

Enabling the Corporation: Lessons Learned in Governance

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Topics

- The Importance of Governance
- Organizational Issues in Indonesian Corporations
- Implementing Proper Governance
- Best Practice Model:
Synergising Governance, Risk Mitigation
and Audit

The Importance of Governance

Recent Findings

Asia's Governance Challenge

- Corporate governance in Asia has improved, but implanting new forms of behaviour will take time
- Asian countries are enforcing the implementation of Independent Directors and Audit Committees
- Agreement is growing, at least in principle, on what good governance entails, and most countries in the region have adopted explicit governance codes
- Securities laws and the listing requirements of stock exchanges have been strengthened, regulatory authorities have enhanced powers, and the media are more inquisitive and probing

The McKinsey Quarterly, 2004 Number 2

EXHIBIT I

Asia steps up

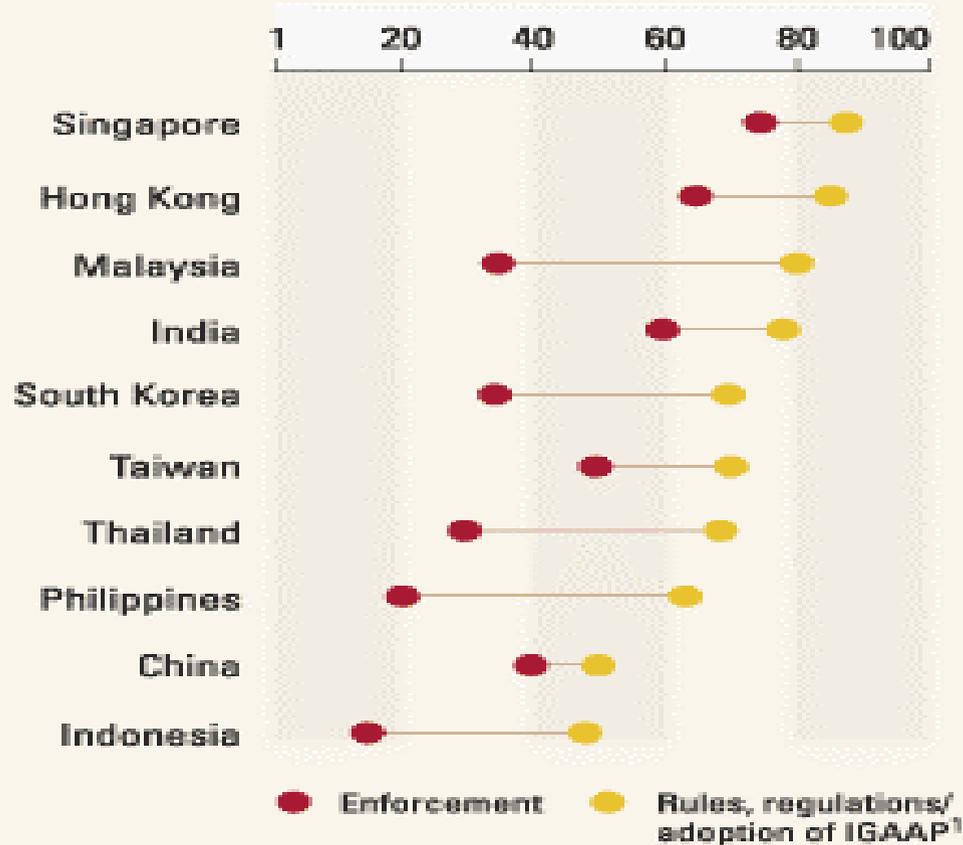
Independent director and audit committee requirements

| | 1997 | | 2003 | |
|-------------|------------------------|-------------------|------------------------|-------------------|
| | Independent directors? | Audit committees? | Independent directors? | Audit committees? |
| China | | | ✓ | ✓ |
| Hong Kong | ✓ | | ✓ | ✓ |
| India | | | ✓ | ✓ |
| Indonesia | | | ✓ | ✓ |
| Malaysia | ✓ | ✓ | ✓ | ✓ |
| Philippines | | | ✓ | ✓ |
| Singapore | ✓ | ✓ | ✓ | ✓ |
| South Korea | | | ✓ | ✓ |
| Taiwan | | | ✓ | ✓ |
| Thailand | | | ✓ | ✓ |

Source: Asian Corporate Governance Association

Toothless tigers?

