



Institute for Economic and Social Reforms

Corporate Governance Risk in the Slovak Republic

Executive Summary of the Project

This Project was initiated and supported by Czechoslovak Merchant Bank (CSOB) as a contribution to the improvement of the entrepreneurial environment. The study was worked out by research fellows Lívía Zemanovičová (INEKO - Institute of Economic and Social Reforms, Bratislava) and Martina Kubánová (SGI – Slovak Governance Institute).

Introduction

Globalisation of world markets, raising amount of international capital flows and extremely quickly changing circumstances set new requirements on investment decision-making. Moreover, business relations become more complicated. While there were often only two parties in the early capitalism (creditor-bank vs. debtor-entrepreneur), many intermediaries are present today. The growing number of relations between an owner who offers capital, and a company that uses it, indeed, increases the risk and mutual dependence of the parties involved. Parties often operate in different legal frameworks and cultural environments, which involves additional risk and costs for involved parties.

Investors consider several risks connected with investing in a foreign environment and create instruments to assess macroeconomic or political risks. It is especially true for emerging markets. Generally, they rely on macroeconomic indicators of a country, of a business sector and characteristics of the selected firm. They are frequently complying about the non-existence of an indicator of the forwardness of the entrepreneurial environment. And this is the place where the Corporate Governance Risk Index (CGRI) fills the gap. It enables structured assessment of the quality of the entrepreneurial environment like quality of legislation, law enforceability, system of regulation institutions and the common business practices. It has emerged on the basis of recent investment experience in Central and Eastern Europe. The final index is comparable both in time and place.

The purpose of the study is to describe the present level of corporate governance risk, using a standardised methodology, and to sketch the development of the risk during recent years. An additional objective can be seen in identifying the most relevant issues that affect the risk.

Methodology

The study is based mainly on the following two sources.

- *OECD Principles of Corporate Governance*¹.
- Crichton-Miller and Worman's work called *Seeking a Structured Approach to Assessing Corporate Governance Risk in Emerging Markets*, Winning Essay in 1999 Essay Competition in honour of Jacques de Larosiere, The Institute of International Finance.

The OECD Principles deal with the rights of shareholders, the equitable treatment of shareholders, the role of stakeholders in corporate governance, disclosure and transparency, and the responsibilities of the board.

The Essay of Crichton-Miller and Worman is based on the OECD Principles but it operationalises and applies them on emerging markets conditions.

This study uses a set of questions (see Appendix) that were worked out by Crichton-Miller and Worman.

The authors define four elements of corporate governance risk: corporate law, legal processes, regulatory regime, and ethical overlay².

The questionnaire is divided into four sections of seven questions. Possible responses are yes/no, whereas each positive answer in the first three sections means one point. In section Ethical Layout, there is one point for every negatively answered question. The index may thus reach maximum 28 points, whereas the standard within the G7 countries lies between 21 and 28 points.

The authors interpret the CGRI as follows:

Index	Risk
0 – 5	Very high
6 – 10	High
11 – 20	Modest
21 – 28	Low

The respondents are mostly managers of medium or big companies operating in the Slovak Republic. We have received 105 questionnaires and 13 questionnaires were filled in at the direct interviews. We adjusted the calculation of the CGRI, so that the ratio between anonymous respondents and interviewees is the same as in the Czech Republic. For this reason we have multiplied each answer from the direct interview by 2.85.

Total number of respondents	118	100%	142	100%
direct interviews	13	11%	13*2,85=37	26%
questionnaires	105	89%	105	74%

The respondents represented these sectors and industries³:

Industrial production	79	69%
Services	12	10%
Retail and wholesale trade	4	4%
Transport	2	2%
Consulting and advisory services	1	1%
Construction	3	3%
Multiple sectors from above mentioned	9	7%
Others	5	4%
Total	115	100%

The Slovak survey has been performed in two time periods. The questionnaires were sent out at the beginning of 2000. On the other hand, the interviews were performed in October 2001-January 2002 period. The results of the whole sample reflect therefore the state of affairs at beginning of 2001 and changes until to January 2002 are reported by the interviewees sample (values in brackets).

All quantified results in this study are based on aggregated responses on the questions. The sources of commentary are direct interviews with respondents and additional notes written in the questionnaires.

One of the reasons why the Institute of International Finance awarded Crichton-Miller and Worman's essay was simple elegance with which the authors operationalised the measurement of corporate governance risk.

On the other hand, this simplicity causes some limitations we had to overcome. The questionnaire has a very simple structure and only limited number of questions that are often very wide and yet require black-and-white yes/no response. Moreover, we would like to point out on different perception of time: snapshot view vs. past track inclusion of our respondents. Another controversial point is the perception of situation: big cases vs. general (average) development, in other words: volume vs. frequency. We remarked as well the differences in questionnaires and direct interview. The explication of this phenomenon may be caused by the possibility of supplementary explication, more time spent on the questionnaires, time delay of 8 months in case of direct interviews and more negative assessment in case of anonymous surveys.

