International Conference

Changes in Corporate Governance of Korean Enterprises after the Financial Crisis

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Part-01 | Introduction

The Crisis and Corporate Governance

In the face of the financial crisis and severe business depression, enhancement of corporate governance ㅈ was a the major concern.

- While the direct cause of the crisis appears to be the shortage of foreign exchange, the root cause was rather the cumulative effect of chronic and systematic problems in the Korean economy, including the corporate governance issues.
  - Size oriented expansion strategy through borrowing from financial institutes proved its limitation.
  - There was no checking mechanism available to restrain the reckless business diversification, vulnerability of financial structure due to excessive borrowing, dogmatic decision-making process by the controlling shareholder.

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After the financial crisis, people began to realize the importance of corporate governance, and various efforts were made to enhance it.

- International organizations such as IMF and World Bank, recommended corporate governance related policies to raise the level of transparency of corporate management, revitalizing hostile M&A, improvement of structures and procedures for board of directors, etc.
- Poor corporate governance is the key factor for Korea discount phenomenon.
- On the course of recovery, corporate governance reform efforts were made mainly by government through the rapid change of institutional settings.

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The importance of CG

The corporate governance of individual company not only enhances a firm's competitiveness but also influence the efficiency of national economy.

- As the market economy matures and the globalization progresses, the corporate governance which determines how to maximize the efficient utilization of the limited resources.
  - Good corporate governance system enables the maximization of the firm value by eliminating the rent-seeking behavior and inter-company transactions, as well as promote efficient utilization of various resources including the human resource.
  - It also lower the cost of financing capital, and promotes smooth flow of money in the capital market, thereby contributing to the economy-wide efficient resource allocation.

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Economists believe that capital market is more suitable than bank system to supply capital to the high risk – high return high-tech industries, and poor corporate governance hinder development of capital market.

- For a firm or an economy to grow, it is essential for the financial system to develop including the capital market.
  - Capital market development will enhance the efficiency of resource allocation. [Wurgler(2000)]
  - The growth of venture firms heavily depends on the level of capital market development. [Black and Gilson(1998)]
  - Investor protection is a key factor in capital market growth, and corporate governance is a mechanism to protect the investors. [La Porta et al. (2000]
  - The industries with higher R&D intensity, higher risk, higher capital intensity, would grow faster in market based countries. [Park, Binh and Shin(2005)]
  - Countries with advanced capital market grow faster than the others. [King and Levine(1993)]

CG from Korean context

- Traditionally, the Korean companies were expanded from family business.
  - The founder and the family as well as the affiliated companies hold major shares of the company.
  - The founding owner, i.e., controlling minority shareholder exercises absolute influence over the business.
  - In doing so, there is a tendency (or risk) of maximizing firm's own interest, while the interests of other minority shareholders and creditors.
- The corporate governance in the Korean context, therefore, is considered to be a mechanism to protect the interests of outsider investors such as minority shareholders and creditors from the selfish expropriation of insiders such as controlling shareholders
  - In U.S.A or U.K., the corporate governance is considered to be a mechanism to solve the agency problem rooted in the separation of ownership and management.

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Ownership-Control Disparity

Trend in Controlling Shareholder's CFR, and CR

	1997	1998	1999	2000	2001	2002	2003	2004	2005
Controlling Shareholder and Relatives	0.14	0.13	0.10	0.11	0.10	0.11	0.12	0.12	0.13
Cash Flow Right (*CFR*)	0.22	0.23	0.19	0.19	0.20	0.23	0.25	0.28	0.31
Control Right (*CR*)	0.45	0.54	0.47	0.41	0.46	0.53	0.59	0.66	0.68
cf) Control Right (Simple Sum)	0.66	0.66	0.65	0.67	0.70	0.71	0.71	0.73	0.74
Number of Chaebols	29	29	29	26	26	31	35	36	38

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Part-02 | CG Reform

Principles of CG Reform in Korea

For the last 10 years, the government followed 5+3 principles established in 1998 and 1999 in the effort to reform corporate governance.

- In January, 1998, after the financial crisis, Dae-Jung then president elected and representative controlling shareholders of major business groups made a mutual consent that contains 5 principles on structural reforms of corporate sector.
  - Reforms include the raising the level of transparency in corporate management, heighten the level of management responsibility.
- In August 1999, in the presidential address for the independence day celebration, then President Kim elucidated 3 additional principles – corporate governance reform in non-banking sector, inhibition of circular share holding and inter-company transactions, prevention of abnormal inheritance.

