



International Conference

**Changes in Corporate Governance
of Korean Enterprises
after the Financial Crisis**

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Korea's Leading Think Tank



C O N T E N T S



Introduction

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Part-01 | Introduction

KDI

The Crisis and Corporate Governance

In the face of the financial crisis and severe business depression, enhancement of corporate governance 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.

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.

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.

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.

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

Part-02 | **CG Reform**

KDI

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.

- ❖ 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.

Shareholder 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.

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 $\frac{1}{4}$ of BOD members as outside directors, for the listed companies whose asset exceeds 2 trillion won strictly more than $\frac{1}{2}$, financial institutions more than or equal to $\frac{1}{2}$.

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.

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	<ul style="list-style-type: none"> ➤ Reform of Securities and Exchange Act for restructuring large enterprise <ul style="list-style-type: none"> • 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	<ul style="list-style-type: none"> ➤ Regulations eased to promote stock investment by foreign investors <ul style="list-style-type: none"> • 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	<ul style="list-style-type: none"> ➤ Prohibition of new stock issues during the tender offer period <ul style="list-style-type: none"> • 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	<ul style="list-style-type: none"> ➤ Reform of Securities Investment Company Act <ul style="list-style-type: none"> • 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	<ul style="list-style-type: none"> ➤ Balancing between takeover attempts and countermeasures <ul style="list-style-type: none"> • 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

Part-03 | **Changes in CG**

KDI

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)

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)

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

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

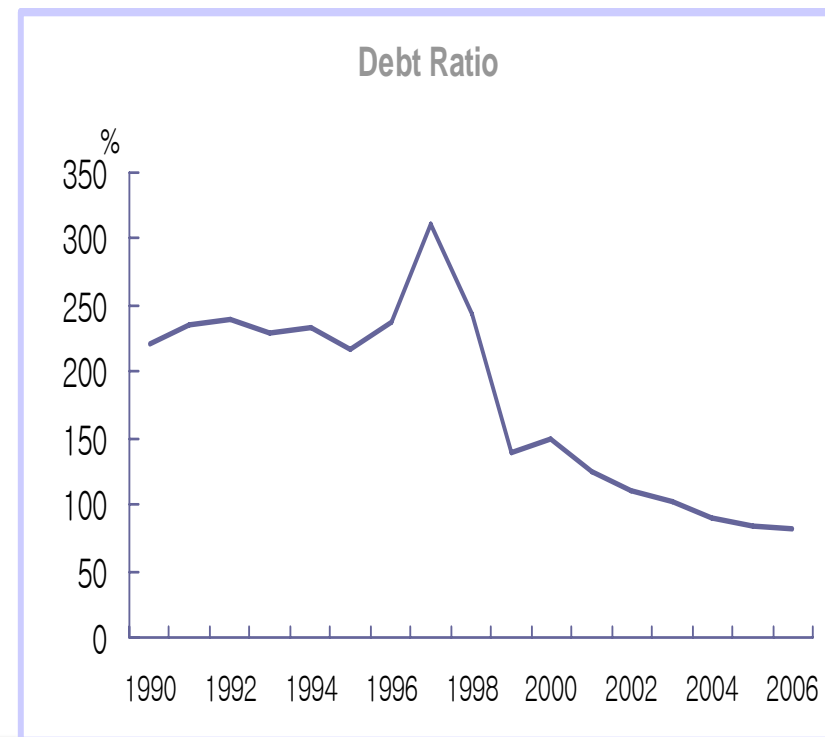
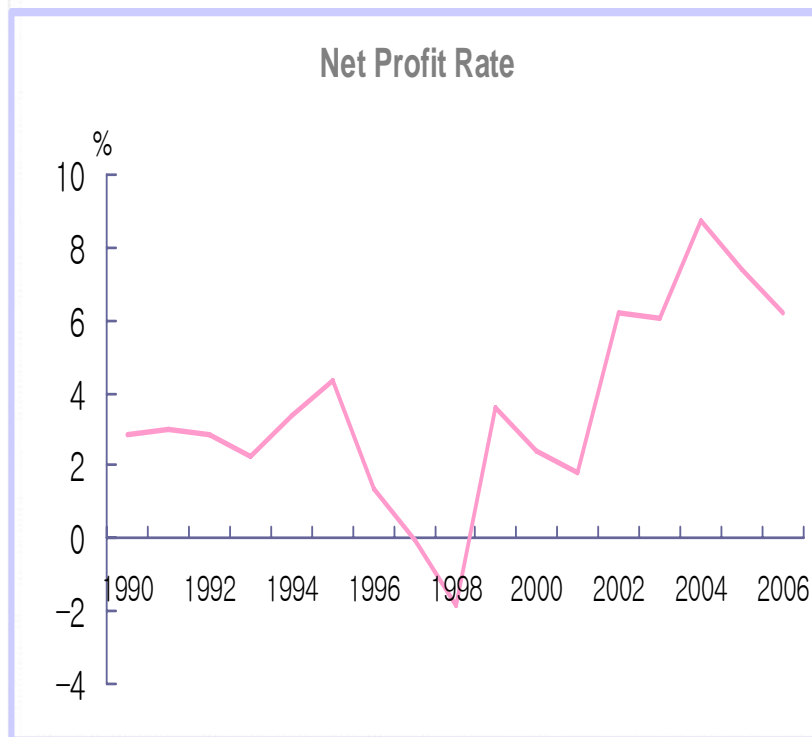
Source: Korea Listed Companies Association(2003)

