REGULATING CORPORATE BEHAVIOUR

KEY POINTS

- **Since the crisis, most East Asian governments recognise the urgent need to strengthen regulations to increase corporate transparency and enforce better treatment of outside investors; this is essential to support regional economies transition from a relationship to a rules based business model and enable their return to robust growth.**

- **In the region's most advanced economies, corporate disclosure requirements now approach or equal international best practice, but in several emerging economies, enforcement is weak.**

- **Since the crisis, accountancy and auditing rules also are stronger, with international accounting standards, external auditors and in many cases, internal audit committees now mandatory requirements for listed companies in most regional economies. However, in most emerging markets and even several mature regional economies, accounting practices still lag legislative requirements.**

- **Many but not all regional economies now protect minority shareholder rights; however, the dominance of family owned corporates still undermines incentives for managers to maximise value for all shareholders, requiring continued vigilance by regulators.**

- **Since the crisis, most economies have introduced best practice bankruptcy legislation but several regional economies lack strong court implementation, undermining creditor protection.**

During the financial crisis, widespread corporate losses threatened financial systems and economic stability, alerting governments to the serious risks corporates and financial institutions pose when they neglect investors' interests, borrow unwisely and misuse their savings. Evidence suggests economies with better investor protection avoid systemic risk and have more efficient capital markets, lower capital costs and faster economic growth (La Porta et al., 1998). Since the crisis, East Asia's low or negative net capital inflows have retarded recovery; these may not turn around until foreign and domestic investors feel confident regulatory regimes protect them.[1] Hence these reforms go to the heart of overcoming East Asia's continuing economic malaise.

Consequently, since the crisis, virtually all regional governments have strengthened rules and laws governing firm behaviour to make future corporate investment decisions more transparent and less risky and better protect shareholders and creditors. Importantly, many governments and professional bodies now accord high priority to enforcing these regulations by strengthening the corporate legal framework and upgrading the skills and awareness of regulators, firm directors and accounting and financial market professionals (Allen, 2000). These efforts complement policies that strengthen market discipline on firm behaviour. (See Chapter 2 – *Markets*.) This chapter maps regional governments' progress in supporting the shift to rules based business by boosting corporate governance standards through regulatory and legal reforms.

REQUIREMENTS FOR GOOD GOVERNANCE

In a sound corporate regulatory environment :

- outside investors and creditors can access accurate and timely information on funded companies' activities
- companies using outside funds protect all investors' interests; listing rules ensure all shareholders are represented in firm decision making through boards of directors and shareholder meetings
- regulations protect minority shareholders against exploitation by letting them take effective action if majority shareholders act against their interests
- insolvency laws protect creditors if firms become insolvent
- strict bank lending and prudential standards and transparency requirements, particularly when bank owners and managers are related to borrowers, protect depositors.

Many East Asian economies have laws and listing rules that attempt to deliver these outcomes; others still are strengthening their legal and prudential frameworks. Enforcement standards and compliance levels also vary greatly. Enforcement is strong in Hong Kong and Singapore, is gradually improving in middle income regional economies but generally remains weak in emerging East Asian economies.

[1] In 2000, excluding China and Japan, US$ FDI flows to other surveyed economies were 17 per cent lower than in 1996 (CEIC, 2002).

IMPROVING TRANSPARENCY

Good quality and timely financial information, ensured by imposing strong penalties for providing misleading information, would improve the volume and quality of portfolio investment and bank financing in East Asia and encourage new business associations. Outside investors, especially shareholders, usually are removed from the daily operations of their investments and are disadvantaged compared with dominant shareholders with close management links. Particularly since the crisis, outside shareholders require credible information to regain their trust and encourage greater shareholder activism. Although some East Asian creditors, especially large Japanese banks in *keiretsu* groups, understand their corporate clients' financial condition, better information would reduce the risk of creditors funding bad investments and their reluctance to resume lending.

Since the crisis began, many East Asian governments have committed to improve the timeliness and standard of corporate information available to banks and investors, through more stringent reporting requirements and upgraded company laws and accounting standards. However, compliance is uneven, with under resourced enforcement agencies and weak compliance incentives frustrating a faster move to rules based disclosure culture.

Disclosure and Financial Reporting

Before the crisis, East Asian corporate transparency and disclosure generally was weak. Complex and opaque links between firms belonging to the same conglomerate demand frequent and comprehensive consolidated reporting of conglomerates' listed and private firm accounts. Most regional economies now require consolidated reporting (Table 3.1). The Republic of Korea Government introduced consolidated reporting in 1998 (East Asia Analytical Unit, 1999a) and the Japanese authorities introduced it in March 2000 (Kurihara, 2001).

In all regional economies, listed companies must inform authorities of major transactions to determine if they are arm's length. Increasingly exchanges like the Thai Securities Exchange Commission vigorously enforce such regulations (McMillan, 2001). In all major East Asian economies, firms also must inform investors of extraordinary events which may affect the company's value; this is especially important in volatile markets (Table 3.1).