The Results of the Survey

A. Overall Outcome

Maximum possible points	28
Average points per questionnaire	10 (12)
Average points in the four sections	
- Corporate Law (max. 7 points)	3.3 (3.8)
- Legal Processes (max. 7 points)	1.4 (1.6)
- Regulatory Regime (max. 7 points)	3.0 (4.0)
- Ethical Overlay (max. 7 points)	1.9 (2.5)
Mean	9.5 (11.9)
Minimum result	3 (5)
Maximum result	26 (16)
The most frequent result	6 (11)

The results of the survey, which involved 118 respondents, especially managers of important companies operating in the Slovak Republic, evaluate the index at 10 out of maximum 28 points. According to Crichton-Miller and Worman's scale, the country ranges in the upper zone of **high risk** for investors

B) The assessment of the four elements of corporate governance risk

The questions in the questionnaire were divided to four sections that characterise four elements of corporate governance risk. One of the contributions of this methodology is that it brings structure into the complex and inter-related debate about corporate governance and enables measuring separate dimensions of this issue.

Element	Average Points
Corporate Law	3,3 (3,8)
Legal Processes	1,4 (1,6)
Regulatory Regime	3,0 (4,0)
Ethical Overlay	1,9 (2,5)

Maximum number of points for each element is 7.

Among all the four surveyed areas of the Corporate Governance Risk, the assessment of **Legal Processes** appears to be the weakest one. The aim of this section was to inquire into the efficiency of legal systems and to show whether it provides sufficient redress to investors, creditors or other parties involved that suffer harm.

Not a single question out of the seven was answered positively by the majority of the respondents. Most of the positive answers (44%) agreed upon that avoiding the verdict is complicating once the court pronounces it. 39% of respondents are persuaded that the decisions of the courts are not influenced by any of the parties in question.

On the other hand, most of the respondents were in a consensus in their negative perception of a whole range of problems. Complete unanimity (99%) was shown in assessing the slowness of legal processes, which allows the debtors the comfortable transfer of propriety into another legal entity. A strong majority (93%) agreed that even if arbitration has several positive effects on rapidity and acceptability of conflicts' solution, its use in Slovakia is marginal. According to the common opinion the losing party would not accept the decision and meet the demands placed upon them by the commercial arbitration institution. They fear that such a decision would be either ignored or an appeal to the courts would be made anyway. Only 8% of the respondents perceive law enforcement to be cost efficient and slightly more than 20% believe in its accessibility at all.

Our respondents identified also some positive development. The Swiss-Slovak project *Court management* has shown spark of hope for our jurisdiction. It has accelerated the delays of court procedures, engaged judges only in decision making while assistants did administration. Moreover, Slovak entrepreneurial environment is improving because of external reasons (approximation of the legislation with the EU) as well as internal reasons (increasing number of foreign companies who implement their entrepreneurial culture and habits and consolidation of domestic entrepreneurs with concentration to the long-term activities and so credibility towards all the partners). Furthermore, companies have found some tools to cope with the imperfect environment. New partners have for example to pay in advance or in cash.

On the other hand, the best-assessed element is **Corporate Law** where two out of seven questions were positively answered by a majority of respondents. If only interviews are taken into account, the number of positively answered questions increased up to 3 and the percentages in most questions are higher. The purpose of the first group of questions was to characterize a legal framework necessary for the functioning of corporations. The questions focus on the wording of laws and other legal norms. Their enforcement was not questioned. In general, interviewees do not consider the legal framework to be the key problem of the Slovak Republic. Even more, in the process of approximation of our legislation to the legislation of the EU (one of the benchmarks of this research) a lot has already been done. Many laws were amended and also the evaluation from the entrepreneurial environment concerning the laws is relatively favorable. The main problem concerning the corporate law in Slovakia may be the instability of legal system, where laws are frequently amended thus creating uncertainty and additional costs for entrepreneurs. The strongest agreement was reached for security of shareholders' voting rights. There is no doubt that shareholders can exert their rights without restrictions. The definition of the rights of all parties does not cause problems in general even though the rights of different parties are not defined in the same extent. Creditors are example of a group with weak legislative definition. On the other hand, 85 percent of the respondents agreed that the procedures of bankruptcy and insolvency are not defined clearly enough to ensure the orderly settlement of liabilities and independent (of managers) distribution of assets. Bankruptcies have been considered as one of the weakest element of the Slovak economy for years. Even the recent amendment to the Bankruptcy Act has not changed expectations toward an improvement of the present situation.

Regulatory Regime ranks second, with 3 out of maximum 7 points. Seven questions in this section investigate either the perceived credibility of different types of regulators, or general conditions or outcomes of the regulatory regime (insider trading, company records or international audit standards). As Crichton-Miller and Worman (1999) mention, for an acceptable investment climate it is essential that regulators perform their main functions that need to be well defined through the laws and commonly accepted industry practices. Since we do not distinguish in details between the legal definitions and its application by the regulator in practice, crucial point in each question is the perceived credibility of the regulator. Credible regulatory regime in a given country shall be secured by regulators (be it the central bank, antitrust office, or capital market regulator) actively pre-empting possible out-of-law or economically dangerous activities and punishing for such steps to the extent their competence allows them to. Regulatory regime is closely linked to the issue of transparency and up-to-date information on the business, as well as protection of business secrets. Questions on insider trading practices, reliability of company records and financial audit cover these issues.