Part-04 | **The Economic Impact
of CG Reform**

KDI

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.



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**

KDI

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.

THANK YOU

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CHAPTER 1**Introduction**

In the face of the financial crisis in 1997, and severe business depression which followed, people began to realize the importance of corporate governance. 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 Korean economy, including the corporate governance issues.

When the crisis hit the Korean economy, number of representative Korean companies that belonged to the biggest business groups went bankrupt along with the group itself being dissolved. It appeared to be caused by the slump in exports and the business recession, but it was an inevitable result from wrongfully designed over-investment accumulated for a long period. This proved the limitations of size oriented expansion strategies of Korean companies through heavy borrowings from financial institutions, which had been the most prevailing management strategy until the crisis. Such mismanagement was only sustainable because 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. Even if there were any outside stakeholders who were willing to raise an issue with such behaviors of the controlling shareholders, it would have been virtually impossible to do so due to the lack of transparencies. Shareholders or creditors had a very limited access to the insider information.

Corporate governance is a complex system of control mechanisms that are supposed to influence the behavior of management in order to guarantee a high equity value for the owners of a firm. Simply speaking, backward corporate governance system left Korean large business groups virtually without any disciplinary pressures against the direct decision-making by the controlling families.

International organizations, such as IMF and World Bank, as well urged Korean government to enhance the corporate governance system in Korean enterprises. They recommended various 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. Suddenly it became the major concern of Korean government and the business alike.

According to the studies that deal with corporate governance issues, there are many expected benefits from enhancing the corporate governance structure at individual company level. Good corporate governance system enables maximization of firm value by eliminating rent-seeking behaviors and inter-company transactions. It also promotes efficient utilization of various resources including the human resource.

On the other hand, it is also claimed that the corporate governance of individual company not only enhances its own competitiveness but also influence the efficiency of national economy. As the market economy matures and the globalization progresses, the good corporate governance becomes prerequisite for economic growth since it ensures the efficient utilization of the limited resources nation-wide.

Having a good corporate governance mechanism also lowers the cost of financing capital, and promotes smooth flow of money in the capital market, thereby contributes to

the economy-wide efficient resource allocation. Economists have shown 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 is a hindering factor for 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. In this sense, poor corporate governance was very well known as one of the key factors for Korea discount phenomenon.

