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Corporate Governance in Asia: A Survey*

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ABSTRACT

Corporate governance has received much attention in recent years, partly due to the Asian financial crisis. We review the literature on corporate governance issues in Asia to develop region-specific and general lessons. Much attention has been given to poor corporate sector performance, but most studies do not suggest that Asian firms were badly run. The literature does confirm the limited protection of minority rights in Asia, allowing controlling shareholders to expropriate minority shareholders. Agency problems have been exacerbated by low corporate transparency, associated with rent-seeking and relationship-based transactions, extensive group structures and diversification, and risky financial structures. The controlling shareholder bears some of agency costs in the form of share price discounts and expenditures on monitoring, bonding and reputation building. The Asian financial crisis further showed that conventional and alternative corporate governance mechanisms can have limited effectiveness in systems with weak institutions and poor property rights. Overall, the understanding of the determinants of firm organizational structures, corporate governance practices and outcomes remains limited, however.

I. INTRODUCTION

Corporate governance has received much attention in recent years. Comparative corporate governance research took off following the works of La Porta *et al.* (1997, 1998; hereafter LLSV). LLSV emphasized the importance of law and legal enforcement on the governance of firms, the development of markets and economic growth. Their ideas are important, although not novel. Coase (1937, 1960), Alchian (1965), Demsetz (1964), Cheung (1970, 1983), North (1981, 1990) and the subsequent literature have long stressed the interaction between property rights and institutional arrangements shaping economic behaviours. The work of LLSV, however, provided the tools to compare institutional frameworks across countries and study the effects in a number of dimensions, including how a

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country's legal framework affects firms' external financing and investment. In a cross-country study, Claessens and Laeven (forthcoming), for example, report that in weaker legal environments firms not only obtain less financing, but also invest less in intangible assets. The investment and financing patterns in turn affect the economic growth of a country. The increasing volume of research on corporate governance is also due to the financial crisis in Asia in 1997, which was partly blamed on corporate governance issues and led to urgent analysis to help to guide corporate governance reforms.

In this paper we review the growing literature on corporate governance issues in Asia. We survey papers on Asia only, but refer to other work when it helps to phrase the issue in a broader context. For general surveys of corporate governance we refer to Shleifer and Vishny (1997), the more recent review of Denis and McConnell (2002) and, for a general review of emerging markets' corporate finance and governance issues, Bekaert and Harvey (forthcoming). Although we refer to corporate governance in Japan, we exclude it from our review, as its corporate governance issues are extensively discussed elsewhere and its institutional features are somewhat different from those in the rest of Asia.[1] We attempt to cover China, for which corporate governance research is just beginning to emerge.

Asia is a very diverse region in terms of levels of economic development and institutional regimes. Income per capita varies from about $1000 in India and Indonesia to more than $30,000 in Hong Kong and Singapore. There are commonalities across the economies, however, most importantly the prevalence of family ownership and relationship-based transactions (Rajan and Zingales 1998). This nexus serves as the institutional structure of most analyses and determines the overall theme of our survey. The corporate governance work on Asia shows that the combination of ownership structure and property rights system (law and enforcement) fundamentally delineates the incentive, policy and performance of managers and their firms. While Asia has some specific corporate governance issues, there are many corporate governance issues in Asia generic to other countries, most importantly the role of family ownership concentration and the degree of minority rights protection. The research surveyed may thus have valuable lessons for other countries.

The main findings of our survey can be grouped around a few themes. Agency problems, arising from certain ownership structures, especially large deviations between control and cash flow rights, are anticipated and priced by investors. Conventional corporate governance mechanisms (takeovers and boards of directors) are not strong enough to relieve the agency problems in Asia. Firms do employ other mechanisms to mitigate their agency problems

1 See Hoshi and Kashyap (2001) for a comprehensive historical description of the corporate financing and governance systems in Japan. Unlike in other Asian firms, which are typically family controlled, the dominant ultimate owners of Japanese firms are institutions, typically the main banks of industrial groups. See Aoki and Patrick (1994) for discussions on the Japanese main bank system. For a more recent and alternative view on the governance roles of the Japanese main bank system, see Hanazaki and Horiuchi (2000, 2001).

(such as employing reputable auditors), but even these have only limited effectiveness. The overall low transparency of Asian corporations relates to these agency problems, with the prevalence of connection-based transactions increasing desires among all owners and investors to protect rents, with rents often arising from government actions, including a large safety net provided to the financial sector. Resulting forms of crony capitalism, i.e. combinations of weak corporate governance and government interference, not only lead to poor performance and risky financing patterns, but also are conducive to macroeconomic crises. Another lesson is that group and diversification structures are associated with agency problems that may more than offset any beneficial effects from transactions in internal markets and learning by doing within the same organization.

While work on Asia has thus clarified some corporate governance issues, many important issues are still unknown. These issues include: (a) the causes of specific ownership structures and the relationships of ownership structures with countries' institutional environments and, vice versa, the effects of ownership structures on institutional environments; (b) how ownership structures influence not only firm performance and valuation, but also other corporate policies, such as investment patterns and financing structures; (c) alternative governance mechanisms in enhancing governance, such as the roles of reputation, second block holders, (foreign) institutional investors and other voluntary mechanisms; (d) family firm internal governance issues, including management, compensation and family succession; and (e) the interaction between the quality of public governance and corporate governance. Most of the challenges of addressing these issues arise because of data availability problems. Resolving the data problems calls for systematic data collection by researchers and corporate governance research centres in this region.

The remaining structure of the paper is as follows. Section II reviews the ownership structures of Asian corporations, the principal agent problems associated with these ownership structures and the empirical evidence regarding effects of ownership structures on firm valuation and performance. Section III reviews the use of traditional and alternative corporate governance mechanisms by Asian corporations. Section IV reviews corporate governance issues somewhat specific to Asia, namely the role of group affiliation and diversification, the impact of transparency and the role of banks and institutional investors. Section V reviews the literature on the interaction between countries' institutional frameworks and corporate governance issues. Section VI concludes and lays out a few future research areas.

II. OWNERSHIP AND INCENTIVES

We begin with an overview of the ownership structures of firms in Asia, followed by a discussion of the causes of the ownership structures. We then discuss how the ownership structures delineate the incentives of managers and owners of the firms, how they affect corporate policies and the roles of ownership structures in affecting the economic performance and valuation of firms.

A. Ownership characteristics of Asian corporations

Unlike in companies in the USA and UK, whose shares are diffusely held, in a typical Asian corporation one or several members of a family tightly hold shares. The company is often affiliated with a business group also controlled by the same family, with the group consisting of several to numerous public and private companies. The family achieves effective control of the companies in the group by means of stock pyramids and cross-shareholdings, which can be quite complicated in structure. Moreover, voting rights possessed by the family are frequently higher than the family's cash flow rights on the firm. Claessens *et al.* (2000b) report these ownership characteristics in detail for a large sample (2980) of listed companies in nine Asian economies. The concentrated family ownership is further confirmed in several single-economy studies, including Joh (forthcoming) on South Korea, Yeh *et al.* (2001) on Taiwan and Wiwattanakantang (forthcoming) on Thailand.

Although high ownership concentration is common among Asian corporations, the extensiveness of the cross-shareholding or pyramid structures varies across Asian economies. Although it is quite popular in Korea and Taiwan according to the cited studies, in Thailand almost 80% of the controlling shareholders do not employ cross-shareholding or pyramid structures. In addition to family, the state controls a significant number of listed companies in several economies, such as in Singapore and predominately in China. Unlike in Japan, control by financial institutions is less common in developing Asia. Individual or institutional investors typically only hold a minority portion of corporate shares.

