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**orporate punishment:
disciplining enterprise in
crisis affected Asian
economies**

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Abbreviations

CDRAC	Corporate Debt Restructuring Advisory Committee
CDRC	Corporate Debt Restructuring Committee
CGB	Chongai Corporation Berhad
ECGN	European Corporate Governance Network
GDP	gross domestic product
IMF	International Monetary Fund
INDRA	Indonesia Debt Restructuring Agency
JITF	Jakarta Initiative Task Force
KLSE	Kuala Lumpur Stock Exchange
MICG	Malaysian Institute of Corporate Governance
OECD	Organisation for Economic Cooperation and Development
ROA	return on assets
SAR	Special Autonomous Region
SEC	Securities and Exchange Commission
SET	Stock Exchange of Thailand
TGB	Tongkah Holdings Berhad
UK	United Kingdom
US	United States
PBMSB	Pembangunan Bandar Mutiara Sdn Bhd

Corporate governance and management control

Publicly traded modern corporations are commonly perceived as having widely dispersed ownership and a separation of ownership and management control. Control is delegated to professional managers. The owners of the firm rely on the board of directors to supervise the managers, voting only on major decisions. According to the original concept of the corporation, managers are not accountable to the shareholders (Marris 1964; Williamson 1964; Galbraith 1967). Berle and Means first propounded this concept of a modern corporation in 1932 and it has continued to hold sway until recently. Shleifer and Vishny (1986) and Holderness and Sheehan (1988) have, however, questioned its empirical validity. They have shown that the concept of widely dispersed corporate ownership should be taken with a pinch of salt, because a modest concentration of ownership can be seen even among the largest American firms. They found that several hundred publicly traded firms had what are known as majority shareholders, that is, those who own 51 per cent of shares. Management ownership in the United States (US) is now markedly higher than when Berle and Means posited their concept of a modern corporation (Holderness, Kroszner and Sheehan 1999).

The United States is not alone in this respect. Other industrial economies display the same trend. A recent study by the European Corporate Governance Network (1997) involving the seven largest members of the Organization for Economic Cooperation and Development (OECD) shows that elsewhere ownership concentration is, if anything, higher than in the United States. The corporate world in Japan replicates this tendency (Prowse 1992). Likewise, there is evidence that corporate ownership is heavily concentrated in emerging market economies (La Porta et al. 1998). Thus, recent research in both industrial and emerging market economies suggests that large corporations generally have large or majority shareholders or domineering shareholders, and, further, that these shareholders are active in corporate governance. Delegation of control to professional managers is frequently a myth. The concept that they run corporations in an unaccountable manner has been invalidated (Burkart, Gromb and Penunzi 1998). The original thesis of Berle and Means and their image of a modern corporation are now frayed. The generalisation that has now emerged is that, with the exception of those in economies with very good shareholder protection, few corporations are widely held. Families or sometimes the state typically control corporations. Equity control by financial institutions is less common.

In theory, corporate democracy grants equality to investors according to how much they invest. In practice, however, the majority or controlling shareholders typically have power over corporations significantly in excess of their cash flow rights. Conversely, it has been commonly observed that small shareholders have even less influence than their stake warrants. The majority or controlling shareholders come to acquire these powers primarily through the use of pyramids¹ and management appointments (La Porta et al. 1999). Cross ownership of shares is frequently found in Asian corporations, as is use of shares having

more votes. A common feature in Asian corporations is the existence of a single controlling shareholder owner who governs the corporation through his or her hold over 20 per cent or more of stocks. Claessens, Djankov and Lang (1999) found that as many as 80 per cent of Asian corporations are controlled in this manner by majority shareholders who double as owners.

In this situation, when other investors invest in a corporation, they become vulnerable to the risk of lower than rationally expected returns—even to a risk of no return. Majority or controlling shareholders—with or without the assistance of managers—determine investors' returns and may decide against giving outside investors and minority shareholders more than a certain level. A controlling stake often goes with inside information. So the stage is set for a conflict of interests between controlling and other or minority shareholders. Corporate governance is, to a large extent, a set of mechanisms through which outside investors or minority shareholders protect themselves against expropriation by majority or controlling shareholders or managers.

Expropriation can be achieved through many elaborate, or gross, mechanisms—for instance, by selling output or assets at below market prices to firms controlled by majority or controlling shareholders or managers, but which outside investors have financed. This kind of transfer pricing and asset stripping is equivalent to theft. As noted above, the use of pyramid structures, deviations from the corporate democracy norms of one-share-one-vote, cross-holdings, and the appointment of managers and directors who are related to the founder or owner families and funneling exorbitant salaries and perquisites to them, are some of the means for, and consequences of, concentrated ownership (Rajan and Zingales 1997). There are many other imaginative forms of expropriation. Controlling shareholders may discourage market-based transactions and direct the corporation into paying more than necessary for services provided to the firms in which they are interested. When these methods are adopted by the controlling shareholders, outside and minority investors need to be protected by the legal system.

Governance and control structure in Asian corporations

Since governance and control structure have serious implications for the level of transparency, openness and market-based transactions, we must scrutinise these issues closely. Although countrywide and intra-country variations exist, Asian corporations generally never accepted the principle of widely held ownership. They deviated far too often from the one-share-one-vote norm.² Many sectors in the crisis-afflicted Asian economies were controlled by small groups of firms or families. They were characterised by non-transparent accounting practices, non-market-based transactions, interlocking ownership between the corporate and financial sectors, strong controlling shareholder groups, and weak minority shareholder rights. A recent survey of 2,980 publicly traded corporations³ in nine Asian economies found substantial family control in more than half of them. These corporations covered three-quarters of total market capitalisation in their

respective economies, making them a robust and reliable source of information. Although significant cross-country differences exist, the largest proportion of corporations under family control was found in Indonesia and Thailand. A notable extent of state control was also found in Indonesia, Republic of Korea, Malaysia, Singapore and Thailand (Claessens, Djankov and Lang 1999). In as many as two-thirds of the corporations which were not widely held, a controlling shareholder held the reins of management.

The study categorised Asian corporations as widely held or those with ultimate owners. In widely held corporations, no stakeholder had significant control rights or control over governance. Corporations where individuals and families owned large stakes, corporations where the state, financial institutions like banks and insurance companies held large stakes, and corporations holding majority or controlling shares in other corporations, were all part of the second category. Different ownership structures prompted differing modes of governance. They can be demonstrated with the help of the following examples. The first illustration is provided by the Ayala group, the largest conglomerate in the Philippines. In 1999, the Ayala family had ultimate control over 46 corporations in the Philippines. The largest publicly owned corporation, Ayala Land, and the fifth largest publicly owned company, the Bank of the Philippine Islands, belong to the Ayala conglomerate. The principal owner of the Ayala Corporation is the privately held Mermac Inc., 58 per cent of which is held by the Ayala family. The second largest shareholder in Mermac Inc. is the Mitsubishi Bank of Japan, which holds 23 per cent control. Notwithstanding Mitsubishi's stake, the Ayala family has complete control over Mermac Inc. and through it all the other corporations.

