

2004

Corporate Governance in Asia Today and Tomorrow

Arthur M. Mitchell

Clare Wee

Recommended Citation

Arthur M. Mitchell & Clare Wee, *Corporate Governance in Asia Today and Tomorrow*, 38 INT'L L. 1 (2004)
<https://scholar.smu.edu/til/vol38/iss1/2>

This Article is brought to you for free and open access by the Law Journals at SMU Scholar. It has been accepted for inclusion in International Lawyer by an authorized administrator of SMU Scholar. For more information, please visit <http://digitalrepository.smu.edu>.

Corporate Governance in Asia Today and Tomorrow

ARTHUR M. MITCHELL AND CLARE WEE*

I. Introduction

Why is a regional development institution such as the Asian Development Bank (ADB), whose over-arching goal is poverty reduction,¹ concerned with corporate governance? Simply stated, good corporate governance is of vital importance to wealth enhancement and economic development in ADB developing member countries (DMCs) without which there can be no sustainable reduction in poverty.² While good corporate governance remains critical, it is important to ensure that corporate governance reform does not become a distraction from other key development issues. Instead, there must be an integrated approach to corporate and public governance reform that ensures balanced development.³ Corporate governance is but a subset of the rule of law, and ultimately, poor corporate governance cannot be divorced from the broader challenges of law, development, and order.

What do we mean by “good corporate governance”? Corporate governance is viewed in terms of (1) accountability, transparency, and disclosure; (2) management incentives; and (3) discipline.⁴ When these factors are balanced, there is a greater chance that wealth reaches a broader segment of civil society, and the greater good will be achieved.⁵ Undoubtedly, it is difficult to balance all of these factors because politics, economics, management, accounting, ethics, and the law all influence good corporate governance.

*Arthur M. Mitchell is the General Counsel of the Asian Development Bank. Clare Wee is Senior Counsel and Deputy Head, Private Sector Legal Group, at the Office of the General Counsel, at the Asian Development Bank. The opinions expressed herein do not necessarily represent the views of the Management of the ADB. An earlier version of this paper was previously presented on September 29, 2003.

1. Asian Development Bank, *Law and Policy Reform*, available at <http://www.adb.org/Law/default.asp> (last visited Nov. 14, 2003).

2. *Id.*

3. See generally Graham Pyatt, *Balanced Development: An Approach to Development Policy and Priorities* 26 (2003) (presented at the Asia and Pacific Forum on Poverty: Reforming Policies and Institutions for Poverty Reduction, held at the Asian Development Bank, Manila, Feb. 5–9, 2003). The causes of poverty and the solutions are found at every level from the individual to the global. The design of strategy needs to address each and every level in turn.

4. Press Release, *The 3rd Asian Roundtable on Corporate Governance*, Apr. 4, 2001, available at <http://www.adb.org/Documents/Speeches/2001/ms2001044.asp>.

5. *Id.*

Corporate governance is at a crossroads at which many developing and emerging economies realize that good corporate governance is important to sustainable economic development, but fail to institute reform because they are searching for a new model to apply to their particular domestic environment. In searching for the right model, one question raised is whether the response of the Americans to the Enron crisis provides a model for corporate governance elsewhere. This paper will look broadly at some of the recent experiences in the United States and other developed economies to ascertain which lessons might be useful in Asia and which ones should be discarded.

II. Asia in Context

A. ECONOMIC, POLITICAL, CULTURAL AND LEGAL DIVERSITY

Much of the recent debate on corporate governance is focused on high-income, developed nations. This debate is usually limited to the relationships between corporate managers, directors, and shareholders, and whether the "bank-centric" system (typically associated with Japan and Germany) or the "market-centric" system (typically associated with the United States and the United Kingdom) offers a better approach. This debate may not always be relevant to DMCs for a variety of reasons.

Particularly in DMCs, corporate governance must be considered in the context of prevailing economic, political, social, cultural, and public governance conditions. Basic preconditions must exist for the proper functioning of corporate governance codes and rules. After all, it is not possible to establish an island of good corporate governance in a sea of poor or underdeveloped public governance.

