

# Evolution of Corporate Governance in Korea After the Economic Crisis

Corporate Governance from an International Perspective:  
Diversity or Convergence  
RIETI  
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Hasung Jang  
Korea University



Asian Institute of Corporate Governance

# Economic Reform Policy after the Economic Crisis

- “Four Economic Reform Policy” (1998)
  - Corporate reform
  - Financial reform
  - Labor reform
  - Public sector reform
- “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
  - 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
  - More than 25% of the board should be outside director
  - For company with asset larger than 2 tr won (\$1.7bil), more than 50% of the board (2001) should be outside director
- Outside director candidate nomination committee
  - Mandatory for company with asset larger than 2 tr won
  - More than ½ should be outside director

# New Regulations to Improve Corporate Governance

- Audit Committee
  - Mandatory for company with asset larger than 2 tr won
  - 2/3 of the committee should be outside directors
- Improved Disclosure
  - Combined financial statement for companies with asset larger than 2 tr won (\$1.7 bil)
  - Electronic disclosure system introduced
- Cross share ownership prohibited
- Cross debt guarantee prohibited

# **New Regulations to Improve Corporate Governance**

- Limitation on equity holding of affiliated companies
  - No more than 25% of net asset value
  - Applies to chaebol groups with asset greater than 5 tril won (\$4.2 bil)
- More Regulation on Related Party Transactions
  - Related party transactions greater than \$8.3 million
  - Board should approve it
  - Should be disclosed immediately

# **New Regulations to Improve Corporate Governance**

- Limit on Equity Ownership by Foreigner Removed
- Hostile Takeover Barriers Removed
  - M&A specialized fund allowed
- Holding Company Introduced
  - Holding company's debt to equity ratio should be less than 100%
- Cumulative Voting in 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 Supervisory Agency Established
  - “Financial Supervisory Commission”
- Minority Shareholder’s Rights Strengthened



# Minority Shareholders' Rights

## Japan and Korea

Minority SH Right	Korea public co. (large c o.)	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 <small>public co.</small> (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)
- Strengthening taxation on gift and inheritance asset

# Positive Changes in Corporate Governance

- Increased awareness on corporate governance
- Disclosures are more reliable
- Related party transactions decreased
- Investor relation is active
- New court rulings sets the standard
  - Derivative lawsuit:
    - Korea First Bank: \$33.3 million
    - Samsung Electronics Co.: \$81.4 million
  - Court ruling against “lack of business judgment”

# Positive Changes in Corporate Governance

- Good corporate governance practicing companies
  - Kookmin Bank, POSCO, KT
- Active institutional investors
  - National Pension Fund
- Positive steps by controlling family
  - CJ Group chairman JH Lee gives up warrants worth of \$92 million
- Shareholder activism brings practical changes
  - PSPD : NGO shareholder activists group

# Persistent Problems in Corporate Governance

- Old habits are hardly changing
  - Mindset of controlling family is the same
  - Persistent moral hazard
- Resistance from establishments
  - 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
  - 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