Since the crisis, several East Asian security exchange commissions, bank supervisory authorities and stock exchanges have reviewed disclosure rules, using standards set by leading international financial centres, such as the UK. Key reforms include requiring disclosure of related party transactions (Table 3.1). Singapore, Thailand and Indonesia have recently strengthened disclosure requirements (Nam et al., 1999). Hong Kong and Singapore now are market leaders in most areas, using a hybrid of disclosure and merit based systems. Malaysian authorities also are moving towards a disclosure based system.[2]

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[2] A disclosure based system ensures it is in firms' interests to comply with regulations, reducing the need for regulators to scrutinise individual firms' behaviour.

Table 3.1

Most Regional Economies Upgrading Reporting

Checklist of Financial Reporting Requirements for East Asian Economies

	Mandatory consolidated reporting	Disclosure of derivatives	Disclosure of related party transactions[1]	Reporting frequency in months[1]	Mandatory disclosure of extraordinary events[1]
Japan	Yes	Yes	Yes	6	Yes
Republic of Korea	Yes	Yes	Yes	6	Yes
China	No	na	Yes	3 (2002)	Yes
Hong Kong	Yes	Yes	Yes	3	Yes
Taiwan	Yes	Yes	Yes	6	Yes
Singapore	Yes	Yes	Yes	6	Yes
Malaysia	Yes	Yes	Yes	3	Yes
Indonesia	Yes	Yes	Yes	12	Yes
Philippines	Yes (draft)	Yes	Yes	3	Yes
Thailand	Yes	Yes (draft)	Yes	3	Yes
Vietnam	No	No	No	3	Yes
Australia	Yes	Yes	Yes	3	Yes

Note: 1 Listed companies' requirements, except for China and Vietnam.
na is not applicable.

Source: PricewaterhouseCoopers, 2001.

International Initiatives

Since the crisis revealed inadequacies in corporate disclosure, multilateral initiatives including the Financial Stability Forum and the International Forum on Accountancy Development have targeted improved disclosure and transparency. A major International Monetary Fund and World Bank program, the Review of Standards and Codes, ROSCs, supports governments and professional bodies in lifting corporate and government transparency in key areas.

REVIEW OF STANDARDS AND CODES

The ROSCs program was commenced in 1999 as a joint International Monetary Fund and World Bank initiative to identify weaknesses which could contribute to economic and financial vulnerability in member economies. It is designed to foster market efficiency and discipline and ultimately to contribute to a more robust and less crisis prone global economy. International standards in a range of regulatory, corporate governance and macroeconomic data areas provide a benchmark to help member countries identify vulnerability and guide policy reform. Hence the ROSCs program aims to increase transparency about global economic governance standards for markets and encourage governments to adhere to core international codes.

Under a five year program, the International Monetary Fund and World Bank are employing independent expert teams to gather detailed data on about 180 member economies' compliance with international standards in 11 key areas:

- statistical data dissemination and transparency
- corporate governance
- accounting
- auditing
- insolvency and creditor rights
- fiscal transparency
- transparency in monetary and financial policies
- banking supervision
- securities regulation and supervision
- insurance supervision
- payments and settlements.

By April 2001, the International Monetary Fund and World Bank had completed 110 ROSCs modules for 43 economies; 76 of these are on the Funds web site, www.imf.org.

Australia is a leader in this process; already it has reported on all 11 modules. Hong Kong also has reported on banking supervision, data dissemination, monetary and financial policy and fiscal transparency; and Japan and the Republic of Korea have reported on fiscal transparency. Malaysia, the Philippines, the Republic of Korea and Indonesia have volunteered for several early ROSC assessments.

Source: Metzen-Quemarez, 2001; Parkinson, 2001; International Monetary Fund, 2001.

Enforcement

Enforcement of disclosure requirements varies considerably. Most regulators prefer to threaten to publish details of firms' non-compliance to expose them and in extreme cases fine them, rather than to de-list companies. In East Asian economies, where corporate loss of face is a serious issue, public exposure can be very effective (Shaw, 2001).

Singapore, Hong Kong and Malaysia tightly enforce disclosure requirements, and Japan, Republic of Korea, Thailand, Taiwan and the Philippines are tightening enforcement. China, Vietnam and Indonesia have relatively weak corporate disclosure, although the China Securities Regulatory Commission is working hard to lift standards.

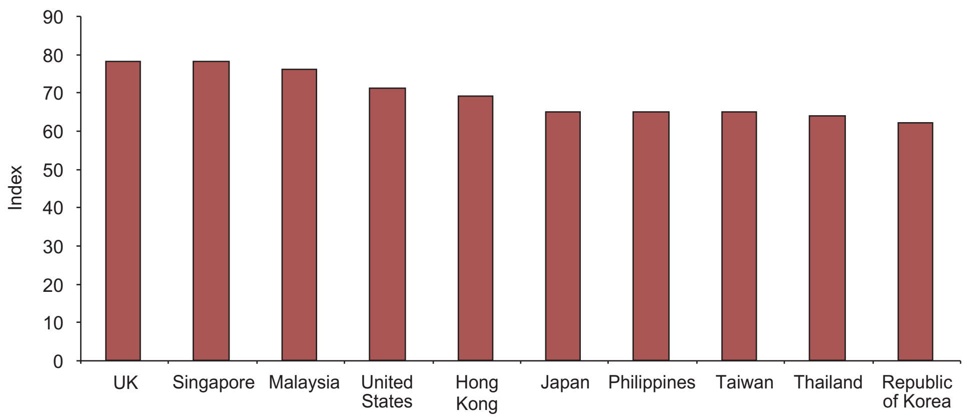
Accounting Standards

Sound accounting standards are critical in improving financial reporting and transparency. Before the crisis, in Japan, the Republic of Korea, many middle income and all emerging East Asian economies, accounting practices were problematic. Since the crisis, most regional professional and quasi-government bodies have reviewed accounting standards and in Thailand, Japan, the Republic of Korea, Indonesia and China authorities have upgraded requirements to more closely correspond with International Accounting Standards. A 1998 survey found Malaysian and Singaporean accounting practices were equal to or above UK and US standards, but average East Asian accounting standards were below these levels (Figure 3.1). Capital market regulators issue listing rules which usually contain financial reporting requirements and accountancy standards and corporation laws also usually prescribe requirements and standards.

