient sharing of risks. Second, the continued participation of the government in many private sector firms reduces the exposure of these firms to competitive markets and creates moral hazard problems through implied performance guarantees. Given the perceived need to use these government-owned companies as tools for economic development and regionalisation of the domestic economy, we are doubtful that Singapore will move towards a model of corporate ownership in which the government does not own significant equity in private sector firms. Thus, we feel there is an urgent need to improve the accountability, management and monitoring of these government-owned companies. Third, the shift towards a disclosure-based regime suggests significant changes in the way the accounting profession will be regulated, accounting standards set and accounting rules enforced. We believe this is a step in the right direction. However because there are powerful vested interests in maintaining the status quo[24] there is a real danger that if these changes are not made quickly and decisively, they will be watered down. The corporate governance regime will be weakened further rather than strengthened by the shift towards a disclosure-based regime.

NOTES

1 Jensen and Ruback, 1983.

2 The discussion in this section draws heavily from the Ministry of Trade and Industry webpage, http://www.gov.sg/mti/mti4.html.

3 Source: Statistics Singapore's website (http://www.singstat.gov.sg/FACT/KEYIND/keyind.html)

4 Source: Statistics Singapore's website (http://www.singstat.gov.sg/FACT/KEYIND/keyind.html)

5 The source of data for the discussion in this section is Recent Economic Developments in Singapore, Monetary Authority of Singapore, 23 November 1998.

6 See Report on Banking Disclosure, May 1998; Report of the Corporate Finance Committee, 29 October 1998; Report of the SES Review Committee, 29 July 1998.

7 Li, 1994; Prowse, 1998.

8 Fama and Jensen, 1983.

9 La Porta et al., 1996.

10 The exception is a management share issued by a newspaper company under the Newspaper and Printing Presses Act.

11 According to some commentators, hostile takeovers should be encouraged because they engender the creation of shareholder value by freeing up cash that has been inefficiently employed (Jensen and Ruback, 1983).

12 The SES, incorporated under the Companies Act and licensed as a stock market under the Securities Industry Act, is regulated by the Securities Industry Act and Regulations and supervised through a set of rules and bye-laws enforced by the 9-member Stock Exchange of Singapore Committee.

13 Recently, some commentators have criticised the decision of the ICPAS not to adopt the new IAS standard on extraordinary items after issuing the exposure draft for comment. The new IAS standard would have tightened considerably the reporting of extraordinary items.

14 In the US, for example, such giant pension funds as the California Public Employees Retirement System (CalPERS) are widely known to be active monitors of investee companies. They develop yearly 'hit' lists of under-performing companies, hold closed door meetings with boards to encourage a shareholder friendly business agenda, organise shareholder revolts through the proxy system, and employ the heavy leverage of public opinion and the popular media to pressure companies to conform to best practices standards for corporate governance.

15 Interestingly, the large institutional investors in the US are almost unanimously against the use of representative directors for this very reason.

16 Singh and Siah, 1998.

17 This can be contrasted with the approach adopted in New Zealand, which underwent a significant restructuring of its public sector in the 1980s. Under the New Zealand approach, many government departments were converted into state-owned enterprises (some were fully privatised), and a major thrust in this restructuring involves the appointment of private sector managers to senior positions within these enterprises.

18 La Porta, Lopez de-Silanes, Shleifer and Vishny, 1998.

19 *Business Times*, 23 August, 1997.

20 *Straits Times*, 15 May 1998, p.52.

21 Lim, 1997.

22 Jensen, 1993.

23 Demsetz and Lehn, 1985.

24 The opacity of financial statements serves the interests of entrenched management and large shareholders who have ready access to private information and can therefore expropriate residual that rightly belongs to the less informed minority shareholder.

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Annnex 1

Review of the financial sector: key initiatives implemented to-date

Banking	Insurance	Fund Management	Equity and Futures Markets	Bond Market
Raised bank disclosure standards Discontinue practice of maintaining hidden reserves Provide details on loan loss provisions Disclose off-balance sheet items in notes to accounts Disclose significant exposures Clarified and liberalised guidelines on S$ loans for regionalisation projects Lowered minimum cash balance (MCB) from 6% to 3% Raised limits on offshore banks' S$ loans to residents from S$200mn to S$300mn. Launched real time gross settlement system for interbank payments	Liberalised investment limits on Singapore General Insurance and non-investment linked life insurance funds Put in place easier operating environment for captive insurers Reduced paid-up capital requirement from S$1 mn to S$400,000. Captive insurers allowed to write prescribed non in-house risks Enhanced tax incentives Extended 10-year tax exemption for Singapore-registered insurers in respect of income from offshore marine hull and liability business	Committed to place out S$25 bn of GIC funds and S$10 bn of MAS funds over next 3 years for external fund managers to manage (GIC placed out S$6.5 bn as at Sep 1998) Revamped CPF investment scheme Set new selection criteria for CPF-approved fund managers Set new investment guidelines and introduced disclosure requirements for CPF-approved unit trusts Liberalised guidelines for non-CPF unit trusts Introduced new investment, borrowing and advertising guidelines Removed minimum investment requirements for unit trust regular savings plans Reduced entry requirements for foreign companies setting	Eased conditions for foreign companies to list in S$ on the SES (see MAS 757) Removed limit on investments in foreign currency-denominated shares by CPF-approved unit trusts Launched new equity derivative contracts SIMEX launched MSCI Singapore Stock Index Futures (Sep 1998) and Dow Jones Thailand Stock Index Futures (Nov 1998); and relaunched MSCI Hong Kong Stock Index Futures (Nov 1998) Widened scope of activities for stockbrokers Reviewed SIMEX membership structure to allow SES members to apply for SIMEX membership so as to market and trade SIMEX's equity index contracts Facilitated applications by stockbroking firms for investment adviser licences	Increased government debt issues and announced a regular calendar of issues Issued S$1.5 bn of 10-yr Singapore Government Securities (SGS) Increased bond issues by statutory boards like JTC, PUB and HDB JTC launched S$4 bn medium-term note programme; HDB announced plans to issue S$2 bn worth of bonds Allowed foreign entities to issue S$-denominated bonds in Singapore (see MAS 757) International Finance Corporation launched the first triple A S$ bond issued by a foreign borrower (Oct 1998) Allowed banks to transact S$ repurchase agreements of up to S$20 mn with non-bank non-residents Allowed banks to transact S$

Banking	Insurance	Fund Management	Equity and Futures Markets	Bond Market
Facilitated regulatory co-operation Made it easier for foreign regulators to inspect Singapore branches of their banks		up as investment advisers in Singapore Reduced minimum shareholders' funds from S$500 mn to S$100 mn Reduced minimum global funds managed by parent company from S$5 bn to S$1 bn Enhanced tax incentives	Introduced new Best Practices Guide on Audit Committees and Dealing in Securities Legalised share buy-backs Commenced inspection of securities market intermediaries	currency and interest rate swaps with special purpose vehicles for securitising mortgages Allowed CPF-approved unit trusts to invest in high grade bonds
Allowed foreign banks to disclose information on credit facilities to their parent advisory authorities		Abolished withholding tax on unit trust distribution Extended tax exemption to unit holders' distributions made out of capital gains Exempted from tax fund managers managing more than S$5bn in Singapore.	Enhanced tax incentives Extended certain tax incentives for venture capital funds for a further 5 yrs beyond the current maximum of 10 yrs. Renewed tax holiday for SIMEX for another 5 yrs Suspended stamp duty on securities transactions for 1 year wef 30 Jun 1998.	Introduced tax incentives to encourage origination and trading of debt securities in Singapore

Source: Singapore's Financial Sector, Monetary Authority of Singapore's website (http://www.mas.gov.sg/singfinsec/singfinsec_finsecreview-c.html

Review of the financial sector: key initiatives currently being worked out

Banking	Insurance	Fund Management	Equity and Futures Markets	Bond Market
Implement risk-focused approach to bank examinations Conduct more focused and regular inspections to distinguish stronger banks from weaker ones	Review investment guidelines for investment-linked insurance policies Enhance operating environment for captive insurers Introduce new reinsurance products Study the actuarial and accounting issues relating to the introduction of specialised pioneer products such as alternative risk transfer products	Consolidate unit trust regulation in MAS Review Trustees Act Relax investment restrictions on statutory boards, private pension funds and authorised unit trusts Delink investment limits under CPFIS from Trustees Act Put in place regulatory framework for private pension funds Introduce regulatory framework for independent financial advisers Introduce code of ethics for fund managers Create conducive environment for indigenous boutique fund managers Introduce training programmes to develop local fund management expertise	Progressively deregulate commission rates Progressively open up to foreign participation in the stock-broking industry Liberalise employee share option (ESOP) schemes Widen product range in equity market Expand the SES options market by introducing options on more stocks Introduce new products (e.g. stock index options, country basket of shares, listed property trusts/real estate investment trusts) Develop an electronic bulletin board/organised OTC market on SES for trading foreign securities Demutualise and merge SES and SIMEX Shift from merit-based regulation towards predominantly disclosure-based regulation Consolidate securities regulation in MAS to reduce duplication and improve efficiency	Promote asset-backed securities market Resolve legal and regulat issues relating to asset-backed securities The Housing and Development Board is considering the issuance o mortgage-backed securitie Introduce regulatory guidelines for underwriter and dealers and trading ru for debt securities Develop efficient clearing system for corporate bond

Source: Singapore's Financial Sector, Monetary Authority of Singapore's website (http://www.mas.gov.sg/singfinsec/singfinsec_finsecreview-c.html

Annex 2

Summary of recommendations of the Corporate Finance Committee

Philosophy of Regulation

Recommendation 1:

A predominantly disclosure-based philosophy of regulation should be adopted as it best fosters a market-driven environment that promotes innovation, entrepreneurship, efficiency and business flexibility while protecting the integrity of the securities market.

The Regulatory Framework

Recommendation 2

To raise the standard of disclosure, there should be a comprehensive and stated legal obligation to disclose.

Recommendation 3

Laws and rules applicable to the securities market, as distinct to core company law, should be consolidated into a single legislation.

Recommendation 4

There should be three tiers of rules. These would consist of primary legislation, secondary legislation and non-statutory rules.

Recommendation 5

a) Securities market rules should as far as possible be made statutory.

b) The securities regulator and the SES should publish their policies and interpretations on rules to provide greater transparency to the market.

c) The securities regulator and the SES should also provide reasons for decisions, and allow an avenue of appeal against the decisions.

Recommendation 6

a) The single securities regulator model should be adopted to clarify responsibility and accountability and raise efficiency. Securities regulation should be consolidated and administered by a securities regulator.

b) The securities regulator would enforce all aspects of securities law and regulations, including disclosure obligations. The RCB would administer core company law. Criminal prosecution would continue to be done by the CAD or the Attorney General's Chambers. The SES would operate a securities exchange and promote the growth of the securities market. The SES' role as a conduit between market participants and the government, to give feedback to government departments to promote growth, would be enhanced. The SES would approve listing applications, undertake market surveillance, monitor continuing disclosure, promote corporate governance and enforce its Listing Manual. Where a breach of the law is suspected, the matter will be handed over to the securities regulator for investigation and enforcement. It would continue to regulate its member firms.

c) The securities regulator should be distinct from and should not be subordinated to the banking prudential regulator.

Recommendation 7

a) The securities regulator should have power to enforce securities regulation, including pursuing civil actions in the public interest.

b) The public interest test must be properly defined to reduce the uncertainty over when the securities regulator will pursue civil actions, and to avoid moral hazard.

c) The law should allow for damages awarded to be distributed to investors. The securities regulator should be able to offset its cost against the damages awarded before distribution to investors. It should be allowed to retain the damages awarded unless and until valid claims are made against it by investors. The rights of individual investors to litigate for themselves should be preserved, but the securities regulator should have the right to intervene in litigation brought by private litigants or to initiate litigation on its own in the public interest.

Recommendation 8

The securities regulator should be empowered to impose administrative sanctions for breaches of its rules. The SES should continue to impose contractual sanctions for breaches of its Listing Manual. The power to impose fines for breaches of securities regulation should be reserved for criminal prosecutions.

Recommendation 9

The securities regulator should be granted investigative powers to enforce both statutory and non-statutory securities rules. Where the securities regulator finds evidence of criminality in its investigation, it should refer the matter to CAD or the Attorney General's Chambers for criminal investigation.

Recommendation 10

a) A civil right of action for insider trading, which is independent of a criminal conviction, should be created to enable persons to obtain compensation for losses suffered as a result of insider trading.

b) The plaintiff must show that the trading was contemporaneous with the insider trading, but not that the counterparty who dealt with the plaintiff's shares was the insider.

c) The securities regulator should be allowed to intervene in or commence civil actions for insider trading.

d) The insider trader should be liable for all losses suffered by all contemporaneous counterparties, up to a certain maximum value. If the losses claimed are more than the maximum value claimable, the maximum value is to be distributed to the claimants on a pro-rata basis. Where the civil action is pursued by the securities regulator, it should be allowed to retain the damages awarded unless and until valid claims are made against it by investors.

A High Standard Of Disclosure

Recommendation 11

a) The disclosure requirement should be in the form of a general test in primary legislation supplemented by checklists in secondary legislation. The general disclosure test should cover both prospectuses and continuing disclosure. Primary legislation should empower the securities regulator to make disclosure checklists as it considers necessary.

b) Prospectuses and all continuing disclosure should disclose all information that investors and their professional advisers would reasonably require and expect to find in order to make an informed investment decision.

