

THAILAND'S CORPORATE FINANCING AND GOVERNANCE STRUCTURES: IMPACT ON FIRMS' COMPETITIVENESS

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1. INTRODUCTION

The corporate finance structure in Thailand has not served the country as well as it could. Many corporates' financial structure was very fragile in 1997, which contributed to the depth and length of the financial crisis. In general, firms found themselves very exposed to the changes in economic environment following the financial crisis. Long term funds from local sources for every type of firm were scarce—due to the lack of institutional investors and the excessive reliance on bank financing. Both contributed to overextended offshore borrowing by Thai corporates. Small and medium enterprises (SMEs) in Thailand have had relatively little access to formal financing, as lending was skewed to large firms, and the cost of any financing for these firms has been high, with resulting constraints on SME growth. In addition to a lack of creditworthiness, poor information and high administrative costs, this is due to the limited forms of collateral that can be used or pledged and the insufficient skills of borrowers.

The recent financial crisis and the slower economic growth in recent years relative to the level of investment have shown that the allocation of savings in Thailand has not been efficient, particularly for the larger non-financial firms. It was also geared towards too risky activities. Our contention is that the financing and corporate governance structure of large corporates has led to inefficient investment, with excessive diversification and declines in profitability over the past few years. Looking forward, large corporates need to reduce their financial vulnerability to economic shocks, and corporate governance needs to be improved to enhance the efficiency of investment. SMEs need to have better access to financing and a more stable funding structure.

This study assesses the various policy options to achieve these outcomes. To do so, the study analyzes the financial structure of firms in Thailand, draws lessons from the international experience, and suggests possible improvements. It reviews the framework for corporate financing in Thailand, using interviews with financial and large non-financial firms and reviews of the legal

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and regulatory framework. The study assesses empirically the relative importance of various factors determining the cost of capital, the availability of financing, and the different policies and distortions affecting the corporate governance framework for non-financial firms. Using data for firms listed on the Stock Exchange of Thailand (SET), the structure of financing, the efficiency of investments, and the effectiveness of current corporate governance mechanisms are analyzed and compared with that in other economies. The empirical findings highlight the weaknesses in corporate governance and the risky corporate financing structures.

The outline of the paper is as follows. Section 2 describes corporate performance and corporate financing patterns in Thailand during the 1994-97 period. The paper then reviews international experience with different financial structures and corporate governance mechanisms in section 3. It proceeds with reviewing the institutional framework for financing and corporate governance in Thailand in section 4. In section 5, some specific hypotheses are tested for Thailand regarding the links between corporate governance, corporate financing and firm behavior. Section 6 reviews medium-term areas of possible policy action.²

2. CORPORATE PERFORMANCE AND CORPORATE FINANCING PATTERNS IN RECENT YEARS

The recent financial crisis in Thailand revealed some of the weaknesses of the corporate sector.³ While the magnitude and severity of the crisis was unexpected, there were signs of deterioration in corporate performance before July 1997. This becomes clear once we consider the evidence on the performance of Thai corporates in the years before the crisis. Productivity growth slowed down starting in 1995, and leverage, already high by international comparison, increased significantly as early as 1995.

Using data for all firms listed on the Thailand Stock Exchange for which financial statements are available, we can show that the deterioration in corporate performance started in 1994 using four indicators of enterprise performance (Table 1). First, we review the time series of the profits over interest expense ratios in 1994-97. In 1994, profits were 5.78 times higher than interest expenses for the average SET firm. By the end of 1995, this ratio fell to 4.01, by end-1996 to 3.11, and was then further reduced by half (to 1.49) in 1997. In other words, by the end of the period, two-thirds of all profits of Thai listed firms went to cover interest expenses.

² While the analysis is made in reference to Thailand's recent financial crisis, the paper does not discuss the issues of short-run (or medium-term) exchange and interest rate management that might be relevant for corporate financing developments. For this we refer to Dwor-Frecaut et al. in this volume.

³ While the focus of the paper is on corporate governance in non-financial institutions, much of the discussion also applies to financial institutions.

Table 1: Deteriorating Corporate Performance

| Period | Number of Firms | Profits over Interest Expenses | No of firms with Profits < Interest Expenses | Loans of Firms with Profits < Interest Expenses (%) | Profits over Liabilities (%) | Leverage |
|---------|-----------------|--------------------------------|--|---|------------------------------|----------|
| 1997:Q4 | 356 | 1.49 | 114 | 36.4 | 7.3 | 2.95 |
| 1997:Q3 | 356 | 2.59 | 83 | 30.8 | 10.2 | 2.95 |
| 1997:Q2 | 357 | 3.18 | 71 | 18.4 | N/A. | 2.12 |
| 1997:Q1 | 353 | 3.66 | 54 | 16.2 | N/A. | 2.01 |
| 1996:Q4 | 354 | 3.11 | 49 | 11.8 | 14.9 | 1.90 |
| 1995:Q4 | 354 | 4.01 | 34 | 7.6 | 18.1 | 1.67 |
| 1994:Q4 | 352 | 5.78 | 18 | 1.4 | 24.0 | 1.50 |

Notes: Profit is defined as earnings before interest, taxes, depreciation, and amortization (EBITDA)
 Leverage is debt over equity.
 Source: SET database.

The number of firms with interest expenses exceeding profits increased six-fold—from 18 to 114—during this same period. The reduction in profitability meant that for more than a third of all outstanding loans (36.4%), firms could not cover interest expenses in full, up from only 1.4% in 1994. The ratio of profits to liabilities also went down from 24.0% to 7.3%. Finally, leverage increased to an average of 2.95—twice as high as the 1994 value. The situation became particularly worrisome in the construction sector, which has now the highest leverage (5.25).

Not just the listed firms, but also smaller Thai firms have seen a decline in financial profitability in the last few years. According to a survey of 842 firms, average firm profits have declined from 17% of capital in 1994 to 4% in 1996 (Dollar and Hallward-Driemeier, 1998). There also has been a sharp rise in leverage, especially of short-term foreign borrowings. The average debt-to-equity ratio in the survey sample is 200%, with almost three-quarters of liabilities short-term. While larger firms tend to have higher debt-equity ratios, smaller firms are thus also quite leveraged.

The financial crisis has revealed these weaknesses. As is typical during a financial crisis, many Thai firms are now complaining about the high cost of funds and the limited access to financing. The survey performed in the last quarter of 1997 and the first quarter of 1998, sheds some light on the nature of this credit crunch (Dollar and Hallward-Driemeier, 1998). In the responses, access to finance was mentioned more often in the first quarter of 1998 than six months earlier as a bottleneck facing firms. More larger firms than smaller firms reported problems with access to financing according to the survey, but firms of all sizes mentioned the cost of finance as a worry. Local firms mention cost as a worry more often than foreign firms in Thailand, but there is little difference between the two types of firms regarding their access to capital. The difference between exporters and non-exporters is more striking: access to capital is mentioned as a problem

by non-exporters three times as often than by exporters, while costs of financing is mentioned two times as often.

The survey also finds that SMEs were generally less likely than larger firms to mention access to finance as an obstacle to growth from a longer run perspective. This may be because SMEs received little external financing in the past and have been better able to adjust to tight liquidity conditions. This does not obfuscate the need for better financing of SMEs, of course, because they are likely to be the growth-engine in Thailand as they have been in other countries. Hence, both as a short-run and as a longer term development goal, particularly in an environment where firms are trying to expand, finance is an issue that needs addressing.

