

# 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

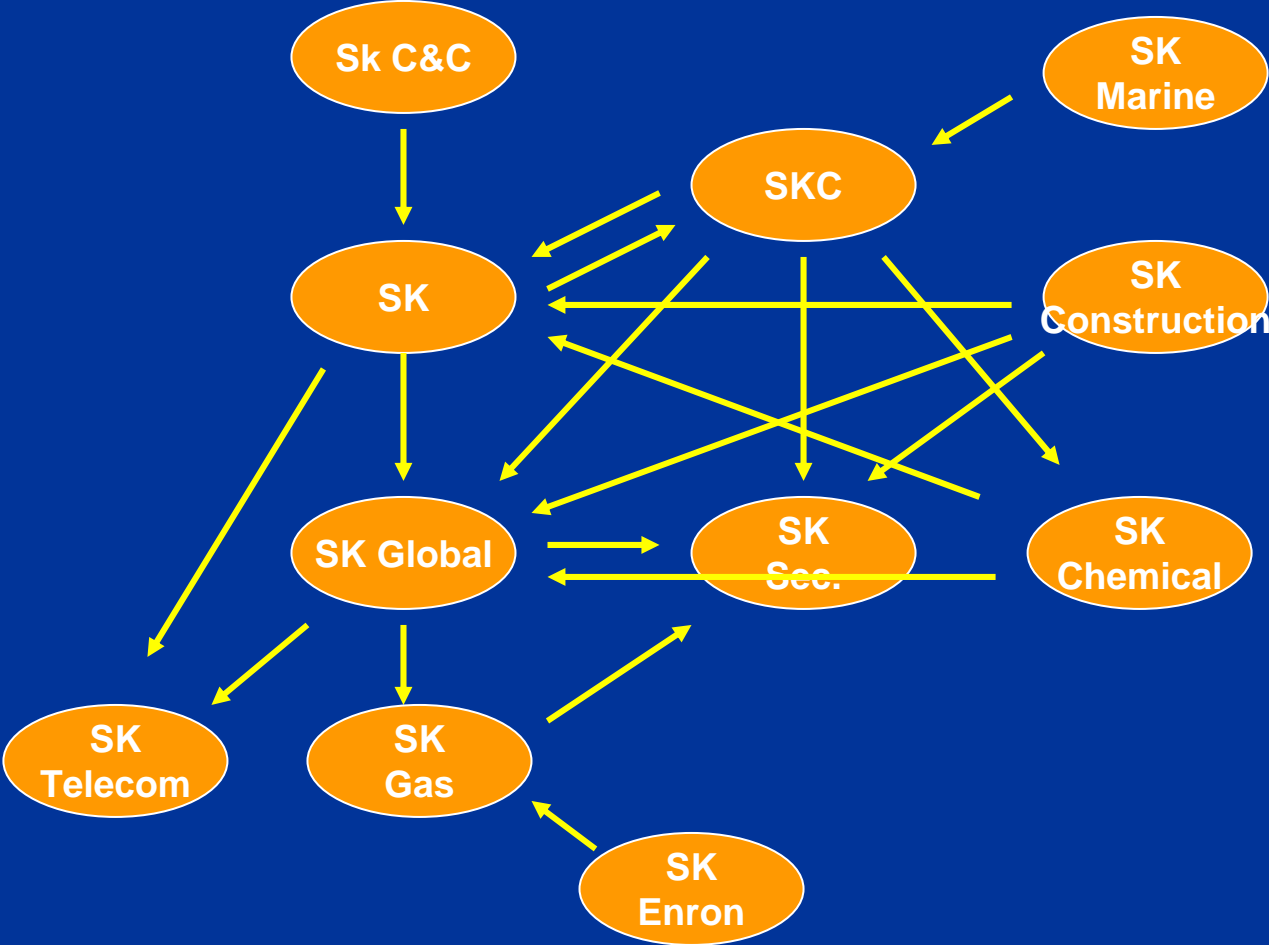
- Expropriation of minority shareholders using equity related securities
  - Discounted Convertible Bond, Bond with Warrant
- Management control descended to 3rd Generation
  - Off-shore paper company operation
  - Equity issuance to family members using CB and BW
- Entrenched ownership structure
  -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

