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Corporate Governance of Family Businesses in Asia

What's Right and What's Wrong?

Haider A. Khan *

I. Introduction

The Asian financial crisis, which can be characterized as a capital account crisis with the twin features of a financial crisis, i.e., currency crisis (international) and banking crisis (domestic) (see Yoshitomi and Ohno, 1999), has highlighted the weaknesses of the domestic banking system and hence underlying corporate governance. In Asia, banks are the dominant source of external finance so that they are naturally expected to have effectively monitored firms as borrowers during the “Asian Miracle” period. However, in retrospect, banks appear to have failed to do so. There are several reasons for the weakness of the banking system in Asia. As a recent World Bank (1998) document puts it:

The East Asian crisis has underlined the importance of the rules, norms, and organizations that govern corporate behavior and define accountability to investors. East Asian corporate finance markets typically are dominated by banks. Because securities markets require a more sophisticated institutional and regulatory framework, bank dominance of corporate finance is probably the best way for developing countries to grow, *provided they are not subject to undue state influence, are exposed to competition, and are prudently regulated.* [italics added] (World Bank, 1998, p. 56)

However, a more crucial question is what exactly determines whether banks are in a position to monitor borrowers in Asia. In the first place, this depends very much on the “location” of banks in the overall industrial and financial organizational structure in an economy. If banks are under the strong influence of large family businesses, they may not be in a good position to monitor such influential large family business conglomerates. Likewise, if banks face heavy and arbitrary government intervention, they will also lose incentives to monitor. In addition to independence from such undue economic and political pressures, the banks must have the internal

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capability to properly evaluate credit and other types of risks of borrowers and their projects. In order for the banks to evaluate risks effectively, it is essential to gather and analyze the relevant information about the firms they finance. The information thus collected, through individual credit agreements and other sources, must include technical data about technology, production, costs, cash flow, debt, balance sheet and other financial variables. Based on the information gathered and processed with respect to borrowers, banks must then have the managerial capacity for monitoring adequately the firms they finance. For banks in developing countries in particular, capabilities for such information gathering and analysis are in short supply.

Corporate governance addresses the fundamental microeconomic issue of how effectively the managers of the firm are monitored and induced by banks, equity markets, or other mechanisms to act in the best interests of its shareholders and hence to maximize the discounted present value of the firm with minimum agency costs, as explained later. What are the key issues in corporate governance in the crisis-affected East Asian economies?¹

It is impossible to address all the complex issues of corporate governance raised by the Asian crisis in a short paper.² The present paper has a limited scope. It tries to present a preliminary conceptual framework within which to frame the salient issues. A preliminary attempt is also made to address some significant issues for reforming corporate governance in East Asia.³

In order to conceptualize corporate governance in the Asian context, this paper extends Berglöf's (1997) twofold classification of corporate governance structures to a threefold one by analyzing family-based corporate governance structures.⁴ Since large family business groups are quite prevalent in East Asian crisis economies, their corporate governance structures would seem to be of immediate relevance. The challenge, however, is to link this structure analytically to the

¹ East Asia, unless stated otherwise, in this paper henceforth will refer to the crisis-hit economies only namely Malaysia, Indonesia, Thailand, South Korea and the Philippines.

² There are many good reviews of the corporate governance literature. Webb (1998) and Shleifer and Vishny (1997) are two excellent introductions to the recent literature. Zhuang (1999) discusses a number of issues relevant for corporate governance in the Asian context.

³ It should also be mentioned here that this paper is concerned with private sector-owned and controlled firms only. Many of the conceptual issues discussed here are, of course, similar in the case of state-owned enterprises (SOEs), but SOEs form a distinct category and their governance should be analyzed separately. I am grateful to Sadrel Reza for helpful discussions with regards to SOEs.

⁴ As Suehiro (1993, 1997) correctly points out "[t]he body of research ... confronting directly the phenomenon referred to as 'family business' is surprisingly small in quantity and rather shallow in its theoretical consideration of the subject matter" (1993, p. 379). Within the scanty theoretical tradition, starting with Berle and Means (1932) and especially in Chandler (1977) the passing away of family enterprise and the rise of 'managerial firm' has been accepted as an indisputable stylized fact. In reality, however, family-based enterprises and family control have been remarkably obdurate, especially in Asia.

two other types that can be called Bank-Led⁵ and Equity Market-Based corporate governance systems.⁶ Only by making the analytical links clear can one begin to consider the policy issues raised by the Asian crisis as well as by transition from one type of governance to another. This paper is organized as follows. The following section presents a new conceptual framework and typology, including family-based corporate governance. Some important aspects, including financing, monitoring and performance of family businesses are discussed in section three. After analyzing the monitoring problems with respect to the family businesses, subsection III.4 examines first what went right with corporate governance of family businesses. It then examines what went wrong, so that the failure of FBS became a contributing factor to the Asian financial crisis. Next, in section four, the transaction costs related to the institutional environment in which the family businesses operate are considered. In particular, the existence and enforcement of property rights laws are examined in order to see how these contribute to the incentive structures and performance of family businesses in East Asia. The analysis in this section suggests that at an early stage of development of an economy, FBS economizes on transaction costs. This provides a rationale for FBS in an economy that is in its early stage of development. Difficult questions, however, arise regarding the future of FBS as firms grow and economies develop further. The final section presents some discussion of the future of the family-based corporate governance system in Asia and some suggestions for areas of future analytical and empirical research.

⁵ There are at least two important variants of the Bank-Led type of governance - the German universal banking system and the Japanese main bank system. A critical difference between the Japanese and German type of BLS lies in the relationship between principal (owners as shareholders of companies) and agent (management of companies). In the German type, this relationship is much closer than in the Japanese type. See e.g. Aoki and Patrick (1995) and Baums (1993).

⁶ These terms are defined with greater precision in the next section. See also Rajan and Zingales (1998) and Zingales (1997) for a discussion of closely-related conceptual issues.

II. A New Conceptual Framework and Typology: Family-Based Corporate Governance

Even before the crisis in Asia extensive debate was taking place in Europe, the United States and Japan about the relative merits of different types of corporate governance systems. Broadly speaking, two general types of corporate governance structures have been discussed.

The first type can be called a shareholder or equity market-based governance system of the Anglo-American type (EMS). This is usually contrasted with the continental European or Japanese-type stakeholder or relationship model. In this model (for example, the Japanese main bank system) banks rather than equity markets play a key role in monitoring the performance of corporations. Therefore, this type of governance structure could be called a bank-led governance system (BLS). Note that BLS can either be a Japanese-style main bank system as mentioned above, or a German-type of universal banking system. However, the BLS and EMS are not the only two possible types of corporate governance systems.

In both Northeast and Southeast Asia there is a preponderance of family-based firms that are not necessarily controlled by banks or by equity markets. Nevertheless they do operate as economic entities within the context of a relationship-based system. Thus corporate governance of family businesses or family-based corporate governance system (FBS) can constitute a third type of corporate governance.⁷

Given this threefold division,⁸ we can now ask: what are the relevant dimensions in which these systems can be compared and contrasted? Berglöf (1997) developed a set of criteria to answer this question for EMS and BLS types of corporate governance. Table 2.1 compares and contrasts the EMS and BLS types of corporate governance, using Berglöf's original criteria. For

⁷ As mentioned earlier, the family-based corporations are relatively little studied. Hence, it is not surprising that almost no attention has been devoted to a systematic study of their structure, conduct and performance until recently. Recent work by Khanna and Palepu (1996, 1999) on India and by Claessens, Djankov, Fan and Lang (1998, 1999b) and Claessens, Djankov and Lang (1999) are important beginnings of serious research in this area.

⁸ It should be mentioned that other forms of classification are also possible. For example, Lehman (1997) offers a six-fold classification comprising of the Rheinal, Mediterranean, Japanese Keiretsu, the Korean Chaebol, the Chinese bamboo network and the Anglo-American systems. It can be seen that most of his categories are sub-species of FBS and BLS systems. Thus, his classification is consistent with the above threefold classification with the exception that his conceptualization minimizes the growth potential of what he quaintly calls 'the Chinese bamboo network'. It is, of course, entirely proper and desirable to look into the sub-categories of FBS if and when necessary. In this paper chaebols are treated as one such special sub-category of FBS.

reasons explained in the next paragraph, we consider FBS in a separate setting in table 2.2. where two additional relevant features (explained below) are included.