One may wonder why some corrective measures were not taken prior to the financial crisis. While we discuss this issue at length in the coming sections, we would like to highlight two reasons. First, businessmen and financiers alike were likely blinded by the success of Thai corporates over the last decades that produced impressive economic growth rates. In spite of the recognition of some of the underlying fundamental weaknesses, most investors did not view the crisis as inevitable. Second, the significant concentration of ownership in the hands of family groups and the lack of counter-balancing forces—professional management, for example—reduced the corporates' ability to change their behavior and more generally their willingness to improve on some of the recognized weaknesses.

Going forward, it is important to identify the fundamental weaknesses of the Thai corporate sector that triggered this deterioration in performance. We discuss the weaknesses in corporate governance and corporate financing in section 4, while in section 5, we try to quantify the impact. First, however, we review the international experience with corporate governance and corporate financing.

3. THE INTERNATIONAL EXPERIENCE ON CORPORATE GOVERNANCE AND CORPORATE FINANCING

The debate of the “model”

The financing and governance of firms depends importantly on the institutional structure of the financial sector. International discussions regarding the “optimal” financial structure have often contrasted two models: bank-centered versus market-centered (see Prowse, 1994 and 1998). The former is typically associated with Japan and Germany (main-bank systems); the latter with the US and the UK. The differences between the two models center on the main agent who monitors the activities of the firm and takes the lead in disciplining management.⁴ Under the bank-centered model, banks play the lead role in the monitoring of firms. Under the market-based system, a broader range of investors plays this role through the pricing, trading and buying of the firm's securities. In both models, the monitoring activities of financial institutions or financial markets are complemented by those of many other agents: other firms (through competition, suppliers and buyers' contracts), labor, the government, etc. (see further Shleifer and Vishny, 1997 for a review).

⁴ Three types of monitoring and related disciplining actions can be distinguished (see Aoki, in Aoki and Patrick, 1994): ex-ante, when investment decisions by the borrower are being reviewed; interim, during the life of the investment or in the day-to-day operations of the borrower; and ex-post, during periods of financial distress and possible bankruptcy.

Bank-centered systems may have advantages in resolving informational asymmetries, and thus lead to less liquidity constraints in firms, particularly at times of distress (see, for example, Aoki and Patrick, 1994). There is some empirical evidence supporting the view that main-bank monitoring mitigates information problems in financial markets.⁵ Since information asymmetries are more likely prevalent at lower-income levels, bank-based systems may have advantages at early stages of development. Thailand can be characterized as a bank-centered financial system, given its high ratio of bank credit to the stock market capitalization. A priori, the bank-based system may thus remain appropriate for Thailand.

There is no easy empirical answer to the question what type of financial system is associated with consistently higher economic growth.⁶ Even for stable developed countries with well-defined financial systems, it has been difficult to “rank” the different governance systems that are in use now or have been in use in (recent) history in terms of their impact on the economy (see, among others, Allen and Gale 1995, Walter 1993, and Saunders and Walter 1994). The debate on whether there is a unique financial structure optimally suited to monitor and govern firms in a given country is therefore perhaps not very useful. There might simply not be any ideal system applicable to a specific country, since in practice the functions and effects of any financial system depend on a host of country-specific circumstances, including legal, social, cultural, and other factors.

However, there is recent evidence that bank-centered systems may be more likely to lead to non-market based lending. Basically, as corporates mature, their needs for outside finance for investment purposes decline as they can rely more on internally generated finance (Jensen, 1986). As “free” cash flow builds up in corporates, banks lose their disciplining influence over firms and firms are more likely to engage in inefficient investment and excessive diversification. The once favorable reviews of the Japanese and German bank-based system are being revised in light of recent experiences given excessive diversification of some German firms and the poor recent performance of corporates (and banks) in Japan. Bank-centered countries like Germany have begun to make the switch to a more open, market-based system, but this has not been without pain and has been a process underway for a decade. Japan is still in the early stages of its transformation process and has had several years of low growth and a weakening banking system.⁷ The issue of an optimal financial system may thus rather be better put as: is the system able to adapt to new circumstances in the real and financial sector?

In summary, there may not be a preferred financial structure and mix between banks and capital markets for Thailand to aim at. Across the globe, there is growing evidence that banks and capital markets do not substitute but rather complement one another (Demirgüç-Kunt and Levine, 1996). In the short-run, Thailand's circumstances may well continue to favor banks over capital markets. Banks are relatively well developed, are closer to enterprises, as they have more

⁵ Hoshi, Kashyap and Scharfstein (1990) compare the strength of the relationship between investment and measures of internal finance, such as cash flow, for Japanese firms who have strong relationship with banks against firms without such ties. They find that cash flow is a more important determinant of investment for independent firms than for those firms who are members of a keiretsu group with a main bank. Hoshi, Kashyap and Scharfstein (1995) find that keiretsu firms which weakened their ties to banks by raising money directly from capital markets became more liquidity constrained than before.

⁶ In part this is because it is hard to characterize a financial system or a reform model adequately. Many countries combine elements of both bank- and market-based systems.

⁷ Fukao, 1998, draws attention to the relationship between poor corporate governance of banks and corporates, and the current weakness of Japan's banking system.

information than capital markets do, and can perform a useful function in the necessary enterprise restructuring in Thailand. Capital markets, on the other hand, depend on corporate law, civil code, and institutions such as courts that are generally perceived as weak in Thailand. Some time will thus be needed before capital markets can play a stronger role in corporate governance. But, as noted, there is the risk of slower adaptation, and in the currently globally financially integrated world, the time to adjust has become more compressed. It is therefore all the more important to move quickly towards a flexible system that includes both well functioning capital markets and banks. Such market-based financial systems tend to have greater flexibility in adapting and provide greater risk sharing. Internationally, market-based financial systems with a greater role of capital markets in the governance and financing of firms have been the general aim.

Financing structures

The starting point for discussing financial structures should be how a financial sector develops for a typical country. Low-income countries are characterized by reliance on informal finance: lending for small investments is secured through a network of social relationships and peer-group monitoring, which often is linked to trading and agriculture and mainly involves advances for trade from one firm to another. Foreign banks may play a large role in financing foreign trade, but much less so in domestic trade. As the economy develops and urbanizes, some of these networks formalize themselves into neighborhood lending associations or banks. This process of more formal financial intermediation is often accelerated when there are major new developments in the economy, for example, opening up of new trading opportunities or new industrial enterprises, which generate concentrated wealth. During most of this process, financial intermediation is dominated by banks. Capital markets only come to play a role in the later stages of development, when legal systems and reputational capital are established and people have enough confidence to trade pieces of papers which just represent promises to pay.

This pattern of financial development at the macro country-level mirrors in many ways the financial life cycle of a typical firm. For example, a firm may start as a family-owned business, using the family's own resources as well as savings collected through a network of social contacts. It will then typically grow from its retained earnings and funding from its suppliers. Risk-capital will thus mainly come from outside the formal financial system. At some point, when it has established a sufficient business record, it may be able to get a loan—often only on a highly secured basis—from a local bank. As it grows and expands its relationships, it will typically be able to attract funds from a wider circle of financial intermediaries, including other banks, venture capital and leasing companies. Over time, it may be able to go to the capital markets, first to the private placement markets; and later to organized, publicly traded bond and equity markets. This process can be hastened by improving the accuracy and reliability of information, reducing the costs of contract enforcement, and encouraging greater transparency. Also, reducing uncertainty at the macro level, such as by encouraging governments to maintain credible and consistent policies, and at the micro level, by encouraging more stable industry regulation, will bolster the evolution of firms along this 'life cycle'.