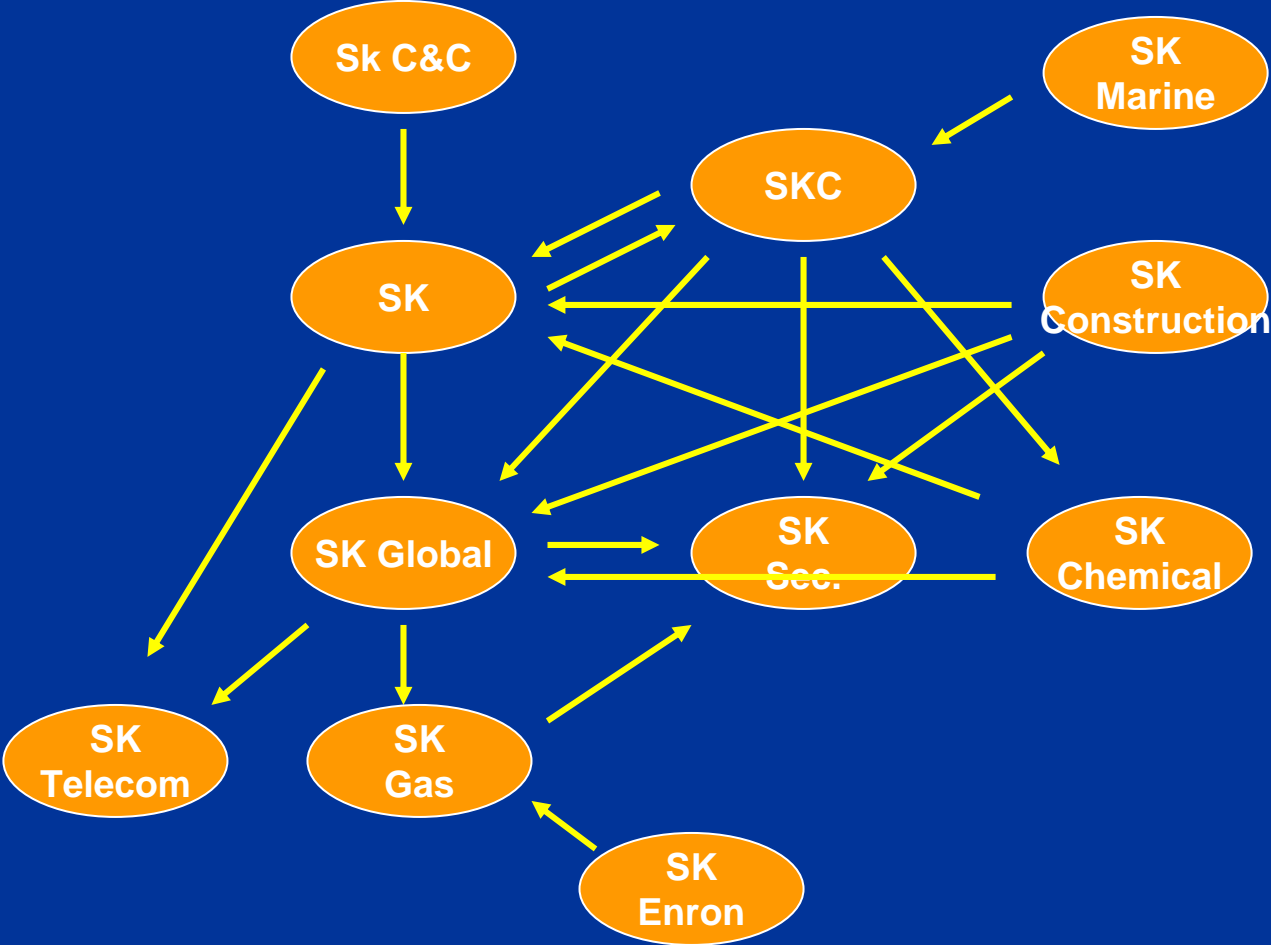
# Source of Controlling Power

## Top 10 Chaebols: Public and Private Companies

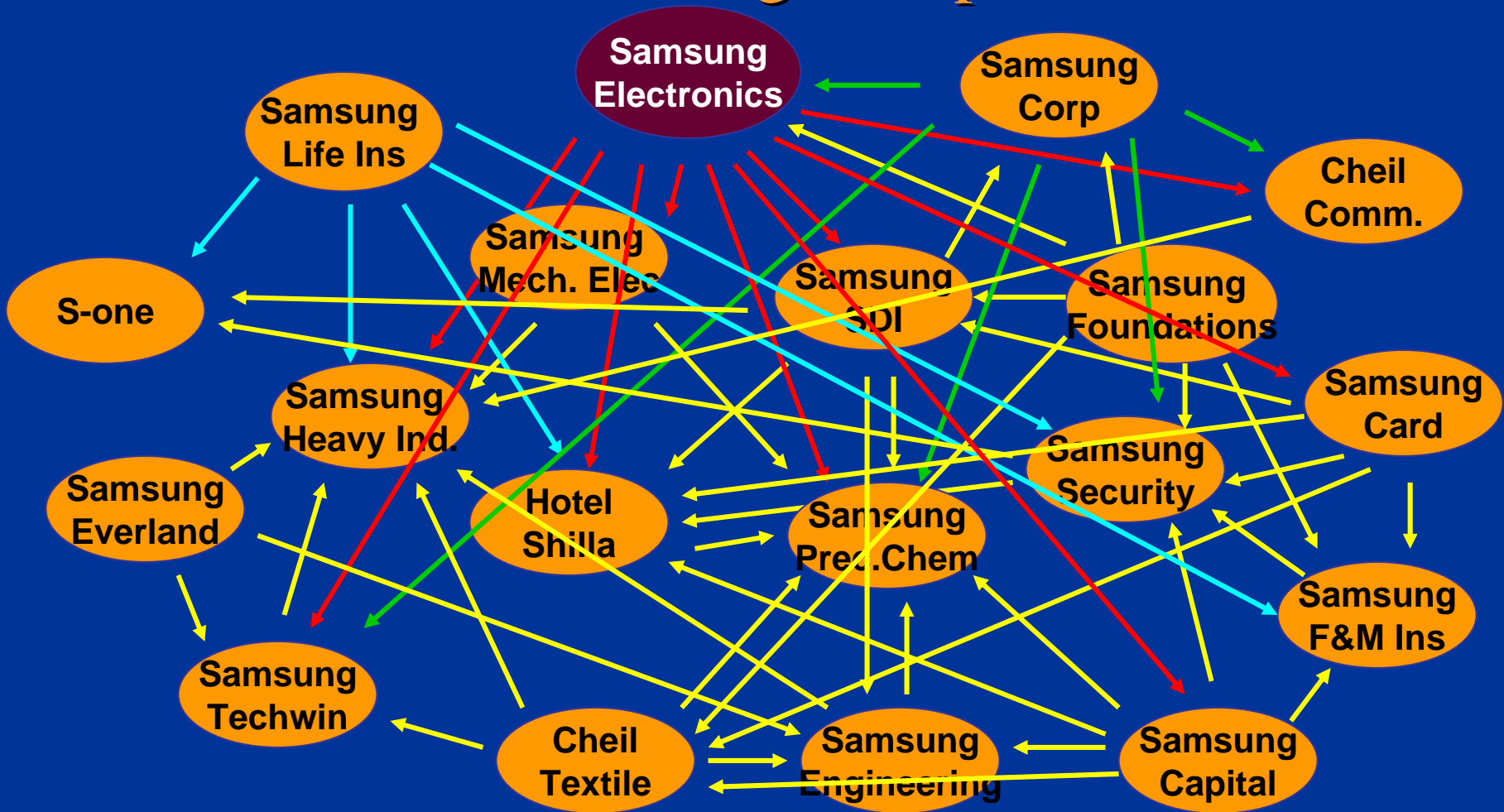
	Controlling Shareholder & Family	Affiliated Companies	Shares under Family Control
1997	9.54%	29.29%	39.57%
1998	7.82%	35.36%	44.16%
1999	5.76%	40.99%	48.07%
2000	4.30%	38.79%	44.72%
2001	4.29%	38.94%	47.61%