B. Causes of the ownership concentration

Why is corporate ownership so highly concentrated in Asia? Why does family ownership dominate other form of ownership? How have ownership structures evolved over time? What can we say about the future of family ownership? Most of these questions have not been adequately addressed empirically in general or for Asia specifically. The body of property rights literature to date emphasizes the roles of customs, social norms, and law and legal systems in shaping the structure of property rights and governance systems. More specifically, the literature points to the balance between public and private enforcement of property rights as affecting the degree of concentrated ownership.[2]

The argument is as follows. Both individual owners and the state can enforce property rights. In economies where the state does not effectively enforce property rights, enforcement by individual owners will be most important. The structure of share ownership itself will then affect the degree to which corporate contracts can and will be enforced because it affects owners' abilities and

2 See Eggertsson (1990) for an excellent survey of the literature.

incentives to enforce their rights. One prediction from this framework is that more concentrated ownership will be observed in economies where property rights are not well enforced by the state. Without relying on the state, controlling owners obtain the power (through high voting rights) and the incentives (through high cash flow rights) to negotiate and enforce corporate contracts with various stakeholders, including minority shareholders, managers, labourers, material suppliers, customers, debt holders and governments. All parties involved in the corporation prefer this outcome, as they share, although to different degrees, in the benefits of this concentrated ownership through better firm performance.

Using this framework, Shleifer and Vishny (1997) suggest that the benefits from concentrated ownership are relatively larger in countries that are generally less developed, where property rights are not well defined and/or not well protected by judicial systems. La Porta *et al*. (1999) confirm this proposition empirically, showing that the ownership stakes of the top three shareholders of the largest listed corporations in a broad sample of countries around the world are associated with weak legal and institutional environments.

The weak state enforcement of property rights is the most probable cause of the concentrated ownership of Asian corporations as well, as they often confront weak legal systems, poor law enforcement and corruption.[3] Likewise, the weak property right systems in Asia may also explain why family-run business groups have been the dominant organizational forms. Family ownership and groups are institutional arrangements that facilitate transactions: the transaction costs among family members and closely affiliated corporations face a lower degree of information asymmetry and fewer hold-up problems, which may otherwise prevail in transactions among unaffiliated parties. Another related reason for the prevalence of groups in Asia may be poorly developed external markets – financial, managerial and other factor markets – which tends to favour internal markets for the allocation of resources.

C. Incentive effects of concentrated ownership

The nature of a corporation's ownership structure will affect the nature of the agency problems between managers and outside shareholders, and among shareholders. When ownership is diffuse, as is typical for US and UK corporations, agency problems will stem from the conflicts of interest between outside shareholders and managers who own an insignificant amount of equity in the firm (Jensen and Meckling 1976). On the other hand, when ownership is concentrated to the degree that one owner has effective control of the firm, as is

3 There might of course also be reverse relationships, i.e. ownership structures may affect the willingness of the state to enforce contracts and affect the degree of corruption in the country. This reverse relationship arises more from the ownership structure of the whole corporate sector, e.g. how many families control the overall corporate sector, than from the ownership structure of a typical firm. In practice, ownership concentration at the individual firm level is likely correlated with ownership concentration at the country level.

typically the case in Asia, the nature of the agency problem shifts away from manager–shareholder conflicts to conflicts between the controlling owner (who is often also the manager) and minority shareholders.

i. Entrenchment effect

Gaining effective control of a corporation enables the controlling owner to determine not just how the company is run, but also how profits are being shared among shareholders. Although minority shareholders are entitled to the cash flow rights corresponding to their share of equity ownership, they face the uncertainty that an entrenched controlling owner may opportunistically deprive them of their rights. The entrenchment problem created by the controlling owner is similar to the managerial entrenchment problem discussed by Morck *et al.* (1988). Higher managerial ownership may entrench managers, as they are increasingly less subject to governance by boards of directors and to discipline by the market for corporate control. Separation between ownership rights and control rights can exacerbate the entrenchment problems raised by concentrated ownership. To consolidate control, stock pyramids or cross-shareholdings can be used, which lower the cash-flow investment needed. A controlling owner in this situation could extract wealth from the firm, receive the entire benefit but only bear a fraction of the cost through a lower valuation of his cash-flow ownership.

ii. Alignment effect

If a controlling owner also increases its ownership stake, or even goes private, the entrenchment problem is mitigated. Once the controlling owner obtains effective control of the firm, any increase in voting rights does not further entrench the controlling owner. Higher cash flow ownership, however, means that it will cost the controlling shareholder more to divert the firm's cash flows for private gain. High cash-flow ownership can also serve as a credible commitment that the controlling owner will not expropriate minority shareholders (Gomes 2000). The commitment is credible because minority shareholders know that if the controlling owner unexpectedly extracts more private benefits, they will discount the stock price accordingly and the majority owner's share value will be reduced as well. In equilibrium, the majority shareholder that holds a large ownership stake will see a higher stock price of the company. Thus, increasing a controlling owner's cash-flow rights improves the alignment of interests between the controlling owner and the minority shareholders and reduces the effects of entrenchment.

iii. Empirical evidence

Theory thus predicts firm value to be increasing in cash-flow rights, although at a diminishing rate, and to be decreasing in the difference between voting and cash-flow rights once controlling owners achieve effective control. Morck *et al.* (1988) and McConnell and Servaes (1990) document non-linear relations for US firms that are consistent with the predicted effects. However, this approach is subject to endogeneity problems: ownership and performance are both determined by other factors, and their relation could thus be spurious. Indeed, Demsetz and Lehn (1985) fail to find any relation between ownership and performance and argue that ownership structure is firm-specific and optimally determined by other factors. Another issue is that it is difficult to disentangle the alignment and entrenchment effects when ownership and control cannot be separately measured.

The literature on Asia and other emerging markets has also examined the relationship between ownership and performance of firms and made inferences on the incentive effects of ownership concentration. Claessens *et al.* (2002a) overcome the measurement (but not the endogeneity) issue in their study of firms in eight Asian countries, as they measure ownership (cash flow rights) and control (voting rights) of firms separately. They report that firm value is higher when the largest owner's equity stake is larger, but lower when the wedge between the largest owner's control and equity stake is larger. The former is consistent with the incentive alignment effect, while the latter is consistent with the entrenchment effect. The significant associations between ownership structure and firm value indicate that equity investors are aware of the potential agency issues and discount equity prices accordingly.

Lins (forthcoming) examines ownership and valuation of 1433 firms in 18 emerging markets half of which are in Asia. Similarly to Claessens *et al.* (2002a), he finds firm value to be lower when the controlling management group's control rights exceed cash flow rights. Lins also finds that large non-management control rights blockholdings are positively related to firm value. Both of these effects are significantly more pronounced in countries with low shareholder protection. One interpretation of these results is that, in emerging markets, large non-management blockholders can act as a partial substitute for missing institutional governance mechanisms.

Country-specific studies on the relations between ownership and performance generally find consistent evidence. Joh (forthcoming) examines ownership structures and accounting performance for a very large sample (5800) of publicly traded and private firms in Korea prior to the financial crisis. She finds that accounting performance is positively related to ownership concentration and negatively related to the wedge between control and ownership. Interestingly, the negative relationships between ownership wedge and profits are stronger in bad years measured by low GNP growth rates, indicating that agency problems are more severe when economic conditions are weak. Moreover, profits are negatively related to investment in affiliated companies (more so for listed companies) but positively related to investment in unaffiliated companies. Chang (forthcoming) also reports a negative relation between ownership wedge and performance for about 400 Korean chaebol (group) affiliated firms. However, his simultaneous regression method shows that performance explains ownership, but not vice versa. He argues that controlling owners use inside information to acquire equity stakes in more profitable or higher growth affiliated firms and transfer profits to other affiliates through internal transactions.

