

Two-Tier Corporate Governance Model for Pakistan

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Abstract

The main purpose of this study was to formulate a model of corporate governance suitable for the Pakistani environment. For this the corporate governance models like Anglo-US, German and Japanese working for the companies of developed and developing nations were critically reviewed. After studying the pros and cons of these models, a hybrid model for Pakistani companies was proposed. According to this model, two-tier boards' i.e. supervisory board and management board have been suggested instead of one-tier board. Entire supervisory board will be comprised of non-executive directors (NEDs) whereas management board will consist of only executive directors (EDs). These boards will together constitute a joint board headed by a chairman (an INED) who will also head the supervisory board and management boards. Supervisory board will conduct its affairs with the help of subcommittees. The hybrid model would aim to fill the board room in the sense of ensuring the balance of representation, talents, power and attitude which is the prime source of poor corporate governance in Pakistan.

Keywords: Corporate Governance, Two-tier boards, hybrid CG model, Pakistan

1. Introduction

Corporate governance is a way of governing activities of a corporation for the well being of all stakeholders (not only for shareholders) that ultimately leads to better financial performance. It is the set of process, customs, policies, laws, and institutions affecting the way a corporation (or company) is directed, administered or controlled. "Corporate governance refers to the manner in which the affairs of a corporate body are or should be conducted in order to serve and protect the individual and collective interests of all stakeholders" (Butt 2008)

According to OECD "Corporate Governance is the system by which business corporations are directed and controlled. The corporate governance structure specifies the distribution of rights and responsibilities among different participants in the corporation, such as, the board, managers, shareholders and other stakeholders, and spells out the rules and procedures for making decisions on corporate affairs. By doing this, it also provides the structure through which the company objectives are set".

According to La Porta et al., (2000), "corporate governance is a set of mechanisms through which outside investors protect themselves against expropriation by the insiders. They define "the insiders" as both managers and controlling shareholders." Therefore, corporate governance refers to the manner in which the affairs of a corporate body are or should be conducted in order to serve and protect the individual and collective interests of all stakeholders.

Corporate governance is a subject with various facets like all stakeholders with different interests. An important subject matter of corporate governance is to make sure the accountability of individuals in an organization through mechanisms that try to reduce or eliminate the principal-agent problem. A related but separate thread of discussions focuses on the conduct of a corporate governance system in economic efficiency, with a strong emphasis on shareholders' welfare. This subject has become a focal interest in the world especially after crisis of Enron and WorldCom. In 2002, U.S. federal government passed the Sarbanes-Oxley Act, intending to restore public confidence in corporate system.

Corporations played a pivotal role in economies in the twenty-first century. Some had become global mergers/acquisitions that had a great deal of influence upon community on the daily basis. Large corporations involved in industries such as media, oil, transport, computing, clothing, food, construction and infrastructure, were examples of this powerful influence. The responsibility of the corporations was extended with the diversity of their functions in various territories of world. Even though, the science of corporate governance and how firms grow and develop is still evolving

The various models of corporate governance that exist globally have evolved as economies and the corporate structure were shaped. The bases of modifications in the corporate governance models were environmental influences such as worldview, culture, and the legislative and political framework (Shleifer 1997). Thus, the basic aim these models are not only to achieve the particular objectives but also to maximize efficiency, economic benefit, shareholder wealth or the protection of minorities. Pakistan is a specific area in point where corporate governance is evolving. The economy is essentially in a state of metamorphose - simultaneously growing, developing and being transformed from a command system to a market economy. A significant recent driving factor of this transformation is the accession of Pakistan to the World Trade Organization (WTO).

In 1997, the economies of Thailand, Indonesia, South Korea, Malaysia and The Philippines rigorously affected by the exit of foreign investment named , The East Asian Financial Crisis, mainly due to the lack of corporate governance mechanism in these countries. In the early 2000s, massive financial crises like Enron, WorldCom, Adelphia Communications, AOL, Arthur Andersen, Global Crossing and Tyco paved the way to raise the issues of corporate governance and resultantly Sarbanes-Oxley Act of 2002.

