

CHAPTER 1

INTRODUCTION



Background of the Study

Before the economic crisis, Thailand, like many countries in Asia, pursued a growth strategy that was largely quantity-oriented. This strategy lacked core components which would ensure the long-term stability of the financial system. The result was vulnerability in the Thai financial system, as well as a bubble situation in the real-estate sector, causing a major financial and economic crisis in the country in 1997. The lack of good corporate governance prior to the crisis was a major factor in the economic collapse. Examples of poor corporate governance include the lack of transparency in transactions and dealings among companies. This led to the expropriation of minority shareholders by management and a weak system of accountability of business. Another example of poor corporate governance was the prevalence of connected lending or clean loan, in which the actual size of a high level of debt was hidden by related-party transactions and off-balance sheet financing. Another example was a high level of foreign exchange risk exposure by corporations and banks generating from large amounts of short-term borrowing in foreign currency. The crisis provoked demands from investors and from the International Monetary Fund (IMF), as the country's major creditor, for a proper corporate governance standard to ensure sustainable growth in the financial system.

The initial improvement of corporate governance in Thailand began in 1998. The Stock Exchange of Thailand (SET) began to require newly listed companies to set up an audit committee. These committees are to be made up of at least 3 independent members, at least one of whom must have expertise in accounting or finance. Already listed companies had until the end of 1999 to set up their committee.

In 2000, SET published the Guidelines for Good Corporate Governance which gave clear guidance on good governance for companies registered in the Stock Exchange of Thailand. SET asked all listed companies to adopt these principles with the expectation that the market would reward companies that met more guidelines than companies that met fewer or none. In August 2001, SET published a new version of the Report on Good Corporate Governance, based on feed-back from the first set of guidelines. This report is regarded as an important benchmark of good corporate governance within companies. The Thai government declared 2002 as the Year of Good Corporate

Governance, indicating interest and motivation by regulators in supporting good corporate governance practices.

In addition, SET introduced financial and non-financial incentives to reward companies for good corporate governance. These included cutting fees for well-governed firms that issue bonds or equity, providing fast-track service for standard and recurrent regulatory approvals, and publishing a list of well-governed companies. The Office of the Securities and Exchange Commission (SEC) placed high importance on both disciplinary and incentive measures for promoting good governance.

The SEC issued regulations to ensure that the rights and interests of shareholders would be protected. Companies are required to have a check and balance management structure in order to prevent conflict of interest and to act in the best interest of minority shareholders. In addition, veto rights for minority shareholders on important issues were imposed. The SEC also implemented education and awareness programs for investors, listed companies, and others in the Thai capital market.

The SEC's assignment to the Thai Rating and Information Services Co., Ltd. (TRIS) to rate governance of companies started in September 2002. Governance rating is an incentive measure which praises companies with good corporate governance and helps investors distinguish such companies from others. The criteria used in this evaluation may be beneficial to companies as a guideline for good corporate governance. In addition, the SEC requires listed companies to disclose their good corporate governance practices and explain any discrepancies in a 56-1 report and annual report of the companies by the end of 2002.

Though many companies state that corporate governance practices are too costly, good governance could enhance investor confidence which would lead to a reduction of cost of capital. The previous surveys suggest that institutional investors are willing to pay a premium for shares in well-governed companies in emerging markets and have made corporate governance a major criterion in their investment decisions.

Although there has been a lot of improvement in corporate governance in the Thai capital market, individual investors still have limited access to companies' governance information. This information is considered a crucial element in making investment decisions. The purpose of this study is to find the proper criteria to evaluate a firms' governance for individual investors. Shareholders and companies need a systematic measurement to identify the level of a companies' current position in governance practices and what key areas need to be improved. Corporate governance rating is a tool

that will help investors to clearly differentiate the level of corporate governance practice of each company.

Since the improvement of corporate governance is an interesting issue, many people have tried to verify whether or not it benefits the investor. Although studies of foreign organizations state that investors are willing to pay for good governance, there is uncertainty whether this will be true in the Thai system. This thesis will focus on Thai companies by examining the relation between level of corporate governance and stock returns of listed companies in the Stock Exchange of Thailand (SET).

Objective of the Study

The Asian economic crisis has been over for some time. It is evident that good governance is a significant topic for companies, especially listed firms in the Stock Exchange of Thailand. This paper investigates the practices of good governance in Thai companies and presents this evidence in terms of a corporate governance index. It also focuses on finding the relation between the corporate governance index and stock return. Such results can infer to what extent Thai companies are willing to invest in good corporate governance and whether or not the promotion of good governance in Thailand is beneficial to investors.

Scope of the Study

The observations are selected from companies registered in SET. The sample groups used in this investigation are selected from 400 listed companies, which are ranked by their stock return and trading-value respectively. Each sample group, stock return and trading-value groups, contains 100 companies. The purpose of using this method of sample selection is that the sample groups would replicate stocks that investors are interested in, and allow for data collection within the limited time of this thesis. This study also surveys fund managers of Asset Management Company limited in Thailand about the level of importance of corporate governance factors in their investment decisions.

Contribution

This research provides evidence of the effect of corporate governance on stock return in Thailand. The result could indicate whether governance plays a crucial role in the Thai market and whether policymakers' actions to promote good governance provide true benefits to investors. If the

outcome shows a positive signal, it will indicate that governance factors as an important criterion in investment decisions.

Methodology in Brief

This study is divided into two main parts, an operational-study and an empirical-study. The operational-study explores how companies build good governance while the empirical-study employs econometrics as a tool to test how governance factors influence stock return.

The operational-study investigates corporate governance practice in Thailand during 2001-2002. Results are presented in the form of a governance index. Evaluation questions are used to develop criteria to evaluate corporate governance practice in Thailand based on the SET guidelines for good corporate governance practice. In addition, questionnaires are used to survey fund managers in Thailand whose results support the criteria index. The outcome of the survey can be used as corporate governance criteria to evaluate the level of good corporate governance in companies.

Information is collected from many available sources such as annual reports, 56-1 reports, company websites, available information on SET and SEC website, as well as necessary information from Integrated-SET Information Management System (I-SIM C.D.) of companies.

The empirical-study examines the relation between governance index and other control variables. Cross-sectional regression estimation is used to evaluate the relation between the level of corporate governance and stock return.

Organization of the Study

The remaining sections of this thesis are organized as follows: Chapter 2 contains the literature review where the relevant theoretical models and research hypotheses are briefly outlined; Chapter 3 gives the sample, data methodology, and hypotheses used in this thesis; Chapter 4 presents the results of the examination of the relations between these variables; and Chapter 5 presents the conclusions of this thesis.