Recommendation 12

The prospectus checklist for local and foreign issuers should be substantially similar to the proposed International Disclosure Standards on prospectus disclosure with appropriate modifications (which should be kept to a minimum) to meet local requirements.

Recommendation 13

Issuers should be allowed to issue an additional mini prospectus that is more useful to the target audience by providing such investors with the information which they need without unnecessary details. Certain detailed information may also be incorporated by reference in the full prospectus but lodged with a relevant authority and be available for inspection at a website or at the company's registered office.

Recommendation 14

The disclosure checklist for rights issue abridged prospectuses and placement statement of material fact should consist of the items currently required in Part V of the Fifth Schedule of the Companies Act and information on the intended use of the proceeds and how the use of the proceeds will impact on the financial performance of the issuers.

Recommendation 15

a) The period to present annual reports of listed issuers to shareholders should be shortened to five months from the end of the financial year.

b) To allow more timely preparation of financial statements, the Companies Act should be amended so that auditors can express their opinion on the consolidated financial statements of the holding company without all the financial statements of the subsidiaries having to be signed off by their respective auditors. The amendment should also allow subsidiaries, especially those located overseas, to have their financial year end not more than, say, two months earlier than that of the holding company, except in the case of subsidiaries in jurisdictions where financial year ends are mandated by legislation.

Recommendation 16

Listed issuers should be encouraged to report their results on a quarterly basis. Subject to changes to the law to permit more timely preparation of financial statements, interim results should be released within 60 days of the period end.

Recommendation 17

a) The securities regulator should have the power to prescribe accounting rules for companies that are listed or have made public offers of securities in Singapore and for public offering documents.

b) Foreign companies not already preparing their financial statements in accordance with the prescribed standards should reconcile their financial statements to accounting standards prescribed by the securities regulator.

c) The securities regulator may grant exemptions to allow locally incorporated public companies that are listed or are making public offers to comply with prescribed accounting standards other than Singapore accounting standards.

Liberalisation and Development

Recommendation 18

a) The SES should continue with its strategy to have different boards to cater to different market segments, for both local and foreign companies, such that:

i. The Main Board should be a market for companies with an established profit track record or large market capitalisation.

ii. SESDAQ should be a market that provides for greater flexibility.

iii. The Foreign Board can be abolished as the Main Board and SESDAQ could cater to companies that would have qualified for the Foreign Board.

iv. The listing criteria for foreign and local companies should be identical.

b) Foreign companies should be allowed to decide the currency in which they trade their shares in order to attract more foreign listings to the SES.

c) The Main Board track record listing criteria would require that the listing applicant's management team remains substantially intact. The continuity of management rule should not apply to companies that seek admission to the Main Board based on the market capitalisation criteria.

d) The SES should consider providing some quantitative benchmarks in its listings criteria on promoters' integrity. The securities regulator may exercise judgement to decide not to accept the prospectus which a listing applicant has lodged where it has confidential information which creates doubt about the integrity of the promoters.

e) Singapore should eventually follow the international practice regarding moratorium on securities disposals, which is driven by investors and underwriters. In the interim, it is proposed that the SES Listing Manual be revised to provide as follows:

i. The promoters of Main Board issuers should give a contractual undertaking to the issue manager that, in the first six months, they will not dispose of any part of their holdings, and in the following six months, they will retain at least 50% of their original holdings.

ii. The promoters of SESDAQ issuers should give a contractual undertaking to the issue manager such that, in the first year they should not dispose of any part of their holdings, and in the following year, they should retain at least 50% of their original holdings.

iii. Promoters subject to the moratorium rule are substantial shareholders who have control over the applicant and associates of such substantial shareholders.

iv. Promoters' shareholdings in the listing applicant's holding company which is listed on a stock exchange should not be subject to the moratorium..

v. Institutional or strategic investors who take a significant stake in a company within one year prior to the company's listing should be subject to a moratorium period of six months.

<u>Recommendation 19</u>

A listed issuer may raise funds without any specific use of funds subject to disclosure of the rationale for the fund raising and to disclosure of material utilisation of the funds as and when the funds are subsequently deployed.

<u>Recommendation 20</u>

a) Listed issuers may obtain a general mandate to issue new shares by way of rights shares, bonus shares or placement shares, or any combination thereof, subject to an overall limit of 50% of the issuer's existing issued share capital.

b) Consideration should be given to allowing the rights shares to trade on a "when-issued" basis immediately after the close of the rights issue.

c) Listed issuers should have the option to sell excess rights shares in the open market.

<u>Recommendation 21</u>

a) Listed issuers may include in the annual general mandate a sub-limit for placements of securities representing up to 20% of the existing issued share capital.

b) Listed issuers may sell placement shares at up to a discount of 10% from the current share price. The price should be based on the weighted average price for trades done on the day of announcement, which provides a better representation of the price done on the day in question.

c) A listed issuer may borrow shares from substantial shareholders for placement, in anticipation of the placement shares being issued.

<u>Recommendation 22</u>

a) The overall limit for warrants and convertibles can be raised to 100% of issued share capital.

b) The issuer should have the flexibility to determine the exercise price for warrants and convertible securities.

<u>Recommendation 23</u>

Listing approval for debt securities offered to sophisticated and institutional investors could be given when the issue is fully subscribed. Such securities need not comply with any listing criteria.

Recommendation 24

The documentation requirements for listing applications should be simplified to require only a brief listing application covering essential corporate information, with the substantive information about the listing applicant and its offering given in the draft prospectus.

Recommendation 25

a) Issuers and their underwriters should be allowed to decide how their issues should be distributed, subject to compliance with the SES' rules on prescribed shareholding spread and other rules to prevent undue concentration of holdings, so as to promote liquidity and an orderly market in the securities. It should be left to them to decide whether to distribute the issues by placement or public offer or a combination of both, to choose their end investors, and whether or not to accept multiple applications.

b) The bookbuilding method of securities distribution should be adopted in Singapore securities as an alternative to or in combination with other methods. Consequent changes are required to permit the issue of "red herring" prospectuses and to allow price stabilisation for Singapore dollar initial public offerings.

c) Changes should be made to permit "when issued" trading for initial public offerings to commence on the market day following the close of the offer.

Recommendation 26

a) For the Main Board, SES could consider adopting a graduated scale for size of free float that varies according with the amount of proceeds raised to provide flexibility in raising funds.

b) To allow SESDAQ companies to have greater flexibility, they should be subject to a spread requirement which is less stringent than Main Board companies.

Recommendation 27

The SES should consider setting continuing free float and spread requirements at a percentage of the levels set for initial listing, in order to maintain a fair and orderly market.

Recommendation 28

a) The rules on corporate governance should eventually take the form of principles and best practices which listed issuers should evolve and observe.

b) Listed issuers should disclose in their annual report the corporate governance practices and procedures in place during the financial period under review. To achieve wide acceptance, a Code of Best Practices on Corporate Governance should be developed by a body with wide sectoral representation. To give such a code the desired effect, the SES should require listed issuers to disclose how they have applied and complied with the Code or, where appropriate, to make a negative statement.

Recommendation 29

a) Controlling shareholders (defined as a person with the capacity to dominate decision-making, directly or indirectly, in relation to the financial and operating policies of the company) in executive positions should be allowed to participate in ESOS, subject to specific approval by independent shareholders of their participation and the actual grant of options. For Main Board companies, the participation by controlling shareholders should be subject to specific individual and aggregate limits.

b) Participation in ESOS should be extended to non-executive directors as well as directors and employees of the parent group whom the listed issuer considers to have contributed, or can contribute, to its success, subject to annual disclosure.

c) Unlisted subsidiaries of a listed issuer are free to implement their own ESOS, subject to approval of the listed parent issuer's shareholders.

d) For Main Board companies, the current scheme size limit of 5% should be increased to 15% and eventually removed. For SESDAQ, no limit should be imposed on the size of the scheme. There should be no individual or class limits.

e) Options may be granted at a discount to market price if the options are exercisable only after a specified vesting period, and shareholders have specifically approved the quantum of the discount.

f) Options should not be exercisable within one year of the date of grant. For employees who have served less than a year, the issuer should have the discretion to decide whether to impose a longer moratorium.

Recommendation 30

a) The law on directors duties should be augmented to cover interested person transactions, such that a breach of which could attract legal remedies that can be enforced by shareholders and the securities regulator.

b) In the interim, interested person transaction rules could be streamlined to give greater flexibility to listed issuers, where the interest of public shareholders is not put at risk, as follows:

1. The scope of interested person transactions should be modified to exclude transactions which involve potential conflict of interest that is remote, or no conflict of interest, by narrowing certain definitions as follows:

- An "interested person" is a director, chief executive officer, or controlling shareholder of the listed issuer; or an associate of any such director, chief executive officer, or controlling shareholder.

- An "associate" is a person who is an immediate family member, or company or trust in which the person and his immediate family has control. An "entity at risk" is the listed issuer, its subsidiaries, and associated companies over which the listed issuer and its interested person have control.

- "Control" means the capacity to dominate decision-making, directly or indirectly, in relation to the financial and operating policies of the relevant company.

2. Materiality thresholds that trigger an announcement and/or shareholders' approval should be expressed in terms of a percentage of the listed issuer's net tangible assets and not as an absolute number.

Recommendation 31

Compliance with the new listing criteria for very substantial acquisitions should be based on the enlarged group, instead of just the acquired assets. Very substantial acquisitions of businesses or assets in a similar line of business which meet certain prescribed conditions should not require SES and shareholders' approval.

Recommendation 32

a) The formation of business angel networks and other forms of informal funding sources should be supported.

b) A programme to assist companies to put up coherent business and financial plans should be developed.

Recommendation 33

To cater to companies that may find listing on SESDAQ uneconomical, consideration should be given to setting up an Internet based bulletin board to provide an infrastructure for private venture capital transactions, which is restricted to sophisticated investors and venture capitalists.

Recommendation 34

To develop the venture capital sector and to build Singapore into a hub for regional venture capital activities, the following initiatives should be considered:

a) Continue to attract foreign venture capitalists with the experience and comfort levels in investing in and nurturing start-ups for public listing and foreign investment banks that specialise in underwriting start-up companies and companies with no profit track record.

b) Leverage off the already established base of regional venture capitalists by promoting a range of services to regional venture capitalists and regional companies from the Internet bulletin board, business plan assistance, business angels network, and eventual listing on SESDAQ.

Recommendation 35

To further develop investment banking activities in Singapore:

a) Focus should be given to attracting clusters of inter-related components of investment banks, as well as supporting legal and accounting and information technology professionals.

b) Large global investment banks should be targeted to centre their Asian or ASEAN equity divisions in Singapore by facilitating their membership in the SES sooner rather than later.

c) The Financial Sector Promotion body in MAS should be given a pivotal and authoritative role, both in laying groundwork for development and in promoting Singapore to leading investment banks. The SES should complement the Financial Sector Promotion body with respect to the listing and fund raising activities conducted on the SES.

Recommendation 36

As liquidity is an important magnet for industry participants, the following steps are recommended:

a) Introduce derivative contracts on currency, interest rate and index futures of Asian countries.

b) Clarify the law on the trading of OTC derivatives to facilitate the growth of the derivatives business.

Recommendation 37

There should be a review of Singapore's tax environment to make it more competitive and to remove any impediments to innovation in the financial industry and attracting professionals to locate to Singapore, including a review of the need to impose withholding tax on financial instruments.

Recommendation 38

a) The adoption of technology should be accelerated to better connect into the international financial system, facilitate information distribution, fund raising, trading, and the exercise of shareholders rights.

b) As a start, the Internet should be accepted as a medium for distributing prospectuses and other continuing disclosure requirements. If necessary, the law should be changed to allow this.

Source: Monetary Authority of Singapore

CORPORATE GOVERNANCE: THE CHALLENGE FACING THE THAI ECONOMY

by
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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. 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 had been 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 a 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 companies fetched only 25-30% of the face value due to unreliable accounting[1]. Poor accounting also poses a major obstacle to the on-going debt restructuring process. Unreliable financial data has caused distrust among creditors and debtors. In transparent 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, recapitalisation has been slow in coming.

The crisis brought a major shift in the structure of 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.

II. Corporate governance

The general economic context

Thailand is a small open economy with 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.

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Much of the growth was generated by the booming export sector. During 1985-90 export grew on average 24.92% per annum. High growth continued throughout the early nineties. In 1994 and 1995, export expanded at 21.34% and 23.58% respectively. Traditional exports of agricultural products such as rice, tapioca and rubber were gradually replaced by manufactured goods, namely computers and parts, electrical appliances, 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 capital, 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 increase 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 on average an increase in its share 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 enterprises to have access to overseas capital. But freeing capital flows without concurrent liberalisation of the domestic banking industry left a gaping disparity 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 further to US$ 83.3 billion 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 capital, but also destroyed many local export industries pre-maturely as the domestic currency 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 that prevail 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, Thai inflation thereafter persistently exceeded that of 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 DM. The strong dollar had a devastating impact on Thai exports, whose yearly growth plunged from 23% in 1994 to mere 0.9% in 1995.