There are many literatures that can be used to show the link among corporate governance, capital market, and eventually economic growth. King and Levine(1993) have shown that countries with advanced capital market grow faster than the others. Economists also seek to detail the rationale behind this relationship. Wurgler(2000) have shown that capital market development will enhance the efficiency of resource allocation. It is also shown by Black and Gilson(1998) that the growth of venture firms heavily depends on the level of capital market development. It is also shown by Park, Binh and Shin(2005) that the industries with higher R&D intensity, higher risk, higher capital intensity, would grow faster in market based countries. Finally, for the link between the corporate governance and capital market, La Porta et al.(2000) have shown that investor protection is a requisite in capital market growth, and corporate governance is a mechanism to protect the investors.

While the fore-mentioned benefits of enhancing corporate governance do apply to Korean businesses as well, there is a major difference in what the enhancement is aiming to achieve in Korea from other countries. Traditionally, the Korean companies were expanded form of family business. The founder and her family as well as the affiliated companies hold major shares of the companies inside the group. The founding owner, i.e., controlling shareholder exercises absolute influence over the business in this way. In doing so, there is a tendency for them to maximize the controlling shareholders own interest, while the interests of other minority shareholders and creditors were

Therefore, it can be said that then existing corporate ownership and governance structures of Korean enterprises belong to the so called insider system(bank-based system) than to the outsider system(market-based system). However it differs from traditional insider system in the sense that in the center of the structure lie the controlling shareholders instead of banking system.

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 contrast, the corporate governance is considered to be a mechanism to solve the agency problem rooted in the separation of ownership and management in U.S.A or U.K..

The <table 1> below shows the recent trend in ownership-control disparities of major Korean chaebol companies. It is surprising to find out in the table that despite all the efforts made to correct such conditions, the disparities between ownership and control rights not only persisted but also aggravated during the years after the crisis. This is an indicator that shows the possibility of the controlling shareholders of Korean chaebol companies having incentives to improperly abuse their controlling rights for their advantages at the price of other shareholders' interests. This implies the need for continuous efforts to properly maintain and enforce the regulatory measures to further enhance the corporate governance of Korean enterprises in the future.

<Table 1 > 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

CHAPTER 2

Corporate Governance Reform

1. Principles of CG Reform in Korea

On the course of recovery from the crisis, corporate governance reform efforts were made mainly by government through the rapid change of institutional settings. 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, DJ 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. Among these, raising the level of transparency in corporate management and heightening the level of management responsibility were related to corporate governance reform.

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.

The following reforms include, but are not limited to, enactment of Code of Best Practice for Corporate Governance, fortification of rules governing the board of directors and audit committee, enhancement of the rights of minority shareholders, supportive actions to promote the activities of institutional investors and NGOs, revitalizing the market for corporate control. Among these reform measures, this paper will only focus on the shareholder rights, board of directors, disclosure, audit, and the market for corporate control.

2. Shareholder Rights

Devices that enable the minority shareholders to actively but properly exercise their rights have been introduced and the eligibilities for exercising the various rights have been mitigated ever since. As is summarized in the <table 2> below, these includes the rights to hold the shareholder's representative suit, to request the court to lay an injunction for malfeasance of directors, request to discharge directors and/or auditors, and make proposals to the general shareholders' meeting, to request for convocation of a general shareholders' meeting, etc.¹

¹ Shareholder's representative suit refers to the right of the minority shareholders to demand the company to institute a lawsuit for damages against directors who inflicted a loss to the company from management decisions. If the company refuses to institute a lawsuit, then the minority shareholder has the right to bring an action against the director by himself.

Cumulative voting is a system where the minority shareholder possesses the number of voting right that is equal to the number of directors to be appointed per share. He can vote his number of votes cumulatively on one or number of director candidates.

Voting by mail is a system that allows the shareholders who cannot attend the shareholders' general meeting to send his ballots via mail to the company with required items filled in and thereby to exercise his votes.

Injunction for malfeasance of directors is the right where the auditor or the minority shareholder can request the injunction of malfeasance of directors that may induce irrecoverable damages to the company.