The second such illustration is that of the Li Ka-shing conglomerate, the largest business group in Hong Kong, which comprises 25 companies. Some of these are among the largest in Hong Kong in terms of market capitalisation. Hutchison Whampoa is the second largest and Cheung Kong the sixth largest corporation in Hong Kong. Both are part of the Li Ka-shing conglomerate. Similarly, it is possible, with a little knowledge of these family ownership structures, to trace the ultimate owner of Hong Kong Electric—the Li Ka-shing family, which controls 34 per cent of the total votes. The chain of ownership works as follows—Li Ka-shing→Hutchison Whampoa→Cavendish International→Hong Kong Electric. Many such chains of family or group controls can be easily traced in all the Asian economies.

The size of a corporation significantly determines the extent of ultimate control, and size is determined by market capitalisation. In the seven Asian countries noted above, the share of family ownership increases for smaller-size corporations. For instance, in Korea, only four of the largest twenty corporations were family controlled, while forty-eight of the smallest fifty corporations were family controlled. A similar trend was observed in Taiwan, where 15 per cent of large-sized corporations were family controlled, whereas 80 per cent of small-sized corporations were family controlled. The same propensity was

observed in Indonesia, Malaysia, the Philippines, Singapore and Thailand. The trend was somewhat diluted in these economies, because more large corporations were family controlled than in Korea and Taiwan. Hong Kong is an exception in this regard, because three-quarters of the largest twenty corporations were under family control, as were 60 per cent of the smallest fifty corporations.

The age of the corporation is another determinant of control. A younger corporation, it is believed, is more likely to have an ultimate owner than an older one. Although the examples of Bill Gates, who owns 24 per cent of Microsoft, and Masayoshi Son, who owns 29 per cent of Yahoo.com, do provide some anecdotal illustration of this notion, in the wider international context little evidence is available of younger firms having more ultimate owners. A simple correlation between the age of the corporation and the controlling stake of the largest owner disproves the hypothesis that younger corporations are more likely to have ultimate owners. In all the Asian economies the correlation coefficients were positive, indicating that older firms had more corporate control. These coefficients were found to be statistically significant for Indonesia, Malaysia and Taiwan.

An interesting observation in this regard is that the pattern of ownership control differed across these nine Asian economies, and ownership concentration generally diminished with the level of economic and institutional development. This negative correlation indicates that corporations gravitate towards less concentration of control as their countries become more developed.

Concentration of ownership and corporate performance

An important causal factor behind the Asian financial crisis was lacklustre operational performance arising from the tardy corporate governance and risky financial structures of Asian corporations. Concentration of corporate ownership, moreover, was one of the significant factors behind tardy corporate governance. After the crisis, it was widely believed that the earlier view of Asian corporations' consistently stellar performance and high real return on assets⁴ (ROA) was ill founded and fallacious. If anything, Asian corporations were risky endeavors just before the crisis broke out. The Asian crisis is a manifestation of the fact that these corporate enterprises were in poor shape and lacked resilience. They could not withstand any systemic shocks—domestic or external—be they plummeting demand, depreciating currencies, or rising interest rates. In addition, their financial structures were far too risky to be stable. Prior to the crisis, analyses of Asian corporations completely overlooked these idiosyncrasies. In fact, analysts of the Asian corporate scene considered them the foundation of the so-called Asian miracle. The question whether these corporate enterprises were poor performers to begin with, or whether they were vibrant institutions initially and subsequently took some missteps, is answered below.

We saw in the preceding section that concentration of ownership leads to conflict between the interests of large and small shareholders. We have also stated that when large shareholders effectively control a corporation, they may choose policies that lead to expropriation of minority shareholders. Asian corporations were not immune from this. In a survey of Asian corporations, it was found that higher control rights are associated with lower market valuation, which suggests expropriation of minority shareholders by controlling shareholders. Using regressions for individual ownership classes, Claessens, Djankov, Fan and Lang (1999) concluded that family control was an important factor behind the negative relation between control rights and market valuation. In Asia, it was also observed that when financial institutions own large stakes they reap large benefits at the expense of the minority shareholders. The Korea First Bank is known to have provided loans to Hanbo Steel and General Construction at higher than market rates. In 1998, the Korean Financial Supervisory Commission took the presidents of five large Korean banks to court on charges of illegal loans. It must be kept in mind, however, that the degree to which certain ownership structures are associated with evidence of expropriation depends on country-specific circumstances, which may include the quality of banking and financial services, the legal and judicial protection of individual shareholders, and the degree of financial disclosure requirements.

Soft spots in the corporate sector

It was indicated earlier that a small number of families had extensive control over corporations in Asia. The Ayalas of the Philippines, the Suhartos and the Salims of Indonesia, and the Chiravanonds, the Soponpanichs, and Shinawatras of Thailand, are well known. Similarly, the Lee Kun Hee family, the Jung Ju Young family and Kim Woo Choong family own the three largest *chaebol* in Korea.⁵ According to Iskander et al. (1999), the top ten families in Indonesia controlled corporations worth more than half of country's market capitalisation in 1997. Similar figures are found elsewhere in Asia, with one-half in Thailand, and one-quarter in Korea and Malaysia. By contrast, the corresponding figure for Japan was only 2.5 per cent of total market capitalisation.

In the family-owned enterprises, ownership is synonymous with control. The high concentration of ownership, and therefore governance, generally leads to weak corporate performance. Groups of firms controlled by families are reputed to be less transparent than non-group firms. They are more frequently given to practices like non-market-based transactions. Given their more complicated structures, they provide more opportunities to engage in questionable practices to the detriment of minority shareholders (Khanna and Palepu 1999a). In Asia, these owner families are known to have close ties with the political apparatus as well, which insulate them from external interference, monitoring, and supervision. Concentration of corporate wealth, together with close relationships with the government, may also contribute to the flouting of legal and regulatory norms. In this atmosphere, the legal system is less likely to protect minority shareholders. In fact, it may

do the reverse, protecting the shady practices of the controlling shareholders. A healthy culture of corporate transparency and market-based activities will necessarily be alien in such a corporate atmosphere. Thus, family ownership and concentration of corporate ownership have been serious sources of vulnerability in Asia.

