

Evolution of Corporate Governance in Korea After the Economic Crisis

Comparative Corporate Governance:
Changing Profile of National Diversity

RIETI

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Economic Reform Policy after the Economic Crisis

- Economic reform on four areas
- “Four Economic Reform Policy” (1998)
 - Corporate reform
 - Financial reform
 - Labor reform
 - Public sector reform
- Corporate reform targeted mainly on chaebol group
- “5 Plus 3” Corporate Reform Principle
 - Agreement between Government and Chaebols
 - Improving corporate governance is a key policy

5 Plus 3” Corporate Reform Principle

- Five Principle Policy (February 1998)
 - Improving financial structure (reduction of debt)
 - Building competence core for chaebol groups
 - Enhancing transparency
 - Removing cross debt guarantee among affiliated companies
 - Enhancing accountability of controlling shareholder & mgt.
- Three Additional Principle (August 1999)
 - Reducing circuitous equity ownership and unfair transaction among affiliated companies
 - Improving corporate governance of non-bank financial institutions
 - Strengthening gift and inheritance taxation

New Regulations to Improve Corporate Governance

- Outside Director
 - Required for all listed companies on KSE & KOSDAQ
 - Company with asset larger than 2 tr won (\$1.7bil)
 - More than three outside director (2000)
 - More then 50% of the board (2001)
 - Others
 - More than 25% of the board
 - As of June 2002, outside directors are 33.0%
- Outside director candidate nomination committee
 - For company with asset larger than 2 tr won (\$1.7bil)
 - More than ½ should be outside director
 - Candidate proposed by shareholder with more than 1% of outstanding shares should be nominated

New Regulations to Improve Corporate Governance

- Audit Committee
 - company with asset larger than 2 tr won (\$1.7bil)
 - 2/3 of the committee should be outside directors
- Improved Disclosure
 - Combined financial statement:
 - Top 30 chaebols (1999)
 - Companies with asset larger than 2 trillion won (\$1.7 bil) (2002)
 - Electronic disclosure system introduced (2001)
 - Related party transactions greater than 10 billion won (\$8.3 million) should be disclosed (top 30 chaebol groups)
 - Mandatory disclosure for institutional shareholders

New Regulations to Improve Corporate Governance

- Cross share ownership prohibited
- Limitation on equity holding of affiliated companies
 - No more than 25% of net asset value
 - Regulation on circuitous share ownership
 - No voting rights for shares exceeding 25%
 - Applies to groups with asset greater than 5 tril won (\$4.2 bil)
- Changes in equity holding limit regulation
 - Removed in Feb. 1998 to allowed defense on hostile M&A
 - Reinstated in April 2001 due to surge in circuitous ownership

	April 1998	April 2001
• Circuitous equity holding amount	17.7 tril won	50.5 tril won
• Proportion to net asset value	27.5%	35.2%

New Regulations to Improve Corporate Governance

- More Regulation on Related Party Transactions
 - Stricter regulation on capital & asset transactions
 - Cross debt guarantee prohibited
 - Board should approve related party transactions greater than 10 billion won (\$8.3 million)
- Limit on Foreign Equity Ownership Removed
 - 14% of outstanding shares in 1997
 - From May 1998, 100%
- Hostile Takeover Barriers Removed
 - 50%+1 shareholding rule removed
 - M&A specialized fund allowed

New Regulations to Improve Corporate Governance

- Holding Company Introduced
 - Allowed under the following regulations since April 1999
 - Holding company's debt to equity ratio should be less than 100%
 - Should own shares of son company
 - more than 30% for listed son company
 - more than 50% for private son company
 - Should not own shares of grandson company
 - Should not own shares of company other than son company
- Cumulative Voting
 - Applied on election of directors
 - Opt-out system

New Regulations to Improve Corporate Governance

- Increased Responsibility of Controlling Shareholder
 - Fiduciary duty of directors
 - Liability of shadow director (controlling shareholder who does not seat on the board)
- Mandatory Compliance Officer
 - Investment Trust Co. & Mutual Fund
- Integrated Supervision Agency Established
 - “Financial Supervisory Commission”
 - Integrated supervision: Bank, Securities, Insurance
- Corporate Governance Guideline (1999.8)