Stockholder's proposal is a right of a minority shareholder to propose a certain matters to be the object of a general

In January 2004, securities class action act was introduced which allows class action lawsuits against unfaithful disclosure, manipulation of stock prices, malpractice audit. The act was effective from January 2005 for companies whose asset exceeds 2 trillion won and was effective from January 2007 for other companies.²

<Table 2> Shareholder Rights Related Provisions and Shareholding Requirements

	Commercial law	Securities and exchange act 1)	Banking act 2), 3)
Shareholder's representative suit	1%	0.01%	0.005%
Injunction for malfeasance of directors	1%	0.05% (0.025%)	0.025% (0.125%)
Request to discharge director/ auditors	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%)

Note : 1) The numbers in the parenthesis are applied to the firms whose capital size exceeds 100 million won.

2) The numbers in the parenthesis are applied to the firms whose capital size exceeds 2 trillion won.

3) Other acts that govern various financial institutions and transactions have similar clauses.

3. Board of Directors

First of all, in 1998, through the revision of commercial law, fiduciary duty of director and de factor director was introduced. This means that those controlling shareholders who used to control the whole group of companies but never bore any responsibilities for his decisions made, are now subject to at least some of the legal responsibilities.

Secondly, based on the recognition that the board had been playing only nominal role under the large business group structure, outside director system is introduced and continuously expanded to improve the function of board of directors. Outside directors, also known as independent directors, are directors who only participate in the board meeting and not attend to daily businesses. They are not supposed to be related to the controlling shareholders in any way.

It is expected that with the outside directors in board of directors, the board can actively curb the selfish expropriation of the controlling shareholders.

By 2001, through the revision of securities and exchange act, having outside directors

shareholders meeting.

² Class action is a procedural device used in litigation to determine the rights of and remedies, if any, for large numbers of people whose cases involve common questions of law and fact. A class action can be instituted by more than 50 shareholders who owns more than 1/10000 of issued stocks.

become mandatory for all the listed companies, and for those whose asset size greater than 2 trillion won it became mandatory to set up a outside director candidate nominating committee. This was same for all the financial institutions.

Currently, the listed companies are forced to have more than or equal to $\frac{1}{4}$ of BOD members as outside directors, for the listed companies whose asset exceeds 2 trillion won strictly more than $\frac{1}{2}$, financial institutions more than or equal to $\frac{1}{2}$.

4. Disclosure

Disclosure lies at the center of any corporate governance related issues. No one can claim anything if they do not have any information on what is going on inside a company. In a world of informational asymmetry, it almost always works for the society to narrow the informational gap among the stakeholders. However, not only the amounts of information, but also the truthfulness and timeliness of information matters, and regulations on disclosure must take this aspect into consideration. In that respect, the penalties for unfaithful disclosure were reinforced in 1999 up to 0.5 billion won.

Another reform that was introduced in 1999 was having top 30 business conglomerates to report consolidated financial statements so that outsider can understand the whole picture of financial status of affiliated companies.

Also in 2000, there was an imposition of duty to the 10 largest business groups to disclose the board decision on inter-company (or related party) transactions between the companies that belongs to a same business group in case the transaction size exceeds 10% of the capital or 10 billion won. Then in 2001, the duty to disclose inter-company transactions expanded to 30 largest business groups. After 2002, this duty was imposed on any corporation that belongs to a business groups whose asset size exceeds 2 trillion won.

In 2002, fair disclosure system was introduced so that everybody has simultaneous access to business and management plan, sales forecasting, estimated profit, etc. This was supposed to help to prevent unfair transactions among the market participants due to informational asymmetry. The companies are strictly prohibited from disseminating such information to specific parties before it is publicly disclosed.

In 2003, there was an introduction of obligation for CEO and CFO to authenticate the disclosure documents, and a way to levy civil liability on practical director if there are any false statements in such authenticated documents.

5. Audit

While auditor is a very powerful institution that was given the authority to inspect operation and accounting of business, its independence and effectiveness had been questioned continually. International organizations such as IBRD also had been requesting for a reform in this area.

First, in 1997, compulsory appointment of more than 1 standing auditor for the listed companies whose asset exceeds 100 billion won was imposed. Then in 1998, compulsory establishment of external auditor appointment committee for all listed companies was added onto it. Finally in 2000, compulsory establishment of audit committee was introduced for the listed companies whose asset exceeds 2 trillion won.