On the eve of the crisis, Asian corporations were highly leveraged. How did this happen? Over the preceding decades, several Asian economies had followed an aggressive export-oriented strategy. The incentives provided by respective governments included direct credit, subsidised loans, and tax breaks. To develop and maintain competitiveness in global markets, Asian corporations needed massive resources to upgrade their technology continuously and remain competitive. Retained earnings were inadequate for these ambitious objectives and, at that time, stock markets were not sufficiently developed. Consequently, Asian corporations borrowed heavily from banks. With rising GDP growth rates, and strong domestic savings, Asian firms developed a large borrowing momentum. Before the onset of the crisis, leverage rose sharply in some economies, doubling in Malaysia and Thailand during the period 1991–96, and increasing by a third in Korea. Given Korean corporations' high degree of leverage compared to other Asian corporations, this increase was highly risky for them. High leverage made Asian corporations particularly vulnerable to systemic shocks. Leverage was lowest in the Philippines, because the magnitude and duration of the lending boom there was smaller than in the other crisis-affected economies.

During the late 1980s, Asian governments, particularly the East Asian ones, began to play down their financial support role. Financial deregulation also started during this period and accelerated throughout the 1990s. As restrictions on foreign borrowings were eliminated, eager foreign investors began investing in Asian corporations. Their eagerness to lend stemmed from the reputation for high performance these economies had developed. Both Asian corporations and lenders assumed that rapid growth would continue indefinitely and that the authorities would maintain a fixed exchange rate. Investing in Asian corporations appeared so rewarding that foreign creditors confidently ignored their own prudential limits. They were not much concerned by this transgression, because Asian assets were only a small part of their total portfolios. Consequently, Asian corporations developed large unhedged positions. Unfortunately, this development took place when the profitability of Asian corporations was actually plummeting, rendering them highly vulnerable.

Changing investment patterns was another causal factor behind the emergence of corporate soft spots. For instance, the large investments made by Asian firms in tradables during the 1980s are well known. Over the 1990s, the investment focus shifted towards non-tradables. A good deal of emphasis was placed on real estate and infrastructure. Because of import competition, when the exchange rate is basically pegged and the economy is open, the prices of tradables cannot rise—only those of non-tradables can rise. This is what happened in the Asian economies that later succumbed to crisis. Among the

crisis affected Asian economies, Thailand recorded the biggest gap between the prices of tradables and non-tradables (World Bank 1998). This justified the shift in investment pattern toward non-tradables, which, in turn, increased corporations' vulnerability to cyclical downturns.

The Asian development paradigm, which produced such admirable results in the decades prior to the crisis, succeeded because of the close relationship between corporations, banks and governments. Unfortunately, this also led to, and nurtured, poor market discipline. There was little incentive to improve corporate governance and disclosure standards in such an environment. The lack of market discipline was also a consequence of policy residuals and certainty regarding future GDP growth. Policy residuals entail early links between government and banks on the one hand and banks and corporations on the other. Political pressure to make advances to favoured corporations and sectors had existed for a long time. This involved an implicit government guarantee regarding bank loans. This mode of operation diminished, if not eliminated, the need for proper risk assessment in bank lending (Haggard 1999; Evans 1999).

Foreign banks are generally known to impose international standards of governance on borrowing corporations. This, however, did not work in Asia, because their role in lending was limited. Unlike in other emerging market economies, foreign banks held a relatively low share of the market in the Asian economies. Some Asian economies did have a high level of borrowings from foreign banks, but these funds originated from offshore financial markets, which do not have the same monitoring impact as a foreign bank operating within the domestic market. In addition, foreign institutional investors did not insist on corporate disclosure. This may be partly because of their belief in the 'too-big-to-fail' doctrine about the Asian banks and corporations. Brisk growth rates and strong stock markets may also have contributed to institutional investors' tendency to disregard poor corporate governance.

The close ties between the government and the corporate sector, such as in Korea or Malaysia, that characterised the Asian development paradigm used to be an object of admiration. Large firms in Thailand also powered ahead with the help of the Asian paradigm (Alba, Claessens and Djankov 1998). Some analysts argue that it is impossible to understand the 'Asian miracle' without appreciating the significance of the role played by governments and government policy (Rodrik 1997). Those who interpreted the corporate-government ties in a positive manner called these governments 'effective' (Stiglitz 1996).

In the wake of the Asian crisis, however, this relationship has become suspect and is seen as a contributory factor in the crisis. Industrial policy that led growth either directly, or through creating a 'zone of vulnerability', was partly responsible for bringing the Asian crisis to a head. To be sure, close relationships between big business and government can be used productively. The downside, however, is that they can potentially become a source

of wasteful corruption. This system thrived on a lack of predictability of, and transparency in, the regulatory environment, a condition inimical to growth (Campos and Root 1996). Lack of transparency—or, putting it more simply, the existence of corruption—has pernicious effects on growth (Johnson, Kaufmann and Zaido-Lobaton 1998).

In the aftermath of the Asian crisis, it appears likely that close corporate-government ties did serve a decisive purpose in the early phase of growth (during the 1970s and 1980s). The price of this strategy was, however, greater systemic vulnerability. In addition, the East and Southeast Asian economies had acquired a certain degree of economic maturity by the 1990s, and, at this stage of economic development, close corporate-government ties can be counterproductive. In today's context, the strategy of government promotion of large corporations or industrial conglomerates is of dubious validity and is marked by high economic and political risks. A pragmatic and non-dogmatic approach is essential. To enhance the efficiency of investment, governments need to rely on new maxims of corporate governance that require reliance on bank debt, more transparency in operations and accounting, and greater and more secure shareholder rights.

Plummeting corporate performance

Before the Asian crisis broke out, profitability had been declining in Asian corporations. Ownership concentration and conflict between the interests of large and small shareholders were two of the most important factors behind plummeting corporate performance. Ownership concentration led to poor corporate decisionmaking, which included extensive diversification of corporations, leading to misallocation of capital investment towards less profitable and more risky business segments. The more diverse and complex the investment opportunities available, the more pronounced was capital misallocation (Scharfstein 1998). One of the causes behind paltry ROA, and declining profitability, was unrelated and less-productive diversification. Many Asian corporations, particularly those from Korea, diversified into operations away from areas of core competence. Although a plethora of anecdotal evidence supporting this argument surfaced in the aftermath of the Asian crisis, more compelling evidence is provided by an extensive empirical study conducted by Claessens, Djankov, Fan and Lang (1998). Using panel data of more than 10,000 firms over the 1991–96 period, they found that Indonesia, Korea, Taiwan, and Thailand, suffered significant negative impacts on profit margins from poor, and often irrelevant, vertical integration.