Yeh *et al*. (2001) report that family-controlled firms with high levels of control have lower financial performance than family-controlled firms with low level of control and firms that are widely held. Moreover, they find that firm value is higher when controlling owners hold less than a majority of a firm's board seats. Wiwattanakantang (2001) reports for Thai firms that the presence of controlling shareholders is associated with higher accounting performance. Moreover, family-controlled firms display higher performance. She argues that the positive performance associated with family ownership is in part due to low agency problems of Thai firms, because they typically do not adopt pyramidal ownership structures.[4] However, she finds that performance is lower when controlling owners are also in top management. Such a relationship is strongest when controlling owners do not possess a majority ownership stake of their firms. Kim *et al*. (forthcoming) report that the accounting performance of Thai firms declines after they go public, and that the magnitude of the decrease in performance is much greater in Thailand than in the USA. They document a curvilinear relationship between managerial ownership (excluding indirect shareholdings) and post-IPO change in performance that is consistent with the entrenchment and the alignment effects.

In addition to the ownership-performance studies, there is evidence that stock performance is related to the quality of corporate governance. Black *et al*. (2002) survey Korean corporations in 2001 to create an index of the quality of firm corporate governance, similar to the approach used by Gompers *et al*. (2001) for US firms, and by Klapper and Love (2001) and Durnev and Kim (2002) for firms from a cross-section of countries. Black *et al*. show that an increase of one standard deviation in the index increases the level of buy-and-hold return of that firm's share by about 5% for the holding period of the year 2001.

iv. The state as the controlling owner: the case of China

The issue of ownership and firm value is more complicated when the state is the controlling owner. This is for several reasons. First, the state is not the ultimate owner but the agent of the ultimate owners – the citizens. Whether more cash-flow ownership provides the state with more incentive for value maximization of its control stake is unclear, because the incentives of the state can deviate from those of the owners, because of political economy, corruption etc. Moreover, the state as owner faces many conflicts of interest, as it also regulates and enforces laws, regulates and often controls the banking system and more generally is concerned about other factors, such as employment. Second, there can be different types of governmental agencies that control the equity stakes of companies. For example, ownership by the central government can have quite different incentives from ownership by local governments. Third, if the state-controlled firms are located in socialist countries, such as China, it becomes difficult to interpret any relations between ownership and performance without

4 Consistently, Claessens *et al*. (2000b) report little separation between cash flow and voting rights of the ultimate owners of Thai firms.

taking into account other institutional structures that are quite different from those in capitalist countries.

State-controlled firms represent the great majority of publicly traded companies in China. Research on corporate governance issues of state-controlled firms in China is at its infant stage. Several papers report that firm accounting performance is negatively related to the level of state ownership (Xu and Wang 1999; Qi *et al.* 2000; Su 2000). Based on over 600 state-owned enterprises (SOEs) that went public during 1994 to 1998, Sun and Tong (forthcoming) find evidence that state ownership is negatively related to accounting performance upon and after the initial public offerings of the SOEs. Tian (2001) reports that the relation is non-linear: increasing government ownership is associated with worsening performance (measured by market-to-book assets and return on assets) when the government ownership is small, but with improving performance when government ownership is large.

Besides these cross-sectional studies, Berkman *et al.* (2002) provide an event study that examines stock performance for about 80 share transfers from government agencies to SOEs. They find that the transfers result in reduced gaps between cash flow and control rights of the SOEs. They report significant positive abnormal stock returns during the period leading up to the announcement. Moreover, the abnormal returns are significantly higher when the new SOE blockholder becomes the largest shareholder, when the new SOE blockholder has private shareholders who participate in the annual shareholders' meetings and when the government agency does not retain a substantial ownership stake. This suggests that state ownership is perceived to worsen firm performance. They also report significant top-manager turnovers within a year after the events, indicating that the share transfers were indeed significant control events.

III. CORPORATE GOVERNANCE MECHANISMS IN ASIA

The high ownership concentration of Asian corporations raises the risk of expropriation of minority rights, as reflected in firm valuations. In this section we discuss corporate governance mechanisms in place in Asia that aim to protect the interest of minority shareholders in the face of this risk. Minority shareholders may exercise direct monitoring (Shleifer and Vishny 1986). Further, theory suggests that firms may voluntarily employ monitoring and bonding mechanisms to mitigate outside investors' concern about being expropriated (Jensen and Meckling 1976). Firms have incentives to adopt governance constraints voluntarily, for doing so mitigates the expropriation risk borne by minority shareholders and thus reduces their share-price discounts and increases their access to external financing.

A. Monitoring by minority shareholders

Minority shareholders may directly monitor the firm when they hold significant equity stakes on a long-term basis. However, even if they attempt to monitor, it is unclear whether they are effective in challenging the usually powerful controlling owners. Chung and Kim (1999) find that voting premiums, the premiums attached to voting stock, in the Korean equity market amount to some 10% of the value of equity. Importantly, the premium is positively related to the block size of shares held by minority shareholders. Lins (forthcoming) provides evidence that large non-management controlled blockholdings are positively related to firm value in his sample of 18 emerging markets, including Asian countries. These results from the two studies may indicate that minority shareholders can influence controlling owners' decisions when they collectively hold a significant block of equity.

One mechanism for creating incentives for improving corporate governance is that, with growing demand for capital, corporations will have to be more responsible to (institutional) investors' demands. Asia witnessed large and increasing capital inflow in the 1990s. Much involved investments by institutional investors. The question arises whether these investments indeed led to an improvement of corporate governance practices, and if so, through what mechanisms.

One possible corporate governance role of institutional investors in Asia, and emerging markets in general, is certification. When ownership is concentrated and a firm is subject to agency conflict between controlling owners and minority shareholders, the firm may invite institutional investors' equity participation so that it can borrow their reputation to enhance its credibility to minority shareholders. Institutional investing, however, may or may not lead to subsequent improvement of corporate governance or be accompanied with active monitoring. As in any situation with rent seeking and relationship-based transactions, institutional and other minority investors may prefer to let controlling owners continue to protect their rents and not force them to disclose all information, as otherwise their own values are negatively affected.

Empirical evidence on the roles of institutional investors in Asia is sparse.[5] Sarkar and Sarkar (2000) examine the roles of large shareholders in corporate performance in India. They find no evidence that institutional investors, typically mutual funds, are active in governance. However, they find significant roles for other ownership classes. Performance is positively related to ownership by directors (after a certain level of holding), foreigners and lending institutions. Qi *et al.* (2000) report for a sample of listed companies in China that performance is positively related to the proportion of shares held by legal persons (institutions or corporate investors) but negatively related to that held by the state. They argue

5 See Gillan and Stark (forthcoming) for a survey of activism of institutional investors. Their reported evidence is concentrated in developed markets. There exists little evidence for emerging markets.

that legal persons are better monitors of management than the state. This result is also reported in Sun and Tong (forthcoming). Chhibber and Majumdar (1999) examine the relations between foreign ownership of firms and performance in India after 1991, when the government lifted foreign ownership restrictions, allowing foreign majority ownership of Indian enterprises. They find that only when foreign owners' control exceeds 51% do firms display superior accounting performance. Their evidence confirms the importance of control in weak property rights environments and suggests that foreign minority owners may be ineffective in monitoring controlling owners in India.