Corporate governance must also be considered in the context of a country's level of development and immediate needs. Asia is one of the most dynamic regions in the world, yet two-thirds of the world's poor live in Asia.⁶ It is staggering to note that at least one in three Asians do not have access to clean drinking water, and at least one in two Asians have no access to sanitation.⁷ For example, in Afghanistan it may be more important to focus on reconstruction, humanitarian aid, and rebuilding the institutions necessary for consistent law and order than it is to focus on corporate governance.⁸ Without going into detail, other examples include Papua New Guinea, Mongolia, Myanmar, Bhutan, Nepal, Fiji Islands, and the Central Asian Republics, which all have fledgling capital markets.⁹

Furthermore, corporate governance reform must be considered in the context of local business practices and traditions. Socially and culturally, Asia's heritage is based predominantly on Eastern religions and philosophies that stress the importance of loyalty to the family.¹⁰ This heritage has subsequently influenced the structure of businesses in Asia. Contemporary Asian legal systems have roots in western civil and common law legal traditions

6. Press Release, *Asia Critical to Reducing World Poverty*, Mar. 18, 2002, available at <http://www.adb.org/Documents/News/2003>.

7. CNN, *Bank Report Paints Bleak Picture of Asia's Environment*, June 20, 2001, available at <http://edition.cnn.com/2001/WORLD/asiapcf/southeast/06/18/asia.pollution/>.

8. Asian Development Bank, *Preliminary Needs Assessment Report*, available at <http://www.adb.org/Documents/Reports/Afghanistan/default.asp> (last visited Nov. 14, 2003).

9. *Id.*

10. Katharina Pistor & Phillip A. Wellons, *The Role of Law and Legal Institutions in Asian Economic Development: 1960–1995*, available at <http://www.adb.org> (last visited Nov. 14, 2003).

as well as socialist law. For example, in the Central Asian republics of Vietnam and the People's Republic of China (PRC) aspects of stakeholder relations are still based upon elements of socialist law.¹¹ Thailand, Indonesia, and the Philippines share a civil law tradition, while Singapore and Hong Kong have legal systems based on common law.¹² In practice, personal and family relationships tend to take precedence over abstract rules.

As a subject, corporate governance tends to focus on listed companies. Generally speaking and with a few notable exceptions, Asian capital markets are still small and fledgling because only a relatively small number of companies are listed. Although small in number, these listed companies are important to the development of the private, banking, and financial sectors of these economies. Presently, Asian capital markets can be characterized as having low liquidity with poor transparency and disclosure.¹³ Regulation tends to be weak, market infrastructure under-developed, and public markets non-existent.¹⁴ For example, in 2001, the domestic bond market in Indonesia was only two billion United States dollars in total outstanding, local currency denominated bonds.¹⁵

While recognizing the wide diversities that separate Asia, it is nevertheless possible to identify some common key civil and corporate governance challenges facing groups or clusters of Asian countries. For East¹⁶ and Southeast Asia,¹⁷ the key challenge is to address the lack of transparency and accountability in regulating the financial and banking sectors.¹⁸ Throughout East Asia, Southeast Asia, and South Asia, the central issue is how to encourage the development of sustainable institutions given the major economic, political, and societal role of family-controlled big business groups.¹⁹ For economies in transition in Central²⁰ and Southeast Asia, the challenge is to redefine the role of the state in developing a market economy. In the small economies of the Pacific,²¹ addressing public sector efficiency, effectiveness, and accountability is particularly important.²²

B. CHARACTERISTICS OF CORPORATE GOVERNANCE AND FINANCING IN ASIA

Generally, Asian business is dominated by state-owned enterprises and family-owned business groups of related companies, some of which are listed and others of which remain privately held. Ownership is extremely concentrated: even listed companies, for example,

11. *Id.*

12. *Id.*

13. CORPORATE GOVERNANCE AND FINANCE IN EAST ASIA: A STUDY OF INDONESIA, REPUBLIC OF KOREA, MALAYSIA, PHILIPPINES, AND THAILAND: VOLUME ONE (A CONSOLIDATED REPORT) (Virginita Capulong et al. eds., 2000).

14. *Id.*

15. Carcunia Malya Firdnasy, *Study on Local Government Finance and Bond Market Financing in Indonesia*, available at <http://www.adb.org> (last visited Nov. 14, 2003).

16. East Asia includes the newly industrialized economies (NIEs) of Hong Kong, China; Republic of Korea; Singapore; Taipei, China; the People's Republic of China; and Mongolia.

17. Southeast Asia includes Cambodia, Indonesia, Lao People's Democratic Republic, Malaysia, Myanmar, Philippines, Thailand, and Vietnam.

18. Asian Development Bank, *Governance in Asia: From Crisis to Opportunity*, in ASIAN DEVELOPMENT BANK ANNUAL REPORT 1998 (1999) [hereinafter *Crisis*].