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- The following reforms include but are not limited to the following : 1) enactment of Code of Best Practice for Corporate Governance, 2) fortification of rules governing the board of directors and audit committee, 3) enhancement of the rights of minority shareholders, 4) supportive actions to promote the activities of institutional investors and NGOs, 5) revitalizing the market for corporate control.
  - Among these, this presentation will focus on the shareholder rights, board of directors, disclosure, audit, and the market for corporate control.

Sharehoder Rights

Devices that enable the minority shareholders to exercise their rights have been introduced and the requirements have been mitigated ever since.

	Commercial law	Securities and exchange act	Banking act*
Shareholder's representative suit	1%	0.01%	0.005%
Injunction for malfeasance of directors	1%	0.05% (0.025%)	0.025% (0.125%)
Injunction for malfeasance of directors	3%	0.5% (0.25%)	0.25% (0.125%)
Inspection of account book	3%	0.1% (0.05%)	0.05% (0.025%)
Stockholder's proposal	3%	1% (0.5%)	0.5% (0.25%)
convocation meeting of stockholders	3%	3% (1.5%)	1.5% (0.75%)

* Other acts that governs various financial institutions and transactions have similar clauses.

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Board of Directors

Outside director is introduced and continuously expanded to improve the board of directors that has played only nominal role under the large business group structure and to curb the selfish expropriation of the controlling shareholders.

- In 1998, through the revision of commercial law, fiduciary duty of director and de factor director is introduced

- In 2000, through the revision of securities and exchange act, outside director become mandatory for the listed companies and were expected to protect the interest of shareholders by curbing the selfish expropriation of the controlling shareholders.
  - Outside directors, also known as independent director, are directors who only participate in the board meeting and do not attend daily businesses.

    - They are not related to the controlling shareholder in any way.
  - Currently, the listed companies are forced to have more than or equal to ¼ of BOD members as outside directors, for the listed companies whose asset exceeds 2 trillion won strictly more than ½, financial institutions more than or equal to ½.

Disclosure

- 1999. Reinforcing the penalties for unfaithful disclosure up to 0.5 billion won
- 2000. Imposition of duty to disclose the board decision on inter-company transactions that exceeds 10% of the capital or 10 billion won to 10 largest business groups
- 2001. Duty to disclose inter-company transactions expanded to 30 largest business groups
- 2002. Introduction of fair disclosure
- 2003. Introduction of obligation for CEO and CFO to authenticate the disclosure documents, and a way to levy civil liability on practical director if there is any false statements in it.

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Audit

- 1997. Compulsory appointment of more than 1 standing auditor for the listed companies whose asset exceeds 100 billion won.
- 1998. Compulsory establishment of external auditor appointment committee for all listed companies
- 2000. Compulsory establishment of audit committee for the listed companies whose asset exceeds 2 trillion won
  - Com Compulsory establishment of audit committee for all listed companies and more than 2/3 of the members to be outside director
  - Voting right of the controlling shareholder for choosing the outside director – audit committee member to be limited to 3% of all shares with voting rights

Market for Corporate Control

- Monitors corporate management and minimizes corporate excesses or inefficiencies. encourages sound decision-making and efficiency from the management. Management will try to maximize shareholder value a fall in share price will increase the probability of becoming an M&A target
  - Promotion of the disciplinary role of the market for corporate control could potentially mitigate this “Korean Discount” phenomenon.*
  - A difficult task to form a lively market for corporate control due to the Chaebols’ virtual monopoly of corporate control.
- Before the crisis, most of the M&A-related regulations tended to protect the founding owners of corporations
  - Hostile M&A was generally considered to be an improper appropriation of another’s property

- After the crisis, most of the regulation that worked against the hostile M&A (and foreign investment) been removed.
  - To invite foreign capital in the face of financial difficulty and restructure faltering enterprises.
- Despite the relaxation of such regulations, the hostile M&A did not play a significant role in Korea.
  - Most cases were conflicts between incumbent shareholders for control rights.
  - There are still limited cases of hostile M&A attempts toward Chaebol-affiliated companies.