Figure 3.1

Singaporean and Malaysian Standards High

Accounting Standards in UK, US and Selected East Asian Economies



Note: The index was created by examining and rating companies' 1990 annual reports based on their inclusion or omission of 90 items. Australian data not available.

Source: Khan, 1999.

Before the crisis, many East Asian economies' accounting practices were deficient in valuing assets, disclosing off-balance sheet items and reporting related party transactions, including cross-guarantees; these omissions compromised outside investors' rights (Nam et al., 1999).[3] Many firms also failed to break down income and expenses in different sectoral activities, potentially concealing from outside investors their exposure to activities concentrated in risky sectors including real estate (Rahman, 2000a). However, since the crisis, most economies have upgraded relevant accounting standards to reduce these practices (Table 3.2).

Table 3.2

Most Economies Formally Comply

Accounting and Auditing Standards in Selected East Asian Economies

	Mandatory disclosure of off-balance sheet items	Mandatory disclosure of foreign exchange exposure	Mandatory disclosure of activities by sector	Mandatory audit committee	Mandatory external audit
Japan	Yes	Yes	No	Yes	Yes
Republic of Korea	Yes	Yes	Yes	Yes	Yes
China	Yes	na	Yes	No[1]	Yes
Hong Kong	Yes	Yes	Yes	Yes[2]	Yes
Taiwan	Yes	Yes	Yes	No	Yes
Singapore	Yes	Yes	Yes	Yes	Yes
Malaysia	Yes	Yes	Yes	Yes	Yes
Indonesia	No	Yes	Yes	Yes[2]	Yes
Philippines	Yes	Yes	Yes	No	Yes
Thailand	Yes	Yes	Yes	Yes	Yes
Vietnam	Yes (2003)	Yes (2003)	Yes (2003)	No	Yes[3]
Australia	Yes	Yes	Yes	Yes	Yes

Notes: 1 Although Supervisory Committees are required.
2 Listed companies only.
3 Foreign invested companies only.
na not applicable.
Source: PricewaterhouseCoopers, 2001.

3 IAS32 and IAS5 cover best practice in accounting for these activities.

Enforcement

With a few exceptions, East Asian economies' formal accounting requirements now are reasonably sound, but in many enforcement is problematic. Many firms' financial statements do not comply fully with national or international standards (Rahman, 2000b).[4] Very few firms are prosecuted for fraudulent accounting or violation of disclosure rules and in the rare cases of convictions, mandated punishments are minimal; this deters authorities from seeking further prosecutions. Very few accountants have lost their licences to practice, though numbers are up since the pre-crisis (Gunadi, 2001).

However, official and professional bodies are pressing to raise standards. Thailand's peak professional accounting body is encouraging the Government to introduce criminal sanctions for fraudulent accounting practices and other fiduciary duty failures (Charuvastr, 2001). Professional accounting bodies also are seeking legal authority to enforce ethics and standards; Indonesia's professional body now licenses accountants and Thailand's professional body promotes new legislation which would give it this authority (Nimsomboon, 2001; Gunadi, 2001).

Auditing

Regional governments also are reviewing auditing regulatory requirements as these provide an important way of enforcing accounting standards. Auditors assure outside investors that a company has complied with accounting standards.

In recent years, formal auditing requirements have strengthened markedly and in most surveyed economies, listed companies now must engage independent auditors to undertake external audits of their financial statements (Table 3.2). Also, national auditing standards require auditors to detect non-compliance with the country's established accounting standards (Rahman, 2000b). Regulators in Australia, Japan, Singapore, Malaysia, Hong Kong, the Republic of Korea, Indonesia and Thailand also require listed firms to have an audit committee, reporting to the board of directors, responsible for financial reporting, and reviewing external and internal audit functions. In some economies, including Thailand and Japan, audit committees must comprise independent members who are not firm directors. In other economies, audit committee members also often hold places on the boards of directors.

Enforcement

However, many auditors in East Asia fail to adhere to prescribed reporting standards due to commercial pressure to return favourable audits, lack of knowledge of standards, ineffective peer review mechanisms and a lack of legal sanctions for non-compliance (Rahman, 2000b). Management can exert undue influence on audit committees or boards can contaminate audits. Many newly formed audit committees have yet to determine their proper role. External auditors lack independence. Some auditors also have close and longstanding ties with the firms they audit. This is a concern to regulators in Indonesia and the Philippines.

4 A survey of accounting practices in the Republic of Korea, Thailand, Indonesia, Malaysia, the Philippines and Japan found rates of compliance with international standards amongst large public companies were poor. Fewer than 50 per cent of large public companies reported related party lending and fewer than 33 per cent reported derivatives and income by sector (Rahman, 2000a).