19. *Id.*

20. The Central Asian republics include Kazakhstan, Kyrgyz Republic, Tajikistan, and Uzbekistan.

21. The Pacific includes Cook Islands, Fiji, Kiribati, Marshall Islands, Federated States of Micronesia, Nauru, Papua New Guinea, Samoa, Solomon Islands, Tonga, Tuvalu, and Vanuatu.

22. *Crisis*, *supra* note 18.

rarely separate ownership and control. These companies and business groups rely heavily on external finance provided mainly through bank loans, resulting in an environment in which financial markets are less liquid. The predominant conflict in these markets is between controlling block-holders and minority shareholders. Truly independent board directors are rare, and the rights of minority shareholders tend to be weak. These business groups and their controlling individuals and families heavily influence the politics and leaders of the state. This heavy political influence by business families is referred to as "relationship capitalism."²³ The reality is that while individual groups may be broken up, it is highly likely that family-owned business groups will be dominant in Asia for the foreseeable future.²⁴

C. CORPORATE GOVERNANCE CHALLENGES IN ASIA

As discussed earlier, throughout East Asia, Southeast Asia, and South Asia, the economic power of family business groups and their controlling individuals and families deeply influences government.²⁵ The central issue is how to manage and reduce the monopolizing influence of such family business groups to enable broader civil society participation and more fair, transparent, and accountable governance.

Although reformers are attempting to reduce the power of family-owned business groups, resistance remains strong.²⁶ Despite half a decade of attempts, policymakers have been unable to effectively implement policies that address the issues related to the power of family-owned business groups.²⁷ Perhaps it is unrealistic to attempt to overhaul what amounts to the social and business fabric of a society without addressing how to economically encourage effective change. The fact remains, however, that anyone will adopt change if it is in their best interests. Accordingly, it will be useful to briefly examine the experience of both the United States and Japan, two of the most successful developed countries, to see what these contrasting models can offer.

III. Governance Models from the United States and Japan

During the bull market of the 1990s when capital markets were delivering outstanding investment returns, it was argued that the American model of corporate governance, also known as the market-centric or equity-based model, would become the global standard.²⁸ The Enron and WorldCom scandals deflated the theory that good corporate governance is a practiced standard in all of the more developed economies.²⁹

Since Enron, the United States has enacted new legislation, most notably through the

23. Press Release, *Concentrated Ownership a Cause of Weak Governance in Asia, Says ADB Report*, Nov. 18, 1999, available at <http://www.adb.org> [hereinafter *ADB Report*].

24. See Abe De Ramos, *End of the Affair*, Mar. 2003, available at <http://www.cfoasia.com/archives/200303-03.htm>.

25. See *ADB Report*, *supra* note 23.

26. Paul Chan, *Fostering Good Corporate Governance in Asia*, BUSINESS TIMES, July 1, 2002, available at <http://www.asiaone.com>.

27. *Id.*

28. George J. Berston, *The Quality of Corporate Financial Statements and Their Auditors before and after Enron*, 497 POLICY ANALYSIS, Nov. 6, 2003.

29. *Id.*

Sarbanes-Oxley Act, aimed at improving the climate of good corporate governance.³⁰ In looking back at the recent crisis in U.S. capital markets, however, many Americans are still asking (1) did the United States need more regulation, (2) did the United States simply need better enforcement of existing laws, or (3) is there something fundamentally wrong with American business culture and ethics?³¹ Standing in stark contrast to the American model is the system practiced in Japan since 1947, which generated high growth in Japan and post-World War II Germany.³² In post-war Japan, the strength of Japanese industry was founded on a close relationship between the political world, financial and industrial interests, and the government itself. This close relationship frequently manifested itself through intricate cross share ownership between the banks and industry, and close policy coordination with the government. The weakness in this system, together with the bank-centric financial model, became obvious when it failed to produce the results that were occurring in the United States during the 1990s.³³

IV. Is There a Model Way Forward?

If one looks at the global landscape of corporate governance today, it is evident that there is no single agreed upon system of good corporate governance. Perhaps it is understandable that some observers in Asia argue that recent corporate crises in the United States have discredited the market-centric model of corporate governance. The more skeptical might even argue that the developed countries have no standing to tell developing countries to apply a western model of corporate governance when the very application of that model in those countries has been uneven at best. The truly cynical might argue that the model itself is deeply flawed, exemplified by recent business debacles in the United States that provided hard lessons. Furthermore, solutions to these troubles are difficult to transpose into different business environments. Therefore, it is arguable that there is nothing to be learned from recent events, nor from the approach taken by developed economies to deal with these events.