Date	Related Laws	Contents
1998.2.	**Securities and Exchange Act** **and** **Foreign Investment Promotion Act**	➢ Reform of Securities and Exchange Act for restructuring large enterprise • Abolition of obligatory tender offer system • Abolition of regulation requiring approval from the minister of MOFE in case of friendly M&A by foreign investors for companies whose assets exceed 2 trillion won • Limit on acquisition of stocks of listed companies by foreign investors without resolution of Board of Directors raised from 10% to 33.3% (except 81 defense companies designated by Minister of Commerce, Industry and Energy and Minister of National Defense) • Simplification of M&A procedure
1998.5.	**Securities and Exchange Act**	➢ Regulations eased to promote stock investment by foreign investors • Limit on foreign investment of listed companies(55%) in KSE & KOSDAQ abolished • Abolishment of limit on stock repurchase

Date	Related Laws	Contents
2001.3.	Securities and Exchange Act	➢ Prohibition of new stock issues during the tender offer period • Shortening of waiting time before the start of tender offer (7 days → 3 days) • Reducing limits on repetitive tender offer(1 yr. → 6 mo.)
2001.4.	Securities Investment Company Act	➢Reform of Securities Investment Company Act • Establishment of private mutual fund only for M&A for less than 50 investors permitted • Sales of stocks acquired for the purpose of M&A in 6 months prohibited in order to prevent greenmail • Prior report system changed to ex-post report system in tender bids
2005.3.	Securities and Exchange Act	➢ Balancing between takeover attempts and countermeasures • Upon become applicable to the 5% rule, the purpose of share holding must be disclosed. • After obtaining more than 5% of shares to affect control right, exercise of voting right or additional stock purchase is prohibited

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Part-03 | Changes in CG

Improvements shown in CG Index

Internal Control Mechanism Index (All)

		1998	1999	2000	2001	2002	2003	2004	2005	2006
Black et al.	KCGI	6.29	9.68	13.29	17.47	24.26	25.17			
	Shareholder Rights	0.39	1.82	3.09	4.38	8.4	8.31			
	Board Structure	0.32	0.79	1.23	1.88	2.85	2.89			
	Board Procedure	4.5	5.99	7.89	8.05	8.91	9.35			
	Transparency	1.08	1.08	1.08	3.16	4.1	4.62			
KDI	KCGI				16.86	20.32	35.29	35.49	37.81	38.73
	Shareholder Rights				4.34	5.17	11.09	12.25	12.12	12.1
	Board Structure				2.72	3.04	5.37	3.61	3.67	3.61
	Board Procedure				8.74	10.75	7.91	8.25	9.32	9.99
	Transparency				1.05	1.36	10.92	11.39	12.69	13

Internal Control Mechanism Index (small firms)

		1998	1999	2000	2001	2002	2003	2004	2005	2006
Black et al.	KCGI	5.37	7.78	11.35	14.97	21.4	21.11			
	Shareholder Rights	0.28	1.36	2.49	3.95	7.75	7.78			
	Board Structure	0.08	0.2	0.56	1.2	2.01	1.65			
	Board Procedure	4.3	5.49	7.55	7.74	8.53	8.69			
	Transparency	0.71	0.73	0.75	2.08	3.11	2.99			
KDI	KCGI				13.34	16.48	31.27	30.75	32.3	33.55
	Shareholder Rights				3.8	4.62	10.72	11.85	11.76	11.53
	Board Structure				1.09	1.28	3.45	1.5	1.46	1.42
	Board Procedure				7.86	10.02	7.05	7.04	7.59	8.75
	Transparency				0.59	0.57	10.04	10.36	11.49	11.8

* Firms whose asset size is less than 2 trillion won (2 billion US dollars)

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Internal Control Mechanism Index (large firms)*

		1998	1999	2000	2001	2002	2003	2004	2005	2006
Black et al.	KCGI	17.07	25.91	34.35	40.77	54.1	52.99			
	Shareholder Rights	1.25	4.97	7.24	7.32	13.7	12.76			
	Board Structure	3.17	6.07	11.04	12.7	14.52	14.23			
	Board Procedure	8.17	10.72	11.99	11.68	13.13	13.38			
	Transparency	4.48	4.15	4.08	9.07	12.75	12.62			
KDI	KCGI				41.41	44.6	58.13	59.55	58.68	58.82
	Shareholder Rights				8.08	8.68	13.33	14.09	13.42	13.71
	Board Structure				14.13	14.22	15.74	14.7	13.85	13.51
	Board Procedure				14.91	15.36	14.5	15.25	15.26	15.43
	Transparency				4.29	6.34	14.55	15.52	16.15	16.15

* Firms whose asset size is more than 2 trillion won (2 billion US dollars)

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How about Individual Components?

