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ADB Institute Discussion Paper No.10

Corporate Governance in the Republic of Korea and Its Implications for Firm Performance

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Il Chong Nam is at the Korean Development Institute, School of Public Policy and Management, the Republic of Korea. This paper is part of a cross-country study on corporate governance in Asia coordinated by Sang Woo Nam of the ADB Institute. The views expressed in this paper are the views of the author and do not necessarily reflect the view or policies of the Asian Development Bank Institute

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1. Introduction

1-1. Corporate Governance: A Key Factor behind the Economic Crisis

A consensus has yet to be reached about exactly what factors were behind the crisis of 1998 and how these factors interacted in bringing about the crisis. However, it seems clear to us that the failure to protect the rights of shareholders of corporations and financial institutions was one of the crucial factors, if not the crucial factor, behind the crisis.

Many *chaebol* groups kept expanding their operations in various industries throughout the late 1980s and early 1990s, using the money mostly borrowed from banks and other financial institutions. In the mid-1990s, some *chaebol* groups that had invested heavily began to show signs of large-scale insolvency. In particular, Hanbo and Kia, each borrowed heavily to invest in the steel and automobile industries respectively, attracted attention because they had such large amounts of debt yet had negative cash flows with little prospect of improving their profitability. There were many other firms in a similar situation, although the magnitude of the bad debts varied across firms.

Firm measures had to be taken to prevent further deterioration of the corporate sector and the problem of non-performing loans. Instead, banks kept extending further credits to those firms that were essentially bankrupt and had little possibility of being viable again on their own. The combination of large-scale corporate failure and bank failure led to the loss of confidence in the Korean economy by the international financial community, triggering the foreign exchange crisis, which quickly spread into a domestic financial crisis.

A great deal of information has been revealed, in the wake of the crisis, about the way large corporations and banks were financed and governed. They were financed and governed in such a way that those with relatively small investments could wield near absolute control over the assets belonging to corporations and banks, subject to little regulation.

While most of the assets of corporations and banks came ultimately from the investment of minority shareholders of firms, shareholders of banks, and depositors of banks, control over those assets was in the hands of a handful of *chaebol* families and bank managers and politicians behind them. Further, there was weak monitoring of actions of the managers of large corporations and banks. Regulation on transactions among firms and banks was also weak even when it was apparent that illegal diversion of funds or illegal accounting practices occurred.

Many *chaebol* firms were highly leveraged, but were incapable of generating the cash flows needed to keep them afloat. Almost all of them had a complicated web of cross-shareholdings and cross loan guarantees. In the end, more than a third of them collapsed. High leverage coupled with cross-shareholdings and cross loan guarantees forced a simultaneous collapse of many of the affiliated firms when a couple of large affiliated firms collapsed. In many of the large corporations that became insolvent, asset stripping by dominant shareholders or managers continued for quite a while, even after insolvency was acknowledged, due to weak monitoring, weak regulation and enforcement of laws.

In the banking sector, commercial banks were owned by private shareholders, but were essentially run by the government, without adequate profit incentives. These banks kept lending large amounts of money to many of the *chaebol* firms that were failing, even after they became aware that these firms were having serious problems. Financial regulators exerted little effort to try to make banks operate in a more prudential way.

1-2. Reform Measures Introduced to Improve Corporate Governance

A huge set of reform measures has been introduced since the financial crisis in order to resolve the problems of large corporations and banks with corporate governance. Many of the measures were initiated at the urge of the IMF. The reform measures encompass not only the laws that deal with the internal governance of corporations, but also the laws on insolvency, mergers and acquisitions, accounting transparency, and financial regulation.

The Commercial Codes, the Securities Exchange Act, and the Monopoly Regulation and Fair Trade Act have been amended extensively to bring the governance of large corporations more in line with the maximization of firm value, rather than the interests of dominant shareholders. Enforcement has also been strengthened substantially. The main objectives behind the amendments and increased enforcement were (1) providing shareholders with increased access to the crucial information regarding their firm, (2) making management reveal more accurate information to the shareholders and the general public, (3) giving shareholders a larger role in the decision-making process of corporations, (4) establishing a board of directors that is independent of management and dominant shareholders and that works in the interest of shareholders in general, and (5) reducing, if not removing, the transactions of a self-dealing nature.

The main reform measures introduced during the period 1998-2003 can be summarized as follows. In 1998, requirements on exercising minority shareholders' right were relaxed through amendments of the Securities and Exchange Act and the Commercial Codes. As a result, threshold shares needed for various actions, including filing of derivative suits, inspecting of accounting records, making a motion to dismiss certain directors, and filing for shareholder proposal, were lowered. In addition, cumulative voting was also allowed. Further, large listed firms began appointing outside directors.

In 1999, voting by mail became possible through an amendment of the Commercial Codes. In addition, disclosure requirements were strengthened. The Securities and Exchange Act was amended to require companies listed or registered on Kosdaq to file periodic financial reports more frequently and increased penalties for violation of disclosure requirements or for misrepresentation. Disclosure requirements were further strengthened by an amendment of the Monopoly Regulation and Fair Trade Act, which made it mandatory for large companies affiliated with *chaebol* groups to disclose large-scale transactions with affiliated firms and obtain approval of the board of directors.

In 2000, the Securities and Exchange Act was amended to make it mandatory for listed companies to give more prominent roles to outside directors. Listed companies were required to elect outside directors. Large listed companies were required to have 3 or more outsider directors and to appoint at least half of the board members from outside. An amendment of the Securities and Exchange Act in 2000 also made the audit committees mandatory for large companies listed or registered on Kosdaq. It was also required that at least 2/3 of the audit committee members be outside directors.

In 2001, ownership requirements on exercising minority shareholders' rights were relaxed further to make it easier to file suits against directors and to request inspection of accounting books. In addition, minority shareholders were allowed to recommend outside directors automatically to the general shareholders' meeting. Further, the Commercial Codes were amended to protect the pre-emptive rights of minority shareholders by limiting the issuance of new equities to cases where there is a financial need for raising additional capital in order to reduce the possibility of abuse by dominant shareholders.

In 2002, disclosure requirements were further strengthened. In 2003, class action suits became possible by the enactment of the Class Action Related Securities Litigation Act.

1-3. Objectives of the paper and survey of listed companies

It is fair to say that corporate governance of large firms has been substantially improved and that banks are operating much more prudently today, compared to the pre-crisis period. Regulation has been significantly strengthened as well. The Financial Supervisory Commission and the Prosecutor's Office are much more aggressive than before in pursuing illegal transactions or activities, such as illegal diversion of funds or illegal accounting practices. KFTC has been very active too in pursuing cases involving illegal intra-*chaebol* transactions.

However, few believe that the fundamental problems in corporate governance of large corporations in the Republic of Korea have been solved satisfactorily. In *chaebol* companies that survived the crisis, dominant shareholder still tightly control affiliated firms, through cross-shareholdings among affiliated firms. Recent scandals involving Hyundai Shipping, SK Global, and SK Shipping suggest that illegal diversion of funds and illegal accounting practices still persist in some large corporations.

In the financial sector too, privatization of banks has not been proceeding smoothly, and the dominance of non-bank financial institutions by industrial capitals has not changed. The recent scandals mentioned above also made many wonder by how much financial regulation has really improved since 1998.

Our objective of this paper is to review the current state of corporate governance of large firms, to identify the factors that impede the emergence of a new form of corporate governance aligned more closely with shareholder value, and to suggest future directions for corporate governance of large firms in Korea. In an attempt to obtain the relevant information regarding the state of governance of large listed firms in the Republic of Korea, we conducted a survey of 116 listed companies in 8 industries on various aspects of corporate governance. The industries and the number of samples in each industry are distribution/trading (16), textiles & clothing (16), transportation equipment (19), food & beverage (11), electrical & electric equipment (16), iron & metal products (13), communications (2), and chemicals (23)¹.

The survey was conducted during June 10, 2003 ~ August 31, 2003. For each sample firm, the survey sought responses from three different agents: a non-director manager, an executive director who is not the CEO, and an outside director. Management from 111 sample firms provided answers to questions about factual information, while executive directors from 112 firms and outside directors from 102 firms responded to the opinion survey.

The overall picture of the ownership and control structure of listed companies that responded to the survey is that most of them have a dominant shareholder, who is either the founder of the company or his or her family member. 65% of the firms have a dominant shareholder. These shareholders are thought of being able to wield tight, and sometimes near absolute control based upon their shares. In 25% of the firms, control is concentrated. Thus, 90% of the firms surveyed have a controlling shareholder.

6.3% of the companies responded that they have a dispersed ownership structure, with no controlling shareholder. We expect most of these companies to be the ones that became insolvent and are now being restructured because almost all small and medium-sized companies in the Republic of Korea have a dominant shareholder and large firms

¹ The number in each parenthesis is the number of sample firms in that industry.

not controlled by a foreign capital are controlled by a family in the Republic of Korea, except for insolvent firms and three recently privatized firms - POSCO, KT, and KT&G.²

57% of the firms surveyed are directly managed by dominant families that founded the firms, as the founder is the CEO in 18% of the firms, and a family member of the founder is the CEO in 39% of the firms surveyed. In most of the remaining firms that have professional managers, who are not a member of dominant families, as their CEOs, dominant shareholders are expected to exert a high degree of influence on the decisions made by those managers.

Government is not an important shareholder, except in 2.7% of the firms surveyed. Further, foreign ownership is also insignificant in 67% of the companies and is concentrated in 31% of the companies surveyed. This result is consistent with other findings that foreign investment in Korean firms is fairly large in terms of the percentage of market capitalization, but is concentrated in large firms³.

The survey results have been used as a part of the data set on corporate governance of listed companies in several Asian countries by the ADBI. Our survey results about the Republic of Korea are also summarized and analyzed along with other findings about the corporate governance of firms in the Republic of Korea in this report.

This paper proceeds as follows. Chapter 2 reviews recent developments in the laws on shareholders' role, describes the survey results on related issues, and assesses shareholders' role in large corporations today. Chapter 3 deals with the effectiveness of the board of directors in a similar format, while chapter 4 deals with the roles of stakeholders other than shareholders. Chapter 5 contains an analysis of the survey results as well as discussions on the results of similar researches. Chapter 6 draws conclusions.

2. Shareholders' Role in Corporate Governance

Most studies on corporate governance of large firms in the Republic of Korea, conducted since the economic crisis, identified the near absolute control of dominant shareholders in *chaebol*-affiliated firms as one of the fundamental causes of the corporate crisis that eventually led to the financial crisis in 1997. Subsequently, a large part of the reform efforts were directed at improving corporate governance of large firms by restoring the balance of power between dominant shareholder-managers and minority shareholders. The Commercial Code and the Securities and Exchange Act were amended extensively to give minority shareholders a much greater role in the decision-making process of large corporations. Key reform measures can be briefly summarized as follows:

- The statutory requirements for minimum threshold shareholding for exercises of key shareholders' rights have been relaxed in order to make it easier for minority shareholders to exercise their rights on various issues.

- The Commercial Code and the Securities and Exchange Act were amended to give minority shareholders an increased role in selecting directors. Cumulative voting was allowed. Further, minority shareholders can nominate their candidates for outside directors to GSM separately from normal nomination process, through the nomination

² POSCO, KT, and KT&G were privatized in 2001 and 2002 with an Anglo-American style corporate governance structure, without a dominant shareholder.

³ Foreign investors collectively own more the 40% of the shares of listed companies in terms of the percentage of market capitalization. However, their investment is generally focused on large firms with good credit ratings.

committee for outside directors.

- The Commercial Code was amended to allow voting by mail provided that the company adopts it in the articles of association in order to facilitate voting by minority shareholders

- Various laws and regulations on securities and financial supervision were amended to make it mandatory for management to provide shareholders with more information about the firm and its dealings with dominant shareholders. The frequency of mandatory disclosure of information has been increased as well.

- Regulations on insider trading and related party transactions have been strengthened. Trading of securities based upon material, non-public information is illegal. Penalties for violation include imprisonment and fines. Violators can also be held liable for damages. Related party transactions are regarded as problems associated with dominant shareholders rather than with directors in the Republic of Korea. The Securities and Exchange Act was amended to require large corporations to obtain approval of the board and report to the GSM transactions involving the largest shareholder or its affiliates.

- Detailed rules governing tender offers, on substantive as well as disclosure aspects of the process, have been incorporated into the Securities and Exchange Act to facilitate mergers and acquisitions. It is worth noting that there remains a mandatory tender offer rule which requires anyone who intends to purchase 5% or more of the shares from ten or more shareholders outside of the stock market must undertake a formal tender offer.

- After a long series of debates, the Securities Class Action Suit Act has finally passed the National Assembly and will be effective in 2004. It should be noted, however, that the Act covers only a limited class of securities fraud cases, such as stock price manipulation, accounting fraud, and false disclosure.

- The Act on External Auditors of Listed Companies has recently been amended to increase the independence of external auditors. Beginning on Jan. 1, 2006, a company cannot use the same external auditor for more than 6 consecutive years.

- In addition to the above reform measures, penalties for violations of the Commercial Code, Securities Exchange Act, and other laws related to the corporate governance of corporations have been increased substantially to induce greater compliance.

In the rest of this paper, we summarize key reform measures on shareholders' rights that have been introduced since 1998 in more detail, analyze the survey results on related issues, and assess the effectiveness of the current system on shareholders' rights.

2-1. Regulatory Reform on Shareholders' Rights since 1998

1) Relaxation of Statutory Requirements for the Exercise of the Rights of Minority Shareholders

The threshold percentage ownership conditions that shareholders must meet in order to claim and enforce their rights have been substantially lowered in order to give minority shareholders larger room for participation in the governance of listed companies. The following table compares the minimum percentage of share ownership required to exercise shareholders' rights before and after the onset of the economic crisis. As can be seen from the table, even a small percentage of minority shareholders can now exercise most of the rights.

There were concerns that relaxing the conditions might result in frequent lawsuits or other cost inducing activities to the firms. However, such concerns have not yet materialized. In fact, minority shareholders rarely initiated derivative suits as they have

little to gain even if they win in court⁴.