Table 2.1: Comparing Equity Market-Based and Bank-Led System of Corporate Governance

	Type of Corporate Governance System	
	Equity Market-Based System (EMS)	Bank-Led System (BLS)
Share of control-oriented finance	Low	High
Equity markets	Large, highly liquid	Not necessarily small but less liquid than EMS
Share of all firms listed on exchanges	Large	Not necessarily small
Ownership of debt and equity	Dispersed	Concentrated
Investor orientation	Portfolio-oriented	Control-oriented
Shareholder rights	Strong	Weak
Creditor rights	Strong	Strong for close creditors but applied according to a “contingent governance structure” (Aoki)
Dominant agency conflict	Shareholders vs. management	Banks vs. management; Workers may be important stakeholders as in Aoki’s model of the Japanese firm
Role of board of directors	Important	Limited, but less so than in the case of FBS
Role of hostile takeovers	Potentially important	Quite limited
Role of insolvency and bankruptcy*	Potentially important	Potentially important; but possible systemic crisis may postpone bankruptcies

*Note: Berglöf uses the term insolvency but the problem of exit of insolvent firms is directly related to bankruptcy laws and procedures.

Source: Berglöf (1997), “Reforming Corporate Governance”, *Economic Policy* 24, modified by the author.

Before presenting the characteristics of the FBS type of corporate governance in table 2.2 below, it may be useful to define family business more carefully. According to Suehiro (1993) the family business can be thought of “... as a form of enterprise in which both ownership and management are controlled by a family kinship group, either nuclear or extended, and the fruits of which remain inside that group, being distributed in some way among its members.” (p. 378).

Suehiro draws his inspiration from Chandler (1977) who defines family business in the following way:

In some firms the entrepreneur and his close associates (and their families) who built the enterprise continued to hold the majority of stock. They maintained a close personal relationship with their managers, and they retained a major say in top management decisions, particularly those concerning financial policies, allocation of resources, and the selection of senior managers. Such a modern business enterprise may be termed an entrepreneurial or family one, and an economy or sectors of an economy dominated by such firms may be considered a system of entrepreneurial or family capitalism. (p. 9, quoted by Suehiro (1993) p. 378)

In discussing family business in East Asia in this paper, the emphasis will be on ultimate control and de facto control rights more than on formal ownership. In their recent studies of corporate control in Hong Kong, China; Indonesia, Korea, Malaysia and Thailand, Claessens, Djankov, Fan and Lang (1998, 1999b) and Claessens, Djankov and Lang (1998, 1999) have pointed out two important features of industrial organization in East Asia. These are:

- a) families have control over the majority of corporations
- b) such control is also magnified “... through the use of pyramid structures, cross-holdings and deviations from one-share-one-vote rules” (Claessens, Djankov, Fan and Lang, 1999b, p. 3)

In appendix 1 the ownership structure for Thai corporations illustrates the first point. In appendix 2 the immediate control/ultimate cash flow rights diagram of the Lotte Group, as calculated by Claessens et al. demonstrates point (b) above.

The evidence gathered so far demonstrates that ultimate control of the corporate sector in East Asia is, on the whole, family-based. One study shows that “...16.6% and 17.1% of total market capitalization in Indonesia and the Philippines, respectively can be traced to the ultimate control of a single family (the Suhartos and the Ayalas)”. It goes on to point out that the top 10

families in Thailand, Indonesia and the Philippines have more than fifty percent of the market capitalization.⁹

In the following table 2.2 a qualitative description of the FBS system is given. The reader should note that the categories for comparison across the rows in this table are the same as for BLS and EMS with the exception of the last two. In addition to Berglöf's original criteria for comparing the BLS and EMS, I have introduced two additional features related specifically to corporate governance of family businesses. The first is monitoring of non-financial enterprises by the system, i.e., how the managers of corporations are monitored by outside financiers such as banks on the one hand, and equity markets or shareholders, on the other. This type of governance is intimately associated with how corporations are financed, i.e., corporate finance. Such monitoring by the firms' financiers is clearly an important function of the financial system. The monitoring of non-financial enterprises by the financiers has special relevance because *a priori* it is not clear if the financial distress of family-based firms is always signalled accurately to the outside financiers. Secondly and more generally, the issue of self-monitoring needs to be addressed. Self-monitoring is important because without some degree of self-monitoring FBS cannot function adequately. Since table 2.2 is intended to give only a qualitative description, in the next section a more detailed analysis of FBS is attempted with the help of some quantitative information and specific references to family-based corporations and corporate groups (e.g. CP Group in Thailand and Lucky-Goldstar Group in Korea).

The reader should note that both BLS and EMS are closely associated with the dominant modes of corporate finance by banks and equity markets, respectively. In the case of FBS in East Asia, the financing can come from three different sources. First, under FBS in the initial phases of growth of family businesses, firms could be financed internally. Second, as the enterprise grows over time, the role of banks becomes more prominent. Third, at some point in time equity markets may become an even more significant source of corporate finance. However, the key difference between FBS as a governance system and BLS and EMS lies in the fact that neither the banks nor the equity markets ultimately control or oversee the family business groups. That control resides with the family (or families) in the final analysis. This is because of various mechanisms of control such as

⁹ Claessens, Djankov and Lang (1999), "Who Controls East Asian Corporations", p. 3.

Table 2.2: Description of Family-Based System of Corporate Governance

	Type of Corporate Governance System
	Family-Based System (FBS)
Share of control-oriented finance	High initially, but may vary as family groups get bank and equity financing from outside
Equity markets	Small, less liquid
Share of all firms listed on exchanges	Usually small
Ownership of debt and equity	Concentrated
Investor orientation	Control-oriented for family groups
Shareholder rights	Weak for outsiders
Creditor rights	Strong for close creditors; Weak for arm's length creditors
Dominant agency conflict	Controlling vs. minority investors
Role of board of directors	Limited
Role of hostile takeovers	Almost absent
Role of insolvency/bankruptcy	Potentially important
Monitoring of non-financial enterprises (NFE)	Information asymmetry and agency costs rise with the growth of firms, making monitoring more costly.
Self-monitoring	Initially, self-monitoring is effective because of non-separation of owner and management. Later stages present monitoring problems as agency costs rise due to separation of owner-managers and outside financiers.

control through subsidiaries that are at the disposal of the family groups, as will be discussed in the next section. An important consequence of this is that when in distress the incentives to fundamentally restructure their business and to change the family management structure with more professionally-oriented management may be weaker than they would be under BLS or EMS type of governance system.

As alluded to above, table 2.2 is only a qualitative description of the FBS corporate governance system. Although it facilitates comparisons and contrasts with the other systems, we need to go into more detail with the help of as much quantitative information as is available at this point. With this in mind, the following section presents some important aspects of the FBS type of governance system. In light of changing sources of corporate finance as family businesses grow, asymmetric information and monitoring problems are emphasized.

III. Financing, Monitoring and Performance of Family Businesses

Without being exhaustive, the essential aspects of the family-based system can be discussed under the following four headings:

1. Extent of family-controlled corporations in East Asia
2. Dominant modes of financing
3. Key information asymmetries and agency conflicts: problems of monitoring
4. Investment and capital accumulation by the corporations (as performance indicators)

These four aspects have been chosen because these are the most significant from the point of view of identifying the problem of corporate governance of the FBS in practice. The first three are the most important elements of corporate governance structure, while investment and capital accumulation can be seen as the most important performance indicators for a late industrializing economy. Through an examination of the connections between corporate governance and corporate performance in this way, we can hope to understand first, what was right and then what went wrong with governance structure of family businesses in Asia.

1. Extent of family-controlled corporations in East Asia

1.1 Overall picture of ownership and control

Although empirical evidence is not widely available, at least for the companies covered in World Scope database, it is possible to calculate the percentage of total market capitalization controlled by families in East Asia.

According to a recent study by Claessens et al. (1999) the share of top 10 families in the total market capitalization in Indonesia in 1996 was 57.7 percent. For the Philippines and Thailand this share was 52.5 and 46.2 percent, respectively. For Korea the share of top 15 families was 38.4 percent and for Malaysia 28.3 percent. As table 3.1 shows, in the South Korean case, even when the formal degree of ownership is low, control can still be exercised through member companies that own stocks.¹⁰

¹⁰ Other methods such as deviation from one-share-one-vote can also be used to magnify control by a select group of shareholders.

Table 3.1: Ownership of Korean business groups by insiders
(percent of common shares held)

Business group	Founder	Relatives	Member Companies	Total
Hyundai	3.7	12.1	44.6	60.4
Samsung	1.5	1.3	46.3	49.3
LG	0.1	5.6	33.0	39.7
Daewoo	3.9	2.8	34.6	41.4
Sunkyong	10.9	6.5	33.5	51.2
Sangyong	2.9	1.3	28.9	33.1
Hanjin	7.5	12.6	18.2	40.3
Kia	17.1	0.4	4.2	21.9

Note: No year is given in the source, but the totals in the last column are the same as the figures for 1995 in table 6 in Nam (1999), p.17.