Building in part on these insights, part of the literature investigates (both analytically and empirically) the "optimal" liability structure for firms. Rather than try to summarize this literature, which mainly focuses on developed countries, we refer to the review by Harris and Raviv, 1991. We wish to highlight two aspects stressed by recent literature: the liability structure

of a particular firm is endogenous to its characteristics; and the importance of the liability structure in disciplining management. The optimal debt to equity ratio, for example, is not just a function of the risk characteristics of a particular firm, but also of the difficulty outsiders have in controlling the behavior of managers. Debt, for example, can be a disciplining device for firms with few investment opportunities, but with good profitability (e.g., firms with so-called free cash flow). In other words, corporate financing structures perform important corporate governance functions. The empirical literature on developed countries has indeed found evidence of many relationships between the liability structure and the behavior of managers.

Empirical work for developing countries on liability structures on non-financial institutions is sparse. Important contributions are Demirgüç-Kunt and Maksimovic, 1994, Glen and Pinto, 1994, Singh and Hamid, 1992, and Singh, 1995. These authors have found that firms in developing countries make more use of external financing than firms in developed countries (this somewhat surprising finding may reflect the fact that the firms investigated in developing countries are typically both larger and “younger” than firms in developed countries, and may thus have relatively easier access to and rely more on outside financing).

More detailed analysis suggests, however, that firm financing in developing countries is not that different from that in developed countries once one corrects for a number of factors. These include the sector in which the firm operates, its riskiness, years of existence, etc. Importantly, one needs to control for the institutional development (for example, quality of the legal framework and the enforcement of laws and regulations), the level of financial development and other macro factors in each country which matter importantly for financing patterns.

It has also been found that when more external financing, including from stock markets, is available, firms grow faster (Demirgüç-Kunt and Maksimovic, 1994). Firms in developing countries use generally much less long-term financing than comparable firms in developed countries (Caprio and Demirgüç-Kunt, 1997). At the same time, increased long-term finance and financing from active stock markets is associated with higher productivity in both developing and developed countries.

These findings suggest some government intervention to stimulate long-term debt financing and financing from equity markets. It has been found, for example, that subsidies and directed credit do not benefit smaller firms, even in developed countries, and while they can lengthen the maturity of loans, they do not necessarily lead to more efficient investment, or higher productivity growth. Indeed in most cases, subsidies are associated with lower productivity growth (Demirgüç-Kunt and Maksimovic, 1996).

Diversification

The high degree of diversification of Thai firms raises specific questions regarding the benefits and costs of diversification. The effect of diversification on enterprise performance has been a long studied subject for developed countries. An increasingly skeptical view has developed about the efficiency of diversified conglomerates. There is much evidence that diversified groups in developed countries tend to trade at a discount relative to a portfolio of independent firms in related industries; have on average lower market to book values (Tobin's Q). Moreover, they tend to be broken up, and their share price significantly increases when that occurs (for a review, see

Rajan and Zingales, 1997).⁸ The leading explanations for such underperformance have focused on the agency conflict between investors and empire-building managers (Jensen, 1986). More recently, some authors have argued that poor internal management, including power conflicts, forces inefficient redistribution of resources to less performing divisions (Lang and Stulz, 1994).

In contrast, industrial-financial groups persist and often prosper in many developing countries (see, for example, Khana, Tarun and Palepu, 1996), where private sector activity is often dominated by diversified business groups. Theoretical rationales for such corporate structures have pointed to the incentive to resolve scarcity in the capital and the intermediate product markets in emerging markets. The emergence of such groups may also be a function of the weak institutional environment in these economies. In countries with weak law enforcement, unstable regulatory system and widespread corruption, groups may have extensive governance functions. They may support internal trade, ensure close monitoring of management decisions and manage a privileged access to political favors, such as subsidized credit, favorable regulation and licensing, and access to strategic resources. In conclusion, groups may emerge to capture scarcity rents or compensate for lack of markets, or both.

A recent paper (Fan and Lang, 1998) distinguishes between two types of diversification: related diversification - for example, joint procurement of inputs, the sharing of marketing and distribution services, or integrating vertically; and unrelated diversification - when the newly acquired or developed business is run separately and does not complement the already existing segments of the corporation. For a sample of US corporates, they find that diversification into related industries is associated with increased corporate value. The authors hypothesize, however, that in times of financial crises unrelated diversification may be more value-enhancing since different segments are affected differently by the financial crunch and the collapse of demand.

It is clear, nevertheless, because of the many cross-ownership and other relationships among members (including banks) of a conglomerate in developing countries, that the normally assumed disciplinary role of corporate debt is likely to be much weaker. The effect might even be perverse for family-controlled firms, i.e., more debt may lead to more risk-taking. Moreover, any positive view on the benefits of conglomerates in emerging markets has to be balanced with the potential cost in terms of slower adaptation of a financial system to new circumstances when insiders dominate.

Investor Protection

An important factor influencing external financing patterns is the degree of protection from abuse by corporate insiders, provided by legal and regulatory mechanisms to outside providers of funds. Securities have rights attached that protect investors: equity shares give investors the right

⁸ Studies include the following: Scharfstein (1997) studies investment patterns across divisions in conglomerate firms, and conclude that they appear to practice some form of suboptimal "socialist" reallocation of resources across divisions, moving funds from profitable firms in high Q industries to support investment in lower Q sectors. Rajan, Servaes, and Zingales (1997) find that diversified firms misallocate investment funds; the extent of mis-allocation is positively related to the diversity of investment opportunities across divisions; and the discount at which these diversified firms trade is positively related to the extent of the investment mis-allocation and the diversity of the investment opportunities across divisions. Lang and Stulz (1994), and Doukas and Lang (1998) find that corporate diversification through mergers and acquisitions and direct investments reduces performance for US firms.

to dismiss management if performance is not satisfactory, while debt gives creditors the right to repossess collateral or more generally drive a company into bankruptcy if debt obligations are not met. The legal and regulatory frameworks will determine to what extent these rights can be exercised and investors protected from potential abuse.

There is growing international evidence that the quality and efficacy of these protection mechanisms influence whether and at what cost outside investors are willing to fund corporations, and hence, the development of capital markets. La Porta, Lopez-de-Silanes, Shleifer, and Vishny (1998) find that there is a strong negative correlation between ownership concentration and the quality of investor protection mechanisms. Ownership concentration substitutes for poor investor protection by reducing the agency problem in corporations, but also has costs that are discussed further below. In another paper, La Porta et al. (1997) suggest that poor protection mechanisms will limit the availability of external finance for firms, as well as raise the cost of funds to compensate for increased risk of expropriation. Based on a sample of 49 developing and industrial countries, they show that countries with poor investor protection tend to have smaller and narrower debt and equity markets, which is consistent with this hypothesis.

The quality of protection mechanisms depends on a wide variety of factors such as the treatment of investor rights in company, bankruptcy and securities legislation, the efficacy of legal enforcement, and the content and enforcement of capital market regulations, including listing rules and disclosure. On the equity side, these protection mechanisms include provisions regarding the duties of insiders (directors and corporate officers), the rights and remedies of shareholders, disclosure and use of information by insiders, and takeovers and new issues (La Porta et al., 1998; Asian Development Bank and World Bank, 1998).⁹ For creditors, the most basic are rights to repossess collateral and to participate in key decisions such as filing for creditor protection and management during reorganization (Baird, 1993). Strong disclosure and accounting standards and practices are essential for both equity and debt investors to monitor corporate performance. Legal and regulatory enforcement is also essential, of course, for these rules to have real content. International experience suggests, however, that countries do not compensate weak investor protection legislation by improving the quality of legal enforcement. Indeed, countries with weak investor protection rules also tend to be those with weak enforcement (La Porta et al., 1998), other factors remaining equal.¹⁰ Overall, the most important determinant of the quality of legal enforcement is the amount of resources allocated to the judiciary, including for creating legal infrastructure such as land and securities' registries (e.g., Posner, 1998).