The strong baht adversely affected many export industries, particularly labour-intensive goods such as textiles, footwear, integrated circuits and parts, which lost their competitiveness to low-wage competitors such as Indonesia, China and Vietnam. The slowdown of the once booming export sector represented an ominous sign of the impending 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 and the foreign debt at 51% of GDP, put Thailand on the watchlist of the

IMF as well as that of foreign investors. What was most worrying was not so much the size of the foreign debt as its 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 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 its long history- was shaken. The exchange rate peg regime, once sacred, became questionable.

The baht came under a series of attacks early in 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 had allowed many years of macroeconomic stability and economic prosperity, blindly defended the currency. In total, US$ 23 billion were spent in a series of attempts to shore up the baht. On the eve of the baht float, the stock of foreign exchange reserves net of currency swap arrangements was merely 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 the real sector had serious impact on the financial sector. As a result, 56 finance companies were closed, 4 banks were 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 unemployed in early 1999. The economic crisis had also begun to take its toll on the number of bankruptcies, which surged in 1998.

The immediate task was to save the financial 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 way, but is still met with very little success as debtors and creditors cannot agree on how much of a “hair cut” creditors are supposed to take and what the future business prospects will be. Several laws, such as the bankruptcy law and the foreclosure law, are also being revised to facilitate quick debt restructuring. The alien business law and the land-ownership law are also being revised to create a more attractive investment environment.

Characteristics of corporate governance

Corporate governance agents

Ownership among Thai corporations is concentrated. Table 1 exhibits the average size of equity share of the 3 largest shareholders among the 10 largest listed companies in 1998. In the 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, as in most other East Asian countries, control of the Thai corporates is often in the hands 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)

The management of Thai business enterprises has been predominantly family-run as pioneered by Chinese merchants. Many of these families have prospered and built 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 recent crisis, however.

Struggling to emerge from a massive debt burden as a result of the sharp depreciation of the baht and the burst of the economic bubble, many of these family-run business empires had to shed a number of their subsidiaries to keep their core businesses afloat. Other less-fortunate ones had to sell off large equity shares in their core businesses. Those involved in banking for generations saw their ownership evaporate within a stroke of the 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 recent crisis has had, and will continue to have, a significant impact on the Thai corporate ownership structure as 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 nationalisation 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, and more can be expected through the current government-sponsored recapitalisation scheme. A significant increase in foreign shareholding is also expected in many sectors, in particular those most affected by the crisis such as banking, finance and securities, insurance, and public utilities (i.e. 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, Thai corporate ownership could be witnessing a much greater foreign presence.

With concentrated shareholding, the control of Thai corporates fell almost entirely into 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 major corporate decisions which require majority share approval, approve interested business transactions, or even change the corporate charter.

Table 2: Post-crisis foreign acquisition of listed companies
(%)

Industry	Company	Foreign share 02/97*	Foreign share 11/98**	Investor- share details
Agribusiness	Advanced Agro	29.38	37.04	Enso Co., USA
Banking	Bangkok Bank Ltd	25.00	48.78	Singapore Government
	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)
	Krung Thai 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
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 17.8%
	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	

Source: *HSBC James Capell: *Thailand Investment Strategy*, March/April 1997.
** Capital Nomura, *Monthly Review*, November/December 1998.

Note: Italicised figures are those from authors' own calculation based on SEC data. The presented figures for foreign ownership share exclude those smaller than 0.5%. Thus, the figures may be slightly understating the true share.

Table 3: Type of ownership share of top 5 largest shareholders among 150 largest listed Thai companies in 1997

Type of Investor	Share (in %)
Private companies and holding companies	38.38
Individuals	21.38
Foreign banks (incl. securities companies and nominees)	15.41
Domestic banks	5.18
Finance and securities companies	5.84
Insurance companies	2.00
Others	11.81

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

The key question is *Who controls the Thai corporate*? The composition of investors with a potential controlling share - i.e. the top 5 largest shareholders - are mostly private companies or holding companies (38% of the total number of the top 5 shareholders), as can be seen in Table 3. One should take note, however, that many of these companies are unlisted and 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 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 the top 5 shareholders with 21.38%. Except for foreign banks, other institutional investors - i.e. commercial banks, insurance companies and finance companies - appear not to hold a significant controlling share in the listed Thai companies. This can probably be explained by the 10% cap on equity share that 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.

Corporate control may vary widely across industries. Table 4 shows the top 5 shareholders classified by type of investors for selected industries. Individual corporate control is particularly prominent in the property and finance and securities sectors; interestingly, these are 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 the top 5 largest shareholders in banking and finance and securities[2] as well as in energy, telecommunications and electronics. However, because of the 10% ceiling imposed on banks' holding of private companies' shares, their corporate control is usually limited. Only in a few cases does a bank represent the largest shareholder.

Thai banks' corporate control appears to be concentrated only in financial businesses, namely in insurance, finance and securities, where banks are allowed unlimited ownership as can be seen in Table 4. The control by banks and finance companies of listed non-financial companies is negligible and therefore 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 the controlling share 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 hypothesises that Thai banks prefer to invest in businesses where they can secure a controlling stake. Banks *do* recognise the value of corporate control.

If these indirect and unlisted holdings are 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 institutions' relationship with non-financial enterprises is more one of creditor than investor.

Table 4: Top 5 shareholders of 150 largest listed companies classified by industry
(%)

Sector	Foreign banks	Thai banks	Insurance	Finance	Company	Individual	Govern-ment*	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

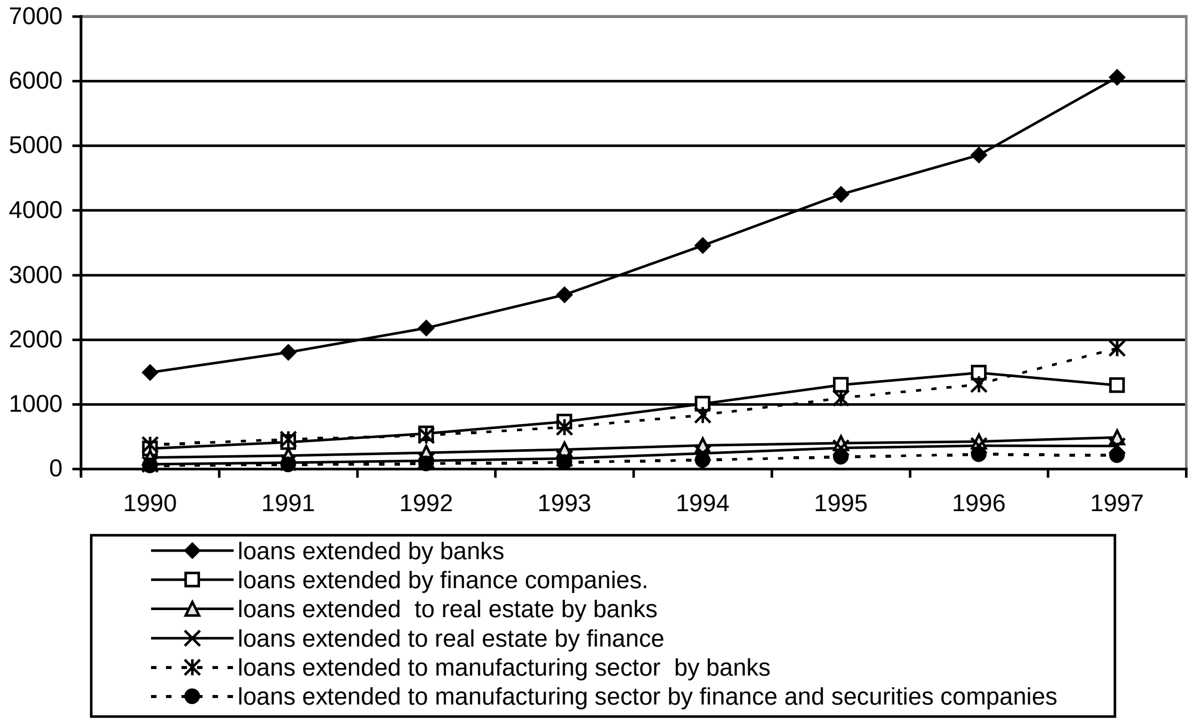
Source: Author's calculation from data from the Stock Exchange of Thailand.
* Government holding includes shares held by the Crown Property, the Ministry of Finance, the Financial Institute Development Fund, state-owned enterprises, and other government organisations.
** Others include mutual funds and shares depository centre.

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 or securities company, they were also indirectly exposed to the bubble sector.

Chart 1 shows 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 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 56 finance companies despite a series of attempts 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 the folding manufacturing sector. As the health of the banking sector began to deteriorate, the ripple effect was beginning to take its toll on some insurance companies affiliated with commercial banks.

Chart 1: Commercial Banks' and Foreign Companies' Exposure to the Bubble Sector



Source: The Bank of Thailand

Corporate behaviour, financing and restructuring

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 sources of financing, rapid economic expansion was afforded by the expansion in banks' credit extensions. Consequently, the debt/equity ratio, or the leverage ratio, of Thai corporates rose dramatically from 1.6 in 1988 to 2.36 in 1996, the eve of the economic crisis.[3] This ratio was the highest among East Asian countries with the exception of Korea and Japan, which showed leverage ratios of 3.54 and 2.37 in 1996, respectively.

As Thai companies were 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 39.37%.

It is clear that the Thai corporates were very vulnerable to external shocks. The sharp depreciation of the baht increased the debt burden of many Thai corporates dramatically. Coupled with a sharp drop in domestic demand, Thai corporates were squeezed by both falling revenues and increasing costs.

This recent 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 bank funds have been channelled into building the required reserves, and funds available for loan extensions have been very limited. Thus, corporates have had to look for alternative sources of financing. Most have turned to corporate bonds. With mounting debt incurred in bailing out financial institutions 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 corporate financing from bank credits to corporate debentures and bonds.

II. Regulatory framework and the role of policy

Equitable treatment of shareholders and other stakeholders

Shareholder protection

The concept of shareholder rights and duties as a corporate owner is relatively new to Thailand. Only in 1993 was the Public Company Act B.E. 2535 introduced. The law offers a relatively comprehensive protection of basic shareholder rights as shown in Table 5. One may criticise that the minimum of shares 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% suffice. But the only serious omission in the provisions for shareholders' 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 some regulatory loopholes. 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 request them to ask their clients (shareholders) to send a backdated letter authorising 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 shareholders' meetings. Minutes of shareholders’ meetings 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 shareholders' lack of participation in corporate management can also be a matter of choice rather than of circumstances.

In the past, minority shareholders rarely exercised their rights, as few were aware of their rights and duty as 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' 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 shareholder activism in Thailand.

Table 5: Protection of minority shareholders' rights

Shareholders Rights	Availability	Minimum Share Requirement
Quorum for shareholder meeting		1/3 of all votes
		½ of all voters
Right to call emergency shareholder meeting	yes	1/5 of all votes
Right to dismiss directors	yes	¾ of voters present
		½ of votes present
Right to audit firm's financial statement and directors' management		1/3 of all voters
		1/5 of all votes
Right to make proposals at shareholder meetings	yes	1/3 of all votes
Right 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

To be an optimist, this crisis may have given birth to shareholder 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 shareholder meetings has begun to appear. This nascent shareholder activism should be nurtured not only by provisions of protection of their rights, but also by a guarantee of access to accurate and timely corporate information.

The role of the board of directors

The board of directors 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 small shareholders through the majority rule. Consequently, both directors and managers represent only the interests of the large shareholder rendering the designed internal corporate control ineffectual.

In the corporate governance literature, there are several proposed measures that can promote independence of the board; these include 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 to certain insiders. In a society where patronage runs deep, such ties can be rather entrenched.

Thus, the boards of directors are often staffed not with qualified professionals who would monitor management of the company, but 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 directors. The law states clearly that directors are jointly responsible for clear violations of the rules of law such as falsifying documents – i.e. shareholder meetings' minutes or the company's financial statements - concealing vital information from authorities, breaking the rules regarding distribution of dividends, extending loans to the directors, etc. When it comes to the board's accountability to its fiduciary duty, however, the law is very 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 meetings, with honesty to protect the interest of the company.*"

With such a statement, and barring 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.

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 statements 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 Revenue or the Stock Exchange Commission. Unlisted companies may have three versions: one for the owner, another for the business partners, and the third one for the taxmen. Poor accounting standards 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 accountants can manipulate the numbers to make the financial report 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 fails to convince the Cabinet that a price increase is required, revalues its assets so as to inflate depreciation and hence, cost. 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 temporarily withdrew its professional certification from two well-known auditors of two reputable auditing companies - one Thai, the other foreign. While such a penalty itself may not be severe[4], the social sanction proved much more caustic.

Auditing, like credit rating, suffers from potential conflicts of interest. Hoping to keep a good business relationship with a company, auditors are often unwilling to report potentially damaging oddities.

To promote an arm's 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 given company through a lottery. A company can choose among the allotted auditors only. But such a scheme requires a relatively 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 standards, 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, 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 does not happen because of ethics; it happens because of 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), have set a corporate governance standard for companies in which they will invest. American credit-rating agencies also rate a company on its corporate governance. Therefore, for self regulation to be effective, investors will have to demand it. Again, this crisis certainly made investors much more cautious about where they choose to put their money.