The experience of Enron in the United States demonstrates the challenge of preserving audit independence and accuracy, especially given the big five accounting firms' practice of selling both audit and other consulting services to client firms. This trend may create a conflict of interest, affecting audit quality. Consequently, the Australian Securities and Investments Commission is inquiring into the independence of auditors of Australia's top 100 companies. Other authorities, including in Hong Kong also are reviewing similar guidelines.

ENRON DISASTER A WAKE-UP CALL

In 2001, several prominent US firms including Enron, Sunbeam and Reliance Group declared bankruptcy, pushing total assets of bankrupt companies to US$258.5 billion, well up from US$94.8 billion in 2000. This spate of high profile bankruptcies reminded creditors and share market investors of the risks involved in corporate financing, and should increase their scrutiny of alternative investments. However, many of these collapses, especially Enron's, also highlight some serious concerns about United States' corporate governance regulations.

In December 2001, Enron filed the biggest bankruptcy in United States history, with debts of US$63.3 billion. Starting life as a gas company, Enron grew rapidly, becoming the seventh largest company in the United States. It traded in many commodities, from energy to television advertising space and bandwidth.

Enron operated a complex and non-transparent business model, which is now subject to regulator scrutiny. It shifted large amounts of debt into a series of separate limited partnerships; by 21 January 2002, 37 of these separate units had filed for Chapter 11 protection. In November 2001, auditor Arthur Andersen pressed Enron to restate its results, reducing reported profits; this collapsed investor confidence and its share price plunged. Enron now admits that between 1997 and 2000, it overstated its debts by US$628 million and profits by US$591 million. After commencing investigations into Enron in October 2001, by January 2002, the Securities Exchange Commission also began investigating Arthur Andersen's auditing of Enron.

Arthur Andersen stands accused of failing to detect the scale of Enron's debt and for shredding key documents related to the audit. The Securities Exchange Commission also will investigate claims senior Arthur Andersen staff, including CEO Kenneth Lay, sold US$3.5 million shares in Enron soon after hearing of Enron's revised financial position. The Enron case is likely to force strengthening of relevant corporate regulations. It also raises concerns about the self regulation of the US accounting profession and potential conflicts of interest big five firms face when simultaneously offering audit and consulting services.

Source: *Australian Financial Review*, 19-20 January, p. 20; *The Australian*, 17 January 2002, p. 2.

Since the crisis, regulatory attention has focused on lifting auditing standards rather than enforcement. However, enforcement should improve as regional economies' professional accounting and auditing bodies become more active and have more authority. Also, capital market regulatory authorities are increasing their surveillance, punishing violations of auditing standards in several economies, including Indonesia and Malaysia (Rahman, 2000a).

While East Asian investors certainly need better access to quality information, this alone will not ensure better investment outcomes. Investors also need safeguards protecting minority shareholder and creditor interests.

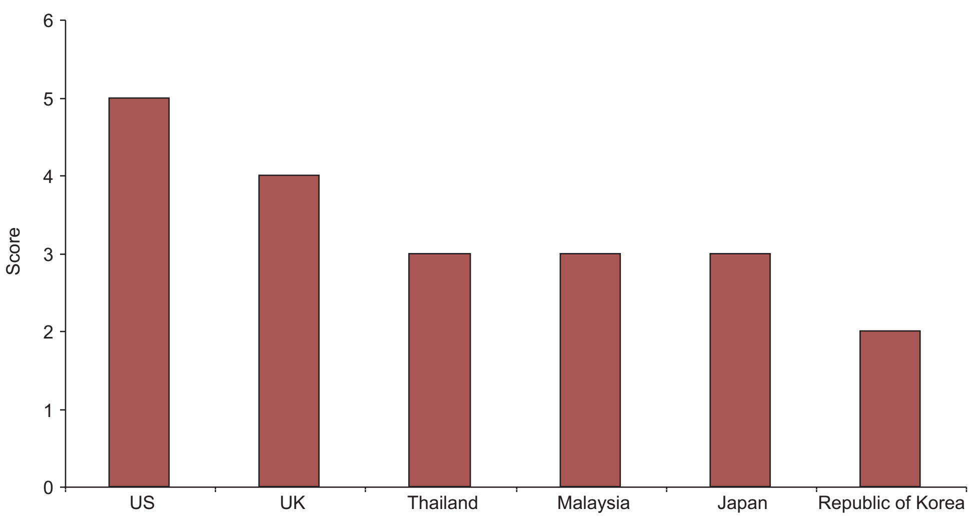
PROTECTING MINORITY SHAREHOLDERS

Protecting minority shareholders is a key regulatory challenge in East Asia (Prowse, 1998). Minority shareholders are highly vulnerable to exploitation by firm insiders. This is in part because ownership in many East Asian corporations is highly concentrated and an individual or family may dominate firm decision making through appointments to boards and senior management. (See Chapter 2 – *Markets.*) As well, pyramid schemes and non-voting share systems are common, so original owners can retain company control although holding a minority of shares; under these, controllers may expropriate the cash flow meant for smaller shareholders (Claessens et al., 1999). Finally, minority shareholders' formal protection traditionally is weak, with selected East Asian economies rating lowly against a sample of economies (Figure 3.2).