Concentrated Ownership

The fundamental benefit of concentrated ownership is that it solves the agency problem since large shareholders are able to more easily assert control over a firm and limit management inefficiency and abuse. Indeed, except for certain industrial countries, high ownership

⁹ These mechanisms are directed at achieving the following objectives: (1) directly prevent abusive behavior by insiders (e.g., prohibition of loans to directors, rules regarding insider trading); (2) limit the discretion of insiders in key corporate matters (e.g., mandatory shareholder approval of fundamental decisions); (3) ensure adequate disclosure and transmission of information (e.g., mandatory disclosure of connected interests of board members); (4) facilitate shareholder control and monitoring (e.g., permitting proxy voting, including by mail); and (5) options for "oppressed" minority shareholders, such as judicial remedies to a broad class of persons regarding corporate decisions that are unfairly prejudicial, or that unfairly disregard the interests of shareholders, and the entitlement for dissenting shareholders to be bought out of the company at a fair appraised value.

¹⁰ East Asia, including Thailand, appears to be an outlier in this respect as is further analyzed below.

concentration, including controlling ownership, is common. For example, the share of the three largest shareholders in the 10 largest publicly traded private companies averaged 46% in a sample of 45 developed and developing countries (La Porta et al., 1998). Table 2 shows ownership concentration in several Asian and Latin American countries. Shleifer and Vishny (1997) discuss several examples of the benefits for corporate governance of concentrated ownership in industrial countries. In particular, large shareholders have been associated with high turnover of directors and managers, and with the increased likelihood of takeovers, which in turn has enhanced firms' efficiency of operations and investment.

Table 2: Ownership Concentration in the Ten Largest Firms (1)

| | <i>All Firms (2)</i> | <i>Private (3)</i> | | <i>All Firms (2)</i> | <i>Private (3)</i> |
|-------------|----------------------|--------------------|----------------------|----------------------|--------------------|
| Asia | | | Latin America | | |
| India | 38% | 40% | Argentina | 50% | 53% |
| Indonesia | 53% | 58% | Brazil | 31% | 57% |
| Korea | 23% | 20% | Chile | 41% | 45% |
| Malaysia | 46% | 20% | Colombia | 63% | 63% |
| Pakistan | 26% | 54% | Mexico | 64% | 64% |
| Philippines | 56% | 37% | Venezuela | N/A. | 51% |
| Sri Lanka | 60% | 60% | | | |
| Thailand | 44% | 47% | | | |

(1) The average percentage of common shares owned by the three largest shareholders in the ten largest non-financial firms. The percentages are not corrected for shareholder affiliation and cross-shareholding between firms.

(2) Excluding the public share.

(3) Largest 10 firms with no public ownership.

Source: La Porta et al. (1998).

Regarding the pursuit of non-profit maximizing objectives, Morck, Shleifer and Vishny (1988) and other authors find evidence of an inverted “U” shape relationship between the degree of ownership concentration and profitability. Intuitively, as ownership concentration rises, agency costs decrease and hence profitability rises in the upward sloping part of the curve; but as owners gain control and wealth, they pursue empire building strategies and other private benefits of control. Controlling ownership may also lead to increased risk taking behavior since other stakeholders such as creditors and employees share in the downside risks but not to the same degree in the benefits. The potential for this type of behavior is greater if there are ownership and/or family inter-relationships between banks and corporations, bank incentives are skewed towards risk taking, and bank supervision is inadequate.

Several studies in the empirical literature on corporate governance make the point of possible negative effects of the dominance of family control. Johnson et al. (1985), for example, study the effect on share prices of sudden deaths of executives—in plane crashes or from heart attacks—and associated transfer of control to other managers. They find increasing prices following the death announcement, particularly for large conglomerates whose founders built

diversified businesses. The authors interpret the evidence to suggest that changes in management can be useful as they can serve to induce more efficient management. The evidence also shows that family control can lead to loss of value.

Both the benefits and costs of ownership concentration are exacerbated in developing countries. Stylized facts regarding the legal and institutional frameworks in developing countries--for example, weaker disclosure and property rights and underdeveloped legal enforcement--suggest that the potential for abuse by managers is higher than in industrial countries. Indeed, as noted above, high agency costs are an important explanatory factor of concentrated ownership. At the same time, however, these same institutional weaknesses also facilitate the abuse of minority shareholders. Similarly, financial systems are more likely to be weak and inadequately supervised, and relationships between corporates and banks more common.¹¹ Concentrated ownership is, hence, likely to lead to increased risk taking behavior in developing countries. Finally, in developing countries, high ownership concentration also reflects the fact that most businesses are relatively young, and still managed by their founders or their direct descendants. While family management may be appropriate during the earlier stages of development, more professional management may be better suited as the economy and firms mature. Presumably, this process of professionalization should be faster in the larger and more complex businesses.

In sum, high ownership concentration is typically both a symptom and a cause of weak corporate governance. Ownership concentration is symptomatic of weak corporate governance because it is a means for investors to monitor and control management when protection systems are weak. It is a cause because it may lead to more risk-taking behavior and to the abuse of minority investors. In addition, controlling shareholders are a potential source of pressure to delay improvements in disclosure and governance, as these improvements may erode their corporate control and insider benefits.

In the next section, we discuss some issues related to the specificity of corporate governance in Thailand.

4. CORPORATE GOVERNANCE IN THAILAND

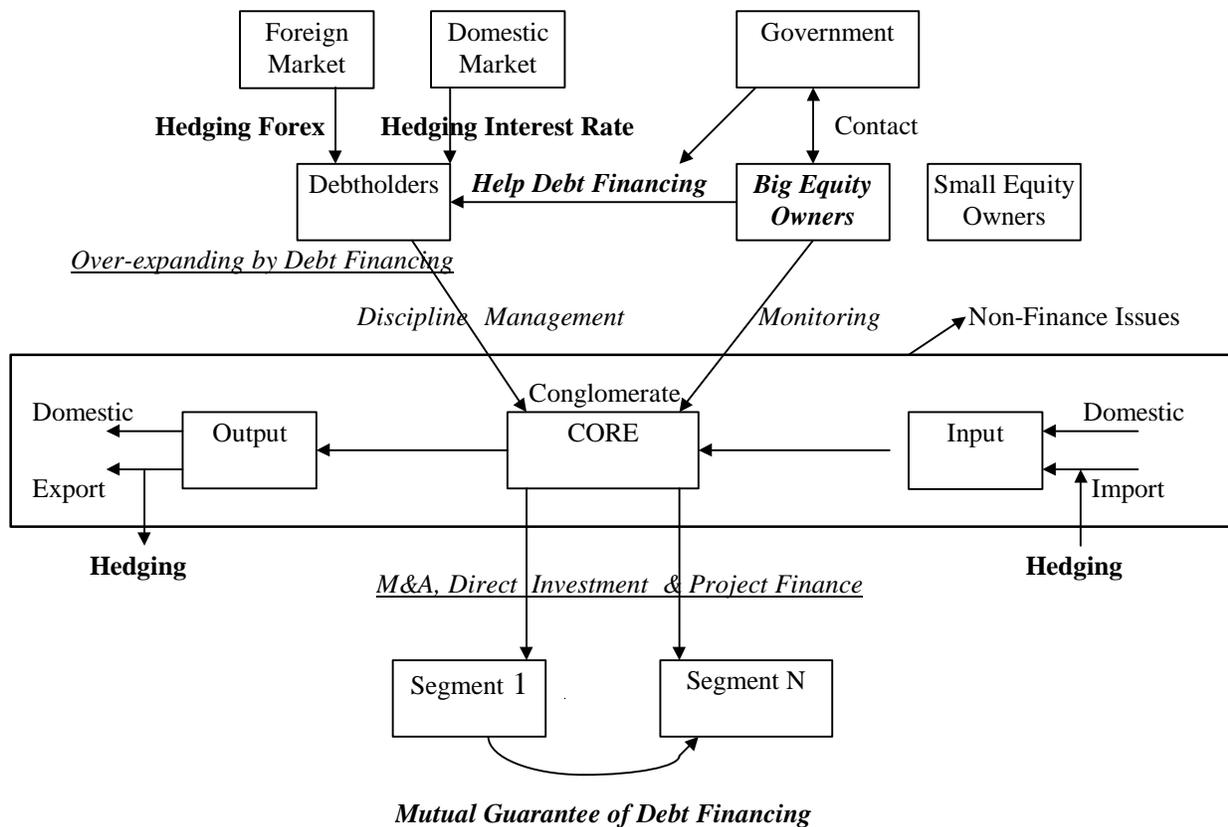
While Thailand made rapid and substantial progress in developing its capital--and especially equity--markets during the 1990s, both corporate governance and disclosure systems were still weak and capital markets played a limited role in the governance of firms. Perverse connections between lenders and borrowers were not uncommon and facilitated excessive expansion and diversification of firms, financing of prestige projects and other "white elephants." There have been five interrelated problems: concentrated ownership; high level of diversification; weak incentives; poor protection of minority shareholders; and weak information standards. But most of these problems were not more severe in Thailand than in the rest of East Asia and indeed in many developing countries.