In addition to the changes summarized in the *Table 2-1*, burden of proof to shareholders for establishing infringement of their rights has been abolished, to make it easier for them to exercise their rights. Before the amendment of 1998, the Securities & Exchange Act required a shareholder to establish with sufficient evidence that his/her rights had been abridged or were likely to be abridged in order to claim or enforce his/her minority shareholders' rights. Now that the requirement has been abolished, minority shareholders can claim their rights without having to prove that their rights have been violated.

Table 2-1. Requisite Percentage Ownership Requirement

	Securities & Exchange Act				Commercial Code	
	pre-'98	Feb. 98	May 98	Mar. 01	pre-'98	Dec. 98
Right to bring derivative actions	1%	0.05%	0.01%	0.01%	5%	1%
Right to demand dismissal of Director/Auditor	1%	0.5%	0.5%	0.5%	5%	3%
Right to claim injunction to stop directors' illegal activities	(0.5%)	(0.25%)	(0.25%)	(0.25%)	5%	1%
Right to Inspect account books and records	3%	1%	1%	0.1%	5%	3%
Right to call convocation of special meetings of shareholders	(1.5%)	(0.5%)	(0.5%)	(0.05%)	5%	3%
Shareholder proposal right	3%	3%	3%	3%	5%	3%
Right to demand appointment of inspector	(1.5%)	(1.5%)	(1.5%)	(1.5%)	5%	3%

Note

1. () is the (combined) stake required for public corporation with KRW 100 billion or more in total asset
2. Pursuant to the Securities & Exchange Act, shareholders must hold the relevant shares at least for a six-month period prior to the exercise.

Further, the restriction that existed before requiring shareholders to maintain the requisite share ownership percentage throughout a derivative suit once they started one has also been abolished to make it easier for minority shareholders to pursue derivative suits when they decide that their rights are violated. Now minority shareholders are allowed to sell their shares even after they have initiated a derivative suit.

2) Greater room for Minority Shareholders in Selecting Directors

Cumulative voting

On average, dominant shareholders in most large firms in the Republic of Korea owned around 5% of the shares of affiliated firms. They also controlled an additional 40% or so of shares of affiliated firms through cross shareholdings by those firms. Thus, they were able to control around 45% of the shares of affiliated firms with an average of only 5% of their shares and to select nearly 100% of directors using their control over 45% of shares. Cumulative voting has been adopted as an attempt to correct this discrepancy between ownership and control of dominant shareholders in *chaebol* firms by allowing minority shareholders a chance to elect directors who can better represent their interests.

The cumulative voting was first adopted in the Commercial Code in 1998.

⁴ The reason for this is that all rewards are to be returned to the company when minority shareholders win in a derivative suit.

Thereafter, the Securities & Exchange Act lowered the requisite percentage ownership necessary to demand cumulative voting. Moreover, the Act restricts controlling shareholder's voting power in a resolution to pass amendment to the articles of incorporation for adoption or exclusion of the cumulative voting system. The cumulative voting is allowed if the articles of incorporation of a company do not explicitly preclude its adoption.

Further, in companies listed or registered on KOSDAQ, shareholders who own more than 3% of the shares are limited by law to exercising only 3% of their voting rights when voting on proposed amendment to the articles of incorporation for adoption/exclusion of cumulative voting. In addition, in these companies, when shareholders propose to amend the articles of incorporation for adoption/exclusion of cumulative voting, that subject matter must be itemized separately in the agenda at the general shareholders' meeting.

Automatic nomination of outside director candidates recommended by minority shareholders

Outside directorship had been largely ineffective even after its adoption in the Securities & Exchange Act in 2000, because candidates for outside directors were nominated upon the recommendation of the Outside Director Nomination Committee, which was composed almost entirely of the inside directors of the company most companies. Thus, minority shareholders were not given a chance to recommend their own candidates even after the adoption of outside directors by law. The law was re-amended in 2001 to correct this problem. Under the amended law, the committee must prepare and present a separate slate for that candidate to the general shareholders' meeting if minority shareholders with 1% or more voting shares recommend an outside director candidate to the committee.

3) Voting by Mail

The Commercial Code was amended in 1998 to allow 'voting by mail' at the general shareholders' meeting to facilitate participation of minority shareholders. A company must have an explicit provision on voting by mail in its articles of incorporation in order to adopt the system. When voting by mail is actually used, the company must give shareholders a notice of meeting and send them a written voting form along with the list of subject matters, the reference manual, and necessary exhibits/attachments that could help shareholders' decision-making.

Voting rights exercised in more traditional ways had been well protected even before 1998. Voting in absentia has also been allowed for a long time. However, most minority shareholders chose not to participate in GSM and vote due partly to the (shoe leather) cost of attending GSM and voting. Voting by mail can substantially reduce the cost of voting.

4) Easier Access of Shareholders to Corporate Information

In order to give the public more information on corporations, the Securities & Exchange Act and the FSS Regulations were amended to extend the lists of the items that must be included in the mandatory public disclosures. The frequency of mandatory disclosure of information has also been increased.

Periodic and continuous public disclosure

Under the Securities & Exchange Act, of which pertinent parts were amended in 1999, the KSE-listed and KOSDAQ-registered firms must file quarterly reports. Further, Presidential Decree of the Securities & Exchange Act was amended in 2002 to require the public companies to disclose the dividend payout ratio based on the market price rather than par value whenever cash dividends are declared and paid out.

Accounting information

The Act on External Audit of Stock Companies and the Securities & Exchange Act were amended in 1999 to require certain companies belonging to the large business groups to prepare and disclose combined financial statements. In addition, the Financial Supervisory Committee's Rules on Public Disclosure was amended in 2001 to require the KSE-listed and KOSDAQ-registered companies to include certain accounting information, such as changes in accounting standard and establishment of allowances, and information pertaining to the independence of the external auditor, such as compensation and service contracts, in the periodic public disclosure documents, including the annual report.

The Financial Supervisory Committee's Rules on Public Disclosure was amended again in 2002 to require public companies to disclose detailed information on accounting matters that can be discretionary, such as the contents and valuation of accounts receivables, asset swap transactions, and equity investment in illiquid stocks. The amendment also required companies to disclose in detail the terms and conditions of loan agreements between the related parties and the company.

Information to be disclosed to the general shareholders' meeting

Amendment to the Securities & Exchange Act in 2002 required corporations to disclose detailed information on the election process of directors and auditors and transactions involving large sums of money. Prior to the amendment, only the names and brief personal histories of the candidates were required to be revealed. After the amendment, companies must reveal any relationship with the controlling shareholder and transactional relationship with the company. Other information that must be disclosed include attendance rate of inside and outside directors, past voting records, and compensation packages. For listed companies with an asset value of 2 trillion KRW or more, certain transactions involving 1% or more of the assets or revenues must be disclosed at the general shareholders' meeting.

5) Increased Penalty for Violations

To us, the biggest problem with corporate governance of large firms in the Republic of Korea lies in implementation and enforcement. There were many laws and regulations on the rights of shareholders, procedural requirements for the board of directors and general shareholders' meetings, and accounting and disclosure, even before 1998. They were simply not followed by dominant shareholders and managers. It has been revealed that dominant shareholders and their managers frequently failed to observe the existing laws and regulations. However, the probability of detection of their illegal activities was low. So were the penalties for violations that became known.

Penalties for violation have been strengthened to induce compliance from dominant shareholders and managers. Before the financial crisis, penalties for violation of the Securities and Exchange Act by an issuer were limited by 5 million KRW or imprisonment of one year or both if convicted of a violation. The 1999 amendment increased the ceiling for fines and prison terms to 30 million KRW and 5 years

respectively.

6) Protection the Preemptive Rights of Shareholders

Before 2001, there was no law regarding the preemptive rights of shareholders. As a result, dominant shareholders of some *chaebol* companies were able to use the issuance of new stocks as a way to transfer wealth from minority shareholders to themselves. Preemptive rights of shareholders were adopted by the 2001 amendment of the Commercial Code to reduce the possibility of such practices by dominant shareholders.

7) Strengthened regulation on related party transactions

Regulation on the related party transactions has also been strengthened. The Monopoly Regulation and Fair Trade Act now requires firms belonging to large *chaebol* groups must obtain approval of the board of directors for certain transactions involving large sums of money with related party and disclose them⁵. In addition, the Securities & Exchange Act requires that large firms must obtain approvals from the board of directors for transactions that involve large sums of money with related parties and report such transactions to the GSM⁶. Further, KFTC enforced the existing regulation on related party transactions more rigorously since 1998.

8) Abolition of the mandatory purchase requirement in merger and acquisition (M&A) attempts

The February 2002 Amendment of the Securities and Exchange Act abolished mandatory stock purchase requirements, which required anyone who purchased 25% or more of the shares of a firm to purchase 50% plus 1 share, in order to facilitate M&A. The amendment is thought to promote the interest of minority shareholders by making M&A easier.

9) Introduction of Securities Class Action Suits

National Assembly passed the Securities Class Action Bill on December 17, 2003, thus allowing class action lawsuits for the first time in the Republic of Korea. The class action lawsuits allowed under the Securities Class Action Act are generally limited to the cases related to securities fraud, such as stock price manipulation, accounting fraud, and false information. Parties filing class action suits must include 50 shareholders with a combined share of 0.01% or more. The Act takes effect on January 1, 2005 for firms with asset value equal to 2 trillion KRW or more. For firms with smaller asset value or for which alleged violation is related to improper audits, the Act takes effect on January 1, 2007.

Class action suits allowed in the Republic of Korea are different from those allowed in the U.S. in the coverage and minimum requirements for the filing party. In the U.S., class action suits are provided as one of procedural means to bring an action under the law of civil procedure and hence are not subject to any restriction on coverage. Further, in the U.S. there is no pre-determined requirement for the minimum number or minimum

⁵ Certain transactions that involve an amount of money in excess of 1% of the equity or 10 billion KRW are subject to this regulation.

⁶ Each transaction that involves an amount of money in excess of 1% of the annual revenue or total asset value is subject to this regulation. The set of transactions which, when combined, involve money in excess of 5% of the annual revenue or total asset value is also subject to the regulation.

share of plaintiffs. Instead, it is in the hands of the court to determine whether a plaintiff is qualified to bring a class action suit.

Class action suits have been the subject of hot debates in the past several years. While few denied that that class action suits would work as a strong deterrent for expropriation of firm value by dominant shareholders, some claimed that their introduction would lead to excessive lawsuits, thus entailing too high a cost to firms. However, we do not expect an outburst of nuisance lawsuits.

2-2. Description of Survey Results and Evaluation

1) Shareholder Rights

87% of the companies issued one class of common stocks with *one share – one vote*, while 13% issued preference stocks with no voting rights. However, preference stocks are not considered as being a means to unfairly discriminate minority shareholders in favor of dominant shareholders. There is no other special stock that gives only the dominant shareholder preferential treatment. Shareholder rights on proxy voting appear to be well protected in most cases too. 93% of companies surveyed answered that there is no restriction on the qualification of proxy voting.

Proportion of required votes for approval by general shareholders' meeting varies according to the matters to be approved. Most companies require 1/2 approval for the fundamental corporate changes such as change in by-laws, but 1/3 approval for issues such as transaction with special interest parties, election of directors and auditors, compensation of directors. Survey results also indicate that shareholder rights are well protected on the issue of access to information on the agenda of general shareholders' meetings and pre-emptive rights. 89% of the respondents answered that sufficient information is provided to shareholders prior to general shareholders' meetings. In addition, 93% of the respondents answered positively to the question about pre-emptive rights.

Majority of companies answered that conflict of interest between insiders and shareholders is not a serious problem as information on related party transaction is properly disclosed to shareholders. Majority of them also answered that the shareholder who is a party in a related party transaction is excluded from voting on the issues related to the transactions. It is worth noting that 25% of the responding managers did not give a positive answer to the question of whether related party transactions are fully discussed. Considering potential bias in answers to this question, this result seems to suggest that related party transactions may not be fully discussed in practice.

Following *Table 2-2* summarizes the percentage of shares that is required for the approval of the general shareholders' meeting on some of the key issues.

Table 2-2. Proportion of Shareholders Required for the Approval on Key Issues

	Responses	Average ratio of approval (%)	Remarks
Amendment of founding documents	74	44.38	
Merger, and major sale of acquisition of assets	73	43.30	
Large related-party transaction, etc	59	37.82	
Appointment of directors and auditors	74	34.89	
Removal of directors	73	42.20	
Removal of auditors	69	42.25	
Remuneration of board members	67	34.97	no need to be approved :

New share issuance	25	36.49	8 no need to be approved : 47
Not giving a priority subscription right when share or convertible bonds are issued	28	32.53	no need to be approved : 42

2) Role of Shareholders in Nominating and Electing Outside Directors

93% of companies disclose the list of candidates for outside directors prior to the general shareholders' meeting. However, in 45% of companies, minority shareholders with substantial shares cannot recommend candidates for outside directors, a restriction that can potentially limit the rights of minority shareholders.

Cumulative voting is not adopted by 91% of the companies. Among those that adopted the voting system, only 1% of companies have actually carried out cumulative voting. Thus, minority shareholders have little chance of electing outside directors that they prefer via cumulative voting, even though that system is possible. That dominant shareholders hold a firm grip on the appointment of outside directors can also be confirmed by the survey result that the candidates for outside directors who are recommended by the management are elected with near certainty in 99% of the firms. 60% of the respondents answered that the candidates recommended by the management always get elected, while 39% answered that the candidates recommended by the management may not be elected but such events are very rare. Thus, it is too early to expect outside directors to provide effective checks and balances in the governance of large firms in the Republic of Korea.

The survey also shows that general shareholders' meetings generally last for a short period of time, taking less than 30 minutes in 20% of companies, and 30 minutes to an hour in 59% of the companies. The average number of shareholders who are present was 122, with 4 being the lowest and 600 the largest. In terms of time spent, general shareholders' meetings do not seem to give minority shareholders sufficient opportunity to actively participate in the decision-making process of large companies in the Republic of Korea, as is the case in most other countries.