New Regulations to Improve Corporate Governance

- Minority Shareholder Rights Strengthened

	1997	2002
• Requesting removal of directors & auditors	1% (0.5%)	0.5% (0.25%)
• Seeking injunctive action against illegal acts (0.025%)	1% (0.5%)	0.05%
• Bringing shareholder derivative actions	1% (0.5%)	0.01%
• Compelling inspection of financial records	3% (1.5%)	0.1% (0.05%)
• Terminating a liquidator	3% (1.5%)	0.5% (0.25%)
• Requesting cumulative voting	--	3%
• Appointing inspector to examine records	3% (1.5%)	3% (1.5%)
• Convening a special shareholders' meeting	3% (1.5%)	3% (1.5%)
• Making a shareholder proposal	1% (0.5%)	1% (0.5%)

The numbers in parentheses apply to companies with at least 100 bil won in paid-in capital
All rights are subject to ownership more than six months

Minority Shareholders' Rights

Japan and Korea

Minority SH Right	Korea public co. (large co.)	Japan
Action to remove directors and auditors	0.5% (0.25%) outstanding shares	3.0% voting rights
Seeking injunction against illegal acts	0.05% (0.025%) outstanding shares	Auditors may request that director cease illegal acts
Bringing shareholder derivative suit	0.01% outstanding shares	Any contemporaneous Shareholder
Limitation on directors liability	Not permissible	Permissible under Certain conditions
Compelling inspection of financial records	0.1% (0.05%) outstanding shares	3.0% voting rights

Minority Shareholders' Rights

Korea and Japan

Minority SH Right	Korea public co. (large co.)	Japan
Convening special shareholders' meeting	3.0% (1/5%) outstanding shares	3.0% voting rights
Making a shareholder proposal	1.0% (0.5%) outstanding shares	1.0% or 300 voting shares
Requesting cumulative voting	3.0% outstanding shares	Any shareholder, unless certificate provides otherwise
Appointing inspector to examine corporate affairs and records	3.0% (1.5%) outstanding shares	3.0% voting rights

New Regulation Proposed by New President-Elect, Mr. Roh

- Security Class Action Lawsuit
 - Stock price manipulation
 - Accounting manipulation and failed audit
 - False disclosure
- Separation of Financial Institutions from Industrial Company (Chaebol group)
 - Unfair loans and equity investments to affiliated companies
- Strengthening taxation on gift and inheritance asset
 - Under-priced convertible bond, bond with warrants
 - Off-shore paper company. Special purpose vehicle

Positive Changes in Corporate Governance

- Increased awareness on corporate governance
- Disclosures are more reliable
- Related party transactions decreased
- Investor relation is active
- Shareholder activism brings practical changes
 - PSPD : NGO shareholder activists group
- New court rulings sets the standard
 - Derivative lawsuit:
 - Korea First Bank: 40 billion won (\$33.3 million)
 - Samsung Electronics Co.: 97.7 billion won (\$81.4 million)
 - Court Ruling against “lack of business judgment”

Derivative Lawsuit

Directors of Samsung Electronics

Court Ruling against Directors: \$72.4 mil (97.7 bil won)

- District court ruled on December 27, 2001
- 1. Illegal political contribution
 - Chairman KH Lee: \$5.6 mil (7.5 billion won)
- 2. Related party transaction at transferring price
 - 6 directors: \$46.4 mil (62.7 billion won)
 - purchased at 10,000 won/share sold at 2,600 won/share
- 3. Investment “without business judgments”
 - 8 directors: \$20.4 mil (27.6 billion won)
 - Debt guarantee to failed company

Positive Changes in Corporate Governance

- Emergence of good guys in corporate governance
 - Kookmin Bank, POSCO, KT
- Emergence of active institutional investors
 - Only few, but a positive direction : National Pension Fund
 - ‘Korea Corporate Governance Fund’ : IFC & Zurich-Scudder
- Positive steps by controlling family
 - CJ Group chairman JH Lee gives up warrants of CJ Entertainment worth of 110 billion won. April 26, 2002
 - Hyundai Motor chairman’s son, ES Chung cancelled merger of Bontec with Hyundai Mobis. June 12, 2002