¹¹ For example, it is more likely that governments in developing countries offer guarantees to financial institutions and that banks are undercapitalized .

Concentrated Ownership

The organizational chart in Figure 1 can describe the salient features of large corporates in Thailand. Compared to the typical organization in developed countries, corporates in Thailand have two distinct features. First, the most influential organizational form in Thailand is the diversified conglomerate that is controlled by large corporations and, most importantly, family. Second, those conglomerates have large debt, much of which is from local financial institutions. Before the 1997 crisis, these large conglomerates used debt financing to expand aggressively—through mergers and acquisitions, direct investment and project finance—while undertaking little hedging against foreign exchange and interest rate changes.

Figure 1: The Organizational Chart of a Typical Thai Conglomerate



One of the most important features of the corporate sector in Thailand is the dominance of family control over business operations. Thai firms are generally closely held and managed by majority - often family - interests. As shown in Table 2, the three largest shareholders own between 44%-46% of the shares of the ten largest non-financial private firms. These numbers do not take into account shareholder affiliation and cross-shareholding between firms, and the former is believed to be particularly important in Thailand. Many shares are held in nominee accounts, which make it difficult to determine shareholder affiliation. However, based on Siam Business

Information (1995), a relatively limited number of families controls many of the corporates listed on the SET.

This characteristic largely comes from the relative youth of Thailand's corporates. The largest Thai-owned non-bank companies date back only to the 1940s and 1950s and many of their founders are still alive. These founders still play a very active role in day-to-day business. Their children usually hold senior management positions in the company. Such companies rarely recruit externally for senior management positions. This pattern of governance limits the aspirations of middle management that do not belong to the founding family. The significance of family ties is re-enforced by the practice of inviting other families to share ownership when setting up new ventures. These help cement existing business relationships, but in the process may encourage the creation of entry barriers and extend the importance of family groups in the corporate sector.

While, as discussed in section 3, concentration of ownership is common in developing countries, and there are both pros and cons to such concentration, on balance it may be excessive in Thailand. First, ownership concentration may impede the development of professional managers that are required as economies and firms mature and become more complex. Second, it may have led to increased risk taking behavior by firms, in particular given the inter-relationships between financial institutions and banks, and the supervisory weaknesses and perverse incentives prevalent in the Thai financial system during the 1990s. In addition, in order not to lose control, large shareholders may have diluted market pressures for improved disclosure and protection for minority shareholders, and are reportedly an impediment today to corporate workouts.

The weaknesses in corporate governance are confirmed by the results of a survey of 202 firms listed on the SET in mid-1996 (Price Waterhouse, 1997). The survey revealed that about 70% of senior management felt that considerable improvements should be made on corporate governance issues in Thailand, with the majority stating that they would prefer an approach which involved both the SET and a system of self-regulation by the listed companies themselves. Financial and institutional advisors felt that improved corporate governance practices would give added benefits to the Thai capital markets relative to other markets in the region.

Weak Market Incentives

The incentives to improve disclosure and governance, either at the individual firm level or at the country level, were not strong in Thailand during the early 1990s. Many firms had comfortable relations with banks and other financial intermediaries and were easily able to raise equity through new stock issues. With ample liquidity and weak market discipline, firms and insiders had little to gain from improving disclosure and corporate governance. This lack of market discipline appears to have been due to five factors.

- First, and probably most important, the rapid and large increase in stock prices in the early 1990s in Thailand and throughout Asia, and the resulting boom type mentality, may have reduced the sensitivity of equity investors to company disclosure and governance.
- Second, as mentioned above, there may have been interlocking ownership and other inter-relationships between financial intermediaries and corporates, as in Chile during the early 1980s. Korea is another example of how interrelationships between banks and corporates can reduce market discipline.

- Third, the relatively heavy presence of government in capital markets, at least compared to industrial country markets, as well as government ownership and contingent government support (e.g., in large infrastructure projects) may have also comforted investors.
- Fourth, domestic institutional investors, in particular pension funds, that are playing an increasing important role in corporate governance in industrial countries, are still developing in Thailand. For example, while the Thai mutual fund industry compares well to those in other developing countries in the region, it is still small; in 1996, trading by mutual funds in the SET only represented 6.8% of total trading.¹² Pension funds are perhaps even weaker in Thailand. Until recently, they have been constrained by the lack of formal institutional pension arrangements as well as by restrictive asset allocation regulations. Provident funds for government workers and workers in public enterprises have only been established recently and are still largely restricted to government paper and cash.
- Fifth, market and regulatory institutions that play a key role in industrial countries in facilitating and creating incentives for market discipline are not yet fully developed in Thailand. For example, Thailand's single credit rating agency (TRIS) was only established in the 1990s and is still considered by the market to be developing expertise. The nascent regulatory framework further aggravated this lack of market institutions. A modern legislative regulatory framework was only promulgated in 1992, at the same time that the Securities and Exchange Commission was established. Although by 1997, Thailand has built the legal and regulatory basis for modern capital markets, this process has been gradual. During this transition period, capital markets did not necessarily adequately perform their signaling and monitoring functions.¹³

Protecting Minority Shareholders

The legal and regulatory systems of many countries in Asia include a relatively wide set of provisions to protect shareholders from abuse by insiders. Table 3 compares the investor and creditor protection in East Asia with other regions and benchmarks from industrial countries. The table shows that shareholders are better protected in Asia than in Latin America and legal protection mechanisms for creditors are also stronger in Asia than in Latin America. With regard to judicial enforcement (of property rights) however, the region, especially Indonesia and the Philippines, scores much below Latin America. Compared to industrial countries, the differences are even more striking. These weak enforcement capacities mean shareholders can not fully use protecting mechanisms. Furthermore, weak disclosure means shareholders often do not have the information to judge corporate performance and insider behavior.

¹² Data provided by the SET.