# Source of Controlling Power

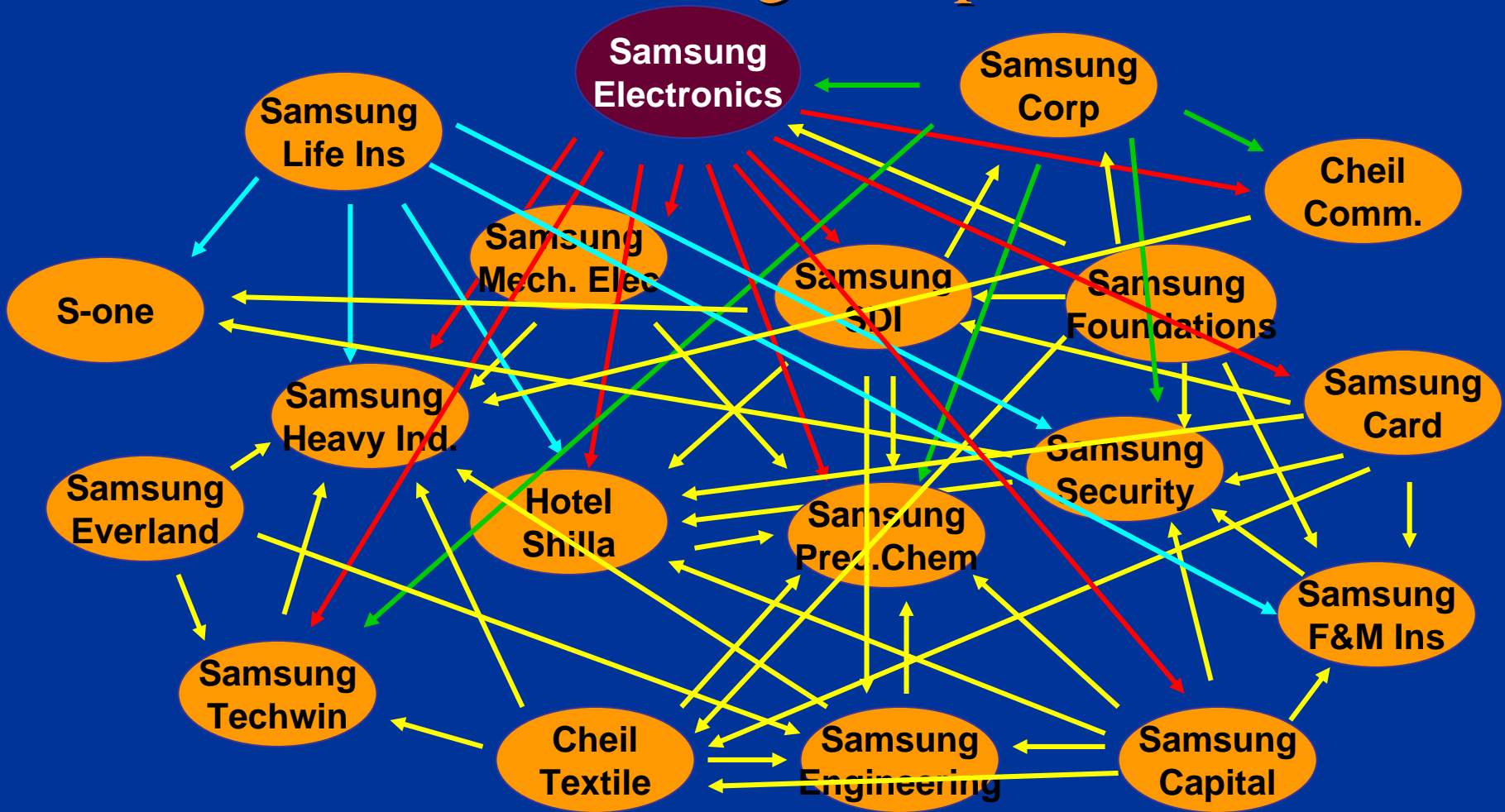
## Top 10 Chaebols: Public and Private Companies

