4. CORPORATE GOVERNANCE AND CORPORATE SYSTEMS

This chapter is divided into four parts. The first part discusses about the corporate governance framework and its importance. The second part explores the corporate systems available. There are basically two types of corporate systems in the world; the market oriented system and the network oriented system. The third part discusses about the disciplinary mechanisms available in the two corporate systems. And the final part is about how politics can influence the corporate system.

4.1 Corporate Governance

The objective of corporate governance is not to shackle corporations but rather to balance the spirit of enterprise with greater accountability. Corporate governance is about maximising value subject to meeting the corporations financial and other legal and contractual obligations. It is also about nurturing enterprise while ensuring accountability in the exercise of power and patronage by firms. (Iskander and Chamlou, 2000).

It involves the balancing of internal and external factors of the firm. Within the firm, corporate governance is a set of arrangements that defines the relationship between the shareholders, directors, management and employees. These arrangements may be embedded in company law, security law, listing requirements, corporate charter, by-laws and shareholder agreements. The board of directors acts as intermediary between shareholders and the management, which operates the firm. The external factors include external laws and institutions that provide a level and competitive playing
field, and discipline the behaviour of insiders. These institutions include regulatory framework such as accounting and auditing standards, laws and regulations; the financial sector such as a well-regulated banking system and transparent and efficient capital markets; contestable markets; and reputational agents and other stakeholders. Reputational agents\(^1\) refer to private sector agents, self-regulating bodies, the media and civic society that reduce information asymmetry, improve the monitoring of firms and shed light on opportunistic behaviour (Iskander and Chamlou, 2000).

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\(^1\) Reputational agents include lawyers, accountants, credit rating agencies, investment bankers and analysts, corporate governance analysts, financial media, environmentalists and consumer activists.
4.11 The Importance of Corporate Governance

Good governance is a source of competitive advantage for corporations. With globalisation and firms growing need for financial resources, firms increasingly turn to the private sector either domestic or foreign for financing. Furthermore financing from the state has also been declining, as the general trend is to reduce the role of the state in the economy and seek financing from the capital markets. Therefore when firms seek external financing, sound corporate governance is important to attract these investors especially local investors.

Otherwise, either the terms can be made unfavourable to the firms or the available financing will be reduced. The market mechanism, when working efficiently will adjust to set an appropriate equilibrium level for the terms or amount of financing. Unlike foreign investors who can diversify their risk, domestic investors are usually captive to the system and will face greater risk. Domestic investors are captive to the system because the costs are sunk and they do not have the sophisticated instruments to diversify their portfolio risks as those enjoyed by foreign investors. Investors need some assurance that they will get back some return on the investment. They will need a certain system that will allow them to have influence over managers or controlling shareholders of firms. As such corporate governance standards need to be at an acceptable level in order to attract them to provide capital.

Without corporate governance, management or controlling shareholders can use their position to expropriate economic benefits at the expense of the firm. Where poor corporate governance is the norm, the repercussions could extend to the financial
system, since local banks and institutional investors provide a large amount of this capital. In a bank based financial system, the victims will be the banks themselves. The situation in Thailand, Korea and Indonesia where a number of banks and financial institutions were closed following the 1997 crisis gives a good indication of the extent of the repercussions. For a capital market based financial system, the repercussion is a downgrading of the market by rating agencies and fund managers making the market unattractive and subsequently leading to a market collapse.

Such risk is called agency costs. All modern organisations, firms among them, face a conflict between their goals and the different objectives of the ‘agents’ who play a role in their operation. The reason is that the interests of those who have effective control of the firm may differ from the interests of those who supply the firm with external finance. This problem is commonly known as the principal-agent problem. It arises due to the inherent structure of the firm, which separates ownership and control and outsiders and insiders. Since the resolution of these conflicts entails transaction costs, residual rights of decision making and control over firms non-human assets must be allocated.

Corporate history is replete with cases of managerial opportunism. Patronage, insider trading, extravagant rewards, unwarranted movements of funds from one company to another, and investments in projects well beyond the bounds of prudence are some of the abuses that can happen given the controlling power and authority of management. Other forms of abuses include managers who are so deeply entrenched that they cannot be removed, and abuses committed by the controlling shareholders at the expense of the minority shareholders.
The systematic enforcement of laws and regulations has created a culture of compliance in developed countries. This has in turn shaped business culture and management ethic in these countries. The spread of globalisation has introduced these business culture and ethic to the developing world. However the same standards of corporate governance are now applied to the developing world. The developing countries may not be ready to achieve the same standards of compliance. Developing countries have neglected corporate governance for a long time. With the rush for development, their main concern is growth and quality is not taken seriously. This situation is rapidly changing. Globalisation is helping to bring harmonisation among the different standards of corporate governance between the developing and developed countries.