Persistent Problems in Corporate Governance

- Old habits are hardly changing
 - Persistent moral hazard problems
 - Mindset of controlling family is the same
- Resistance from chaebols is getting stronger
 - Political uncertainty
- Enforcement of regulation is not effective
- Independence of outside director in question
- Capital subsidy through financial institutions

Persistent Problems in Corporate Governance

- Expropriation of minority shareholders using equity related securities
 - Discounted Convertible Bond, Bond with Warrant
- Management control descended to 3rd Generation
 - Off-shore paper company operation
 - Equity issuance to family members using CB and BW
- Entrenched ownership structure
 - Control via ownership by affiliated companies
 - Pyramidal and circuitous ownership
 - Control with no ownership

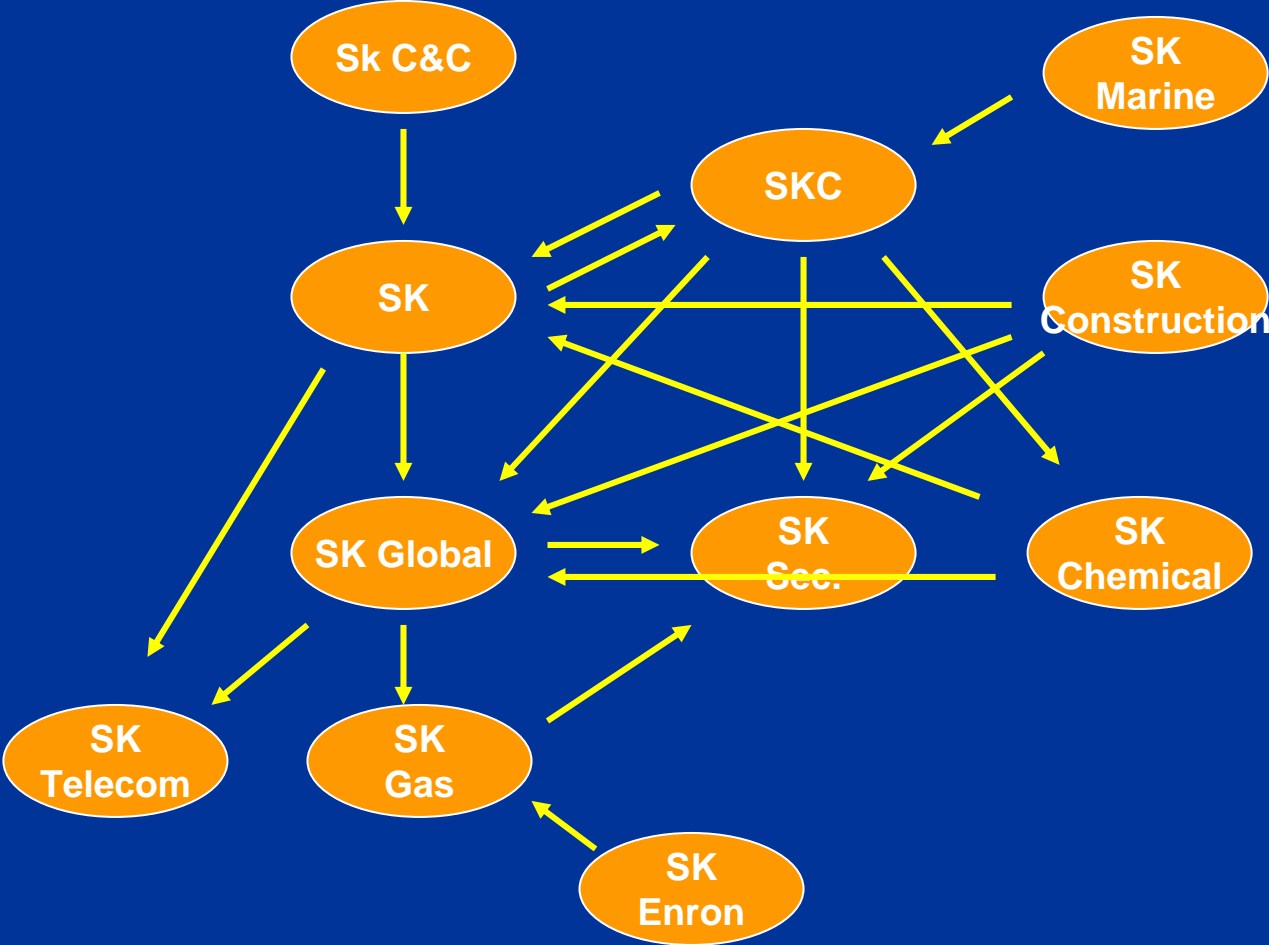
Source of Controlling Power

Top 10 Chaebols: Public and Private Companies

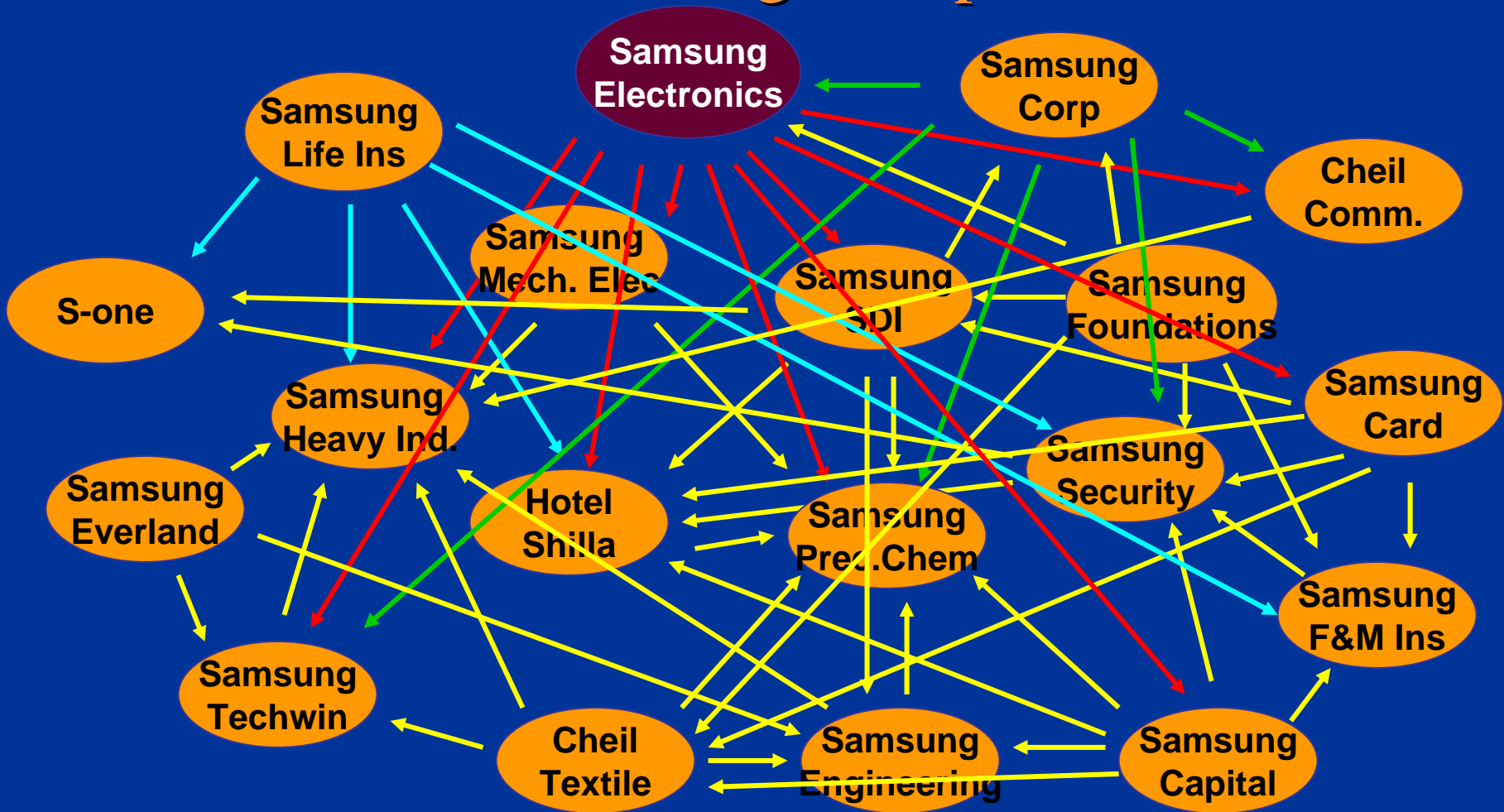
	Controlling Shareholder & Family	Affiliated Companies	Shares under Family Control
1997	9.54%	29.29%	39.57%
1998	7.82%	35.36%	44.16%
1999	5.76%	40.99%	48.07%
2000	4.30%	38.79%	44.72%
2001	4.29%	38.94%	47.61%