Although the demand for capital in emerging markets has been high and increasing in the past two decades, corporate governance practices of listed companies in these markets seem little changed. Could it be that (foreign) institutional investors have been cherry picking good performers and cared little about improving firm governance? Fan and Wong (2002a) argue that good performing firms may be the most opaque and poorly governed, because they derive profits from rent seeking. Hence, these firms do not want to be more transparent, as that would only attract financial markets, social and other sanctions. Shareholders, including institutional investors, thus prefer poor firm governance as well. Institutional investors and their financial analysts may also face conflicts of interest, as they have other business dealings with the firm, making them reluctant to tackle corporate governance problems. Foreign investors may further be handicapped in being less informed about the companies in these markets. Given little firm-specific information, they may end up investing on the basis of country or industry criteria rather than company's specific characteristics. Given the controversy, future research could address the roles of institutional investors in Asia and more generally in emerging markets.

B. Takeovers and internal governance

Compared with the USA and UK, conventional governance mechanisms such as boards of directors and takeovers are weak in most other developed countries and emerging markets. This is also true in Asia, where hostile and disciplinary takeovers are extremely rare. Dyke and Zingales (2002) report that block premiums paid in actual transactions are relatively high in Asia. Consistent with this, Nenova (forthcoming) finds that control premiums are larger in countries with weaker shareholder protection. On the contrary, some mergers in Asia may occur because of agency problems, not to resolve or mitigate agency issues. Bae *et al*. (2002a) report evidence that supports the hypothesis that acquisitions by Korean business groups (chaebols) are used as a way for controlling shareholders to increase their own wealth at the expense of minority shareholders through tunneling. When a chaebol affiliated firm makes an acquisition, its stock price on average falls, but the controlling shareholder of that firm on average benefits because the acquisition enhances the value of other firms in the group, evidence consistent with the tunnelling hypothesis.

Internal governance is typically equally weak as a disciplining device on controlling shareholders. Boards of directors are typically dominated by insiders and hardly have any outsider presence. Yeh (2002) reports that boards of Taiwan corporations are populated with insiders and controlling owners are more likely to insert family members on boards when their voting rights substantially exceed cash flow rights of the firms. As controlling owners' cash-flow rights increases, however, the likelihood of family members on boards decreases, suggesting that the insider dominant board structure is attributable to agency problems from separation between control and cash flow rights.

In China, politicians and state-controlling owners occupy most board seats. Chen *et al*. (2002) present data on the boards of directors of 621 companies that went public from 1993 to 2000 in China. They report that almost 50% of the directors are appointed by state controlling owners, and another 30% are affiliated with various layers of governmental agencies. There are few professionals (lawyers, accountants or finance experts) on Chinese boards and almost no representatives of minority shareholders. Moreover, Chen *et al*. find a negative relation between politician presence and professionalism. The presence of politicians, especially those affiliated with local governments, is associated with fewer directors possessing business experience or expertise in law, accounting or finance, fewer academician directors and fewer directors from non-local administrative regions. They argue that local politicians use their administrative power to influence both the markets and the firms under their jurisdictions. In the resulting relationship-based markets, firms benefit from politicians' services in creating economic rents and enforcing transactions. In such markets, professionalism is in low demand, also because professionalism may reveal information that can jeopardize the firms' rent-seeking activities.

Given that the conventional governance mechanisms are weak, are managers of Asian firms disciplined at all when they perform their duties poorly? Gibson (forthcoming) examines chief executive turnover in eight emerging markets, including five Asian markets: India, South Korea, Malaysia, Taiwan and Thailand. He finds that CEOs are more likely to lose their jobs when firm performance is poorer. The relationship is stronger when performance is measured by accounting-based measures than when measured by stock-based measures. The relationship is weaker when a firm's large owner is another domestic firm, i.e. when the firm is part of a business group. Overall, his evidence suggests that corporate governance in these markets is not entirely ineffective, for that would predict a lack of relationship between turnover and performance, but that changes in stock market valuation are less effective in triggering turnovers. Campbell and Keys (2002) examine top executive turnover and firm performance in South Korea during 1993 to 1999. Consistent with the Gibson study, they find that although turnover is negatively related to performance in their overall sample, it is insensitive to performance for chaebol affiliated firms. Furthermore, executive turnover is insensitive to performance for firms with bank ties, inconsistent with banks acting as monitor of managers.

C. Alternative governance mechanisms

Management control and a separation of management ownership and control are associated with lower firm value in emerging markets. Weak minority owners, inactive boards and limited takeover markets are unlikely to challenge the causes: controlling owners' self-interested activities. A question thus arises as to whether alternative firm-level governance mechanisms exist that might improve the situation for minority shareholders. These governance mechanisms may play more important roles in emerging markets than in more developed markets, where substitutive mechanisms are more abundant. In this sub-section we discuss several monitoring and bonding mechanisms that Asian firms may employ to mitigate their agency problems in order to attract external financing and achieve reasonable stock valuation.

i. External auditors

Controlling owners could mitigate minority shareholders' concerns of being expropriated by employing high quality external auditors to endorse financial statements. Fan and Wong (2002b) use a broad sample of firms from eight Asian economies to document that firms are more likely to employ Big Five auditors when they are subject to agency problems imbedded in their ownership structure. Among Asian firms subject to agency problems, Big Five auditors charge a higher fee and set a lower audit modification threshold, while other auditors do not. Taken together, their evidence suggests that Big Five auditors in Asia do have a corporate governance role.

Kim *et al*. (2002) examine a specific case: designated auditors in Korea to mitigate accounting manipulations. They report that the level of discretionary accruals, accounting artefacts that can be used to manipulate earnings, is positively related to the divergence between management control rights and ownership rights, and the affiliation with a chaebol, suggesting a transparency issue associated with these organizational structures. Since 1990, Korea's regulatory authorities have designated external auditors for target firms that are deemed to have a high possibility of accounting manipulation. They find that auditor designation constrains the ability for income-increasing earnings management associated with the control–ownership divergence and the chaebol affiliation. In this case, however, the governance role of the designated auditors was imposed by the regulatory authorities rather than voluntarily selected by managers. As such, it has not been market forces that led firms to choose bonding mechanisms and to improve corporate governance.

The merit of using regulatory means in place of firms' voluntarily governance choices remains debatable, however. DeFond *et al*. (1999) find that as the Chinese government made efforts to improve auditor independence, domestic firms listed in China took flight from high quality to low quality auditors. They document that, in 1996, the percentage of modified opinions increased by ninefold after the promulgation of new auditing standards to improve audit quality. However, as audit firms toughened their standards, those that provided high quality monitoring services lost market share to low-quality audit firms. In this case, weak government enforcement of accounting practices of listed companies clearly weakens the effectiveness of employing quality auditors as a corporate governance mechanism.

ii. Equity analysts

Controlling managers have incentives to hide information from the investing public in order to facilitate consumption of private control benefits. Research analysts have the potential to increase the scrutiny of controlling management groups endowed with private benefits of control, which should improve firm values. Can financial analysts indeed play a transparency-enhancing role in emerging markets? A negative view would be that analysts could not make much contribution to information discovery for opaque firms. They may not have the ability, because it is very costly, nor the incentive, because of the free-rider problem in cases of weak legal protection of information property rights (Morck *et al*. 2000). Furthermore, in a weak property rights environment, inside investors with private information, including analysts, may even trade on information before it is disclosed to the public. On the other hand, a positive view would be that analysts engage in information discovery and their individual efforts collectively improve corporate transparency. This could be for two reasons. Investors may have more demand for information about opaque firms if information acquisition has large profit potential. And, if a firm's demand for external financing is large, it may be willing to provide information to analysts whose certification improves the credibility of the released information.