Increasingly, developing and transition economies see a healthy and competitive corporate sector as fundamental for sustained and shared growth. Previously these countries are only concerned with growth per se. However the focus on growth is not enough. Poverty persists in part because the benefits of growth are distributed unevenly and because poor governance diminishes growth’s potential impact on poverty (World Bank 1999). It is increasingly recognised that corporate governance is an important determinant of economic performance. Therefore, just as public governance is important in the public sector, corporate governance is also important in the private sector.

Corporate governance in advanced economies has evolved over centuries. But the developing economies may not have that luxury of time on their side. The speed of
technology advancement and globalisation may force corporate governance in
developing countries to evolve faster. In emerging markets, however, many elements
are still lacking. The situation is made worse by the complexity of the ownership
structure in the corporate sector, interlocking relationships between government and
the financial sector, weak legal and judicial systems, absent or underdeveloped
institutions, and scarce human resource capabilities (Iskander & Chamlou, 2000).

Furthermore the state often has a heavy presence in both the real and financial sectors.
It directs credit to privileged firms on subsidised terms through a poorly regulated
banking system that conducts little credit analysis and seldom monitors or disciplines
large borrowers effectively. For example some of the local banks set up a credit-
monitoring unit only after the crisis when the non-performing loans (NPLs) start to
worsen. In many countries, private conglomerates have special relationships with the
banks as well as the state. These alliances, and the absence of arm’s length
transactions within them, have led to excessive concentration of ownership, over
reliance on debt financing, high leveraging and in many cases investment in marginal
or speculative projects.

4.2 Corporate Systems

The governance problems that need to be addressed depend very much on the
ownership structure in the corporate sector. In a publicly traded company, with widely
dispersed shareholdings, the problem is how outside shareholders are able to control
the performance of managers. Since managers dominate because of the power
allocated to them by the structure of the firm, the key governance mechanism is the
rules for selecting directors, who needs to be independent in order to ensure proper monitoring of managers. On the other hand, for a closely held company with a controlling shareholder and a minority of outside shareholders, the managers most of the time are under the influence of the controlling shareholder. In this case, the governance issue is how outside shareholders can prevent the controlling shareholder from extracting excess benefits through self-dealing or disregard the economic rights of the minority shareholders. Whether the agency problem stems from conflicts of interests between managers and dispersed shareholders or controlling shareholders and minority shareholders depends on the ownership structure of the firm.

Many privatised companies in Malaysia, especially those with substantial monopoly powers in their respective industries or natural monopolies, are still very much tightly held by the state with the public holding only minority shares. In this regard, the corporate governance issue would focus on how minority shareholders rights are protected from expropriation by the controlling shareholder, which in this case is the state. Furthermore, directors representing the state, managing taxpayers money rather than their own, might not be as vigilant as if the money were their own.

Ownership structures are part of a corporate system. Therefore a look at the corporate system is important because it will shape the governance mechanism of the country. It is important to note that corporate systems themselves are shaped by the customs and legal environment of the respective country. Different systems have resulted in different structures of ownership and control, performance, different mechanisms of capital mobilisation and different roles in the domestic banking system. It will also influence the development of the disciplinary mechanism.
4.21 Types of Corporate Systems

The historical development of commerce plays a major role in how corporate systems are shaped in any particular country. Therefore there are differences in the corporate systems adopted by different countries. Moerland (1995) has identified two types of corporate systems in major industrialised countries. The market oriented systems and the network oriented systems. Charkham (1994) calls it the networked and the high-tension systems.