Pyramidal Equity Ownership

SK Group



Pyramidal Equity Ownership Samsung Group



Does Corporate Governance Affect Firm Value?

Evidence from Korea

Bernard Black, Stanford Law School

Hasung Jang, Korea University Business School

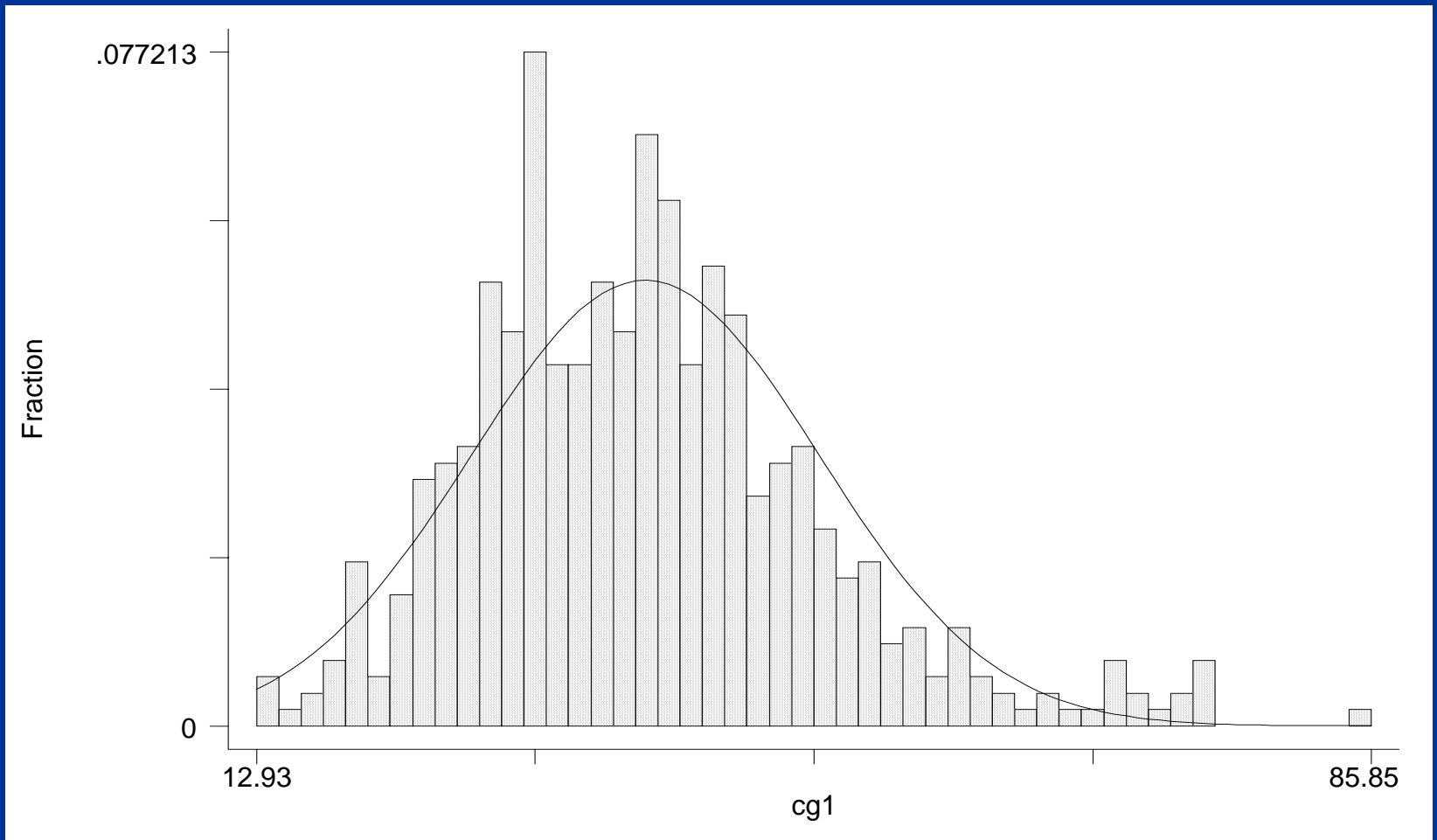
Woochan Kim, KDI School of Public Policy and Management

