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INTRODUCTION

Corporate governance is a key policy issue now confronting many governments in East Asia. Countries that suffered dramatic reversals of fortune during the Asian financial crisis have identified weaknesses in corporate governance as one of the major sources of vulnerabilities that led to their economic meltdown in 1997. The five worst affected countries, namely, Indonesia, Republic of Korea (henceforth Korea), Malaysia, Philippines and Thailand, all suffered, in varying degrees, from over-capacity, poor quality of investments, excessive diversification by large business groups, and excessive exposure to debt, especially unhedged short-term foreign debt. Casual observations suggest that ineffective boards of directors, weak internal controls, poor audits, lack of adequate disclosure and lax legal enforcement characterize corporate governance in many Asian countries. These weaknesses are believed to have contributed to the crisis by shielding banks, financial companies and non-financial corporations from market discipline, and by failing to terminate unprofitable projects, recognize bad loans, restructure or bankrupt poorly performing enterprises and discipline banks.

To assist the member countries most affected by the crisis in addressing structural weaknesses in the corporate sectors, the Asian Development Bank (ADB) launched *A Study of Corporate Governance and Financing in Selected Developing Member Countries* in November 1998. The objectives of the study were: (i) to evaluate the historical development, current state and major weaknesses of corporate governance and financing in the affected countries; (ii) to establish a sound analytic basis for the design and implementation of policy and regulatory reform measures for strengthening the governance and improving the efficiency of financing and investment of the corporate sectors of countries in the region; and (iii) to identify areas where interventions by the ADB could be effective.

The study involved in-depth analyses of the key characteristics of corporate governance and financing in Indonesia, Korea, Malaysia, Philippines and Thailand. Five individual country studies investigated the structure of corporate ownership, corporate management and internal control, corporate financing and investment, as well as the legal

and regulatory framework. The country studies analyzed the historical, institutional and policy factors that shaped the pattern and structure of corporate ownership, reviewed the role of large shareholders and how companies are organize and controlled, and examined the relationships between ownership structure, the level of financial leverage and corporate performance. The studies also discussed weaknesses in the corporate legal and regulatory framework in each of the five countries, evaluated the current efforts to reform corporate governance systems, and proposed further reform measures in a number of key areas. The studies focused mainly on publicly listed non-financial corporations. A total of around 260 of these corporations in the five countries were surveyed on issues relating to corporate governance and financing.[1] Company level financial account data were also used in evaluating corporate performance.

The findings of the country studies support the view that poor corporate governance was one of the major contributors to the building-up of vulnerabilities in the affected countries that finally led to the Asian financial crisis in 1997. The findings suggest that weaknesses in corporate governance in these countries appear to owe much to highly concentrated ownership structure, excessive government interventions, under-developed capital markets, and the weak legal and regulatory framework for investor protection. The corporate ownership structure, characterized by significant family control and interlocking shareholdings among affiliated firms, may have left insiders with excessive power to pursue their own interests at the expense of minority shareholders, creditors and other stakeholders. The high concentration of ownership reduces the effectiveness of some important mechanisms of shareholder protection, such as the system of the board of directors, shareholder participation through voting during shareholder meetings, and transparency and disclosure. It may also have been one of the major sources of resistance to any reform initiatives in these areas.

In principle, the problems of concentrated and family-based ownership could be lessened by external discipline. The studies argue that, in the five countries, external discipline in the corporate sector has been weak for several reasons. First, high levels of industry concentration, partly due to excessive government interventions in the past, and the lack of the market for corporate control, limit the scope and effective-

[1] These consist of 42 in Indonesia, 81 in Korea, 50 in Malaysia, 43 in Philippines and 43 in Thailand. These are companies responding to the questionnaire, not randomly selected.

ness of market competition. Second, capital markets in these countries are still at an early stage of development, and are characterized typically by low liquidity, thin trading, large volatility, poor transparency, inadequate disclosure and undeveloped market infrastructure. These create ample opportunities for rent seeking, encourage excessive risk-taking behavior and distort market incentives. Third, banks, being the prime sources of finance for Asian corporate sectors, are ideally suited to play the role of imposing external discipline on companies. But they failed because of their interlocked relationships with non-financial companies, weaknesses in bank supervision and regulations by concerned authorities, and explicit and implicit government guarantees.

The studies noted that there are important variations in the quality of corporate governance across the five countries. Overall, Malaysia scores higher than the other four countries, at least on paper. Philippines suffered less during the Asian crisis because its banking sector was in a stronger position than its counterparts in Indonesia, Korea, Malaysia and Thailand. This was partly due to the debt moratorium, ended in the early 1990s, which imposed certain prudential regulation and control requirements on foreign borrowing and hence limited the country's access to foreign debt markets. Further, especially in Malaysia, but also in the other four countries, the governments initiated measures that attempted to strengthen and modernize the regulatory framework for the corporate sector and capital markets well before the outbreak of the Asian crisis. The basic regulatory structure for the corporate sector appears to be in place in these countries, although there are gaps and loopholes, and some areas need to be modernized. Poor compliance and enforcement appear to be the major problems. These problems might have been caused by a number of factors including, among others, an ineffective judiciary, the existence of widespread corruption in some countries, the lack of trained and qualified personnel for legal enforcement and, to some extent, the preference for private negotiations and out-of-court settlements by parties involved in disputes. The studies also noted that during, and perhaps because of, the years of high growth in the past, investors appear to have paid inadequate attention to corporate governance issues. So long as investments were profitable and levels of return were satisfactory, investors appear to have cared little about excessive long-term risks that some projects were exposed to.

The studies proposed a number of reform measures for strengthening corporate governance and improving the efficiency of corporate financing in the five affected countries. These fall into the following

areas: (i) corporate ownership structure; (ii) corporate internal control and shareholder protection, including the system of the board of directors, minority shareholder rights, participation by institutional shareholders and transparency and disclosure; (iii) external monitoring and disciplining, including creditor monitoring, insolvency procedures, the market for corporate control, security market regulations and competition in product market; and (iv) capital market development and corporate financing.

The studies highlighted the need to identify priority areas where corporate governance reforms could be most effective in the short or medium term. To strengthen external disciplining, a priority area is prudential regulations and supervision of banks and non-bank financial institutions. The studies argue that, as creditors, banks and non-bank financial institutions should play a bigger role in monitoring and disciplining non-financial corporations, not only when they have become insolvent, but also when they are in solvent states. To strengthen corporate internal control, measures that improve standards of accounting, auditing and financial reporting systems and their enforcement should be placed on top of the reform agenda. Likewise important are initiatives to develop capital markets, promote market competition, advance the market for corporate control and encourage participation by institutional shareholders. However, it may take considerable time either for these mechanisms to be in place or for their effects to be felt. Two further issues that the governments of Asian countries should consider in reforming corporate governance are (i) how to balance the use of legal enforcement and self-regulation and (ii) how to account for each country's own specific conditions in formulating reform packages.

This report pulls together key findings of the five country studies. Section II outlines a framework for analyzing corporate governance and finance that was developed in the economic and legal literature over the past several decades. Section III summarizes key characteristics of corporate governance and financing in the five countries. Section IV reviews recent efforts of the affected countries in reforming corporate governance. Finally, Section V recommends key reforms for strengthening corporate governance and improving the efficiency of corporate financing and investment in these countries.