3) Disclosure and Transparency

Our survey suggests that the annual report was the main channel in conveying information on corporate governance or on transaction with special interest parties (90%) to shareholders. Internet homepages are rarely used as the medium for information disclosure (20%). 33% and 31% of companies did not reveal information regarding risk management and corporate governance policy, respectively. Meanwhile, 45% of companies answered that they disclose information on whether their corporate governance structure lives up to that of the government guideline (or manual). With respect to the accounting and auditing principles, 60% of the corporations said that they are to live up to the international standard. Thus, quite many companies know that their accounting and auditing systems are backward or lack transparency.

On managing homepages, which is increasingly becoming an important source of information, only 49% answered that they are managing both Korean and English versions well, while 44% answered that they are not managing their home pages well or have no English versions. 60% of the companies have no homepages or have homepages but do not provide sufficient information through them.

2-3. Assessment of the role of shareholders and Major Constraints

1) Assessment

Reform measures introduced since 1998 and shareholder activism led to a significant improvement in the corporate governance of large firms in the Republic of Korea. As a result, the interests of minority shareholders are better protected today than in the pre-crisis era. Survey results summarized above indicate that legal infrastructures in the Republic of Korea concerning corporate governance are relatively well developed. Voting rights are well protected. Shareholders have the rights to participate in making decisions on key issues, including the appointment and removal of directors. They also have access to information provided by the management on key issues including related-party transaction. Many companies also provide information on a voluntary basis through internet homepages and various IR (investor relationship) activities.

In practice too, it is true that shareholder rights are better protected now than in the pre-crisis era on most issues. Even the practice of using the issuance of new shares or convertible bonds as a means to giving dominant shareholders preferential treatment, which had been taken for granted for a long time, is being challenged. Recently, dominant shareholders of several *chaebol* firms, including CJ and Doosan, cancelled the issuance of such stocks and bonds that could give them a favorable treatment, when confronted by criticisms from minority shareholders.

Furthermore, directors are paying more attention to the interests of minority shareholders in making decisions in board meetings, after the Korea First Bank and Samsung Electronics cases in which the court acknowledged the liability of directors. Directors were found to be liable for the damages suffered by shareholders by the court in the Korea First Banks case. In Samsung Electronics case, the trial court upheld the position of the plaintiff-minority shareholders, although the case is still pending at the appellate level.

However, few believe that governance of large firms has been fundamentally changed in terms of the role of dominant shareholders on key issues, including the appointment of directors and CEO. Few believe that the diversion of resources among affiliated firms and accounting irregularities that were characteristic of large *chaebol* firms in the Republic of Korea have stopped. The recent scandals involving some Hyundai and SK companies confirmed the suspicion of many that inappropriate and often illegal activities that promote the interest of dominant shareholders at the expense of minority shareholders are continuing in some *chaebol* firms.

2) Remaining Constraints

There are several constraints that work as barriers to a fundamental change in governance of large firms in the Republic of Korea. They are the ownership structure of *chaebol* firms, the distortion in the incentive schemes managers face in *chaebol* firms, the "free-rider problems" with minority shareholders, weak enforcement, and weaknesses in the legal infrastructure concerning corporate governance of large firms.

The most important barrier to the fundamental change in corporate governance of large firms in the Republic of Korea is the ownership and control structure of *chaebol* firms. The ownership structure of *chaebol*-affiliated companies has not changed much, except in a couple of *chaebols* that have chosen a holding company structure. Dominant shareholders of *chaebol* firms own a small percentage of the equity of firms, but still control affiliated firms using the money borrowed by affiliated firms and cross shareholding of them. This unique ownership structure of *chaebol* firms enables dominant shareholders to make most key decisions unilaterally and makes it impossible for minority

shareholders to participate in the decision-making process effectively, even though minority shareholders own around ten times more shares owned by dominant shareholders.

3) Role of Institutional Investors

Institutional investors are an important group of players in the corporate governance game that has been largely neglected thus far. The role of institutional investors in the corporate governance of large firms in the Republic of Korea had been very weak before the economic crisis, but has been growing steadily since 1998. Insurance companies, securities companies, investment trust funds, and pension funds were important institutional investors even before the economic crisis. Their role has been increasing since the economic crisis because dominant shareholders in many *chaebol* companies lost control of the affiliated firms. Foreign institutional investors in particular became important shareholders of most large listed companies as they aggressively purchased the shares of large Korean firms since 1998 and now own more than 40% of the market capitalization.

Institutional investors can potentially play an important role as block shareholders in the governance of large firms and help solving substantial parts of the corporate governance problems that exist in large firms in the Republic of Korea today. However, most of the large, domestic institutional investors in the Republic of Korea do not operate under sound corporate governance structures and are difficult to rely on as block shareholders of large firms. Most of them are either affiliated with *chaebols* or controlled by the government. Institutional investors that are affiliated with *chaebols* run the risk of operating in the interest of the affiliated *chaebol* group rather than the interest of the investors whose money they manage. Institutional investors that are run by the government are subject to the risk of being run by a management that does not have proper profit incentives. Currently, all of the four largest pension funds are essentially run by the government.

Efforts to privatize the investment trust funds owned by the government have not been successful thus far. There do not seem to be any domestic funds that are plausible candidates to become new owners, in the sense that they are owned and managed by private investors and that they do not rely on money borrowed from financial institutions. Efforts to install a profit-oriented management in the government-controlled pension funds have not been very successful either.

Regulation on the ownership and operation of institutional investors has been strengthened over the last several years. Takeovers of non-bank financial institutions by industrial capital must satisfy certain conditions, such as low debt equity ratios and clean financial records. Insurance companies are prohibited from making loans in excess of 2% of their total asset value to affiliated firms. Loans to affiliated firms or related persons by securities companies, investment trust funds, and mutual savings have also been banned.

There also are ceilings on the shares of affiliated firms that an institutional investor can own. The ceiling is 3% of the total asset value of for insurance companies, 8% of the capital for securities companies, and 5% of the capital for mutual savings. In addition, there are restrictions on the way an institutional investor exercises shareholding rights. Institutional investors, other than investment trust funds, are generally prohibited from exercising the shareholding rights of affiliated firms, although some exceptions are allowed. Investment trust funds are generally required to exercise shadow voting in affiliated firms.

In spite of many reform measures that have been introduced since the economic crisis, problems associated with the lack of arms' length relationship between institutional investors and other affiliated firms have not been resolved significantly. It is expected that

regulation on the relationship between industrial capital and institutional investors will become tighter in the future. Role of foreign institutional investors is expected to become much larger in the future too.

3. Effectiveness of the Board of Directors

3-1. Regulatory Reform and Related Developments

It was discovered, in the wake of the financial crisis, that boards of directors did not function properly according to the company laws and the spirits behind the laws. The board was the highest decision-making organ of a corporation in law after the general shareholders' meeting even before 1998. However, they did not function as envisaged by laws. In fact, they were essentially a rubber stamp for dominant shareholder in most corporations in the Republic of Korea. A fundamental reason for the lack of independence of board of directors in large corporations, almost all of which were *chaebol*-affiliated, was that dominant shareholders control the appointment of directors through high internal shareholders of affiliated firms. It was realized that it would be difficult to achieve independence in boards of directors unless a fundamental change of ownership occurs. It was also realized that it would be difficult to induce a fundamental change of ownership in *chaebol* firms within a short period of time. As a result, much of the reform efforts that followed the economic crisis focused on the role of outside directors in the board.

1) Outside Directors

Board composition

The 1998 Amendment of the Commercial Code urged listed corporations to organize the board of directors with a minimum of one fourth of outside directors. 2001 amendment to the Securities & Exchange Act made this recommendation mandatory. Thus, it is necessary that at least 25% of the members of the board of a listed company must be outside directors. Corporations registered on Kosdaq are also subject to the same constraint since 2002. In addition, corporations with asset values exceeding than KRW 2 trillion must appoint three or more outside directors and at the same time maintain a minimum 50% proportion of outside directors in their boards.

Recommendation of outside directors

However, boards did not seem to function properly even after the introduction of mandatory outside board members described above. There was a widely held suspicion that outside board members were appointed by dominant shareholders, who had power to do so based upon their control over shares owned by affiliated firms, and were not really independent. Thus, the ability of minority shareholders to appoint outside directors became an important issue in ensuring independence of outside directors. The Recommendation Committee of Outside Directors was introduced as a way to deprive the dominant shareholder of its monopoly over the appointment of outside directors.

Large listed companies are now required to establish a Recommendation Committee of Outside Directors, which must consist of 50% or more outside directors. Candidates for outside directors must obtain recommendation from the Committee. The Committee can recommend its own candidates to general shareholders' meeting. In addition, the Committee must automatically recommend the candidates to the general shareholders' meeting who are recommended by shareholders with 1% or more of the

shares of a corporation, and shareholders with 0.5% of the shares of a corporation with an asset value exceeding 100 billion KRW. Thus, minority shareholders who have certain shares can recommend their candidates to general shareholders' meeting.

Cumulative voting

Cumulative voting was introduced as another possible solution to the problems associated with the near absolute voting power of dominant shareholders in appointing directors. The Commercial Codes were amended in December 1998 to allow cumulative voting. However, cumulative voting is not mandatory, but is optional. 78% of Korean corporations excluded it by opting out in their by-laws. The Securities and Exchange Act was amended in March 2001 to limit the voting power of dominant shareholders in opting out of cumulative voting scheme.

Qualification for outside directors

The Securities & Exchange Act prohibits persons falling under any of the followings from becoming an outside director to ensure the independence of outside directors.

- ① A person who together with any specially related persons holds the largest number of stocks on the basis of the total number of stocks with voting rights of a particular securities company;
- ② A person that has a special relationship with the largest shareholder;
- ③ A major shareholder of the concerned company and that person's spouse and lineal ascendant and descendant;
- ④ A person who was an officer or a full-time employee of the concerned company or its affiliate or worked as an officer or employee for such relevant securities company within the preceding two years;
- ⑤ The spouse or lineal ascendant and descendant of an officer of the concerned company;
- ⑥ An officer or employee of a corporation that has an important business relationship prescribed by Presidential Decree with a relevant company, a competitive relationship or a cooperative relationship with such securities company or was an officer or employee for such corporation within the preceding two years;
- ⑦ An officers or employees of a company in which an officer or employee of the concerned company was a non-full-time director;

The same Act also requires corporations to disclose information on the activities of directors to shareholders. The information to be disclosed includes their attendance rate, voting record of each director, and compensation.

Outside director's rights

The 2001 amendment of the Securities and Exchange Act allows outside directors, as well as inside directors, to request the company to provide them with the services of experts who can assist them in performing their duty as directors.

2) Audit Committee

Internal auditors were essentially appointed by dominant shareholders or CEOs and did not play audit functions properly before 1998. As a result, dominant shareholders and the directors who worked for them were able to make decisions that led to excessive

risks, diversion of large amounts of resources from corporations, and illegal accounting practices without much difficulty. Audit committees were introduced as an alternative to the internal auditor system, which has been proved to be ineffective. Relevant laws, including Commercial Code, Securities and Exchange Act, and Corporate Outside Audit Act, were amended in order to make audit committee effective. Corporations with an asset value exceeding 2 trillion KRW must set up an audit committee and must appoint at least two thirds of the members of audit committee from outside directors. The chairpersons of audit committees must also be outside directors. Further, audit committee is allowed to select an external auditor.

3) Role of the Board in Approving Intra-group Transactions

In another attempt to limit the ability of dominant shareholders to carry out insider trading and inappropriate intra-group transactions, the Securities and Exchange Act was amended in March 2001 to require corporations with an asset value in excess of 2 trillion KRW to obtain approvals from the board of directors for large scale transactions with the largest shareholder or other related persons or firms. In addition, the transactions must be reported to the first general shareholders meeting to take place after the board meeting in which they were approved. Transactions subject to this provision are i) each transaction with the controlling shareholder (including specially related persons) which involves an amount that exceeds 1% of the total revenue or total asset value, and ii) set of transactions with the controlling shareholder that, when combined together, involves an amount that exceeds 5% of the annual revenue or total asset value within the year.

4) Other Measures

The 1998 amendment of the Commercial Code made it possible to hold anyone who is in a controlling position of a corporation responsible for mismanagement of the firm, even if that person is officially not a director. This measure was introduced to make dominant shareholders, who often evaded responsibility by not appointing themselves as directors while making key decisions behind the directors whom they appointed, legally responsible for the decisions that they made. 1998 amendment of the Commercial Code also adopted 'duty of loyalty' for directors, in an attempt to address fiduciaries' conflict of interest.

Further, the 2001 amendment of the Commercial Code made it mandatory for corporations to acquire approvals from the board of directors for disposal of important assets and transactions that would lead to a significant increase in a corporation's liabilities. It also allowed directors to demand CEOs to provide relevant information about the operation of the companies.

3-2. Description of Survey Results and Evaluation

1) Board Structure

The number of directors varied between 2 and 14, with an average of 6.2. The number of outside directors was between 0 and 8, with the average of 2.06. The proportion of outside directors, which is around 33%, is lower than that in most firms in other OECD countries, which is thought to lie between 50% and 70%. Board composition dominated by inside directors seems to be a crucial factor behind the lack of independence of the board from the management in the Republic of Korea. Only 7% of the surveyed companies have foreign directors. In 93% of the companies, the CEO coincides with the chairman of the board.

27% of the surveyed companies have officers of affiliated firms as directors, while 15% have the employees of the law firms or consulting firms, which have provided the firms with services, as a director. 9% of them appointed former or present employees of their main banks, while only 1% appointed a candidate from labor as its director. The tenure of directors ranged from 1 year to 4 years, with an average of 2.7 years.

2) Independence of and the Board Independence

Only 13% of the surveyed companies record the opinions of individual directors expressed during board meetings often, and 62% of the companies never or rarely record them. A lack of records can be an important factor behind the lack of independence of outside directors. According to the survey, outside directors rarely participate actively in board discussions in 24% of the firms, confirming the suspicion that many outside directors are not playing their roles properly.

The survey also reveals that outside directors rarely or never have meetings without management to discuss corporate matters in 75% of the firms and that they rarely or never alter or add the board meeting agenda set by the CEO in 83% of the companies. Further, agenda items have rarely or never been disapproved at board meetings by outside directors in 85% of the surveyed firms. These results all indicate that outside directors play a limited role at best in majority of companies.