According to World Bank (1998) calculations, the return on assets in Thailand fell from eight to one per cent during 1991–96—the most dramatic decline in the region. Korea recorded a fall from two per cent to 0.5 per cent, Indonesia from six per cent to four per cent, and the Philippines from seven per cent to four per cent over the same period. Malaysia was the only exception, where profitability, measured as ROA, recorded a small increase during this period. Another empirical study provides more conclusive results by focusing on two periods—1988–96 and 1994–96. Based on the analysis of balance sheets

and income statements for 5550 Asian corporations over the 1988–96 period, Claessens, Djankov and Lang (1998) concluded that profitability, measured by real ROA in local currency, was relatively low in Hong Kong, Korea, and Singapore throughout the period under review. Conversely, ROA was high in Indonesia, the Philippines and Thailand between 1988–96. It was twice as high as recorded in Germany and the United States over the same period. Thus, to some extent, Asian corporations were vibrant and did contribute to the Asian miracle. During 1994–96, however, ROA declined in all the Asian economies named above. This decline was found to be the steepest in Korea and Thailand.

Pomerleano (1998) also computed the ROA for the 1992–96 period and found that it was 20 per cent for Hong Kong, 10 per cent for Malaysia and Indonesia, and 7.5 per cent for Korea, Singapore and Taiwan. Although these ratios seem good in absolute terms, they are overshadowed by domestic interest rates, which varied between 15–18 per cent. The ROA for Thailand during this period was 6 per cent. For the sake of comparison, the ROA for the United States was 11 per cent during this period and 16 per cent for Latin American economies. Thus, these empirical results lead one to the conclusion that capital resources were not efficiently used by Asian corporations because of poor corporate governance. Basically, they misallocated productive capital.

Pomerleano computations (1998) also confirmed that Asian corporations were highly leveraged before the crisis broke out. Calculations for the end of 1996 show that Korean and Thai corporations had the highest debt-equity ratios at around 150 per cent. With a debt-equity ratio close to 100 per cent, Indonesian companies came next. Corporations in the Philippines and Taiwan had moderately high debt-equity ratios at around 70 per cent. At the same time, debt-equity ratios in Latin America, Germany and the United States were about 90 per cent. A high degree of leverage⁶ and declining profitability is an unhealthy combination for any firm at any point in time.

Fixed assets accumulated rapidly in Asia during the 1990s. They expanded by 33 per cent per year in Indonesia, 29 per cent in Thailand, 25 per cent in Singapore, 20 per cent in Malaysia, and 17 per cent in Hong Kong and Korea. This rapid annual growth in fixed assets was in stark contrast to the more moderate pattern in the industrial economies (1–5 per cent).⁷ These statistics provide evidence of unsustainable growth in Asian corporations. No well-managed corporations, with the exception of software manufacturers, can easily absorb annual growth of 20 per cent or more. Such rapid growth in fixed assets is sure to overwhelm managerial capacity as well as distribution and marketing channels.

The ROA and debt-equity ratio for Thailand, as seen above, suggest that it was no accident that the Asian contagion started in Thailand. Both of these indicators show that Thailand was an outlier. The performance of Thai corporations progressively deteriorated over the 1992–96 period. Average credit ratios for Thai firms declined, margins were squeezed, and return on equity declined significantly, from 13 per cent in 1992 to 5 per cent in 1996.

These statistics add up to create a disturbing scenario of Asian corporations before the crisis. Apparently, control by majority or controlling shareholders or managers contributed to the weak performance and risky investment of many Asian corporations before the outbreak of the 1997–98 financial crisis. It is also more than likely that the development of legal and regulatory standards was impeded by the concentration of corporate power and wealth. In addition, close government-business links must have had a pernicious impact over the governance and performance of Asian corporations.

Restructuring corporate systems

The term ‘corporate governance’ is new; it did not exist until two decades ago. In the last two decades, however, these issues have become important, not only in the academic literature but also in public policy debates. Reforms in corporate governance are clearly needed in Asia but also more or less globally. Proposals regarding improvements in corporate governance have covered a large area. The Cadbury Committee (Charkham 1994) focused on the reform of boards of directors, and the European Corporate Governance Network (1997) stressed the need for improved disclosure norms. There is a pressing need for these reforms in Asia in the wake of the crisis. Changes in corporate control are an important part of corporate restructuring and include mergers and acquisitions, takeovers, divestitures, and so forth. Changes in corporate control allow businesses to be transferred to the control of new owners, who can put business assets to work more efficiently and, in the process, enhance shareholders’ value. Changes in corporate control have started in Asian corporations in the aftermath of the crisis. Policy makers in Asia are also reforming bankruptcy and disclosure norms, and other aspects of corporate governance. They need to find strategies to restructure the corporate sector in the short term and make substantive changes in corporate governance in the medium term.

It is important that Asian policy makers take an integrated approach to the issues of corporate governance and corporate finance. As the crisis-stricken Asian economies have demonstrated, it is often not possible to extricate one from the other. Given the fact that financial resources are scarce and the legal environment has been permissive in Asia, corporate restructuring seems a daunting task. Resolving this systemic crisis will require collaborative endeavours from corporate enterprises, governments, and financial institutions. A comprehensive strategy must be devised by these entities to restructure and rejuvenate the now languishing Asian corporations.

Corporate restructuring strategies should be devised such that taxpayers do not bear the brunt of the restructuring burden, while shareholders do. Also, at the end of the day, governments must not be left holding the baby in the form of a large number of sick corporations. There are three principal methods of corporate restructuring—market-based, bank-led and government-led (World Bank 1998). Of the three, the first is considered the most healthy and pragmatic, because it harnesses market forces to restore corporate profitability. One problem with this method, however, is that it works exceedingly slowly.

The restructuring measures that fall under the rubric of market-based measures include

- (i) operational restructuring of enterprises leading to higher efficiency and profitability
- (ii) asset sales to domestic and/or foreign investors whenever necessary
- (iii) equity issuance, both offshore and domestic
- (iv) enacting laws enforcing minority shareholders' rights which are so frequently ignored.

All these means of restructuring are currently being used on a case-by-case basis in the Asian economies. Governments in these economies are also busy improving the 'enabling environment', which includes allowing mergers and acquisitions, liberalising foreign investment rules, and further developing capital markets. Sometimes, however, market-based solutions are neither the best, nor enough. For example, the application of market-based solutions in Korea will leave the debt-equity ratios for some *chaebol* at exceedingly high levels. This will aggravate the lack of confidence among investors, and the corporations will continue to feel the credit crunch. Policies involving accelerated debt restructuring are needed for such cases.

The bank-led approach is a two-stage process. It focuses first on recapitalising banks, which in turn undertake corporate restructuring. This process is known to be swift and works as follows. First, the government estimates bank losses and recapitalises them. Next, the bank works out problem corporate debts and supervises the necessary operational restructuring. The restructuring bank continues to meet the financial needs of the corporations during the restructuring period. This method was remarkably successful in some transitional economies, notably Poland.