	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

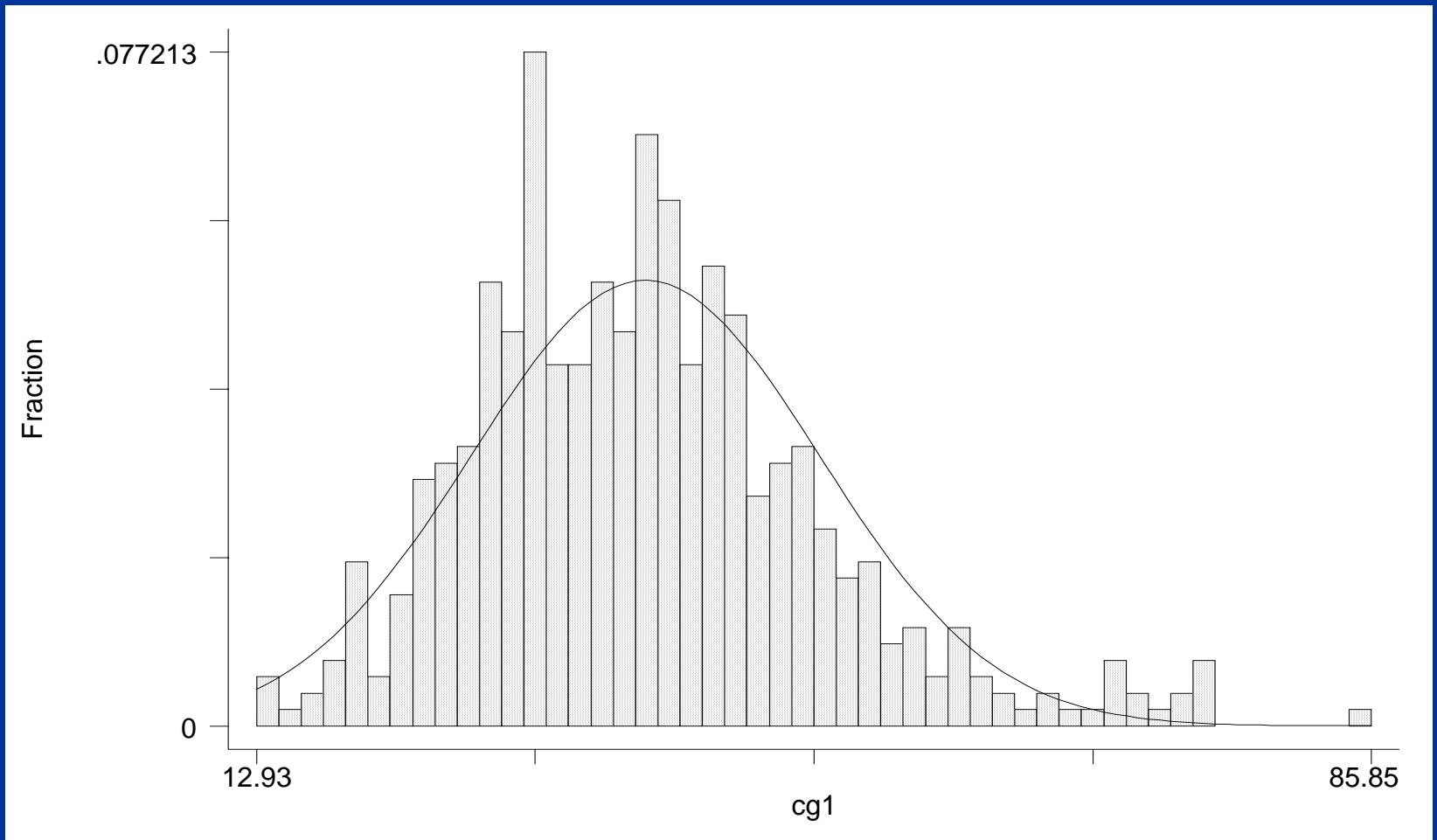
Woochan Kim, KDI School of Public Policy and Management