(a) Market oriented systems

Market oriented systems are characterised by well-developed financial markets, firms with widely dispersed shareholdings, and active markets for corporate control. Countries identified in this category are the Anglo Saxon countries of the United States, the United Kingdom, Canada and Australia. With a well-developed financial market, substantial capital is raised through the capital markets. Capital raised through the banking sector are relatively less important. There are a comparatively larger number of firms publicly owned in the US and the UK than any other country. The European Corporate Governance Network (ECGN) found that in the US, over 50% of the companies have largest shareholder that holds less than 5% of the shares. In the UK the median largest voting block was only 9.9% (Becht and Roell, 1999). Proxy voting is widely used. This system gives the CEO of the firm virtually full control of the firm. Pension and mutual funds, and insurance companies hold significant shares. Private individual holdings are also significant as compared to Japan or Germany.
Interlocking shareholdings are not common. However in the US, a well known firm practising this is the Warren Buffet controlled Berkshire Hathaway Corporation.

This system also emphasises on individuality and meritocracy. In the US, where the population are made up of immigrants from many different countries traditionally distrust centralised government power. Therefore the system evolved into one that emphasise checks and balances. Openness is important. This allows the media to play an important role. The media is used to disseminate information to the dispersed shareholders. Adverse publicity in the media could act as a disciplinary mechanism. Because dispersed shareholders have no interest in corporate governance, the shareholdings need to be combined under an institution for corporate governance to be cost effective. Some of these institutions include shareholders associations and pension funds.

The type of corporate system that developed in any country is closely associated with the legal environment and politics of the country. The US law bar banks from involvement in the governance of American firms. The Glass-Steagall Act for example, limits banks' security business. Regulations imposed on capital deployment can affect how firms are organised. Historically due to legal restrictions, American banks are small and weak in terms of German or Japanese standards even though the US economy is very much larger. Banks in the US are prevented from operating nationally, entering commerce, affiliating with investment banks, equity mutual funds, insurers or co-ordinating stockholdings with other intermediaries. But recently some of the restrictions may be eroding. A study by Roe (1993) found that large US
banks’ role in the US economy is only about \( \frac{1}{4} \) of the role, played by large banks in Germany and Japan.

The UK system is very different from its European neighbours. It favours a more adversarial approach. It distrust co-operation because it fears that they will act primarily to their own advantage (Charkham, 1994). The UK legal system also allows international proxy solicitation. This is because foreigners hold a high proportion of the shares.

(b) Network oriented systems

Network oriented systems are characterised by closely held corporations, cross shareholdings and substantial involvement of universal banks in financing and controlling corporate firms. This category is identified with countries in continental Europe and Japan. In this system, financial capital is mobilised to a substantial degree by banks, insurance companies, families and national states. Private individual holdings are less common because it is mostly channelled through the financial intermediaries. In the group of Germanic countries,\(^2\) the relative amount of publicly listed enterprises is smaller than in the Anglo Saxon countries.

Germany’s industrial expansion is facilitated by the emergence of universal banks. The banking sector still plays an important role in financing and controlling corporate enterprises. The large German banks\(^3\), not only is a supplier of loans but also equity capital. They possess large blocks of voting shares in their own account. In addition

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\(^2\) Germanic countries refer to Germany, Switzerland, Austria and the Netherlands.
they also hold voting rights on behalf of their clients through trustee shares deposited with them. However, the banks do not have a policy of acquiring company shares. Most of the holdings were acquired because companies failed to repay their debts. In some cases the government made use of the banks under their control to save ailing companies in the national interest (Charkham, 1994).

The banks will generally be represented in the board of directors of corporations with which they have financial relationships. These holdings are mostly long-term participations. Therefore in this system, power is shared between firms and financiers. This kind of situation is represented not only in banks but also in insurance companies and cross holdings. In Germany voting pacts are quite common. Voting pacts is a device where two substantial shareholders concentrate their voting power by voting together.

The evolution of the legal regulations is closely associated with politics. In the US, anti bank/monopoly sentiments combined with powerful interest groups produced laws that restricted the US banks. The situation is different in Germany. Restrictions here are mainly informal and self-imposed. Although managers, like their US counterparts, would like to see banks power restricted, they also need the banks power to prevent a take-over. On top of that, the German system that allows various interest groups to be represented at board level has reduced political pressure for formal restrictions.

3 Deutsche Bank, Commerzbank and Dresdner Bank.
In countries such as Belgium, France, Italy and Spain, the ownership structure is characterised by family control, financial holding companies, cross holdings and state ownership. The stock exchanges are comparatively less developed. The ownership structure also depends on government policies at the time. For example in France, a socialist government nationalised the banking system in 1981 but later when a different government came into power, it reversed the process and started a privatisation programme. State involvement in France is significant. Because of the ownership structure, private shareholders play very little role in corporate governance. State involvement can also be found in Germany. However under French law, abstention is tantamount to vote against management's position. This could shift the power to the minority shareholders if there is dispersed shareholdings.