By contrast, under a government-led approach, the government or a government designated agency takes over a large share of distressed bank assets and replaces them with government bonds, recapitalising the banks in the process. The government then forces corporations to restructure. This process is quite swift. Both of these approaches, however, are not without risk. In the bank-led approach, governments can go on injecting capital into insolvent corporations without bringing about the necessary corporate restructuring. In the government-led approach, the government-designated agency may have poor incentives to restructure corporations. In addition, there is the risk of poor management by the asset management agencies created by the government. At the end of the exercise, after infusion of a great deal of scarce capital resources, corporate restructuring may only be superficial.

Given the pros and cons of each approach, it is pragmatic to be eclectic. The three approaches could be amalgamated on the following lines—banks may be partially capitalised by the government so that they can work out the small and medium-sized assets of the corporations that are to be restructured. Restructuring of large assets may be left to the asset management agencies. If the crisis has predominantly affected small and medium-sized corporations, this method may be the most suitable. As there is already a

strong link between banks, corporations and government in Asia, they can collaborate to devise better corporate restructuring programs. Large corporate enterprises can be denied fresh infusions of capital until they undertake the necessary operational restructuring, including implementing measures to protect minority shareholders and divesting affiliates that are not in their area of core competence.

In the process of corporate restructuring, when asset management agencies become the largest single shareholder of a certain corporation, they should treat this as an opportunity to undertake the necessary corporate restructuring measures. Second, retaining ownership is not the ideal course of action. Therefore, the asset management agencies should dispose of these securities at an early, though opportune, moment. The eclectic approach has several advantages. For instance, unlike the market-led approach, it contributes to speedy corporate restructuring and allows resolution of corporate structuring in the framework of debt restructuring (World Bank 1998).

The legal facet of corporate governance reforms is vitally important. It is crucial that the rights of minority investors—that is, both shareholders and creditors—are protected. This requires both legal and functional coverage. Legal coverage refers to the changes in rules, as well as changes in enforcement mechanisms, toward some desirable standards. Most Asian economies need extensive legal, regulatory and judicial reforms if investors are to be protected effectively. In most countries, company and bankruptcy laws need to be amended or reinforced. Also, the regulatory and judicial mechanisms to enforce shareholders' and creditors' rights need to be improved substantially. Giving shareholders the right to a class action suit against directors may be a first step in this direction. It can work as a powerful measure in an environment where other shareholder rights are yet to be established (Coffee 1998; La Porta, Lopez-de-Silanes, Shleifer and Vishny 1999). In most countries, such reforms quickly run into political obstacles. The most stringent opposition comes from the families that control large corporations. They feel threatened because the legal rights of minority investors and creditors are strengthened, and opportunities for expropriation recede. The first order effect is a redistribution of wealth from the controlling shareholders to minority shareholders and outside creditors.

Achievements so far

As a generalisation, it may be stated the Asian corporations have finally begun earnest, if painful, corporate restructuring. It is taking different forms—restructuring debt, cutting costs, buying back shares, making ownership control patterns more democratic, selling assets, promoting mergers and acquisitions, breaking up conglomerates, focusing on core operations, changing company law, enacting rational bankruptcy laws, taking the necessary legal measures, and improving other aspects of corporate governance. Asian corporations are giving up their obsession with growth and concentrating on profits—a development which was long overdue. They are, for the first time, embracing the concept of shareholder value.

If the restructuring endeavors continue at the current pace for two or three years, the corporate landscape in Asia will change substantially. Asian corporations will have much lower debt-to-equity ratios, better balance-sheet structures, higher returns on equity, greater production in areas of core competence, more focused operations and more transparency. Excess capacity is being trimmed, because idle capacity adds to fixed costs. Therefore, higher sales volumes are needed to maintain profitability (*Asian Business* 1999). The wave of mergers and acquisitions that reshaped the corporate landscape in Europe and the United States now looks set to sweep across Asia. Although finance and securities industries have made several such deals, corporate restructuring through mergers and acquisitions was somewhat slow to start in Asia. Most observers believe that this activity is largely crisis-driven in Asia, and that the forces driving it are intensifying. Leung, Pouillet and Shavers (1999) have predicted a surge in the mergers and acquisitions in Asia. According to their reckoning, this has been sparked by the Asian crisis but will move to a higher plateau in the future.

It should be noted, however, that, among the crisis-affected Asian economies, corporate restructuring was adopted with differing degrees of commitment and enthusiasm and consequently progressed with a varying pace. The economies that adopted it in earnest were Korea, Malaysia and, to an extent, Thailand, and all of these countries have substantial achievements to their credit. Indonesia has also made some progress. The Philippines was not so enthusiastic, which is not to imply, however, that it has not endeavoured to restructure its corporate sector. It should be remembered, however, that it was not so badly mauled by the crisis. The Philippines was also the first Asian economy to start stabilising. The restructuring principles and strategy, as well as available details of measures taken so far, for different economies are detailed below.⁸

Indonesia

Corporate restructuring in Indonesia was slow and late to start. In mid January 1998, President Suharto signed an agreement with the IMF that required him to corporatise family-owned businesses and loosen his control over the economy. A conglomerate run by Ms. Siti, Suharto's daughter, had one of its power projects cancelled at the urging of the IMF. Another IMF target was the timber and trading empire run by the Trade and Industry Minister, Mohamad 'Bob' Hasan. Suharto agreed to dismantle key monopolies, including those on cloves, fuel, and all commodities controlled by BULOG, the state trading agency. The rice monopoly was not dismantled. Tax benefits for the national car project were withdrawn. A detailed structural transformation program was prepared in cooperation with the World Bank. This program aimed at ending agricultural import and domestic marketing monopolies and price controls and abolishing the monopoly of BULOG over the importation and distribution of essential food items. This program also outlined the elimination of all formal and informal restrictive marketing arrangements in both retail and wholesales trade. It designed private participation in the provision of public infrastructure, with transparent and competitive bidding. It also proposed a law on competition.