Cumulative voting

	2004	2005
KSE	62 (9.31%)	38 (5.74%)
KOSDAQ	114 (13.06%)	82 (8.95%)

Voting by mail

	2004	2005
KSE	62 (9.31%)	38 (5.74%)
KOSDAQ	114 (13.06%)	82 (8.95%)

1) Based on the survey performed by KCGS on KSE and KOSDAQ listed companies for 2004 and 2005. For KSE listed companies, 666 firms participated in the survey for 2004, and 662 for 2005. For KOSDAQ listed companies, 873 for 2004 and 916 for 2005.

Appointment of outside directors

	1999	2000	2001	2002	2003	2004	2005	2006
No. of companies	701	693	684	669	676	668	655	660
Total no. of directors	4,850	4,601	4,336	4,108	4,133	4,103	4,055	4,156
Avg. no. of directors	6.92	6.64	6.34	6.14	6.11	6.14	6.19	6.18
Total no. of outside directors	1,204	1,418	1,421	1,356	1,399	1,437	1,454	1,511
Avg. no. of outside directors	1.72	2.05	2.08	2.03	2.07	2.15	2.22	2.25
Ratio of outside directors (%)	24.8	30.8	32.8	33.0	33.8	35.0	35.9	36.4

Appointment of outside director by asset size

Asset	2004	2005
Less than 0.1 trillion won	1.4 (29.1%)	1.4 (30.1%)
0.1 ~ 0.5 trillion won	1.7 (29.6%)	1.8 (30.7%)
0.5 ~ 1 trillion won	2.4 (33.4%)	2.3 (33.6%)
1 ~ 2 trillion won	2.8 (38.0%)	2.6 (35.1%)
More than 2 trillion won	5.1 (56.0%)	5.2 (58.2%)

Attendance of outside director in the BOD meeting by asset size (%)

	2004	2005
Less than 0.1 trillion won	68.1	67.3
0.1 ~ 0.5 trillion won	66.3	66.4
0.5 ~ 1 trillion won	66.7	74.8
1 ~ 2 trillion won	73.1	70.7
More than 2 trillion won	85.3	86.9

Outside directors' presentation of opposing or revising opinion

Asset size (trillion Won)	2004			2005		
	No. of firms	No. of firms whose outside director presented opposing or revising opinion	%	No. of firms	No. of firms whose outside director presented opposing or revising opinion	%
~ 0.1	203	7	3.4	183	0	0.0
0.1 ~ 0.5	273	5	1.8	280	3	1.1
0.5 ~ 1	68	1	1.5	72	4	5.6
1 ~ 2	44	5	11.4	46	4	8.7
2 ~	78	24	30.8	81	18	22.2

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Appointment of Outside Directors in 2003

Identity of shareholders nominating outside directors	Portion(%)
Controlling Shareholders, Blockholders	76.0
Minority Shareholders	0.8
Bondholders	5.9
Institutional Investors	0.2
Others	17.1

Source: Korea Listed Companies Association(2003)

