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Corporate Governance and Risk Management in Developing Market: A Logic Analysis and Proposal

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Abstract

The lessons from financial crisis illustrate the importance of risk management; corporate governance is increasingly being considered as an important part of risk management. In this paper, the author discusses the role of corporate governance in risk management in developing markets from shareholders vote, board of directors, top management, and auditors. This paper also presents recommendations to improve corporate governance in order to strengthen risk management.

Key words: Corporate risk; Corporate governance; Risk management

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INTRODUCTION

The frequent financial crisis has seen the collapse of numerous businesses internationally, illustrating that no industry or jurisdiction is immune from inadequate or inappropriate risk management. All businesses should have the capacity to develop policy with a full appreciation of risk and the development of a suitable set of operating procedures in order to respond to changing circumstances in a timely manner. The lessons from financial crisis illustrate the need for appropriate risk management, planning, control and the need for companies to reassess their governance structure to ensure adequate risk management.

Meanwhile, corporate governance has attracted considerable attention over the past decades, leading to recommended codes of practice, conceptual models, and empirical studies. A growing number of empirical studies have demonstrated that good corporate governance contributes to better investor protection, lower costs of capital, reduced earnings manipulations, increased company market value, improved stock returns, and even economic growth. Corporate governance has been seen at the forefront of establishing standards of corporate ethics aimed at reducing unscrupulous corporate practices while preserving a fair business environment. Corporate governance is also increasingly being considered as an important part of corporate risk management and the logic is poor. Corporate governance is viewed as risky, whereas creditors and investors view good corporate governance as a sign of strength in a corporation.

In this paper, the author discusses the relationship between corporate governance and risk management, and puts forward recommendations to improve governance structure to manage corporate risk.

1. THE ROLE OF CORPORATE GOVERNANCE INSTRUMENTS IN AFFECTING CORPORATE RISK

The governance structure can be divided into the internal governance and external governance, which can affect corporate risk. Economic and financial theory suggests the instruments mentioned below affect corporate risk.

1.1 Shareholders Votes

The shareholders' votes play an important role in risk prevention, and there should be a negative relationship between corporate risk and shareholders rights. Each shareholder has been delegated with a vote to play a role in the operations of a firm and can use their vote in removing and appointing the board of directors. They can make decisions about the compensation of employees in a firm and can also participate in financial decisions of a firm, including the rules of financial risk management.

The shareholders enjoy the right to represent themselves on the board. They are also allowed to gain all kinds of information from the officials of the firm such as analysts, board of directors and employees. The easy access to public and private information by the shareholders can reduce the information asymmetry between the shareholders and managers, reduce the agency cost and result in improvement in unfortunately, the majority shareholders are negative in affecting risk management in developing market (China as an example). The controlling shareholder equity is highly concentrated. The equity interest of minority shareholders is highly fragmented, it is difficult to check and balance between the shareholders. The controlling shareholder can easily manipulate the shareholders' meeting resolution. ; It is more likely for the largest shareholder to occupy the interests of minority shareholders. The controlling shareholders achieve their own revenue maximization through controlling assets restructuring and equity transactions, which will bring a great deal of the operating and decision-making risk.

1.2 Role of Board of Directors

The board of directors can play an important role in risk management. The corporate risk is also appropriately dealt with when the board performs its fiduciary duties such as monitoring the activities of management and selecting the staff for the firm. The board can also appoint and monitor the work of an independent auditor to avoid the related risks. The board of directors can resolve internal conflicts and decrease the agency cost in a firm. The member of a board should also be accountable to the shareholders for their decisions.

The board consists of two directors: outsider (independent) and insider directors. The majority of directors in a board should make rational decisions to add value for shareholders and avoid risk. The role of independent directors is very important to improve risk management as they can monitor the firm and force the managers to take unbiased decisions. The insider directors are also important in safeguarding the interests of shareholders. They provide the shareholders with important financial information, which will decrease the information asymmetry between managers and shareholders. The board size should be chosen with the optimal combination of inside and outside directors for the value creation and risk prevention.

The board of directors in developing market is unlikely to be responsible for the whole shareholders, as the weak judiciary and regulatory authority in this market enables the directors to be involved in biased decision-making that serves the interests of the majority shareholders; meanwhile, in the case of high concentration of shareholding, the largest shareholder can influence the operations of the board through electing insider directors to be easy to control the Board .The actual controller generally serves as chairman of the board, so the independence of the board is difficult to get protection providing a disadvantage to the firm.

1.3 Role of CEO (Chief Executive Officer) and Managers

A Chief Executive Officer (CEO) is the highest-ranking corporate officer (executive) or administrator in charge of total management of an organization, and can play an important role in risk management. The CEO can follow and incorporate governance provisions in a firm to avoid risk. An individual appointed as a CEO of a corporation, company, organization, or agency typically reports to the board of directors, the decisions of the board about hiring and firing a CEO and their proper remuneration and tenure have an important bearing on risk management. In developing market, the board is easily controlled by the CEO; the CEO is more likely to make decisions for his own interest, which adds the risk for the firm.