Figure 3.2

East Asian Shareholder Protection Relatively Weak

Survey of Shareholder Protection in Selected Economies



Note: The scale is from 1 (lowest) to 5 (highest) based on legal remedies available to shareholders and the quality of legislation.
Source: La Porta et al., 1998.

Many East Asian regulators recognise these problems and are strengthening minority shareholder protection, concentrating on legal remedies and shareholder activism. Governments in Japan, the Republic of Korea and China are strengthening listing requirements, so firms seeking funds from outside shareholders must meet tougher capital, minimum listing proportions, profitability and disclosure criteria; this should minimise minority shareholder risk. In the Republic of Korea, new regulations allowing cumulative voting for directors, proxy voting and smaller quorum requirements give small shareholders better representation (Shin, 1998). Also directors need to be legally accountable for their actions to all shareholders, including minority shareholders, with most surveyed economies allowing class actions.

Minority shareholders traditionally are passive in East Asia, voting with their feet rather than their shares. However, assisted by new regulations, Korean minority shareholders are becoming extremely active and vocal (Lee, 1998). Also some regional regulators are promoting shareholder activism. For example, the Thai Securities and Exchange Commission sends staff members to annual general meetings to ensure minority rights are protected (Sucharitakul, 2001). However, in most economies, it is too early to tell whether these new policies are enforced adequately or minority shareholders' effective rights are stronger.

Listing Requirements

Many regional stock exchanges and securities and exchange commissions have strengthened listing requirements since the crisis, increasing regulators' capacity to ensure equity issuing firms comply with basic corporate governance standards. These regulations typically require listed firms to meet transparency and reporting requirements, be profitable for a sustained period, usually for three years before listing, provide minority shareholders with appropriate board and general meeting representation and protect them from wealth expropriation by majority shareholders. The threat of delisting due to unreported related transactions, other listing rule violations and insolvency encourages firms to comply. Most listing rule reforms have focussed on requiring independent directors and audit committees. Since the crisis, regional capital market regulatory authorities have achieved the most thorough overhaul of standards, incorporating the Malaysian Code of Corporate Governance into Malaysian listing rules. Other authorities, including those of Thailand, Singapore, Hong Kong, China and Indonesia, also have issued corporate governance codes formulated by private and public sector experts, although few have enforced statutory backing. Thai and Hong Kong listed companies must indicate in their annual reports the extent to which they comply with their codes (PricewaterhouseCoopers, 2001; Sucharitakul, 2001).

Since the crisis, some regional securities exchange commissions have established secondary bourses with lower standards (Benjapolchai, 2001; Daniri, 2001). This is because, since the crisis, few local companies could meet the initial public offer requirement of three years of profits. While this may allow more companies to list, lower standards on these bourses may undermine the effectiveness of listing in boosting corporate governance. Many governments, including Thailand's, also give considerable tax incentives to list. The impact of such policies on improving corporate governance is problematic as family owned companies may list only to attract lower tax rates, without having any commitment to producing value for minority shareholders.

Representation

In many regional economies, minority shareholder representation is weak. However, regulations ensuring minority shareholders can protect their interests and express critical views should help rectify this. First, a small minority of shareholders should have the right to call an emergency shareholder meeting. Second, if shareholders cannot attend the meeting, they should be able to vote by mail or proxy. Third, cumulative voting would grant each shareholder a number of distributable votes equal to the number of directors being elected.[5]

Most economies grant shareholders the right to call an emergency shareholder meeting, especially where a management or dominant shareholder decision is controversial. Since the crisis, the Republic of Korea reduced the percentage of a listed companies' shareholders required to initiate such a meeting to 1 per cent, but in Japan, the required proportion is still a very high 33 per cent and in Thailand, 20 per cent. Legislation to reduce these shares is still pending (Table 3.3) (Sucharitakul, 2001).

In all regional economies except Japan, shareholders can vote by proxy and in most economies shareholders must approve transactions involving insiders. In all economies, shareholders are entitled to make proposals at shareholder meetings (Nam et al., 1999). However, cumulative voting is less widely available, reducing the representation of minority shareholders on the board (Table 3.3) (APEC, 1999).

With some exceptions, many features of regional shareholder protection align with world best practice, suggesting shareholders have in principle rights to access information and participate in meetings. However, large shareholders dominate most East Asian companies; often they do not accept minority shareholders should exercise these rights or challenge the dominant shareholder's view (Nam et al., 1999).

Hence, regulators are reviewing other measures, including the structure and duties of boards, to increase scrutiny of firm management.

[5] Cumulative voting therefore allows minority shareholders to elect some directors to the board, even if major shareholders oppose the election.