On the other hand, the survey results shows that outside directors are more independent in a small but potentially significant proportion of firms. The survey shows that outside directors have meetings without management to discuss corporate matters in 25% of the firms and that they alter or add the agenda item set by CEO in 17% of the firms.

Answers from directors to survey questions on independence of outside directors and the board are not conclusive, but strongly suggest that outside directors and the board are not independent in the majority of companies. 53% of inside directors and 58% of outside directors answered that outside directors are independent from CEOs and dominant shareholders. In other words, 47% of inside directors and 42% of outside directors did not answer that outside directors are independent. Considering the incentives of the directors who responded to the question in providing answers, the true proportion of directors who negatively assess the independence of outside directors is expected to be substantially higher.

As reasons for lack of full independence, 63% of inside directors and 64% of outside directors picked the fact that CEO has effectively selected the board members. Only 32% of inside directors and 26% of outside directors disagreed with the statement that outside directors are not independent because CEO will decide the extension or termination of the directors. Thus, the relationship between CEOs and the directors seems to be a crucial factor that determines the independence of the board.

Survey result also indicates that the majority of directors believe that it is the CEO or dominant shareholder who has the strongest voice in selection and dismissal of directors. 45% of inside and outside directors respectively picked the CEO while 21% of inside directors and 17% of outside directors picked dominant shareholders. 30% of inside directors and 34% of outside directors picked the board or nomination committee. We believe that CEOs coincide with dominant shareholders or are tightly controlled by dominant shareholders in many companies.

Our belief seems to be confirmed by the answers to the survey question on who has the strongest voice in replacing and selecting CEOs. The majority of directors answered that dominant shareholders make the decisions either unilaterally or with some inputs from the managers and the board. 15% of inside directors and 20% of outside directors answered that the dominant shareholder single-handedly makes the decisions

on selection and removal of CEOs, while 15% of inside directors and 19% of outside directors answered that the dominant shareholder makes the decision with some inputs from the other managers. 61% of inside directors and 54% of outside directors answered that the dominant shareholder makes the decisions with some inputs from the board. Only 17% of inside directors and 16% of outside directors answered that board makes the decision.

The above survey results confirm the widely held suspicion that CEOs and dominant shareholders have a strong influence in the appointment of directors and that they have a strong influence in decision-making process through their control over directors and CEOs.

Most directors, 85% of inside directors and 78% of outside directors, answered positively to the question of whether the board is a forum of serious discussions for significant matters of the firm. Given this survey result, however, it is puzzling that 37% of inside directors and 43% of outside directors did not disagree with the statement that the board is rather perfunctory, dominated by the CEO. One way of interpreting the apparently conflicting results is that important matters are discussed in the board as required by laws, regulations, and articles of incorporation, but are frequently decided upon by CEOs.

On the performance and contribution of the board, majority of inside and outside directors expressed positive views, although there is substantial gap between the proportion of inside and outside directors who gave positive answers. 86% of inside directors and 69% of outside directors said that the board is involved in formulating long-term strategies. 84% of inside directors and 72% of outside directors answered that it helps ensuring integrity of financial reporting. In addition, 69% of inside directors and 61% of outside directors answered positively to the role of the board on ensuring proper disclosure and communication with shareholders.

However, a much lower proportion of the directors gave positive answers to the questions on selection and monitoring of CEOs (36% and 28%), executive remuneration (47% and 34%), and on effectiveness of various governance practices (52% and 47%). Again, inside directors gave a substantially large proportion of positive answers than outside directors.

3) Function of the Board of Directors and Board Committees

There seems to exist big gap between two groups of companies about the independence of the audit function. Only 21% of the surveyed companies organized an audit committee belonging to the board of directors. This indicates lack of independence in auditing function in the majority of companies. The survey result that there are no written rules for audit function indicates that a substantial number of companies may seriously lack proper audit function.

On the other hand, audit committees appear to be organized appropriately in companies that set up one. In 89% of the firms that have an audit committee, the committee has two thirds or more outside directors. In 94% of them, the audit committee includes a member with expertise in accounting or finance and prepares the minutes of the meeting each time. In 83% of them, an outside director is chairman. Few companies, in fact only one among the respondents, have remuneration of each audit committee member approved separately by the general shareholders' meeting. It is not clear whether this can be associated with a lower level of independence.

The survey results show that there is a wide variation among respondents about whether their audit committees are performing one of the most important roles of the committee, namely independently selecting an external auditor. In 33% of respondents, audit committee selects external auditors very autonomously, while in 27% of them audit

committee hardly does so. Survey shows a similar degree of variation on the authority of the committee over the appointment of internal auditor, risk management, and accounting procedures.

Few companies, only two out of 89 respondents, have a compensation committee. Thus, board and outside directors are seen to have little role in determining compensation of executives in almost all companies. Only 23% of companies surveyed have a nomination committee. Among those that set up a nomination committee, only 38% have the majority of two thirds or more by outside directors. Thus, in more than 91% of the companies, there is no nomination committee, and even when there is one, it is dominated or heavily influenced by the management.

Only 16% of the companies conduct evaluation of the performance of the CEO on a regular basis, and 54% of the companies rarely or never evaluate CEO's performance. 15% of the companies routinely review CEO's compensation, while 17% of the companies sometimes review it. In 64% of the firms, CEO's compensation is rarely or never reviewed. Stock options are given to CEOs in only 14% of the firms.

We believe that these survey results are closely associated with the fact that majority of listed firms in the Republic of Korea are tightly controlled by a dominant shareholder. When a dominant shareholder coincides with the CEO, he has little incentive to evaluate his own performance. Even if the dominant shareholder of a company appoints a professional manager as the CEO, he has incentives to induce the CEO to work in his interest rather than the interest of the firm or general shareholders. The dominant shareholder is expected to evaluate the CEO unofficially, through his personal staffs rather than to introduce an official evaluation mechanism that can be observed by many. The dominant shareholder will also have limited incentives to employ stock option schemes that tie the compensation of the CEO strongly with the performance of the firm, for similar reasons.

Still, the survey results are encouraging in that in around 15% of the companies, proper incentive schemes based upon proper evaluation procedures seem to be operating.

4) Board Meeting Frequency, Attendance, Etc.

There were 8 or more board meetings in 61% of the companies, and 6~7 meetings in 17% of the companies. The attendance rate of directors was over 90% in 46% of the companies, and between 80% ~ 90% in 22% of the companies, 70% ~ 80% in 22% of the companies. Thus, board of directors appear to be functioning quite actively in roughly 80% of the firms, in terms of the frequency of meetings and attendance rates.

5) General Support, Compensation and Liability

21% of the companies actively provide training opportunities, while 66% do so only occasionally. Further, only 32% of the companies provide a contact person for the support of outside directors. Thus, we can conclude that no or scanty logistical support is provided to outside directors in most of companies.

On the issues of evaluation of and compensation for outside directors, only 11% of the companies answered that they have an effective evaluation system, and only 8% answered that they have a program of stock option or stock ownership. Thus, proper evaluation and performance-related rewards are used in only a small proportion of firms.

It is somewhat surprising that 76% of the firms do not provide outside directors with insurances for any personal liabilities, considering that outside directors seem to be exposed to risks over which they have only limited control, as their roles in the decision-making processes are quite limited.

3-3. Assessment of the Current Situation and the Effect of Reform Measures

It is true that board of directors in most listed companies is much more effective than pre-crisis era. Before 1998, board of directors existed in listed companies, but did not play a significant role and did not even function in accordance with the laws and regulations. Few, if any, listed companies had outside directors before 1998⁷. Virtually all board members were appointed from the management by dominant shareholders. Directors were expected in the interest of dominant shareholders, not general shareholders or the firm itself. It was not uncommon that board of directors made decisions that were inappropriate or illegal in order to promote the interest of dominant shareholders at the expense of other shareholders and creditors.

Now, listed companies must appoint outside directors. Large companies must appoint at least 50% of their directors from outside and also establish an audit committee, 2/3 of which must consist of outside directors. A Recommendation Committee for outside directors is also mandatory. The boards of directors evaluate the performance of the CEO and makes decisions on remuneration in some companies. The boards of directors in most firms actually discuss important issues and make decisions on some of the key issues that have important implications on the interests of shareholders, as required by laws.

However, the boards of directors are still, in general, not very effective. The survey indicates that the majority of directors are not independent of the management and that the board is dominated by the CEO. Further, board of directors is not active in performing key functions such as appointment, evaluation, and remuneration of the CEO. The survey also indicates that the source of the ineffectiveness of the board of directors is the fact that dominant shareholders have the power to appoint and remove directors.

We believe that the board functions significantly more effectively in large private firms that are not affiliated with *chaebols*. In particular, three large former public enterprises that have been privatized recently are believed to have a board that functions significantly better than the boards in *chaebol*-affiliated firms.

In most *chaebol*-affiliated firms, the changes in the structure and operation of the board have only a limited effect on the way the board actually works. Dominant shareholders still appoint outside directors effectively single-handedly. Recommendation Committee of Outside Directors seems to play only a limited role because most of the members of that committee were appointed by dominant shareholders and have little incentive to act against the will of dominant shareholders in selecting candidates to be recommended to general shareholders' meeting. Thus, there is little chance the Committee selects candidates who are independent of the dominant shareholders of the firm in most companies. The automatic recommendation of candidates recommended by minority shareholders also seems to have little chance of making significant differences in firms with dominant shareholders.

Most firms decided not to accommodate cumulative voting. According to the Financial Supervisory Commission, 82.5% of the listed corporations opted out of the cumulative voting in 2002, an increase from 78.4% in 2001. Few among the companies that did not opt out of cumulative voting actually practice it.

Outside directors have little incentive to work in the best interest of the firm even if

⁷ Notable exceptions were four large commercial SOEs. The Special Act on Privatization, which took effect in November 1997, forced Korea Telecom, Kogas, Korea Tobacco and Ginseng, and Korea heavy Industry, which were owned and controlled by the Korean government at the time, to appoint all of the board members except for the CEO from outside of the firm and the government.

they are truly independent under the compensation schemes currently used in most firms. Many outside directors have their regular jobs as lawyers, accountants, professors, or consultants. They carry high opportunity costs of time, while their compensation scheme are not tied strongly with the performance of the firm. There also is suspicion that a large proportion of outside directors are recruited from the pool of retired government officials mainly as lobbyists for the firm or dominant shareholders.

Lastly, we believe that another important reason for suboptimal performance of outside directors is the weak enforcement of law applied to outside directors. There have been few, if nay, criminal or civil cases in which outside directors were held responsible for participating in board decisions which turned out to be illegal or which led to serious mismanagement of the firm.

The policy implication is clear. Boards of directors in large firms need to be more independent. Board members need to be given a stronger incentive to participate in the decision-making process. Board members also need to be exposed to stronger law enforcement when they participate in making decisions that are illegal or that seriously undermine the value of the firm. However, we do not think that limiting the shareholding rights of dominant shareholders is a solution because such a drastic measure is incompatible with the rules governing the governance of corporations.

Instead, we believe that we need to pay more attention to the ownership structure of *chaebol*-affiliated firms and the relationship between *chaebol* firms and financial institutions, which is behind the near absolute control of dominant shareholders in most large firms in the Republic of Korea. The near absolute control of dominant families is based upon their control over large cross-shareholdings by affiliated firms, which in turn was made possible by extensive borrowing from financial institutions by affiliated firms. It was ultimately the government that was behind the heavy borrowing and cross-shareholdings of *chaebol* companies, as it allowed them through policies on financial industry and ineffective financial regulation.

Thus, one needs to focus on the policy on the relationship between large firms and financial institutions and on cross-shareholdings by affiliated firms. As long as the government allows *chaebol* companies to borrow heavily from the financial sector and use the borrowed money in buying controlling interests of other firms, large internal shareholdings of *chaebols* will continue. Independence and effectiveness of the board will continue to be difficult to achieve.

If the government changes its policy toward the relationship between industrial capitals and financial capitals and sets up an effective firewall between them, dominant families in *chaebol* companies will find it difficult to control large firms with the money of other people without their voluntary consent. This can eventually lead to an ownership structure which reflects the incentives of investors more closely, which can also lead to a board structure that allows more independence of the board.

4. The Role of Other Stakeholders in Corporate Governance

4-1. Introduction

Shareholders and the board of directors are the most important players in corporate governance of most large firms in most countries that are based upon a market economy. However, banks and labor also play substantial roles in some countries. For instance, in Japan and Germany, banks have traditionally played a significant role in the governance of large firms, as key shareholders, while at the same time playing the role of main creditors to the firms. Labor also plays an important role in corporate governance of large firms in Germany where it is given seats in one of the two boards. Recently, labor

is becoming an important institutional investor in large firms in some countries, as many labor unions invest parts of the pension funds of their members in the stock market.

Banks can be effective corporate governance agents of large firms as major shareholders in countries in which there are few other economic agents with sufficient capital to become key shareholders of large firms. However, for bank-led corporate governance of firms to work, banks themselves must be under a proper ownership and governance structure. In the Republic of Korea, banks have been under a tight control of the government and have not been under a corporate governance structure that is based upon proper profit incentives. Their role has been generally restricted to passive, and oftentimes generous, creditors. They were not allowed to become major shareholders of large private firms.

Conversely, firms and *chaebols* in the industrial sector have been prohibited from becoming key shareholders of banks. Thus, there have been firewalls in both directions, at least in terms of ownership of controlling shares. Corporate governance of banks and large firms as well as the relationship between them have changed substantially since the financial crisis, and are still changing.

Despite continued demands from labor for a stronger presence in the board and participation in decision-making processes, labor has not been allowed to participate in the governance of large firms in the Republic of Korea, except in a handful of isolated cases⁸. Their role as shareholders has been limited as well. However, there is a chance that labor or employees may play a more prominent role in the future if the collective ownership program by employees becomes more popular.

In this section, we review the recent development in the role of banks and labor in corporate governance in the Republic of Korea, based upon the survey results and the information we collected independently from various sources. We also touch on the roles of institutional investors and the government, two other key stakeholders in corporate governance of large firms in the Republic of Korea.