The role of institutional investors

As discussed above, small shareholders cannot expect to rely on the board of directors 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 products and pension plans can also be seen as an individual's indirect investment in corporate equity shares. 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 relatively good corporate governance often have large institutional investors, such as commercial banks in Germany[5], mutual funds in the US, or pension funds in the UK. In the case of Thailand, the promotion of institutional investors 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 institutions that we are where we are today? How can one then expect to rely on these institutions 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 were lending extensively, as most housebanks (such as those in Germany and Japan) often do. This may be due to two factors. First, a large part of the loans extended by commercial banks was secured through personal connections. Thai banks rarely scrutinise the feasibility of projects; rather they rely on the 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 the 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 suspected is that they often have vested interests in the companies that they invest in. 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 "conflicts of interest", and the other for imprudent investment.

To conclude, unless 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 to promote the interests of small shareholders. After a lengthy analysis, we are back to square one. After all, in the immediate term, shareholders may have to make 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.

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 such control runs against the basic concept of accountability, equity and transparency, the three pillars of good corporate governance.

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 as to how 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 system 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 realise 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 the financial report to make the company look better than it actually is, then why should you submit a veritable report that may make your company look worse than your competitor's? Thus, bad accounting *must* be penalised 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 behaviour 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, the 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 the board's independence, rights of the shareholders, development of a long-term equity market, etc. These are important, but are secondary to those mentioned above. If we get our accounting right and are able to take legal actions against abusive behaviour by corporate insiders, then we can believe that bad corporate governance will no longer pay.

NOTES

1 The bid submitted by a (well-informed) foreign consulting company that 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.

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

3 See Claessens, Stijn, Simeon Djankov and Larry Lang (1998).

4 The revised auditing law, currently under scrutiny by the parliament, imposes harsher penalties.

5 German banks exercise corporate control through custodianship of shares deposited therewith.

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CORPORATE GOVERNANCE IN CHINESE TAIPEI

by
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I. Introduction

The Asian financial crisis that began in mid-1997 has produced serious consequences for the economic and financial development in the Asia-Pacific region. Some factors contributing to the financial crisis are found in the inadequate corporate governance systems of the affected countries. Chinese Taipei is no exception in this regard, even though its corporate governance environment is somewhat different from other countries. This paper presents the background and issues of corporate governance in Chinese Taipei.

II. Economic development and the impact of the Asian financial crisis

Economic development

The economic development of Chinese Taipei has evolved over past decades. In the 1950s, Chinese Taipei's industrial policy was to develop import substitute industries to reduce the reliance on foreign imports and to stem the outflow of foreign exchange. From the 1960s onward this policy was replaced by developing an export-oriented economy (Ma, 1994). Many industrial processing and export zones were developed to allow foreign and domestic companies to import materials and parts for assembly and then export finished products to the international markets. This policy has been maintained and upgraded to develop a high-tech industrial park and the computer industry. Although Chinese Taipei still lacks advanced technology and intensive research capability to develop original products, its sophisticated production ability does allow many of its industries to profit from production efficiency and become an integral part of the global production network. Implementation of government policies and development of the business sector have produced consistent economic growth over the years.

Chinese Taipei's GDP was about US$260 billion in 1996, which represents about 3.66% of that of the US for the same year (Table 1). During the five years prior to 1997, the GDP growth rate of Chinese Taipei averaged 6.3%, which was lower than its growth rate prior to 1990. However, this growth rate is higher than that of some major industrialised countries, such as the US, Canada, the UK, and Germany, although lower than that of several newly industrialised countries like Korea, Singapore, Malaysia, Indonesia and Thailand (Table 2). While the majority of Asian countries were experiencing economic contraction after the financial crisis that started in mid-1997, Chinese Taipei still had a moderate growth rate of 4.83% in 1998.

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Table 1: Size of Economies-1996
Amounts in US$ billion

	GDP	Percentage to US GDP
US	7,100	100.00
Japan	4,964	69.92
Germany	2,252	31.72
France	1,451	20.44
UK	1,095	15.42
Italy	1,088	15.32
PRC	745	10.49
Canada	574	8.08
Korea	435	6.13
Chinese Taipei	260	3.66
Indonesia	190	2.68
Thailand	160	2.25
Hong Kong	142	2.00
Singapore	80	1.13
Malaysia	78	1.10
Philippines	72	1.01

Source: Pocket World in Figures, The Economist, 1999.

Table 2: GDP Growth Rate of Chinese Taipei and Other Countries (%)

Year	C-Taipei	Korea	Singapore	Hong Kong	Thailand	Malaysia	Indonesia	Philippines
1993	6.32	5.8	10.4	6.1	7.8	8.4	7.3	2.1
1994	6.54	8.6	10.1	5.4	8.8	8.8	7.9	4.4
1995	6.03	8.9	8.8	3.9	8.6	9.5	8.2	4.8
1996	5.67	7.1	6.9	4.6	6.7	8.2	7.8	5.7
1997	6.77	5.5	7.8	5.3	-0.4	7.8	4.6	5.1
1998	**4.66	-6.8	-0.7	-7.1	-7.5	-8.6	-7.9	1.6

Year	PRC	Japan	US	Canada	UK	Germany	France	Italy
1993	13.5	0.3	2.3	2.2	2	-2.3	-1.5	-0.7
1994	12.6	0.6	3.5	4.1	3.9	2.3	2.9	2.1
1995	10.5	1.5	2	2.3	2.6	1.9	2.1	3
1996	9.7	3.9	2.8	1.5	2.3	1.4	1.6	0.8
1997	8.8	0.9	3.8	3.8	3.4	2.2	2.3	1.5
1998	7.6	-2.6	3.3	1.8	2.3	2.8	2.8	1.2

*GDP of 1998 is data of 1998/Q3, except Thailand is 1998/Q1.
**Chinese Taipei's 1998 annual growth rate is 4.83.
Source: Key International Economic Financial Indices, Chinese Taipei, Economic Research Department, the Central Bank, December 1998.

The GDP shows a shift from the manufacturing sector toward the service sector (Table 3). From 1993 to 1998, the agricultural sector decreased from 3.66% to 2.73%, and the industrial sector from 39.0% to 34.28%. During the same period, the service sector increased from 57.34% to 62.83%, while financial and business services gained the most, from 19.33% to 23.05%. From the figures in 1998, it is clear that the service sector has surpassed the industrial and agricultural sectors in their contributions to the GDP. Among these sectors in 1998, manufacturing represents 27.27%, followed by financial and business services with 23.05%, commercial and trading with 16.93%, government services with 10.20%, agriculture and fishery with 2.89% and, finally, mining, electricity and gas with 2.81%.

Development in international trade has long been a major government policy and business focus since the 1960s. With the buildup of manufacturing capabilities in many industries, Chinese Taipei's international trade has consistently produced a trade surplus (Table 4) that has led to the accumulation of huge exchange reserves - about US$90 billion - at the end of 1998. This trade surplus has shown a decreasing trend from its peak of US$14 billion in 1989 to its low of US$5.9 billion in 1998. The trade surplus provides needed capital for domestic economic development and, at the same time, fosters rapid growth and turnover in stock market activities.

During the past decade, Chinese Taipei's trading partners have grown from the US and Japan and now include the People's Republic China (PRC) and Southeast Asian (ASEAN) countries (Table 5). In the 1980s, the US and Japan were the most important trading partners, with the US being the major export market and Japan being the major import country. However, their importance as trading partners has been steadily declining. On the other hand, PRC and ASEAN countries have substantially increased their share of trade with Chinese Taipei during this period. They constituted 2% and 5.4% of export markets respectively in 1986, which increased to 23.5% and 13.3% in 1997. But, in 1998, due to the Asian financial crisis, their percentages dropped to 22.5% and 10.6% respectively. The annual fluctuation rates of exports and imports are shown in Table 6.

In terms of investment, fixed capital formation has been consistently maintained above 20% of GDP. In addition, Chinese Taipei has provided substantial direct investment in PRC and ASEAN countries over the past decade. Due to growing production costs since the mid-1980s and a shortage of labour, Chinese Taipei's business started shifting some of its production facilities overseas. PRC and ASEAN countries are two primary regions for Chinese Taipei's foreign direct investment (Table 7). The official record shows that during the period from 1991 through 1997, Chinese Taipei's investment in these two regions totalled US$17,392 million and US$25,121 million respectively. The actual amount is recognised to exceed the official one since there have been investments not registered with the government agencies.

Impact of Asian financial crisis

Since July 1997, the Asian financial crisis has had an impact on Chinese Taipei's economic and financial performance. The growth of GDP and the trade surplus has slowed down compared to previous years (Tables 2 and 4). The growth rate of GDP decreased from 6.77% in 1997 to 4.83% in 1998. The economic contraction of neighbouring countries has decreased their demand for Chinese Taipei products, resulting in a decrease in trade surplus by 43.6% to US$7.6 billion in 1997. In 1998 Chinese Taipei continued to experience a 9.4% decrease in exports, a 8.5% decrease in imports, and a 22.9% decrease in trade surplus to US$5.9 billion. The exchange rate of the New Taiwan dollar (NTD) to the US dollar (USD) depreciated from 27.812 to 32.265 from 30 June 1997 to 31 December 31 1998 (Table 8), with the lowest quarterly rate of 34.462 reached at the end of the second quarter in 1998. As for the balance of payments (Table 9), the average current account balance during the period of 1991 through 1997 was US$8,392 million, while the average capital and financial account balance showed an outflow of US$6,192 million. The current account balance showed a clear drop from US$11,027 million in 1996 to US$7,688 million in 1997, and a further drop to US$3,451million in 1998. Outflow in capital and financial accounts decreased from US$9,455 billion in 1996 to US$8,380 billion in 1997 and then changed to inflow of US$1,648 billion in 1998. The Asian financial crisis also resulted in the worsening of corporate debt payback ability, with the percentage of overdue loans increasing from 3.78% in 1996, to 3.82% in 1997, and 4.47% in 1998 (Table 10). The stock market index declined with a shrinking trading volume. The Taiwan Stock Exchange index dropped from 8,411 at end 1997 to 7,738 at end 1998, with trading volume shrinking from NT$37,241 billion to NT$29,619 billion (Table 11). Falling stock prices and worsening debt service capacity have added substantial pressure on corporate financial stability, and contributed to the failures of a few business groups in the market.

Although the Asian financial crisis has slowed economic growth and created pressure on the financial market, its impact has been relatively moderate and deferred on Chinese Taipei compared to neighbouring countries. Several factors contribute to this development. First, Chinese Taipei has no current account deficit since it has been able to maintain its trade surplus albeit at a decreasing trend. Second, it holds a minimal foreign debt of about US$100 million, a very small percentage compared to its foreign exchange reserves of US$90 billion. Third, its progressive deregulation policy toward short-term foreign investment moderates the impact of rapid flows of international capital. Fourth, the Central Bank takes rather decisive action to fend off currency speculators in order to maintain the exchange rate of the domestic currency.

However, since the second half of 1998, other factors have contributed to the recent financial difficulties of several corporations. First, the prolonged Asian crisis has decreased exports and led to reduced corporate profits and market confidence, which have increased the pressure on the market. Second, over-reliance on leverage using stock as collateral has created a hidden financial risk for a number of listed companies. Stockholders are allowed to use stocks as collateral to obtain bank loans. The amount of a loan is set at a certain percentage (usually 50 to 60%) of the market value of the stocks. When the stock price drops, the borrower is required to provide more stocks as collateral or the lenders will sell off the stock and collect the proceeds for loan protection. Although the practice is originally to facilitate market liquidity, many business group owners have used this approach to borrow excessively for additional investments or expansion into other businesses. When the stock price drops, the borrowers are induced to maintain the stock prices in order to avoid immediate loss. To do so, they will have to use whatever sources of funds are available. As a result, several business group owners commit fraud to use corporate assets to purchase stocks to sustain their prices. When stock prices continue to fall, their ability to uphold prices is exhausted and financial failures occur. This type of behaviour constitutes the major reason for financial failures in the corporate sector. Third, potential bad loans or overdue bank loans have increased lately due to slower market demand and over-expansion of corporate investment prior to the Asian crisis. Overdue loans have consistently increased over the years, reaching NT$535.6 billion, about 4.47% of total outstanding loans as of December 1998 (Table 10), which is the highest percentage since 1991. The potential bad loan situation may be worse than the official record shows as audited financial statements for 1998 are not yet available. The overdue loan problem would need to be resolved for the market to recover from the financial crisis.

During 1998, twelve listed companies filed for suspension of trading in the stock market for the above reasons. Their total capital is NT$44.3 billion, about 0.5% of the total capital in the Taiwan Stock Exchange. To rescue the failing companies, the Ministry of Finance has formed an ad hoc committee to review their financial situation and assist their restructuring efforts. The MOF declares that the rescue is only an emergency measure to help companies with normal business operations. It is only to rescue the company, not the individuals (owner/executive) who have violated their fiduciary duties or even committed fraud. In addition, the government has taken several steps to reinforce financial regulations and oversight in the banking industry, and to strengthen the capital market and corporate governance. As stock collateral has induced excessive lending without adequate credit evaluation of the borrower, the MOF is rewriting the rules that regulate the amount limit for a stock collateral loan. In addition, the MOF is also rewriting the rules in order to make it easier for banking institutions to write off their overdue loans on a more timely basis. It will also strengthen the early warning system for monitoring credit risks of the banking industry.