The impact of Sarbanes-Oxley Act of 2002 has changed the ways of corporate governance in listed companies .Recent studies concluded that the cost of compliance with SOX was significant. These mandatory requirements apply almost exclusively in public companies. In order to cost of compliance, many companies adopted the umbrella privatization. While the costs of application the provisions of SOX are undeniably high, certain provisions do have significant advantages. This advantageous mechanism can be applied by non-corporate companies to provide good organizational governance and reduce the potential for falsified activity. In addition, all enterprises should believe that failure to respond properly today could lead to impending disaster in the future. The penalty may include not only the loss of resources but also the negative media hype that can relentlessly damage a corporation's reputation. One particular element of SOX that is applicable to non-corporate companies is whistle blowing, the act of reporting unlawful activity to another party. Grant Thornton study concluded that only 29% of non-profits had a whistleblower policy in position. Firms of all kinds should better realize what whistle blowing is, what the elements of a whistle blowing policy are, and where to turn for more information.

1.1 Corporate Governance in Pakistan

Corporate governance in Pakistan has recently started scratching the surface. Due to many distortions in economy, market forces do not reward good governances or punish unethical practices. The large part of the undocumented economy discourages promotion of transparency and accountability in the organization. Overall management structure is also not conducive to establishing the norms of good governance. Many companies in listed Stock Exchange are not fully practicing the code of good governance. Tightly held ownership, lack of professional skills, missing change agents, audit dependability and overall structural weaknesses are bottlenecks in developing the corporate governance in the organizations.

1.2 Objectives of the study

The main purpose of this study is to explore the framework for appropriate model of corporate governance for Pakistan. The specific objectives of the research are to:

1. Review different international models of corporate governance from developed and developing economies.
2. To highlight the pitfalls of these models being faced by the economies.
3. Review the effectiveness of existing models.
4. Identify the potential alternative model to fit with existing environment of Pakistani system.
5. To make policy suggestions and recommendations based on alternative model for Pakistan.

1.3 Contribution of Research Study

This research study will make a meaningful contribution to the research environment as it will analyze and identify the pros and cons of some important models working for the corporations for developing and developed economies. Learning from the success stories of these models, an alternative hybrid model suitable for the specific situation of Pakistan, has been proposed. This model if adopted in its essence will alleviate the current corporate governance issues in Pakistan. It will not only run the corporations smoothly and efficiently but also enhance the GDP growth leading to reduction in poverty which is the prime objective of Government in Pakistan.

2. Literature Review

There is an emergent literature of different models of capitalism from alternative analytical frameworks showing the nature and extent of diverse forms of capitalism, their comparative strengths and weaknesses, and the prospects for institutional miscellany when confronted with mounting pressures for international economic integration (Deeg and Jackson 2006). The varieties of capitalism research articles illustrated by Hall and Soskice (2001) takes on a firm centered approach focusing on the incentives for coordination; a wider typology of governance mechanisms in terms of social systems of production is existed by Hollingsworth and Boyer (1997); and a national business systems approach of Whitley (1999) inspects the internal capacities of business corporations.

The Japanese model of corporate governance which developed under these situations has sometimes been explained as 'state-contingent corporate governance' (e.g. Aoki *et al.*, 1994). Whenever firm performance is satisfactory, management acts independently or, some argue, is examined by the company's large and stable shareowners. When firm performance is poor, then creditors, and in particular, the firm's intervene, initiate a restructuring plan, and discipline the poorly performing management