The most positively perceived regulatory institution is the central bank (71% positive answers). A narrow majority considers insider trading illegal or unethical (52%). Three questions were perceived slightly below average: regulator of capital markets, financial watchdogs and fair competition regulation (all between 40-45%). Worst results stem from low dissemination of international audit standards (31%), by now typical only for the big or foreign firms, and from a weak quality of the company records (15%). The latter result is caused by not up-to-date or sometimes inaccurate company records that can promote environment

suitable for fraud. If only results from interviews are taken into account, this section would receive higher rating (4.0) and most of questions would gain higher score.

The legal and regulatory system, be it perfectly designed, applied and enforced, can be disrupted when in touch with a culture tolerating criminal activity, corruption, trespassing law and unethical behavior of economic agents. **Ethical Overlay** is the second worst ranked section in the Slovak part of the research with only 1.9 points out of maximum of 7. None of the seven questions is perceived positive, the only one close to the average value is the perception of the role of criminal groups in the economy. Most negatively perceived is the failure to combat the organized criminal activity (12%), “wide perception of government officers” to expect bribes (14%) and the corruption rating by the Transparency International (15%). If we consider single results from interviews, we can see they are sometimes more critical than the whole sample, but usually more optimistic. The interviewees do not think that extra fees for services occur in Slovakia more frequently than in G7 countries and also think that the role of criminal groups in substantial industry sectors is not significant. Slovakia ranked 51-54th in the recent 2001 ranking of Transparency International⁴ with CPI 2001 index 3.7 (upper and lower bounds are 2.1 - 4.9).

C) The Identification of Concrete Corporate Governance Risks

If we were to identify the three most crucial factors that increase the corporate governance risk in the Slovak Republic today, they would be:

1. The law enforceability;
2. the low effectiveness of bankruptcies;
3. and the high level of corruption.

Questions	% of positive answers of the whole sample	% of positive answers of the interviewees
Rate of agreement 100% - 80%		
3. Shareholder rights to vote in general meetings and elect members of the board are well-defined.	83	92
Rate of agreement 79% - 60%		
16. The Central Bank is a politically independent regulator of the banking sector.	71	85
Rate of agreement 59% - 40%		
2. The definition of the rights of all parties.	58	77
18. Insider trading is considered to be illegal or unethical.	52	31
1. The transparency and security of the registration of claims upon companies.	48	69
23. No substantial industrial sector is controlled by any criminal group.	48	62
14. It is difficult to evade the consequences of legal judgements against business entities.	44	42
19. The Antimonopoly Office possesses powers of investigation and sanction.	44	62
5. The quality of contracts is comparable with that in the G7 countries.	42	46
7. Members of company's board are forced to disclose their material interests in the company's activities.	42	38

15. Impartial and consistent action of the regulator of the capital market.	42	78
26. Extra fees for services for which such fees are not usual in the US or EU.	41	66
25. Level of assassinations, kidnapping, or threats to business figures does not exceed that on the developed markets.	40	46
17. The effectiveness and independence of financial watchdogs.	40	77
Rate of agreement 39% - 20%		
4. The disclosure of a disproportionate degree of control.	39	38
12. Non-influencing of the court decisions by any improper interests.	39	50
21. The use of international standards of accounting.	31	42
8. The possibility of access to redress through legal process for all the involved parties.	21	31
27. Tenders are not biased, opaque, and likely to have been influenced improperly.	20	38
Rate of agreement 20% - 0%		
13. The enforcement of legal decisions is effective and respectable.	17	31
24. Transparency International corruption rating below 30th place.	15	0
20. Company records are thorough, dependable, and up to date, with adequate sanctions and safeguards.	15	25
28. Government officers are not known to expect or require payment for either preferential or basic discharge of their powers.	14	31
6. Bankruptcies are clearly defined and lead to the orderly discharge of liabilities.	13	15
22. Combating organized criminal activity is effective.	12	8
10. The access to legal redress is cost effective.	8	8
11. The commercial arbitration has a strong tradition.	8	0
9. The redress through legal process is reasonable speedy.	1	0

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1) Published in 1999 and downloadable from www.oecd.com

2) The first three elements are based on the OECD Principles, while the ethical overlay issue is a new contribution of Crichton-Miller and Worman who, however, built it on the Russian specific practice. We left this section without "localising" it for the Slovak environment in order to keep the comparability of the results.

3) The number of respondents and that of the firms represented by them are not equal since in some

cases we have obtained two questionnaires from one company.

4) see <http://www.transparency.sk> for more details

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