Table 3: Composition of GDP in Chinese Taipei
(%)

Year	Agriculture, Fishery, etc.	Industry Sector				Service Sector			
		Manufacturing	Construction	Mines, Water, Electricity	Total	Commerce	Banking, Financial	Government	Total
1993	3.66	30.48	5.28	3.24	39.00	15.13	19.33	10.78	57.34
1994	3.57	29.00	5.31	2.97	37.28	15.35	20.85	10.63	59.15
1995	3.55	28.14	5.22	2.89	36.25	15.97	21.14	10.51	60.20
1996	3.29	27.92	4.76	2.79	35.47	16.34	21.61	10.55	61.24
1997	2.73	27.67	4.39	2.87	34.93	16.64	23.01	10.40	62.34
1998	2.89	27.27	4.20	2.81	34.28	16.93	23.05	10.20	62.83

Source: Monthly Report on Economic and Financial Conditions, Taiwan District, Chinese Taipei Economic Research Department, the Central Bank, January 1999

Table 4: Chinese Taipei's International Trade (1991-1998)
(US$ million)

Year	Export		Import		Surplus	
	Amounts	% of Change	Amounts	% of Change	Amounts	% of Change
1991	76,178	13.3	62,861	14.9	13,317	6.55
1992	81,470	6.9	72,007	14.6	9,463	-28.94
1993	85,091	4.4	77,061	7	8,030	-15.14
1994	93,049	9.4	85,349	10.8	7,700	-4.11
1995	111,659	20	103,550	21.3	8,109	5.31
1996	115,942	3.8	102,370	-1.1	13,572	67.37
1997	122,081	5.3	114,425	11.8	7,656	-43.59
1998	110,640	-9.4	104,740	-8.5	5,900	-22.94

*Compared to prior year.
Source: Analysis of International Trade, Bureau of International Trade, Ministry of Economic Affairs, January 1999.

Table 5: Chinese Taipei's Major Trading Partners and Their Weights (1992-1998)

Year	Export (100%)						Import (100%)					
	US	Japan	PRC	EU	ASEAN	Other	US	Japan	PRC	EU	ASEAN	Other
1992	28.9	10.9	18.9	15.2	10	16.1	21.9	30.2	1.6	13.1	8.4	24.7
	(1)*	(4)	(2)	(3)	(5)		(2)	(1)	(5)	(3)	(4)	
1993	27.7	10.6	21.7	13.3	10.5	16.2	21.7	30.1	1.4	13.3	8.8	23.9
	(1)	(4)	(2)	(3)	(5)		(2)	(1)	(5)	(3)	(4)	
1994	26.2	11	17.2	12.1	11.5	22	21.1	29	2.2	13.9	9.9	23.5
	(1)	(5)	(2)	(3)	(4)		(2)	(1)	(5)	(3)	(4)	
1995	23.7	11.8	17.4	13.1	12.4	21.6	20.1	29.2	3	14.4	9.8	23.9
	(1)	(5)	(2)	(3)	(4)		(2)	(1)	(5)	(3)	(4)	
1996	23.2	11.8	17.9	13.6	12.2	21.3	19.5	26.9	3	16.2	10.5	24.1
	(1)	(5)	(2)	(3)	(4)		(2)	(1)	(5)	(3)	(4)	
1997	24.2	9.6	18.4	14.1	12.2	21.5	20.3	25.4	3.4	15.6	11.2	10.4
	(1)	(5)	(2)	(3)	(4)		(2)	(1)	(5)	(3)	(4)	
1998	26.6	8.4	22.4	17.7	14.5	10.4	18.9	26	1.9	19.9	22.9	11.5
	(1)	(5)	(2)	(3)	(4)		(2)	(1)	(5)	(4)	(3)	

*Figure in parenthesis is the ranking during the year.

Source: Analysis of International Trade, Bureau of International Trade, Ministry of Economic Affairs, January 1999.

Table 6: Annual Change in Chinese Taipei's Export and Import among Trading Partners (1992-1998) (%)

Year	Export Change					Import Change				
	US	Japan	PRC	EU	ASEAN	US	Japan	PRC	EU	ASEAN
1992	5.6	-3.2	24	-0.5	10.6	11.7	15.4	-8.5	25.1	23.4
1993	0.1	0.9	19.7	-7.4	9.1	6	6.5	-3	8.7	11.6
1994	3.2	13.9	15.2	0.2	20.1	7.9	6.9	-11.3	17.6	24.5
1995	8.5	28.7	22.8	21.6	30.1	15.1	22.1	20.2	17.2	20.7
1996	1.7	3.8	2.6	7.8	2.2	-3.8	-9.2	-7.5	7.7	5.7
1997	10	-14.4	7.1	8.7	4.7	16.3	5.6	17.1	7.2	19.7
1998	-0.6	-20.2	-13.3	6.7	-29.7	-15.3	-6.9	-2.2	-4.5	-5.1

Source: Monthly Report on Economic and Financial Conditions, Taiwan District, Chinese Taipei, Economic Research Department, the Central Bank of China, January 1999.

Table 7: Chinese Taipei's Foreign Direct Investment in PRC and ASEAN (US$ million)

Year	FDI in PRC	FDI in ASEAN
1991	685	3,489
1992	1,050	1,985
1993	3,139	1,151
1994	3,391	4,953
1995	3,162	4,216
1996	3,475	4,497
1997	2,490	4,830
Total	17,392	25,121

Source: International Investment Office, Ministry of Economic Affairs, February 1998.

Table 8: Exchange Rate Changes of Chinese Taipei and Other Asian Countries (US$1=Other Currency)

		1997/6/30	1997/9/30	1997/12/31	1998/3/31	1998/6/30	1998/9/30	1998/12/31
Chinese Taipei	Exchange rate	27.812	28.602	32.638	32.860	34.462	34.480	32.265
	Ratio*	0.00	-2.76	-14.79	-15.36	-19.30	-19.34	-13.80
Hong Kong	Exchange rate	7.748	7.739	7.748	7.748	7.748	7.749	7.747
	Ratio	0.00	0.12	0.00	0.00	-0.01	-0.01	0.01
Singapore	Exchange rate	1.430	1.531	1.677	1.611	1.700	1.687	1.656
	Ratio	0.00	-6.57	-14.71	-11.22	-15.87	-15.22	-13.61
Korea	Exchange rate	887.90	914.50	1,695.00	1,386.00	1,376.00	1,387.50	1,195.00
	Ratio	0.00	-2.91	-47.62	-35.94	-35.47	-36.01	-25.70
Philippine	Exchange rate	26.376	34.360	40.116	37.750	41.800	44.040	39.050
	Ratio	0.00	-23.24	-34.25	-30.13	-36.90	-40.11	-32.46
Indonesia	Exchange rate	2,432.00	3,278.00	5,100.00	8,520.00	14,700.00	10,800.00	8,005.00
	Ratio	0.00	-25.81	-52.31	-71.46	-83.46	-77.48	-69.62
Thailand	Exchange rate	25.880	36.100	48.000	38.800	42.300	39.350	36.625
	Ratio	0.00	-28.31	-46.08	-33.30	-38.82	-34.23	-29.34
Malaysia	Exchange rate	2.525	3.237	3.876	3.640	4.150	3.800	3.800
	Ratio	0.00	-22.01	-34.86	-30.65	-39.17	-33.57	-33.57
Japan	Exchange rate	114.360	121.100	130.150	132.910	139.800	135.790	113.700
	Ratio	0.00	-5.57	-12.13	-13.96	-18.20	-15.78	0.58
PRC	Exchange rate	8.291	8.285	8.280	8.279	8.280	8.278	8.279
	Ratio	0.00	0.07	0.13	0.14	0.13	0.15	0.14

*Changes compared to exchange rate at 6/30/1997.

Table 9: Balance of Payments of Chinese Taipei (1991-1998)
(US$ million)

Year	Current Account	Capital Account	Financial Account	Total Capital and Financial Accounts
1991	12,468	-443	-2,228	-2,671
1992	8,550	-393	-6,910	-7,303
1993	7,042	-328	-4,629	-4,957
1994	6,498	-344	-1,397	-1,741
1995	5,474	-650	-8,190	-8,840
1996	11,027	-653	-8,802	-9,455
1997	7,688	-314	-8,066	-8,380
1998	3,451	-181	1,829	1,648

Source: Economic Research Department, the Central Bank, Chinese Taipei, January 1999.

Table 10: Percentage of Overdue Loans of Domestic Banks (1991-1998)

Year	1991	1992	1993	1994	1995	1996	1997	1998
Percentage	1	0.8	1.2	1.8	2.92	3.78	3.82	4.47

Source: Monthly Report on Economic and Financial Conditions, Taiwan District, Chinese Taipei, Economic Research Department, the Central Bank of China, January 1999.

Table 11: Listed Companies and Their Capital in Chinese Taipei's Stock Market
(1991-1998)

(NT$ billion)

	Taiwan Stock Exchange				Over-the-Counter Stock Exchange			
	Number of Firms	Capital	Market Capitalisation	Capitalisation Ratio	Number of Firms	Capital	Market Capitalisation	Capitalisation Ratio
1991	221	643.08	3,184.03	4.95	9	3.78	10.52	2.78
1992	256	761.09	2,545.50	3.34	11	4.47	9.79	2.19
1993	285	908.37	5,145.41	5.66	11	3.96	9.61	2.43
1994	313	1,099.81	6,504.37	5.91	14	9.79	26.92	2.75
1995	347	1,346.68	5,108.44	3.79	41	173.01	245.73	1.42
1996	382	1,661.27	7,528.85	4.53	79	264.13	833.46	3.16
1997	407	2,106.29	9,696.11	4.60	114	314.89	1,026.86	3.26
1998	437	2,731.58	8,377.03	3.07	176	382.39	887.63	2.32

Source: Major Indices of Securities and Futures Market, Securities and Futures Commission, Ministry of Finance, January 1999.

III. Capital market development and corporate governance characteristics

Capital market development

The stock market in Chinese Taipei has developed rapidly in recent years with the Taiwan Stock Exchange (TSE) and Over-the-Counter (OTC) Stock Exchange constituting the backbone of the market. Table 11 shows that from 1991 to 1998 the total number of listed companies in the Taiwan Stock Exchange increased from 221 to 437, with a growth rate of 97.7%. During the same period, their equity increased by 324.7%, from NT$643 billion to NT$2,731 billion, and market capitalisation increased by 163.1%, from NT$3,184 billion to NT$8,377 billion. In addition, the trading volume increased by 205.9%, from NT$9,683 billion to NT$29,619 billion (Table 12). By trading volume, the Taiwan Stock Exchange ranked in 1998 among the top four stock exchanges in the world, and as the top one in Asian markets. Also, Chinese Taipei rebuilt its over-the-counter stock market in 1994 with the establishment of the Over-the-Counter Stock Exchange, a *de facto* exchange to attract medium-size and high-tech companies. During 1994-1998, the number of OTC traded companies increased from 14 to 176, a growth rate of 12.6 times. OTC's capital increased by 38 times (from NT$9.79 billion to NT$382.39 billion) and its market value increased by 32 times (from NT$26.92 billion to NT$887.63 billion). During the same period, its trading volume increased from NT$0.57 million to NT$1198.16 million, showing phenomenal growth.

The stock market has become an important source for capital formation. For example, in 1997 and 1998, listed companies raised NT$238.5 billion of new capital from the Taiwan Stock Exchange, and NT$54.8 billion from the OTC market (Table 13). In addition, listed companies can issue corporate bonds or convertible bonds for debt financing, as well as issue GDR or overseas corporate bonds to raise capital from the international market (Table 14). In 1998, these companies raised US$1.92 billion through this market.

Table 12: Transaction Volume and Stock Indexes in Stock Markets

(Volumes in NT$ million)

Year	Taiwan Stock Exchange			Over-the-Counter Stock Exchange		
	Total Trading Volume	Average Daily Trading Volume	Stock Index	Total Trading Volume	Average Daily Trading Volume	Stock Index
1991	9,682.740	33.86	4,929	0.464	1.6	-
1992	5,917.080	20.83	4,272	0.671	2.4	-
1993	9,056.720	21.23	4,215	0.649	2.2	-
1994	18,812.110	65.78	6,253	0.568	2.0	-
1995	10,151.540	35.49	5,544	2.796	9.8	96.55
1996	12,907.560	44.82	6,004	453.509	1,574.7	170.27
1997	37,241.150	130.21	8,410	2,310.659	8,079.2	274.29
1998	29,618.970	109.30	7,738	1,198.158	4,421.2	213.23

Source: Major Indices of Securities and Futures Markets, Securities and Futures Commission, Ministry of Finance, January 1999.

Table 13: New Equity Issues in Stock Markets

Year	Taiwan Stock Exchange			OTC Stock Exchange			Bonds Outstanding (NT b$)
	No. of Firms	Capital Raised		No. of Firms	Capital Raised		
		Total (NT b$)	Per Firm (NT m$)		Total (NT b$)	Per Firm (NT m$)	
1991	48	13.58	282.92	4	0.45	112.50	58.99
1992	54	14.93	276.48	-	-	-	62.67
1993	114	19.62	172.11	-	-	-	47.79
1994	72	29.46	411.67	1	0.02	20.00	32.03
1995	74	33.77	456.35	3	0.95	316.67	48.74
1996	91	55.53	610.22	25	10.16	406.40	124.33
1997	145	129.39	892.34	64	29.53	461.41	219.11
1998	103	109.13	1059.51	66	25.23	382.27	383.79

Source: Major Indices of Securities and Futures Markets, Securities and Futures Commission, Ministry of Finance, January 1999.