We are unaware of research on the roles of financial analysts in Asia specifically. However, international evidence suggests that analysts' activity is indeed constrained by institutional factors and quality of disclosure. Chang *et al*. (2000) examine analysts' activity in 47 countries. They identify a set of institutional factors that influence analysts' activities and forecasting performance. These factors include a country's legal origin, the quality of accounting disclosures, the size of its stock market and the average size of its firms. They also report that earnings of business group affiliated firms are harder to forecast, even though they are more likely to be followed by analysts. However, this relation is weaker after country institutional factors are considered. Lang *et al*. (2002) examine analyst activity in 27 economies and find that analysts are less likely to follow opaque firms, including those controlled by families. However, analysts' following of firms subject to agency problems is associated with higher firm valuation, consistent with analysts' certification role. Furthermore, these benefits of analyst coverage are significantly more pronounced for firms from countries with poor shareholder rights and from countries with non-English origin legal systems.

iii. Dividend policy

A manager can pay shareholders dividends to alleviate their concern about agency problems (Easterbrook 1984). Faccio *et al*. (2001) examine the dividend patterns of listed companies in Asia and Western Europe. They report that dividends are related to the degree to which the largest owner's control stake exceeds its cash-flow ownership – a proxy for agency problems. However, the relation depends on the 'tightness' of group affiliation. Dividend rate is positively related to separation of ownership and control when companies are 'tightly' affiliated with a business group. But a negative relation is found for 'loosely' affiliated firms, i.e. more independent firms. They argue that investors are more aware of tightly affiliated firms' agency problems than those of loosely affiliated firms. They also report that loosely affiliated firms are more prevalent in Asia than in Western Europe, indicating more agency issues undetected by investors in Asia. Overall, the argument that dividends alleviate agency problems is not overwhelmingly supported by their data.

iv. Foreign listings

Another potential firm-level governance mechanism that has received considerable research attention is the choice for a firm to access foreign markets, either directly by issuing a cross-listed security, or indirectly, such as through a Depositary Receipt (ADR or GDR). For firms from emerging markets and those with poor external governance environments, this allows the firms to 'opt in' to a better external governance regime and to commit to a higher level of disclosure, both of which should increase shareholder value. Studies do not exist specifically to Asia, but on broader samples of emerging markets. Confirming this line of reasoning, Miller (1999) finds that emerging market ADR issuers have larger announcement period abnormal returns than issuers from developed markets. Doidge *et al*. (forthcoming) present evidence that non-US firms with US exchange-listed ADRs have higher Tobin's *Q* values and that this effect is most pronounced for firms from countries with poorer investor rights. Lang *et al*. (forthcoming) find that firms from emerging markets or non-English legal origin countries that have exchange-listed ADRs show a greater improvement in their information environment (as measured by stock market analyst coverage and analyst forecast accuracy) than do ADR firms from developed markets with English legal origins. Lang *et al*. also show that improvements in the information environment for ADR firms are positively related to firm valuations.

Lins *et al*. (2002) directly test whether improved access to capital is an important motivation for emerging market firms to issue an ADR. They find that, following a US listing, the sensitivity of investment to free cash flow decreases significantly for firms from emerging capital markets, but does not change for developed market firms. Further, emerging market firms explicitly mention a need for capital in their filing documentation and annual reports more frequently than developed market firms do, whereas, in the post-ADR period, emerging market firms tout their liquidity rather than a need for capital access. Finally, Lins *et al*. find that the increase in access of external capital markets following a US listing is more pronounced for firms from emerging markets. Overall, these findings suggest that greater access to external capital markets is an important benefit of a US stock market listing, especially for emerging market firms.

v. General studies
A few papers have investigated whether voluntary corporate governance mechanisms can complement forms of regulatory-based corporate governance. These studies cover not only Asia, but also other emerging markets. Klapper and Love (2001) and Durnev and Kim (2002) interact indexes on firm-specific corporate governance measures with countries' corporate governance indexes to analyse the effects on firm valuation and firm performance. They find that firm-level corporate governance matters more in countries with weaker investor protection, implying that firms do adapt to poor legal environment to achieve more efficient corporate governance practices. They also find, however, that voluntary firm mechanisms can only partly compensate for ineffective laws and enforcement.

IV. ASIA-SPECIFIC CORPORATE GOVERNANCE ISSUES

There are some corporate governance issues specific to Asia or at least more important in Asia. These include business group affiliation, corporate diversification, corporate disclosure and transparency, the causes and effects of the Asian financial crisis and the role of banks and other financial institutions.

A. Group affiliation

Business groups are popular in Asia. Claessens *et al.* (2002b) report that almost 70% of listed companies in their sample of nine East Asian economies are group affiliated. A group can be described as a corporate organization where a number of firms are linked through stock pyramids and cross-ownership. In Asia, as in most other emerging markets, families typically control groups.[6]

Relative to independent firms, group structures are associated with greater use of internal factor markets, including financial markets. Through their internal financial markets, groups may allocate capital among firms within the group, which can lead to economic benefits, especially when external financing is scarce and uncertain (Khanna and Palepu 1997). Kim (forthcoming) shows that conglomeration can be an optimal strategy for risk-averse managers to mitigate the probability of liquidation by banks. By following good firms to join a conglomerate or a business group, a bad firm weakens the bank's information set about the low productivity of the firm, and therefore lowers the likelihood of its liquidation. As long as the business group's overall performance is not sufficiently bad, the bank is likely to adopt a full-bailout policy because it has difficulty in telling good from bad firms within the group. Consistent with the view that internal markets relieve financial constraints, Shin and Park (1999) find that

6 This is different from in many developed countries, where groups are often controlled by financial institutions, such as insurance companies in Japan and banks in continental Europe. See Khanna (2000) for a survey of the literature on business groups.

investment by chaebol affiliated firms is less sensitive to firm cash flow than is investment by unaffiliated firms. Chang and Hong (2000) provide evidence that transfers of products and managerial expertise within a Korean chaebol have a positive effect on performance.

Internal markets in combination with the typically complex ownership and control structure of group affiliated firms may, however, lead to greater management and agency problems, resulting in resource misallocation. The value of business groups and the relative size of the benefits and the costs of internal markets in turn may depend on institutional factors that shape the relative costs of using external financial market versus internal markets. For example, Kali (1999) presents a model of business networks, including groups. He argues that in countries with weak legal systems, contract enforcement by networks is a substitute for legal enforcement. Interestingly, he demonstrates that the existence of networks negatively affects the functioning of anonymous markets, as the networks absorb honest individuals, raising the density of dishonest individuals in external markets.

The evidence to date on the benefits and costs of group affiliation in general and in Asia specifically is mixed and far from conclusive. A number of studies examine the relations between group affiliation and performance across firms. Khanna and Palepu (2000), who study the performance of business groups in India, find that accounting and stock market measures of firm performance initially decline with the scope of the group – as measured by the number of industries the group as a whole is involved in – and subsequently increase once group size exceeds a certain level. While affiliates of the most diversified business groups outperform unaffiliated firms, Khanna and Palepu do not find systematic differences in the sensitivity of investment to cash flow for group affiliated firms compared to independent firms, suggesting that the wealth effect from group affiliation is not attributable to internal financial markets.