Source: World Bank, *East Asia: The Road to Recovery*, 1998, p. 60

This picture of concentrated ownership of corporations by several (usually a number between 5 and 10) family groups is supported by individual country studies by Suehiro (1993, 1997) for Thailand, Sato (1993) for Indonesia, Taniura (1989, 1993) for Taipei, China and Korea and Koike (1983) for the Philippines. For example, in Thailand in 1988 top three stockholder individuals owned 61 percent of about a quarter of the large corporations (see table A.1.2). In the context of the Philippines, Koike describes how the Ayala group expanded into diverse activities while retaining "... control firmly in the grasp of one family." (1983, p. 459)

1.2 Ownership and control in the financial sectors

Most of the private commercial banks and finance companies in Thailand are controlled by family business groups (see table A.1.4). For example, the top bank in Thailand, Bangkok Bank Limited, is controlled by the Sophonpanich family. The Farmers Bank, which is the second-largest bank, is controlled by the Lamsum family. Of the 15 private domestic commercial banks and 53 finance or security companies before the crisis in Thailand, the great majority was

controlled by the family groups.¹¹ In the Philippines and Indonesia also a similar system prevailed. In Indonesia before the crisis, of the 144 private commercial banks, many were controlled by combinations of family groups. Korea seems to have been an exception in this respect. In Korea, there are explicit, fairly low limits (15% for regional banks and only 4% for all other banks) on ownership of stocks by a family or chaebols in a particular financial institution or bank.

2. Dominant modes of financing

After an initial period of internal financing (Koike, 1993) in some East Asian countries family-based businesses developed into highly leveraged firms. In 1996, Korea was the economy with the highest debt/equity ratio of 3.54. Thailand was the next with a ratio of 2.36. In some sectors such as construction the debt/equity ratio was double the national average. What is significant is that despite high debt, the BLS type of governance did not come into play. The lack of effective bank monitoring in the face of such high level of debt, much of which is owed to the banks, is indeed a crucial issue of corporate governance of family businesses. This is discussed further in the subsection on monitoring.

Furthermore, in the case of Korea the overall share of family-owned equity is formally quite small, only about 1.4 percent (Akaba et al., 1998). The share of equity outside of families is also small (16%) but much larger than that of the families. Nevertheless, there is seemingly no control by outside shareholders. Table 3.1 suggests a plausible hypothesis. Actual control by the family groups far exceeded the formal ownership of chaebols, preventing monitoring by outside shareholders or their representatives. Table 3.2 below shows trends in modes of corporate financing for Korea from 1993 to 1997. Crucially, it should be noted that outside financing from bank and equity markets dominated in the 90s while the system of governance remained the same, i.e., FBS type of governance. According to Nam (1999), based on the recent history of major chaebols, there is no evidence of banks as creditors monitoring the management of the borrowing firms adequately (i.e. BLS).

¹¹ Although the extent of family ownership of Thai banks will decrease as a result of the crisis restructuring, the top banks will still have considerable family ownership, along with foreign ownership.

**Table 3.2: Korea: Trends in the Structure of Corporate Financing for all Industries
(in percent of total external financing)**

	1993	1994	1995	1996	1997 ³
Indirect financing	31.4	44.5	31.8	31.3	50.1
Direct financing	49.1	38.1	48.1	47.0	26.8
Financing from overseas	1.6	4.9	8.4	10.2	10.3
Others ¹	18.0	12.4	11.7	11.5	13.0
Total ² (in billions of won)	100 (64.982)	100 (89.041)	100 (100.016)	100 (118.201)	100 (62.102)

¹ Inter-firm credits, borrowings from government, bills payable, etc.

² Figures may not add up exactly to 100 percent due to statistical disturbances; Figures in parentheses represent total amounts of external financing in billions of won

³ Data for 1997 corresponds to averages of the first two quarters

Sources: Bank of Korea; and Financial Statements

3. Key information asymmetries and agency conflicts: problems of monitoring

In case of FBS, initially the family members act as owner-managers. Then, as the firm grows and is professionalized, there is still close monitoring of managers by the owners. When the family business is almost entirely financed “internally” (including associated financing from relatives and other informal networks, as in the case of overseas Chinese), and remains limited in scope and scale, the asymmetry of information between the financiers and owners on the one hand, and between owners and managers on the other, is not usually very severe. This is largely because there is no effective separation between financiers and owners, nor between owners and management.

However, as a family business grows and external corporate finance becomes important, a potential conflict arises due to the separation between the dominant owner-managers and the external financiers (whether banks or outside minority shareholders). In order to avoid possible confusion it is important to emphasize that the problem is not the separation between the dispersed owners of a widely-held corporation and the hired managers. On the contrary, the firms are not widely-held; but outside equity ownership by minority shareholders exists side by side with the predominant ownership and control by the family groups. Debt financing through outside banks is also present at this stage. In other words, there is still no separation between dominant family owners and managers; but there is a clear separation between the large, controlling family

owners and the outside financiers. In this context, serious problems can arise from the nature of the financial markets where there is information asymmetry between banks and borrowers and between equity issuers and purchasers. Thus, there could be a possible failure of the dominant owners under FBS to appreciate the interests of minority shareholders.

More importantly, there could be another possible failure of FBS due to adverse selection and moral hazard. The adverse selection problem arises from the selection of relatively more risky borrowers in the financial markets unless external financiers carefully perform ex-ante monitoring of potential borrowers.¹² The moral hazard problem also arises from the asymmetry of information between the lenders and borrowers. If the lender does not have precise inside information about the investment projects undertaken by the borrower there is a chance that funds will be misused by the borrower. The misuse of borrowed funds can occur through the selection of more risky projects unless external financiers perform interim monitoring function.¹³ Under a situation of moral hazard, the borrowers take on extra risks because they do not bear the full costs of their actions.

Therefore, with the increasing importance of external finance, the FBS system works well only when (i) self-monitoring is practiced or (ii) when outside financiers are able to monitor adequately. The latter can happen only when there is either *de facto* control of major shareholders over management, or when risk-measurement and -management capabilities of financial institutions are well-developed and banks are “located” in a good position to monitor borrowers independently of state’s and family businesses’ undue intervention. In addition, banking and security market (prudential and other) regulations and an effective legal system make the misuse of finances less likely and therefore act as mitigating factors.

Given the complexity of the monitoring problems, the first step is to see how self-monitoring has been practiced under FBS type of governance. To what extent has self-monitoring worked in the case of FBS type of corporate governance in Asia?

As mentioned previously, the self-monitoring under FBS works well only at an earlier phase of growth of the firm. Apparently, in all the East Asian economies self-monitoring was effective at the earlier phase. Many family enterprises, particularly under their founder-owners,

¹² Such monitoring is always costly. More importantly, the lenders may not have the technical capacity for ex ante monitoring.

¹³ Technical capacity for interim monitoring may also not exist.

showed tremendous flexibility during the period of accelerated growth. The available evidence clearly indicates that family enterprises succeeded in economizing on scarce managerial resources.¹⁴ It would have been impossible to function flexibly and effectively without constant self-monitoring – ex ante, interim and ex post – at this phase.

Later, with a relatively small amount of external financing, self-monitoring may still have been effective to some extent but as external finance became dominant, self-monitoring incentives declined with corresponding rise in agency costs. This is because under the increasing separation between owner-managers and external financiers as mentioned above, the cost of information gathering and processing about family businesses as borrowers must have increased and hence the financiers did not have proper incentives to monitor the borrowers at such high costs. Problems of monitoring might have become particularly acute when some firms developed into conglomerates, investing in areas where they did not have much experience or expertise. With little incentive for self-monitoring, the monitoring by outside financiers became the crucial requirement for good corporate governance. By now it is well-known that banks were the major financiers of the family-based businesses in the crisis-hit economies. Unfortunately, banks were not in a good position to effectively monitor the firms they had financed.

Various explanations can be offered for this lack of effective monitoring by the banks. One factor is that state intervention effectively curtailed the banks' ability to monitor the firms. Another is the massive capital inflow in an environment of weak (prudential) regulations and lack of enforcement that caused banks to overextend their loan portfolio without proper risk assessment. The double mismatch between currencies and maturities aggravated these problems, precipitating the financial crisis (Yoshitomi and Ohno, 1999). This may also have seriously jeopardized the already weak capacity of the banks to monitor the firms.

While all these are important, the heart of the problem lies in the weakness of banks' capacity to monitor the firms through risk-measurement and risk-assessment based on information creation and collection about and from borrowers and their projects.

¹⁴ See next subsection III.4.

