

CORPORATE GOVERNANCE AND FINANCE IN THE FIVE AFFECTED COUNTRIES

Several factors have played an important role in shaping corporate governance and finance in the five affected countries. First, most companies in these countries started as family businesses and are still under the control of the founders or their offspring. Second, during various periods in the past, the governments have played an important role in the development of certain industries, in directing funds towards them and in determining the degree of competition. All of the economies at one time or another embraced industrial policies aimed at import substitution followed by export promotion. Third, all the five countries have engaged in financial liberalization and capital market development in recent years. However, the capital markets are still not well developed. Compared to those of the industrialized economies, stock markets in these countries can be characterized by low liquidity, poor transparency and disclosure, a weak regulatory framework, and under-developed market infrastructures. Generally, public debt markets barely exist. These factors have significant bearing on how the companies are governed and financed. The basic characteristics of corporate governance and financing in the five affected countries are summarized below.

3.1 Ownership Structure

Ownership Concentration

The five countries have very concentrated corporate ownership.¹⁷ As shown in Table 1, for the publicly listed companies (PLCs), the average

¹⁷ Claessens, et al (1998) find that ownership concentration hurts both operational performance and market valuation across the region. Ownership by the government or managers has a positive relationship with performance, particularly in the more developed countries. They find that concentration is more pronounced in developing countries and in countries that have inadequate shareholder protection and more corruption as defined by La Porta, et al (1997 and 1998b).

ownership concentration ratio ranges from 20.4 percent (the largest shareholder) and 38.5 percent (the top five shareholders) in the case of Korea to 48.2 percent (the largest shareholder) and 67.5 percent (the top five shareholders) in the case of Indonesia. The ratios would be even higher if the non-listed companies are included.

Table 1
Ownership Concentration

Country	Concentration Ratio ¹ (Percent)		As of End of the Year	Company Coverage
	Largest Shareholder	Top Five Shareholders		
Indonesia	48.2	67.5	1997	All PLCs
Korea	20.4	38.5	1998	81 non-financial PLCs ²
Malaysia	30.3	58.8	1998	All PLCs
Philippines	33.5	60.2	1997	All non-financial PLCs
Thailand	28.5	56.6	1997	All PLCs

¹ Defined as the percentage of total outstanding shares of an average PLC owned by the largest or top five shareholders. The percentages are not weighted by market capitalization.

² Based on the ownership data from the ADB survey of 81 non-financial PLCs. Ownership data comparable to those of the other countries are not available.

Sources: Country Studies under RETA 5802, Asian Development Bank (1999a, b, c, d, and e).

In Indonesia, the largest shareholder owned 48.2 percent and the top five shareholders owned 67.5 percent of total outstanding shares of an average PLC in 1997. No significant differences were noted across industries, and the pattern of ownership concentration barely changed during 1993-1997. The country report for Indonesia suggests that one of the reasons for the relatively stable ownership concentration is the prevailing practice of raising equity mainly through rights issues. In Malaysia, in 1998, the largest shareholder owned 30.3 percent, the top five shareholders owned 58.8 percent and the top 20 owned 80 percent of total outstanding shares of an average PLC. Ownership data on the prominent large conglomerates indicate a similar concentration pattern. This pattern has not changed much since the early 1990s. In Thailand, the largest shareholder owned 28.5 percent and the top five owned 56.6 percent of total outstanding shares of an average PLC in 1997. This pattern did not change significantly throughout the period 1990-1998. In

Philippines, the largest shareholder owned 33.5 percent, the top five owned 60.2 percent and the top 20 owned 69 percent of total outstanding shares of an average non-financial PLC in 1997 (40.8, 65.3 and 75.9 percent respectively if weighted by market capitalization). In three fourths of the listed companies, the top five shareholders owned more than 50 percent of voting shares. In one third of the listed companies, the largest controlling shareholder owned at least a majority of shares. Finally, in Korea, among the 81 non-financial PLCs surveyed by the ADB study, the largest shareholder owned 20.4 percent and the top five owned 38.5 percent of outstanding shares of each of these companies on average. Fragmented ownership data suggest that small shareholders, defined as those holding less than 1.0 percent of outstanding shares, held 48.8 percent of shares in 1997. Those identified as controlling shareholders as a whole held 25.9 percent of total Korean non-financial PLCs in 1997.

Ownership Composition

The ownership profiles in all the five economies suggest substantial family corporate holdings. Family ownership is usually achieved through holding companies and/or nominee accounts. Financial institutions, in particular commercial banks, do not own significant proportions of non-financial companies.¹⁸

In Philippines, the non-financial corporation is usually the largest shareholder group among top five shareholders of an average non-financial PLC. In 1997, of the shares of an average non-financial PLC held by the top five shareholders, the non-financial corporations owned 71.1 percent. The rest were owned by securities brokers (7.6 percent), investment trust funds (5.9 percent), individuals (5.5 percent), nominee companies (4.9 percent), the government (2.6 percent), commercial banks (2.1 percent) and insurance companies (0.2 percent). Non-financial corporations held majority ownership in four out of nine industrial sectors. Most of these non-financial corporations are holding companies owned by families or family groups. Commercial banks and insurance companies are minor investors in the stock market because of prudential regulations that prevent them from investing significant amounts even in large widely traded companies.

¹⁸ Shareholdings discussed in this section are not weighted by market capitalization, unless otherwise specified.

In Thailand, the non-financial company is also the largest shareholder group among the top five shareholders of an average PLC. In 1997, of the shares of an average PLC held by the top five shareholders, the non-financial companies owned about 50 percent. The rest were owned by individuals (35.2 percent), finance companies (9.9 percent), the government (2.5 percent), banks (2.2 percent) and others (0.6 percent). Most of the non-financial companies, as in Philippines, are holding companies owned by families. Individuals among the top five shareholders are mostly family members holding top managerial positions in the companies.

Table 2
Ownership Composition¹ in 1997
(Percent)

	Korea	Malaysia	Philippines	Thailand
Non-financial companies	16.7	25.1	71.1	50.0
Nominee companies	...	45.6	4.9	...
Banks	8.5	...	2.1	2.2
Finance companies	...	5.9	...	9.9
Investment trusts	5.9	...
Insurance companies	2.0	...	0.2	...
Individuals	60.0	4.8	5.5	35.2
Securities companies	6.1	...	7.6	...
Foreign investors	4.5	1.5
Government	1.5	17.2	2.6	2.5
Others	0.6
Total	100	100	100	100

... indicates that the particular group is not separately classified in ownership data.

¹ Refers to ownership composition of the shares of an average non-financial PLC held by the top five shareholders in the cases of Malaysia, Philippines and Thailand, and composition of the total outstanding shares of an average non-financial PLC in the case of Korea. The ownership composition is not weighted by market capitalization.

Sources: Country Studies under RETA 5802, Asian Development Bank (1999a, b, c, d, and e).

In Malaysia, the nominee company is the largest shareholder group among the top five shareholders. In 1997, the nominee companies held 45.6 percent of the total shares of an average non-financial PLC held by the top five shareholders. The rest were shared by non-financial companies (25.1 percent), the government (17.2 percent), finance companies (5.9 percent), individuals (4.8 percent) and foreign investors (1.5 percent). This ownership pattern has changed little overtime and it is believed that the majority of shareholdings by the nominee companies and institutions (non-financial and finance companies) were owned by families. The institutional holdings were in part due to the government's efforts to reallocate corporate shares to indigenous Malaysians and the countervailing efforts of non-indigenous Malaysians to maintain their ownership. Shareholders opted for nominees as a means of not revealing the identities of true holders—a practice that was to some extent the result of the government's effort to shift the balance of ownership towards the indigenous Malay population.

In Korea, in 1997, around 60 percent of the total outstanding shares of all non-financial PLCs were owned by individuals, which include controlling shareholders and their family members. Financial institutions, including banks, securities companies and insurance companies, owned around 17 percent of the total outstanding shares. Although banks owned 8.5 percent, this category includes commercial banks, merchant banks, investment trust companies, mutual savings and finance companies. Non-financial corporations owned 17 percent, reflecting mostly equity investments in affiliated companies by member companies of the *chaebols*. The shares owned by the government were insignificant, at less than 2 percent. Notably, there is no significant difference in ownership composition between *chaebol* and independent firms.

In Indonesia, companies owned 67.2 percent of the total outstanding shares of all the PLCs in 1997. The companies are mostly controlling owners, usually holding companies owned by members of the founders' families.