- 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

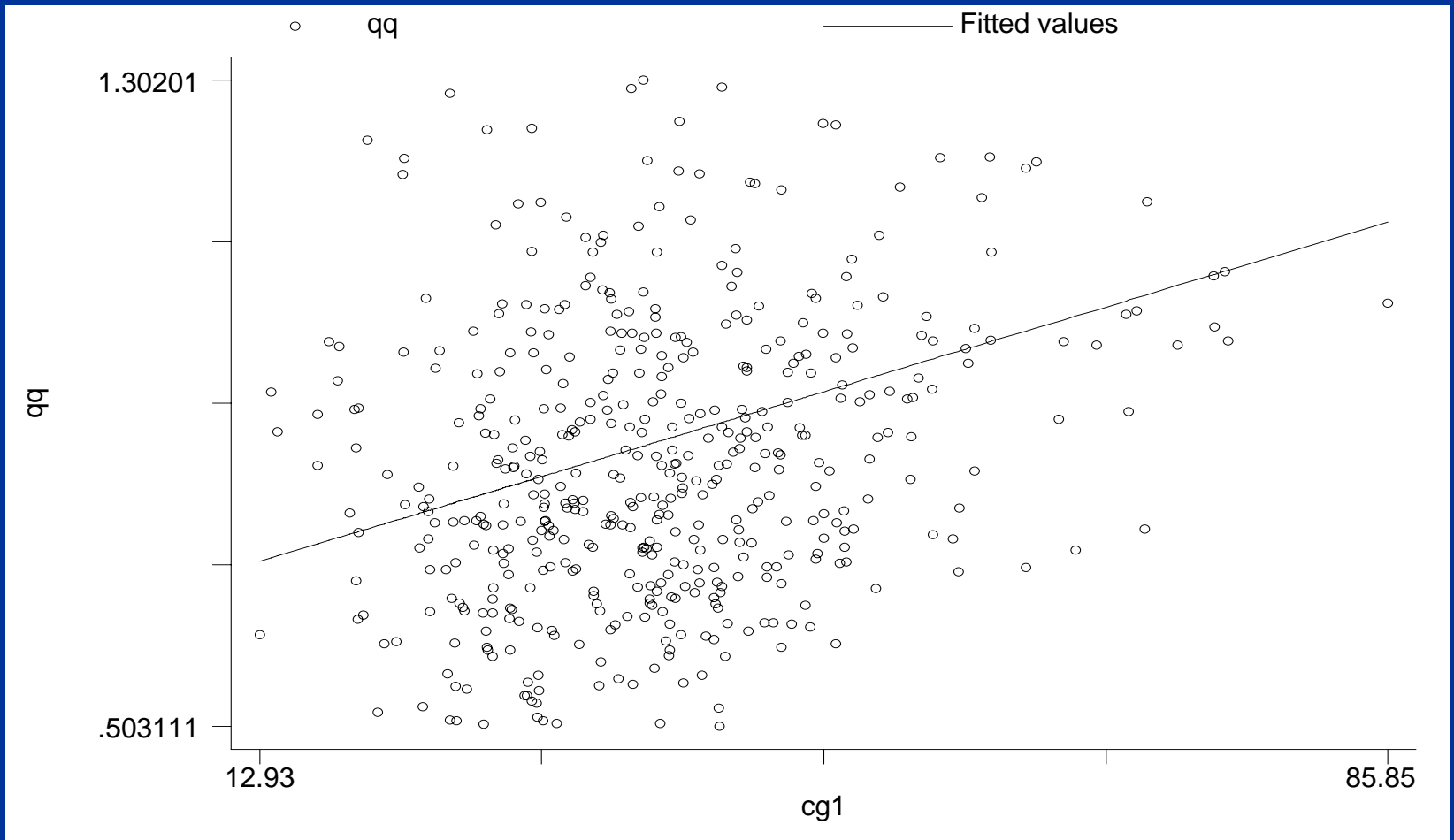




- Hypothesis 1: Firms with better governance practice have higher firm value
  - Firm value = Tobin's Q as of June 2001
  - CG1, A, B, C, D, E, P
- Hypothesis 2: Robustness check for 6 sub-samples
  - Banks and non-banks
  - Chaebols and non-chaebols
  - Large firms and small firms
  - Korean laws require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