1 = lowest, 100 = highest



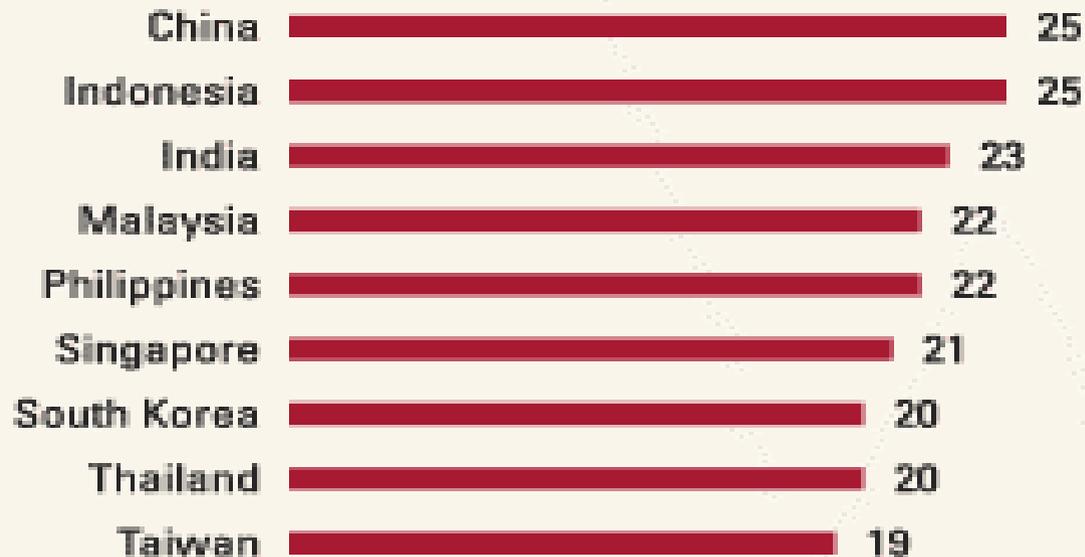
¹ International generally accepted accounting principles.

Source: CG Watch 2003, CLSA Emerging Markets and Asian Corporate Governance Association, April 2003; McKinsey analysis

EXHIBIT 3

The governance premium

Average premium investors are willing to pay for well-governed company,¹ 2002, %



¹ Of those investors willing to pay premium.

Source: 2002 McKinsey investor opinion survey

Market Impact:

Does Good Governance Pay?

LPBN's Shareprice (IDR)



Market & Business Impact:

Does Good Governance Pay?

- LPBN, 30 June 2005 performance:
 - Share price increased over 750% in 30mo
 - PER valued slightly higher than market average (13.42)
- Turnaround in financial performance:
 - Over IDR510bn loss in 2003, or over IDR1tn in accumulated losses in 2002 and 2003
 - 2004 net-income after tax IDR893bn
- Market recognition:
 - February 2004 divestment of GOI majority share done at 40% over book value
 - Since May 2004 included in the Morgan Stanley's MSCI Indonesia Index
 - Since July 2004 included in the Jakarta Stock Exchange LQ-45 index
 - September 2005 majority (52.05%) bought by Khazanah at Rp 1,619.11
 - 4Q05 Khazanah issuing a tender offer for the rest of the shares

Organizational Issues in Indonesian Corporations

Implications of Dual-Tier Model

- The dual-tier board model (Board of Commissioners & Board of Directors) is believed to:
 - Improve control
 - Separate strategy/policy setting from tactical/operational activities
- In reality, especially in light of the current crisis:
 - Control failed to function properly
 - Management becomes heavily burdened with both operational and governance issues