4-2. Role of Banks

1) Role of Banks before 1998

When the Republic of Korea embarked on an economic development path in the early 1960s, all of the banks were owned and run by the government. There were very few, if any, families that possessed capital sufficient to finance large firms in strategic industries that the Korean government planned to build. Thus, in early 1960s, the Korean government had to make decisions on the following issues: (1) a mechanism to finance large projects that the government pursued in target industries, (2) an ownership and governance structure for those large firms to be built in target industries, and (3) an ownership and governance structure for banks.

The choice made by the government of Park Chung Hee was government ownership and control for banks, heavy reliance on loans from banks to firms controlled by *chaebol* families in financing large firms to be built, and the *chaebol* system for corporate governance of large firms. The *chaebol* system is an ownership and governance structure of firms that is based upon heavy borrowing from banks for the source of capital to be invested in large firms. It also allowed dominant families to acquire and maintain control of an increasing number of firms with large amounts of assets, using the money that the firms under their control borrowed, with little investment of their own.

⁸ The most widely known example is that of the Kia Motors. Managers and labor of that company were accused of having colluded and badly mismanaged the company, eventually leading Kia to bankruptcy in mid-1990s.

Thus, banks were perceived and used as a source of capital in the form of loans for *chaebol*-affiliated firms to finance their operation and new projects, rather than profit-seeking commercial entities. The profitability of banks was frequently sacrificed to support the industrial sector and expansion of industrial activities. The government exercised tight control over the banks as the owner and used the control in appointing top managers and in making key decisions regarding loans.

Ownership of commercial banks changed substantially since 1972. Starting with the Commercial Bank in 1972, the government privatized six commercial banks during the 1980s. The government put an individual ownership ceiling of 4% on the privatized banks in order to prevent the emergence of a controlling shareholder⁹. However, the government somehow retained the control of the privatized banks and made key decisions, including the appointment of top managers and loan decisions, even after privatization¹⁰. Thus, the governance of the privatized banks changed little despite the change in their ownership structure. Proper enforcement of financial regulations was impossible too as the government was behind the actions that were likely to lead to severe losses for banks. It is not surprising that the profitability of the privatized banks did not improve significantly after privatization under such a market environment.

2) Role of Banks since 1998

The financial crisis of 1997 ~ 1998 resulted in a massive failure of large firms and banks, and led to a significant change in the corporate governance of banks and large firms. Financially troubled banks were nationalized and became public enterprises, owned and controlled officially by the government. Some of those nationalized banks are being privatized along with some other banks which had been maintained as public enterprises.

Change in the corporate governance of banks and relevant regulation

Table 4-1 below summarizes the ownership structure of banks as of September 2003. The government is ultimately the largest or a major shareholder in Chohung, Cheil, Hana, Woori, Kookmin, Gwangju, Cheju, and Kyungnam Banks. Among those, Chohung, Cheil, and Hana are run by a management that has been appointed by a major private investor. Woori, Kookmin, Gwangju, and Kyungnam are thought to be run by a management appointed by the government, who is their largest shareholder.

As of September 2003, Deposit Insurance Corporation and Woori Financial Holding Company, both of which are essentially public enterprises, are main shareholders of the commercial banks in which the government is in a dominant position. Shinhan Financial Group, a private firm whose main shareholders are private funds, is the largest shareholder of Chohung Bank, Shinhan Bank, and Cheju Bank. Other commercial banks, that are basically owned and governed by private investors, do not have such a dominant shareholder.

⁹ There were few investors other than *chaebol* groups who had the money to become a controlling shareholder of a bank. Takeovers by *chaebols* would have meant takeovers of banks using the money *chaebol* firms borrowed from the banks.

¹⁰ The exact mechanism that enabled the government to wield control of the privatized banks without corresponding ownership has never been fully revealed.

Table 4-1. Shareholding Ratio of Controlling Shareholders by Banks (As of Sept 2003)

Bank	Controlling Shareholders (%)
Chohung Bank	Shinhan Financial Group (80.04)
Korea First Bank	Newbridge (48.56), Korea Deposit Insurance Corporation (48.49)
Hana Bank	Korea Deposit Insurance Corporation (21.66), Allianz (8.16)
Woori Bank	Woori Financial Group (100.00)
Kookmin Bank	Government (9.93), Goldman Sachs (5.13)
Shinhan Bank	Shinhan Financial Group (100.00)
Hanmi Bank	KAI (15.71), Samsung Life Insurance (7.28)
Daegu Bank	Samsung Life Insurance (7.40), Franklin Templeton Investments (5.06)
Busan Bank	Lotte Confectionary Co. Ltd (14.11), Small Carp World Fund (6.20)
Kwangju Bank	Woori Financial Group (99.99)
Cheju Bank	Shinhan Financial Group (62.42), Korea Deposit Insurance Corporation (31.96)
Jeonbuk Bank	Samyang Co. Ltd (11.82), Daehan Printing & Publishing Co. Ltd (5.02)
Kyongnam Bank	Woori Financial Group (99.99)

Source: Financial Supervisory Board

The government has been trying to privatize the commercial banks in which it owned shares listed above. At the same time, it also wanted make sure that the firewall between banks and firms is effective. A series of amendments in the Banking Act gradually relaxed regulation on the ownership of banks and increased room for control by strategic investors, which own large shares. At the same time, regulation on bank ownership by industrial capitals has been gradually strengthened in order to discourage *chaebols* from trying to take control of banks in an effort to secure easy loans.

While the principle of the individual ownership ceiling of 4% was maintained, exceptions have been introduced to allow a larger ownership by investors who are financial capitals, specialized in investing in and running financial institutions. A 1998 revision of the Banking Act allowed the purchase of shares of a bank in excess of 4%, with the permission of the Financial Supervisory Commission.

However, industrial capitals were prohibited to purchase more than 4% of the shares of a bank with borrowed money. They are also subject to some additional constraints. They must obtain the permission of the Commission to purchase more than 4% of the shares of a bank. They must also maintain good credit ratings and low debt equity ratios. Restrictions on loans made by a bank to its large shareholders became more stringent as well to ensure prudential management of banks and to reduce incentives for a takeover by industrial capital.

Recently, the government raised the ceiling for unconditional individual ownership, which does not require permission of the Commission, to 10% of the shares of a bank for investors which are not industrial capital. For industrial capital, however, the government maintained the ceiling at 4%, making it clear that it does not want takeovers of banks by *chaebols*. Even when an industrial capital purchases more than 4% of the shares of a bank, after the permission of the Commission, it is prohibited to exercise the shareholding rights for its shares in excess of 4%. In addition, the Commission has the authority to order a shareholder of a bank who owns more than 10% of the shares to sell its shares in excess of 10%, if the Commission decides that the shareholder is inadequate as a major shareholder¹¹.

¹¹ 2002 amendment of the Banking Act.

Changes in the role of banks in corporate governance of large firms

A plethora of insolvency of large firms in the Republic of Korea during and after the financial crisis ultimately led to a larger role for banks in the corporate governance of insolvent firms through corporate restructuring that often included extensive debt equity swaps as a key component of rescue packages. Banks ended up becoming major shareholders in those financially troubled firms, to which large-scale debt equity swaps were applied.

The Banking Act was amended in 1998 to allow the banks to own more than 10% of the shares of a firm, a restriction that had been enforced for a long time before 1998, so that they could implement debt equity swaps, which were an indispensable part to the rescue packages applied to many ailing firms. Banks were allowed to own up to 15% of the shares of a firm without special permission from the government and more with the permission from the Financial Supervisory Commission.

Banks became major shareholders of many insolvent firms that entered the court-supervised reorganization proceedings, since almost all reorganization plans approved by the court included debt equity swaps since 1998. In many reorganization cases, banks succeeded in selling the shares of those firms to a third party after the debt equity swaps were completed. However in some cases, banks were not successful in their attempts to sell the shares and ended up being stuck with insolvent firms as both large shareholders and main creditors. Little information is available about the role of banks in the corporate governance of those firms.

Banks also played a significant role in the governance of some ailing firms that entered workout programs. Some of the firms that were in workout programs went through debt equity swaps, similar to the ones that occurred to the firms in court-supervised insolvency proceedings, and ended up having banks as their major shareholders¹². The role of banks in those firms is similar to their role in the firms that entered reorganization proceedings, which the banks could not sell to a third party, mentioned above.

It is worth mentioning that there is criticism about the role of banks in ailing firms. The criticism is that many banks themselves are plagued by poor corporate governance and cannot be trusted as corporate governance agents of large firms. In fact, there have been accusations that banks were using the opportunity to control ailing firms as a way to create jobs for the retiring employees of them.

On the other hand, the role of banks in corporate governance of large firms that are not financially troubled remains unchanged. Banks are not significant shareholders of these firms. Most banks lack the resources to invest in the shares of normal firms, as they were busy with the financial crises of their own. As creditors, banks appear to become more efficient and disciplined than before. By how much they became more efficient remains to be seen.

3) Discussion of Survey Results

A majority of the respondents answered that banks are generally performing better as creditors now than in the pre-crisis era. Around 80% of the directors who responded to the survey answered that banks are screening loan applications and monitoring debtor firms more carefully. However, directors were less optimistic about the role of banks in corporate restructuring. While 51% of inside directors and 61% of outside directors answered that banks are playing a more active role in corporate restructuring, nearly half of inside directors and 40% of outside directors do not share the positive view that banks

¹² Some of large firms, including many Daewoo companies, appear to have banks as their major shareholders after extensive debt equity swaps in workouts.

are performing better in corporate restructuring now compared to the pre-crisis era.

This survey result is consistent with the view shared by most experts on financial markets and bankruptcy. Governance of commercial banks has improved significantly after the financial restructuring started. Banks became more cautious at the stage of making loan decisions. Banks are paying more attention to the financial performance of the debtor firms after the loan decisions are made as they attempt to learn the financial difficulty of debtor firms earlier. However, banks have limited autonomy in dealing with bankruptcy of large debtor firms, as they are substantially influenced by the Korean government in handling bankrupt firms. Further, successful corporate restructuring requires coordination of many creditors, which is often difficult to achieve for Korean banks, most of which lack sophistication and experience.

In fact, most commercial banks in the Republic of Korea are still owned substantially by the government or are being privatized and are not under a stable and efficient ownership and control mechanism. As a consequence, they have not been able to develop into efficient lending institutions yet and are under substantial government influences.

Directors who responded to the survey are generally favorable to a close relationship between banks and their firms. A majority of them held the view that firms will be better monitored by banks, have easier access to capital, and face reduced chance of going bankrupt. For instance, 86% of inside directors and 87% of outside directors responded that appointment of some directors by banks would lead to improved monitoring by banks. At the same time, however, around half of directors expressed concern over the possibility that the more intimate relationship between banks and firms would lead to interference of banks in the management of firms.

It is true that both possibilities strongly exist. However, the appointment of some directors of debtor firms by their banks has implications that go far beyond monitoring of debtor firms and raises the fundamental question about the responsibility of directors of a corporation. The Commercial Codes in the Republic of Korea makes it clear that a director should try to maximize the interest of his/her firm or its shareholders. Appointments of directors by banks will cause serious conflict of interest.

There is another reason to believe that appointment of directors by banks is unlikely to lead to more efficient outcomes in the Republic of Korea today. Banks in the Republic of Korea suffered heavily from their own failure in corporate governance and are struggling to cope with the problem. There still remain doubts about the effectiveness of the board of directors of most Korean banks. It is difficult to expect that directors of debtor firms appointed by those banks will perform properly and contribute to a more effective board in the debtor firms.

It is important that banks have access to necessary information about their debtor firms for the efficiency of the financial market. At the same time, it is also crucial to clearly separate the role of a banker from that of a director of a debtor firm. Relationship banking similar to that used in Japan or Germany requires a total redesign of the economic system if it were to be introduced in the Republic of Korea. The problem of banks' access to information can be better addressed by information provision and disclosure requirement of debtor firms, improving corporate governance of banks, and strengthening financial supervision.

4-3. Role of Labor

The survey results about the trend in labor participation in decision-making processes are generally inconclusive and show an approximately even distribution over the possible answers. In other words, both executive directors and outside directors

appear to believe that the degree of labor participation in various decision-making processes has not changed much since the economic crisis. To the only question that is directly related to the corporate governance of the firm, directors answered quite decisively that strong labor participation is expected to lead to the effect that “abusive behavior of controlling shareholders will be held in check.” This implies that labor has been playing the role of checking abusive behavior of controlling shareholders.

Labor has traditionally been perceived as having interests that are not well aligned with the interests of shareholders and managers in the Republic of Korea and has not been given a significant role in governance of large firms. However, labor unions in large firms are quite powerful and have strong influence on various key matters, such as work environment and job assignment. Labor has also been continually demanding an active role in governance of firms, with little success thus far. Survey result above indicates that labor is strong enough to pose a threat to dominant shareholders.

Thus, strong labor unions may serve the interest of shareholders by checking the abusive behavior of dominant shareholders. However, it would be wrong to conclude from this observation that strong labor unions lead to an increase in the economic interest of shareholders. First, strong labor unions are likely to lead to higher wages and other work conditions that are against the economic interest of shareholders. Second, there is no guarantee that labor will use its power to check the abusive behavior of dominant shareholders to increase the firm value or shareholder value. It is possible that labor will use its leverage over dominant shareholders to promote its own interest at the expense of shareholders.

In fact, *chaebol* families and labor unions in large *chaebol* firms are in a similar situation in that they have influences over huge amounts of assets in which their own investments are small. There were cases, most notably Kia Motors and Daewoo Motors, in which collusion by labor and the management aimed at expropriating resources of their companies that ultimately belonged to minority shareholders and creditors was strongly suspected.

Militant labor unions and dominant shareholders of *chaebol* groups have been helped by each other in another important sense too. Militant labor unions were able to attract a wider support for them by attacking the abusive behavior of dominant shareholders that hurt firm value and that frequently are illegal, despite that they also hurt firm value by forcing dominant shareholders to agree on conditions that adversely affect the interest of shareholders. *Chaebol* families on the other hand successfully portrayed themselves as the only protector of capitalism who can fight with militant labor unions who deny capitalism, despite the fact that *chaebol* families have been undermining the very foundation of capitalism by controlling money belonging to other people illegally, or by using a system that is at odds with capitalism¹³.