In mid 1998, the overseas debt of the corporate sector was estimated at \$66 billion. To deal with this problem, the government announced a freeze on debt repayments until a new framework could be worked out between international lenders and Indonesian borrowers. A bankruptcy law was adopted. The Indonesia Debt Restructuring Agency (INDRA) was established in August 1998 to facilitate restructuring of corporate debt. A detailed reform program was agreed with the IMF which included eleven measures ranging from amendments to the bankruptcy law to lifting restrictions on overseas investments in wholesale trade. Special commercial courts were also established. In order to accelerate the process of corporate restructuring and address the debt problem, the Indonesian government adopted a two-pronged strategy. The first element of this strategy involved the adoption of legal, regulatory and administrative reforms, including removal of restrictions on debt-for-equity conversions, the removal of tax disincentives for restructuring and substantially streamlining procedures relating to foreign direct investment. Tax neutrality for mergers and acquisitions was also provided. The second element of this strategy involved the establishment of a framework of non-binding principles to guide negotiations between debtors and creditors. Thus, comprehensive corporate reform and restructuring was started in the latter half of 1998. To improve competition and governance, restructuring of state-owned enterprises was also begun as a prelude to accelerated privatisation. Transparent procedures for divestiture and privatisation were designed with the help of the World Bank.

The Jakarta Initiative Task Force (JITF) was established in November 1998. It was sufficiently staffed and funds were made available by the World Bank to finance its activities. At the time of inception, more than 143 companies signed up with the JITF seeking assistance in corporate restructuring. By July 1999, 234 corporations were being assisted by the JITF. A good number of corporations was also busy restructuring without the assistance of the JITF. In May 1999, the government of Indonesia reconfirmed its commitment to the reform package—designed in association with the IMF and the World Bank—in order to cleanse the corporate sector of huge bad debts, which are estimated at \$72 billion.

Korea

Korea based its restructuring a number of basic principles. All corporate restructuring should be voluntary—that is, it could be government directed but market oriented, and public funds would not be used to bail out corporations in distress. An important measure in this regard was legislation to liberalise the rules on takeovers of non-strategic Korean corporations by foreign investors, eliminating the ceiling on the amount of stock foreigners can acquire in a company without approval by the Board of Directors. Banks were encouraged to set up voluntary creditor committees, with foreign participation, to exchange information and assess the need and modality of corporate debt restructuring.

Measures were adopted to promote better governance through improved accounting, disclosure and auditing standards. Major improvements have been made in the area of corporate financial transparency. The role of the Board of Directors, as well as minority shareholders, has been strengthened. Conditions on foreign investment have been eased. By moving decisively to restructure Daewoo, the government has demonstrated that the large conglomerates are not 'too big to fail'. To address the corporate debt overhang, a framework of voluntary creditor-led corporate restructuring was established. This framework is already operating for the top six *chaebol*. Corporate debt restructuring amongst the remaining 64 *chaebol* is proceeding reasonably well. Operational restructuring of the *chaebol* through asset sales and liquidation of nonviable companies is continuing. This kind of restructuring is expected to help economically viable, but distressed, companies reform their business operations and management, and also financially restructure their liabilities to restore corporate financial health.

Plans for improving capital structure were prepared by the five largest *chaebol* and submitted to creditor banks. These plans included the 'Big Deals', which involve asset swaps and joint ventures among the top five *chaebol*. These plans must be implemented by the end of 2000. They will be closely monitored to enforce compliance and ensure adequate burden sharing between banks and the *chaebol* so that banks are not financially weakened.

Policy action was taken to strengthen the role of the Fair Trade Commission to enforce anti-trust laws. Also, the legal framework of creditors' rights was strengthened by improving the insolvency system. Disclosure norms now require *chaebol*, or large conglomerates, to disclose all liabilities. This includes external liabilities, off-balance sheet liabilities, projected cash flows, and interest coverage capabilities to their major creditor banks. To this end, *chaebols* were given the deadline of 30 September 1998. The central bank asked commercial banks to create debt workout units, hire international experts to help assess corporate restructuring plans and strengthen corporate workout capabilities. The Financial Supervisory Commission, which was established in April 1998, has set up an information and analysis unit staffed with the expertise necessary to compile and interpret financial disclosures from large conglomerates.

Capital market development was to be promoted through the creation of mutual funds and the issuance of asset-backed securities. Lack of transparency was addressed by requiring listed companies to publish quarterly unaudited financial statements, as well as half-yearly financial statements, prepared and reviewed by external auditors in accordance with international standards.

To strengthen accountability to shareholders, the shareholding thresholds required for a shareholder to initiate legal action against a company, or request a change in auditors and directors, has been lowered. Since the beginning of 1999, at least one-quarter of the Board of Directors of each company listed on the Korean Stock Exchange must be comprised of people from outside the company. Restrictions on the voting rights of institutional investors in listed companies have been removed. The possibility of allowing for class action suits against corporate executives and auditors is being reviewed.

Malaysia

In March 1998, the Malaysian government established a high level inter-agency committee to strengthen corporate governance. The committee felt that there were serious corporate governance weaknesses, particularly in the following areas—transparency and disclosure requirements, corporate monitoring responsibilities, and accountability of company directors, including the rights of minority shareholders. The committee believed that corporations should be required to provide comprehensive financial information prepared in accordance with international best practice. Therefore, all listed companies were required to comply with the norms of the Malaysian Accounting Standards Board and the Financial Reporting Foundation by June 1998.

Several important measures were planned and executed during the latter half of 1998 to improve the accuracy and frequency of disclosure of information by firms. They are now required to disclose financial results, shareholding structure, and borrowing positions on a quarterly basis. The compliance norms outlined in the preceding paragraph are sure to improve the accuracy of financial data. As these two bodies have adopted most of the accounting standards of the International Standards Accounting Committee, financial disclosures are expected to fall in line with the international best practices. To implement these requirements efficiently, the Kuala Lumpur Stock Exchange (KLSE) initiated a comprehensive review of its policies and requirements for listing. The KLSE also commenced work on establishing an electronic database for efficient dissemination of information. Changes were brought about in the Companies Act to strengthen the governance structure and enforcement mechanism. The Securities Commission proposed incentives and penalties to encourage companies to adhere to good corporate governance.

In July 1998, the government established a Corporate Debt Restructuring Committee (CDRC). Since its inception, the CDRC has restructured the debts of several large Malaysian corporations, including Tongkah Holdings Berhad (TGB), Chongai Corporation Berhad (CGB) and Pembangunan Bandar Mutiara Sdn Bhd (PBMSB). By March 1999, a total of 47 companies had applied for corporate debt restructuring through the CDRC. The task is ongoing, but results should be visible by the end of 2000.

The KLSE and PricewaterhouseCooper conducted a survey of corporate governance practices in listed Malaysian companies in 1998. The survey findings detailed a broad range of information and data and analysed industry participants' views and opinions. An overwhelming majority (94 per cent) of respondents called for corporate governance reforms. A large majority (62 per cent) also believed there was a need for improved education in this regard. In March 1999, the Malaysian Institute of Corporate Governance (MICG) launched several research projects and training programs on corporate governance. To this end, it was given a grant of US\$100,000 by the government. The training programs cover duties, obligations and responsibilities of corporations with a view to improving governance. Training programs were also being planned for directors, auditors and company secretaries. The objective of these programs is to bring practices into line with international norms.

