Evolution of Corporate Governance in Korea After the Economic Crisis

Corporate Governance from an International Perspective: Diversity or Convergence
RIETI
January 10, 2003, Tokyo

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Korea University
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

<table>
<thead>
<tr>
<th>Minority SH Right</th>
<th>Korea public co. (large c o.)</th>
<th>Japan</th>
</tr>
</thead>
<tbody>
<tr>
<td>Action to remove directors and auditors</td>
<td>0.5% (0.25%) outstanding shares</td>
<td>3.0% voting rights</td>
</tr>
<tr>
<td>Seeking injunction against illegal acts</td>
<td>0.05% (0.025%) outstanding shares</td>
<td>Auditors may request that director cease illegal acts</td>
</tr>
<tr>
<td>Bringing shareholder derivative suit</td>
<td>0.01% outstanding shares</td>
<td>Any contemporaneous Shareholder</td>
</tr>
<tr>
<td>Limitation on directors liability</td>
<td>Not permissible</td>
<td>Permissible under Certain conditions</td>
</tr>
<tr>
<td>Compelling inspection of financial records</td>
<td>0.1% (0.05%) outstanding shares</td>
<td>3.0% voting rights</td>
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## Minority Shareholders’ Rights
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<tr>
<td>Convening special shareholders’ meeting</td>
<td>3.0% (1/5%) outstanding shares</td>
<td>3.0% voting rights</td>
</tr>
<tr>
<td>Making a shareholder proposal</td>
<td>1.0% (0.5%) outstanding shares</td>
<td>1.0% or 300 voting shares</td>
</tr>
<tr>
<td>Requesting cumulative voting</td>
<td>3.0% outstanding shares</td>
<td>Any shareholder, unless certificate provides otherwise</td>
</tr>
<tr>
<td>Appointing inspector to examine corporate affairs and records</td>
<td>3.0% (1.5%) outstanding shares</td>
<td>3.0% voting rights</td>
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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**

<table>
<thead>
<tr>
<th>Year</th>
<th>Controlling Shareholder &amp; Family</th>
<th>Affiliated Companies</th>
<th>Shares under Family Control</th>
</tr>
</thead>
<tbody>
<tr>
<td>1997</td>
<td>9.54%</td>
<td>29.29%</td>
<td>39.57%</td>
</tr>
<tr>
<td>1998</td>
<td>7.82%</td>
<td>35.36%</td>
<td>44.16%</td>
</tr>
<tr>
<td>1999</td>
<td>5.76%</td>
<td>40.99%</td>
<td>48.07%</td>
</tr>
<tr>
<td>2000</td>
<td>4.30%</td>
<td>38.79%</td>
<td>44.72%</td>
</tr>
<tr>
<td>2001</td>
<td>4.29%</td>
<td>38.94%</td>
<td>47.61%</td>
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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