The Japanese system involves the concept of 'obligation', 'family', and 'consensus' (Charkham, 1994). In Japan, large industrial groups, the Keiretsus such as Mitsubishi, Mitsui and Sumitomo are dominant. Some of them originated from pre-war zaibatsus, which were outlawed after WWII. These groups are diversified and vertically integrated conglomerates. Their organisational structure is characterised by a close relationship among member companies in the group, which would normally include at least one financial institution. These financial institutions provide capital in the form of loans as well as equity. The banks will have representation on the board of directors of the member companies and vice versa. The importance of banks in this system is mainly because the post-war rebuilding in Japan was financed by banks and directed by the Ministry of International Trade and Industry (MITI). Cross shareholdings and interlocking directorships are very common. As such in both the
Japanese and German model, their chief executive officers (CEO) interact regularly with the large owners. The use of the legal recourse is minimal in Japan.

The problem with this structure is it limits the number of freely floating shares. Unlike the market-oriented system, this structure will inevitably limit the ability of the exit mechanism available to minority shareholders. This exit mechanism is very important to the minority shareholders because in the event that other mechanism such as the rules and regulations fails to protect their rights or is not properly enforced then it is the only governance mechanism available to most minority shareholders. An illiquid market will make it more costly to exit. The significant role of the banks has also attracted allegations of conflict of interests between the bankers and owners. The banker being an insider may have knowledge of the company’s secrets that could be useful for its fund managers.

Table 10. Characteristics of the corporate systems

<table>
<thead>
<tr>
<th>Characteristic</th>
<th>Market Oriented System</th>
<th>Network Oriented System</th>
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<tbody>
<tr>
<td>1. Capital markets</td>
<td>Well developed</td>
<td>Less developed</td>
</tr>
<tr>
<td>2. Banks</td>
<td>Less important</td>
<td>Universal banks</td>
</tr>
<tr>
<td>3. Shareholding structure</td>
<td>Dispersed</td>
<td>Closely held</td>
</tr>
<tr>
<td>4. Type of holdings</td>
<td>Cross shareholdings (less significant), private individual (significant), insurance, mutual/pension funds</td>
<td>Cross shareholdings (significant), private individual (less significant), family, state, financial institutions</td>
</tr>
<tr>
<td>5. Publicly owned firms</td>
<td>Relatively more</td>
<td>Relatively less</td>
</tr>
<tr>
<td>6. Voting</td>
<td>Proxy voting</td>
<td>Voting pacts &amp; proxy voting</td>
</tr>
<tr>
<td>7. Distribution of power</td>
<td>CEO has full control</td>
<td>Power sharing between CEO and financiers</td>
</tr>
<tr>
<td>8. Interlocking directorship</td>
<td>Less significant</td>
<td>More significant</td>
</tr>
<tr>
<td>9. Market for corporate control</td>
<td>Active</td>
<td>Less active</td>
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</table>
Most developing countries have adopted the networked system with certain aspects of market oriented system. For example in Malaysia, capital mobilisation is mainly through banks. However bank based financing is slowly losing its importance in corporate financing as the development of the capital market, supported by the government, offered alternative mechanisms of financing to corporations. Financial capital is increasingly mobilised through the government, trust and mutual funds, insurance companies and the public. However any shareholder activism among the major trust and mutual funds such as the Employee Provident Fund (EPF) and the Kumpulan Wang Amanah Pencen (KWAP) or the Permodalan Nasional Bhd (PNB) is not known. The ownership structure is characterised by family holdings, cross holdings and state ownership.

(c) Convergence between the two systems

The market oriented system may be more adaptable and may be better suited for an environment of increasingly slower growth. On the other hand, the network-oriented system may work well during the high growth period but not so during a slowdown. Downsizing is relatively more difficult in this system. For example, German firms are known to react gradually when they are performing poorly as compared to their US counterparts. But the German system somehow is able to induce accountability. Although there may be differences between the two systems, there is no real evidence to suggest that any one is superior (Roe, 1993).