The Indonesian Board Model

- Dual-tier model quite often deemed obsolete, and not amenable to current crisis-solving movements:
 - Board of Commissioners: collective, no individual responsibilities
 - Board of Directors: collegial, quite normal in an executive environment
- In companies trying to restructure or revamp themselves, this model is quite often a burden, mainly due to difficulties in synchronizing tasks and efforts in both tiers

Transformations in Private Firms

- With time, “entrepreneurial” private companies became more “structured”
- The real entrepreneurs in the company moved from the management positions to the board of commissioners
- These commissioners have extensive knowledge of the business, often better than the management themselves
- Executives hired to manage have difficulties in carrying out their tasks

State-Owned Enterprises

- Increasingly, SOEs became more professional and entrepreneurial, although:
 - Most of commissioners are bureaucrats or members of the armed-forces, without sufficient knowledge about the business, much less about how to perform control
 - Often, senior bureaucrats serve as commissioners in companies they are supposed to regulate
- More professionals from the private world are hired to manage SOE. They do however, run into extra risks since business failures in SOEs increasingly regarded as corruption of people's money.

Implementing Proper Governance

Implementing Good Governance

- Relevant references and metrics are needed, preferably at world-class best practice levels
- Compliance assessment by an independent party with recognized capabilities to perform the task
- Transparency, accountability and good decision making require proper information support, which is often insufficient due to poor management of the company's knowledge repository

General Challenges

- The overall system tends to be “regulatory driven” rather than “ethics driven”:
 - Regulations generally affect us at the corporate levels
 - Ethics pertain more to individuals
- Governance and management tend to be “compliance driven” rather than “voluntary based”:
 - Voluntary conformity is needed to complement regulatory compliance
- Regulations alone can not cover all possibilities, good corporate governance and professional ethics are needed
- Most corporations still do not recognize the (almost) direct financial impact of good governance

Risk Management in a Good Governance Context

- In addition to good design and operationalization of a corporate governance structure, main key performance indicators are:
 - Timely mark-to-market valuation of its books
 - Proper handling of risk and its disclosure by the management
- The most important adage is:
“Transparency loses its meaning without information”
 - Information to be disclosed need to be readily available in the bank’s information system
 - Ad hoc solutions will lack the repeatability necessary in a sustainable risk management context
 - While banks may be familiar with audit frameworks, risk and the information about it are new