Table 14: Capital Raised Through Domestic and International Bonds (1991-1998)

Year	Domestic Bond Issues (NT billion)		International Bond Issues (US$ million)			GDR (US$ million)
	Ordinary	Convertible	US$	Swiss Franc	Yen	
1991	52.20	6.79	155	-	-	-
1992	50.11	12.56	96	-	-	615
1993	37.14	10.65	-	60	-	115
1994	22.71	9.32	1,580	545	4,000	461
1995	41.79	6.95	250	-	3,000	590
1996	108.34	15.99	977	-	20,000	1,704
1997	177.21	41.90	3,183	62	-	1,344
1998	298.61	85.18	1,330	-	-	588

Source: Major Indices of Securities and Futures Markets, Securities and Futures Commission, Ministry of Finance, January 1999.

Market performance and the corporate financial situation

The average rate of return on equity for listed companies on the Taiwan Stock Exchange and in other economies are summarised in Table 15. The Chinese Taipei stock market is volatile, and the turnover of shares is high. The rates of return on equity in Chinese Taipei for the period 1992-1998 range from a high of 80% to a low of -27%. Although Chinese Taipei's stock market has been developing rapidly in terms of the number and size of listed firms, market irregularities, such as insider trading, dissemination of rumours, and other market manipulation, cannot be totally rooted out. Institutional investors, such as mutual funds, pension funds, and insurance companies, have gradually gained in importance and play a critical role in information collection and dissemination, but individual investors, who still represent about 90% of trades, remain the major force in Chinese Taipei's stock market. The prevalence of a high proportion of individual investors and a high turnover in their investment behaviour has generally created over-valued stock prices.

Table 15: Rate of Return on Equity (1992-1998)

Year	C-Taipei	Hong Kong	Korea	Singapore	Thailand	Japan	US
1992	-27%	27%	11%	1%	26%	-26%	5%
1993	80%	117%	28%	60%	75%	3%	13%
1994	17%	-31%	19%	-8%	-13%	13%	2%
1995	-27%	23%	-14%	1%	-6%	1%	33%
1996	34%	34%	-26%	-2%	-35%	-3%	26%
1997	18%	-20%	-42%	-31%	-55%	-21%	23%
1998	-22%	-6%	49%	-9%	-5%	-9%	16%

*Estimated from stock market indices.

Due to the recent financial crisis of many enterprises, banks in Chinese Taipei have tightened up credit lines, despite government efforts to ease a prevailing corporate credit crunch by setting the rediscount and secured loan accommodation rates at record low levels. Since safety is the primary consideration for most banks, they are taking a more prudent approach in evaluating credit applications. Therefore, the stagnating domestic economy has slowed private investment. The annual rate of increase of investment in the private sector declined from 18.30% in 1997 to 16.56% (estimated) in 1998, and to 9.82% (forecast) in 1999.

From a corporate perspective, listed companies in Chinese Taipei have not incurred huge debt and are able to maintain a reasonable financial foundation. The average debt-to-equity ratio for firms reached 79% at the end of September 1998, an indication of the relative financial stability of the business sector. Table 16 indicates that, in the past, the median debt-to-equity ratios of listed companies has been decreasing steadily, down from 139% in 1981 to 67%. It also shows that companies rely more on short-term debts for their external financing, with short-term debts constituting 70% of all debts in 1997.

In addition to traditional loans from banks, corporate bonds have gained in importance for business finance in recent years. Table 17 summarises the developments of bonds and bank loans in terms of the shares in total long-term debt. It shows that corporate bonds constituted about 32% of total long-term debts in 1997, up from 5% in 1991. And among corporate bonds, foreign issues represented about 27.2% in 1997.

Since the beginning of the Asian financial crisis, corporate and individual financial difficulties have increased. The ratio of dishonoured checks, in terms of their amount, increased from 0.26% in July 1997 to 0.64% in December 1998, an increase of 1.46 times during this 18-month period. This indicates a worsening situation of solvency. As for failing businesses, they will file for bankruptcy or restructuring to exit the market or re-align their ownership.

Table 16: The Median Ratios of Debt-to-Equity, Short/Long-Term Debts

Year	Debt/Equity Ratio	Short-Term Debts	Long-Term Debts	Others
1981	139%	86%	7%	7%
1982	134%	81%	13%	6%
1983	139%	79%	12%	9%
1984	142%	78%	12%	10%
1985	135%	77%	13%	10%
1986	140%	81%	11%	8%
1987	133%	83%	9%	8%
1988	125%	81%	11%	8%
1989	102%	81%	10%	9%
1990	85%	81%	11%	8%
1991	84%	79%	12%	9%
1992	76%	80%	10%	10%
1993	79%	78%	12%	10%
1994	74%	78%	13%	9%
1995	72%	75%	11%	14%
1996	71%	71%	12%	17%
1997	67%	70%	17%	13%

Source: Financial Database, Taiwan Economic Journal (TEJ).

Table 17: Profile of Corporate Debt Composition of Bonds to Bank Loans

Year	Bonds	Banks
1981	0%	100%
1982	0%	100%
1983	7%	93%
1984	7%	93%
1985	8%	92%
1986	7%	93%
1987	6%	94%
1988	4%	96%
1989	3%	97%
1990	3%	97%
1991	5%	95%
1992	5%	95%
1993	6%	94%
1994	13%	87%
1995	14%	86%
1996	25%	75%
1997	32%	68%

Source: Financial Database, Taiwan Economic Journal (TEJ).

Chinese Taipei‘s biggest worry right now is the banking system. Several newly formed private banks are expected to report earnings far below expectations, because they are now forced to set aside tremendous amounts of loan loss provisions due to rising bad loans. The overdue or non-performing loan ratio in Chinese Taipei’s banks has reached an all-time high amid a prolonged domestic economic slowdown. According to Central Bank statistics, domestic banks had recorded a total of NT$535.6 billion in non-performing loans in their domestic operations by the end of 1998. That amount accounted for 4.47% of the NT$11.98 trillion in total bank loans to domestic corporations and individuals.

The recent financial difficulties of many enterprises are mainly caused by imprudent and highly leveraged investments, and their failures mostly resulted from misconduct or even fraud by owner/executives. A new term - “land mine stock” - has been coined on the local stock market to refer to the stocks of companies suffering from financial difficulties, but which may not be fully revealed in their disclosed information. These failures are mainly the result of inadequate corporate governance of these companies, leading to excessive but hidden risks.

Corporate governance characteristics

With the growth of the capital market, public companies are able to raise needed capital from the public. However, there are inherent corporate characteristics that shape the corporate governance environment, including (1) the family-controlled business group; (2) lack of major institutional investors; and (3) inadequate separation of ownership and management.

In Chinese Taipei, a family usually constitutes the basis for founding a company and developing a business. Family members also become corporate managers as the business grows. Family-controlled business has the advantage of having strong leadership and a cohesive management team formed by the family members. Even when the company has grown and become a public company, family ownership or control remains a dominant characteristic of large corporations. According to Su, Yeh and Ko (1998), for 1994-1995 various family groups controlled 78% of listed companies on the Taiwan Stock Exchange (Table 18). In 57.6% of family-controlled companies, the largest family holds more than half of the board seats. The same study also shows that, on average, the largest family controls 27.4% of outstanding shares, which is more than the sum of the total that directors hold (20.1%). These results suggest that family ownership has substantial control over board decisions and the agenda in stockholders’ meetings.

Another characteristic of corporate governance in Chinese Taipei is the absence of major institutional investors. Based on the trading volume, individual investors constitute 90% of trades, with corporate institutional investors participating in the remaining trades (Table 19). The ownership by institutional investors (including domestic financial institutions and investment trust funds) constituted only a minor portion (5.21%) in 1998 (Table 20). Ownership by corporations or other juridical persons are mainly affiliated companies or private investment companies associated with corporate family members. Table 20 provides a complete profile of ownership composition of listed companies on the Taiwan Stock Exchange. The table indicates the following points:

- From 1991 to 1998, government ownership decreased from 15.51% to 4.33%, indicating the results of privatisation of state-owned companies during this period.

- Banking institutions’ ownership of listed companies is about 4% to 5%, since there is a regulatory limit as to how much banks and insurance companies can invest in public companies.

- Since 1990, domestic investment trusts or mutual funds own about 1% to 2%, indicating that they have not become a major participant in corporate governance.

- Corporations or other juridical persons are mainly affiliated companies or private investment companies affiliated with major stockholders. This group owned about 24.74% of shares in 1998 and created a cross-holding mechanism in the market.

- Foreign investors had an aggregate ownership of 7.37% in 1998. Among them, juridical persons own 3.87%; investment trust funds (Qualified Foreign Institutional Investor, QFII) 1.74%; foreign financial institution 0.47%; and foreign individuals 1.29%.

- Domestic individuals have long had the largest ownership and constituted 58.36% in 1998. This group of ownership can generally be categorised into business family ownership and public ownership. One study (Semkow, 1994) indicated that in 1993 individual ownership had a very skewed distribution, with the top one percent of the individual stock owners holding 30.3% of all listed shares in the Taiwan Stock Exchange, and the bottom 95% of owners holding only 16.7%.

Although the government has a policy to increase the role of institutional investors, their share of ownership is still limited and they are not able to play an effective role in corporate governance. Regulations for the insurance industry place a limit - a certain percentage of its net worth - on how much it can invest in stocks. The government employee pension fund sets a restriction on its investment, with a certain percentage to be invested in stocks. It can be seen that institutional investors are only beginning to increase their shares of ownership in the stock market. Although mutual funds make their investments based on corporate performance, pension funds are directed by guidelines in making their investment, usually with a more conservative approach.

Mutual fund shareholders are required by securities regulations to cast their votes in favour of candidates or proposals recommended by corporate boards, except when current corporate boards are not acting in the interest of the company or stockholders. With their insignificant ownership share and default support for the corporate board, mutual or pension fund investors are not likely to play major roles in corporate governance in the near future.

Improper separation of ownership and management constitutes another major corporate characteristic. As the large major shareholders own a greater portion of corporate shares than the general public, they are able to elect board directors based on their share percentage. In addition to their personal shares, these shareholders often utilise non-public investment or holding companies to hold the shares of listed companies. They may also use nominee accounts to control more shares than disclosed. Further, they may use cross-shareholding of affiliated companies to strengthen their control of listed companies. With the ownership controlled by family groups, the decision making of companies usually resides with the dominant executives who are likely to be the major owners or their family members. Although companies will also retain a capable management team for running the business, usually it is the owner/executives of the company who form the inner circle for strategic decisions and operations.

Corporate groups are thus formed through family ownership, cross-shareholding and control of the corporate board. One study (Financial Bulletin, 1998) indicated that the market value of listed companies controlled by the top 20 business groups is about 37.32% of total value. Their approach can be demonstrated with the following example of how two well regarded business groups are able to maintain family control of their businesses: In case 1, Family X, through their own individual shareholdings, non-public investment companies, hospital and university, owns listed companies in petro-chemical company A, plastic company B, and chemical company C, with 23.9%, 29.48% and

56.95% of shares respectively. Company C then holds the textile company D with 37.2% shares. In addition, companies A, B and C hold cross-shares in the range of 2% to 5%. In case 2, Family Y controls five listed companies. Family Y, through family members, affiliated foundations, a university, investment and other companies, owns 29.13% of textile company E, 9.8% of a cement company F, 14.36% of a department store G, 10.9% of a shipping company H and 10.31% of a chemical company I. Among these listed companies, they also hold cross-shares. For example, in Case 2, textile company E owns 24.97% of cement company F while F owns 25.74% of E. This type of cross-shareholding forms closely controlled business groups. There are other less well known business groups that take a similar approach, even if they are smaller in size.

Business groups can obtain their external financing through bank loans or from capital markets. Prior to the Asian financial crisis, the financial market did not seem to question its ability to provide external financing as long as business groups could demonstrate reasonable profitability. The existence of major shareholders does not necessarily carry a negative implication when seeking external financing. It depends upon the track record of the past performance of major shareholders, who usually serve as key executives of business groups. Sometimes well-known major shareholders may command a premium when seeking outside investments.

By legal requirements, all stockholders of the same class share the same risk and equal return on a per share basis. However, there is a perceived control risk that is the improper or even non-separation of ownership and management, which presents an uneven risk for general stockholders. Although a company with reputable shareholders may be a plus for business development, proper check-and-balance may not exist in the corporate board and top management. If the owner/executive commits moral hazard to take advantage of the company or general stockholders, there is no effective control mechanism to prevent it from happening. This potential risk has indeed been occurring since late 1998 and causing alarming damage to the public's confidence in the accountability of major shareholders or owner/executives.

Minor roles of banking and non-banking intermediaries

The banking sector plays a minor role in corporate governance. According to 1998 data (Table 20), the domestic banking sector only owns 4.19% of listed shares while foreign financial institutions own 0.47% of listed shares. This is mainly due to the government's policy of segregating the banking industry from other industries in their cross-shareholding arrangements. The limit for commercial banks to make stock investments in listed companies was very restrictive and recently allowed up to 15% of a bank's net worth. As a result, banks have not been able to become an active participant in corporate governance.