However, lately there seems to be a movement towards convergence between the two systems. In the United States, the role of financial institutions, as important
shareholders is steadily increasing, while in Japan, the central role of main banks is fading (Moerland, 1995). Recently there are proposals for the merger of the London Stock Exchange with the other exchanges in Europe. If this happens it could create a bigger and more active capital market in Europe. The United Kingdom market oriented equity and disciplinary system could be more prevalent in the other European markets. In the United States, the mutual funds, banks and insurance companies are taking a more active role in monitoring their investments. A leader in shareholder activism in the United States is CALPERS, one of the larger pension funds in the country. While in countries like Germany and Japan, the main banks' role is slowly changing from debtor to shareholder that allows them greater control of the firms. These changes are partly due to conversion of debts to equities. However some of these troubled Japanese banks may have to sell the equity to raise cash which in the long run could lead to dispersed shareholdings.

4.3 Disciplinary Mechanisms

Corporate governance disciplinary mechanism are different for different corporate systems. There are two types of disciplinary mechanisms. The internal mechanism and external mechanism. Some mechanisms work well in the market oriented system but not in a network oriented system and vice versa. In addition to the two systems, countries are coming out with a regulatory framework, in order to improve and enhance the existing disciplinary mechanisms.

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4 CALPERS — California Public Employees Retirement System.
4.31 The External Disciplinary Mechanism

(a) Take over

Take-over is a powerful market mechanism, which can discipline managers to maximise shareholder value. Managers who fail to perform risks takeover by outside investors who may perceive that the company’s assets could produce higher earnings. In most cases if this happens then a more efficient team will replace the incumbent management. In the market oriented system, takeover is quite common. In the US it is known as ‘hostile takeover’ because the incumbent management will tend to fight the takeover and the process is seldom friendly. ‘Poison Pills’ are commonly used. The reason that takeover is more common in the Anglo Saxon countries is because of the ownership structure. The ownership structure in these countries is widely dispersed, which allows takeover to be easily executed as compared to countries with a network-oriented system.

Large and concentrated shareholdings in these countries provide a barrier for takeovers to work. A well-known case in the Malaysian corporate history is the attempt by Hong Leong Group to takeover BHL Bank\(^3\) that failed. In some countries, the regulatory policies discourage takeovers to proceed. For example, voting rights for foreign shareholders are limited as compared to domestic shareholders. This effectively prohibited takeovers by foreign companies. Countries like the United States which has a one share one-vote system facilitates take-over easily. However countries like Japan with substantial cross holdings also acts as a barrier for take-over.

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\(^3\) BHL Bank was a family controlled bank from Penang.
Franks and Mayer (1990) studied France, Germany and the United Kingdom. They documented significant differences between countries in forms of ownership and control changes. According to their study, hostile take-overs, buy-outs and buy-ins are higher in the United Kingdom than in France or Germany. Levels of executive dismissals are higher in the United Kingdom. They also found very few full acquisitions in Germany. The transactions are mainly purchases of majority stakes. As such a high proportion of merger here is suspected to be associated with economies of scale and not managerial performance. Their study suggested that the observation reflect fundamental features of different countries' capital markets.

National regulations explain much of the differences between the countries. The United Kingdom legal system discourages close links between investors and firms by having laws relating to insider trading and exploitation of minority shareholders. Arrangements that limit transferability of ownership and control are restricted. But in France and Germany limitations on transfers of ownership and control are not restricted by the legal system.

Although barriers restrict take-overs in a network-oriented system, take-overs can still happen. However take-overs here can only happen between friendly parties. Hostile takeovers are virtually non-existent due to the structural barriers. Because of the ownership structure, a hostile takeover is very unlikely to succeed. Otherwise it can only succeed if the bidding group has strong political backing or if it is engineered by the state. State intervention is one way to overcome the market failure. However it may not be ideal, as it may not create an efficient outcome. Policies that reduce the
existing barriers could help the market perform better. This could lead to a more efficient outcome.

The recent banking consolidation exercise in Malaysia, which involves massive state intervention through the central bank, is an example of a state engineered take-over process. This process successfully overcame the problem of concentrated ownership. For example, after fighting hard to resist the take-over by Hong Leong Group, this time BHL Bank just gave up without a fight, to a group smaller than Hong Leong. For politically connected firms, to mount a take-over on these companies is virtually impossible, for locals or even foreign companies especially if the state is opposed to foreign takeovers. Franks and Mayer (1990) found that the French government has delayed and impeded take-overs that have been deemed to be against the national interests. For companies in this category, take-over will be useless as a disciplinary mechanism.