On the other hand, some might see progress arising from these hard lessons, leading to a set of principles and objectives that ultimately will be the foundation of a new economic and business order. While the solutions to recent crises may not be ideal, those arguing in favor of the western models see them as eventually contributing to the greater common good.

A. WHAT NOT TO LEARN FROM THE MARKET-CENTRIC SYSTEM

As the United States is still the world's premier market-centric financial system, the practices and procedures developed there have enormous implications for other capital markets. There is no doubt that practices in the United States are and continue to be the predominant influence on Asian capital markets.³⁴ In the case of recent financial debacles, the United States' response has been characterized by a wide variety of incremental regu-

30. Sarbanes-Oxley Act, 12 C.F.R. 513.8 (2003).

31. Kevin Gribbon & Glenn Conway, *Sarbanes-Oxley: Legislating Morality or Mandating Change? Consequences of 2002 Law Are Considerable*, available at <http://www.localtechwire.com> (last visited Nov. 14, 2003).

32. *Japanese Economic Takeoff*, available at http://www.iun.edu/~hisdc1/h207_2002/jecontakeoff.htm (last visited Jan. 21, 2004).

33. *Id.*

34. OECD, WHITE PAPER ON CORPORATE GOVERNANCE IN ASIA (2003). This work was partially financed by the Asian Development Bank.

latory and accounting rules and practices.³⁵ The applicability of this approach to Asian emerging economies is questionable.

The Organization of Economic Cooperation and Development's (OECD) White Paper on Corporate Governance in Asia documents that many Asian economies have in place adequate corporate governance standards, and others have made huge strides in enacting legislation that incorporates good governance principles.³⁶ Articulating such internationally recognized standards is an important step when accompanied with the passage of new laws. It is equally important, however, to recognize that these reforms will not be fully implemented in Asia until the relevant parties come to believe that adherence will enhance wealth creation and lead to more rapid economic development. In the near term, it is critically important to focus on resolving the rule of law deficit that exists in so many DMCs.³⁷ Resolving the rule of law deficit will enable the creation of institutions that will foster capital formation and a more broad-based, socially inclusive allocation of that capital.³⁸

The risk of focusing on regulatory and accounting reform in the United States and elsewhere is that decision-makers in emerging Asia become bogged down in the minutia of standards and practices of corporations without focusing on the broader issues of what reforms are most effective in promoting broad-based wealth creation. While the traditional approach may be to view corporate governance as a means of maximizing the wealth of corporate stakeholders, it is not suitable for Asia to adopt such a narrow focus. Corporate governance must be integrated and viewed in the context of public governance. Regulatory and accounting reforms are important components of the process to ensure that good corporate governance remains a defining characteristic of the system, but they are not the only tools that are needed to ensure wealth creation and economic development.

At this time in Asia, it is critically important for countries to focus on the implementation gap. Good laws on the books do not immediately translate into good governance. As will be discussed in more detail later in this paper, good governance can be achieved by creating incentives for compliance, markets that broaden the opportunities of wealth creation, and transparent and accountable public governance.

Legal culture has a huge impact on what is ultimately appropriate for a country. The rules in the United States are very detailed in part to provide clarity to a highly litigious society and system. A highly codified system may be overkill and inappropriate for a society that is less litigious. This does not mean that rules and principles of corporate governance are irrelevant. It is also important, however, that clarity and detail do not come at too high a price. That is to say, it is important to ensure that such reforms do not function to dampen entrepreneurship particularly in the emerging economies.

The convergence of legal and accounting standards is perhaps an inevitable part of the globalization of financial markets. The most important lessons for Asia, however, lie not in the minutia of new legislation or accounting standards, but in ensuring that proper accountability exists so that risk is well understood by all actual or potential market participants. Proper accountability is also an issue of consistent application of the rules, which requires good and transparent public governance and oversight.³⁹

35. *Id.*

36. *Id.*

37. *Id.*

38. *Id.*

39. Aryan Ashman, *THE POLITICAL ECONOMY OF GOOD GOVERNANCE FOR POVERTY ALLEVIATION POLICIES* 10-12 (prepared for the Asian Development Bank, OECD, Working Paper Series No. 39, 2003).