Labor is an important stakeholder in large firms. Its role will continue to have a profound impact on the performance of large firms in the Republic of Korea. It can affect the evolution path of corporate governance of large firms in the Republic of Korea. But, it is hard to see labor as a legitimate corporate governance agent unless it becomes a key shareholder.

Employees of some firms became shareholders of their firm through employee stock ownership programs. Employees as a group can potentially play a significant role as a block shareholder if they collectively own large shares through the association of employee stock ownership program. Employee stock ownership programs have been in place for quite a while, and are regulated by the Stock Exchange Act. As of December

¹³ Dominant shareholders have control over the money borrowed from the banks, which ultimately belongs to the depositors of the banks, and the equity of their firms most of which came from minority shareholders.

2002, 1,981 companies in the Republic of Korea, including 670 listed companies, have an employee stock ownership program¹⁴.

However, employee stock ownership programs were deemed not very successful for several reasons. First of all, there was little incentive for employees to participate in the program voluntarily because there was no merit in joining the program while there were costs as they were prohibited from selling their shares for a certain period of time. Furthermore, in many cases, employees were forced by the management to participate in the program, which wanted to raise capital from the employees of their companies. As a result, employee stock ownership programs have been introduced in many firms, but became quite unpopular and did not play a significant role.

A new program was introduced to replace the old program in 2002. The Framework Act for the Welfare of Workers aims at transforming the old employee stock ownership programs into a profit-sharing mechanism that is supported by tax benefits. In the new program, employees can buy shares of their firms partially with the money provided by the firm, which in turn can claim tax breaks for the money that it spent on providing funds to workers.

The new program does not give a special status to the representative of an association of employee stock ownership program. Thus, the only way by which the association can play its role is through the exercise of shareholding rights. Their role can be potentially important in the future if the associations become large shareholders. However, they are not large shareholders currently.

5. Corporate Governance Practices and Firm Performance

5-1. Introduction

In this paper, we look into the inquiry whether firm-level corporate governance practices correlate with firm performance. Theoretically, there can be a number of channels through which corporate governance may influence firm performance. One obvious route is through discouraging value-destroying tunneling by corporate insiders. For example, better-monitoring boards will effectively block transactions that would give private benefits to corporate insiders (executive managers or controlling shareholder) at the expense of outside shareholders. Another path is through encouraging value-enhancing role of corporate boards. One example would be a compensation committee, exclusively composed of outside directors, that adopts a compensation scheme that tightly links executive compensation to long-term firm performance. Another would be a board comprised of tough outside directors that would not approve projects unless return exceeds cost of capital.

The purpose of this section is to test the link empirically. We first construct a corporate governance index for 112 firms from the survey data discussed in earlier chapters, and then investigate the relationship with firm performance variables. Index (hereafter *CG*) is coded to take a value between 0 and 100, greater index value indicating better governance. As for firm performance, we limit ourselves to market value measures, such as Tobin's *q*, market-to-book, and market-to-sales. The result, however, is not encouraging. Although the simple *OLS* regression shows a positive link between the two variables, statistical significance of the coefficient on *CG* dies out with additional control variables.

¹⁴ In terms of percentage, 97.2 % of listed companies had an association of employees' stock ownership program, while 0.7% of non-listed companies had an association.

Despite such weak evidence we find in our data, we do not conclude that there exists no link between corporate governance and firm value. Instead, we complement our findings with that in Black, Jang, and Kim (2003), which look into the same issue in the same market with a larger sample size of 525 firms. We believe that small sample size, and the resulting small degrees of freedom, is masking the relationship between corporate governance and firm performance. They construct a corporate governance index (*CGI*, 0~100) for 525 companies based on responses to a Spring 2001 survey of all listed companies by the Korea Stock Exchange. They also construct five sub-indices for shareholder rights, board structure, board procedure, disclosure to investors, and ownership parity.

According to their *OLS* result, a worst-to-best change in *CGI* predicts a 0.48 increase in Tobin's *q* (about a 160% increase in share price)¹⁵. This effect is statistically strong ($t = 6.11$), robust to choice of market value variable (Tobin's *q*, market/book, and market/sales), robust to specification of the corporate governance index, and robust to inclusion of extensive control variables. They show that each sub-index is individually significant and contributes to the predictive value of the overall index. They also find that a firm with 50% outside directors has a 0.13 higher Tobin's *q* (roughly 40% higher share price) after controlling for the rest of *CGI*. Also, their result shows that investors appear to value the same cash flows more highly for better-governed firms, implying a lower cost of capital.

In governance studies, one cannot infer causation from *OLS* results because of the potential for reverse causation, for governance and market value to be jointly and endogenously determined by economic factors, and for governance to be a signal of (unobservable) management quality.

To address the endogeneity explanation, they make use of the fact that several important Korean governance rules apply only to firms with assets over 2 trillion Korean won, and construct an instrumental variable for corporate governance that takes a value of 1 if book asset value is greater than 2 trillion won, and 0 otherwise. They report that two-stage and three-stage least squares coefficients are larger than *OLS* coefficients, are highly significant, and that there is no significant evidence of reverse causation or other endogeneity. Thus, their paper offers strong evidence, not previously available, that better corporate governance in general, and 50% outside directors in particular, likely causally predict higher share prices in emerging markets.

In recent years, academics and private sector professionals alike are showing increased interest in the construction of a corporate governance index (or rankings), and on the association of such index with firm performance¹⁶. The paper by Black, Jang, and Kim (2003) is only one example. Similarly Gompers, Ishii, and Metrick (2003) show evidence that U.S. firms with the strongest set of takeover defenses have lower valuation than those with the weakest defenses.

Durnev and Kim (2003) find that higher scores on both the CLSA corporate

¹⁵ This is for firms with Tobin's *q* and debt/assets equal to the sample means. Tobin's *q* is market value of assets over book value of assets. But the only variable part of Tobin's *q* in the numerator is market value of equity. Suppose that a firm has book assets of 100, book debt of 55, book equity of 45, and market value of assets of 85 (all corresponding to sample means). Then market value of equity is 30. A worst to best increase in governance then increases Tobin's *q* by 0.48 to 1.33, so market value of assets will now be 133, which means that market equity must increase to 78. This is a 160% increase in market value of equity.

¹⁶ There is an array of private-sector corporate governance rankings. The list includes the following: Deminor in 2000, Credit Lyonnaise Securities Asia (CLSA) in 2001, Standard & Poor's (S&P) in 2001, Institutional Shareholder Services (ISS) in 2002, The Corporate Library (TCL) in 2003, GovernanceMetrics International (GMI) in 2003

governance index and the S&P disclosure index predict higher a Tobin's q for a sample of 859 large firms in 27 countries. Klapper and Love (2003) is a second study that relies on the CLSA index. They find somewhat stronger results than Durnev and Kim for the CLSA index for a sample of 495 large firms in 25 countries. Drobetz, Schillhofer, and Zimmerman (2003) find a correlation between a corporate governance index and the market value of German firms.

Such empirical findings have important public policy implications, for they provide the rationale behind the corporate governance reform the government initiated since the 1997-98 financial crisis. Prior to the 1997-1998 financial crisis, Korean corporate governance practices were weak by international standards, and self-dealing by controlling shareholders was common. Since the financial crisis, the Korean government has aggressively transplanted legal institutions that it deemed necessary to raise corporate governance standards in the Republic of Korea. A minimum number of outside directors became legally mandatory. Audit and nomination committees were introduced. *Chaebol*-affiliated firms must disclose consolidated statements and obtain board-of-directors approval for self-dealing transactions. The number of shares a shareholder must hold to file a derivative suit or inspect a company's financial records has been reduced dramatically. The list goes on. However, complacency soon crept in among corporate managers. The *chaebol* are lobbying the government against further reforms and are seeking to reverse some of the post-crisis reforms. They portray corporate governance regulations as choking off their freedom and creativity, and question the link between corporate governance and firm performance.

5-2. Data and Measurement

1) Sample Firms

We constructed a corporate governance index using the survey data responded by the disclosure officers. The two opinion surveys responded by executive or independent directors were not used for their subjectivity. 113 companies responded to the survey. One firm, however, did not respond to the questions necessary for index construction¹⁷. This resulted in a sample size of 112 firms. At the time of the survey, there were 686 firms listed in the Korea Stock Exchange (KSE)¹⁸. Thus, the sample firms take up roughly 16% of the total population.

The survey was conducted in a way to have a balanced number of firms in each industry. Table 5.1 Panel A shows the number of firms across seven industries. Notice that survey questions were not sent to any financial institution. Firms, however, are not evenly spread out across different asset sizes. As shown in Table 1 Panel B, 87% of the sample firms have book asset value less than 2 trillion won. This can be a problem because Korean firms are subject to a different governance standard depending upon the size of book asset value, and there can be only a modest variation in corporate governance index among the firms under the 2 trillion won threshold¹⁹. Table 1 Panel B also shows that firms affiliated to *chaebols* are over-represented in firms with large asset size. Without controlling for asset size dummy (1 if above 2 trillion won; 0 otherwise), *chaebol* affiliation will be picking up the effect of government regulation that mandates firms with asset size greater than 2 trillion won to have higher governance standards.

¹⁷ This firm was listed in the stock exchange on January 9, 2003.

¹⁸ There were 683 firms in July 2003, and 686 firms in August 2003.

¹⁹ Firms with book asset value above 2 trillion won must have a 50% outside director ratio, an audit committee, and an outside director nomination committee. Firms with book asset value below 2 trillion won only need to have a 25% outside director ratio.

Table 5-1. Sample Firms by Industry, Asset Size, and *Chaebol* Affiliation

Panel A: By Industry

Industry	Number of Firms	Fraction (%)	CG
Wholesale Trade	16	14.3	48.5
Textiles	16	14.3	39.7
Transport Equipment	18	16.0	47.9
Foods and Beverages	11	9.8	43.3
Electronic and Electrical Products	16	14.3	48.3
Manufacturing of Iron and Steel	13	11.6	45.8
Chemicals	22	19.6	48.3
Total	112	100.0	46.3

Panel B: By Asset Size and *Chaebol* Affiliation

Asset Size	<i>Chaebol</i> Affiliation	Number of Firms	Fraction (%)	CG
< 2 trillion won	Affiliated	16	14.3	48.7
	Not Affiliated	82	73.2	42.1
> 2 trillion won	Affiliated	13	11.6	67.5
	Not Affiliated	1	0.9	69.3
Total		112	100.0	46.3

2) Construction of Corporate Governance Index (CG)

We follow the method used in Black, Jang, and Kim (2003) to construct the corporate governance index. First, we exclude those survey questions not appropriate to be included in the index construction: questions that are subjective (asking for opinions or future plans), questions not directly related to corporate governance structure or practice; questions that are ambiguous as to which answer indicates better governance; questions with minimal variation among firms; questions that overlap highly with one another; questions with very few responses; and questions ambiguously phrased, which can lead to incorrect answers.

This screening process left only 41 questions to be included in the index. *Table 5.2* shows the details of those questions and some summary statistics. Notice that questions are grouped into four categories: shareholders' right (*A*), board and subcommittee structure (*B*), board and subcommittee practice (*C*), and transparency (*D*).

Table 5-2. Corporate Governance Index

Shareholders' Rights (A)

Label	Description (yes = 1, no = 0)	Responses	Mean	"1" Responses
A1	No exceptions to 1-share 1-vote	112	0.87	97
A2	Vote by mail possible	109	0.32	35
A3	No restriction on the qualification of person to receive proxy	110	0.95	104
A4	Sufficient information on AGM items provided to shareholders	111	0.95	105
A5	Sufficient information on related party transaction disclosed to shareholders, and exclusion of related party from the vote	111	0.72	80
A6	Not difficult to identify major shareholders' direct/indirect shareholdings	111	0.87	97
A7	Disclosure of candidate before AGM	111	0.93	103
A8	Allow shareholders to recommend director candidate	110	0.56	62
A9	Allow cumulative voting by AOI	111	0.07	8

Board & Subcommittee Structure (B)

Label	Description (yes = 1, no = 0)	Responses	Mean	"1" Responses
B1	Outside director ratio	112	0.33	N/A
B2	Foreign director exists	112	0.09	10
B3	Different person assumes the role of CEO and board chairman	112	0.07	8
B4	Regularly hold meetings exclusively composed of outside directors	111	0.26	29
B5	Audit committee exists	111	0.23	26
B6	Compensation committee exists	107	0.02	2
B7	Director nomination committee exists	108	0.24	26
B8	Fraction of outside directors in audit committee	25	0.82	N/A
B9	Fraction of outside directors in nomination committee	23	0.55	N/A

Board & Subcommittee Procedure (C)

Label	Description (yes = 1, no = 0)	Responses	Mean	"1" Responses
C1	Outside directors sometimes make changes to board agenda	111	0.21	23
C2	Outside directors sometimes disprove board items	111	0.15	17
C3	Record individual director's position in minutes	110	0.14	15
C4	Accounting or finance expert in the audit committee	30	0.93	28
C5	Independent director chairs the audit committee	31	0.84	26
C6	Record audit committee minutes	30	0.90	27
C7	Compensation for individual audit committee member set at AGM	29	0.14	4
C8	Explicit audit by-law exists	28	0.89	25
C9	Audit committee appoints and supervises external auditor	29	0.83	24
C10	Audit committee appoints and supervises internal auditor	29	0.90	26
C11	Board or compensation committee regularly evaluates CEO's performance	105	0.39	41
C12	Board or compensation committee regularly evaluates CEO's compensation	104	0.39	41
C13	Board meet at least 6 times a year	110	0.89	98
C14	Each board meet lasts at least 3 hours	110	0.03	3
C15	Average board attendance rate is at least 70%	110	0.75	82