- Objective
 - Show empirical evidence that better corporate governance leads to higher firm value
- Address positive causality
 - Firms adopt good governance rules to signal quality
 - Firms with high firm value choose good governance rules

Corporate Governance Index

- Survey by Korea Stock Exchange (KSE)
 - March – July, 2001
 - High response rate (540 out of 560)
- Variable Selection
 - Out of 123 survey questions, exclude 85 (left with 38)
- Index Construction: 6 Sub-indices
 - A = Shareholder rights (5 elements)
 - B = Board of directors in general (6 elements)
 - C = Outside directors (13 elements)
 - D = Audit committee and internal auditor (11 elements)
 - E = Disclosure to investors (3 elements)
 - P = Ownership parity (1 element)
 - Overall-index $CG1 = A + (B+C)/2 + D + E + P$

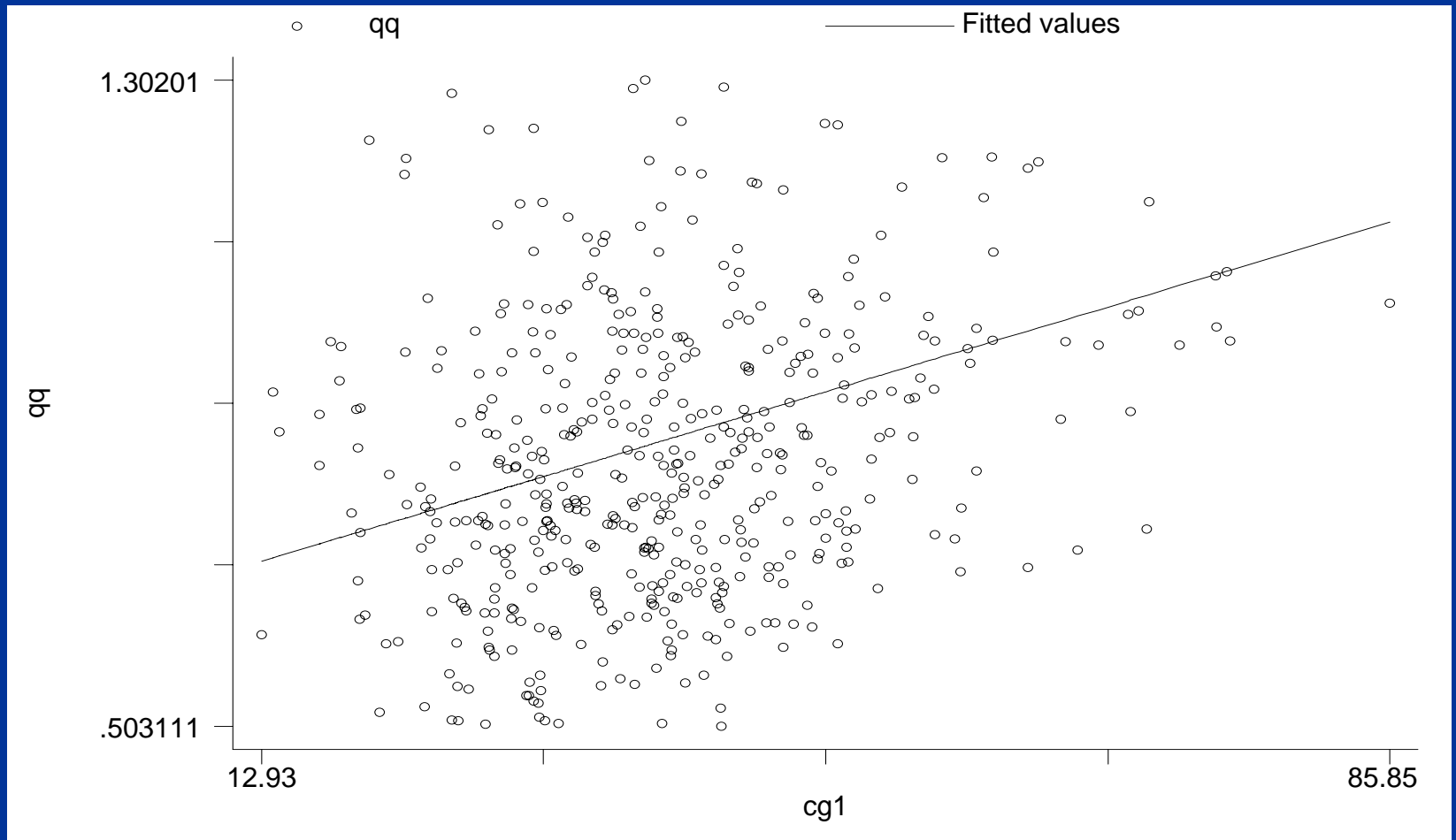
CG Index Distribution



- Hypothesis 1: Firms with better governance practice have higher firm value
 - Firm value = Tobin's Q as of June 2001
 - CG1, A, B, C, D, E, P
- Hypothesis 2: Robustness check for 6 sub-samples
 - Banks and non-banks
 - Chaebols and non-chaebols
 - Large firms and small firms
 - Korean laws require banks, chaebol firms, and large firms to adopt higher governance standards

- Hypothesis 3: Endogeneity
 - Better corporate governance practice causes higher firm value
 - 2SLS and 3SLS
 - Instrument = asset size dummy
 - CG1, A, B, C, D, E, P
- Hypothesis 4: Robustness check
 - Other measures of firm value
 - Market-to-book ratio
 - Market-to-sales ratio
 - Other weighting scheme in constructing cg index

CG Index and Tobin's q



Key Results

- Firms with better governance practice have higher firm value