The Sarbanes-Oxley legislation was an example of necessary emergency rulemaking in a particular context. Retrospectively, the Sarbanes-Oxley reforms may be viewed as problematic because of the negative effect they are likely to have on capital formation, new Initial Public Offerings (IPOs), and risk-taking. Worse, the reforms may create an adversarial relationship between management and the board on matters requiring nuanced business judgment. These are lessons that should be studied, but not emulated in Asia.

Another set of proposals currently being debated relates to the role of shareholders in managing businesses. The most extreme of these proposals would have shareholders actually running businesses. This would be neither efficient nor effective and thus is a lesson best not learned by the emerging economies of Asia. Management is responsible for running businesses in the interest of shareholders with directors exercising business judgment in the best interest of all shareholders.

Recent coverage in the financial press has also focused on the hidden cost of executive compensation or more particularly the active use of options in executive compensation. This is identified as yet another example of how proper governance procedure, in this case the importance of transparency, has been undermined. Various accounting reforms have been proposed, including a requirement that all executive pay options be identified as explicit expenses on a corporation's financial statements.

Rather than getting entangled in the debate over whether options truly function to provide a performance incentive to management or how best to treat the accounting for option packages (for example, whether to expense them and how), Asia should focus on the larger issues of implementation, enforcement, and accountability. Since the Asian financial crisis, Asia has seen much reform in corporate governance but little accountability. The debate today should not focus, for example, on whether to adopt the latest approach on options treatment. However options are treated, the bottom line remains that all costs, whether explicit or contingent, should be clearly reported to enable effective evaluation of the financial condition of the corporate entity to which they pertain. This is not to say that such details should be ignored. It is simply to reiterate the importance of context and timing. First and foremost, in Asia the debate should center on enforcement, and the fair and transparent application of rules.

B. WHAT NOT TO LEARN FROM THE BANK-CENTRIC SYSTEM

It has been said that "today the lessons to be learned from Japan are negative; how not to handle corporate governance, how not to simply hope for economic recovery, how not to postpone difficult decisions about macroeconomic policy and especially banking sector reform."⁴⁰ The key problem presented by bank-centric finance systems is that they tend to concentrate too much risk in a relatively few banks, thus making the system highly vulnerable to financial shocks.⁴¹ This "risk concentration" is a problem that is endemic to most Asian banking systems. In fact, banks are not well suited to finance long-term investments on a large scale due to the problems inherent in maturity mismatches. This is evidenced

40. Hugh Patrick, *Corporate Governance, Ownership Structure and Financial Crisis: Experience of East Asian Countries* 36 (2001) (prepared for the KDIC International Financial Symposium on December 11, 2001).

41. See Kevin L. Mellyn & Matthew I. Saal, *A Perspective on the Risk and Regulatory Implications of Market-Centric Financial Systems*, in THE INSTITUTE OF INTERNATIONAL FINANCE, "1998 Essay Competition in honor of Jacques de Larosiere. Winning Essay," Washington (1998).

by the default of nearly half of all Thai borrowers on loans following the devaluation of the Baht during the Asian financial crisis.⁴² The lesson to be learned is twofold: first, banking regulation and supervision must be strengthened throughout Asia; and second, Asia must develop larger and more liquid capital markets to reduce the traditional reliance on bank and syndicated loans as a primary source of corporate finance.

In this connection, priority should be given to strengthening or developing the legal frameworks and ensuring their application and enforcement for the creation of local currency-denominated corporate debt markets,⁴³ securitization,⁴⁴ credit diversification, derivatives, collateral-based lending, the effective and speedy enforcement of property rights, and strengthening the non-bank financial sectors of the economy.

When the speculative balloon burst in Japan, the close relationship between banks and industry made it difficult for bank management to effectively address the bad debt problem and to sell the equity investment holdings they held in related firms. This contributed to the dramatic deterioration in capital at many of these banks and the subsequent failure or merger of these institutions with other, sometimes equally weak, institutions.

Over the last decade, the Japanese government has failed to deal decisively with its non-performing loan (NPL) problem. In retrospect, Japan created its own crisis both in terms of the enormous fiscal deficit it used to bail out these firms and in terms of the credibility of government policy. Japan's willingness to allow the perpetuation of intimate corporate cross-shareholdings and the rather ineffective measures it pursued in addressing the resultant crisis are definitely not examples to be followed. In particular, the policy that no bank should fail must be discarded.