4. Investment and capital accumulation by the corporations: what went right and what went wrong

We can now turn to begin the task of more explicitly ascertaining what went right and what went wrong with respect to the FBS type of governance of East Asian corporations. For this purpose, we have to see the connections between corporate governance structure and corporate performance. It is, therefore, important to keep the distinctions between the early phase of FBS when self-monitoring is effective and the later phase when problems arise with respect to both self-monitoring and outside monitoring.¹⁵

Some earlier studies of family business groups such as the Lucky Goldstar Group in Korea (Koike, 1993), Samsung in Korea (Khan, 1998, forthcoming) and CP Group in Thailand (Suehiro, 1993) have pointed out how family firms rapidly grew and diversified. Although these studies do not directly discuss corporate governance (or for that matter FBS type of governance) one can clearly draw a connection between successful growth at an earlier period and effective self-monitoring under FBS in its first phase.

For example, in Thailand the large conglomerate CP Group started as a family business trading eggs and seeds. It then advanced into feedmilling by using the family network and aided by government connections. Suehiro describes the further expansion of CP in the 1960s and 1970s in the following terms, emphasizing the linkage with the government:

Thanks to the Thai government's promotion policies, the CP Group was able to quickly extend its business activities from feedmilling to crop growing, broiler stock breeding, slaughtering, and food processing, and even to exporting the finished products. From the end of the 1970s the CP Group introduced the same vertically integrated system it used in the broiler industry to its prawn and pork business. (Suehiro, 1997, p. 39)

In a similar way, Goo In-Whoi, the founder of the Lucky-Goldstar group in Korea went from being the owner of a cosmetics manufacturing firm, Lucky Chemical Company, in 1947 to plastics, toothpaste and soap and electrical appliances in the 1950s. In each case of business expansion, Goo showed remarkable entrepreneurial flexibility by launching successive related lines of business, and making quick decisions to forestall competition. For example, in 1951, in

¹⁵ Although it is difficult to be exact, historically we can think of the period up to the mid-eighties as the first phase and thereafter as the second in a very rough way. Although for advanced countries such as

the middle of the Korean War, Goo invested in an injection molding machine from a US firm – a sizeable and risky investment costing 3 million won at that time. In order to buy this machine he had to obtain scarce foreign exchange. According to Taniura, “[t]he fact that Goo successfully obtained a foreign exchange allocation suggested that he was supported by some influential persons in the government.” (Taniura, 1993, p. 466). By Taniura’s account, it was only by exploiting business, family and government networks in an ill-defined legal environment that Goo was able to advance into the plastic-processing business. In the 1960s, after initially being charged by the Park regime with the crime of illicitly accumulating wealth, Goo went along with the changed government policy by establishing Korea Cable Co. according to government orders in 1962 and prospered afterwards.

The examples described above are consistent with the behavior of family businesses in the first phase of their growth. At this phase, their growth depended critically on their ability to mobilize internal resources and take advantage of the market opportunities quickly and efficiently. Without constant self-monitoring this would have been impossible to achieve.

Is there more systematic evidence of the successes of family businesses during this earlier phase of expansion than the detailed studies of the individual firms or entrepreneurs cited above? Unfortunately, for the earlier period (1950s, 60s or even 70s) there is no systematic firm-level data base that can be readily used. One might use the first year for which such data are available (which is 1988) in the World Scope database referred to earlier, as proxy for the previous periods. Since by this time external financing was already quite dominant in the case of family businesses, all other things being equal, the estimated efficiency for this year as a proxy for efficiency in earlier years should be biased downwards. Therefore, if the performance in this year is reasonably good, it can be said that in all probability the average performance of firms in the earlier phase was even better.¹⁶

There is a second difficulty with respect to the World Scope database. The performance indicators that can be calculated from it are financial indicators (e.g. return on assets) whereas we would like to have real indicators of firms’ performances. To be consistent with economic theory, the cost-minimizing output level using the most efficient techniques should be estimated and compared with actual performance at the firm level. Over time the increase in productivity also

Korea, the second phase may have started earlier, whereas for countries such as Thailand, the first phase may have continued longer.

needs to be captured. The available indicators at the firm level are measures of financial returns on assets and do not necessarily correspond to the actual performance of the firms. Judged by these measures – with the above qualifications in mind – firms in most of the crisis-hit economies in an earlier period performed reasonably well. The return on assets for 1988 (measured as book values) was 10.8 percent for Thailand. For Malaysia, Indonesia and the Philippines, the returns were 5.4, 9.4, and 7.1, respectively.¹⁷

In terms of growth of corporate investment, the East Asian corporations registered impressive annual rates. For example, in 1988 the median growth rate for a large sample of listed companies in Korea was 15.6 percent. Thailand's mostly family-based corporations showed an even more impressive rate of capital accumulation over the same period at 10.4 percent per year. Indonesian corporations were close behind at 12.1 percent.¹⁸ The sample includes both financial and non-financial firms. It would appear that mainly as a result of massive accumulation of capital, both types of firms grew rapidly and were able to diversify.¹⁹ While the period of rapid growth and diversification was overall a success, there were problems inherent in the process that can be understood by considering the motives for diversification more closely.

In retrospect, it appears that quite often the motive for diversification was to protect and enhance family fortunes, rather than build up productive capacity (Suehiro, 1993). Suehiro further pointed out that in the case of Thailand, much of the diversification was carried out in order to take advantage of existing tax shelters as well. Another motivation for diversifying was to pass on entirely new companies to younger family members. Figure 3.1 illustrates what is wrong with such diversification by drawing our attention to third generation unrelated diversifications by the Osothsapha Group in Thailand.²⁰ The founder of the group, Pe Osathanukhro started in 1930 with a company dealing in Chinese medicinal herbs. In the 1940s it diversified into related pharmaceutical industries, including a technological tie-up with Taisho Pharmaceutical Co., Ltd.

¹⁶ Of course, we are also faced with the difficulty of how to interpret the performance in the later phase. More on this follows.

¹⁷ The years are different for Indonesia (1990) and the Philippines (1991).

¹⁸ The figure for Indonesia is for the year 1991.

¹⁹ Needless to say, since the crisis, the appropriateness of undertaking many of these (often quite large-scale) investment projects has been questioned.

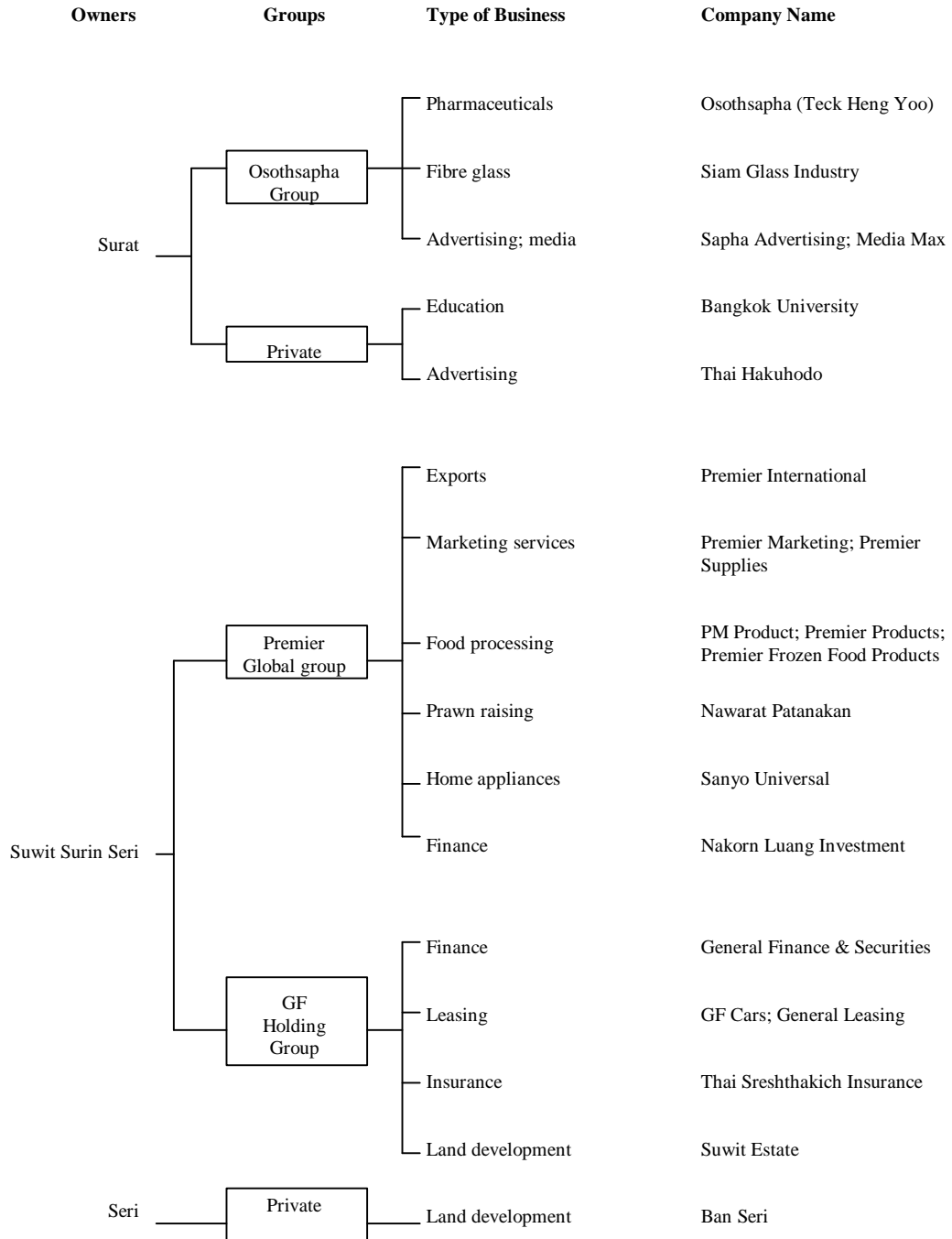
²⁰ More systematic evidence for firms covered in the World Scope data base is discussed by Claessens, Djankov, Fan and Lang (1999a, b). However, there are some problems of interpretation for individual economies which are our foci of interest. For this purpose, instead of cross-section or pooled data, one needs to use time-series data for individual economies. This may be possible, but would certainly be quite time-consuming as annual reports of companies and other sources will need to be cross-checked and made consistent. The specification issues will also need to be addressed. Indeed, this looms as a necessary (and necessarily time-intensive) research task in the future.