On the other hand, commercial banks have their own corporate governance arrangements. The banking industry was tightly controlled by the government prior to 1992, with 13 state-owned banks, 3 commercial banks, 8 medium business banks and other credit co-operatives. In 1992, the banking industry was deregulated with new licenses granted to 15 new commercial banks (Table 21). As of 1998, out of a total of 40 domestic banks, 31 are listed on the Taiwan Stock Exchange and 4 are traded in the OTC market. Each new commercial bank is required to have invested capital of NT$10 billion and a 5% limit on shares to be owned by any particular business group. The aim is to build an equity base large enough to sustain potential risk as well as prevent commercial banks from becoming the "cash vault" of a business group. Although newly established commercial banks do have connections with certain business groups, government regulations place limitations on the total loans that can be made to affiliated business groups.

Table 18: Sample Statistics on Ownership Structure and Board Composition

A. Board Composition

Total Sample Size		203
1. Family Controlled Companies (Classification 1)		158
(a) with second largest group (other family or institutional) on the board	53	
(b) with no other group on the board	105	
1. Family Controlled Companies (Classification 2)		158
(a) with the largest family holding less than half of the board seats	67	
(b) with the largest family holding more than half of the board seats	91	
2. Non-Family Controlled Companies		50

B. Ownership Structure-Shareholding Distribution

	Mean	Standard Deviation	First Quartile	Med.	Third Quartile
Total shareholding % of the largest family	0.2743	0.1854	0.1217	0.2344	0.3840
Total shareholding % of board members	0.2015	0.1260	0.1088	0.1604	0.2740
% of board members belonging to the largest family	0.5280	0.2780	0.3246	0.4881	0.7143

*The sample consists of 208 companies, which stands for 73% of 285 companies already listed in the Taiwan Stock Exchange in 1993.

Source: Su, Yeh and Ko (1998).

Table 19: Investor Composition in Taiwan Stock Exchange (1991-1998)

(Amounts in NT$ billion)

Year	Domestic Institutional Investor		Foreign Institutional Investor		Domestic Individual Investor		Foreign Individual Investor
	Amounts	%	Amounts	%	Amounts	%	Amounts
1991	620.59	3.0	11.00	0.1	19,828.97	96.9	10.8
1992	452.72	3.6	31.63	0.1	11,953.80	96.1	11.4
1993	993.24	5.4	89.69	0.5	17,415.11	94.1	16.8
1994	2,260.99	5.8	264.46	0.7	36,415.24	93.5	33.2
1995	1,378.31	6.7	283.99	1.4	18,940.02	91.9	26.1
1996	2,265.43	8.6	556.73	2.1	23,445.16	89.3	26.7
1997	5,694.86	7.6	1,289.02	1.7	68,428.21	90.7	108.5
1998	5,144.25	8.6	964.75	1.6	53,480.51	89.7	90.8

Source: Major Indices of Securities and Futures Markets, Securities and Futures Commission, Ministry of Finance, January 1999.

Table 20: Analysis of Capital Source of Listed Companies in Taiwan Stock Exchange

(Units in %)

Year	Govern-ment Agency	Domestic Financial Institution	Domestic Securities Investment Trust Fund	Corpora-tion	Other Domestic Juridical Person	Foreign Financial Institution	Foreign Juridical Person	Foreign Securities Investment Trust Fund	Domestic Individual	Foreign Individual
1991	15.51	4.08	1.52	14.61	2.85	0.05	4.62	0.27	53.55	2.94
1992	11.90	4.54	1.14	16.34	2.70	0.02	4.58	0.46	55.84	2.49
1993	11.62	4.28	1.42	15.95	2.51	0.02	4.25	0.52	57.16	2.27
1994	9.15	3.74	1.97	17.21	3.27	0.04	4.11	1.50	57.17	1.85
1995	7.45	4.40	1.91	17.44	3.05	0.06	3.86	1.52	58.74	1.57
1996	6.01	4.49	1.71	18.43	4.13	0.18	4.66	2.43	56.54	1.42
1997	6.57	4.16	1.44	19.21	3.62	0.24	4.45	2.55	56.27	1.49
1998	4.33	4.19	1.02	20.40	4.34	0.47	3.87	1.74	58.36	1.29

Source: Capital Source Analysis of Listed Companies, Statistics on Securities Market, Securities and Futures Commission, Ministry of Finance, 1999.

Non-bank intermediaries, such as merchant banks, finance companies and securities companies, do not hold significant shares in public companies. Regulations set a limit on their shareholding or holding period and so their ownership percentage is limited. As a result they play a minimal role in corporate governance.

Decreasing role of state ownership

State ownership has been decreasing consistently over the years due to the policy of privatising state-owned companies. Table 20 indicates that state ownership decreased from 15.51% in 1991 to 4.33% in 1998. With state-owned companies, the government usually appoints their directors or supervisors to monitor operations. However, with smaller ownership, the government cannot continue this practice, except in some rare cases. Since deregulation of the banking industry in 1992, the government's influence over individual banks is also decreasing. It is now less likely to exercise monitoring through the banking system.

The main issues of corporate governance between state and corporations arise from the lobbying pressure exercised by elected legislators for their constituent businesses. When corporate behaviour or transactions are constrained by regulatory requirements, corporate constituents may seek legislators' lobbying efforts to provide them with relief for individual cases or the amendment of laws and regulations. For example, if companies violate the securities laws, they may request their representative legislators to lobby for them. As a result, regulatory agencies have to develop more formal guidelines to deal with these issues and maintain their independence in processing these cases.

Table 21: Some Statistics of the Banking Industry in Chinese Taipei (1991-1998)

		Domestic Banks	Medium Business Banks	Foreign Banks	Coopera-tives	Postal Savings System	Investment Trust Companies	Life Insurance. Companies	Total
1991	Head Office	17	8	36	74	1	8	15	471
	Branches	756	290	47	425	1,211	62	64	3,640
1992	Head Office	32	8	36	74	1	7	22	493
	Branches	897	315	50	439	1,223	54	71	3,852
1993	Head Office	33	8	37	74	1	7	27	500
	Branches	1,030	352	55	482	1,243	60	67	4,111
1994	Head Office	34	8	37	74	1	6	28	501
	Branches	1,174	403	57	530	1,260	53	68	4,410
1995	Head Office	34	8	38	73	1	5	29	501
	Branches	1,361	446	58	556	1,269	49	76	4,745
1996	Head Office	34	8	41	73	1	5	30	505
	Branches	1,464	472	65	595	1,273	55	85	4,981
1997	Head Office	39	8	45	64	1	5	30	507
	Branches	1,685	491	69	505	1,276	61	103	5,181
1998	Head Office	40	7	46	54	1	5	31	499
	Branches	1,933	426	72	446	1,285	64	104	5,336

Source: Financial Statistics Monthly, Chinese Taipei, Economic Research Department, The Central Bank of China, December 1998.

Inadequate functioning of the equities market for corporate governance

The equities market has become more important in providing external funds for corporate finance. Table 22 gives an approximate indicator comparing the value of outstanding stocks to total corporate loans from 1991 through 1998. It can be seen that the loan balance in October 1998 was about 2.2 times that of 1991, while the capital raised in the stock market in 1998 was about 9.6 times that of 1991. Apparently, the equities market has rapidly complemented the bank industry as a major source of finance for listed companies. The development of the stock market can be seen in Tables 11-13.

There are some characteristics that reveal the investment behaviour of the market. In Chinese Taipei's stock market, the individual investor is the major participant. From 1991 to 1998, transactions made by individuals decreased from 96.6% to 89.7%. Although this demonstrates a decreasing trend, the proportion of investment made by individuals still far exceeds that of other major stock markets. In addition, Chinese Taipei's market has an excessive turnover rate. There were major fluctuations in the turnover rate during 1991-1998, with a high of 4.07 times in 1997, and a low of 1.61 times in 1992. As of November 1998, the turnover rate is about 2.95, which is approximately 460% of that in New York, 931% in Tokyo, 674% in London, and 168% in Seoul. Although the government has been trying to increase the proportion of institutional investment and reduce the turnover rate, improvement has been slow. These characteristics suggest that public investors pay less attention to corporate control structures and long-term performance of the company.

Table 22: New Equity Raised in Stock Markets Comparing to Business Loans
(Amounts in NT$ billion)

Year	Total Business Loans (1)	Capital Raised in TSE and OTC (2)	(2)/(1)
1991	5,427	14.03	0.26%
1992	6,876	14.93	0.22%
1993	8,019	19.62	0.24%
1994	9,316	29.66	0.32%
1995	10,084	34.72	0.34%
1996	10,329	65.69	0.64%
1997	11,571	158.92	1.37%
1998*	11,976	116.74	0.97%

*As of Oct, 1998. Excluding loans to state-owned enterprises
Source: Financial Statistics Monthly, Chinese Taipei, Economic Research Department, the Central Bank, December 1998.

Market discipline, such as for takeovers, is not an effective mechanism for corporate control. As many listed companies are controlled by family business groups through family ownership or cross-shareholding, corporate raiders or interested parties may not be able to take over a company through open market purchase. Takeover occurs usually when there are internal conflicts between family owners or when major stockholders dilute their holdings through the market. Although poor management performance provides an incentive for corporate raiders to contemplate takeover actions, it is mainly other reasons that contribute to the changeover of ownership. Prior to 1997, proxy could be purchased in the market; as a result, corporate raiders took advantage of this to amass enough proxy to elect themselves in stockholders' meetings as board directors and took over the company, even when they did not have sufficient shares. There are several cases where new owner/executive teams took control of the company, shored up the share price and took the profit without actually improving the company's performance. Therefore, since 1997, the regulations have been amended to prohibit this practice.

Corporate governance and foreign direct investment

The role played by foreign direct investment (FDI) in corporate governance is not much of a problem in Chinese Taipei. It is generally considered more beneficial to invite FDI than foreign investment in securities because FDI usually has more long-term impact on economic development and brings in technology as well as employment to invested countries. Table 23 indicates that during the period from 1991 through 1998, approved FDI in Chinese Taipei totalled US$19,476 million, about 59.5% of total FDI since 1952. It reached its peak at US$4,267 million in 1997, but decreased by 12.4% to US$3,739 million in 1998. Although the ratio of FDI to foreign exchange reserves ranges from 1.45% to 5.11%, its contribution to economic development is well recognised and encouraged by the government. FDI is mainly used to develop branch, subsidiary or joint ventures with domestic companies. They generally remain under the control of parent companies or are set up according to joint venture agreements, presenting fewer corporate governance problems.

Table 23: Foreign Investment in Chinese Taipei
(Amounts in US$ million)

Year	Approved FDI	Foreign Exchange Reserve	FDI/FX Reserve
1991	1,778	82,405	2.16%
1992	1,461	82,306	1.78%
1993	1,213	83,573	1.45%
1994	1,631	92,454	1.76%
1995	2,925	90,310	3.24%
1996	2,461	88,038	2.80%
1997	4,267	83,502	5.11%
1998	3,739	90,341	4.14%

Source: International Investment Office, Ministry of Economic Affairs, 1999.

On the contrary, foreign investment in portfolios or securities is more short-term oriented. For example, in 1997, foreign investment in equity securities shows an outflow of US$2.23 billion and in 1998 an outflow of US$1.65 billion. With such rapid movement and drastic impact on the stability of the financial market, the government is taking a more cautious approach in dealing with foreign investment of this kind. Chinese Taipei opened its securities market to foreign investment in three stages. In 1982, it first allowed foreign investment in the securities market indirectly through investment funds. Then it opened the market to foreign institutional investors in 1990. In 1996, all foreign institutions and individuals were allowed to invest in Chinese Taipei's securities market. During this period, the ceilings on foreign investment were also raised. The ceiling on foreign capital investment in Chinese Taipei's stock market was first set at US$2.5 billion in December 1990. It was then changed to a ceiling for investment in individual companies instead of being a ceiling for total market investment. As of now, total foreign investment in a company' stock can reach 30%.

Growth of business groups

Diversified corporate groups are representative of major economic activities in Chinese Taipei, and offer a variety of goods and services, including not only high-tech products but also ordinary products. By definition, a company that owns over 50% of the voting stock of another company is able to control this company through its stock ownership, creating a parent-subsidiary relationship (i.e. corporate group) between the two companies. The parent controls economic policies of the subsidiary. In form, they are independent legal entities, but in substance they are the same economic entity. Actually, effective control of a diversified corporate group in Chinese Taipei exists in many forms. Control is presumed to exist when the parent owns, directly or indirectly through subsidiaries, more than one half of the voting power of an enterprise. In addition, control exits even when the parent owns one half or less of the voting power of an enterprise, but has the power to govern the financial and operating policies of corporate groups that are under the control of family members. In other words, family members can exercise their control through appointing or removing the majority of the members of the board of directors or through casting the majority of votes at meetings of the board of directors.