 - Overall index (CG1) : positive and statistically significant
 - Sub-indices: positive and statistically significant in all sub-indices
 - Elements: positive (35/38), positive and statistically significant (8/38)
- Positive relationship persists even in sub-samples
 - Positive and statistically significant in 5 out of 6 sub-samples
 - Bank sub-sample only has 17 observations

Key Results

- When controlling for endogeneity, the coefficient becomes even larger
 - A 10-point increase in CG1 leads to 0.157 increase in Tobin's Q (increase in market cap by 15.7% of book asset value)
 - Larger coefficients in C (outside directors) and D (audit committee)
- Robust to the measure of firm value and the weighting scheme of CG overall index

OLS for Overall Index and Sub-Indices

Dependent Variable: Tobin's q

CG Index	0.0059***		
Shareholder Rights		0.0081***	
BOD in General			0.0056**
Debt/Equity	0.0008*	0.0007*	0.0009**
Log (asset)	-0.0127*	0.0048	0.0068
Log (years)	-0.0530***	-0.0528***	-0.0613***
Sales Growth	0.0186	0.0288	0.0288
Sole Ownership	-0.0002	0.0000	-0.0002
Intercept	0.7569***	0.8137***	0.8332***
Adjusted R-Square	0.1700	0.1209	0.1141

OLS for Overall Index and Sub-Indices

Dependent Variable: Tobin's q

Outside Directors	0.0082**			
Audit Committee		0.0043**		
Disclosure			0.0114***	
Ownership Parity				0.0193***
Debt/Equity	0.0009**	0.0009**	0.0011***	0.0009***
Log (asset)	0.0019	0.0052	0.0012	0.0129*
Log (years)	-0.0562***	-0.0604***	-0.0543***	-0.0605***
Sales Growth	0.0287	0.0281	0.0351	0.0169
Sole Ownership	-0.0002	-0.0002	-0.0002	-0.0013**
Intercept	0.8592***	0.8303***	0.8723***	0.5537***
Adj R-Square	0.1135	0.1119	0.1279	0.1656

