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Good corporate governance is vital

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MUCH has been said, debated and discussed on the endemic financial crisis shrouding east Asia over the past twenty months or so, with particular focus on the structural weaknesses in the affected countries.

Among these is the governance of the corporate sector.

Although there are contending, varied and complex views on the causes of the crisis, many were acquiescent that weak corporate governance was partly to blame for poor investment decisions, lower quality public investment and public services, reduced private investment, risky financing practices and the resultant large-scale non-performing loans in the financial sector, growing number of corporate bankruptcies, and poor audits.

In general, corporate governance in developing countries is still relatively under-researched.

Available assessment of factors contributing to the current crisis have frequently singled out family-dominated corporate ownership structures, inter-locking relationships between financial intermediaries and non-financial corporations, lack of transparency and adequate disclosure rules, and an ineffective regulatory framework as major sources of weakness in the corporate sector.

However, our understanding of why, how and to what extent these have weakened the governance of the corporate sector, which led to the poor investment decisions and risky financing practices is still inadequate.

Corporate governance, narrowly defined, deals with ways of ensuring that suppliers of finance reap maximum returns on their capital.

Just as corporations have their individual goals and objectives, so too have the stake holders of a firm, such as shareholders, creditors and managers.

While profit maximisation is the shareholders' top priority, creditors are more concerned about whether or not they will be repaid, which sometimes means firms taking on less risky projects.

Managers would rather maximise benefits to themselves than outside investors. Even among shareholders there may be serious moral hazard problems because of information asymmetries the impossibility of writing complete contracts, the necessity of giving managers or insiders a lot of discretionary control, and high cost of monitoring.

For instance, incumbent managers may pay themselves exorbitantly, shun their responsibilities, or protect their positions at the expense of shareholders' interests, or large shareholders with a controlling interest in the firm (insiders) to increase their return at the expense of smaller, minority shareholders (outsiders).

Problems of moral hazard among shareholders, creditors and managers is not the only reason for concern over corporate governance in the present context.

The recent financial crisis suggests that the social risk of a financial decision can far exceed the private risk to a corporation that makes the decision. This is especially true when the problem of moral hazard becomes pervasive due to an explicit and implicit government guarantee for key aspects of transactions.

The accumulation of private risks could lead to systemic market risks and eventually to a crisis.

Therefore, corporate governance is important not only for protecting

investors' interests but also for reducing systemic market risks, ensuring the stability of the market environment where corporations conduct business, and preventing financial crisis and the consequent social destruction as experienced by some countries in the region.

However, while some degree of ownership concentration is vital in addressing the moral hazard problem between managers and shareholders, such ownership concentration should be subject to strict rules of disclosure and transparency so as to protect the interests of minority shareholders and creditors.

The issue of corporate governance in mature economies is generally addressed through a combination of corporate laws and regulations (which are primarily embodied in other laws such as company laws, competition laws and securities laws), the enforcement of these laws and regulations, particular ownership arrangements, and markets for corporate control.

Ownership arrangements such as concentration, institutional shareholding, and inter-locking relationships between banks and non-financial corporations could give owners effective monitoring of management, and a significant degree of control potential.

Clearly, in many East Asian countries, as reflected in the recent crisis, these mechanisms either have not been functioning or are non-existent.

While it may be true that the regulatory framework for the corporate sector in many East Asian countries is inadequate, the lack of enforcement of the laws and regulations probably merits greater cause for concern.

The implementation of the right macroeconomic policies, particularly in times of an economic downturn, is not enough.

Good governance at both the State and corporate levels are just as crucial. Therefore, as the crisis unfolded, regulators have paid greater attention to the importance of good corporate and public governance, as well as adequate disclosure and transparency, in addition to an effective surveillance and risk management system.

Corporate governance reform necessarily includes the promotion of accountability of management to shareholders.

Indeed the improvement in transparency and disclosure will play a key role in restoring and promoting investor confidence and facilitating greater access to capital in global markets at lower cost.

Over the long term, it will strengthen the competitiveness of businesses and ultimately enhance their ability to function as a quality economic and social agent and contribute to the overall economic growth and social welfare.

In Malaysia, initiatives toward enhancing corporate governance are no less ambitious.

Taking the lead is Bank Negara Malaysia which exercises both prudence and independence in its role as a central bank.

This enhances its credibility which, in turn, will translate into a more effective transmission of monetary policy, among the many other positive efforts it has undertaken to promote transparency in the financial sector.

Bank Negara has also made it compulsory for banks and finance companies to disclose the position of their non-performing loans every three months.

The Finance Committee on Corporate Governance recently submitted to the Cabinet 70 recommendations on enhancing corporate governance, further attesting to Malaysia's commitment towards this end.

This is also in line with Prime Minister Datuk Seri Dr Mahathir Mohamad's recent call for the formulation of a new set of rules to address the situation as there is the tendency for many existing laws and rules to aggravate rather than mitigate the situation faced by corporations.

As much as the culture of good governance is vital for corporations and

the economy, the formulation of a code on corporate governance should necessarily be tailored in accordance with, among others, the country's customs, religions and cultural beliefs.

Corporate governance, disclosure and transparency are, after all, the hallmark of good business and economic conditions.

Such are the important lessons that the current crisis has taught us all. If we fail to heed, the crisis will only repeat itself.