The prevalence of holding companies, nominee companies, and non-financial corporations as direct corporate shareholders in the five countries makes the assessment of ultimate ownership and control by families difficult. A recent study by Claessens, et al (1999a) examined the ultimate ownership and control of 2,980 publicly listed (financial and non-financial) companies in nine East Asian countries, including the five countries covered by the present study. Based on the notion of the so-called "ultimate control rights" as opposed to the cash flow

rights,¹⁹ their findings, summarized in Table 3, suggest that families controlled 67.3 percent of 178 listed companies in Indonesia, 24.6 percent of 345 listed companies in Korea, 42.6 percent of 238 listed

Table 3
Control of the Publicly Listed Companies in 1996

Countries	Number of Sample Companies	Percentage of Control ¹				
		Family	Widely Held	The State	Widely Held Financial Institutions	Widely Held Non-financial Corporations
Indonesia	178	67.3	6.6	15.2	2.5	8.4
Korea	345	24.6	51.1	19.9	0.2	4.3
Malaysia	238	42.6	16.2	34.8	1.1	5.3
Philippines	120	46.4	28.5	3.2	8.4	13.7
Thailand	167	51.9	8.2	24.1	6.3	9.5

¹ Weighted by market capitalization

Source: Claessens, Djankov and Lang (1999a), Who Controls East Asian Corporations? Financial Economics Unit, Financial Sector Practice Department, World Bank.

Table 4
Foreign Ownership of the Publicly Listed Companies
(Percent)

Year	Indonesia ¹	Korea ¹	Malaysia ²	Thailand ¹
1992	...	4.1	24.9	...
1993	30.2	8.7	24.6	...
1994	29.5	9.1	23.4	14.0
1995	25.0	10.1	20.3	12.0
1996	28.1	11.6	23.9	12.6
1997	25.4	9.1	24.9	13.0

¹ Based on the number of shares of the publicly listed companies.

² Based on equity (at par value) of the publicly listed companies.

Sources: Jakarta Stock Exchange (JSX) monthly statistics; Korea Stock Market; the Kuala Lumpur Stock Exchange Annual Handbook; Companies Handbook of the Stock Exchange of Thailand.

¹⁹ For example, if a family owns 11 percent of the stock of publicly listed Firm A, which in turn has 21 percent of the stock of Firm B, the family is considered as controlling 11 percent of Firm B, rather than 2.3 percent (the product of the two percentages). The latter refers to the cash flow rights. See Claessens, et al (1999a) for details.

companies in Malaysia, 46.6 percent of 120 listed companies in Philippines, and 51.9 percent of 167 listed companies in Thailand. Using the same notion, the control by the general public (widely held) is highest in Korea (51.9 percent), which is followed by Philippines (28.5 percent), Malaysia (16.2 percent), Thailand (8.2 percent) and Indonesia (6.6 percent). The governments also have significant control, except in Philippines. The controls by widely held financial institutions and non-financial corporations are relatively insignificant.

Foreign Ownership

Ownership of the publicly listed companies by foreign investors varies across the five countries. Foreign investors owned around 9 percent in Korea and 13 percent in Thailand of the total outstanding shares (not weighted by market capitalization) of the publicly listed companies in 1997. Indonesia and Malaysia have more significant foreign ownership, which stood at 25.4 and 25 percent (weighted by the par value of equity in the latter case), respectively, in 1997.

Cross Shareholding

There is no systematic evidence to suggest that cross-shareholding is widespread in the five affected countries. Cross shareholding, that is, two companies owning each other's shares, is a means of enhancing corporate control. In Korea, the extent of cross shareholdings is minimal since various laws prohibit or limit it. In Indonesia, Malaysia, Philippines and Thailand, there is also a minimal degree of cross-shareholdings even in the absence of laws explicitly prohibiting a company from owning shares of companies that own it. Table 5 shows the incidence of cross shareholding reported in Claessens, et al (1999a).

Pyramid Structure

In the five affected countries, controlling blocks are mostly derived from a pyramid structure, also called the parent-subsidiary structure.²⁰ A family-owned holding company owns shares of operating

²⁰ See Hattori (1989), Lee (1997) and Lim (1998). Pyramid structures are defined, in Berle and Means (1932), as "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."

Table 5
Means of Enhancing Control in the Publicly Listed Companies

Countries	Incidence of Pyramiding with Ultimate Owners ¹ (in percent of total)	Incidence of Cross Shareholding (in percent of total)
Indonesia	66.9	1.3
Korea	42.6	9.4
Malaysia	39.3	14.9
Philippines	40.2	7.1
Thailand	12.7	0.8

¹ Pyramiding with ultimate owners (when companies are not widely held) equals 1 if the controlling owner exercises control through at least one publicly listed company, 0 otherwise.

² Cross shareholding equals 1 if the company has a controlling shareholder and owns any amount of shares of its controlling shareholder or in another company in her chain of control, 0 otherwise.

Source: Claessens, Djankov and Lang (1999a), Who Controls East Asian Corporations? Financial Economics Unit, Financial Sector Practice Department, World Bank.

companies that usually are parent companies themselves, i.e., holding shares of other operating companies as well. The purpose of investing in other companies is to obtain strategic control, to facilitate supply contracts, and to obtain economies of scale through shared management and financing. These structures are inherently risky to the extent that parent companies borrow through subsidiaries to acquire other companies, resulting in high leverage. Table 5 shows that the pyramid structure is a prevalent practice in all the five countries. The highest incidence of the pyramid structure is in Indonesia (66.9 percent), and the lowest incidence is in Thailand (12.7 percent).

3.2 Shareholder Control and Protection

Board Composition and Fiduciary Responsibilities

The country studies examined the structure of boards of directors and their effectiveness as an oversight mechanism in safeguarding interests of all shareholders. A number of features were identified. First, in the five countries, boards of directors are often dominated by controlling

shareholders that represent the interests of families or family groups. The studies suggest that family control tends to disregard the rights of small shareholders. In Korea, for example, it was found that dominant shareholding families usually make the key decisions. Candidates for directorship are often handpicked by controlling shareholders from among senior managers. The handpicked choices are automatically approved at the AGMs. In Thailand, majority shareholders can appoint board members, through majority rule, without needing the approval of other small shareholders. Moreover, boards of directors often consist of friends and relatives of controlling shareholders who would not oppose management, also appointed by large shareholders. Indonesia has a two-tier board system: the board of commissioners representing shareholders and supervising the board of directors and the board of directors making strategic and operational decisions for a company. The commissioners are usually either the majority owners or persons trusted by the majority owners. The chairman of the board of directors is the CEO and usually represents the controlling party of the company. Only a few companies responding to the ADB survey indicated that the CEO could decide on important matters on his/her own. In Philippines, as noted earlier, a single shareholder often has strong or even dominant control over corporate decisions. The separation of boards of directors from management is often only nominal. The tenure of boards of directors in Philippines is one year. This short tenure appears inconsistent with directors' role of making strategic decisions for the long term. Arguably, the short tenure helps large shareholders impose their will on boards of directors. However, board turnover was found to be low with board members staying an average of over seven years in office.

In some affected countries, boards of directors lack the representation of non-executive or independent directors. In other affected countries, although the law requires the representation of independent directors, the selection and business procedures do not usually encourage their effective participation in reviewing board decisions. In Korea, before the crisis, directors were appointed as employees of a firm (or were controlling shareholders), not as representatives of all shareholders. Appointments to the board came automatically for executives once they reached certain levels of seniority. While statutory provisions existed concerning the election of directors to ensure their independence, these were often ignored in practice. Interlocking directorship is also a common practice, whereby members of controlling shareholders' families or their trusted company personnel act as directors for multiple

boards of *chaebol* affiliates. In Thailand, the stock exchange listing rules require that at least two directors are independent. However, the term “independent directors” excludes only management, employees and sometimes relatives of large shareholders, not those with personal ties with insiders. In Indonesia, the ADB survey revealed that most responding companies do not have independent commissioners or directors. In Philippines, the country study found that the practice of appointing independent directors is not common. Many directors are well-known business associates of large shareholders.

The country studies found that in general, the practice of setting up independent sub-committees in boards for major issues such as auditing, nomination, and remuneration is not common. In Korea, the ADB survey of 81 listed non-financial companies in 1998 found that 91 percent of these companies have no independent sub-committees. The board has a nomination committee and an auditing committee in a small number of companies, but these committees were set up only recently after the Asian crisis. It is not a common practice for boards of directors and of commissioners to set up sub-committees in Indonesia. In Philippines, some companies have compensation, external audit and other committees, which consist of members of the board, but their independence could often be questioned. Small firms and large shareholder-dominated firms usually forgo this formality.

The country studies suggest that the effectiveness of boards of directors might also have been undermined by the fact that, in many companies, the chairman of the board of directors is often the CEO or a member of the top management team. In Korea, the country study found that, in most listed companies, the controlling shareholder is officially designated as the CEO or at least acts as the *de facto* CEO. In 1997, the controlling shareholder was the CEO in 354 out of 551 non-financial listed firms. The higher the ownership share of the dominant family shareholder, the more likely it is for the CEO to be a member of that family and for the family to have significant control over decision-making. The ADB survey of 43 listed non-financial companies in Thailand found that in 71.3 percent of the surveyed companies the chairman of the board of directors is also a member of the top management team. In the case of Philippines, the survey results show that in 44 percent of the responding companies, the chairman of the board and the CEO are the same person. In Malaysia, a study of 92 companies listed at the main board of the Kuala Lumpur Stock Exchange (KLSE) shows that 48 percent of them have executive chairmen on their boards

while only 23 percent have non-executive chairmen. An analysis of large listed companies reveals that only a few have non-executive directors as chairmen of boards, while some chairmen are appointed by the government.