C16	Provide education/training opportunities for directors	112	0.54	24
C17	Designated staff exists for outside directors	112	0.41	46
C18	Stock or stock option included for outside directors' compensation	110	0.11	12
C19	Official evaluation system exists and used for directors	112	0.18	20

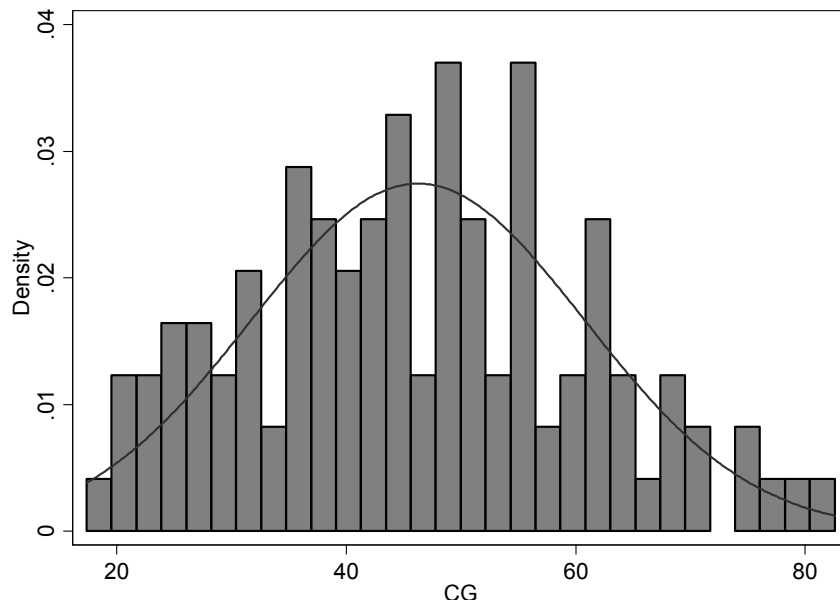
Transparency (D)

Label	Description (yes = 1, no = 0)	Responses	Mean	"1" Responses
D1	Disclose risk management policy	108	0.67	72
D2	Disclose corporate governance policy	109	0.71	77
D3	Sufficient English disclosure though homepage	112	0.52	58
D4	Accounting and audit standard comparable to IAS and ISA	112	0.56	63

To construct the overall index (CG), first, each question is coded to take two values, 0 or 1, 1 if the answer indicates better governance, and 0 otherwise²⁰. Then, using the coded questions, labeled as elements, four subindices are constructed by simply computing the sum of the element values within the group, dividing the sum by the number of non-missing elements, and multiplying by 25. The overall index (CG) is constructed by simply adding the four sub-indices. Each sub-index ranges from 0 to 25, and the overall index ranges from 0 to 100, greater index value indicating better governance.

Figure 5.1 shows the histogram of the overall index (CG). A normal distribution curve is superimposed. Table 5.3 shows the summary statistics of CG and sub-indices. The index mean (median) is 46.26 (45.50); the minimum is 17.40, and the maximum is 82.58.

Figure 5-1. Distribution of Corporate Governance Index, CG



²⁰ Exceptions are B1 (outside director ratio in BOD), B8 (outside director ratio in audit committee), and B9 (outside director ratio in nomination committee), which can take any value between 0 and 1.

Table 5-3. Summary Statistics of Corporate Governance Indices and Subindices

	Code	Number of Firms	Mean	Standard Deviation	Minimum	Maximum
Shareholders' Rights	A	112	17.37	3.32	11.11	25.00
Board & Subcommittee Structure	B	112	4.83	4.68	0.00	21.03
Board & Subcommittee Procedure	D	112	8.92	4.88	2.08	19.74
Transparency	D	112	15.14	7.51	0.00	25.00
Overall Index	CG	112	46.26	14.53	17.40	82.58

3) Firm Performance

Three measures are used for firm performance: Tobin's q , market-to-book ratio, and market-to-sales ratio. *Table 5.3* shows the definition of each measure. Tobin's q is defined by [market value of asset] over [book value of asset], and market value of asset is estimated by a sum of [book value of debt] and [market value of common equity]. Market value of common equity is measured as of June 30, 2003. Market-to-book ratio is defined by [market value of common equity] divided by [book value of total equity]. Book value of total equity is treated as a missing value if negative. Market-to-sales ratio is defined by [market value of common equity] divided by [total sales]. Also notice that in this paper, we do not use stock return or accounting profitability (such as EBITDA/sales) as the measure of firm performance. Instead, I concentrate only on firm valuation measures²¹.

Table 5.4 also shows the definition of the other control variables. Notice that accounting data are measured at the end of fiscal year, ending between July 2002 and June 2003, most often December 2002. If more than one fiscal year ends during the period, we use the most recent fiscal year for balance sheet data and the most recent fiscal year that covers a full year for income statement and cash flow data.

Table 5.5 shows the summary statistics of our three performance measures with other control variables. For our sample firms, the average Tobin's q is 0.83; the average market-to-book and market-to-sales ratios are 0.77 and 0.84, respectively.

²¹ It is worth noting that the association between the corporate governance index and stock return (or accounting profitability) captures something that is quite different. First, the positive association between corporate governance and stock return may be simply indicating that the market is slow in incorporating governance factors into the share price. Thus, any empirical finding of such a positive association may simply be evidence of market inefficiency. Second, the positive association between corporate governance and accounting profitability implies that corporate governance actually improves operating efficiency, and not merely block tunneling activities that give private benefits to the managers (or the controlling shareholders) of a company.

Table 5-4. Other Variables

Accounting data are measured at the end of fiscal year, ending between July 2002 and June 2003, most often December 2002. If more than one fiscal year ends during the period, we use the most recent fiscal year for balance sheet data and the most recent fiscal year that covers a full year for income statement and cash flow data. Market data are measured as of June 2003.

Variables	Description
Tobin's Q	Estimated as [Market value of asset] / [book value of asset]. We estimate market value of asset as [book value of debt + market value of common equity]. Source: Korea Listed Companies Association (KLCA)
Market/Book	[Market value of equity] / [book value of equity]. Source: KLCA
Market/Sale	[Market value of equity] / [total sales]. Source: KLCA
Book Value of Equity	[Book value of asset] – [book value of debt]. We treat this variable as missing for one firm with negative book value of equity. Source: KLCA
Market Value of Equity	Market value of common equity. Source: KSE
Firm Age	Number of years since establishment. Source: KLCA
Sales Growth	Geometric average growth rate of sales during the 5 fiscal years from 1998 through 2002. If data is available for less than 5 years, We compute the average growth rate during the period for which data is available. Source: KLCA
R&D/Sales	Ratio of research and development (R&D) expense to sales. We assume this ratio is zero if R&D expense data is missing. Source: KLCA
Advertising/Sale	Ratio of advertising expense to sales. We assume this ratio is zero if R&D expense data is missing. Source: KLCA
Export/Sales	Ratio of export revenue to sales. We assume this ratio is zero if R&D expense data is missing. Source: KLCA
PPE/Sales	Ratio of property, plant, and equipment to sales. Source: KLCA
Capex/Sales	Ratio of capital expenditures to sales. Source: KLCA
EBIT/Sales	Ratio of earning before interest and tax to sales. Source: KLCA
Share Turnover	2002 average of daily turnover defined as [number of common shares traded] / [number of common shares outstanding]. Source: KSE
Foreign Ownership	Foreign ownership of the firm's common shares divided by common shares outstanding as of December 2002. Source: KLCA
Group Affiliation	1 if a member of one of the <i>chaebols</i> subject to Korea Fair Trade Commission's regulation; 0 otherwise. The Fair Trade Commission identifies such chaebols and their members, in April of each year. Source: Fair Trade Commission press releases.
Sole Ownership	Percentage share ownership by largest shareholder (the shareholder that, together with its related parties, holds the largest number of common shares. Related parties include relatives, affiliated firms, and company directors). Source: KLCA
Disparity	Total affiliated ownership (percentage share ownership by all affiliated shareholders) – sole ownership. Source: KLCA

Table 5-5. Summary Statistics of Other Variables

	Number of Firms	Mean	Median	Standard Deviation	Minimum	Maximum
Tobin's Q	112	0.83	0.79	0.30	0.24	1.95
Market/Book	111	0.77	0.49	0.89	0.11	7.72
Market/Sale	112	0.84	0.70	0.70	0.07	4.38
Book Value of Asset (1,000 won)	112	1.01E+0	2.20E+0	2.77E+0	1.49E+0	2.09E+1
		9	8	9	7	0
Book Value of Debt (1,000 won)	112	5.20E+0	8.58E+0	1.37E+0		1.04E+1
		8	7	9	4979146	0
Book Value of Equity (1,000 won)	111	4.96E+0	1.10E+0	1.49E+0		1.13E+1
		8	8	9	1010393	0
Market Value of Equity (1,000 won)	112	6.85E+1	6.13E+0	3.31E+1		2.62E+1
		0	7	1	5181785	2
Firm age	112	32.69	33.50	13.23	1.00	70.00
Sales Growth	108	0.11	0.07	0.41	-0.32	4.06
R&D/Sales	112	0.01	0.00	0.04	0.00	0.44
Advertising/Sale	112	0.01	0.00	0.01	0.00	0.09
Export/Sales	112	0.32	0.27	0.29	0.00	0.99
PPE/Sales	112	0.48	0.40	0.39	0.00	2.02
Capex/Sales	112	0.05	0.04	0.04	0.00	0.23
EBIT/Sales	112	0.07	0.06	0.09	-0.10	0.84
Share Turnover	112	0.02	0.01	0.02	0.00	0.13
Foreign Ownership (%)	112	7.95	0.96	13.13	0.00	61.46
Group Affiliation	112	0.26	0.00	0.44	0.00	1.00
Sole Ownership (%)	98	23.12	17.67	15.95	2.50	79.01
Disparity (%)	98	17.87	14.93	16.34	0.00	58.95

5-3. Analysis of Association

1) Scatter Plots and Difference-in-Mean Tests

Figures 5.2-5.4 show the fitted lines between our three measures of corporate governance and firm value. As for Tobin's q and market-to-book ratio, the fitted lines are upward sloping, indicating that firms with better governance are more highly valued. When firm performance measures are regressed on CG and the intercept term, the coefficients are 0.0056 and 0.0108, respectively²². This implies that a 10-point increase in CG predicts an increase of market capitalization by 5.6% of book asset value or by 10.8% of book equity value²³. Alternatively, a worst-to-best improvement in CG (by 65-points) predicts an increase of market capitalization by 36% of book asset value or by 70% of book equity value. This is equivalent to a 70-80% increase in share price for a firm with book asset, book equity, and market equity values equal to the sample means²⁴.

When market-to-sales ratio is used as a performance measure, however, the coefficient is negative and insignificant. Figure 5.4 shows that the fitted line is slightly downward sloping. This suggests that our result of positive correlation found for Tobin's q and market-to-book ratio is not robust²⁵.

²² The t -values are 2.96 and 2.61, respectively.

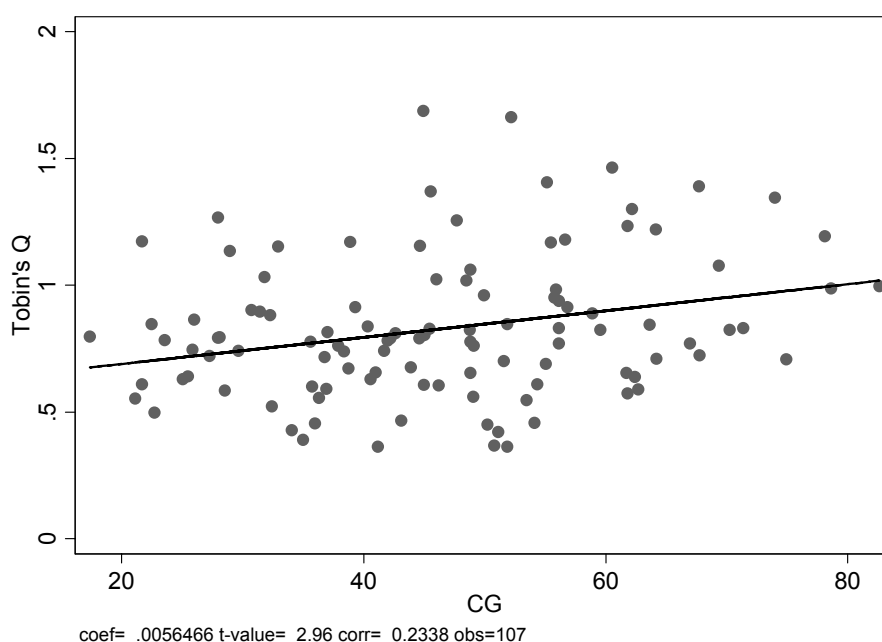
²³ A 10-point increase in CG predicts a 0.056 increase in Tobin's q or a 0.108 increase in market-to-book ratio.

²⁴ Sample means for book asset, book equity, and market equity are 1.09, 0.54, and 0.51 trillion won, respectively.

²⁵ Notice that outliers are removed from the analyses. Outliers are identified and dropped if a studentized residual obtained from a regression of Tobin's q on CG and a constant term exceeds

In *Table 5.6*, we conduct a difference-in-mean test between two portfolios: best versus worst governed firms. The full sample of 112 firms is grouped into quintiles in terms of the *CG* index. For each group, we compute average *CG* index, Tobin's *q*, market-to-book ratio, and market-to-sales ratio. The last two columns show the difference-in-mean between the best and the worst portfolios, and their respective *t*-values. It shows that the best-governed group has Tobin's *q*, market-to-book, and market-to-sales higher than those of the worst governed group. The difference, however, is significant only for Tobin's *q* and market-to-book ratio. *Figure 5.5* shows the difference in a bar chart.

Figure 5-2. Corporate Governance and Tobin's *q*



± 1.96 , and similarly for other market value variables (market-to-book ratio and market-to-sales ratio).