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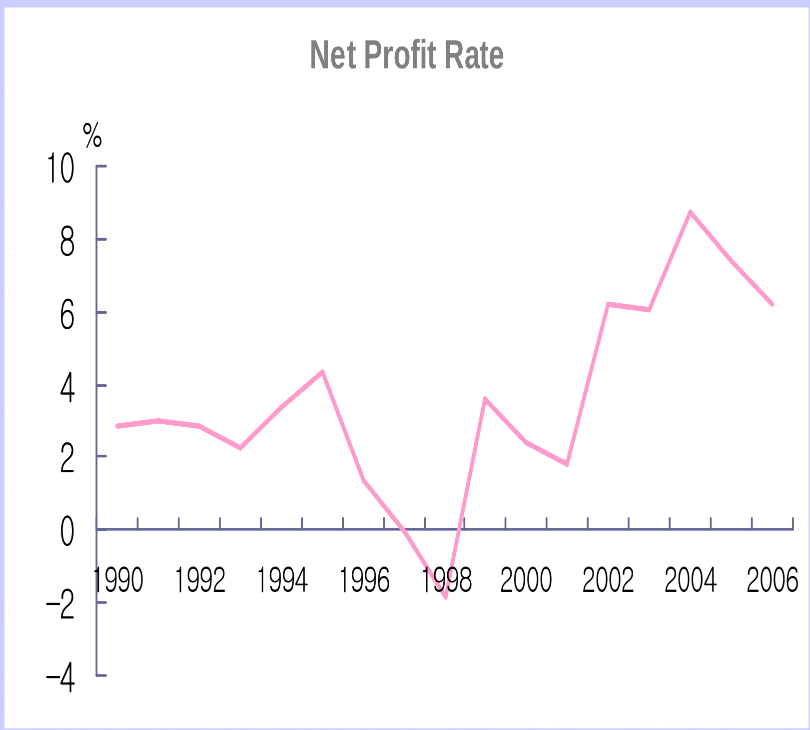
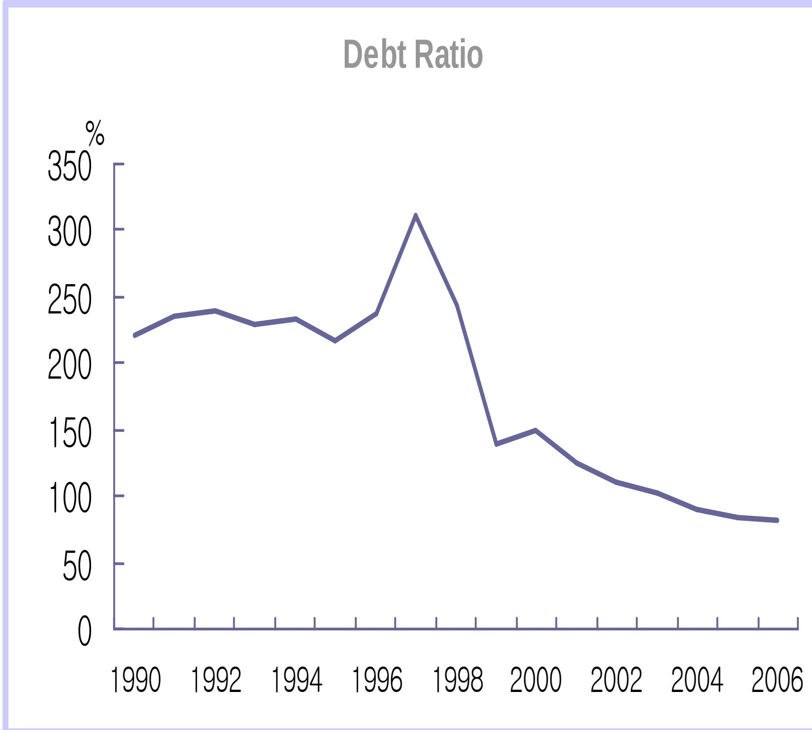
Part-04 | The Economic Impact of CG Reform

Fruits from CG reform?

As profitability and cash flow began to affect business, the performance and financial structure of domestic companies improved drastically after the crisis.





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Empirical studies in Korea

Since both theoretical analyses and empirical analyses of corporate governance tend to deliver ambiguous answers, additional researches need to be performed to clarify the relationship between the governance reform and firm performance.

- Yoon and Oh(2005) used year 2002 data to analyze the effect of firm-specific corporate governance on the firm's performance, market value and returns.
  - In Korean stock market, the good corporate governance causes good performance, while the relationship between the governance and the market value could not be identified.
    - Information on corporate governance has not been fully reflected in the stock prices in the Korean stock market.
  - From examining the subindices, it appears that shareholder rights and board procedures variables are much stronger in explanatory powers than the other subindices.

- Moon and Park(2005) used 1,249 non-banking firms listed on Korean Stock Exchange over the period of 2000~2002 to study how independent director in board of directors and audit committee affect earnings persistence and pricing multiples on earnings
  - Firms with more efficiently composed and managed board of directors and audit committee appears to enjoy higher earnings persistence. The efficient composition and management refers to higher ratio of outside directors, more financial and accounting professionals in the audit committee, higher attendancy of outside directors, more frequent meeting of audit committee.
  - Firms with more efficiently composed and managed board of directors and audit committee also show higher pricing multiples on earnings.

- Black, Kim, Jang and Park(2005) using panel data on the governance of Korean public companies over 1998-2003, report time-series evidence that an overall corporate governance index is an important and likely causal factor in explaining the firms' market values.
  - When the index is decomposed into subindices, subindices that reflect substantive governance are important, while procedure is not.
  - Better governed firms pay higher dividends than others, but do not report higher accounting profits.