(b) Market for management and skilled workers

Another external disciplinary mechanism is the competition in the market for management and skilled workers. This mechanism is commonly used in a market-oriented system. Companies are always looking for high quality staff. In order to attract this group of people, they must offer good opportunities and incentives. One of the most frequently sighted reasons for employee resignation is the lack of career opportunities (Dibble, 1999). As for those who do not perform, the turnover is high. It can happen as a result of a takeover or a board decision. In the event of a takeover, the incumbent management team will usually be dismissed.
As for the latter, it will only work if the managers are not deeply entrenched. This is because in a one-tier board system, managers can make up part of the board. This gives them the power to influence board decisions. One way of reducing this agency cost is the have a management buy out (MBO). When the management become owners of the firm they will have the motivation to perform. But motivation must be accompanied by competence.

This mechanism is less important in network oriented systems. For example in Japan, managerial failure is corrected by an internal system through internal transfers within corporations or groups. Japanese employees tend to stay in the same firm, and are promoted internally. For them long term perspectives are more important than short-term performance. In addition to that, the takeover market is virtually non existent. In these circumstances, the competitive market for labour as a disciplinary mechanism is not very effective. In developing countries, many companies are closely held by families or through cross holdings. Entrenched management in these companies are quite common and could be a problem for disciplinary action because they may be the controlling shareholder or is related to it.

Another way to reduce the principal agent problem is to introduce incentive schemes. Incentive schemes tied to performance is prevalent in the Anglo Saxon systems. In the United States, these remuneration schemes like stock options, are very common especially in knowledge based activities. These compensation schemes are designed to align the interests of managers and shareholders. But these incentive schemes are less prevalent in the network-oriented systems. In Japan, these compensation schemes
are very rare. Companies in network oriented systems rarely resort to incentive schemes because they provide better job security.

(c) Code of Best Practice – a regulatory framework

Corporate governance is most countries are embodied in a loose framework of law and other regulations such as the listing requirements of their respective stock exchanges. In order to improve corporate governance many countries have come up with their own set of best practice, which covers both the internal and external mechanisms. This code will supplement the existing laws.

The law for governance is usually set in the Companies Act, which is passed by the parliament. Stock exchanges also play a regulatory role through its listing regulations. In addition to the existing rules and regulations, there is the code of best practice. The code identifies and proposes best practice for companies to the relevant parties. The adoption of the code is voluntary. However some countries rely more on the law than voluntary codes of best practices. A case in point is Germany and its Kon Trag law.

There is no single prescription for the problems of corporate governance. As corporate governance depend on various factors, the corporate governance practices will have to vary across nations and cultures. In the United Kingdom, the Committee on the Financial Aspects of Corporate Governance established the well-known Cadbury Code in 1992. This committee was set up in the aftermath of the Maxwell scandal. Other codes include Malaysia’s own Code on Corporate Governance, which
was prepared by the High Level Finance Committee on Corporate Governance in 1999 and the OECD Principles of Corporate Governance in 1999.

Although the codes of best practices are voluntary by nature, some aspects of the codes have been adopted into the rules and regulations by regulatory bodies such as the stock exchanges.

4.32 The Internal Disciplinary Mechanism

(a) Board of Directors

Internal disciplinary systems are just as important because of its internal nature, which will allow it to reduce the asymmetric information problem. One of these mechanisms is the board of directors. The board of directors stands between the shareholders and the management. They represent the shareholders by serving as a disciplinary mechanism to monitor the management. Their fiduciary duty to the shareholders is to motivate managers to enhance shareholder values.

In the Anglo Saxon one tier board system, there are two types of directors on the board. The executive directors are from the ranks of inside managers and are involved with the daily operations of the firm. While the non-executive directors are outside experts, which usually have good reputation in their respective fields. All directors are appointed by the controlling shareholder. In a dispersed ownership structure such as the United States, the CEO is the most powerful person on the board and he selects
the other directors even though the shareholders elect the board. When there is
trouble, the CEO tends to be given the benefit of the doubt for a long time.

The Germanic countries have two tier boards consisting of an executive board – the
Vorstand and a supervisory board – the Aufsichtsrat. The executive board is made up
of the management team while the supervisory board is made up of outside experts,
such as bankers, directors of other corporations through interlocking directorships and
employee representatives. The supervisory board appoints the executive board and
approves major decisions. The executive board’s role is to handle day to day
decisions. In Germany, for firms with more than 2000 employees, the supervisory
boards are legally bound to consist of equal representation from both shareholders and
employees. This type of board structure reflects the German social market economic
model, which emphasised co-determination.