The country studies also noted that the effectiveness of boards of directors as an oversight body appears to vary across the five countries. It appears that, overall, Malaysia scores highest. This is due possibly to Malaysia's efforts before the crisis to strengthen the regulatory framework of the corporate sector. For instance, the KLSE listing rules require every company to have two independent directors who are not related to its officers or do not represent concentrated or family shareholdings. The KLSE endorsed the Cadbury Report²¹ recommendation that companies should form an audit committee as a sub-committee of the board. The KLSE requires that all the member companies establish an audit sub-committee with a majority of committee membership being independent of management. A majority of companies responding to the ADB survey indicate that they have audit sub-committees, many of which were set up before the KLSE made it mandatory. The ADB survey of Malaysian listed companies also found that the appointment of directors is most frequently based on professional expertise, followed closely by the percentage of shareholdings. The apparently advanced state of rules governing the accountability of directors in Malaysia before the crisis is reflected in the introduction in 1996 of the Directors Code of Ethics.

Directors' Remuneration

The country studies found that outside shareholders have little influence in determining directors' remuneration. Only a limited number of companies have separate remuneration committees. There is also relatively little use of incentive related pay. This is usually taken to be an indicator of inactive shareholders and suggests poor alignment of management's incentives with shareholders interests.

²¹ The Cadbury Report contains recommendations from the Committee on the Financial Aspects of Corporate Governance on the control and reporting functions of boards and on the role of auditors. At the heart of the Committee's recommendations is a Code of Best Practice designed to achieve the necessary high standards of corporate behavior. The Committee was set up in May 1991 by the Financial Reporting Council, the London Stock Exchange and the accountancy profession in the UK.

In Thailand, about half of the companies that responded to the ADB survey have a separate remuneration committee but only about one-quarter assign the remuneration committee to determine directors' compensation. In the majority of the companies the remuneration committee does not include outside directors as members. Compensation packages require shareholder approval during the AGMs. Also, a majority of companies compensate their chairmen using a fixed-fee schedule. A minority of respondents use schemes combining a net profit-related bonus and fixed fees.

Most companies in Indonesia remunerate their CEOs and board chairmen by fixed compensation only or by fixed compensation cum a profit-related bonus. More CEOs are paid by fixed compensation and a profit-related bonus than fixed compensation alone while the reverse is true for board chairmen. In Korea, CEOs usually propose the maximum total amount of director compensation for approval at the AGMs. On this basis, the boards set the base salary and bonuses for individual executives. About 40 percent of the listed companies have amended their charters in 1999 to introduce incentive stock options. But the number of companies that actually give stock options to their executives or employees remained small as of March 1999. Korean companies have rarely distributed shares as direct compensation.

In Malaysia, the country study found that board chairmen and the CEOs are mostly paid by fixed salary. Only a few companies reported that their CEOs get a fixed salary plus performance-related pay including stock options. The CEOs propose the remuneration packages for approval by the boards or, alternatively, they are proposed and approved by the boards or by the executive committees. In Philippines, the compensation schemes of directors reflect the relationship between shareholders and directors. The ADB survey reveals that a majority of companies pay their chairmen a fixed fee and the rest pay a fixed fee plus a net profit-related bonus or *per diem* for meetings. Most companies reported that it is the board that determines the compensation for the chairman.

Shareholder Participation and Protections

The country studies found that in all the five countries, the mechanisms for participation by minority shareholders in corporate decision making are generally weak, shareholder participation is passive,²² and legal

²² Black (1990; 1998) documents a low level of shareholder activism even in the US.

protection for shareholders is inadequate. A number of causal factors were identified. First, with the exception of Malaysia, until recently laws concerning shareholder rights are inadequate. Even where some rights are stipulated, they are often ignored in practice because of the excessive power enjoyed by family-dominated controlling shareholders. Minority shareholders rarely try to ascertain their rights through legal procedures due to various obstacles. Class action laws did not exist in some countries before the crisis and even where they did, they were too costly to yield benefits to small shareholders. Second, investors did not pay adequate attention to corporate governance issues before the crisis. As long as they are paid they appear to have been content. Investors care mainly about current profits, while long-term performance prospects and risks are usually ignored. The consequences of the lack of power of small shareholders are that dominant shareholders run firms in ways that maximise their own benefit but are usually inconsistent with the objective of maximizing the value of their companies. Controlling shareholders may gain greater benefits from increases in the number and size of the firms under their control than from increases in profits. This has led firms to put more emphasis on growth in sales and market shares than on profits. They may shift funds from profitable to ailing firms in order to save the latter, through inter-firm transactions and cross-guarantees of debts. The widespread excessive borrowing in these countries could be a symptom of the dominant shareholders' drive to increase the capital under their control without simultaneously reducing their ownership share.

In Korea, up until 1994, the government maintained a policy of protecting the incumbent management of the listed companies from hostile takeovers in order to induce financially sound private firms to go public. The corporate laws and regulations are also weak in protecting rights of minority shareholders. For instance, cumulative voting is not allowed. Shareholders have pre-emptive rights²³, but these rights could be waived by an amendment to the articles of incorporation. The investment trust companies and the trust accounts of commercial banks are rendered ineffectual by the requirement to follow shadow voting rules under which these institutions divide their votes in accordance

²³ Pre-emptive rights are opportunities to acquire shares or other securities under terms and conditions that the board of directors may fix for the purpose of providing fair and reasonable opportunities for the exercise of the rights by a particular group of investors, usually the existing shareholders.

with the accept/reject ratios of votes cast by other shareholders attending shareholder meetings. This also helps the controlling shareholders or the incumbent management to maintain control. The requirements for action by minority shareholders are relatively stringent: the representation requirement for shareholder derivative suits is 1.0 percent; calls for an emergency shareholder meetings, 3.0 percent; recommendations for dismissal of directors and internal auditors, 1.0 percent; and access to unpublished accounting books and records, 3.0 percent. The country study for Korea suggests that because of weak protection, minority shareholders were often expropriated. The expropriation may take the form of transactions of goods and assets, loans and loan guarantees among affiliates within a *chaebol* on terms more favourable than those of markets and purchases of shares of connected firms approaching insolvency. Furthermore, the study suggests that simple diversion of funds by dominant shareholders is common. Controlling families sanction inefficient investment in large risky projects by using borrowed funds, which lead to insolvency or bankruptcy of many large corporations and cost the lending institutions and taxpayers unprecedented amounts. To make matters worse, in the course of company bailouts, management teams are usually not replaced. The ADB survey of 81 listed non-financial companies in 1998 found that on average about 11 percent of shareholders attended the last annual general meetings and these attendees represented 63 percent of outstanding shares. About 6 percent of shareholders on average voted by proxy, representing 26.5 percent of shares. Management in most cases acted as proxy.

In Thailand, shareholders have the right to be elected as directors, to call a shareholder meeting, to vote by proxy, to use cumulative voting unless otherwise stipulated in the company charter, and to request an inspection of the company's affairs. Moreover, the Public Company Act, the Securities Act and Stock Exchange Listing Rules have several provisions for the protection of shareholders against unfair treatment in cases of transfer pricing, takeovers and insider trading. However, many small shareholders are unaware of their rights. Company information is not freely available in proxy solicitations and shareholder meeting notifications. Class action laws do not exist. Shareholder protection suffers from various barriers, including minimum shareholdings required before shareholders could exercise their rights. For instance, the law requires that shareholders must hold an aggregate amount of at least five percent of total shares outstanding in order to

seek relief and compensation against a director who violated the articles of association or did not preserve the company's interest. A shareholder must hold at least one fifth of outstanding shares in order to hire an outsider to examine the company's business operations and financial condition. To exercise their lawful right to call an extraordinary session of the shareholder meeting, a group of at least 25 shareholders must gather at least one tenth of total outstanding shares. In practice, it is almost impossible for minority shareholders to meet these requirements. The country study for Thailand found that managers often take business decisions without the approval of shareholders. Minutes of shareholders' meetings are often drafted before the meeting and could take up to one year to be circulated. The ADB survey of 43 listed companies found that on average only eight percent of shareholders attended the last annual general meetings, and these attendees represented 66 percent of total outstanding shares. An average of 82 percent of shareholders representing 28 percent of outstanding shares did not vote. Shareholders rarely reject proposals emanating from management during the AGMs. The high ownership concentration of Thai companies precludes small shareholders from mustering enough shares to enable them to file for grievances.