Best Practice Model: Synergising Governance, Risk Mitigation and Audit

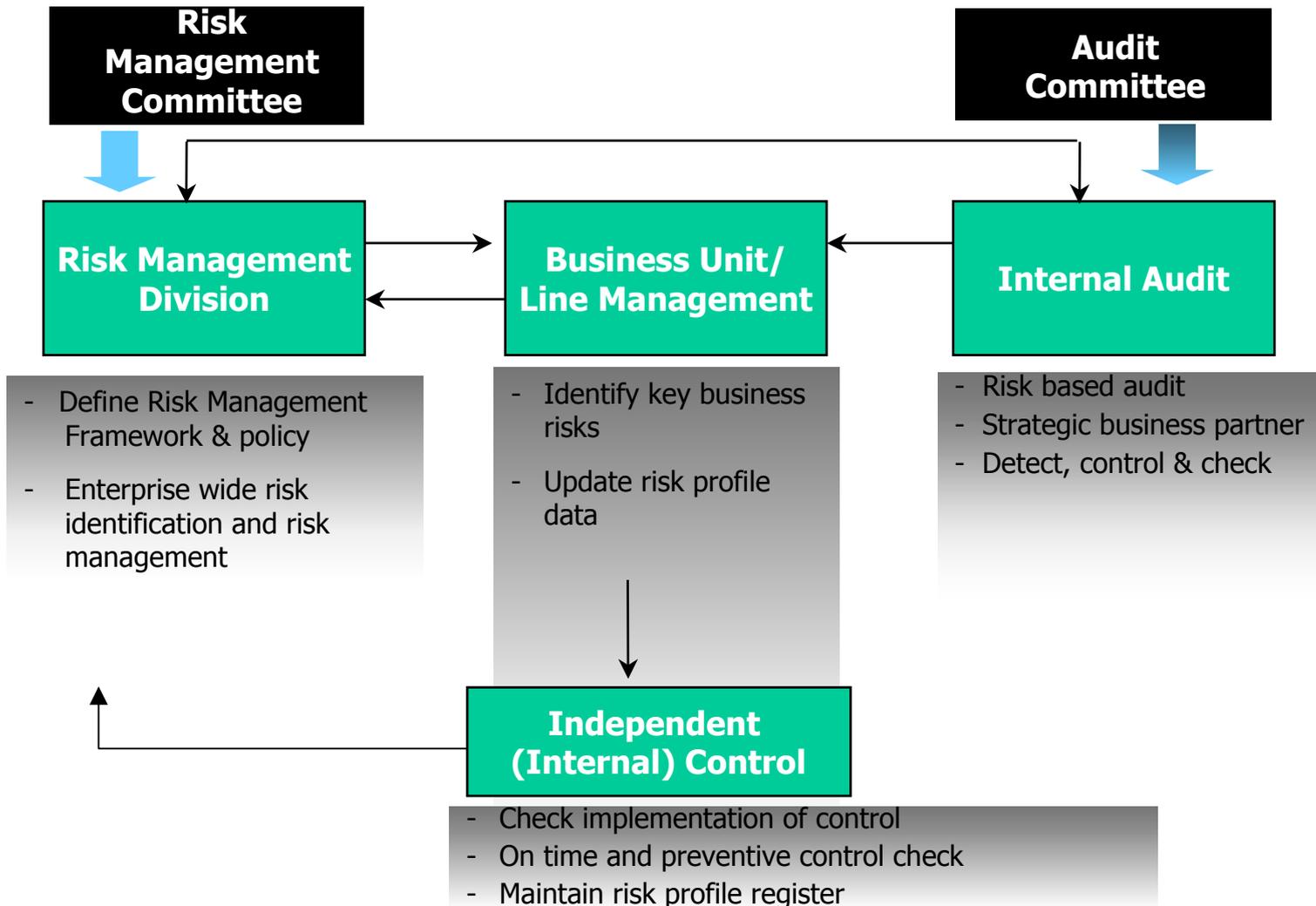
Governance in Dual-Tier Boards

- The single-tier model is moving towards “quasi dual-tier” model:
 - Separate Chairman from CEO function
 - Or, while Chairman & CEO may remain as one person, and additional “Lead Director” will take over chairmanship wherever necessary
- The dual-tier model is moving towards “quasi single-tier” model:
 - Chairman still separate from CEO, but CEO will attend (and most likely drive) most BoC meetings
 - Commissioners are given individual responsibilities through formation of standing committees

Quasi Single-Tier Board Structure



A Possible Framework



Preventing & Detecting Breaches

- Identified risk-profiles will help focus control and audit:
 - Proper division of tasks among risk management, control and internal audit
 - Top management “hands-on” action on audit reports
- Build-up of a knowledge-base:
 - A well documented fault-event database is urgently required, with emphasis on governance breach cases
 - This enables controllers and auditors to quickly detect possible acts of governance breach
 - It also serves historic precedence information to help determine follow-up actions, including punishments
- Managed sharing of these knowledge-bases:
 - Organizations need to develop a shared knowledge-base so that benefits can be realized on a national level

Conclusion

- Improvement of corporate governance will be increasingly important, both within a company, and on a “macro” level affecting the companies market values
- Within a more global economy, good governance will help support a bank’s business role and importance
- The main motivating factors behind good governance are:
 - Investors and creditors
 - Society at large
 - Government and regulators
 - The bank itself (including its internal stakeholders)
- It is important for a bank to formalize its corporate governance platform into its management, operations and administration

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Thank You