The Co-Determination Act, 1976, sets out proportions of employee and shareholder
representatives in the aufsichtsrat. A point to note about this system is that all parties
work together for the good of the firm. Social responsibility is held in high regard.
Management takes a long-term view in making investment decisions as compared to
the short-termism in the United States model. The difference between these two
systems is that the two tier boards make a formal separation between supervisory and
executive functions and it incorporates formal employee representation, which is not
found in the one tier board system.

France is unique. Both the one tier and the two-tier board system are allowed. But
most companies still prefer the one tier system. The difference with the German board
and the French board is, employee representatives in the French board have no voting powers.

Japan follows the one tier board system. The high proportion of stable shareholders (bank holdings and cross holdings) leads to a board that consists mainly of insiders that have come up through the ranks. With the close relationships among firms, cross holdings and interlocking directorships, the supervisory function of the board may not be as effective as the Germanic two tier system or even the Anglo Saxon system with widely dispersed shareholdings. On the other hand, this system will make it easier for group interests to be effectively carried out. This could lead to the expropriation of minority shareholders. Helping out a distressed member firm by a stronger member firm may be beneficial to the minority shareholders of the distressed firm and controlling shareholders because they are most likely to hold shares in both firms through cross shareholdings. The minority shareholders of the stronger firm will lose out. However, accountability is quite high because of peer pressure. This kind of system would work only in societies whose people have sufficiently high moral standings and pride.

Malaysia also has a one tier board system much like the Japanese. It also has stable shareholdings with high concentration of shareholdings and cross holdings due to family control and state ownership. This led to close relationship among firms. In addition to that, firms also tend to have cosy relationships with the government, which many analysts believe is how the system functions here.
4.4 Political Ownership and Corporate Systems

It is clear that governance problems depend on the ownership structure of the firm, which in turn is part of the corporate system. The corporate system on the other hand is shaped by the customs and legal environment. Since many developing countries follow the network-oriented system and their financial markets are still developing, state invention in the system is quite high. When the state gets directly involved in the corporate system it is inevitable that there would be state ownership and political linkages between the various parties in the system.

In this situation government can interfere in firms' decisions and firms' can influence government's policy. The financial sector provides debt at cheap rates generally with the support of the government. With government guarantee, financing can easily be raised for large high-risk projects. As such the government basically bears the risks. The external markets do not function properly because of market barriers set by the government in order to fulfil its political agenda. Examples include the bailout of the financial sector by Danamodal and Danaharta. The funding for this bailout is from public savings through the sale of government guaranteed bonds to the financial institutions.

In this system the state influence can be universal especially for state owned companies. This is because the state controls both the external and internal environment. The state controls the external environment by influencing the three external sectors; financial sector, regulatory sector and the markets. The state can control the financial sector through the regulatory bodies such as the Central Bank.
and the Securities Commission. It also controls the regulatory sector because laws are passed in parliament by the same politicians in control of the government. For example in Malaysia, the regulatory structure is governed by the Companies Act, 1965, Securities Commission Act, 1992, Securities Industry Act, 1983, Futures Industry Act, 1992 and the Banking and Financial Institutions Act, 1989. The Minister of Domestic Trade and Consumer Affairs enforces the Companies Act, while the Minister of Finance enforces all the others.

As for the control of the markets the state can easily implement restrictions like the limit on foreign shareholdings and other restrictions. The state being the majority shareholder can also control the internal environment by controlling the board of directors. Directors are appointed by the state. The board in turn is responsible for appointing the management team. Figure 2. shows the political influence in the corporate system. With political influence so strong in the corporate system it seems that enforcement of the laws would be very difficult. In a rapidly growing economy, the acceptable boundaries for these transgressions are wider. But it is not the same in a crisis. When bad management is combined with weak banks and underregulated capital markets and poorly enforced laws of external discipline, the whole system could implode.
Figure 2. Political influence in the corporate system.

Internal
- Shareholders
- Board of Directors
- Management
- Employees

External
- Markets
  - Product market
  - Foreign Direct Investment
  - Corporate control
- Regulatory
  - Standards
  - Laws & Regulations (SC, KLSE, etc.)
- Financial Sector
  - Debt
  - Equity