and Sawat, the founder's son, continued in this direction. However, in the third generation, under Sawat's children the group went into many other industries, as Suehiro has noted:

It was during the third generation of Sawat's sons and daughter that the group began to diversify into such unrelated industries as leasing, finance, real estate, and export-oriented manufacturing (processed food, sport shoes, luggage, and shrimp). While maintaining the pharmaceutical business as their main line, this new generation of owner/managers turned their investment activities mostly towards new, growth industries that were popping up in Thailand at the time. They also separated new businesses of the Premier group and the GF Holding group from their parent's business. (Suehiro, 1993, p.400)

Part of what went wrong – at the micro level – certainly came with the expansion of the core family enterprises beyond the point where they could be financed and technology could develop primarily from the internal resources of the family groups. In many cases, this resulted in highly

Figure 3.1: Business Diversification of Osothsapha (Premier) Group



Source: Suehiro (1993), "Family Business Reassessed: Corporate Structure and Late-Starting Industrialization in Thailand", *Developing Economies* 31- 4, p. 401

leveraged debt-financing. At the same time, the control of the firm – through means discussed earlier – was not shared with outside shareholders. As a result, neither BLS nor EMS type of governance could be exercised efficiently. It can be argued that increased agency costs and the weak and underdeveloped capacity for effective monitoring by the financiers led to this undesirable situation.

It appears from the emerging literature on what is wrong with corporate governance in Asia (e.g. World Bank, 1998) that the violation of rights of minority shareholders, not having enough independent members on the board of directors and similar legal and quasi-legal aspects of governance should be at the heart of corporate governance reform. However, from our analysis of the monitoring problem of banks and family-businesses in Asia, it seems that while such majority versus minority shareholder issues are clearly significant – particularly for equity considerations – they may not be central to rectifying the unsatisfactory governance of the firms in Asia. What is of more immediate importance is the ability of banks to financially monitor the family businesses properly.

As we have seen, this has proved difficult both because of the weak position or location of the banking system itself in the overall structure of economies that are dominated by family business, and the lack of capacity to collect and analyze the appropriate technical and financial information necessary to monitor the family-controlled businesses financed by the banks.

To summarize the argument so far, it is clear that family-based corporations played a major role during the boom period of “East Asian Miracle”. What went right during this period at the firm level, as documented by the studies cited above, is the economically efficient use of limited entrepreneurial abilities and the flexibility of family-based management. The owner-managers, together with the professional managers they hired (e.g. the CP Group in Thailand, the Ayala Group in the Philippines, or Samsung and Lucky-Goldstar in Korea among others) met the challenges of late industrialization in many sectors by exploiting profit opportunities as they arose. These ventures were certainly helped by government policies, including industrial policies and investment. The government-business nexus in many cases also economized on transaction costs arising from the low level of development of legal systems. Finally, the family and kinship networks, especially among the Southeast Asian overseas Chinese, made “internal” (in the broad sense of the word) financing a perfect source of expansion for some time initially. Self-monitoring must have been effective and sufficient during this period. In addition, the family members in leading positions probably monitored the newly-hired management closely as well.

However, at a later phase when family enterprises had expanded so much that large amounts of external finance were necessary, agency costs increased. At this point, banks should logically have monitored these businesses to see that value was being maximized. But they failed to do so mainly for two reasons. First, most banks lacked the capacity to collect and analyze technical and financial information from diverse clients. Second, the banks themselves had governance problems for various reasons. Since security markets were not well-developed, EMS type of governance was also out of the question.

Reforming the FBS system, as Hong Kong, China has been doing throughout the 1990s was another option, but this apparently did not happen in the crisis-hit economies. Thus, the prevailing form of FBS type of governance generally failed to prevent mounting inefficiencies and simply bad business decisions.

These failures of FBS type of governance in the crisis-hit economies raise the question of where the governance system can go from here. In order to answer this question adequately we must further understand the initial rationale for FBS and why it evolved to be the dominant governance system in the first place. This is the task of the next section.

IV. The Relevance of FBS for Economies at Different Stages of Development: The Role of Transaction Costs

In this section we examine the rationale for the FBS type of governance in some Asian countries in order to see how FBS may evolve further. Specifically, we ask if there is a relationship between the level of development of particular Asian countries and FBS as a corporate governance system. Here it may be useful to think in terms of transaction costs. Transaction costs in the economic world are like friction in the physical world. In standard economic analysis transactions are supposed to be costless; but in the real world there are costs of planning, organizing, adapting and monitoring (Williamson, 1985). These costs exist both within the firm and in the market. Transaction costs include both economic and non-economic (e.g. legal) aspects of transactions. For an institution such as corporate governance of family businesses to survive, it must economize on transaction costs relative to other alternatives. Therefore, we need to think about how transaction costs may vary in different Asian economies and how FBS may (or may not) lower them in each case. Generally, the transaction costs vary with the level of economic development – with low level of development giving rise to relatively high transaction costs.

For our purpose in particular, underdevelopment may be associated with not only incomplete markets but also imperfect legal systems where property rights are not well-defined nor the court systems well-developed. Enforcement of such laws as may exist could also be haphazard. This latter phenomenon is related to weakness of governance in a broader sense. Given this type of weakness – legal and institutional – firms may be able to minimize transaction costs by using a flexible, relationship-oriented form of organization. Historically and culturally, in East Asia this form has generally been identified with family businesses. Therefore, it is possible that FBS may be the paradigmatic form of corporate governance for the Asian countries. Naturally, this implies that Asian economies at different stages of development will have to address different problems with respect to their systems of family-based corporate governance.

In order to clarify whether this is indeed the case, it is instructive to look at some common measures of how the legal systems perform in various Asian countries. Table 4.1 below gives some quantitative measures used specifically to assess the quality of legal environments (La Porta et. al. 1998). Using exactly the same measures as La Porta et. al. have introduced in the literature through their pioneering study of law and (corporate) finance, but applying them in the specific

context of Asian economies at different stages of development we can draw a number of interesting conclusions.

Table 4.1 measures the quality of the legal environments that firms face in selected Asian countries. The relevant information is summarized in this table for the Asian economies that are of particular interest to us. Five measures of the quality of legal environment are used in table 4.1 below, namely rule of law, efficiency of the judicial system, corruption, risk of expropriation by the government, and probability of contract repudiation by the government. In addition, an assessment of the quality of a country's accounting standards is presented since accounting plays a crucial role in corporate governance.