In Philippines, corporate laws and regulations require that operating decisions be approved by at least the majority of shareholders. Strategic decisions concerning the direction of companies require at least two thirds of votes. The Corporation Code allows cumulative voting for directors and prohibits the removal, without cause, of directors representing minority shareholders. Shareholders who do not agree with the decisions of the board on a number of specific issues are given appraisal rights, that is, the right to demand payment for their shares. In practice, however, few minority shareholders exercise their appraisal rights and those who do are usually offered below-market values for their shares. It is not usual for corporations to issue shares with different rights. There used to be non-voting shares for foreigners because they were not allowed to vote but this restriction has now been removed. Proxy voting, including through electronic means, is allowed and practised. In practice, AGMs serve mainly as a formal procedure for getting board decisions confirmed by shareholders. No real discussions take place. A shareholder could freely present proposals regardless of the amount of shareholding, but in the case of minority shareholders it seems to be a futile action. Shareholders have the right to file derivative suits against directors regardless of their levels of shareholdings. But

court proceedings are costly and take a long time to resolve. While legal protection is available, minority shareholders could not expect to successfully litigate claims against large shareholders. Issues of minority rights and claims are more likely to be resolved through negotiations between minority and large shareholders. Litigation is not a viable option because, firstly, minority shareholders do not have good access to company information and, secondly, minority shareholders are likely to have been brought in by, or be affiliated with, large shareholders. The odds are even worse for minority shareholders of privately held firms.

In Indonesia, the Capital Market Law was passed in 1995, aimed at protecting small investors and promoting prudential practices. This law is complemented by other regulations. All shares have one vote each and voting by proxy is allowed. The minimum percentage of shareholders that must attend shareholders meetings is usually 67 percent in the company charter. To amend the company charter, two thirds of the votes are needed. Shareholders are allowed access to regular information, have pre-emptive rights on new share issues, can call emergency shareholder meetings and make proposals at the meetings. Disclosure of specific information and approval by shareholders of specific transactions are mandatory. Moreover, there are severe penalties imposed on insider trading. However, it appears that these shareholder protective measures exist only on paper. It is generally believed that the legal enforcement of shareholder protection was weak in Indonesia before the crisis. The ADB survey of 42 listed companies found only one case in the last three years of a rejection of a proposal put forward by management at the shareholders' general meeting.

In Malaysia, the Companies Act of 1965 stipulates a number of shareholders' rights. They have access to regular and reliable information; can call emergency shareholder meetings and make proposals at shareholder meetings. Companies have to disclose specified information to shareholders, such as connected interests, company affiliation, affiliated lenders or guarantees, among others. Shareholders are entitled to full pre-emptive rights on new stock issues unless they have voted to do otherwise. The law protects shareholders by (i) stipulating regulations governing the duties of company directors, (ii) requiring AGM approval for the acquisition or disposal by directors of assets of substantial value, and for the issue of shares; (iii) prohibiting loans to directors or director-related parties, unless they are subsidiaries; (iv) disclosing and requiring shareholders' approval on substantial transactions in any non-cash assets involving directors or persons connected with

directors; and (v) disclosing substantial shareholdings to the company and the KLSE. The Securities Industry Act (SIA) of 1973 set a milestone for the protection of investor interests. Among others, it aimed at curbing excessive speculation, insider trading, share rigging and other forms of market manipulation. A new SIA came into force in 1983, which provides more effective supervision and control of the securities industry by regulating the operations of dealers, and prohibiting artificial trading and market rigging.

Thus, in Malaysia, the rights and protection of shareholders appear to be both comprehensive and well defined. However, the ADB survey found that the number of shareholders who voted at annual general meetings is low and rejections of proposals put forward by management or the board of directors at the annual general meetings are few. In the case of locally controlled companies, the control exercised by the major shareholders is usually in excess of their cash-flow rights. Foreign owned firms are seen to pay more attention to shareholder rights and to pay out a higher level of dividends.

Transparency and Disclosure

The ADB country studies found that poor transparency and inadequate disclosure characterized the financial and corporate sectors of the affected countries. The studies identified a number of causal factors. First, corporate insiders, mainly families and family groups, appear to have little tradition of disclosure and sharing corporate control. Further, because of weak market discipline and ample finance in the years running up to the crisis, companies and insiders had little to gain from improving disclosure and corporate governance practices. Second, while there have been improvements in the legal and regulatory framework regarding disclosure and corporate governance, these improvements have been largely instituted only recently in the 1990s, and market practices in these areas are still in a nascent stage. Third, both corporate governance mechanisms and disclosure have been undermined by inadequate accounting standards and, especially, weak implementation and compliance of these standards, and by poorly functioning legal systems.

In Korea, before the crisis, accounting and auditing procedures appeared to be below international standards. The ADB survey of 81 listed non-financial companies in 1998 reveals that 41 percent of the responding companies indicated that they have followed some international accounting standards, but 49 percent indicated they did not follow

the international standards at all. Only 10 percent of the surveyed companies followed all international accounting standards. The ADB study for Korea also noted that Korean listed companies with subsidiaries are required to compile consolidated balance sheets, and consolidated reporting was introduced before the outbreak of the crisis. A large number of cases noted during the crisis suggest that many companies have not implemented this legal requirement. The Commercial Code requires a corporation to have at least one internal auditor elected at the AGM; internal auditors should not be members of the board; they have the duty and power to monitor the activities of executive directors. In practice, however, internal auditors cannot be expected to discharge this monitoring duty effectively because representative directors who select them can easily force them to resign. Notwithstanding a regulation limiting votes of largest shareholders to a maximum of three percent of outstanding voting rights, internal auditors are considered to be subordinates of controlling shareholders. Boards of directors have the power to appoint external auditing firms. In the ADB survey of 81 listed companies, almost all firms responded positively to the question on whether or not the external auditor is independent from the company. Large Korean accounting firms are usually affiliated with large American accounting firms. The survey reveals that the current external auditors of the responding companies have been associated with them for 4.6 years on average. In the past, however, there were many cases where external auditors could not detect omissions and false information in the financial statements of the listed firms.

The accounting profession in Philippines is considered to be a fairly developed one. All major international auditing firms operate in the country. However, there appears to be a shortage of qualified accountants. The Corporation Code stipulates that a firm must submit a statement to every shareholder containing the audited financial statement, a discussion of the business by management and an analysis of the financial statement. In the ADB survey, all respondents stated that they have independent auditors. Either the boards or shareholders during the AGMs appoint auditors and in the majority of cases firms use an international auditing firm. However, there was a low level of auditor turnover and, on average, responding companies have been associated with their present auditors for 13 years. There are many cases of poor financial reporting by large companies and many small- and medium-size businesses do not have quality financial statements. The country study for Philippines noted that there have been problems about the

quality of independent audits even with established firms. There also appear to be significant problems in enforcing accounting standards. Shareholders have the right to inspect records of company businesses and minutes of board meetings. However, a corporation can refuse such a request by claiming improper use of such information or bad faith on the part of investors. The Philippine Securities and Exchange Commission (SEC) requires corporations to submit reports periodically in order to update their registration statements. Publicly listed firms are required to provide details of their operations and management. Penalties would be imposed for filing false statements or the failure to disclose facts that make the registration statements filed with the SEC misleading. However, it is worth noting that there have been no known cases of penalties imposed by the SEC on companies that misrepresent their financial statements.

In Indonesia, independent auditing is mandatory. The ADB survey reveals that most respondents have independent audit committees. All the surveyed companies indicated that they are independently audited and almost all make use of international auditors. Auditors are appointed during the AGMs. According to the survey, external auditors have been associated with their client firms for more than 5 years on average. The ADB survey also reveals that most respondents have substantially followed international accounting standards even before the financial crisis. However, it is well known that accounting authorities could easily change accounting methods. A recent example is the treatment of the potential foreign exchange loss. Initially, the Indonesian Accountants Association recommended that the potential loss be reported as a loss at the end of the accounting year. However, later, the association allowed companies to select between two options: (i) reporting as a loss in the profit and loss statement at the end of the accounting year and (ii) reporting in the balance sheet.

In Thailand, the general picture of the standards of financial reporting is poor. The country study noted that companies often have two sets of accounts: one for management and the other for tax authorities and the SEC. The shortage of qualified accountants aggravates the problems in producing reliable accounts. The poor accounting standards are attributed to insufficient regulatory supervision, mild penalties and unclear valuation rules. Furthermore, auditors often develop good business relationships with their clients and are unwilling to produce damning reports.

The country study indicated that Malaysia scores relatively high, even by international standards, for the general quality of its auditing

and financial reporting. It adopted accounting standards that are consistent with those issued by the International Accounting Standards Committee (IASC) in the 1980s. The approved accounting standards, which constitute the generally accepted accounting principles in Malaysia, include Malaysian Accounting Standards, which cover issues not dealt with by the IASC and reflect particular features of the Malaysian business environment. The Research Institute of Investment Analysis in Malaysia was established in 1985 by the KLSE to enhance the level of investment analysis, research and professionalism in the Malaysian securities industry.

In the main, there is an increasing use of independent international auditors throughout the region. The main concerns arising from the above discussions are whether international accounting standards are always and everywhere applied and whether the resulting financial reports are made available and effectively used. Each country must have an independent accounting standard setting body. Because of the limited involvement of institutional investors and the lack of capital market analyst communities, the markets for investment information are underdeveloped. Throughout the region, foreign investors demand greater transparency and disclosure. Generally the quality of accounting must be improved. For example, conglomerates must be compelled to produce consolidated accounts. Another major concern is the availability of properly trained accountants in the region's financial centers both within auditing firms and the accounting standard authorities as well as within the businesses themselves. Finally, it seems clear that the standards of compliance and the implementation and effectiveness of penalties for non-compliance need to be reviewed and strengthened.