For other emerging markets results are more mixed. Claessens *et al.* (2000a) document that for group-affiliated firms in East Asia and Chile, market risk is influenced not only by own characteristics – such as size, price/book ratio – but also by group characteristics. In the case of Chile, group affiliation leads to lower market risk, suggesting that group structures are used to diversify risks internally, whereas for group affiliated firms in East Asia this lowering of market risk is not found. Keister (1998) reports that group affiliation in China is associated with better performance and productivity in the late 1980s. Chang and Choi (1988) report that chaebol affiliated firms in South Korea outperform unaffiliated firms. More recent evidence from Korea is more negative on this issue. Ferris *et al.* (forthcoming) document that chaebol affiliated firms are associated with a value loss relative to non-affiliated firms. They identify that the value loss is related to the chaebol firms' risk reduction behaviour, investment in low performance industries and cross-subsidization of weaker member firms in their groups. Similar evidence is also reported in Joh (forthcoming) and Campbell and Keys (2002).

Cross-country studies also produce mixed results. Khanna and Rivkin (1999) examine the relations between group affiliation and accounting profitability in

14 emerging markets, including several in Asia. They do not find consistent relations across these economies. Claessens *et al.* (2002b) examine business groups in nine East Asian economies. They find that more mature, slower growing and financially constrained firms gain in value from group affiliation. They further find that the value gains from group affiliation for these firms are especially large for group affiliated firms with more agency problems, as indicated by the control stake of the largest ultimate owner exceeding his ownership stake. This suggests that there are agency problems associated with groups, which limit any potential beneficial effects of internal markets.

Several other papers also suggest that agency issues are important for determining the gains and losses from group affiliation, specifically agency issues centering on conflicts between controlling and minority shareholders. Bertrand *et al.* (2002) find that groups in India are used by controlling shareholders to 'tunnel' resources away from minority investors. Bae *et al.* (2002a) find similar tunneling activities in acquisitions by Korean chaebols.

There exist few studies that examine the evolution of business groups over time. An exception is Khanna and Palepu (1999), who examine the role of business groups in Chile and India during periods of financial deregulation. Conventional wisdom would predict the economic roles of groups to weaken with market deregulation. On the contrary, they report increase in both group scope and group profitability in both countries. They argue that the increased importance of groups in the deregulated environments is mainly due to the slow development of institutions to support transactions in the markets. That is, transaction costs in these markets increased after deregulation, and hence the relative benefits of creating internal markets through group formation increase. Choi *et al.* (2001) examine the effects of financial liberalization in Indonesia on group affiliated firms relative to independent firms. Again, they find few differential effects of liberalization on stock valuation measures, trading volume and covariation of stock returns. Their evidence does not support the contention that group firms, which are primarily controlled by powerful families in Indonesia, suffered or gained relative to independent firms from liberalization.

B. Diversification

Asian corporations are known for extensive diversification of their businesses. Has this diversification strategy been beneficial? Khanna and Palepu (1997) argue that a 'focused' strategy may not be beneficial in emerging markets. Instead, creating internal markets in developing countries can be beneficial because external markets are often poorly developed and unable to allocate resource efficiently. Fauver *et al.* (forthcoming) provide support for this argument, as they do not find a diversification discount for developing countries, even though such discounts exist in developed countries. They further find that diversification discounts are less in countries with a legal system of non-English origin (German, Scandinavian or French origin), countries where shareholder protection tends to be less. Lins and Servaes (2002) also study the effect of corporate diversification on firm value, but find opposite effects. They use a sample of over 1000 firms from seven emerging markets, many from Asia, to find that diversified firms trade at a discount of approximately 7% compared to single-segment firms. From a corporate governance perspective, Lins and Servaes find a discount only for those firms that are part of industrial groups, and for diversified firms with management ownership concentration between 10 and 30%. Further, the discount is most severe when management control rights substantially exceed their cash flow rights. Their results do not support internal capital market efficiency in economies with severe capital market imperfections.

The internal market view would predict a better performance of diversified firms during periods of financial distress when external markets are turbulent, as firms may still obtain financing from internal markets. Several studies examine the performance of diversified firms during the Asian financial crisis (Mitton 2002; Claessens *et al*. forthcoming a; Lemmon and Lins forthcoming). All these studies find, however, that diversified firms performed poorly relative to focused firms during the crisis, inconsistent with the internal market view, which predicts a better performance of diversified firms during turbulent times. One possible explanation is that corporate diversification creates management and agency problems, whose costs outweigh any benefits of internal markets, in particular during turbulent times (see Lins and Servaes 2002).

Little research on corporate diversification distinguishes the degree of relatedness among diversified firms' segments. Claessens *et al.* (forthcoming b) examine patterns of vertical relatedness and complementarity for a large sample of diversified firms in nine Asian economies between 1991 and 1996. They document that firms in developed economies are more successful than firms in less developed economies in vertically integrating, in terms of both short-term profitability and market valuation. Firms in less developed economies in contrast experience higher short-term profitability, with complementary diversification, but firms in more developed economies are more likely to benefit from such strategies in the long run. This suggests that institutional differences, including the ability of external financial markets to oversee corporate activities and the quality of corporate governance, are important determinants of the gains and costs of related diversification.[7]

7 They also investigate two hypotheses: learning by doing and misallocation of capital. The first hypothesis suggests positive productivity consequences of combining different types of businesses that are related (and less from unrelated business); the second suggests lower productivity from combining businesses, especially when unrelated, as it reflects overexpansion. They find that the two effects vary systematically with the types of business combination. Except for Japanese firms, vertically integrated firms experience poor performance in both the short and the long term. By contrast, firms undertaking complementary diversification generally exhibit positive short- and long-term performance. They argue that, relative to complementary diversification, vertical integration is more complex, involves higher short-term costs of learning by doing and entails a higher probability of capital misallocation adversely affecting long-term productivity.

C. Financial disclosure and transparency

Public corporations in Asia typically have low levels of transparency and disclosure quality, which may be the outcome of poorer corporate governance structures. Fan and Wong (2002a) report that accounting transparency, measured by the relation between reported earnings and stock return, of firms in seven Asian economies is generally low. They argue that the low transparency is related to agency problems and relationship-based transactions. Earnings figures are less informative when controlling owners possess high voting rights and when voting rights substantially exceed cash flow rights. The evidence is consistent with the presence of agency problems: earnings figures lose credibility as investors perceive them to be manipulated by controlling owners; and low earnings informativeness and high ownership concentration reflect controlling owners' desire to protect proprietary information related to rent seeking activities. Bae and Jeong (2002) report similar evidence for Korean firms: earnings informativeness is weaker for firms that are affiliated with business groups or subject to cross-equity ownership. They also document that firms with foreign ownership have more informative earnings.

Closer adherence to international disclosure rules and the adoption of international accounting standards could help to improve corporate transparency. Despite efforts following the Asian financial crisis to impose stricter reporting rules and standards, however, there is a perception that corporate transparency has declined in Asia. While new accounting rules may have increased the quantity of accounting information, investors have still reservations about the quality of reported numbers. Ball *et al.* (forthcoming) argue that a country's accounting standards alone are not sufficient for company financial reporting transparency; incentives for accurate reporting matter more. They examine earnings transparency of listed companies in Hong Kong, Malaysia, Singapore and Thailand, economies that have relatively high accounting standards. Notwithstanding the high standards, they find that the reported earnings generally lack transparency and that adopting International Accounting Standards alone does not ensure high transparency.

Does corporate transparency matter to stock return and trading activity in the market? The answer is yes, based on a study by Bhattacharya *et al.* (forthcoming). They analyse the accounting earnings of a large sample of firms from over 30 countries to find that an increase in a country's overall earnings opacity, measured by earnings aggressiveness, loss avoidance and earnings smoothing, is related to a significant increase in the cost of equity and a decrease in stock trading activity of the country.