Table 4.1: Stages of Development and the Assessed Legal Environment in Selected Asian Economies

Economy	Enforcement variables					Accounting	GNP per capita (US\$)	
	Rule of law	Efficiency of judicial system*	Corruption (lower score indicates more corruption)	Risk of expropriation (lower score indicates higher risk)	Risk of contract repudiation (lower score indicates higher risk)	Rating on accounting standards	1996	1997
HongKong,China	8.22	10.00	8.52	8.29	8.82	69	24,290	25,280
Malaysia	6.78	9.00	7.38	7.95	7.43	76	4,370	4,680
Singapore	8.57	10.00	8.22	9.30	8.86	78	30,550	32,940
Thailand	6.25	3.25	5.18	7.42	7.57	64	2,960	2,800
Indonesia	3.98	2.50	2.15	7.16	6.09	na	1,080	1,110
Philippines	2.73	4.75	2.92	5.22	4.80	65	1,160	1,220
South Korea	5.35	6.00	5.30	8.31	8.59	62	10,610	10,550
Taipei,China	8.52	6.75	6.85	9.12	9.16	65	13,310	14,069

*1980-83 only

Definition of variables

Variable	Description	Sources
Rule of law	Assessment of the law and order tradition in the country produced by the risk-rating agency <i>International Country Risk</i> (ICR). Average of the months of April and October of the monthly index between 1982 and 1995. Scale from 0 to 10, with lower scores for less tradition for law and order. (Scale has been changed from its original range going from 0 to 6).	International Country Risk Guide
Efficiency of judicial system	Assessment of the "efficiency and integrity of the legal environment as it affects business, particularly foreign firms" produced by the country-risk rating agency <i>Business International Corporation</i> . It "may be taken to represent investors' assessments of conditions in the country in question". Average between 1980-1983. Scale from 0 to 10, with lower scores signifying lower efficiency levels.	Business International Corporation
Corruption	ICR's assessment of the corruption in government. Lower scores indicate "high	International

	government officials are likely to demand special payments” and “illegal payments are generally expected throughout lower levels of government” in the form of “bribes connected with import and export licenses, exchange controls, tax assessment, policy protection, or loans”. Average of the months of April and October of the monthly index between 1982 and 1995. Scale from 0 to 10, with lower scores for higher levels of corruption. (Scale has been changed from its original range going from 0 to 6).	Country Risk Guide
Risk of expropriation	ICR’s assessment of the risk of “outright confiscation” or “forced nationalization”. Average of the months of April and October of the monthly index between 1982 and 1995. Scale from 0 to 10, with lower scores for higher risks.	International Country Risk Guide
Repudiation of contracts by government	ICR’s assessment of the “risk of a modification in a contract taking the form of a repudiation, postponement, or scaling down” due to “budget cutbacks, indigenization pressure, a change in government, or a change in government economic and social priorities”. Average of the months of April and October of the monthly index between 1982 and 1995. Scale from 0 to 10, with lower scores for higher risks.	International Country Risk Guide
Accounting standards	Index created by examining and rating companies’ 1990 annual reports on their inclusion or omission of 90 items. These items fall into 7 categories (general information, income statements, balance sheets, fund flow statement, accounting standard, stock data and special items). A minimum of 3 companies in each country were studied. The companies represent a cross-section of various industry groups where industrial companies numbered 70 percent while financial companies represented the remaining 30 percent.	International Accounting and Auditing Trends, Center for International Financial Analysis & Research, Inc.
GNP per capita	Gross National Product per capita in constant dollars of 1996 and 1997.	World Bank

Source: Modified from La Porta et al. (1998) pp. 1122-26 and 1142-43. Assessments not endorsed by ADB/I.

Scrutinizing table 4.1, it can be seen that in general, countries with low GDP/capita such as Indonesia, Thailand and the Philippines have relatively underdeveloped legal systems and uneven enforcement of laws. This would seem to imply that *ceteris paribus* firms in these economies face high transaction costs. While more developed economies such as Hong Kong, China and Singapore score 10 out of 10 in terms of efficiency, less developed countries like Indonesia, the Philippines and Thailand score much lower (2.5, 4.75 and 3.25, respectively). Therefore, it seems plausible that FBS can economize on transaction costs – given the inefficient legal systems – in these lower income countries because of its flexibility. This is clearly true for the first phase of the growth of family businesses when there is only internal finance. Even when there is large external financing of family businesses, FBS may still have lower transaction costs than with the BLS and EMS both of which require complex financial markets and efficient law enforcement institutions in order to work well. In the absence of well-developed law-enforcement institutions, selection mechanisms such as the firms’ high profitability and/or their ability to grow would favor the FBS over the other alternatives.

What is really surprising is that some economies with efficient legal systems such as Hong Kong, China also have the family-based system of corporate governance.²¹ How can FBS function successfully in these economies? Are there features of FBS that remain relevant even at higher levels of income in Asia? It could be conjectured that there are *specific* factors in each case that can explain the continuing relevance of FBS. For example, in Hong Kong, China bank lending to corporations is much less than in the Southeast Asian countries or in South Korea. In 1997, the average debt for Hang Seng Index listed companies was only 36 percent of equity (Shiu, 1999). Also, in Hong Kong, China the government and banks hold a negligible portion of the shares of the companies, making family control almost inevitable. However, competition in a more or less *laissez faire* environment where corporate and other laws are interpreted clearly and enforced reasonably well might explain why FBS is still a workable form of corporate governance in Hong Kong, China. In addition, the relatively strong financial and banking sectors in Hong Kong, China²² contribute significantly to the success of FBS.²³

Another interesting case is Singapore which has some large family-controlled firms and business groups but a system of corporate governance that is influenced by the government through the government-linked corporations. In effect, this is the predominant form of corporate governance in Singapore. In the case of Singapore, the close guidance from government in a competitive environment might also explain the relatively better performance and governance of the family businesses there. These are, of course, conjectures that would require more careful formulation and further verification. In particular, competition should not be overemphasized. It should be recognized that competition is a necessary condition for better functioning enterprises

²¹ Singapore also has some large family-controlled businesses. However, on the whole, the government-linked corporations, the relatively well-functioning banking system (compared to the other banking systems in the region) and the presence of multinationals are the major factors in good corporate governance. See also Linda Lim (1983).

²² One should, of course, distinguish between competition in the real and financial sectors. In both sectors competition occurs within a regulatory framework. For financial sectors, the regulatory structure is particularly important and competition without appropriate regulations could increase financial fragility.

²³ In addition to the commonly expressed concerns with corporate governance, including these other factors should usefully focus the attention of policy-makers on the nature and extent of managerial expertise and incentive structures within the firm such as remuneration of management and employees and the nature of contract between employees and management. It should also direct the policy-makers' attention to the extent of competition in the markets in which the family businesses participate. One hypothesis that can be called the governance parity hypothesis attributes equal importance to both corporate governance and to factors that are related to the internal technological and managerial capabilities of the firm as well as market competition. Specifying the parity hypothesis as a null hypothesis and testing this against various alternatives statistically could throw more light on the relative importance of corporate governance in determining corporate performance in Asia. Of course, the formulation of the hypothesis should emphasize the role of governance - in particular, monitoring capabilities of the banks - in determining the performance of the corporations.

in general, but competition by itself cannot resolve the problem of information asymmetry and agency problems nor conflicts of interests between financiers and management (and dominant owners) of family businesses.

Finally, both South Korea and Taipei, China have similar levels of development and family-based systems of corporate governance. Yet, South Korean chaebols are undergoing restructuring after the crisis while Taipei, China's system continues to work relatively well. One important feature that is frequently overlooked in discussions of Taipei, China's corporate sector is the role of large enterprises. While small and medium size enterprises are significant, there are also large state-owned as well as privately-owned enterprises. Among the latter are companies such as Acer and Tatung that seem to perform quite well. We need to ask what can explain the different performances of FBS in South Korea and Taipei, China.

The upshot of the whole discussion is that concrete case studies of corporate governance of these economies must be done in order to assess the workability of the FBS in each particular case. Among other things, this should also help focus attention on the feasible policies for making the transition from FBS, if necessary, in economies such as South Korea in particular. In the final section we discuss the future of the FBS type of governance in the context of the post-crisis paradigms of corporate governance for Asia.

V. Where Will FBS Go From Here: Suggestions for Future Research

In this paper I have tried to analyze some basic issues related to corporate governance systems in East Asia. The threefold division of corporate governance systems presented in this paper seems appropriate. In particular, the FBS structure has played an important role in the initial phase of capital accumulation in the East Asian countries. Indeed, its prevalence in Asian economies at all levels of development makes FBS almost a paradigmatic feature of corporate organization and governance in Asia. Complex questions, however, arise with regards to how appropriate this system is currently in both Northeast and Southeast Asia.

All things considered, there are three logically possible roads to corporate governance reform in Asia. One is to improve the existing FBS type of governance. The second is to see how a transition to the BLS type of governance can be made. Finally, there is the logical possibility of EMS type governance but given the fact that capital markets are not well-developed in most Asian countries this can only be a long-run option. The choice at present is between the first two alternatives.

As for improving the FBS type of governance, the ability of family businesses to adapt and reform may be the most crucial factor. As Suehiro (1993, 1997) has pointed out, one rationale for the FBS system is its flexibility in terms of managerial decision making process and its efficiency in capital accumulation in the context of latecomer industrialization. The question that arises here is whether in particular for the Southeast Asian economies, at their current relatively low level of development, the FBS type of governance may still be relevant. We also need to ask if the reform of the FBS system is indeed a realistic possibility. It is relevant to note here that some family groups such as CP in Thailand have shown the capacity for self-reform, including admitting non-family members to the board of directors (Suehiro, 1997).