¹³ One particular aspect of concern are disclosure rules. Regarding *what* to disclose, while in most developed markets rely on market practice and due diligence obligations to ensure disclosure of all material information, in developing countries, it is prudent for the authorities to be more proactive. In several East Asian countries, however, markets were still struggling to define more precisely what this meant in practical terms. Disclosure systems were also weak in *how* information was disseminated through public repositories and mandated requirements for publicly held firms. This weakened market incentives, particularly for financial intermediaries and for firms issuing short-term paper.

Table 3: Investor Protection in Asia and Latin America

| | Investor Protection (1) | Creditor Protection (2) | Judicial Enforce- ment (3) | | Investor Protection (1) | Creditor Protection (2) | Judicial Enforce- ment (3) |
|-------------|--|--|---|-----------|--|--|---|
| India | 2 | 4 | 6.1 | Argentina | 4 | 1 | 5.6 |
| Indonesia | 2 | 4 | 4.4 | Brazil | 4 | 1 | 6.5 |
| Malaysia | 4 | 4 | 7.7 | Chile | 4 | 2 | 6.8 |
| Pakistan | 5 | 4 | 4.3 | Colombia | 1 | 0 | 5.7 |
| Philippines | 4 | 0 | 4.1 | Mexico | 0 | 0 | 6.0 |
| Sri Lanka | 2 | 3 | 5.0 | Venezuela | 1 | NA | 6.2 |
| Thailand | 3 | 3 | 5.9 | Average | 2.2 | 0.8 | 6.1 |
| Average | 3.1 | 3.1 | 5.4 | | | | |

(1) An index of how well the legal framework protects equity investors. It will equal six when (1) shareholders are allowed to vote by mail; (2) shareholders are not required to deposit share in advance of a meeting; (3) cumulative voting is allowed; (4) when the minimum percentage of share capital required to call a meeting is less than 10%; (5) an oppressed minority mechanism is in place; and (6) when legislation mandates one vote per share for all shares (or equivalent).

(2) An index of how well the legal framework protects secured creditors. It will equal four when: (1) there are minimum restrictions, e.g., creditors' consent, for firms to file for reorganization; (2) there is no automatic stay on collateral; (3) debtor loses control of the firm during a reorganization; and (4) secured creditors are given priority during a reorganization.

(3) An index measuring the quality of judicial enforcement ranging from 1 to 10 (best) equal to the average of five sub-indexes measuring: (1) efficiency of the judicial system; (2) rule of law; (3) corruption; (4) risk of expropriation; and (5) risk of contract repudiation.

Source: La Porta et al. (1997 and 1998).

In Thailand, like in many other countries in East Asia, the enforcement of minority shareholder and creditor rights is being undermined by a weak judicial system. As shown in Table 3, the quality of judicial enforcement is weaker in Thailand than in Malaysia, India and in four out of six Latin American countries included in the table. For example, according to one of the legal sub-indices reported by La Porta et al. (1998), the efficiency of the financial system in Thailand is the second worst among the 49 countries in their sample.¹⁴ The speed of foreclosing on collateral (reportedly up to two to three years for mortgages) as a result of slow court procedures and lack of registries is among the critical issues that may undermine Thailand's Financial Restructuring Authorities' sale of assets of the closed finance companies.

¹⁴ An assessment of the "efficiency and integrity of the legal environment as it affects business" as reported by Business International Corporation (La Porta et al, 1998).

Accounting Standards and Practices

According to the International Financial Reporting Index constructed by the Center for International Analysis and Research, several countries in the East Asia region, including Malaysia and Thailand, have made strong efforts during the 1990s to improve accounting and reporting standards.¹⁵ But while many of the accounting and auditing standards in Thailand, and in the region more generally, are generally consistent with those issued by the International Accounting Standards Committee, several need further improvement.¹⁶ In Thailand, the standards that need to be reinforced or created include standards for financial statement disclosures, asset classification, marketable securities, loss recognition and debt restructuring and impairment of assets. In the long run, the need to create an independent standard setting body that includes representation from all stakeholders is more important to help ensure conditions relevance and quality of accounting standards.

There is strong anecdotal evidence that accounting and auditing practices in Thailand are not yet up to international standards. First, compliance with accounting rules, certification, and enforcement of a code of ethics has been hampered by weaknesses in industry self-regulatory organizations. The lack of strong self-regulatory organizations in the auditing and accounting profession is common in many countries in South East Asia. In Indonesia, for instance, in the absence of strong professional associations, BAPEPAM (the official capital market regulatory agency) licenses legal and accounting professionals to work in the securities areas. Currently, in Thailand three official agencies share regulatory authority. An additional problem in Thailand has been a shortage of well-qualified accountants and auditors together with unnecessary statutory and mandatory requirements. In particular, 300,000 partnerships and inactive limited companies need to be audited every year. The impact of this shortage of well-qualified accountants has been compounded, as in many other countries in East Asia (e.g., Indonesia), by restrictions on the activities of foreign accounting firms.

5. EMPIRICAL TESTS

In this section, we study the various relationships between ownership concentration, leverage, and corporate performance. In particular, we investigate three related hypotheses. First, on a cross-sectional basis, we expect that firms with more tightly held ownership display a higher level of productivity and profitability. We expect, however, that these firms may be less flexible over time in changing their corporate governance, and hence may experience a deterioration in financial performance. Second, firms with concentrated ownership—and associated links to the banking system—may have had easier access to debt financing and may have disproportionately increased their leverage, thus creating greater exposure to adverse shocks. Finally, if financing was indeed not made available on an arms-length basis, firms with rapidly deteriorating performance may have been able to finance their losses, rather than being forced to adjust. If this

¹⁵ The Center for International Analysis and Research is an investment advisor located in the United States. The index is based on the reporting practices of major domestic corporates with regard to 85 disclosure variables.

¹⁶ Malaysia, for instance, has adopted 24 of the 31 international accounting standards without alteration, while the others are generally consistent with international standards (World Bank, 1997).

hypothesis is true, firms with worse profitability may, over time, have had more rather than less access to external finance as compared to firms with better financial performance.

Ownership Concentration and Corporate Performance

High ownership in the hands of a few holders may lead to slower response to changing market conditions. To test this hypothesis, we investigate some relationships for the firms listed on the SET (see Annex 1 for a description of the data). First, we regress 1992 profitability on 1992 ownership concentration. Our prior is that more profitable firms will have higher concentration of ownership for two reasons: there will be a bias of more profitable firms attracting more concentrated owners; and there will be better monitoring when ownership is concentrated, leading to more profitable firms. Second, we regress 1996 profitability on 1992 ownership concentration. We hypothesize here that the more concentrated ownership is, the less likely it is that management has made the necessary changes in corporate behavior over the period 1992-96, leading to a deteriorating profitability. The results for both regressions are reported in Table 4 and are also depicted in Figure 2, where the vertical axis depicts the level of profitability while the horizontal axis shows the concentration of top five owners. The left bars are for 1992 and the right bars are for 1996.