According to the current Securities and Exchange Act, all listed companies must establish an audit committee and more than 2/3 of the members need to be outside directors. It is also mandatory for these companies to have at least an audit committee member who is an expert in accounting or finance, and the chairman of the committee must

be an outside director.

The act also took a caution that 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.

6. Market for Corporate Control

Market for corporate control monitors corporate management and minimizes corporate excesses or inefficiencies. It encourages sound decision-making and efficiency from the management. In the face of a market for corporate control, management will try to maximize shareholder value since a fall in share price will increase the probability of becoming an M&A target. Therefore, there had been a recognition that promotion of the disciplinary role of the market for corporate control could potentially mitigate the so-called "Korean Discount" phenomenon, which was thought to be based on the opportunistic behavior of controlling shareholders. However, it still is a difficult task to form a lively market for corporate control due to chaebols' virtual monopoly of corporate control in business group affiliated companies.

Before the financial crisis, most of the M&A-related regulations tended to protect the founding owners of corporations. In that era, hostile M&A was generally considered to be an improper appropriation of another's property. However, after the crisis, most of the regulation that worked against the hostile M&A (and foreign investment) has been removed. One of the reasons why such an abrupt change in the spirit of the legal system is there was a need to invite foreign capital in the face of financial difficulty and restructure faltering enterprises. Series of reforms in M&A or more specifically hostile M&A related regulations are summarized in the <Table 3> below.

<Table 3> M&A related Government Policy Changes since 1997

Date	Related Laws	Contents
1997. 2.01	Foreign Investment Promotion Act	<input type="checkbox"/> Reform of Foreign Investment Promotion Act - Under the resolution of Board of Directors, each foreign investor can acquire more than 10% of old share per company (only in the case of a friendly acquisition.) - For those companies whose assets exceed 2 trillion won, the transfer of controlling rights through a friendly M&A must be approved by the minister of MOFE.
1997. 4.01	Enforcement Decree of Securities and Exchange Act	<input type="checkbox"/> Reform of Enforcement Decree of Securities and Exchange Act - Free to acquire more than 10% of listed company: - If the amount acquired exceeds 25%, then 50%+1 in total must be acquired by tender offer for the difference between the amount acquired and 50%+1 at the highest acquisition price in the past 12 month
1997.12.30	Securities and Exchange Act	<input type="checkbox"/> Policy to stimulate M&A - Obligatory tender offer system eased: Lowered required total acquisition to 40%+1 - Per stock limit on foreign investment raised to 55% from 50%
1998. 2.04	Securities and Exchange Act and Foreign Investment Promotion Act	<input type="checkbox"/> 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. 2.18	Labor Standards Law	<input type="checkbox"/> Reform of Labor Standards Law: Allowing the dismissal of employees in case of firms involved in M&A transactions
1998. 5.22	Securities and Exchange Act	<input type="checkbox"/> 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
1998. 12. 28	Securities and Exchange Act	<input type="checkbox"/> Simplification of M&A procedures - For small M&A cases, general meeting of shareholders can be omitted
2001. 3. 28	Securities and Exchange Act	- Prohibition of new stock issuance during tender offer period - Shortening of waiting time until the beginning of tender offer (7 days → 3 days) - Relaxing the restriction of repeated tender offers (1 year → 6 months) - Conversion into ex-post reporting for tender offer
2001. 4.24	Securities Investment Company Act,	<input type="checkbox"/> 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. 29	Securities and Exchange Act	<input type="checkbox"/> Balancing between takeover attempts and countermeasures - Upon becoming 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 for 5 days

CHAPTER 3

Changes in Corporate Governance

In this chapter, we will examine how the fore-mentioned reforms in corporate governance related regulations had changed corporate governance status of Korean enterprises using comprehensive index approach developed in two previous studies as well as individual elements of corporate governance system.