In discussing the possibilities for reform of the FBS type of corporate governance it is important to look at the role of banks as well. According to the most recent available information (appendix tables A.1.4 and A.1.5) during the crisis the share of family ownership in all the Thai banks declined considerably. If the current plans for reorganizing and recapitalizing the banks are followed through, then after the reorganization, out of 11 family-based banks (table A.1.4) only three will still be family-based, as shown in table A.1.5 (viz. Bangkok Bank, Thai Farmers Bank and Bank of Ayudhaya). Most of the currently government-owned banks will come under foreign

ownership. The current plans are to privatize through selling to foreigners all the banks that the government took over during the crisis.

If the above scenario for the banking sector restructuring in Thailand is accomplished then in the future the corporate governance of the banks may be different from the governance structure before the crisis. Thus, even the family-owned banks may have greater incentive to monitor the borrowers than before because of foreign competition. Although it is impossible to predict exactly what the overall corporate governance structure will be definitively, the mix of family, foreign and government ownership and increased market competition may lead to a more effective overall monitoring system by the banks. However, there will still be the problem of how effectively the banks themselves can be monitored.

An important area of investigation for future research should be Asian economies with strong family-based corporate groups that weathered the crisis relatively well. Economies such as Hong Kong, China seem to have a large presence of family-based corporations and yet have managed to maintain their economic vigor. What explains the seemingly better performance of FBS in these economies? Following a methodology that combines fieldwork, statistical analysis of existing data bases and an examination of the legal and institutional environment, should lead to a better understanding of corporate governance and performance. Contrasting findings of this type of research with the findings about corporate governance in the crisis-hit economies is a necessary condition for discovering the right road to reforming corporate governance in Asia. It is also clear that there is no single royal road to reform. Rather, a case by case approach that takes the institutional histories and their path dependence in each economy is necessary.

The second alternative for some countries such as South Korea may be a BLS type of governance. For instance, the new bank-based governance could be modeled after either the Japanese or German type of corporate governance. For this to happen, first, the banking system has to be strengthened through bank restructuring and recapitalization. Then, banks should be given autonomy to monitor the borrowers, including large family businesses. Furthermore, an adequate amount of prudential regulation and bank-supervision will also be required. In general, state intervention should be minimal in allocating finance to the corporate sector so that banks alone have the responsibility to evaluate risks properly. In addition, governance of banks themselves (i.e., monitoring the monitor) should be efficient. In short, the proper location of the banks in the industrial and financial structure of the economy and the effectiveness of the banks themselves are among the main prerequisites for BLS to be successful.

In the present context one might also ask: will the recent IMF-sponsored and other proposed corporate governance reforms move the system in Korea closer to either BLS or EMS? In Korea, the abolition of regulations protecting the chaebols (table A.3.1) is intended to lead to a lowering of debt-equity ratio and enhanced shareholder rights. Whether the monitoring system will necessarily improve is an open question. In the long run, mergers and acquisitions market deregulations may lead to a market for hostile takeovers. However, it is not realistic to expect this to take place quickly. It is also not clear what real effects some other reform measures such as abolishing the group chairman's office, and increasing the number of independent board members will have on corporate governance as such, although the board in theory will have more independence than before.

On the banking side, however, during the crisis the government ended up owning large portions of many banks (table A.3.2). As a result of this, will future privatization of the banks lead to an improved corporate governance structure for the banks? There is clearly an opportunity to develop the roles of banks as monitors. As mentioned above, this will require a strong and independent banking system. It has also been suggested that principal transactions banks (PTBs) could develop as monitors within a Japanese-style main bank system. However, as Nam (1999) points out the PTBs have not developed as banks that take a strong leadership role in reorganizing or liquidating the distressed corporations that are borrowers of PTB funds. There is also not much cross-shareholdings between PTBs and their clients. As a result, reduction of information asymmetry through delegated monitoring both as lender and shareholder is not an immediate possibility. Clearly, if PTBs could develop as main banks an improvement in corporate governance and performance could take place as a result of better monitoring. Transition to the BLS type of governance through PTBs as main banks could also lower the cost of corporate restructuring in case of severe distress. However, this must be considered as a possibility that can be realized only if the conditions mentioned above can be realized.

It should be emphasized that much more empirical research using detailed micro data sets with country-, sector- and firm-specific information is necessary before reaching any definitive conclusions regarding the most appropriate system of corporate governance in Asia. In this context, the suggestion that the firms' managerial expertise as well as the competition policy can be just as important as the form of corporate governance in determining their performance should also be taken seriously. The crucial question is how best corporate governance reforms, together with these other factors can contribute to improved performance of the firms in the region.

In the final analysis, the issue of reforming corporate governance can be resolved only when the monitoring problem can be solved adequately. One important precondition for this is to increase the capability of the financial institutions – banks in particular – for collecting and analyzing the relevant technical and financial information about the firms they finance. Actual prospects for improving corporate governance through enhancing the capacity for monitoring will vary from one economy to another and should therefore be addressed on a case by case basis in a series of individual country studies.

Appendix (1)

Family-Based Businesses in Thailand

Table A. 1.1: Characteristics of Top Shareholders in Large Thai Corporations, 1979 and 1988

Top Stockholders/Equity Percentage	1979	%	1988	%
(1) Individual:	72	(33.0)	74	(29.7)
1-9%	3		4	
10-29%	35		43	
30-50%	29		23	
51-100%	1		4	
Foreigner	4		0	
(2) Family investment company:	26	(11.9)	16	(6.4)
1-9%	3		5	
10-50%	17		9	
51-100%	6		2	
(3) Thai corporation:	37	(17.0)	67	(26.9)
1-9%	3		5	
10-29%	15		24	
30-50%	10		19	
51-100%	9		19	
(4) Foreign corporation:	78	(35.8)	81	(32.5)
10-48%	32		26	
49-50%	10		11	
51-98%	10		13	
99-100%	26		31	
(5) Government bureaus	3	(1.4)	8	(3.2)
(6) Crown Property Bureau	2	(0.9)	3	(1.2)
Total	218	(100.0)	249	(100.0)

Notes: 1. Large corporations indicate firms with 0.3 billion baht (1979) and 1 billion baht (1988) in terms of total annual sales.
2. Public corporations have been excluded.

Sources: Calculated by Suehiro (1993, p. 388) using the following directories: for 1979, Pan Siam Communication Co., *Million Baht Business Information Thailand, 1980-81* (Bangkok, 1981); for 1988, International Business Research Thailand Co., *Million Baht Business Information Thailand, 1989* (Bangkok, 1989).

**Table A. 1.2: Top Three Stockholders in Thai Large Corporations,
1979 and 1988**

Top Three Stockholders	1979	%	1988	%
(1) Individuals (Thai):	60	(27.5)	61	(24.5)
Belonging to the same family	21		33	
Belonging to multiple families	39		28	
(2) Individuals plus corporations:	38	(17.4)	32	(12.9)
With group companies ^a	14		13	
With non-group companies	24		19	
(3) Thai corporations:	22	(10.1)	48	(19.3)
Belonging to the same group	4		17	
Among different groups	15		19	
Holding-company type ^b	3		12	
(4) Foreign corporations:	90	(41.3)	97	(39.0)
Exclusively foreigners ^c	33		38	
With Thai corporations	43		51	
With Thai individuals	14		8	
(5) Government bureaus	8	(3.7)	11	(4.4)
Total	258	(100.0)	249	(100.0)

Source: Calculated by Suehiro (1993, p.389) using same sources as Table A 1.1.

^a Group companies are members of the group of companies that the stockholders in question own and operate.

^b E.g. Siam Cement Co., Ltd. and Suramahakhun Co., Ltd.

^c Includes a single firm with 100 per cent stockholdings.