The function of the top institutional owners, such as Allianz, as spiders in the web of cross-holdings has been well identified (Story and Walter, 1997). Like other characteristics of ownership concentration however, the understanding of the dynamics of top holders and cross-holdings is at best scrappy. Many authors report on big banks and insurers selling their stakes and leaving boardrooms (O'Sullivan, 2000; Mülbart, 1998). Some of these stakes are not really sold but rather spun off to one by one managed holdings or investment funds, still controlled by the big actors (Jürgens and Rupp, 2001). This is one of the reasons why Doremus *et al.* foreseen that universal banks would maintain their position in the German market for corporate control (1998). Interconnected with the position of the top institutional shareowners, is whether the responsibility of cross-holdings, extensively reported to be significant in the past (Prowse, 1994; Wenger and Kaserer, 1998), has varied. In the light of the questionable research evidence, I anticipate that the power of the top institutional shareowners was maintained.

3. Methodology

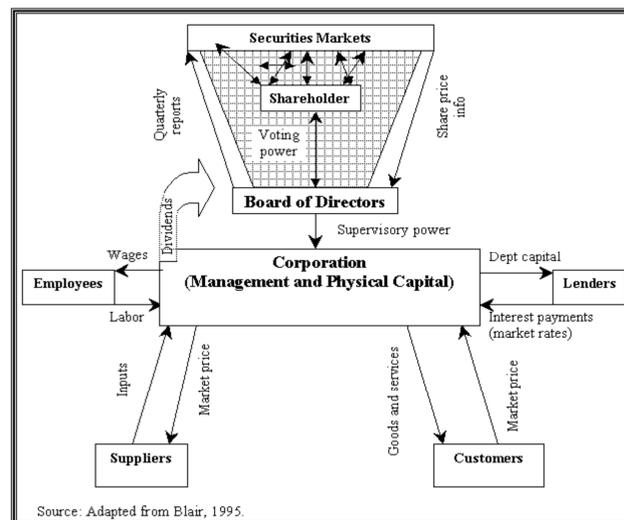
This is a descriptive study. In order to fulfill the objective of this study, three most commonly used corporate governance models (Anglo-US, German and Japanese) in the whole world are selected for review. The Anglo-US, German and Japanese models are working successfully in majority of the developing and developed nations of the world. Among them the most important countries are United States, United Kingdom, Germany, Japan, Canada, New Zealand, Australia, India, South Korea, Thailand and the Republic of Ireland etc. Due to the success stories of the economies in which these models are working, it is decided to review the Anglo-US, German and Japan for final descriptive analysis.

3.1 Salient Features of Anglo-US Model (ASM)

Anglo-US model mainly concentrates on the free financial market, as the bulk of the literature basically focuses on this idea. The different components of the business like inputs, operation/ production, out puts/ pricing are the main principle factors of the theory of the firm. The principal objective of firms is to maximize shareholder's wealth irrespective of ownership or control in the board. Prior to the twentieth century, wealthy and powerful industrialists and entrepreneurs typically controlled all big corporations. However, a lot number of corporations listed publicly changed the scenario of ownership and control, starting from the mid nineteenth to twentieth century.

The main characteristics of Anglo-US model are share ownership of individuals, increasing institutional investors, outsider shareholders, well defined rights and responsibilities. There is comparatively uncomplicated relationship among three main key players, management, directors and shareholders in AGM. Evidences from US and UK indicate that equity financing is the common method of raising capital in the Anglo-US model. The origin of Anglo-US model can be found in Berle and Means Model.