Based on a review of the 1987 Code on Take-overs and Mergers and international standards, a new code has been prepared which requires high standards of commercial behavior. The new code allows minority shareholders a fair and equal opportunity to consider the merits and drawbacks of a merger offer and decide on whether they should retain, or dispose of, their shares. The UK bankruptcy law provided the prototype for the Bankruptcy Act in Malaysia. Steps were introduced to expedite bankruptcy procedures as well as make them more transparent.

The Consumer Protection Bill and the Trade Practices Bill were tabled in parliament in an effort to lessen the rigidities in marketing and distribution. The bills have specific provisions against price-fixing, market sharing and other collusive arrangements, and anti-competitive merger and acquisition activities. These bills address oligopolies in key domestic industries. In addition, privatisation procedures were reviewed to enable wider participation by corporations in the ongoing privatisation program. To promote competitive forces, the government liberalised investment restrictions. Restrictions on foreign investment have been reduced, equity limits on foreign investment have been raised for selected sectors, and foreign investors are now allowed to purchase all types of residential, shopping, commercial and other properties, provided they bring in capital resources.

The Philippines

Limited efforts at corporate sector restructuring have been made in the Philippines. There are indications that several companies have undertaken unproductive investments. Since mid 1997, there has been a steady increase in the number of companies seeking suspension of debt servicing liabilities from the Securities and Exchange Commission (SEC) so that they can start rehabilitation measures. There is a pressing need for improvement in accounting and disclosure standards, which are well short of international standards. Lack of transparency in local companies has been a serious problem. Two conspicuous corporate restructuring exercises currently underway are the restructuring of the National Power Corporation and National Food Authority, which are being privatised with private sector equity holding.

The whole area of corporate governance needs to be studied carefully. The new agenda for corporate reforms is outlined in the Memorandum of Understanding with the IMF, dated 20 January 1999. These reforms are to be implemented with technical and financial assistance from the World Bank. The SEC has drafted a new set of operating regulations for corporate debt resolutions, which were intended to be adopted by the end of 1999.

Thailand

Although quick to start economic and financial restructuring, Thailand did not begin serious corporate restructuring until the second quarter of 1998. Restructuring corporate debt with external and domestic creditors was crucial for economic recovery. The legal framework for bankruptcy protection of debtors and foreclosure rights of creditors were

reformed. A new Bankruptcy Act was passed in April 1998 to provide an opportunity for financially distressed companies to have their businesses reorganised through court-supervised procedures. The cabinet approved an amendment of the act in May 1998 to allow creditors and debtors to create voluntary creditor committees and debt workout units. Two of the three bills dealing with foreclosure proceedings have been approved by parliament.

To improve corporate governance, the SEC embarked on a review of accounting principles and practices in an attempt to bring them in line with international best practices by the end of 1998. The objective was to improve the transparency and disclosure standards of all listed companies. These companies are now required to disclose all liabilities, including external and off-balance sheet liabilities. Several other measures were taken to improve accountability to shareholders in mid 1998.

To improve corporate disclosure and governance, corporations were also implored to follow international best practices by the beginning of 1999. To increase accountability to shareholders, the boards of listed companies were asked to appoint an audit committee to supervise operations. Directors with managerial responsibilities and those representing major shareholders were barred from membership of the audit committee.

Corporate restructuring was also facilitated by market opening policies, which were expected to increase the role of foreign investment in the economy. These policies were aimed at reducing liquidity shortages and increasing the efficiency of firms. To this end, the Alien Business Law was amended in August 1998 to enhance competitiveness, increase transparency, and make Thai practice consistent with international norms. The principle of freedom of business activity by foreigners was established for all activities except the two existing lists. Conditions on foreign participation were liberalised in many activities, including brokerage services, wholesale and retail trade, construction, non-silk textiles, garment, footwear, hotel, and beverage production.

Corporate debt restructuring was the crucial element for restoring sustained growth over the medium term. The government committed itself to facilitating this process through legal, tax, and other institutional reforms. The Corporate Debt Restructuring Advisory Committee (CDRAC), established in early 1998, had a mandate to promote and implement market-based corporate debt restructuring, with a view to supporting the economy and employment. To this end, the CDRAC hired internationally accredited advisors, assessed debtor viability, elected lead banks in cases of multilateral credit, and organised discussions between creditors. It succeeded in negotiating an agreement with the debtors to provide creditors with accurate and complete financial information, including audited accounts, in return for creditors' agreement to a debt 'standstill'. The CDRAC also monitored debt-restructuring agreements and reviewed the regulatory and supervisory framework. By the end of 1998, the CDRAC had drawn up a list of 200 target firms for debt workouts, including the 100 largest cases submitted. A lot of work (approximately 500 more firms) in this regard is, however, yet to be done.

The other measures taken for corporate debt restructuring were allowing debt-equity conversions, and the removal of limits on financial institutions' holdings in companies undergoing debt restructuring. A working group with representatives from the public and private sectors was also formed to identify potential impediments to the efficient sale of distressed debt.

Tasks for the future

Having taken the necessary corporate restructuring measures, the next logical step for these economies is to bring about long-lasting improvements in corporate governance. As elaborated earlier in this paper, concentration of ownership and control and poor protection of the rights of minority shareholders characterised pre-crisis corporate governance in Asia. There were significant market restrictions on changes in corporate controls. Weak company laws and supervision frameworks persisted in the Asian economies. These fundamental systemic weaknesses led to unrelated diversifications, inefficient boards of directors, weak internal controls, unreliable and inaccurate financial reporting, lack of transparency, inadequate disclosures, lax enforcements to ensure compliance, poor audits and an inadequate legal framework for bankruptcy. These problems were manifested by unreported corporate losses and understated liabilities. Regulatory institutions monitoring corporate and financial enterprises failed to spot these soft spots and did not enforce timely corrective actions, a fact which precipitated the crisis.

Therefore, it is imperative that corporate governance be improved, but this is a time consuming and onerous task, which also requires considerable behavioural changes. The crisis-affected nations have identified the specific vulnerable areas of their economies and are taking appropriate measures to remedy the situation. Yet, there are six general areas of corporate governance that need to be addressed in the immediate future. These are

- (i) enterprise monitoring
- (ii) disclosure and accounting practices
- (iii) enforcement of corporate governance practices
- (iv) improvement of the corporate governance framework
- (v) facilitation of equity institutions.

When these policy areas have been addressed and appropriate institutional development measures have been implemented, long-term improvements in the framework of corporate governance in the Asian economies may be possible (World Bank 1998).