First, the two studies that develop comprehensive corporate governance indices are Black et al.(2005) and KDI(2006) and both are utilizing the corporate governance survey data maintained by Korean Corporate Governance Service(KCGS).³ While the indices – called Korean Corporate Governance Index (KCGI) in both studies - constructed and used in two studies are based on the same data set, they differ in the time horizon covered and the way the indexes were constructed. In addition, Black et al. collected and used additional data from various sources to extend the data into 1998. Therefore, one to one comparison or amalgamating the two indexes would be impossible. However, by looking at the two indexes together will give us an enough idea of how the overall changes in the corporate governance status of Korean enterprises have changed since the crisis.⁴

<Table 4> Internal Control Mechanism Index (All)

		1998	1999	2000	2001	2002	2003	2004	2005	2006
Black et al. (2005)	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 (2006)	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

As can be seen from the <Table 4> above, for KSE listed firms, the overall status of corporate governance has been improving throughout the years since the crisis. Such

³ The survey data was initially conducted by Korea Stock Exchange in 2001 and the task to perform the survey and maintain the data was later transferred to KCGS in 2002.

⁴ While the KCGI constructed in Black et al.(2005) contains additional sub-index called ownership parity, we modified the overall index so that the ownership parity sub-index can be excluded for head to head comparison between the two indices.

improvement is observable in each sub-indices as well except a very few incidences. The magnitude of change is more visible in earlier years until year 2003 and it sort of slow down after that.

It is more interesting to examine the difference in the level of changes between the small firms and large firms shown in the <Table 5 > and <Table 6> below. From comparing the pure level of the indices, it is apparent that the large firms whose asset size exceeds 2 trillion won – the usual break point for the level of regulatory intensities in most of the cases – displays higher overall level of corporate governance. However, if we consider the speed of adjustment, the small firms were making a lot more progress in implementing the required changes.

<Table 5> 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)

<Table 6> 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)

Looking at the two indices shown above, it seems clear that there have been a enormous progress in the corporate governance of Korean Stock Exchange listed firms. This statement, however, may be misleading in some sense. Below, we will examine more micro evidence that for individual components, this may not be the story. Some of the corporate governance elements need whole lot more improvement. Some of the elements are actually showing some regressions. Some of the elements are simply showing the need for further adjustments in the regulation.

First, <Table 7> below shows the number and percentage of KSE and KOSDAQ (formerly Korea Securities Dealers Automated Quotation but now the electronic stock market division of Korea Exchange).⁵ The table shows that only 62 firms in KSE adopt cumulative voting clause in 2004 and this even shrinks to 38 firms in 2005.⁶ This is similar in the KOSDAQ cases. The number is low at 114 firms in 2004 and reduced to 82 in 2005. It is not too different in voting by mail cases as well as shown in <Table 8> below.

<Table 7> Cumulative Voting

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

<Table 8> Voting by mail

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

Next, looking at the trend regarding appointment of outside directors as shown in <Table 9> below, the level of prevalence of outside directors for Korea Stock Exchange listed companies has been still low at 2.25 out of 6.18 in 2006, even though the ratio is continuously increasing.

It can clearly seen in <Table 10> below that the ratio of outside directors in board of directors exceeds 50% for companies whose asset size exceeds 2 trillion won thanks to the regulation. The ratio, however, is lower around 30% for companies of smaller size.

⁵ In 2005, the Korea Exchange (KRX) was newly established by consolidating three Korean exchanges; Korea Stock Exchange, KOSDAQ, and Korea Futures Exchange.

⁶ The statistics used in this chapter is based on the information provided by White Paper on Corporate Governance in Korea (2006) unless otherwise noted. The information provided in the White Paper is 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.

<Table 9> 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
Avg. 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

Source: Korea Listed Companies Association

<Table 10> 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%)

The attendance of outside director in the board of directors meeting by asset size, shown in <Table 11>, shows that the outside directors for companies whose asset size exceeds 2 trillion won is more assiduous at least in their attendance rate. This shows that regulation itself cannot explain everything because the attendance rate is not subject to any regulation.

The same phenomenon can also be found in <Table 12> below that shows the frequency of outsider directors presenting opposing or revising opinion in the board of directors meeting.