It is imperative that Asian countries seriously address the handling of their NPLs. Regrettably, the NPLs in the People's Republic of China (PRC), Hong Kong, Thailand, Malaysia, and Indonesia also continue to be a source of concern. In the PRC there is an estimated five hundred billion American dollars in non-performing loans, representing 22 percent of the PRC's total loan portfolio as of the end of June 2003. The lesson to be learned is that such forbearance by governments is incompatible and destructive to an efficient and well functioning financial system. To ensure bank safety and performance, a combination of good corporate governance, effective prudential supervision by governmental regulatory authorities, relatively high risk-adjusted capital adequacy ratios, and the maintenance of market competition is needed.⁴⁵

It should be noted that over the last five years, Japan has earnestly reformed its legal and regulatory system by introducing amendments and new legislation that permit holding companies (1997), stock-for-stock exchanges (1999), a Chapter 11-type Civil Rehabilitation Law (2000), a corporate spin-off law (2001), a broader range of corporate stock options

42. Asian Development Bank, *Regional Highlights, Developing Asia* 103 (1998), available at http://www.adb.org/Documents/Reports/Annual_Report/1998/hilights.pdf.

43. The ADB has undertaken several regional initiatives to support the development of Asian bond markets, including a study leading to its most recent publication. ASIAN DEVELOPMENT BANK, BACKGROUND STUDY FOR APEC FINANCE MINISTERS' PROCESS, HARMONIZATION OF BOND MARKET RULES AND REGULATIONS (2003).

44. Asian Development Bank, *Country Economic Review, People's Republic of China* 16 (2002). It is encouraging that securitization of non-performing loans has begun in the PRC with the completion of two landmark deals by Huarong Asset Management Corporation in 2003 for almost \$1.5 billion dollars.

45. Many of the positive developments in Asia in the corporate governance practices of companies have taken place as a result of those companies' changing relationships with their banks, resulting from changes in the governance of those banks.

(2002), and a new emphasis on protection of intellectual property. The Japanese economy and the state of its banks and corporations, however, remains no better than it was five years ago. It is not enough to simply put in place changes in corporate or securities laws. Good corporate governance will ultimately depend upon good public governance, the successful reform of government agencies and the legal system, as well as the development of a culture of governance. Again, the lesson to be learned is that rules and regulations alone will not suffice. Implementation and commitment to enforcement are paramount.

V. A Prescription for Success

Our analysis of the current situation in Asia should not be used as justification for prior policy failures or as an excuse for inaction. On the contrary, we think that it is the basis for realistic reforms that will lead to wealth creation and economic development. What Asia needs or wants to accomplish with its corporate governance codes must be taken in the context of the reality on the ground; that is, the existing conditions for the application and enforcement of those codes. Governments play key roles in shaping the legal, institutional, and regulatory framework within which corporate governance systems are developed. Good public governance and legal frameworks must be an integral part of any government's policy for shaping the institutional framework within which corporate governance is just a part. If the fundamental conditions are not in order, the corporate governance regime is unlikely to be either.

This is particularly true for Asia's transitional economies. Successfully dealing with the problems of opening markets, legal reforms, socialist-style central planning agencies, lack of independent regulators, poor understanding of competition and regulatory reform concepts, and weak institutional capacity for analysis of market structure and business performance will be the challenge not merely for a strong corporate governance culture, but also for the overall development of these economies-in-transition. Here, capacity and institution building are of critical importance.

A. GOVERNANCE, RULE OF LAW, AND CORRUPTION

First and foremost, governments in Asia must continue to strengthen the four key components of governance—accountability, transparency, predictability and participation.⁴⁶ Without these, corporate governance is likely to remain poor. Yet despite broad acceptance and acknowledgment of the importance of these factors, a culture that supports good corporate governance remains underdeveloped in a number of countries. What lies at the root of poor corporate governance, particularly in a region as diverse as Asia?

There clearly are no simple answers. While some may argue that the dominance of family groups in Asian corporations result in flexible organizations capable of making strategic decisions rapidly and efficiently, the risk of high ownership concentration creates severe informational asymmetries that manifest themselves in illiquid and opaque financial markets. This can create environments where the rule of relationships takes on as much importance as the rule of law. Another way to describe these destructive forces to development is to use the two "c's"—"corruption" and "cronyism." This risk is exacerbated by govern-

46. ASIAN DEVELOPMENT BANK, *GOVERNANCE: SOUND DEVELOPMENT MANAGEMENT* (1995).

ment interventions that tend to favor one sector of society over another, such as subsidized lending and loan guarantees for family-owned companies.⁴⁷