The banks that dominate the financial sector in Asia must maintain an arm's-length relationship with enterprises and develop proper institutional practices for enterprise monitoring. The so-called 'relational banking' of the pre-crisis era has to give way to professional banking which complies with international banking norms and best practices. To this end, the banking sector requires a great deal of institutional change and development. The borrowing limits of firms within the same group must be strictly

enforced. Abusive pyramiding behavior must be prevented. Prior to the crisis, borrowing limits were ignored, resulting in questionable quality intermediation. In cases where the lending bank and borrowing firms belong to the same shareholders, increased transparency is necessary, but such transparency is only feasible if stringent disclosure norms are in place.

Policy makers need to understand that improved reliability and integrity of financial reporting and corporate disclosure norms is a precondition corporate governance reform. Disclosure norms and accounting practices are certainly being strengthened in many Asian economies, but the role played by self-regulatory agencies has improved little. Establishing independent self-regulating professional bodies for setting and implementing accounting norms, both for the financial and corporate sectors, is indispensable. Also, those who violate these norms must be disciplined, and, to this end, legal provisions need to be developed, otherwise the application of improved disclosure norms and accounting practices will remain limited. It has been suggested (World Bank 1998) that the market structure of the accounting industry in Asia, which allows for only limited foreign participation, is partly responsible for the underdevelopment of accounting norms. These market barriers should be dismantled immediately.

Enforcement of corporate discipline in Asia has traditionally been weak. Part of the blame for this goes to shallow capital markets and inefficient judicial systems. Both of these need to be changed significantly. As the protection of minority shareholders' rights is such a pressing problem, stock exchange monitoring bodies must be strengthened. Such institutions need to develop appropriate tools to enforce regulations. In addition, several medium-term corporate improvement measures need to be planned for the Asian economies. Corporations, Securities and Exchange Commissions or academic bodies can take initiatives in devising self-regulation of corporate governance in listed companies. Between 1992–97, several industrial economies (Canada, Japan, the Netherlands, the United Kingdom, the United States) took such initiatives. The 1997 proposal by the Stock Exchange of Thailand (SET) is a significant self-regulation plan and involves the adoption of standards regarding the roles, duties, and responsibilities of the directors of listed companies (Stock Exchange of Thailand 1997). New equity financing needs in Asia will remain high in the near future. It is essential, therefore, that minority shareholders are given a direct role in monitoring their investments. To this end, they need to be allowed representation on company boards. It would also be useful to introduce a supermajority voting rule for fundamental corporate decisions, such as large investments or new acquisitions (Shleifer and Vishny 1997).

Other than enforcing corporate discipline, Asian corporations—particularly large conglomerates—need to improve their management of group finance. In the aftermath of the crisis, many corporate finance experts have recommended that corporate headquarters must not be the financial coordinators. The old command model must not be followed in financial affairs. When the headquarters control financial matters, they tend to subsidise unprofitable lines of business and obfuscate the economics of individual companies.

Corporate headquarters should take an approach similar to a venture capital firm. That is, they should limit themselves to providing the risk capital for new ventures and expect the venture to rely on capital markets and banks to fulfil less risky financial needs. The headquarters of the conglomerate should refrain from transferring funds from one venture to another—this practice should be an exception, not a rule. Likewise, day-to-day interference in finance must be completely eschewed (Khanna and Palepu 1999b). The command model may, however, contribute to improved corporate governance, if the corporate headquarters invests in conglomerate-wide recruiting, training, and job rotation programs. World-class business faculty could be invited to the headquarters to provide management education to participants from the entire group. This would raise corporate management standards throughout the conglomerate, reducing its vulnerability to the next crisis.

Conclusion

The corporate concepts of widely held ownership and separation of ownership and control were poorly understood in Asia. As a result, Asian corporations were characterised by non-transparent accounting practices, interlocking ownership between the corporate and financial sectors, and weak rights for minority shareholders. Corporate democracy or one-share-one-vote was not a commonly accepted practice in Asia and was often flouted in a variety of novel and inventive ways. Majority shareholders had power over corporations significantly in excess of their cash flow rights. Expropriation by majority or controlling shareholders, or controlling families, was endemic in Asia.

Close ties between business and government, once considered a major factor in the so-called Asian miracle, fostered and promoted weak corporate governance and poor company laws. An important causal factor behind the Asian financial crisis was lacklustre operational performance arising from poor corporate governance and risky financial structures. Several empirical studies have shown that, before the crisis broke out, profitability and the rate of return on assets were plummeting in Asian corporations. Extensive diversification of Asian corporations had led to misallocation of capital investment towards less profitable and more risky business segments. Many Asian corporations, particularly those in Korea, had diversified into operations that were far away from their areas of core competence. Because of poor corporate governance, Asian corporations did not use capital resources efficiently. If anything, they misallocated productive capital. Asian corporations were also highly leveraged. This, combined with declining profitability, is an unhealthy combination at any time.

Family ownership and the concentration of corporate ownership were significant sources of vulnerability in Asia. Changes in the pattern of investment—from tradables to non-tradables—also increased corporate vulnerability. In the pre-crisis business environment, when a close nexus existed between corporations, banks, and governments, there was little incentive to improve corporate governance and disclosure norms.

There are three principal methods of corporate restructuring—market-based, bank-led, and government-led. The most pragmatic approach, however, is the eclectic one. A great deal of corporate restructuring, including corporate governance improvements, has taken place, but the task is far from complete. As the degree of enthusiasm and commitment differed from country to country, progress in this regard varies significantly—Korea, Malaysia and Thailand have progressed more than Indonesia and the Philippines. Having taken the necessary corporate-restructuring measures, the next logical step for these economies is to bring about long-standing improvements in corporate governance.

Notes

¹ According to Berle and Means (1932), pyramid structures are defined as owning a majority of the stocks of one corporation which, in turn, holds a majority of the stocks of another, a process that can be repeated several times over. By using this mechanism the controlling shareholder exercises control over corporate management through one or more publicly traded companies.

² Such arrangements are rare in the English-speaking world.

³ Ownership information was derived by Claessens, Djankov and Lang (1999), from the Worldscope database, and from the hard copies of Company Handbooks for different Asian economies for 1998–99.

⁴ Return on assets (ROA) captures the efficiency with which a corporation uses all its capital resources.

⁵ Samsung, Hyundai and Daewoo.

⁶ A company's debt divided by shareholder equity indicates a company's leverage.

⁷ These computations are based on data from the Financial Times Information's Extel Database.

⁸ These measures have been compiled from *The Asian Wall Street Journal*, *The Financial Times*, various publications of the central banks of the crisis-stricken economies, and the Article IV reports of the International Monetary Fund (IMF) for these economies.

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