Figure-1: Berle Means Model
 Berle and Means Model of Corporate Governance

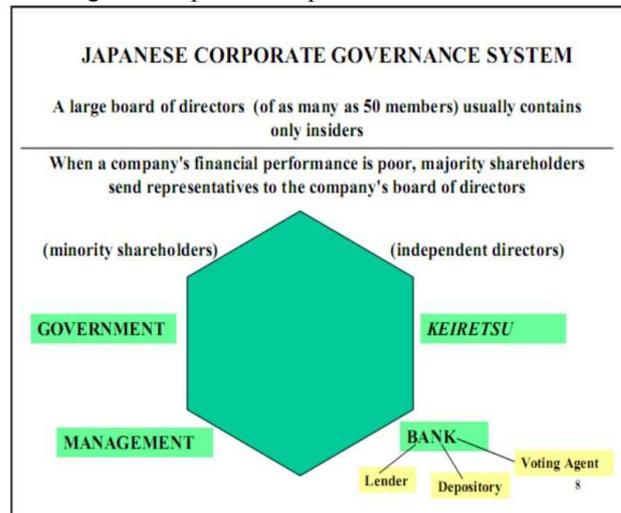


3.2 Salient Features of Japanese Model

The Japanese model of corporate governance is essentially featured by a high level of share ownership by allied banks and corporations. “Keiretsu” is a well built, long-term industrial and trading relationship between bank and corporations where banks take part largely in debt and equity financing of businesses. A legal, public policy and industrial policy networking structure has been planned to support and promote “keiretsu”.

In Japanese model of corporate governance board of directors comprises almost wholly by insiders and very low level of outsider. It is found that this dominant insider board of directors in most cases makes the procedure complex for exercising shareholders' vote. Equity financing is vitally important for Japanese companies. On the other hand, insiders and their associated parties are the major stockholders in most Japanese companies. As a result, they play duplicate role in individual companies and in the system as a whole. The duplicate role means that owners working as managers as well. On the contrary, the interests of outside stockholders are minor. The percentage of foreign investment in ownership of Japanese stocks exchange is small, but it may become an essential factor in making the model more responsive to outside stockholders.

Figure-2: Japanese Corporate Governance Model

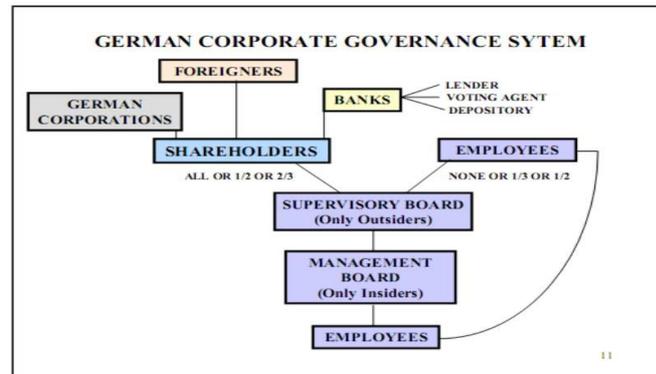


3.3 Salient Features of German Model

The corporate governance model of German is significantly different from both the Anglo-US model and The Japanese model of corporate governance, although some of its features resemble with the Japanese model. In both German and Japan models, institutional investors play very important role in the formation of corporate governance structure. In both countries, Japan and German, bank representatives are elected to the board of directors but this representation is constant in Germany while in Japan the representation comes only at the time of financial distress. There are three largest universal banks (providing a multiplicity of services) whereas play a major role in the whole economy in Germany. Also, in some parts of country, public sector banks are major active players in financial markets than the private sector banks.

There are three distinctive features of the German model that differentiate it from the other existing models. Two of these elements relate to board composition and one concern stockholders' rights: Firstly, the German model prescribes two layers of boards with separate members. German firms have a two-tiered board structure comprising of a management board (composed completely of insiders, that is, executives of the company) and a supervisory board (composed of labor/employee representatives and stockholder representatives). The two boards are entirely different; no one may serve at the same time on a firm's management board and supervisory board. Secondly, the size of the supervisory board is set by law and cannot be changed by stockholders.

Figure-3: German Corporate Governance Model



Thirdly, in all countries following German Model, the voting right restrictions are legally imposed by regulatory authority that is necessary of certain percentage of casting voting out of total shares regardless of ownership position. Bank financing/ loan are traditionally preferred over equity financing in most countries following German model of corporate governance. So in Germany equity capitalization is small as compared to the size of economy. In addition, the level of individual stock ownership in Germany is low, showing Germans' conservative investment strategy. It is not amazing for that reason, that the corporate governance structure is geared towards preserving relationships between banks and companies.