3.3 Credit Monitoring, Disciplining and Protection

Creditor Monitoring and Disciplining

The country studies reveal that in all the five affected countries, creditors, including banks and non-bank financial institutions, in general have limited involvement with companies' management and decision making, and their role in corporate governance is weak. This could be explained by a number of factors. First, creditors themselves are often poorly governed due to the weak internal control and inadequate regulations and supervision. In many countries, banks' internal risk management

systems appear to be underdeveloped. Capital adequacy and solvency requirements for banks are below international standards, with frail mechanisms in place to ensure compliance. Second, the pervasive relationship-based business practices (crony capitalism) limit competition within the banking system. In some cases, the fact that creditors (banks or non-bank financial institutions) are parts of conglomerates distorts incentives of lenders to discipline borrowers and undermines their role in monitoring. Third, the implicit and explicit government guarantees on loans may have further weakened creditors' incentives to monitor and discipline bad borrowers and to recognize non-performing loans.

In the case of Korea, the country study noted that banks have few incentives to monitor borrowers, since the government guarantees their loans. Large shareholders of most banks are passive in exercising their voting rights and in monitoring the bank management because of government intervention. For example, the government appoints bank chairmen even if it does not have ownership in commercial banks after privatization.²⁴ The government did not allow banks to fail before the crisis to avoid the social costs of bank failures. Risk control and credit analyses are underdeveloped. Credit decisions tend to rely on collateral and cross-debt guarantees among affiliates, rather than on the basis of projected cash flows or some broader methods of project evaluation. The information disclosure system of banks falls short of International Accounting Standards. Also, high entry barriers and the lack of a takeover market for financial institutions mean that bank management is accountable to no one except the government.

In the case of Thailand, the country study reveals that the main creditors are commercial banks, and finance and securities companies. A high level of affiliation between banks and borrowing firms leads to low standards in making and monitoring loans. According to the ADB survey, the responding companies are associated with one affiliated bank and 14 independent banks on average. Each company also has, on average, 35 non-financial corporations as their creditors with most of them being affiliated companies. The relationships with creditors are mostly long-term. Collateral requirements are generally weak but companies indicated that these have been tightened after the crisis. Most responding companies indicated that creditors have little or no influence over management decisions and, in cases where they do, the influence is exercised mainly through loan covenants.

²⁴ See Il Chong Nam, et al (1999).

The Malaysian financial system consists of commercial banks, merchant banks, finance companies and discount houses, development finance institutions, the Employees' Provident Fund, insurance companies and national savings banks. Of the 37 commercial banks, only a few are part of conglomerates. A significant deregulation measure introduced in the Malaysian banking sector in 1991 was the liberalization of the base lending rate, whereby rates are allowed to be determined on the basis of each lending institution's own cost of funds. This framework was further liberalized in 1995, when each lending institution was free to quote its own base lending rates subject to an industry ceiling rate determined in relation to the three-month inter-bank weighted average rate. Another measure implemented in the early 1990s was the requirement for foreign banks to be incorporated locally. Following deregulation, interest rates moved closer to market levels. This led to product innovation and the development of the derivatives market. A two-tier regulatory system for commercial banks was introduced in 1994. This allows well-managed banking institutions with strong financial standing to conduct certain operations under a more liberal regulatory environment. This liberalization was aimed at reducing the cost of compliance and at increasing the efficiency of cross-border transactions of residents. Requirements for collateral in granting loans seemed deficient but have been tightened after the crisis. The county study for Malaysia reveals that creditors in general do not have influences on companies' management and decision-making, apart from restrictions set in loan covenants. In Philippines, out of 31 domestic commercial banks that existed in 1997, 16 are linked through ownership to non-financial business groups. Most creditors are commercial banks but non-financial institutions are also an important group. The ADB survey found that companies deal with commercial banks on a longer-term basis than they do with non-financial institutions. The General Banking Act regulates operations of banks and the Monetary Board prescribes the qualifications of bank directors and officers. The maximum amount that a bank can lend to a firm is limited by a single borrower limit. The Philippine Central Bank has deregulated interest rates and foreign exchange control. It has liberalized the entry of foreign banks and hiked capital requirements. Because of unstable macroeconomic conditions, banks maintained high lending rates and limited their lending to prudent levels before the outbreak of the crisis. The banking system absorbed the impact of the crisis well because of its strong capital position. A number of small banks were locked up during the crisis, but they represent only

less than 1 percent of total resources of the financial system. Because commercial banks were strongly capitalized, they were willing to restructure and re-negotiate existing loans of corporate borrowers, albeit at current market interest rates. According to the ADB survey, in cases of actual or potential defaults on loans, most corporate borrowers (81 percent of the responding companies) went through re-negotiation. While most banks require collateral, they rarely take legal action and foreclose on the collateral. Most corporate borrowers indicated that creditors with whom they have re-negotiated loans were still willing to lend to them after the re-negotiation. Corporate borrowers are of the view that creditors have little or no influence over the management and decision making of their companies.

In Indonesia, the banking sector used to be dominated by state-owned banks, but this situation has gradually changed. In 1988 the government allowed the establishment of new commercial banks with looser requirements. If not owned by the government, banks are usually owned by big business groups, or politicians, or both. Most business groups own banks. A bank owned by a group usually acts like a “cashier” that provides credit to the companies in the group. Prudential credit analysis tends to be ignored, which later results in large amount of non-performing loans. In cases where banks are linked to government officials, bank supervision is usually non-existent. Politicians seem to be unwilling to regulate politically affiliated banks. When financial liberalization started in 1988 in Indonesia, the number of banks increased dramatically to more than 200, making bank regulations more difficult. Financial liberalization without proper supervision led to unsound lending practices by banks. The ADB survey found that not all creditors asked for collateral, with 22 out of 29 respondents to the survey reporting that they renegotiated their loans with their creditors without penalty and that they could still borrow from their creditors without any difficulty. The responding companies also indicated that creditors have no influence over company decision-making. It is noteworthy that most of the banks liquidated in 1997 by the government had violated the legal lending limits set by the central bank (Bank Indonesia) and that most of the banks liquidated during 1997-1999 were affiliated with one of the business groups.

The Insolvency Law and Effectiveness of Insolvency Procedures

The ADB country studies provide a general picture of feeble legal protection of creditors. First, in some affected countries, the insolvency law is old and no longer suitable for the new business environment. In particular, there are many omissions and loopholes in the law. Second, the insolvency procedures are in general slow, inefficient and costly, due partly to the inefficient judicial systems in some of these countries. The inefficient insolvency procedures put creditors in a disadvantageous position, and also discourage creditors from taking legal action against firms that default. Third, companies are sometimes interconnected through ownership or other business relationships with their creditors, which is a further obstacle for creditors to take legal action against their borrowers. Consequently, loans are usually re-negotiated informally or simply rescheduled when firms fail to repay. The insolvency law and procedures are ineffective both in protecting creditors and in disciplining borrowers.

Before the crisis, insolvency procedures were rarely used in Korea. Incumbent management and controlling shareholders remain in control even after shares of the latter have been wiped out. In addition, formal procedures have not been effective in restructuring debtor firms for the following reasons: legal proceedings are time-consuming and expensive; there is a lack of legal expertise; a separate bankruptcy court did not exist; the bankruptcy rules leave too much room for discretion by judges. Most workout programs contain a debt-equity conversion provision and, due to huge stakes, debtors and creditors have incentives to reschedule debt rather than go through the court procedures and even more so when the two parties are connected through the main bank system. To confirm this, a recent ADB study²⁵ on insolvency law reforms in nine Asian countries found that over the past few years, the incidence of liquidation cases was “low” and that of reorganization was “high” in Korea.

In Thailand, the Bankruptcy Law has been in effect since 1940. Although there were two major amendments in 1968 and 1983, those amendments only deal with minor details of the law. The main part of the original law remained intact and, therefore, the insolvency law was no longer compatible with the new and changing business environment.

²⁵ A study under RETA 5795: Insolvency Law Reform, Asian Development Bank (1999g).

In 1989, the government appointed a panel of judges to consider the possibility of amending and modernizing the law. The focus of the amendment was on business rehabilitation and reorganization modelled after Chapter 11 of the US Bankruptcy Code and, to a lesser degree, the Company Voluntary Arrangement in the British Insolvency Act of 1986. However, the drafting process took almost ten years. After the outbreak of the financial crisis, a Bankruptcy Act Amendment Bill was submitted to the National Assembly in September 1997. Some of the problems the proposed Amendment Bill intends to address are (i) adding reorganization provisions to the Bankruptcy Law in order to provide for court supervised restructuring and avoid premature liquidation because of temporary liquidity problems; (ii) eliminating loopholes in the 1940 Law that allow borrowers to delay court decisions and bankruptcy proceedings for a long time. The problems of the insolvency law and procedures in Thailand are confirmed by findings of the recent ADB study: the number of liquidations was “low” and of reorganization cases was “very low”. Thailand also amended the Foreclosure Act after the outbreak of the crisis in order to reduce obstructive rules and procedures that have caused delays in foreclosure proceedings.