However, the same two tables also show the negative side of the story as well. The number of attendance of outside directors as well as the frequency of outside directors stand out in the board of directors meeting do not seem to meet the expectation regarding the effectiveness of outside director system. Apparently, the outside directors are not doing their best in fulfilling their obligations.

<Table 11> Attendance of outside director in the BOD meeting by asset size (%)

Asset	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

<Table 12> 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

Maybe the part of the explanations for such behaviors can be found in <Table 13>. As is seen from the table, the majority of the outside directors are the ones who were nominated by the controlling shareholders and blockholders. They, therefore, may not have strong incentive to attend all the meetings and even further to oppose any of the proposals made by the controlling shareholders.

<Table 13> 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).

Finally, we will review the status of market for corporate control in Korea. Even with the arrangement of institutional settings that provides the ground for hostile takeover in 1997 and after, due to the lack of potential acquirer equipped with size and know-how, the realization of hostile takeover deals had been considered to be a rare possibility. Takeover, therefore, has not played a significant role thus far in Korea except very limited cases.

More recently, however, the threat on the control right of domestic companies as well as the foreign capital as the source of such threats become the center of public interest. A few takeover attempts that were made by foreign funds toward some of the chebol-related companies, which were considered to be takeover-safe, played as the source of turmoil. Since then, the potential of being the target of takeover attempts and the way to defend itself from such a threat suddenly became (or at least appeared to be) one of the central concerns of managements and controlling shareholders of Korean listed companies. It then led the academia and other stakeholders into hot debates over the takeover and foreign capital related issues. It seems, however, that the debates so far have been based on fragmentary information on extreme examples, or on emotional responses without the considerations of practical constraints.

However, it is clear that the takeover-related issues need to be examined from a corporate governance standpoint as well, since the market for corporate control is considered to be one of the major external control mechanisms on a company. When internal and external monitoring mechanisms are ineffective in curbing the selfish behavior of controlling shareholders, it is inevitable to recourse to the market for control. It is especially true when the corporate control system in Korea can be characterized with the chaebol structure, which is known to shed additional complications among shareholders.

After all, it is our and many others' conclusion that it is beneficial to the society as a whole as well as the relevant stakeholders to maintain an appropriate tension regarding the corporate control through efficiency enhancement. Under the assumption that the rules that govern the relevant behaviors are fair, and that the supervision and enforcement are strict and impartial, it is preferable to have the threat of being takeover remains above a certain level.

In fact, various empirical studies performed in countries where the market for corporate control is active have shown that the takeovers realized through the capital markets bring economic benefits to the shareholders of the target company. It is also shown that these takeovers can be beneficial to the shareholders of the acquiring company depending on the situation, and it also brings beneficial effect on to the whole society through efficiency enhancement.

It is also important to keep in mind that the rules that govern the market for corporate control should be free from concerns regarding the existence or role of foreign capital. When the rules are devised and imposed, it should be nationality-neutral.

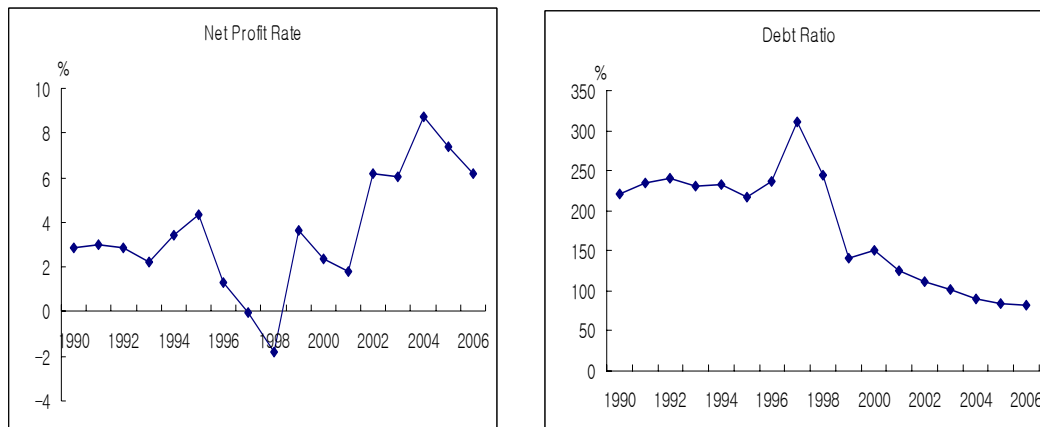
After all, the answer to all the questions lies in the fact that the enhancement of corporate governance as well as raising the level of transparency in the business management is the surest and most efficient way to defend anybody's control right over an enterprise.