- Cho(2005), using data consists of non-financial listed firms between 1999 and 2003, applies a simultaneous equation methodology and investigates the interdependence among the corporate control mechanisms, and its effects on firm performance.
  - Firm performance, measured by Tobin's Q, has a positive association with leverage ratio while having a negative relation to outside director ratio.
    - This suggests that the role of outside directors is limited in monitoring insider directors although the appointment of outside directors is mandatory.
  - This does not imply that the regulation with regard to outside director appointments have no value. Rather, this suggests that there may be a room for reforming corporate governance in Korea.
    - Specifically, it is necessary to enhance the independence of the outside directors of whom 76% are appointed by controlling shareholdings as of 2003.

- Hwang and Kim(2007) used 2002 and 2003 corporate governance index based on the survey run by CGS to analyze the relationship between corporate governance and the stock market.
  - the corporate governance index appears to be higher in financial institutions than the others.
    - the direct supervision and regulation by the authority affects the corporate governance
  - in a cumulative sense, the firms with higher governance index score enjoy higher excess profit, which means the market value reflect the corporate governance at least in the long run.
  - from a event study, the announcement of corporate governance award do not produce any significant change in its stock price.
    - They consider this as an evidence that the value of corporate governance is already recognized and reflected in the stock price by the market.

Part-05 | Concluding Remarks

Corporate Governance: Institution Index and Enforcement Index

	Institution Index (A)	Enforcement Index (B)	(A)-(B)
Disclosure and Audit	0.79	0.50	0.29
Disclosure	0.88	0.47	0.41
Audit	0.63	0.53	0.10
Supervision and Litigation by shareholders	0.72	0.39	0.33
Independence of supervisory bodies	0.50	0.47	0.03
Power of supervisory bodies	1.00	0.51	0.49
Litigation by shareholders	0.67	0.19	0.48
Accountability of managers	0.90	0.45	0.45
Shareholders' rights	0.88	0.34	0.54
Market for corporate control	1.00	0.56	0.44
Director/controlling shareholders' liability	0.83	0.45	0.38
Overall	0.80	0.45	0.35

Note: Index score ranges between 0 and 1, with 1 being the perfect score

IMD World Competitiveness Yearbook

	1999	2000	2001	2002	2003	2004	2005	2006
Foreign Investors	6.53 (36)	6.857 (36)	6.761 (37)	7.33 (33)	6.449 (46)	6.08 (53)	7.06 (37)	5.74 (52)
Foreign Financial Institutions	6.57 (42)	7.429 (31)	7.859 (30)	7.63 (38)	7.184 (46)		-	-
Rights (and Responsibilities) of Shareholders	2.86 (47)	4.114 (45)	4.282 (48)	5.38 (40)	4.571 (57)	5.08 (55)	5.66 (46)	5.19 (53)
Financial Institutions' Transparency	3.39 (44)	4.286 (45)	4.592 (41)	5.05 (36)	4.367 (51)	5.21 (44)	6.00 (35)	5.14 (47)
Corporate Credibility	3.98 (45)	4.571 (45)	4.592 (47)	5.24 (40)	4.694 (52)	5.08 (51)	5.93 (35)	5.35 (54)
Corporate Boards	3.61 (45)	4.114 (45)	4.451 (47)	4.76 (41)	3.959 (58)	4.63 (53)	5.62 (36)	4.68 (56)
Auditing and Accounting Practices	-	-	-	-	-	-	6.58 (37)	5.29 (58)
Shareholder Value	3.20 (44)	3.77 (44)	4.225 (44)	4.62 (39)	4.163 (54)	4.67 (53)	5.82 (39)	4.94 (52)
Overall Country Ranking	38	28	28	27	35	35	29	38
Number of Countries Covered	47	47	49	49	59	60	60	61

* Index score ranges between 0 and 10, with 10 being the perfect score.
** Numbers in parenthesis are ranks in each category.

Conclusion

While there are scattered evidences supporting the continuous effort to enhance the corporate governance, the efforts are starting to pay off. There are still more to be pursued than what have already been achieved.

- With further vitalization of the capital market through proper protection of property rights and establishment of transparent governance, the market will become more dynamic which will eventually lead to higher potential growth rate.
- The government should look for the ideal type and optimal standard of governance related regulations, and try to enforce it at a proper level.
- The government should also look for promoting the firms' insiders such as the controlling shareholder or the management to pursue further reform voluntarily.
- Need to search for ways to raise the effectiveness of the system.
  - As pointed out in Lim et al.(2003), while the overall governance-related regulatory system has improved, the level of actual operation of the system is lower than expected.

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