These models were critically reviewed and their salient features like key players, shareholding, ownership concentration, board size, board compositions, regulatory framework and disclosure requirements etc were analyzed individually. After analyzing the features of these models, a model covering different aspects of aforesaid models suitable for the corporation of Pakistan economy was proposed. Some important additional innovations which existing Pakistan model was lacking were also incorporated. The proposed model covers the important features of said models as well as proposes more additional innovations that are specific to Pakistani environment.

4. Empirical Evidences

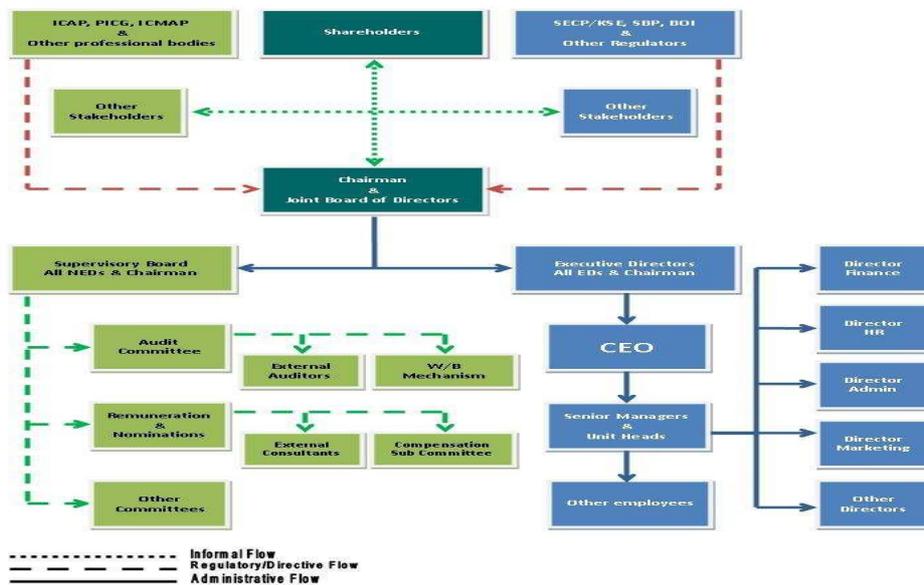
Table-1: Comparison of the Competing models

| S.No. | Critical Issue | Current Situation in Pakistan | Anglo-US Model | Japanese Model | German Model |
|-------|---|--|---|---|---|
| 1 | Investors Protection | Well defined, yet not very effective | stringent | More stringent | More stringent |
| 2 | Participation of shareholders in AGM | Discouraging, unmanageable and cumbersome | Low | High | High |
| 3 | Ownership concentration and control | High. Majority often controlled by families/ managers. | Discouraging | Encouraging | Encouraging |
| 4 | Disclosure Requirements | Strict | Most strict | Strict | Strict |
| 5 | Related party transaction | Explicit guidelines | Most strict | Strict | Strict |
| 6 | Check and Balance on Audit profession | No real system exists. (ineffective) | The system exists but is outside the content of corporate law | The system exists but is outside the content of corporate law | The system exists but is outside the content of corporate law |
| 7 | Duties of care and loyalty: | Insufficient guidance | Comprehensive | Less comprehensive | Less comprehensive |
| 8 | Independent directors | Non-existing in real sense | Less non-executives | More non-executives | More non-executives |
| 9 | Remuneration of Non-Executive Directors | Very low | Low | High | High |
| 10 | Enforcement by Authority | Strongly needed | Self regulatory, no need to be regulated by authority | Comprehensive role regulatory authority. | Comprehensive role regulatory authority. |

5. Conclusion

In summary, it can be seen that both the outsider-based system (Anglo-US Model) and insider-based systems (Japanese and German Models) of corporate governance have their respective flaws. No individual model/system of corporate governance is suitable to be adopted for the Pakistan. There is dire need to formulate and adapt a hybrid model of corporate governance for the betterment of Pakistani economy.