OLS in Sub-Samples

Dependent Variable: Tobin's q

	Banks	Non-Banks
CG1	0.0005	0.0063***
Debt / Equity	-0.00002	0.0029***
Log (asset)	0.0083	-0.0156*
Log (years of listing)	-0.0247***	-0.0563***
Sales Growth	-0.0014	0.0253
Sole Ownership	0.0000	-0.0001
Intercept	0.9546***	0.7523***
Number of Obs	17	476
Adj R-Square	0.6949	0.1632

OLS in Sub-Samples

Dependent Variable: Tobin's q

	<i>Chaebol</i>	<i>Non-Chaebol</i>
CG1	0.0088***	0.0051***
Debt / Equity	0.0005	0.0010**
Log (asset)	0.0103	-0.0242**
Log (years of listing)	-0.0337	-0.0562***
Sales Growth	0.0415**	-0.0131
Sole Ownership	0.0010	-0.0003
Intercept	0.4545**	0.8497***
Number of Obs	103	390
Adj R-Square	0.3395	0.1594

OLS in Sub-Samples

Dependent Variable: Tobin's q

	Asset > KRW 2 trillion	Asset < KRW 2 trillion
CG1	0.0085**	0.0048***
Debt / Equity	-0.0004	0.0040***
Log (asset)	-0.0364	-0.0352***
Log (years of listing)	-0.0180	-0.0554***
Sales Growth	0.0412	0.0310
Sole Ownership	0.0007	-0.0001
Intercept	0.6878**	0.8938***
Number of Obs	65	428
Adj R-Square	0.3400	0.1528

2SLS/3SLS for Overall CG Index

Dependent Var	2SLS		3SLS	
	CG1	Tobin's q	CG1	Tobin's q
CG1		0.0157***		0.0157***
Tobin's q			11.696	
Debt / Equity	0.015	0.0005	0.0066	0.0005
Log (asset)	2.397***	-0.0533***	2.5813***	-0.0533***
Log (years)	-0.602	-0.0420***		-0.0420***
Sales Growth	2.417**	-0.0038	2.0188	-0.0038
Sole Ownership	-0.002	-0.0001	-0.0011	-0.0001
Asset Size Dummy	10.533***		8.6026***	
Intercept	20.799***	0.6272***	9.6508	0.6272***
Adj R-Square	0.4183	0.1339	0.4512	-0.0189

2SLS/3SLS for Chaebols

	2SLS		3SLS	
	CG1	Tobin's q	CG1	Tobin's q
CG1		0.0135		0.0135*
Tobin's q			6.0784	
Debt / Equity	-0.1390**	0.0011	-0.1342	0.0011
Log (asset)	2.5393**	-0.0114	2.4005	-0.0114
Log (years)	-0.2170	-0.0328		-0.0328
Sales Growth	1.4377*	0.0325	1.1221	0.0325
Sole Ownership	0.0633	0.0006	0.0541	0.0006
Asset Size Dum	7.0103**		6.4351	
Intercept	18.585**	0.5730	13.577	0.3707
Number of Obs	103	103	103	103
Adj R-Square	0.3904	0.2020	0.4440	0.2928

2SLS/3SLS for Non-Chaebols

	2SLS		3SLS	
	CG1	Tobin's q	CG1	Tobin's q
CG1		0.0100***		0.010***
Tobin's q			5.365	
Debt / Equity	0.010	0.0008	0.006	0.001
Log (asset)	2.182***	-0.045***	2.306***	-0.045***
Log (years)	-0.282	-0.049***		-0.049***
Sales Growth	5.689**	-0.034	5.565**	-0.034
Sole Ownership	-0.016	-0.0001	-0.015	-0.0001
Asset Size Dum	19.72***		18.66***	
Intercept	21.39***	0.784***	16.04	0.784***
Number of Obs	390	390	390	390
Adj R-Square	0.4264	0.1312	0.4455	0.1139

What Will Expedite Changes in Corporate Governance?

- Corporation
 - Voluntary adaptation of global standard
- Market
 - Pro-active role of institutional investors
 - Reform of commercial banks
- Government
 - More direct regulations on corporate governance
 - Enforcement of regulations
 - Strengthening minority shareholder's right

What Will Expedite Changes in Corporate Governance?

- Legal System
 - Fair and effective court system
 - Fair and independent prosecution
 - Security class action suit
- Civil Society
 - Minority shareholder activist watch dog