In Philippines, debt restructuring is mainly conducted between banks and borrowers through private negotiations. Suspension of payments for corporate borrowers used to be administered by the courts, but was transferred to the SEC in the late 1970s to speed up the process. Under the earlier system, suspension of payments was granted only if two-thirds of creditors accepted the rehabilitation plan. Now the SEC has the quasi-judicial power to make final decisions. However, there are concerns about whether the SEC has sufficient resources to evaluate business rehabilitation plans. Settlement of many petitions was usually delayed for considerable time, which may have led to serious moral hazard problems as some debtors might not make their best efforts to repay loans. Moral hazard may have been aggravated by the government’s concerns about the social and economic costs of bankruptcy, especially for larger companies and, consequently, the bias towards debtors in granting suspension of payments. It is striking that the legal process has so far not been instrumental in the successful and satisfactory rehabilitation of financially distressed companies. According to the ADB (1999g) study on insolvency law reforms, there have been very few liquidation cases for a number of years in Philippines.

The insolvency procedures in Malaysia were modelled on the English law with a mix of creditor-oriented formal procedures and

informal procedures for bringing debtors and creditors together to restructure loans. The latter is a variant of the London Approach.²⁶ However, before the crisis, there was no unified approach to workouts. Restructuring appears to have been slow and ineffective. The Indonesian insolvency law, developed from the Dutch law, is widely viewed to be ineffective before the crisis. The ADB (1999g) study on insolvency reforms found that there were practically no cases of liquidation in Indonesia prior to the 1998 amendments to the insolvency law.

3.4 The Market for Corporate Control

Few mergers and acquisitions took place in the five affected economies before the Asian crisis. In some countries this is the result of government attempt to protect large family shareholders—incumbent managers when their companies become listed. The protection was meant to encourage greater listing on the stock exchange. The outcome was that the incumbent management felt quite entrenched in its position and therefore relatively free to undertake activities not in the best interest of companies and small shareholders. Although takeovers are now on the rise in some of the affected countries, most of these are forced mergers brought about through government rescue packages. The large size of shareholdings by controlling shareholders and other defense mechanisms make it difficult for outsiders to mount successful takeover bids.

In Korea, until 1994, no one could accumulate more than 10 percent of the voting shares in a company without prior approval of

²⁶ The London Approach as it has recently come to be known has been evolved by the banks in the UK, with considerable leadership from the Bank of England, as a widely used set of principles that govern how banks respond when a company to which they are exposed faces serious financial problems. These principles do not have any formal status; they are not statutory and the regulatory authority does not have powers of enforcement. The main elements of the London Approach are (see Kent, 1997):

- (i) banks should remain supportive on hearing that a company to which they have an exposure is in financial difficulty. In practice, this means that they keep their facilities in place and do not appoint receivers;
- (ii) decisions about a company's longer term future should only be made on the basis of comprehensive information, which is shared among all the banks and other parties to a workout;
- (iii) banks work together to reach a collective view on whether and on what terms a company should be given a financial lifeline; and
- (iv) the seniority of claims continues to be recognized, but there has to be an elements of "shared pain", that is, equal treatment for all creditors of a single category.

Korea's SEC. Shareholders already owning such stakes were exempted. The purpose was to encourage firms to become listed by assuring them that the incumbent owners and managers would be protected from hostile takeovers. In 1994 this limit was abolished and hostile takeovers by tender offers took place for the first time. From 1994 to 1997, 13 hostile takeover attempts occurred. But more than half of these failed due to white knights,²⁷ share repurchases (greenmail) and other tactics used by the incumbent management.

The market for corporate control is not very active in Thailand. From 1978 to 1997 (before the outbreak of the crisis) there were only nine mergers and acquisitions of listed companies. Although there is evidence that the number is now growing, most came about from forced mergers or rescue packages. Since 1992 the regulations governing takeovers have been developed. For example, Thailand's SEC now requires that any person accumulating more than five percent of the total outstanding shares of a company must report this within ten days from the date of acquisition.

The Malaysian Code on Takeovers and Mergers came into effect in April 1987. It aims at ensuring that all takeovers and mergers are conducted in an orderly manner and at protecting minority shareholders. In 1993, penalties for breaches of the Code became stricter. Greater disclosure of information is required so that shareholders could assess whether or not to accept a takeover. The new law also intends to ensure that minority shareholders are treated fairly. The new Malaysian Code on Takeovers and Mergers that came into effect in 1998 increased the market disclosure requirements relating to takeovers. The new Code requires that shareholders be given all necessary information. Criminal liability is imposed on relevant parties providing false or misleading information. Standards of disclosure in cases of takeovers were generally enhanced and amendments were made for this purpose in the KLSE listing rules, effective from 1999. Provisions relating to "creeping" takeovers have been amended to reduce the amount of time required for an acquirer to accumulate shares in a target firm. Numerous examples of mergers, acquisitions and restructuring, which resulted from the crisis, are provided in the ADB country report on Malaysia.

In Philippines, hostile takeovers are not common due to large shareholdings by controlling large shareholders. The only successful

²⁷ A white knight is a third party that makes a better offer or is considered more compatible with the target company than the company that made the initial bid.

hostile takeover occurred in 1998 and the target was a widely held company (First Pacific Group of Philippine Long Distance Telephone Co.). Takeovers are usually friendly and involve negotiations between the purchasers and the family-based owners.

During 1993-1997 there were 52 mergers and acquisitions in Indonesia. In five of them a company outside of a group was acquired, while in the rest a company within the group of the buyer was acquired. Most of them constitute unrelated diversification. There were virtually no hostile takeovers. This is due to the dominant role of family based shareholders and other impediments.

Throughout the region hostile takeovers are therefore difficult to mount and quite rare. To a large extent this reflects the predominant role of family based shareholders. However, it also mirrors the difficulties in mounting hostile takeovers in the face of available defense tactics. The situation likewise reflects the low level of shareholder democracy. Company laws regarding takeovers may vary across East Asia, but all should specify disclosure requirements on shareholdings of large shareholders. Likewise, there are good arguments for compulsory bid rules when shareholders gain more than a certain number of shares. The compulsory bid rules have already been adopted in a number of countries in the region.

3.5 Capital Markets and Regulations

Capital markets are not well developed in most East Asian countries. Stock markets in the region are relatively small and characterized by poor transparency and disclosure, low liquidity, thin trading, high volatility and under-developed market infrastructure. In December 1997 the ratio of market capitalization of the stock market to gross domestic product (GDP) was less than 30 percent for Thailand, Indonesia and Korea, 52 percent for Philippines and 132 percent for Malaysia. It is the banking sector that has played a dominant role in domestic resource mobilization in all the five affected countries. Table 6 shows the relative size of the domestic bank lending, domestic corporate bonds and equity markets in the five affected countries.

An ADB/World Bank study (1998) reported that the average turnover ratio of stock markets in 1996 for a sample of nine Asian countries was less than 40 percent, far lower than the figures for the UK (115 percent), the US (95 percent) and Germany (120 percent). The

Table 6
Bank Lending, Corporate Bonds, and Equity Markets in 1997
 (percentage of GDP)

Countries	Outstanding Bank Loans	Outstanding Corporate Bonds	Equity Market Capitalization
Indonesia	60.2	1.5	21.7
Korea	47.6	20.4	16.9
Malaysia	165.8	16.9	132.3
Philippines	72.3	12.5	51.7
Thailand	125.5	3.8	23.0

Source: A Study on Mortgage-Backed Securities Markets in Asia under RETA 5756, Asian Development Bank (1999h).

study also reported that, in 1996, the average bid-ask spreads (another measure of market liquidity) in the largest four East Asian emerging markets ranged from 100 to 170 basis points, about double those in industrialized countries' markets that ranged between 70 and 85 basis points. Concentration of market capitalization and trading value further indicates the low liquidity of stock markets in Asia. In 1996, in almost all the countries in the sample used by the ADB/World Bank study, about one third or more of market capitalization was concentrated in the ten largest stocks. Trading was also concentrated in these largest stocks. Low market liquidity and thin trading volumes may partly be a result of the high concentration of ownership. The concentrated ownership structure and dominance of control-orientated shareholders also have a negative impact on transparency and disclosure. Large and presumably politically powerful shareholders are unlikely to press for improvement in transparency and disclosure and tend to be reluctant to put in place mechanisms that may erode their control. Poor transparency and disclosure further reduce market liquidity, limit market competition and undermine market discipline.