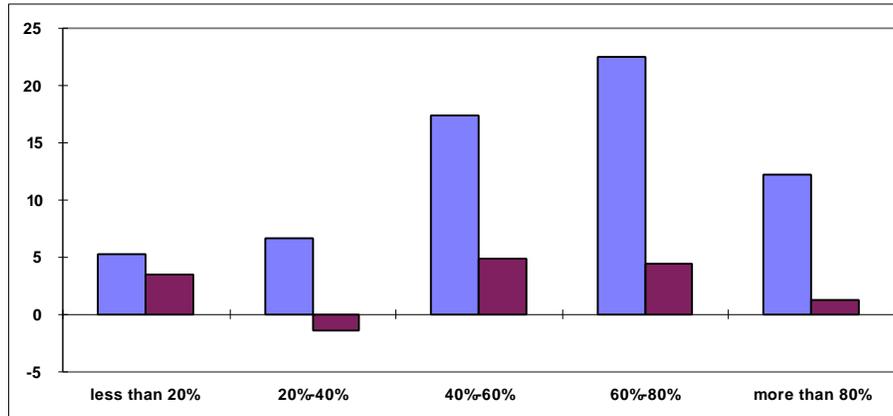
Table 4: Ownership Concentration and Profitability

| | <i>PROFIT92</i> | <i>PROFIT96</i> |
|------------------------------|-----------------|-----------------|
| Ownership Concentration 1992 | 0.202* | -0.063 |
| | (0.084) | (-0.090) |
| Sector Dummies Included | Yes | Yes |
| Size Dummies Included | Yes | Yes |
| Observations | 236 | 236 |
| R ² | 0.176 | 0.163 |

Notes: Profitability is defined as EBIT over sales. Ownership concentration is the share of top 5 owners. Standard errors in parentheses.

Ownership concentration is positively (and significantly) related to profitability in 1992. This association, however, turns negative by 1996 (albeit not significant). Since we have the same sample of firms in both periods, the results suggest that firms with concentrated ownership show a deteriorating performance relative to firms with less concentrated ownership. This may be for a number of reasons, as argued in the previous paragraphs, one of them being the aspiration of owners to extend their business, frequently beyond efficient levels.

Figure 2: Ownership Concentration and Level of Profitability (1992 versus 1996)



Ownership Concentration and Leverage

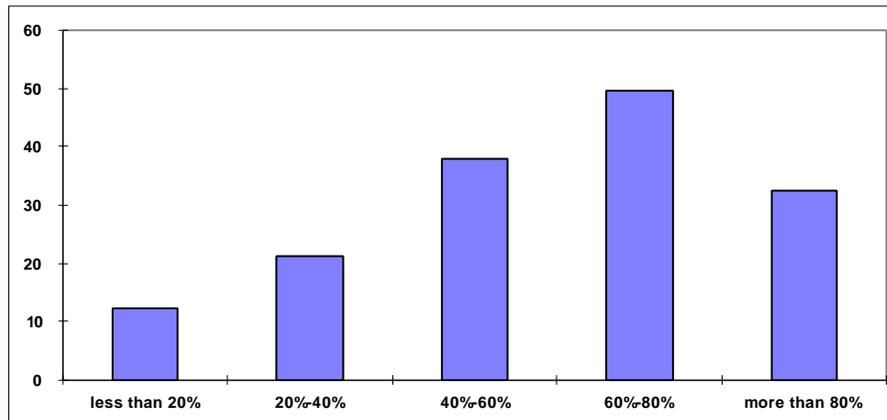
Another negative consequence of concentrated ownership, particularly ownership in the hands of families that have controlling interests in banks, is the possibility of easy borrowing and the resulting increase in leverage. We illustrate this possibility by regressing leverage on initial ownership concentration for 1992 and 1996 (Table 5 and Figure 3). The effect is present in both years: firms with more concentrated ownership have higher leverage, even when we adjust for cross-sector differences. This effect almost doubles in magnitude between 1992 and 1996. Figure 3 confirms this relationship between initial ownership concentration and changes in leverage. Firms where top-five owners' concentration is 60-80% have the highest increase in leverage between 1992 and 1996 - an average of 53%. In contrast, firms with dispersed ownership (below 40% of shares belonging to the top five owners) show an increase in leverage of only 17% on average.

Table 5: Ownership Concentration and Leverage

| | <i>Leverage92</i> | <i>Leverage96</i> |
|------------------------------|-------------------|-------------------|
| Ownership Concentration 1992 | 0.151* | 0.287* |
| | (0.044) | (0.072) |
| Sector Dummies Included | Yes | Yes |
| Size Dummies Included | Yes | Yes |
| Observations | 236 | 236 |
| R ² | 0.265 | 0.322 |

Notes: Leverage is defined as debt over equity. Ownership concentration is the share of top 5 owners. Standard errors in parentheses.

**Figure 3: Ownership Concentration and Changes in Leverage
 (1992 versus 1996)**



Note: The vertical axis is the Percent Change in Leverage 1992-96, the horizontal axis is the top-five owners' concentration.

By including sector and size dummies, we control both for cross-sector variation and for size within-sector variation. The possibility that large firms have on average (increasingly) higher leverage is controlled for by the inclusion of size dummies in the regressions. We constructed the size dummies by ranking all companies in a particular sector by employment, and then constructing dummies for each quartile of firms. Thus the largest 25% of firms in a given sector are dummied out separately; the second largest 25% form another group, etc. The correlation between ownership structure and leverage may nevertheless be spurious if firms with high ownership concentration also display some distinguishing characteristics other than cross-sector variation and size that are not included in the regressions.

Leverage and Profitability

We then study the contemporaneous correlation between corporate financing patterns and corporate performance in Thailand. One possible contributing factor to the financial crisis in Thailand may be related to the non market-based access to outside financing, especially from commercial banks. Firms which experience deteriorating performance may have been tempted to get involved in projects with possibly high returns, but high risk. To undertake such projects would have required extra outside financing. If the bank-corporate links have been less than arms-length, financing may have gone towards riskier projects at the expense of firms which required financing for less risky projects, but whose performance was stable.

We find no apparent correlation between leverage in 1993 and corporate profitability in 1992. In contrast, higher leverage in 1996 is associated with lower profitability in the previous year. This pattern lends some support to our hypothesis: firms with relatively worse performance got a disproportionately large share of financing in the period immediately preceding the crisis. This likely exacerbated the severity of the crisis.

The simple associations demonstrated in this section give some credence to the problem areas identified in the previous section regarding Thailand's corporate governance and finance. There are, unfortunately, no quick fixes to these problems as they arise endogenously from the structure and incentives of the Thai corporate sector, and they may require deep changes in the way

the ownership of the real and financial sector of Thai economy is distributed. We do believe, however, that some change is possible and suggest some specific options for policy actions in the concluding section.

Table 6: Leverage and Profitability

| | <i>Leverage⁹³</i> | <i>Leverage⁹⁶</i> |
|-----------------------------|------------------------------|------------------------------|
| Profitability ⁹² | 0.063 (0.108) | |
| Profitability ⁹⁵ | | -0.071* (-0.033) |
| Sector Dummies Included | Yes | Yes |
| Size Dummies Included | Yes | Yes |
| Observations | 236 | 236 |
| R ² | 0.089 | 0.208 |

Notes: Leverage is defined as debt over equity. Profitability is defined as EBIT over sales. Standard errors in parentheses.

6. OPTIONS FOR ACTION

The main lesson from the international experience is that it is important to take an integrated approach to the issue of corporate governance and corporate financing. There are strong links between corporate governance and corporate financing on the one hand and the legal framework, competition policies, the evolution of the real sector, etc. on the other hand. Consequently, policy recommendations on corporate governance and corporate financing can not focus on one aspect only. To assure, for example, that the objective of lowering the leverage of firms is consistent with the overall financial sector evolution, one would have to ensure that there is enough equity available, either in the domestic system as a whole, or from foreign sources. Equally, to ensure that incentives are not skewed towards continued lending to the largest firms, it will often be important to restructure the banking system. Otherwise, undercapitalized banks may continue to lend to firms which are “too big to fail.” The quality and effectiveness of commercial laws will in turn partly determine the extent to which all types of creditors can play a role in corporate governance.