# 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

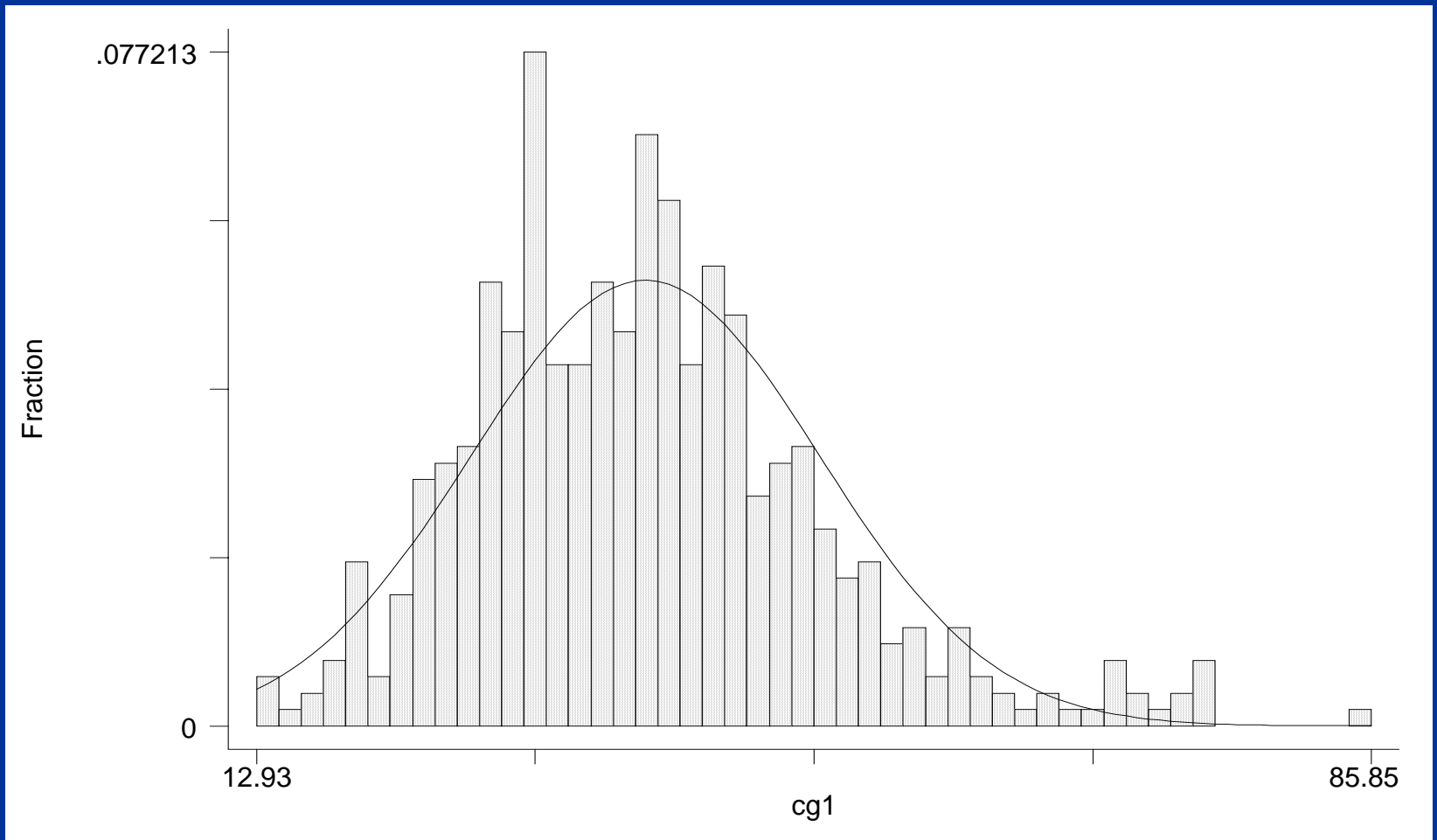
Woochan Kim, KDI School of Public Policy and Management

- Objective
  - Show empirical evidence that better corporate governance leads to higher firm value

# Corporate Governance Index

- Survey by Korea Stock Exchange (KSE)
  - March – July, 2001
  - 493 companies in sample
- Index Construction
  - Shareholder rights
  - Board of directors in general
  - Outside directors
  - Audit committee and internal auditor
  - Disclosure to investors
  - Ownership

# CG Index Distribution



# Key Results

- Firms with better governance practice have higher firm value
- When controlling for endogeneity, the effect of corporate governance on firm value is even larger
- A 10-point increase in CG Index leads to an increase in market cap by 15.7% of book asset value
- Greater effect in outside directors and audit committee

# 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