D. The Asian financial crisis

Rajan and Zingales (1998) discuss the pros and cons of relationship-based financial systems. They argue that such systems work well when contracts are poorly enforced and capital is scarce. But relationship-based systems can misallocate capital in the face of large capital inflows. Because of lack of price signals and legal protection, investors will keep their contracts short term. Such arrangements can work well for both investors and capital raisers during normal times, but are prone to external shocks. Consistent with their argument, Johnson *et al*. (2000) present country-level evidence that weak legal institutions for corporate governance were key factors in exacerbating the stock market declines during the 1997 financial crisis. They find that in countries with weaker investor protection, net capital inflow was more sensitive to negative events that adversely affect investors' confidence. In such countries, the risk of expropriation increases during bad times, as the expected return of investment is lower, and the country is therefore more likely to witness collapses in currency and stock prices.

Mitton (2002) examines the stock performance of a sample of listed companies from Indonesia, Korea, Malaysia, the Philippines and Thailand. He reports that performance is better in firms with higher accounting disclosure quality (proxied by the use of Big Six auditors) and higher outside ownership concentration. This provides firm-level evidence consistent with the view that corporate governance helps explain firm performance during a financial crisis.

Lemmon and Lins (forthcoming) use a sample of 800 firms in eight Asian emerging markets to study the effect of ownership structure on value during the region's financial crisis. The crisis negatively impacted firms' investment opportunities, raising the incentives of controlling shareholders to expropriate minority investors. Further, because the crisis was for the most part unanticipated, it provides a 'natural experiment' for the study of ownership and shareholder value that is less subject to endogeneity concerns. During the crisis, cumulative stock returns of firms in which managers have high levels of control rights, but have separated their control and cash flow ownership, are 10–20 percentage points lower than those of other firms. The evidence is consistent with the view that ownership structure plays an important role in determining the incentives of insiders to expropriate minority shareholders.

E. Financing structures and the role of banks

Titman *et al*. (2001) examine the financing patterns of firms in six developing economies in Asia. One would expect firms in less developed countries to rely more on internal financing than firms in developed economies do, since external capital markets are less developed. To the contrary, they find that firms in less developed countries use more external than internal funds to finance their investment projects, all else equal. They argue that the heavier reliance on external funds of Asian firms simply reflects the fact that their investment needs far exceed internally generated cash flow, and do not find any specific evidence for institutional-based explanations. Moreover, they found no significant difference in financing sources between group affiliated and independent firms.

Asian companies' financial policies may nevertheless be affected by controlling owners' desire for effective control of their firms in a weak property rights environment. Wiwattanakantang (1999) examine corporate financing policies in Thailand and find that Thai firms' capital structure choices are affected by similar factors to those found to be important in developed economies. Controlling for these factors, however, leverage in Thailand is higher in family owned firms. This evidence is inconsistent with the incentive alignment effect, for that would predict lower leverage for family firms, whose managers typically possess large equity stakes. Instead, the evidence is consistent with the view that leverage is used by family owners as a means of concentrating control (Harris and Raviv 1988; Stulz 1988).

Harvey *et al.* (2001) examine whether debt contracts can alleviate problems with potentially misaligned incentives that result when managers of emerging market firms have control rights in excess of their proportional ownership. They provide evidence that higher debt levels have a dampening effect on the loss in value attributed to these managerial agency problems. When they investigate specific debt issues, they find that internationally syndicated term loans, which arguably provide the highest degree of firm-level monitoring, are the ones that enhance value the most when issued by firms with high levels of expected managerial agency problems.

In addition to family control, relationship banking or affiliating with banks is another pronounced feature of Asian corporate finance. However, whether it is beneficial for firms to be affiliated with banks is debatable. Relationship banking can be beneficial to both lenders and borrowers, because the degree of information asymmetry between the two parties is smaller relative to that under arm's length lending (Diamond 1984). However, relationship banking can lead to misallocation of capital (Bolton and Scharfstein 1996) or fail to relieve borrowers' credit constraints due to lenders' rent extraction (Rajan 1992; Weinstein and Yafeh 1998). Ferri *et al.* (2001) examine small and medium-size enterprises whose external financing probably solely depends on banks, and argue that relationship banking had a positive effect on value during the 1997–8 crisis. They argue that relationship banking reduces the degree of financial constraints, and thus mitigates the probability of bankruptcy, which may be very costly. Other evidence, however, suggests that relationship banking is detrimental to firm value when facing negative shocks. Bae *et al.* (2002b) examine the value of durable bank relationships in Korea during the crisis years 1997 and 1998. They find that negative shocks to banks have a negative effect on both banks and client firms.

Several papers examine bank insolvencies in Asia and their effects on clients' value. Djankov *et al.* (2000) examine 31 announcements of bank insolvencies in 1998 and 1999 in Indonesia, Korea and Thailand. Not surprisingly, bank closures resulting in firms losing credit relationships are associated with drops in firm market values. Nationalizations, preceding recapitalizations and new management, are associated with positive abnormal return of affiliated firms. This evidence suggests that bank relationship (ownership) is important and can lead to value gains in these economies. Claessens *et al.* (forthcoming c) examine firms' decision to file bankruptcy in nine Asian economies. They find that the likelihood of bankruptcy is negatively related to ownership links to family and banks. They argue that information advantages and non-market based resource allocations encourage out-of-court renegotiations and delay the use of formal reorganizations procedures. They also find that filing for bankruptcy is positively related to the quality of countries' judicial system and creditor rights protection. This suggests that bankruptcy, one of the normal corporate governance mechanisms, is not as effective in this region and that family and banking ties substituting for weak courts in some economies may lead to worse outcomes in terms of governance. On a broader cross-country level, Claessens and Klapper (2002) confirm this finding. Dewenter *et al.* (2002) examine how cross-sectional differences in the probability of bankruptcy affect the indirect costs of financial distress. They rely on the Asia financial crisis as the event that precipitates distress, examining how proxies for the probability of bankruptcy (legal environment, size and ownership) affect the relation between leverage and performance for firms in Indonesia, Korea, Malaysia and Thailand. They find that the indirect costs of bankruptcy are larger and more significant in structured bankruptcy environments, i.e. those with better judicial systems and creditor protection, than in weak environments.

Governments in Asia typically play an important role in influencing banks' lending policies, and hence affect borrowing companies' governance and financial structures. Lee *et al.* (2000) examine the capital structure in Korea from 1981 to 1997. They report that the average total debt to total assets ratio during that period was almost 70%, very high compared to most countries. Controlling for conventional factors known to affect capital structure, they find that affiliating with a chaebol is associated with even higher leverage and more use of long-term debt. The causes of the high debt ratio, they argue, are the favourable loan conditions given to chaebols by banks, partly under the direction of the Korean government.

Similar evidence is reported for other Asian economies. Suto (2001) examines the capital structure of Malaysian listed companies before and after the financial crisis of 1997. She reports an increase in debt ratio before the crisis, related to bank dependency, which was encouraged by the government. She argues that the increasing debt financing by banking institutions worked to accelerate excessive corporate investments before the crisis. Pomerleano (1998) examines corporate sector financial structures and performance in seven Asian economies, benchmarking against those in Latin America and developed countries. He reports rapid investment in fixed assets financed by large amounts of debt in Indonesia, Korea and Thailand and associated with poor accounting profitability. He argues that the evidence describes crony capitalism, further supported by governments' implicit guarantees and weak banking supervision.