Figure-4: Proposed Corporate Governance Model for Pakistan
Proposed Corporate Governance Model for Pakistan



5.1 Discussion

1. It is concluded that the traditional insider and outsider models of corporate governance are unsuitable for Pakistan due to her diverse social, cultural and economic conditions.
2. The proposed model recommends intensive regulation of the companies through regulatory bodies.
3. Joint board of directors will be a higher decision making body of the companies. It will scrutinize the proposals or agenda sent by supervisory board.
4. Supervisory board will be comprised of non-executive directors (NEDs). The NED would be a representative non-executive director (RNED) or/and independent non-executive director (INED).
5. The strength of the AC committee will be at least three non-executive directors including chairman.
6. An external auditor is an audit professional who performs an audit on the financial statements of a company, government, individual, or any other legal entity or organization, and who is independent of the entity being audited.
7. Whistle blowing mechanism is an essential ingredient of the body of corporate governance as it signals about the working of the corporation to the decision makers.
8. The Nomination & Remuneration (N&R) committee will consist of three members.
9. The proposed hybrid model also suggests hiring the external consultant to solve the complex problems which may be beyond the approach of internal experts.
10. The middle and lower class of the employees working in the companies is of prime importance. Particularly the job satisfaction of this class is a key to the success of the company.

6. Recommendations

Pakistan has made considerable development in efforts of improving corporate governance especially in current decade. World Bank Report "Getting Finance in South Asia 2009" has ranked Pakistan first in the areas of corporate governance, performance and efficiency. However entirely tapping the potential of financial markets, and professionalizing management and board of directors will require more efforts to continue. No doubt, good governance ensures that corporations use their resources more effectively,

efficiently and pad to better relations with employees and other stakeholders. For the rapid business growth that will ultimately lead to economic growth of Pakistan following areas are to be intensified regarding corporate governance in Pakistan.

1. SECP should focus on enforcing the rule of law on disclosure especially ownership and related parties transactions. In this regards three areas are important. First, the disclosure of beneficial ownership and control; Second, reporting of related parties transactions; third, compliance of company with respect to the AGM.
2. SECP should continue to enhance its enforcement capability. For this purpose SECP should take important steps include increasing the technical size and level of staff in critical areas like accounting etc.
3. SECP should refine enforcement procedures regarding all accounting, legal and technical issues particular in code of corporate governance.
4. The existence of one tier is discouraged and be replace with two tier board system in Pakistan.
5. The chairman board of directors must be an independent non executive director (INED).
6. The strength of the Supervisory Board (SB) must be twice of the strength of Management Board (MB).
7. Simple majority of the directors is recommended for approval of agenda sent by lower level.
8. The audit committee must have a member with the expertise and experience related to the area of financial reporting.
9. In order to tackle the burning issues faced by the company some Adhoc committees are recommended under the supervision of SB.
10. The statements regarding financial performance of the business should be disclosed to stakeholders on quarterly basis.
11. The suggested first tier (MB) and second tier (SB) will call their meetings regularly on quarter basis. The meeting session of SB will follow the MB session.
12. A final meeting joint session for the decision of unsettled issue would be called by the joint chairman after the meeting of SB.
13. Whistle blowing mechanism is strongly recommended, which is a weaker area under existing set up of the corporate governance of Pakistan.
14. The qualification for the independent non-executive director (INED) should be clearly stated in article of association/ charter of the company.
15. In order to keep in touch with latest development in the area of corporation, the periodical trainings of the directors are strongly recommended under the supervision of Pakistan Institute of Corporate Governance (PICG).

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