Table 3.3

Checklist of Shareholder Rights

Shareholder Standards in Selected East Asian Economies

	One share equal to one vote	Compulsory proxy voting	Compulsory cumulative voting	Shareholder initiated meetings	Quorum required to call a meeting (per cent)	Mandatory shareholder approval of related transactions
Japan	Yes	No	No[1]	Yes	33 (draft)	Yes
Republic of Korea	Yes	Yes	Yes	Yes	1	Yes
China	Yes	Yes	No	Yes	10	Na
Hong Kong	Yes	Yes	Yes	Yes	10	Yes
Taiwan	Yes	Yes	Yes	Yes	3	Yes
Singapore	Yes	Yes	No[2]	Yes	10	Yes
Malaysia	Yes	Yes	No	Yes	10	Yes
Indonesia	Yes	Yes	Yes	Yes	10	Yes
Philippines	No[3]	Yes	Yes	Yes	10	Yes
Thailand	Yes	Yes	Yes (draft)[4]	Yes	20	No[4]
Australia	Yes	Yes	Yes	Yes	100 shareholders	Yes

Notes: 1 Company Articles can allow cumulative voting.
2 Not permitted under Company Law.
3 Non-voting shares are allowed in some cases.
4 Nikomborirak, 1999
na is not applicable

Source: PricewaterhouseCoopers, 2001.

Board of Director Composition

In many East Asian firms, dominant shareholders can exploit smaller shareholders by appointing themselves, their relatives or their representatives to the board of directors, weakening its capacity to provide effective and independent oversight of management (APEC, 1999). The board chairman and Chief Executive Officer often come from the family that controls the firm and may be the same person (Claessens et al., 1999).

All economies surveyed now require a minimum proportion of independent non-executive directors on listed company boards (Table 3.4). Most companies also must advise shareholders of their boards' composition. However, independence involves not working within the company or being related to owners, but does not preclude friends and associates of owners. Often senior management or other insiders capture so-called independent board members (APEC, 1999). Furthermore, suitably qualified independent board members are in short supply (Moore, 2001). Even in China, Japan and Indonesia where a second supervisory board exists, its members also often have close links with management.[6]

Directors' Obligations

Before the crisis, many East Asian regulators were vague or silent on directors' duties (APEC, 1999); few economies passed or enforced legislation ensuring minority shareholders could challenge board decisions which neglected their interests. Since the crisis, many governments are increasing priority to ensuring directors meet fiduciary duties (Table 3.4). Many directors and management now receive compensation in proportion to firm profitability, providing directors with incentives to add value for shareholders. However, statutory backing for these requirements remains weak.

If directors are closely linked to insiders, boards of directors can marginalise outside investor interests. By contrast, good corporate governance obliges directors to assess the effectiveness of board directors and management in maximising shareholder value (Californian Public Employees' Retirement System, 1999). Boards and managements should disclose the reasoning behind key decisions to all shareholders and remain open to their inquiries, thereby protecting shareholder interests.

Table 3.4

Rights Stronger, Enforcement Variable

Checklist of Board of Directors and Minority Shareholder Protection

	Independent directors mandatory	Shareholder approval of beneficial transactions	Well defined fiduciary obligations	Allows derivative suits	Allows class actions
Japan	Yes (draft)	Yes	Reasonable	Yes	Yes
Republic of Korea	Yes	Yes	Yes	Yes	No
China	Yes	Yes	Yes	No	Yes
Hong Kong	Yes	Yes	Yes	No	No[1]
Taiwan	Yes	Yes	Yes	Yes	Yes
Singapore	Yes	Yes	Yes	Yes	Yes
Malaysia	Yes	Yes	Yes	Yes	Yes
Indonesia	Yes	Yes	Yes	Yes	Yes
Philippines	Yes	Yes	Yes	Yes	Yes
Thailand	Yes	No	No[2]	Yes	Yes (proposed)
Australia	Yes	Yes	Yes	Yes	Yes

Notes: 1 However, common law remedies apply.

2 These are covered under voluntary codes of conduct rather than law (Nikomborirak, 1999).

Source: PricewaterhouseCoopers, 2001.

6 In Japan, China and Indonesia, boards of directors comprise company insiders and a second supervisory board, the board of supervisors, performs the oversight role of the board of directors.

Legal Action against Directors

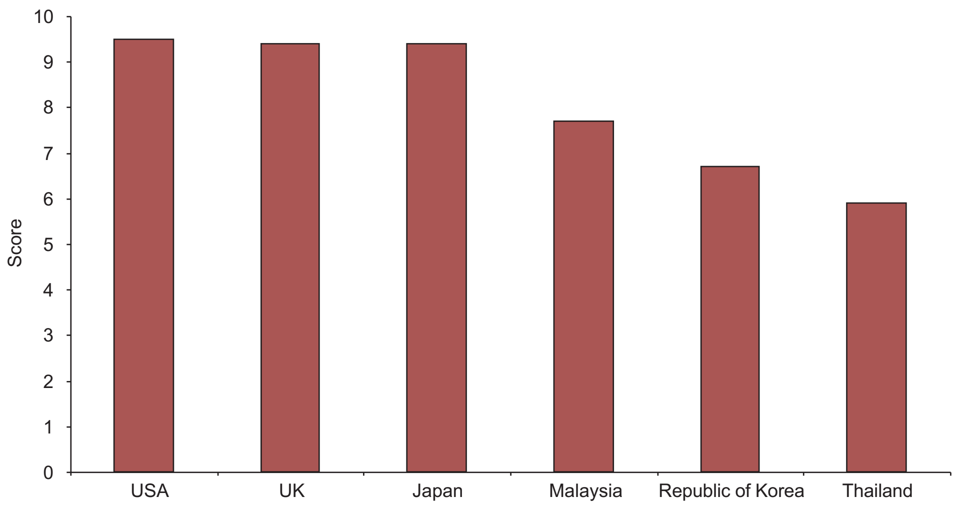
Legal action is an important last resort for minority shareholders where directors or majority owners have acted against their wishes or expropriated minority shareholder wealth. However, shareholder litigation is rare in East Asia. Shareholders can seek to recoup losses from directors through criminal penalties for breaches of trust and class action suits for damages (Table 3.4). However, penalties for violating shareholders' rights to information and decision making participation are weak. Even where legal provisions exist, legal system weaknesses undermine enforcement; only Japanese enforcement rivals that in the United States and United Kingdom (Figure 3.3).