The regulatory structure for capital markets came late in countries such as Thailand, which set up its SEC in the 1970s and Indonesia, which set up its Capital Market Supervisory Agency in 1988. Philippines, Malaysia and Korea installed their regulatory frameworks for their capital markets much earlier. The unification of securities market regulations under one agency marked the beginning of modern securities market operations in Asia. In most of the affected countries, the

regulatory framework for transparency appears to be adequate on paper. Their SEC regulations, listing rules of stock exchanges and company laws have ample provisions requiring disclosure of information to protect investors. The real problem is compliance, enforcement and how to strengthen regulations to facilitate compliance and enforcement. There has been some progress, however. In Philippines, for example, the law was revised to simplify prosecution of insider trading cases. In Malaysia, the KLSE prescribed stricter standards of disclosure for takeovers and improved its provision of information to investors regarding relative valuation of traded shares. Overall, the capital markets of the affected countries showed considerable growth in recent years. The growth is attributable to financial liberalization and rationalization of the legal framework supporting the debt and equity markets. The ADB country studies suggest that to some extent the capital markets now offer a disciplining mechanism for the listed companies. However, the low liquidity of markets as measured by high average bid-ask spreads and weaknesses in the implementation and enforcement of regulations indicate the need for further developing the capital markets and strengthening their regulations.

The underdevelopment of the public debt markets, especially the long-term public debt markets, is due to many factors. These, among others, include repressive regulatory processes, statutory restrictions on the issuance of fixed-income instruments, low standards of transparency and disclosure in the corporate sector (which have negative impacts on investors' confidence), and inadequate market infrastructure such as trading systems and credit rating agencies (ADB, 1999f).

Throughout the region there is a lack of professionalism in regulations. There is a need to ensure that regulators fulfil their legal responsibilities. There is also a need for more trained personnel with the appropriate knowledge and experience.

3.6 Corporate Finance

Finances of the corporate sectors in the five affected countries are characterized by heavy reliance on debt financing, especially bank loans. In the years running up to the crisis, many corporations borrowed excessively from abroad either directly or through banks. Foreign loans with short maturity were amassed in such high levels that they were believed to be unsustainable. Excessive borrowing finally triggered in-

vestor panic. The investor panic was one of the immediate causes of the Asian crisis. Patterns of debt-equity ratios of the corporate sectors of these countries during 1990-1997 (Table 7) and the distribution of their debts in 1996 (Table 8) partly reflect these developments.

Table 7
Debt-Equity Ratios¹ of the Corporate Sectors, 1990-1997
(Percent)

Year	Indonesia	Korea	Malaysia	Philippines	Thailand
1990	...	297	40	181	145
1991	...	318	45	149	152
1992	253	325	45	121	138
1993	238	313	42	119	140
1994	215	308	46	102	126
1995	223	306	49	107	140
1996	229	336	71	109	146
1997	307	425	88	149	350

¹ Debt-equity ratio = total liabilities/stockholders' equity.

Data cover all the publicly listed companies in the cases of Indonesia, Korea, Malaysia and Thailand, and 1,000 largest corporations in the case of Philippines.

Sources: Country Studies under RETA 5802, Asian Development Bank (1999a, b, c, d and e).

Table 8
Distribution of Debt in 1996
(Percent)

	Indonesia	Korea	Malaysia	Philippines	Thailand
Domestic					
Long term	29	26	22	34	26
Short term	31	27	35	25	32
Subtotal	60	53	57	59	58
Foreign					
Long term	19	18	11	21	12
Short term	21	29	32	20	30
Subtotal	40	47	43	41	42
Total	100	100	100	100	100

Sources: Adopted from Claessens, Djankov and Lang, East Asian Corporations: Heroes or Villains? Discussion paper, Workshop on Corporate Governance and Financing in East Asia, Asian Development Bank, Manila (1999b).

The country studies examined corporate financing in the five affected countries in detail by using balance sheet data of publicly listed companies.²⁸ Table 9 provides a summary of patterns of financing of non-financial PLCs in the five countries during 1981-1996, estimated by using flow of funds analysis.²⁹ The period averages indicate the contribution of each source of finance over the period indicated.

Table 9
Financing of the Non-Financial Publicly Listed Companies
(Percent)

	Indonesia (1986-96)	Korea (1982-95)	Malaysia (1981-96)	Thailand (1981-96)	Philippines (1992-96)
Internal	17.3	6.4	32.7	13.6	...
Borrowings	37.9	28.5	31.6	38.2	35.0
Short-term	16.5	16.7	16.0	17.0	15.7
Long-term	21.4	11.8	15.6	21.3	19.3
Debenture/equity	23.5	31.8	12.5	31.6	41.1 ²
Debenture ¹	(0.1)	12.0	...	6.1	...
Equity	23.6	19.8	12.5	25.5	...
Trade credit	8.6	25.4	5.3	3.9	8.5
Others	12.6	7.9	17.9	12.7	15.4
Total	100.0	100.0	100.0	100.0	100.0

¹ Figures in brackets indicate negative;

² Combined new equity and internal funds.

Sources: Estimated from the Pacific-Basin Capital Markets Database compiled by the University of Rhode Island in the US and the Philippine Stock Exchange database.

A number of observations can be made on the results in Table 9. First, in most affected countries, internal finance (retained earnings) is relatively unimportant. In all the five countries, external finance dominates corporate financing. Second, the most important form of

²⁸ Balance sheet data on assets and liabilities for Indonesia, Korea, Malaysia and Thailand are from Pacific-Basin Capital Markets Database compiled by the University of Rhode Island in the US and those for Philippines from the database of the Philippine Stock Exchange.

²⁹ The flow of funds analysis follows Mayer (1990), Corbett and Jenkinson (1994) and Cobham and Subramaniam (1998). This approach looks at sources of financing by using financial flow variables, rather than stock variables as in the case when estimating debt-equity ratios. Sources of financing represent estimates of the gross contribution of various sources to the financing of a company's acquisition of new assets.

external finance is bank loans, which is followed by equity. With the exception of Korea, corporate bonds constitute only a small share of corporate liabilities. Third, short-term bank loans have more or less equal importance as long-term bank loans.

This particular pattern of corporate financing may be explained by a number of factors. (1) The insignificance of internal finance may partly be explained by the rapid growth of the corporate sector in these countries during the past decade. In some countries, especially in Korea, this may also be explained by the poor financial performance of the corporate sector (Table 10). (2) The dominance of bank loans can be explained by the fact that firms with a dominant family shareholder rely on financial leverage in order to maintain high family ownership and control.³⁰ This is supported by empirical evidence documented in the

Table 10
Return on Equity of the Non-financial PLCs, 1990-1997
(Percent)

Year	Indonesia	Korea	Malaysia	Philippines	Thailand
1990	...	6.2	10.1	11.5	18.5
1991	...	6.7	11.8	12.2	15.8
1992	12.6	5.5	11.2	12.8	14.2
1993	12.5	5.4	11.5	12.1	10.2
1994	12.0	8.1	12.2	16.4	10.0
1995	11.3	9.1	11.9	13.1	7.7
1996	10.7	2.5	12.0	12.8	5.8
1997	1.1	-4.2	7.6	6.2	-31.0

Sources: Country Studies under RETA 5802, Asian Development Bank (1999a, b, c, d and e).

country studies: there was a positive correlation between degree of ownership concentration and level of financial leverage. The lack of a well-developed capital market may also be one of the main reasons why in some countries firms have relied mainly on bank finance. (3) The insignificant role of corporate bonds in corporate financing can be explained by regulatory restrictions, the ineffectiveness of legal procedures in cases of insolvency, and the lack of market infrastructure, such as credit rating agencies. (4) The remarkable increase in short-term

³⁰ See Claessens, Djankov and Lang (1999a).

foreign debt may have been caused by the inconsistent mix of macroeconomic policies implemented in varying degrees by the East Asian economies during the 1990s. Liberalized foreign interest rates were more favourable than the regulated domestic interest rates, while pegged exchange rates were seen to guarantee against exchange rate fluctuations, so that firms chose not to hedge their foreign debt. As exchange rates tumbled during the crisis, many firms ended up with unprecedented amounts of foreign debt.

The lack of a well-developed capital market in Korea in the past was one of the main reasons why firms often relied on bank finance. Furthermore, the government influence in credit allocations was strong, and financial supervision and regulation were weak. More than half of bank credit went through state-owned banks. Credit to the target sectors was subsidised and bank lending was in many cases guaranteed by the government. Thus the government entered into implicit risk sharing with private firms. This created a moral hazard problem: firms could make reckless investments and banks had low incentives to monitor the firms, as they believed that the government would not allow them to fail. The government also undertook to bail out failing corporations in several cases, which reinforced the tendency of Korean firms to undertake risky ventures. The country report for Korea argued that the “too-big-to-fail” hypothesis led to over-borrowing: the social costs of bankruptcy of a *chaebol* would be enormous; hence the more *chaebol* borrow, the safer they are.

The overvalued exchange rate, and the fact that since the early 1990s short-term capital inflows were liberalized ahead of long-term inflows, contributed to the heavy exposure of the Korean firms to short-term foreign debt. The ratio of liquid assets over short-term liabilities of Korea was far lower than that of the US, Japan and Taipei, China, which implies high default and indeed systemic risks. The importance of internal capital markets has also been significant. *Chaebols* have non-bank financial institutions as affiliates and use them to finance their activities in various ways such as direct provision of funds and priority underwriting of securities. Loan guarantees between *chaebol* firms were widespread. The country report argued that cross-guarantees of debt among firms within a *chaebol* hindered early exits of non-viable firms and such guarantees were extended because of the belief that the government would not allow large *chaebols* to go bankrupt.