Another important lesson is that improving the framework for corporate governance and corporate financing takes time and requires considerable changes in attitudes. Only countries that have gone through extreme crises have been able to alter the form of governance and distribution of control of the real and financial sector in a short period of time.¹⁷ We do not expect that the corporate governance structure, and the related corporate financing structure, will change dramatically in Thailand in the near-term through some major “stock” changes. We rather expect

¹⁷ Chile is an example of a country that achieved a significant ownership and control transformation of its economy following its financial crisis of the early 1980s. The transformation involved a reduced role for conglomerates, the privatization of state enterprises, a fully funded pension system, and various other tools. Many transition economies have also been able to achieve a rapid transformation (see World Bank, 1996).

changes on a “flow” basis, where the financial pressures under which many firms currently operate will be the main driving force for corporate restructuring and changes in corporate governance.

Near-term policies should aim at making the necessary restructuring, de-leveraging of firms (through divestiture or sale of assets; the stream-lining of business units; operational restructuring, etc.) and new equity infusion most efficient. They should aim at ensuring that the least amount of going concern value and goodwill is lost and the smallest number of viable, but over-indebted firms are pushed into bankruptcy. This requires a number of changes in tax and regulatory policies to assure a more smooth enterprise restructuring process. In the case of Thailand, the most important policies are: to expand the role of foreigners in the enterprise sector, to review tax rules that may discourage debt restructuring, debt-equity swaps and mergers and acquisitions, and to review the bankruptcy legislation so as not to discourage new money to firms in financial distress. It will also be important to take initial steps in the governance and disclosure areas to assure new outside investors of the long-term commitment of the regulatory authorities and domestic market participants to the reform process.

To improve the structure of corporate financing and the framework for corporate governance, the most urgent task now will be to change incentives such that the overall system allows for better outcomes over time. This will involve, inter alia, accelerating planned legal reforms, including the bankruptcy and foreclosure laws. In addition, six areas of specific importance for changing the corporate governance and corporate financing are:

1. *Enhancing Enterprise Monitoring* The role of commercial banks in enterprise monitoring and corporate governance will have to be enhanced through a comprehensive program of bank restructuring and institutional development. Banks, which in the short-run will dominate Thailand's financial sector, need to become more effective monitors of firms' management, in an ex-ante, interim and ex-post sense. At the same time, banks need to develop more arms-length relationships with firms. This will require stricter enforcement of insider and connected lending limits, violation of which has contributed to the recent financial crisis and poor intermediation. In those cases where banks and firms are effectively controlled by the same shareholders, increased transparency is required (which could take the form of increased disclosure or the requirement of a formal ownership relationship, such as through a holding company). Other financial institutions and agents involved in disciplining firms should be encouraged to enhance their role. For example, over time, bond investors can play an important role in disciplining managers, but this requires some changes in the commercial codes. Foreign investors' role in corporate governance and corporate financing will benefit from the removal of some impediments in the legal framework, including in the Alien Business Law.

2. *Improving Disclosure and Accounting Practices* The disclosure of information and the accounting practices in Thailand should be improved. While disclosure and accounting rules are becoming increasingly consistent with international standards, the application of these rules appears to be hindered by the limited role of the self-regulatory agencies (SROs) in raising standards and practices and imposing sanctions on irregular behavior. A larger role for SROs, backed up by increased legal powers to discipline violators, may be needed. In addition, the market structure of the accounting industry, with limited participation by foreigners, may have been a hindrance to upgrading practices.

3. *Better Enforcement of Corporate Governance Rules* The formal corporate governance framework in Thailand is not different from the standards used by developing countries at similar income levels. But, again, the practice and enforcement of the corporate governance rules are weak. Important changes in the capital markets as well as in the judicial system are needed such that minority shareholders' rights are better protected in practice. The main lead for improvements will have to come from two institutions: SET and SEC. Extra tools to enforce regulations and discipline members may be needed to make these institutions more effective. In this context, it may be useful to review the process for the appointment of commissioners of the SEC and board members of the SET. Also, an enhanced role of SEC and SET in monitoring shareholders' actions is necessary, as insider transactions have damaged Thailand's capital markets reputation.

4. *Facilitating Equity Institutions* As external financing needs are high, particularly for new equity, attracting new investors will be important. To facilitate the process of new equity infusions, it will be necessary to provide new investors with a more direct role in monitoring and disciplining managers. This will require a good minority shareholders representation on the board of directors, which in turn may imply ensuring broader application of the one-share one-vote principle and using cumulative voting for the appointment of directors. It may also be useful to introduce supermajority voting rules for fundamental corporate decisions, such as acquisitions and major investments. Some market participants and analysts have even suggested that new equity infusions may require a more-than-proportional representation on the board of directors by new equity owners, at least initially until other investor protection mechanisms are strengthened. And improving corporate governance will require enhancing the role of institutional investors in Thailand in firm monitoring, which will have to start by improving the governance of these investors themselves.

5. *Improving the Corporate Governance Framework* In the more medium-term, a number of improvements in the corporate governance framework are desirable. The proposal by SET (see Stock Exchange of Thailand, 1997) for self-regulation on corporate governance of listed firms, i.e., to adopt standards regarding the roles, duties and responsibilities of the directors of listed companies to which firms can subscribe, could be made mandatory. More generally, Thailand could benefit from a broad public discussion on the topic of corporate governance, similar to what happened in the UK and other developed countries in recent years.¹⁸ In the end, the issue of corporate governance concerns the distribution of control in the economy over the real sector. A discussion of the preferred evolution of the real (industrial sector) should form the basis of the desired evolution of the corporate governance framework. The process of consultations used for the 1998 OECD report on corporate governance provides a good starting point on how this public discussion might be conducted.

6. *Strengthening Institutions* In terms of institutional development, it is clear that data availability and analysis of corporate financing and corporate governance represent major weaknesses in Thailand. Not only is the data on corporates, especially on SMEs, incomplete and

¹⁸ For example, the Cadbury (1992) and Hamel (1998, UK) report, the Toronto Stock Exchange (Canada, 1994) report, the Peters report (Netherlands, 1997), the Corporate Governance Forum (Japan, 1997), the Statement on Corporate Governance (US, 1997), and similar efforts in a number of other countries.

of poor quality, there are also institutional gaps, as the responsibility for monitoring firm performance and behavior is scattered. Follow up work should aim at systematizing data collection on firms and performing more and regular surveys. This should be a joint effort of private, semi-public and public organizations.

ANNEX 1: DATA FROM THE STOCK EXCHANGE OF THAILAND

The data on which the regressions made in this paper are based are provided by the SET and include balance sheet and income statement data, major shareholders, prices and market capitalization for all listed companies. The balance sheet and income statement data are available on a yearly basis, from 1992 through 1996. The companies issue different type of securities, and the shareholder information is available for these securities. For some securities, there is information across multiple years, but often the information is available for one year only. The earliest shareholder information available is for 1995, the latest is for 1997. Price data is available from 1975 through 1997. The financial statement and shareholder data include firm identification numbers. The financial data also include firm names, and the shareholder data include security names. The price data only includes security names, no firm identification numbers or firm names.

The only security types retained in the final data set are those of common stock since these are the only securities that match across the price and shareholder data. Financial data with firm identification numbers that matched the identification numbers of the firms included in the shareholder data set are selected based on the statements' classification. Those firms with financial statements classified as consolidated and either audited or reviewed, with preference given to audited information, were included in the final data set. Since shareholder information was sparse, the earliest available time series point was used to fill in time series gaps prior to data availability, and the latest available time series point was used to fill in gaps which occurred after data availability. This was done on the assumption that major shareholders did not change very much over this small time span. Based on the firm identification numbers, the SET sector codes were assigned to each firm. These sector codes were grouped such that the final sector codes assigned were more coarsely defined than those of the SET were.

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