Where the rule of law works well, law and relationships are complementary mechanisms for making and enforcing business transactions. Although good laws are important, their *effective implementation* is even more important. For example, both India and the Philippines have legal systems that are well established and based on principles that, in theory, meet international standards in some respects.⁴⁸ In practice, however, corruption, excessive bureaucracy, and political interference taint the systems. Another example is Indonesia where court systems are marred by corruption.⁴⁹ Legal reform, including of the courts, must be of high priority.⁵⁰

In other words, in many of Asia's developing countries systemic problems with legal frameworks continue to undermine the efficiency and ultimately the legitimacy of legal, judicial, and law enforcement institutions. Additionally, these problems undermine the ability of governments to implement their development policies, particularly those that look to the private sector as engines of economic growth. Indonesia and the Philippines are notable examples, but there are many others. In these jurisdictions, efforts should be directed at restoring the faith of the public in the legal system. Laws need to be enforced fairly, predictably, and uniformly. Among the systemic problems found in many of ADB's DMC's are delays in court hearings, poor physical infrastructure, low status of judges, poor terms and conditions of employment, weak judicial accountability mechanisms that in some countries permit widespread buying of favorable verdicts particularly in rural areas, lack of trained support staff and case management systems, and the poor state of legal education and training. Chronic problems with the judiciary, however, are not the only priorities for reform. Weaknesses in all institutions of legal administration and enforcement, including the securities regulators, the banking regulators, and prosecutors charged with the civil enforcement of financial laws and white collar crimes, should be among the top priorities of reform for Asian governments.

In many Asian economies, the corporate tax base does not form an important part of public revenue. Poor corporate tax generation arising from efforts to hide corporate revenues contributes to private wealth maximization at the cost of public wealth enhancement.

47. The ADB has provided assistance to the governments of certain Pacific economies, such as the Philippines and Thailand, to facilitate the adoption and implementation of anti-money laundering measures based on internationally accepted standards, and to avoid sanctions under the United States Patriot Act of 2001, which sanctions governments that fail to maintain effective multi-pronged anti-money laundering programs. The developments of anti-money laundering programs are equally essential to prevent graft and corruption.

48. Patrick, *supra* note 40, at 5.

49. *Id.*

50. ASIAN DEVELOPMENT BANK, PART 1: AN OVERVIEW OF ADB'S LAW AND POLICY REFORM ACTIVITIES IN 2001-2002, available at http://www.adb.org/Documents/Reports/Movables_Registries/part01.pdf (last visited Nov. 14, 2003). The ADB has provided and continues to provide considerable loan and technical assistance aimed at law reform. Examples include the following: two policy loans to Pakistan amounting to three hundred, thirty-three million dollars to support the government's Access to Justice Program; a twenty million dollar technical assistance loan to Pakistan to translate the program's legal and policy framework into institutional and organizational arrangements; a regional judicial independence project to improve awareness of the importance of judicial independence and the means to achieve it in selected DMCs; and a technical assistance loan to the Philippines to strengthen the independence and define the accountability of the judiciary. In promoting law and policy reform in the financial sector, the ADB continues to contribute to the regional debate on issues of insolvency and secured transactions law reforms in Asia and the Pacific.

Without sufficient public revenue, government faces the recurring problem of internal corruption and questionable legitimacy. This continues to be a major problem in various Asian nations. It is perhaps the key stumbling block to recovery of Indonesia and the Philippines from the Asian financial crisis.

Where an impartial, uniform, and transparent application of the law cannot be assured, foreign investment faces serious risk. Indeed, it is the failure of many state agencies to establish their legitimacy in terms of acting in a fair, impartial, and uniform fashion that perpetuates the rule of relationships. The legitimacy of these institutions is tested further when the state fails to use public revenue in a clear and transparent fashion, as in providing decent and lasting infrastructure, a social safety net (that is, unemployment insurance and pension assistance), or an effective and apolitical law enforcement service. In this environment, self-interest becomes manifest because the state is perceived as failing to act on behalf of the population and business interests at large.

B. RESTRAINING RELATIONSHIP CAPITALISM

While personal relationships are essential for doing business in any economy, it should not rise to the level of patronage, cronyism, or corruption if there are institutional and legal frameworks to ensure against their abuse. Some might argue that because of the influence of business elites on politics, trying to improve governance before improving politics is useless. In reality, neither can be done independently of the other. Where rules and public sector legitimacy are tenuous, reciprocal favoritism flourishes. It is this favoritism that is anathema to broad wealth creation and economic development.