Thailand liberalized international capital flows in 1993 before the domestic banking industry was deregulated. Thus foreign loans became

cheaper than domestic loans and Thai companies borrowed heavily from abroad. The overvalued exchange rate and the scarcity of domestic long-term funds also contributed to the accumulation of excessive foreign debt. The proportion of short-term debt in total foreign debt increased dramatically during the 1990s. Foreign debt reached a peak in 1996. Retained earnings provided around 14 percent of the total finance of new assets of the non-financial PLCs during 1981-1996. The country study for Thailand reveals that firms with higher ownership concentration had higher leverage.

Malaysia boasted the largest debt and equity markets among the ASEAN countries in the mid-1990s. A pegged exchange rate and free capital inflows led to a high level of foreign debt. Foreign borrowings constituted 13 percent of total private sector borrowings in 1990. This figure stood at 13.7 percent in 1997. The retained earnings provided the prime source of finance during 1981-1996, followed by loans from banks and non-bank financial institutions and equity. In lending, Malaysian banks require collateral more frequently than non-bank financial institutions do, which can explain the higher non-performing loan ratio of non-bank financial institutions. Requirements for collateral seemed to have tightened after the crisis. The corporate sector had relatively easy access to loans before the crisis, which were often soft, especially for politically affiliated groups, which were often offered credit from the government-backed banks.

As documented, the politically affiliated business groups in Malaysia arose out of the effort of the government to increase the number of Bumiputra entrepreneurs. Government-affiliated groups could easily obtain bank loans from government-controlled banks using political influences.³¹ They also undertook most government projects for which large loans were provided. The New Economic Policy, which sought to achieve economic parity for the Bumiputra, was the main vehicle for achieving this. The Malaysian central bank also waived the single lender limit for government projects so that these would not be dependent on foreign funds. However, in Malaysia, loan guarantees between firms are not widespread and the law prohibits a firm from lending or issuing a loan guarantee on behalf of a director-related entity unless this entity is a subsidiary.

Within the region, the Philippine corporate sector was least affected by the crisis of 1997. Part of the reason is its limited exposure

³¹ See Yoshihara (1988).

to foreign debt, especially short-term foreign debt. In contrast to the other affected countries that had already large and increasing access to international capital markets by the late 1980s, the Philippine debt problem during that time and the recession in the early 1990s ensured that the country was a latecomer in accessing capital inflows. The country report for Philippines states that “[I]n the 1990s, while its counterparts in other Asian countries were building upon their stable growth experiences, the Philippine corporate sector was just coming out of its recent crisis and a 15-year period of ‘boom-and-bust’ cycles. Corporate financing enjoyed a ‘bubble-like’ period in the equity market during 1993-1996 but foreign portfolio investment remained small.” From 1990 to 1997, the average corporate debt-equity ratio ranged from 102 to 181 percent. Thus, unlike in other East Asian countries, the Philippine corporate sector did not build up debt beyond prudent limits before the crisis.³² The pressure of the crisis in most of the countries was proportional to the ratio of foreign short-term debt to the country’s net foreign reserves. This ratio exceeded 200 percent in the other countries at the height of the crisis. In Philippines, the discipline of the loan moratorium in the past and the restructuring of the country’s loans to long-term loans kept this ratio below 100 percent. Thus the corporate sector was in a relatively strong financial position at the time of the crisis.

The capital markets in Philippines are not well developed. The markets for debt and equity instruments are small and have limited depth and liquidity. As a consequence, stocks are probably not priced efficiently and prices are vulnerable to manipulation. Negotiated bank loans are the major source of financing. Other types of finance are rights-issues, short- and long-term commercial papers (CPs), and bonds. Only a few large companies offer CPs due to their high transaction and regulatory costs. Companies issuing CPs are usually affiliated with the banks underwriting the issues. Bond issues are even more limited, with only companies that are strongly capitalized and with predictable cash flows being in a position to issue bonds. Other problems are volatile interest rates and the absence of a secondary market for bonds. Foreign investment in Philippines has been lower than in other East Asian countries. However, prior to the crisis, foreign portfolio investment increased relative to direct investment.

³² For further information on the financing of the Philippine corporate sector during the crisis, see Lim and Woodruff (1998).

Before 1983, interest rates charged by the state banks in Indonesia were regulated by the government and kept below the market levels. As a result, firms had little interest in the stock market. After the financial reform of 1983, lending rates were raised closer to the market levels. However, there still remained a tax advantage for the use of debt. Until 1988, the main financing instrument for companies was bank loans. There had been some increases in stock market listing since then. In 1989, there were only 37 listed companies in Indonesia. By 1997, the number had increased to 280. State-owned firms also used the stock market to raise funds. Privatization of state-owned enterprises used to be carried out through private placements. But as Indonesian capital markets developed, six state-owned companies issued equity through the stock market, although the government still maintains the majority ownership in these companies. In the early 1990s, capital inflows were liberalized and private companies were allowed to borrow freely US dollar (USD)-denominated loans. Some constraints were, however, imposed on state-owned firms. As foreign debt grew, the government tried to obtain data on the amount of foreign borrowings by domestic companies, but interestingly, the borrowing companies refused to provide such information.

The Indonesian private sector appeared to have had confidence in the managed floating exchange rate system. From the 1986 devaluation until the outbreak of the Asian crisis, the depreciation of the Indonesian rupiah (IDR) never reached more than 4 percent annually. Between 1987 and 1996 the average interest rate for USD-denominated loans was 9 percent, while the average interest rate for IDR loans was 18 percent. Thus there was a significant rate differential even after taking into account currency depreciation, inducing firms to borrow heavily in USD (capital flows were free from regulations) without hedging. Further, short-term debt was used to finance long-term investment, with more than two thirds of the private sector debt being short-term. Data for 1996 show that the average maturity of all the private sector debt was 18 months, and 81 percent of the total USD-denominated debt was unhedged. At the end of 1997, 67 percent of the debt of the 200 non-financial PLCs came from banks and non-bank financial institutions and the rest from commercial papers and syndicated loans. Loans denominated in USD constituted 90 percent of the total debt. The total liabilities of these PLCs almost doubled in 1997, mainly due to the increase in foreign debt in IDR as a result of the currency depreciation. In December 1997, the average debt-to-equity ratio for all the listed

companies was 3.07. In June 1998 the average for 161 listed companies was 13.8 (the rest reported negative equity). The dramatic increase in debt-to-equity ratio was due to the decline in equity value and the increase in the value of debt in IDR due to the currency depreciation.

The general conclusion from discussions in this section is that throughout the region firms relied on issuing debt to finance investments, with a limited use of equity market finance, in particular, in the years running up to the crisis. This means that the amount of risk sharing between borrowers and lenders was limited, with the borrowers having to carry risk through repeated re-financing and loan re-negotiation. This has certain advantages, as at least in principle, it limits free cash flows and managerial discretion and also limits the extent of risk shifting. But in all of the economies under consideration, with the possible exception of Philippines, short-term borrowings were clearly excessive and the problem of maturity mismatch acute. The risks associated with this were made much worse because the loans were to a large extent denominated in USD and not hedged. The reason why this borrowing was generally kept at more than a prudent level is almost certainly because of the close relationships that existed between firms and banks, the system of implicit and explicit loan guarantees that characterize the financial systems of these economies, and inconsistent macroeconomic policies.

3.7 Market Competition

The five country studies documented a high degree of concentration of industries. Firms are typically structured into groups or conglomerates, which are highly diversified. Korean *chaebols* are some of the largest conglomerates in the region. Virtually all the large Korean firms belong to *chaebols*. Those that do not are mainly state-owned and foreign companies. The ADB study found that as the size of a *chaebol* (measured in assets) increases, its degree of diversification and the number of affiliated firms in the group both grow. It is also noted that when the stake and control exercised by a large family shareholder are higher, the number of the affiliated firms in a *chaebol* is smaller.

Chaebols in Korea may have diversified for a variety of sound reasons such as to internalise transactions due to imperfect and inefficient markets for inputs and to take advantage of economies of scale and of scope. However, this has also been done to increase monopoly

power. There is evidence that through internal capital markets *chaebols* have promoted investments that would otherwise not have obtained market finance. The levels of their diversified investments might have exceeded those that even an efficient outside capital market would have sanctioned. In the case of Malaysia, the government had actively promoted the creation of business groups. A key feature of these groups is that they are, as a result of the government's involvement, often owned by indigenous Bumiputra. This has created strong political affiliations and formed the basis for crony capitalism. In Indonesia and Philippines, firms and conglomerates are on average smaller than those in the other affected economies. However, large firms have many of the characteristics of the Korean *chaebols*.

The prevalence of conglomerates, close affiliation to suppliers and banks, and the government interference may explain the limited role of competition in enforcing sound corporate governance in these countries.