The lack of credible legal options open to minority shareholders reduces shareholder activism (APEC, 1999). Furthermore, in economies like the Republic of Korea, even if a case alleging minority shareholders are excluded from decision making is successful, low shareholder compensation can deter litigation (PricewaterhouseCoopers, 2001).

Figure 3.3

Shareholder Protection Not Strong

Survey of Judicial Enforcement of Shareholders' Rights



Note: The scale from 1 (lowest) to 10 (highest), is based on five measures of the judicial system, the rule of law, degree of corruption and risk of government appropriation. Comparable Australian data not available.

Source: La Porta et al., 1998.

PROTECTING CREDITORS

Minority shareholders often are a relatively minor source of funds for most East Asian companies; banks and their depositors provide most corporate finance so protecting creditors sustains corporate growth. Since the crisis, East Asian governments have strengthened bank prudential control and bankruptcy laws to better protect banks and their depositors. However, enforcement effectiveness varies greatly.

Bankruptcy Laws

The expectation creditors will be treated fairly in the event of firm failure is crucial to ensuring companies can access reasonably priced finance. Banks and their depositors are far less likely to lend if they cannot recoup value if the borrowing company fails. If they do continue to lend, the risk premium will be high. Latin American experience over recent decades illustrates weak creditor protection and resulting dysfunctional banking systems impose a high cost on economies (East Asia Analytical Unit, 2001). Similarly, government bailouts of imprudent lenders weaken incentives for sound lending. Hence, bankruptcy systems must distribute the costs of firm failure fairly, in accordance with pre-determined and transparent criteria so as to motivate sound commercial behaviour.[7]

Insolvency measures comprise formal bankruptcy procedures, informal debt workouts and mergers and acquisitions. Formal procedures include liquidation, winding-up and reorganisation, or rescue. Informal workouts are more flexible, less costly and potentially faster. A market for mergers and acquisitions can act as an insolvency mechanism allowing investors to buy insolvent firms and rearrange repayment terms as part of the process (Nam et al., 1999).

Formal Measures

Bankruptcy laws require several key features to protect creditors' rights. First, secured creditors should be a priority when allocating a bankrupt company's resources. Second, automatic stays on secured assets should not prevent creditors recouping value from collateral in a timely manner. Third, managers should not be allowed to file for bankruptcy protection without creditors' consent. Finally, a party appointed by creditors or the courts should replace the bankrupt company's management (Prowse, 1998).

Most economies in the survey have insolvency laws providing for both liquidation and rescue described under the company law, separate bankruptcy legislation or presidential decree. Hong Kong, Singapore and Malaysia have more robust and better managed insolvency systems than Thailand, the Republic of Korea, Philippines and Indonesia (Nam et al., 1999). However, several of these economies, especially Indonesia, Thailand and the Republic of Korea, have not yet adequately tested recently strengthened legislation. This reflects court delays and in several economies, controversial legal decisions (Table 3.5).

[7] Unsuccessful firms must be able to exit the market to preserve the dynamism of market economies. Firm exit ensures only firms using savings effectively survive, penalises firms making unsound commercial decisions and minimises creditors' exposure when a corporate fails.

Table 3.5

Formal Procedures Still Lacking

Checklist of Bankruptcy Measures, Selected East Asian Economies

	Specialised bankruptcy court exists	Informal workout facility in place	Secured creditors paid first	Management does not remain in reorganisations[1]
Japan	No	Yes	Yes	Yes
Republic of Korea	No	Yes	Yes	Yes
China	Yes (proposed for Shanghai)	na	No	Yes
Hong Kong	No	Yes	Yes	Yes
Singapore	No	Yes	Yes	Yes
Taiwan	No	Yes	Yes	Yes
Malaysia	No	Yes	Yes	Yes
Indonesia	Yes	Yes	No[2]	Yes[3]
Philippines	Yes[4]	Yes	No[2]	No
Thailand	Yes	Yes	No[2]	Yes
Australia	No	Yes	Yes	Yes

Notes: 1 Insolvency Asia, 2000.
2 Asian Development Bank, 2001.
3 Although the recent Texmaco case in which management was retained raises concerns about implementation.
4 Securities Exchange Commission carries this role.
na is not applicable

Source: PricewaterhouseCoopers, 2001.

Workouts

The crisis sharply increased potential insolvency cases in many regional economies, encouraging the development of informal workouts. These programs include the Indonesia's Jakarta Initiative, Malaysia's Corporate Debt Restructuring Committee, Republic of Korea's Corporate Restructuring Agreement among financial institutions and Thailand's Corporate Debt Restructuring Advisory Committee. These institutions were established to speed up the debt and corporate restructuring process, reducing costs for creditors and debtors and demands on the legal systems. Authorities and creditors often feared these mechanisms could not handle the large backlog of insolvency cases in an efficient manner, as rules were vague and judges' discretion was too great. The hope of retrieving more value for creditors and saving viable businesses provided incentives for parties to participate in these workout schemes (Nam et al., 1999).