**Table A. 1.3: Family Stockholders and Management Control
in Thai Large Corporations, 1988**

Top Management	Equity Percentage of Largest Stockholder			Total	%
	1-9%	10-49%	50-100%		
Presidents / general managers:					
(1) Same family with the largest stockholder	3	33	55	91	59.5
(2) Same families with 2 nd or 3 rd stockholders	2	8	1	11	7.2
(3) Different families ^a	4	22	11	37	24.2
(4) Foreigners	2	11	1	14	9.2
Sub-total	11	74	68	153	100.0
(5) No data available	---	3	2	5	
Chairmen of board:					
(1) Same family with the largest stockholder	1	21	34	56	62.9
(2) Same families with 2 nd or 3 rd stockholders	1	4	---	5	5.6
(3) Different families ^a	7	13	5	25	28.1
(4) Foreigners	1	2	---	3	3.4
Sub-total	10	55	39	89	100.0
(5) No data available	---	39	31	71	
Presidents (P) / chairmen (C):					
(1) Both of P/C belonging to the same family with top three stockholders	2	14	29	45	50.0
(2) Either of P/C belonging to the same family with top three stockholders	2	19	8	29	32.2
(3) Others	6	8	2	16	17.8
Sub-total	10	57	39	90	100.0
(4) No data available	1	38	31	70	

Notes: 1. Figures cover large corporations with annual sales of 1 billion baht in 1988
2. Foreigner 100 per cent controlled and government partially owned companies have been excluded
3. Subsidiaries of holding companies Siam Cement group and Suramahakhun group have been excluded

Sources: Survey by Suehiro (1993); same as table A.1.1

^a Figures include non-identified presidents or chairmen.

Table A.1.4: Market Share (as of May 1999) and Ownership of Commercial Banks before the Crisis and Change during the Crisis

Please insert file table A.1.4a

Table A.1.5: Future Market Ownership Pattern of Commercial Banks

(using the market shares in May 1999 and the current restructuring plans)

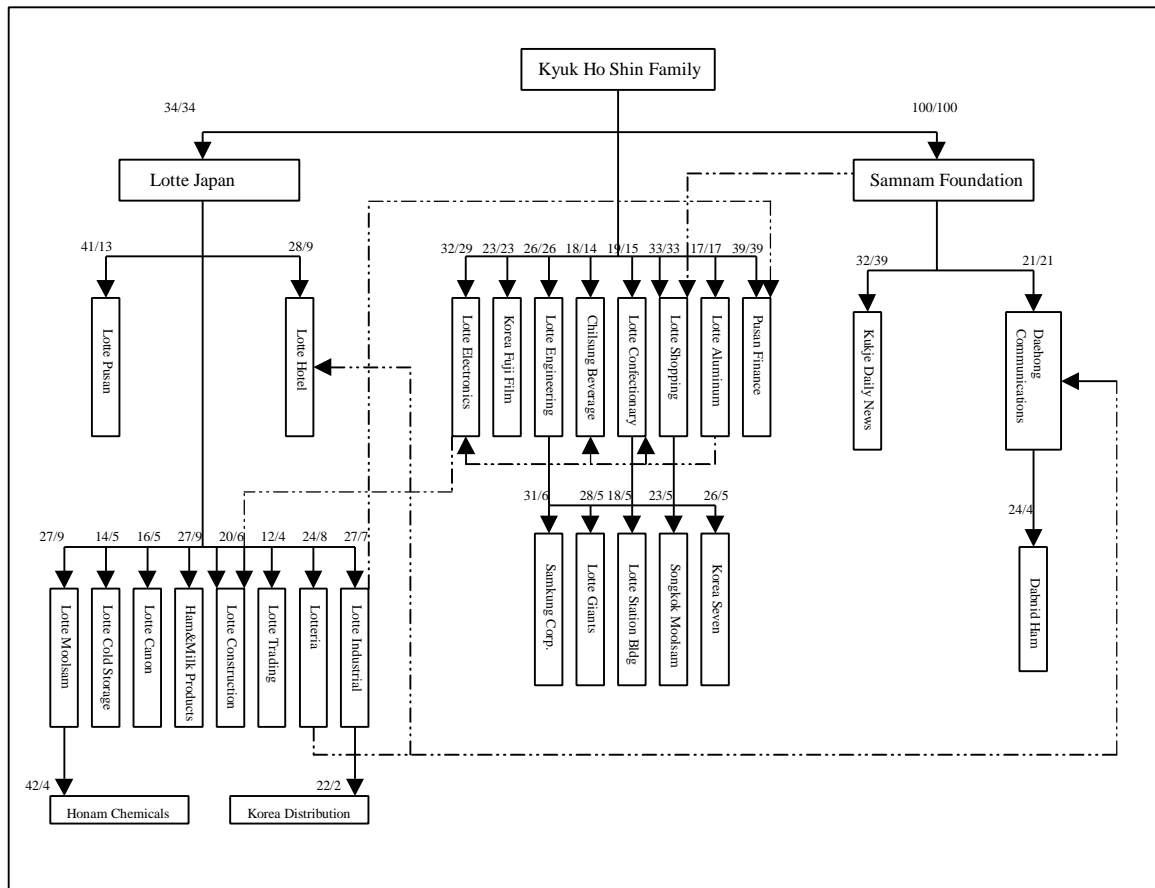
	Market share	
	credit (mb)	share (%)
Family-Owned	1890.44	42.54
Bangkok Bank	955.51	21.5
Thai Farmers Bank	555.45	12.5
Bank of Ayudhaya	379.48	8.54
Government-Owned	1203.34	27.08
Krung Thai Bank	913.38	20.56
Thai Military Bank	289.96	6.53
Foreign-Owned	1349.67	30.37
Bank of ASIA	125.58	2.83
DBS Thai Danu	107.78	2.43
Siam Commercial Bank	544.63	12.26
Siam City Bank	237.39	5.34
Bangkok Metropolitan Bank	180.74	4.07
Nakorn Thon	54.24	1.22
Thai Bank	56.07	1.26
Radhanasin	43.24	0.97
Total	4443.45	100

Source: Kanit Sangsubhan, "Capital Account Crisis: Some Findings in the Case of Thailand", paper presented at ADBI, 11 August, 1999

Appendix (2)

Structure and Control in the Family-Based Type of Corporate Governance: An Example

Figure A.2.1: The Lotte Group
(Immediate Control/Ultimate Cash-Flow Rights)



Source: Stijn Claessens, Simeon Djankov, Joseph P.H. Fan and Larry H.P. Lang (1999b, p.12)

Appendix (3)

Chaebols and Banks in South Korea after the Crisis

Table A.3.1: Abolition of Regulations Protecting the Chaebols

External Shocks	Expected Changes	1998	1999	2000
Cross-shareholdings	"IMF crisis"	Likely to be phased out to increase transparency	▲ 1998 Limited to 25% of net worth for top 30 chaebols	
Protection from M&A threats		M&A market deregulation likely to result in hostile takeovers	▲ February 1998 Tender offer obligation abolished ▲ May 1998 Ceiling on foreign ownership abolished	
Lack of minority shareholder rights		Enhanced shareholder rights and monitoring system will provide disciplinary mechanisms	▲ 1998 Cumulative board voting expected	▲ 1999 Shareholder derivative lawsuits likely to be legalized
Ability to grow via financial leveraging	Deregulation	Securing capital will become more difficult for chaebol Debt-to-equity ratio needs to conform to international standards	▲ 1998 No new cross-guarantees	2000 ▲ Cross-guarantees to be phased out
Strong coordination via chairman's office	Financial and political pressure	Dissolution of group chairman's office may lead to vacuum of control and coordination	▲ 1998 At least one outside board member ▲ 1998 Group chairman's office dissolved; each legal entity required to form its own board ▲ 1999 At least 25% of board to be outsiders	

Source: Yuji Akaba, Florain Budde and Jungkiu Choi, "Restructuring South Korea's Chaebol", *The McKinsey Quarterly* 1998, number 4

Table A.3.2: Ownership Structure of 10 Largest Banks in South Korea
(end of 1998)

	Market Value (\$bil.) ¹	Government Share (%)	Other Shareholders Holding over 1%		
			Number	Combined Share (%)	Major Shareholders
Hanvit	8.2	94.8 (KDIC) ²	1	2.3	Own holdings (2.3)
Chohung	3.5	0 (pending)	8	19.8	(Existing shares to be lowered after Gov't recapitalization)
Korea First	0.9	93.8 (Gov't + KDIC)	0	0	-
Seoul	0.9	93.8 (Gov't + KDIC)	0	0	-
Kookmin	3.4	8.2	11	28.1	Employee share plan (7.4), Bank of N.Y. (DR, 5.0), Hyundai (2.6)
Shinhan	2.4	0	7	11.6	-
Korea Housing	2.0	16.4	5	20.1	Bank of N.Y.(DR, 9.9), Samsung (4.5)
Korea Exchange	1.9	33.6 (Bank of Korea)	3	34.6	Commerzbank AG (32.4)
Koram	1.1	0	13	68.4	BOA, Daewoo, and Samsung (16.8 each)
Hana	1.1	0	16	55.7	IFC (6.2)

Notes: 1. Market values are as of April 12, 1999
2. KDIC: Korean Deposit Insurance Corporation

Source: Sang-Woo Nam, "Korea's Economic Crisis and Corporate Governance", KDI working paper (1999)

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