It is increasingly important to understand the complex interface between private and public sector governance, and within it, the institution of influence and capture by elite interests.

It is highly doubtful and wishful thinking to anticipate that family-owned and family-controlled corporations are going to vanish from the Asian business landscape even in the medium-term. The cultural and social norms and values underpinning the importance of family in Asia are too deeply rooted to be quickly overturned. In other words, it is more realistic for Asian economies with strong family-owned and family-controlled corporations to regulate and control "relationship financing and banking" through sound macroeconomic management, the development of a strong banking sector, a deep equity and bond market, and fairly transparent rules and laws that are firmly implemented.

While there remains room for improvement, it should be noted that the regulators in Singapore and Hong Kong do impose discipline and relative transparency on the market. In Singapore, monitoring by the Monetary Authority of Singapore is strict and companies are subject to relatively transparent accounting and auditing procedures as well as a competitive and open market. Both have business communities characterized by the presence of large numbers of high quality banking and financial professionals, both within and outside family-owned and controlled businesses that can properly monitor financial and other institutions. There are similar changes underway in Korea, which will be interesting to watch in the near and medium-term.

Stated differently, the lesson to be learned is that given the strength of relationship banking in Asia, it is critically important that banking regulations and supervision are strengthened throughout Asia. Banks and other financial institutions must be subject to the same good governance norms, rules, and practices applicable to corporations. There should also be rules to ensure that banks do not engage in excessive risk-taking, excessive concentration

of loans to connected companies, or loans allocated on the basis of collusion, corruption or nepotism.

It must be remembered that the main goal is a banking regulatory framework that protects identified public interests while minimizing private transaction costs. A good banking regulatory framework does this by fostering accountability, transparency, and predictability in the formulation and application of the rules and regulations. This is especially necessary for transitional economies where the issues of corporate governance of public enterprises must reflect the general principles of good governance of market-centric and other non-government mechanisms.

Lastly, measures should be taken to increase competition to reduce the monopoly power of large business groups in Asia. This can be achieved by eliminating barriers to entry for new firms that have been put in place by earlier industrial policies.⁵¹

VI. Conclusions

Rather than trying to replicate the steps that helped create the most developed financial systems over a very long period of time, Asian countries should pursue these separate but inter-related initiatives:

- (i) Governments must strengthen legal frameworks and institutions and enforce existing laws equitably and transparently. That is, governments must resolve the implementation gap and create accountable public governance systems, which are the fundamental preconditions for the functioning of a corporate governance regime.
- (ii) As it is almost impossible to create deep equity markets in the near future, the bank-centric systems must be reformed to clean up the bad debts and non-performing loans and to implement state-of-the art risk management techniques.
- (iii) To mitigate systemic-risk, regulators, multi-laterals (like ADB), and investors should support diversification of risk through, among other things, the creation of robust local currency denominated corporate bond markets to provide an alternative to bank financing; and
- (iv) Transparency must be emphasized to support reform of the banks and to allow the development of corporate bond markets.

Corporate governance reform in Asia must recognize the deep-rooted structures of family-owned businesses and work to restrain rather than eliminate them. The existence of family-controlled corporations in Asia is a testament to entrepreneurship in the region, and they will remain big fish in small ponds unless they permit reform. The trade-off is the emergence of a system that permits numerous geographically dispersed investors to have confidence that insiders will not abuse them. This is of critical importance to foreign investors and necessary to enhance the development of domestic sources of capital as well.

Models developed by the OECD, America, and Japan in particular can offer developing countries valuable insights, but these models of governance can only serve us if we understand their strengths and weaknesses in context. As it always has, Asia should adopt that which is useful and not spend too much time on lessons that should not be learned. Let us

51. ASIAN DEVELOPMENT BANK, *CORPORATE GOVERNANCE AND FINANCE IN EAST ASIA, A STUDY OF INDONESIA, REPUBLIC OF KOREA, MALAYSIA, PHILIPPINES, AND THAILAND*, VOLUME 2 76 (Juzhong Zhuang et al. eds. 1999).

not get mesmerized by the buzzwords and the details of audits and accounting. Let us instead focus on the big picture and remember that corporate governance reforms must be integrated with public governance reforms. Let us restore our business order and systems of governance based upon the principles of open competitive business within a framework of fair, transparent, and accountable systems of public governance. Asia's financial systems can be supported by strong, transparent, accountable frameworks of corporate and public governance implemented with a level of discipline. We believe that these are the most important basic building blocks for future prosperity in Asia.