CHAPTER 4

The Economic Impact of Corporate Governance Reform

As profitability and cash flow started to take root in business, the performance and financial structure of domestic companies have improved drastically after the crisis as shown in the tables below. This could be a result of enhanced corporate governance system in Korean enterprises due to the reinforced regulations. However, this could be simply a coincidence while there is a true explanation that has nothing to do with the corporate governance. It, therefore, is required to further examine the correlation before saying anything definite. In this chapter, we will review some of the existing literature that carefully studied the economic impact of corporate governance reform.

[Figure 1] Trend in Net Profit Rate and Debt Ratio



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

First, 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. They suspect that the information on corporate governance has not been fully reflected in the stock prices in the Korean stock market. They also showed that, from examining the sub-indices, shareholder rights and board procedures variables appear to be much stronger in explanatory powers than the other sub-indices.

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. They found that firms with more efficiently composed and managed board of directors and audit committee appears to enjoy higher earnings persistence. Here the efficient composition and management refers to higher ratio of outside directors, more financial and accounting professionals in the audit committee, higher attendance of outside directors, more frequent meeting of audit committee. It is also shown that firms with more efficiently composed and managed board of directors and audit committee also displays 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 sub-indices, sub-indices that reflect substantive governance are important, while procedure is not. It is also shown that 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, however, does not imply that the regulation with regard to outside director appointments has 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.

Finally, 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. In their study, the corporate governance index appears to be higher in financial institutions than the others. So it can be concluded that the direct supervision and regulation by the authority affects the corporate governance.

On the other hand, in a cumulative sense, the firms with higher governance index score enjoy higher excess profit, which means the market value reflects the corporate governance at least in the long run. They also performed a event study, and it showed that 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.

CHAPTER 5

Concluding Remarks

In this paper, we have overviewed the surge of interests in corporate governance after financial crisis in Korea, the successive reformative efforts to enhance the corporate governance system in Korean enterprises, and the result of such reforms.

While there are scattered evidences supporting the continuous effort to enhance the corporate governance has started to pay off, there are still more to be pursued than what have already been achieved to attain a step higher level of corporate governance system. For example, as can be seen in the table below, while the institutional arrangements have scored fairly high, the enforcement of such institutional settings are relatively low. This can be a critical weakness of the current corporate governance system of Korea.

<Table 14> 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

Such a weakness results in a persistently low scores and rankings of Korea in IMD's world competitiveness yearbook. While Korea is ranked between 27th and 38th depending on the year of evaluation, the ranks Korea has received in the shown corporate governance related elements were a lot lower than the overall score or the rank. This implies that the corporate governance system of Korea is seen as a weakness from a global perspectives, and this also means that Korea can gain an edge in its competitiveness by improving the corporate governance system.

<Table 15> 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

Note : * Index score ranges between 0 and 10, with 10 being the perfect score.

** Numbers in parenthesis are ranks in each category.

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.

In doing so, however, the government should look for the ideal type and optimal standard of governance related regulations, and try to enforce it at a proper level. In other words, it is about time for us to look back upon the previous path taken to improve the system, and find our own customized direction and method of future improvement. 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. It is, therefore, crucial to understand that being equipped with proper institutional setting is not a sufficient, and we need to come up with a better way to raise the level of enforcement.

The government should also look for how to promote the firms' insiders such as the controlling shareholder or the management to pursue further reform in a more voluntary way. It is always the easiest and cheapest way to involve the stakeholders to voluntary reform using various sticks and carrots.

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