Managers can play an important role in risk management. They can reduce the agency cost in a firm by decreasing the information asymmetry, which results in improving risk management. The rights of minority shareholders are suppressed and the actions of the managers mostly favor the majority shareholders in developing market, meanwhile the management and the shareholders in these markets rarely use the tools of hostile takeover and incentives to control the actions of managers, which can’t help to strengthen risk prevention.

1.4 Role of Auditors

The role of auditors is important in implementing corporate governance principles and improving risk management. The principles of corporate governance suggest that auditors should work independently and perform their duties with professional care. In case of any financial manipulation, the auditors are held accountable for their actions as the availability of transparent financial information reduces the information asymmetry and helps to avoid the risks, especially financial risk.

However, in developing market, auditors tend to manipulate the financial reports of the firm and serve the interests of the majority shareholders further disadvantaging the minority shareholders. The weak corporate law and different accounting standards also deteriorate the performance of the auditors and create financial instability in developing market.

2. IMPROVE CORPORATE GOVERNANCE TO STRENGTHEN RISK MANAGEMENT

Corporate governance structure is sound directly affect the business decision-making, and will also affect the corporate risk. It is more important for companies in developing market. This paper puts forward the following suggestions.

2.1 Optimize the Ownership Structure and Introduce Institutional Investors

There are many defects in governance structure which cause or exacerbate corporate risk; the biggest drawback is the excessive concentration of ownership in developing market, the majority shareholders, especially the largest shareholder can not only manipulate the resolution of the general meeting of shareholders, but also control the board of directors and managers, they may harm the interests of minority shareholders for their own interests. Moreover, the weak judiciary regulatory authority in this market, and decision-making is lack of binding and scientific procedure, which is not conducive to the development of the company. The ownership must be diversified in order to solve the problems of corporate governance

Controlling shareholders need transfer some of the shares to small investors, or transfer to institutional investors; Transferring to the former will not achieve the desired effect, because the "free-rider" phenomenon is prevalent for small and medium-sized investors in developing market, They are accustomed to vote with "foot", therefore reducing controlling shareholder equity ratio will not affect its control over. The introduction of powerful institutional investors is necessary to be introduced,. They can accept a relatively large proportion of the shares and have the motivation and ability to participate in corporate governance, and internal controlled problem will be solved to some extent.

2.2 Improve Board of Directors and Board of Supervisors

Improving the performance of the board is a global problem, but this demand is much more urgent in developing markets. These markets are also facing the various deficiencies existing in market mechanisms. Because in these markets, the social supervision system composed of the forces has not formed. The board is bound to be last line of defense to protect shareholders, especially minority shareholders, thereby it is vital to increase the independence and scientific decision-making of board of directors and to strengthen the oversight functions of board of supervisors.

First of all, in the building of the board of directors, in order to ensure the board's independence and scientific decision-making, the independent directors system must be improved. On the other hand, the practice of the Taiwan Stock Exchange deserves referring and popularizing, some rules should be constructed to limit the proportion of board members belonging to the relationship, spouse, lineal relatives of the second generation, third generations of collateral blood, while increasing the proportion of non-managerial staff as a directors; At the same time, chairman-CEO duality should be avoided, thus both the scientific decision-making of the board and effective supervision of the management can be enhanced. In order to strengthen internal control on decision-making, the board should build audit committee to play the role of audit in risk management.

Secondly, we should pay more attention to the construction of board of supervisors. Supervisors are usually held by the shareholders or employees, their election is basically manipulated by the controlling shareholders or the board of directors, their identity is destined to not really fulfill their supervisory functions. In order to enhance the independence of the board of supervisors, we recommend to increase supervisor's composition sources, such as creditors on behalf of external supervisors; meanwhile it is necessary to further improve the supervision and inspection of board of supervisors,. We can expand the scope of supervision and give some hard and fast approval to increase the effectiveness of supervision, allow supervisors to carry out personal inspection and supervision on board of directors to improve the efficiency of supervision.

2.3 Strengthen the Construction of Balances and Incentive Mechanisms

Risk management needs the building of a proper check and balance mechanism among the shareholders' meeting, the board of directors, board of supervisors and managers. And it also needs the building of a set of effective incentive and restraint mechanisms for top management.

First of all, the cumulative voting system should be introduced in the selection of the members of the board, members of the board of supervisors and the core management. We should improve the right to speak to the small and medium investors, and reduce negative effects of the second tier of agents.

Secondly, we must accelerate the introduction of professional managers. Professional managers should be employed as much as possible, and ensure their independent exercise of the operating right in the system, so we can avoid the control of the controlling shareholder, and ensure that ownership and management are separated and balanced.

Finally, we should improve the incentive and restraint mechanisms of management (Board of Directors, the operator), especially perfect and implement equity incentive plan. Wwe should take full account of the degree and duration of the incentive problem in this process.

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