V. THE ROLES OF INSTITUTIONAL FACTORS

A. Legal environment and equity market

A rapidly growing law and finance literature has established that the legal environment, and more specifically the extent of investor protection, can affect the quality of corporate governance (La Porta *et al.* 2000) and the development of equity markets (Shleifer and Wolfenson 2002). La Porta *et al.* (2002) provide cross-country evidence that corporate stock returns are positively related to the degree of investor protection provided by a country. Johnson *et al.* (2000) report that the Asian financial crisis had a more severe impact on stock markets in countries (not limited to Asia) with weak investor protection. Morck *et al.* (2000) report that stock prices move more together in emerging markets than in developed economies. They suggest that the high co-movement of stock prices reflects weak property rights discouraging informed trading and allowing insider dealings that make firm-specific information less useful.

Using similar approaches, several studies examine the role of legal factors in Asia's equity markets' behaviour. Brockman and Chung (forthcoming) compare the trading patterns of Hong Kong based and China based equities in the Hong Kong equity market. They find that, within a common trading mechanism and currency, Hong Kong based equities display narrower bid–ask spreads and thicker depths than their China based counterparts. They argue that the difference in liquidity measures is attributable to the different degree of investor protection offered to the two classes of securities. Choi *et al.* (2002) examine stock momentum strategy (buying past winners and selling past losers) in eight Asian economies. Among others, they find evidence of momentum in all four of the common law countries in their sample, but do not find any evidence of momentum in the four civil law countries. They conjecture that the absence of momentum in civil law countries is explained by the greater potential to manipulate stock prices in ways that induce negative serial correlation, offsetting the momentum effect. They also report that group affiliated firms exhibit significantly less momentum than independent firms do, perhaps because group affiliated firms are subsidized by the group when doing poorly and taxed when doing well.

B. Public governance and corporate governance

As noted at the outset, the quality of public governance is a crucial determinant of corporate governance practices. In those Asian economies plagued by corruption, rent seeking has often been reported to be an important source of corporate profit. Furthermore, in economies where politicians and entrepreneurs collude to extract or protect monopoly rents, high quality corporate governance practices are unlikely to arise. Quite a few studies report evidence consistent with rent seeking activity. Fisman (2001) conducted an event study on the stock price effects of news announcements regarding the health of then-president Suharto. He finds that political connections were valued by investors, with about a quarter of each firm's value arising from Suharto connections. Johnson and Mitton (forthcoming) examine the impact of the Asian financial crisis in Malaysia on government subsidies to politically favoured firms. They document that the loss in political connections amounted to a 9% loss in stock value during the initial phase of the crisis. With the imposition of capital controls, about 32% of the gain in value of politically connected firms can be attributed to increases in the value of their connections. After the crisis, 16% of the value of connected firms can be attributed to political connections. The effects of public governance on the corporate sector are also found outside Asia. Ramalho (2003) evaluated the impact of an anti-corruption campaign on politically connected companies in Brazil. She reports that politically connected firms' stock values dropped significantly around dates when negative information related to the 1992 presidential impeachment was released.

Charumilind *et al.* (2002) examine the debt maturity structure of 270 (almost all) non-financial companies listed on the stock exchange of Thailand in 1996. They find that firms with connections to banks and politicians have more long-term debt than firms without such ties. By contrast, conventional explanatory factors do not explain much of firms' access to long-term debt. They interpret that 'cronyism' was the main driver of pre-crisis borrowing and lending activities in Thailand.

VI. CONCLUSIONS AND RESEARCH AGENDA

Corporate governance has received much attention in recent years, partly due to the financial crisis in Asia. A review of the literature on corporate governance issues in Asia confirms that, as in many other emerging markets, the lack of protection of minority rights has been the major corporate governance issue. While much popular attention has focused on poor corporate sector performance, most studies do not suggest that firms in Asia were run badly. Instead, the returns went disproportionately to insiders, accompanied with extensive expansion into unrelated business, high leverage and risky financial structures. The usage of group structures created internal markets for scarce resources. However, the internal markets were prone to misallocate capital due to the agency problem. Conventional governance mechanisms were weak to mitigate the agency problem, as insiders typically dominated boards of directors and hostile takeovers were extremely rare. Neither did external financial markets provide much discipline, partly as there were conflicts of interest, but mostly as there existed rents through financial and political connections, which combined with the moral hazard of a large public safety net for the financial system.

It is important to note that the identified governance problems of Asian corporations do not necessarily imply that investors are worse off. The reviewed evidence indicates that shareholders discount stocks according to perceived corporate governance issues. This means that stock markets are increasing the cost of capital for firms with greater corporate governance problems and controlling owners/managers ultimately bear some of the agency costs. We reviewed research on the possibility for the controlling owners to mitigate the agency problems by employing monitoring or bonding through auditing, analysts, institutional investment and foreign listing. However, these mechanisms are not necessarily extensively used and/or well functioning. Asian corporations, for example, do not list much offshore, which could be expected given the weaknesses in their own countries' corporate governance frameworks. On the other hand, foreign and domestic investors do not seem to avoid these markets, despite low valuations and minority rights violations.

We conclude this survey by laying out several future research directions that we think are valuable. First, more research is needed to understand the determinants of ownership structures and corporate governance practices in this region. Specifically, what are the causes of ownership structures and the relationships of ownership structures with countries' institutional environments? How do ownership structures interact with corporate policies such as investment and financing? What are the roles of reputation in corporate governance and what are the specific mechanisms controlling owners can and do employ to enhance their reputation? Particularly valuable will be studies that examine how ownership and governance structures evolve over time. These studies could focus on the effects of external shocks and associated legal or regulatory changes.[8]

Second, the roles of financial systems and market mechanisms can be explored in more detail. Future research can include investigations of the roles of financial and information intermediaries in corporate governance. As this survey has found, whether banks, institutional investors or equity analysts take any active role in enhancing corporate governance in Asian countries remains a controversial issue to date. More generally, the overall development of a country's financial system may affect the degree to which corporations are subject to market discipline and experience corporate governance pressures. Corporations in financial systems that are repressed may experience more corporate governance problems. Little is known thus far about how corporate governance problems in Asia vary with the development of countries' financial systems.

Third is the interaction between corporate and public governance. As suggested in several studies reviewed in this paper, governments and politicians can determine the rules of the game and the nature of competition in the market place.[9] Listed companies' corporate governance practices are likely to be influenced by the rules, in particular how and to what degree the rules are enforced. Therefore, it would be important to examine how corporate governance practices of a country are shaped by the quality and the integrity of its government and its regulatory policies.

Fourth, while empirical research has made great progress, the relationships between institutional frameworks, financial market development, firm behaviour

8 An example is Kole and Lehn's (1999) study of the adaptation of governance structures of firms in the airline industry after the industry's deregulation.

9 Acemoglu *et al.* (2002) provide cross-country evidence that macroeconomic volatility and slow economic growth are probably observed in countries with weak institutions that provide weak protection of property rights for investors or fail to constrain corruption and self-interested politicians and their elites. The effects of the institutional factors are more fundamental than distortionary macroeconomic policies that are also observed in these countries.

and firm financing structures have received limited analytical attention. Only recently have there been some theoretical papers exploring the various links and channels between, say, the prevalence of group structures, the strength of creditor and equity rights and the role of financial intermediaries. More theoretical work will help to provide a better perspective on some of the empirical findings to date. It will need to include analysis of the dynamics of institutional development and change, since understanding why countries do (or do not) change their institutions has proven the most difficult.

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