Most business groups in Chinese Taipei started their business in a primary industry and then gradually diversified into other segments. Their diversification consisted of vertical and horizontal approaches. Vertical diversification frequently occurs in the computer-related industry, where the purpose is to consolidate the upstream and downstream production facilities as well as to use the same marketing channels for product sales. On the other hand, horizontal diversification mainly occurs in traditional business groups, where the purpose is to utilise the resources accumulated by the original business to develop business segments. For example, the Lin-Yuan Group led by Mr. Tsai Wan-Lin, the richest entrepreneur in Chinese Taipei, controlled three listed companies, Cathay Life Insurance, Cathay Construction, and Hui-Feng Bank (originally First Investment Trust). The Sinkong Group, led by Mr. Wu Dong-Chin, controlled 8 listed companies in the textile, clothing, heating gas, life insurance, bank, securities, and security protection industries. On average, a corporate group in Chinese Taipei consists of about eleven companies and maintains a presence in six different industries (Table 24).

Table 24: Diversification Scope of Top 100 Business Groups

Number of companies			Number of sectors		
Average	Minimum	Maximum	Average	Minimum	Maximum
11	2	41	6	1	18

Source: Survey of Top 100 Corporate Groups in Taiwan, Commonwealth Magazine, August 1997.

There exist several incentives to create corporate groups: expansion, efficiency, strategic alliance, reputation, risk diversification, and contractual arrangement of long-term relationships. However, it is business expansion, efficiency, strategic alliance, and risk diversification that are usually the major reasons for forming corporate groups in Chinese Taipei. Expansion and efficiency motives are associated with revenue generation and cost minimisation for an organisation's economic activity. The firm will be regarded as providing synergy between different units at a given moment to exploit economies of scale or of scope. Corporate groups also use strategic alliances and reputation expansion to strengthen their competitive edge.

Corporate restructuring

Several business groups are experiencing financial difficulties since the Asian financial crisis started. During 1998, 12 listed companies in the Taiwan Stock Exchange have filed for trading suspension. Currently, major owner/executives of many of these companies are under judicial investigation for their illegal acts of taking corporate assets. These companies are working with bank syndicates to restructure their loans. They are mainly seeking to extend their credit and, at the same time, soliciting other companies to provide equity funding. The government is forming a special task force to review the credit situation of these companies for the possibility of extending additional financial assistance. Bank syndicates are working with other financially able companies and CPA firms to reassess the viability of their rescue programmes for troubled companies which usually demand that the original owner/executives relinquish their shares at realistic prices and new management teams be formed. The government is also encouraging banks to be more active in the restructuring process instead of taking a quick exit by cutting off the credit completely.

Many corporate groups have taken steps to rescue or take over troubled companies through buying stocks. For example, China Agritech bought out the Independence Evening Post under the agreement that CAC acquired the newspaper at a cost of NT$1.3 billion, while the owner of IEP would pay off the accumulated wage liability. Although, signs of ownership re-alignment are beginning to appear, it seems to take conventional processes for the company's management to work out restructuring programmes with bank syndicates.

IV. Transparency and disclosure

Accounting regulations

Generally accepted accounting principles are those principles that have "substantial authoritative support". Currently, accounting standards in Chinese Taipei are mainly developed through the Financial Accounting Standards Committee (FASC) of the Accounting Research and Development Foundation. FASC is an independent private sector body, with the objective of providing accounting guidelines, procedures, and practices in recording and reporting accounting information in audited financial statements. The committee comprises representatives from accounting academies, practitioners, and government. In addition, one special task force was also set up to resolve emerging accounting issues that are not covered by any authoritative documents. There are 27 Statements of Financial Accounting Standards as of 15 February 1999. Annex 1 summarises the standards issued by FASC.

As Chinese Taipei has rapidly developed into a major trading and commercial centre, existing disclosures required by the authorities do intend to provide users with timely, accurate and relevant information. The Securities and Futures Commission requires that corporate financial forecasts be reviewed by independent auditors and timely disclosed. The SFC regulations also require that semi-annual financial statements be audited and not just reviewed by independent auditors. Although financial accounting standards are generally considered adequate for market participants, the increasing complexity of business organisations and transactions has created an urgent demand for developing more timely authoritative accounting standards. For example, accounting for financial instruments, off-balance transactions, asset impairment, and troubled company financial/organisation restructuring needs further development. Also, the disclosure of cross-shareholdings is still not adequate for revealing the actual owners of public companies. The recent financial failures present urgency in this respect. The SFC is currently tightening up its disclosure regulations for cross-shareholding and consolidated financial statements.

Asset valuation

Current General Accepted Accounting Principles (GAAP) in Chinese Taipei require that assets be valued either at cost or at lower of cost or market value. For example, short-term investments should be valued by the lower-of-cost-or-market method. Similarly, inventory is valued using the lower-of-cost-or-market method. Fixed assets should be recorded at either their acquisition costs or construction costs. Hence, asset valuation in general cannot reflect the current market value of assets. However, SFAS No. 27 "Disclosure of Financial Instruments" issued in 1997, requires companies to disclose market values of financial instruments in the notes to financial statements. In sum, there is no mark to market accounting for any securities and liquid assets under the current GAAP in Chinese Taipei.

According to the GAAP, intangible assets, such as goodwill, trademarks, patents, copyrights, franchises, etc., should be presented separately. Purchased intangible assets should be recorded at actual cost. Self-developed intangible assets that cannot be identified clearly (e.g. goodwill) should not be recorded. However, those that are specifically identifiable (e.g. a patent right) can only be recorded in an amount representing no more than the registration and application fees. Research and development costs should be recorded as expenses when incurred. Startup costs are costs incurred prior to the beginning of business operations. Unless the startup costs have future economic benefits, they should be recorded, net of proceeds in the same period, as current expenses. Items with future economic benefits or recoverable from future operations may be deferred. All intangible assets should be amortised for a period equal to the duration of associated economic benefits but no longer than twenty years.

Non-financial information disclosure

In order to achieve a higher standard of transparency, to understand business and financial activities of publicly held companies, and to allow investors to make informed and rational decisions, the SFC demands full disclosure in prospectuses, periodical financial reportings as well as other important information that may affect shareholders' interests. For example, the SFC requires companies to abide by rules such as the "Rules Governing Acquisition and Disposition of Asset by Publicly Held Companies" and the "Guidelines for Acquisition of Real Estate from Related Party by Publicly Held Companies". In addition, the SFC requires that the Taiwan Stock Exchange and the Over-the-Counter Stock Exchange comply with additional rules, such as the "TSE/OTC Procedures for Verifying and Publishing Important Information Pertaining to Listed/OTC Companies", the "Procedures of Press Conference for Disclosure of Important Information of Listed/OTC Companies", and the "Guidelines for the Implementation of Stock Market Monitoring System".

To strengthen the public disclosure system, the SFC has instructed the Securities and Futures Institute, a quasi-public organisation for research and training, to collect additional related information on public companies to satisfy investors' needs for more information. Furthermore, in order to improve risk management of financial derivatives by public companies, the SFC has promulgated the "Rules Governing Engagement in Financial Derivatives Transactions by Publicly Held Companies".

In addition, the articles of incorporation in the Company Law stipulate the obligations and rights of board members. Components of compensation (i.e. salary, bonuses, benefits in kind) paid to top management and directors, and boardroom procedures are all required to be disclosed in a public company's prospectus.

Disclosure of consolidated business accounts and related party transactions

The Statement of Financial Accounting Standards No. 7 establishes the accounting standards for consolidated financial statements. It requires that the gains or losses resulting from affiliated company transactions must be mutually eliminated from the consolidated financial statements and the footnotes of financial statements should disclose the following items:

- the name of each subsidiary, nature of its operations, and the percentage of shareholders' equity held by the parent company;
- change of subsidiaries that are included in the consolidated statements;
- the name of each subsidiary not included in the consolidated statements, percentage of shareholder's equity held by the parent company, and reasons for its exclusion from the consolidated statements; and
- the details of the parent company's stocks held by the subsidiary.

The SFC requires publicly held companies to disclose ownership information, including percentage composition of shareholders such as the government, financial institutions, other institutional investors, foreigners, and individuals. In addition, statistics of ownership dispersion and change in major stockholders' shareholdings should be reported. Although disclosure of the above detailed information on parent-subsidiary relationships and ownership structure is required, it is still insufficient for investors due to the complexity of relationships among related parties. In sum, the information regarding ownership structure and affiliated patterns in Chinese Taipei corporate groups is still obscure, especially when the subsidiaries are not publicly held companies, or the subsidiaries have investments in their own subsidiaries (i.e. grandparent-subsidiary relationships).

Since current disclosure of ownership links is not sufficient, the SFC is drawing up the "Draft of Guidelines of Parent and Affiliated Companies: Relationship Reports, Group Management Reports and Consolidated Financial Statements" to respond to the revised Company Law requirement. Cross-shareholding among Chinese Taipei's companies is especially likely to add further damage to corporate balance sheets if the market continues its decline and enters into a vicious cycle. The SFC has thus put into effect the provision that listed and OTC companies will be suspended from trading if their financial statements contain misleading information or that important financial or operational information is not disclosed in time or properly.

Regulations of the banking administration in the Ministry of Finance require that loans made to affiliate companies do not exceed a certain percentage. SFAS No. 6 ("Disclosure of Related Party Transactions") and the draft of SFAS No. 28 ("Disclosures in the Financial Statements of Banks") require banks to report their lending to affiliated firms so that disclosure of information about their lending to affiliates is not a point of controversy.

The FASC has issued SFAS No. 27 ("Disclosure of Financial Instruments") requiring companies to disclose off-balance-sheet transactions related to financial instruments. Similarly, significant commitments, cross-guarantees of credits and other such risks are all required to be properly disclosed under the GAAP.

Effectiveness of independent auditors

The audit service of a CPA gives credibility to the financial information of a business. The SFC has promulgated several procedures to enhance the auditor's professional standards. According to Certified Public Accountant Law, a CPA shall file an application for registration with the authority when commencing to practice. In addition, a CPA shall not perform professional services without being admitted to the membership of a CPA association after he/she has been duly certified. Also, a CPA shall perform professional services in accordance with the laws, regulations and ordinances of the authority. The related authority may take disciplinary action against a CPA who violates laws, regulations or professional ethics.

To improve the professional standards of CPAs, the SFC has requested the National Federation of CPA Associations to implement peer review procedures, promoting the CPA's audit quality. Furthermore, the CPA Disciplinary Committee of the MOF has the authority to take action against CPA misconduct. In 1997, 27 cases were transferred to the Committee and 13 of them proceeded for further review. Among them, 3 were punished with suspension of practice, 2 received a reprimand, 1 was disciplined with a warning, and 7 were found not guilty and freed from sanctions.

Regulatory policies to improve transparency

The recent crisis has heightened awareness of the importance of transparency and disclosure, as well as of the need for regulatory changes. In this context, the government has taken several steps in order to:

- Enhance the independence of the SFC and its authorities (the government is planning to raise the SFC's administrative status and independence in the government hierarchy).

- Establish a consolidated investigation agency covering various financial institutions.

- Avoid banking institutions from becoming intertwined in business groups (the chairman and CEO of a bank are required to possess professional qualifications).

- Amend laws and regulations to increase the legal liabilities of board directors and independent auditors.

- Amend laws and regulations regarding cross-shareholding as well as related disclosure requirements.

- Require listed and OTC companies to file computerised financial reporting on-line (investors could then obtain financial information of listed and OTC companies in time through the Stock Market Observatory System, a quick market information dissemination system).

- Amend the "Guideline for Endorsement by Listed and Over-the-Counter Companies" to improve relevant endorsement information disclosure and effectively regulate the endorsement by listed and OTC companies.

- Require listed and OTC companies' to computerise and disclose their financial forecasts through the "Securities and Futures Information System on Internet", and reinforce the monitoring of the required information, in order to ensure timely disclosure and the quality of financial information.

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Annex 1: List of Statements of Financial Accounting Standards

SFAS 1	Summary of Generally Accepted Accounting Principles
SFAS 2	Accounting for Leases
SFAS 3	Capitalization of Interest Cost
SFAS 4	(Superseded)
SFAS 5	Long-term Investments in Equity Securities
SFAS 6	Disclosure of Related Party Transactions
SFAS 7	Consolidated Financial Statements
SFAS 8	Accounting Changes and Prior Period Adjustment
SFAS 9	Contingencies and Subsequent Events
SFAS 10	Valuation and Presentation of Inventory
SFAS 11	Long-term Construction Contracts
SFAS 12	Accounting for Income Tax Credits
SFAS 13	Accounting by Debtors and Creditors for Troubled Debt Restructuring
SFAS 14	Accounting for Foreign Currency Transactions and Translation of Foreign Financial Statements
SFAS 15	Disclosure of Accounting Policies
SFAS 16	Preparation of Financial Forecasts
SFAS 17	Statement of Cash Flows
SFAS 18	Accounting for Pension
SFAS 19	Development Stage Accounting
SFAS 20	Disclosure of Segment Financial Information
SFAS 21	Accounting for Convertible Bonds
SFAS 22	Accounting for Income Taxes
SFAS 23	Interim Financial Reporting and Disclosures
SFAS 24	Earnings Per Share
SFAS 25	Accounting for Business Combination – Purchase Method
SFAS 26	Accounting for Corporate Bonds issued with stock warrants
SFAS 27	Disclosure of Financial Instruments

Source: Accounting Research and Development Foundation, Taiwan (Chinese Taipei).

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