However, since the crisis, workouts in many regional economies aim to minimise formal bankruptcies, so firms can be rescued and debts restructured. This has resulted in wide spread shallow restructuring where creditors' rights have not been protected, corporates have been insufficiently restructured and non-viable companies' loans again have become notionally non performing (Markels, 2001). This shallow process has been in the short term interest of many banks who are struggling to retain capital adequacy, as it has allowed them to present doubtful loans as performing. The impact on corporate governance also is undesirable as depositors bailed out non-viable firms and managers responsible for bad decision making.

Mergers and acquisitions

Before the crisis, concentrated ownership, poorly developed share markets, cultural resistance to hostile takeovers and legal obstacles to foreign takeovers inhibited the mergers and acquisitions market, limiting its use in insolvency workouts. However, since the crisis, economies like the Republic of Korea have relaxed legal restrictions on mergers and acquisitions, including by foreigners. Attitudes towards takeovers are changing, as they are associated with a high proportion of FDI inflows and have enabled companies to keep operating and maintaining employment (East Asia Analytical Unit, 1999a).

Prudential Supervision

In an environment of financial liberalisation, weakly enforced prudential rules governing bank lending led to a build up of non performing loans. The financial crisis exposed low capital adequacy, poorly enforced legal limits on lending to single borrowers, risky sectors or related borrowers and inadequate asset classification systems; provisioning rules for losses and exit strategies for failed institutions were also found to be lacking (World Bank, 1998; East Asia Analytical Unit, 1999b). When prudential regulations were adequate, authorities often failed to enforce them. For example, Korean and Indonesian capital adequacy requirements were rarely enforced before the crisis. Implicit government guarantees on bank lending, close connections between lenders and borrowers, and banks' lack of sound financial and creditor information also contributed to the build up of bad loans (Krugman, 1998).

State backing of lenders and borrowers is most obvious in China and Vietnam, where the state banks dominate and mostly lend to state enterprises. However, some other regional economies also have significant state owned banking sectors that lend to well connected borrowers; most now have high levels of non performing loans.

Since the crisis, governments are improving bank supervision (East Asia Analytical Unit, 1999b). The Indonesian, Korean, Malaysian, Chinese and Thai Governments have adopted international norms regarding capital adequacy and provisioning requirements and impaired loan definitions. Most have tightened enforcement of rules on lending to related and single lenders and risky sectors. Even in Singapore and Hong Kong, where non performing loans are low, authorities are reviewing their regulatory frameworks and increasing disclosure requirements. Several economies now require banks to report their exposure to foreign borrowing; some impose foreign borrowing limits.

LEGAL SYSTEMS AND ENFORCEMENT

Legal system quality varies greatly across the region. Singapore, Taiwan and Hong Kong have strong legal systems that consistently apply laws and contracts and enforce governance standards (Table 3.6). Malaysia also has a strong commercial legal system. By contrast, the Philippines and Indonesia have relatively weak legal systems, so implementing new governance standards is more difficult.

Table 3.6

Several Legal Systems Need Strengthening

Status of East Asian Legal Systems' Corporate Governance Protection

	Rule of law[a]	Efficiency of judicial system[b]	Transparency[c]	Risk of expropriation[d]	Risk of contract repudiation[e]	Average
Singapore	8.57	10.0	8.22	9.30	8.86	8.99
Hong Kong	8.22	10.0	8.52	8.29	8.82	8.77
Taiwan	8.52	6.75	6.85	9.12	9.16	8.08
Malaysia	6.78	9.0	7.38	7.95	7.43	7.71
Republic of Korea	5.35	6.0	5.30	8.31	8.59	6.71
Thailand	6.25	3.25	5.18	7.42	7.57	5.93
Indonesia	3.98	2.5	2.15	7.16	6.09	4.38
Philippines	2.73	4.75	2.92	5.22	4.80	4.08

Note: a produced by International Country Risk with a scale from 0 to 10. Lower scores indicate less tradition of law and order.
b produced by Business International Corporation, with lower scores signifying less efficiency.
c Scale from 0 to 10. Lower scores indicate more corruption, with government officials more likely to demand special payments.
d Lower scores indicate higher risk from outright confiscation or forced nationalisation.
e Scale from 0 to 10 relates to risk of contract being modified due to budget pressures, change in government or other circumstances.

Source: Khan, 1999.

IMPLICATIONS

While much work is still needed, most East Asian governments are firmly committed to upgrading corporate regulatory environments and since the crisis, most have made considerable progress in achieving this. Laws and regulations have boosted corporate disclosure, minority shareholder and creditor protection and legal system effectiveness. However, this process is ongoing and in many regional economies vested interests oppose further disclosure and investor protection reforms. Furthermore, the professional body development, regulatory institution building and corporate culture change needed to implement new regulations and laws will take several years to mature. Nevertheless, over the next decade or so, more vigorous regional market forces and the regulatory changes achieved to date and in progress promise to support East Asia's gradual transition to a more rules based business environment. Continued strong commitment to vigorous enforcement will be key to achieving this objective.

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