Figure 5-3. Corporate Governance and Market-to-Book Ratio

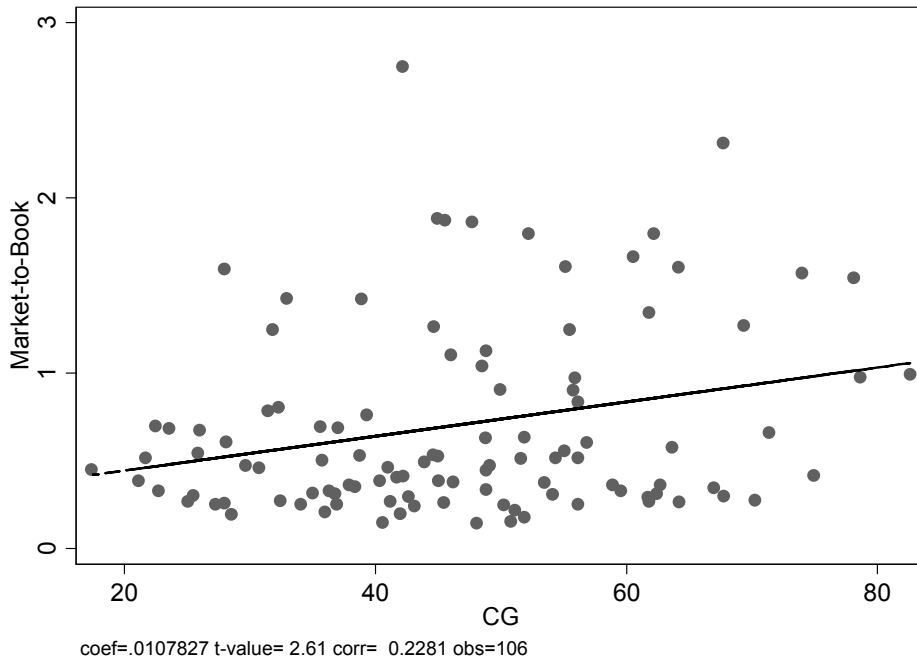


Figure 5-4. Corporate Governance and Market-to-Sales Ratio

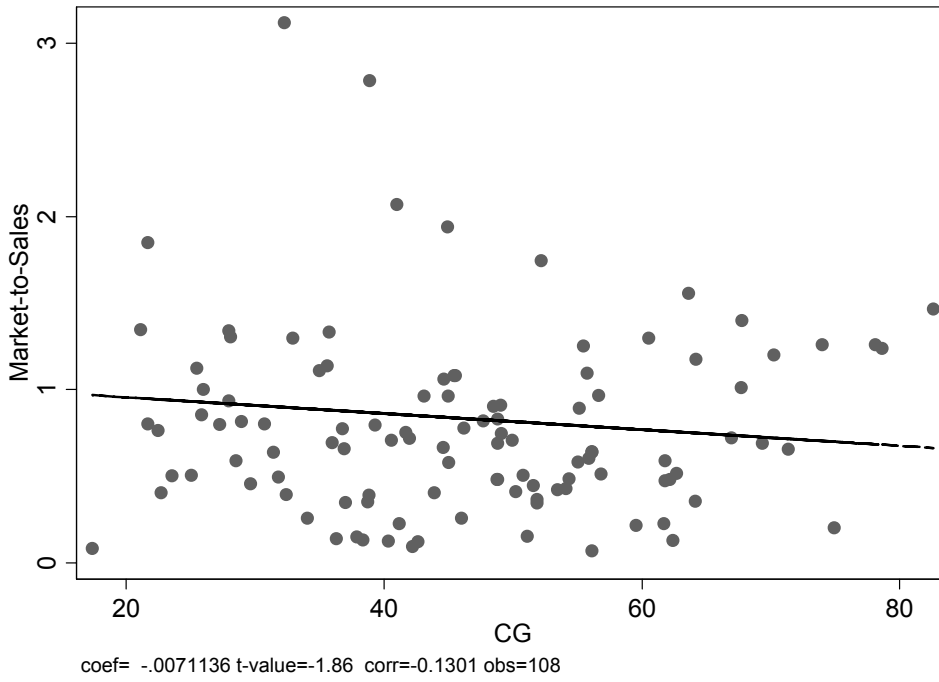
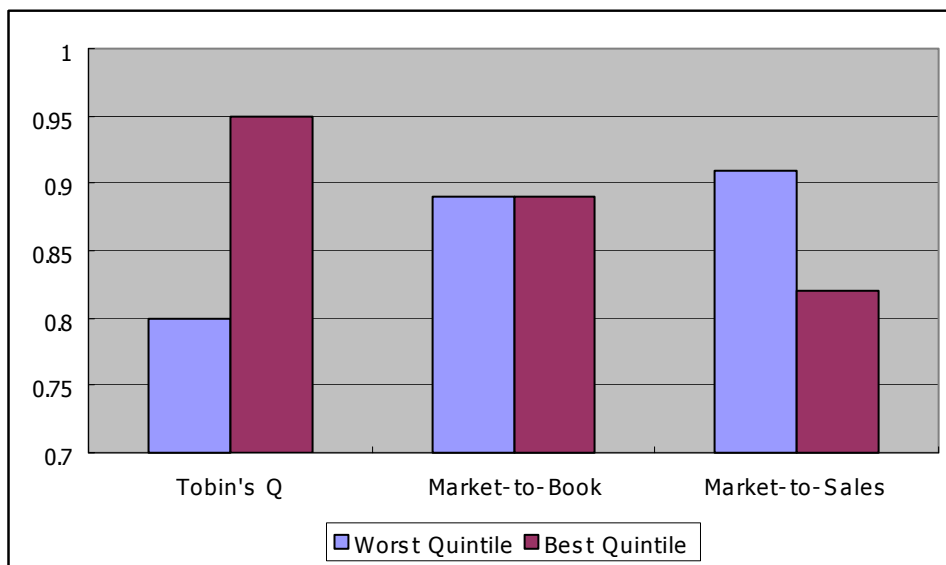


Table 5-6. Difference-in-Mean Test

Full sample of 112 firms are divided into quintiles. The best and the worst groups, in terms of CG index, are compared, and difference-in-mean tests are conducted.

	Worst (1)	(2)	(3)	(4)	Best (5)	Difference (5) – (1)	t-value
CG	26.55	37.98	46.05	54.08	67.56	41.011	25.231
Tobin's q	0.80	0.68	0.90	0.82	0.95	0.150	2.033
Market/Book	0.89	0.47	0.81	0.78	0.89	0.002	0.006
Market/Sales	0.91	0.77	1.07	0.61	0.82	-0.086	0.521

Figure 5-5. Worst versus Best Quintiles



2) Multivariate Regressions

Table 5.7 shows the result of multivariate regression analyses. Equations from (1) to (6) are ordinary least squares regressions of Tobin's q on corporate governance index, CG, with additional control variables added sequentially. Control variables include asset size in logs, firm's age in logs, debt-to-asset ratio, 5-year sales growth, R&D expenditure over sales, advertising expenditure over sales, export over sales, PPE over sales, capital expenditure over sales, firm profitability (EBIT/sales), share turnover, foreign ownership, group affiliation, sole ownership by the largest shareholder, and control-ownership disparity. Notice that two firms are identified as outliers and dropped from the sample. t -values, based on White's heteroskedasticity-consistent standard errors, are reported in parentheses.

The equations in *Table 5.7* show that the positive correlation between corporate governance index, CG, and Tobin's q , found in *Figure 5.2* is not robust to the inclusion of control variables. The coefficient on CG is positive and statistically significant in

Table 5-7. OLS for CG with Different Control Variables

Ordinary least squares regressions of Tobin's q on Corporate Governance Index (CG) with additional control variables added sequentially as shown. 2 observations are identified as outliers and dropped based on studentized residuals obtained from a regression of Tobin's q on CG greater than 1.96 or smaller than -1.96. *, **, and *** respectively indicate significance levels at 10%, 5%, and 1% levels. t -values, based on White's heteroskedasticity-consistent standard errors, are reported in parentheses. Significant results (at 5% level or better) are shown in boldface.

	Tobin's q					Market/Book	Market/Sales
	(1)	(2)	(3)	(4)	(6)	(7)	(8)
CG	0.0052***	0.0044*	0.0023	0.0033	0.0012	-0.0010	-0.0021
	(2.83)	(2.23)	(0.77)	(1.30)	(0.58)	(0.41)	(0.40)
Ln(assets)			0.0218	0.0137	-0.0521	-0.0228	-0.0472
			(0.72)	(0.47)	(1.47)	(0.64)	(0.59)
Ln(firm age)			-0.0157	-0.0398	0.0225	0.0097	-0.0485
			(0.46)	(0.73)	(0.43)	(0.18)	(0.29)
Debt/Asset			0.5061***	0.4481***	0.2920*	0.2177	-0.1488
			(3.19)	(2.93)	(1.72)	(1.11)	(0.33)
Sales Growth				-0.0329	0.0673	0.0446	0.0028
				(0.56)	(1.15)	(0.74)	(0.02)
R&D/Sales				8.0117**	7.9232***	5.4141*	5.8983
				(2.24)	(2.91)	(1.94)	(1.20)
Advertising/Sales				4.9316**	3.7399*	2.8678	4.4647
				(2.05)	(1.98)	(0.95)	(0.78)
Exports/Sales				-0.1285	-0.0789	-0.0473	-0.3263
				(0.94)	(0.71)	(0.36)	(1.22)
PPE/Sales				-0.0022	-0.0142	0.0459	0.1336
				(0.01)	(0.08)	(0.26)	(0.42)
Capex/Sales				0.1286	0.5224	0.4567	-0.4039
				(0.14)	(0.71)	(0.66)	(0.26)
EBIT/Sales				-0.2774	0.0493	-0.1134	-0.1709
				(0.53)	(0.12)	(0.32)	(0.21)
Share Turnover					4.0098***	3.8042**	10.1903**
					(2.79)	(2.63)	(2.47)
Foreign Ownership					0.0087***	0.0068**	0.0147**
					(2.94)	(2.22)	(2.13)
Group Affiliation					0.2473**	0.2414**	0.4658**
					(2.45)	(2.28)	(2.08)
Sole Ownership						0.0017	0.0005
						(0.74)	(0.11)
Disparity						-0.0005	0.0001
						(0.26)	(0.03)
Intercept Term	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Industry Dummies	No	Yes	Yes	Yes	Yes	Yes	Yes
Sample Size	106	106	106	102	102	89	88
Adjusted R-squared	0.0397	0.0531	0.1357	0.2242	0.4365	0.4221	0.3092

equations (1) and (2), but insignificant in equations (3), (4), and (5). Equations (7) and (8) show the result when market-to-book and market-to-sales ratios are used as dependent variables. With the full set of control variables, the coefficients on the corporate governance index are insignificant in these equations.

5-4. Discussion of the Results

The weak results found in *Table 5.6*, however, do not mean that there is no relationship between corporate governance and firm value. It may well be that we have failed to empirically find the relationship that actually exists. The equations in *Table 5.7* use a limited sample of 112 firms, which takes up only 16% of the listed firms in the stock exchange. Also, as noted earlier, among the 112 firms, 87% of them have book asset value below 2 trillion won, decreasing the degree of variation of our explanatory variable, CG. Moreover, the number of control variables used may be disproportionately large compared with the sample size of 112 firms. For example, equation (6) uses 22 control variables²⁶.

The high correlation coefficient of 0.5873 between corporate governance index, CG, and asset size in logs can also be the reason for low coefficient significance²⁷. A *Wald* test conducted for equation (3) shows that CG and $\ln(\text{asset})$ are jointly significant at a *p*-value of 0.073. This is somewhat different from the *t*-test results that say none of the variables is significant. Also, when $\ln(\text{asset})$ is removed from equation (3), the *t*-value for CG doubles from 0.77 to 1.86.

Table 5.8 is from Black, Jang, and Kim (2003) that investigates the relationship between corporate governance and firm value using 495 sample firms in year 2001²⁸. We are introducing this result because it shows how the positive correlation between corporate governance and firm value is sustained even with a large number control variables, as long as the sample size is sufficiently large. Even if equation (5) in *Table 5.8* uses 63 control variables, the coefficient on corporate governance index (CGI) is positive and highly

Table 5-8. OLS for in Larger Samples

Following is a Table from Black, Jang, and Kim (2003). Ordinary least squares regressions of Tobin's *q* on Corporate Governance Index (CGI) with additional control variables added sequentially as shown. 20 observations are identified as outliers and dropped based on a studentized residual obtained from a regression of Tobin's *q* on CGI greater than 1.96 or smaller than -1.96. *, **, and *** respectively indicate significance levels at 10%, 5%, and 1% levels. *t*-values, based on White's heteroskedasticity-consistent standard errors, are reported in parentheses. Significant results (at 5% level or better) are shown in boldface.

	Tobin's <i>q</i>					Market/Book	Market/Sales
	(1)	(2)	(3)	(4)	(5)	(6)	(7)
Overall Index (CGI)	0.0073*** (7.15)	0.0073*** (7.02)	0.0068*** (6.52)	0.0060*** (5.64)	0.0064*** (6.11)	0.0132*** (4.75)	0.0120*** (4.63)
$\ln(\text{assets})$	-0.0328*** (3.82)	-0.0321*** (3.67)	-0.0287*** (2.62)	-0.0369*** (3.24)	-0.0446*** (3.83)	-0.1758*** (4.60)	-0.0329 (1.01)
$\ln(\text{years listed})$	-0.0346*** (2.88)	-0.0416*** (3.42)	-0.0311*** (2.62)	-0.0335*** (2.77)	-0.0338*** (2.74)	-0.0479 (1.56)	-0.0853** (2.56)
Debt/Equity	0.0019*** (3.07)	0.0020*** (3.24)	0.0025*** (3.82)	0.0027*** (3.89)	0.0032*** (4.45)	-0.0072*** (3.97)	0.0026 (1.48)
Sales Growth		0.0797 (1.05)	0.0140 (0.18)	0.0077 (0.10)	0.0209 (0.28)	0.0422 (0.18)	-0.3250 (1.60)

²⁶ 15 variables shown in the table plus 6 industry dummies and an intercept term make up 22 variables.

²⁷ Greater firm size (asset size in logs) may be picking up the effect of government regulation that requires higher governance standard for firms with book asset value greater than 2 trillion won.

²⁸ Number of sample firms reduced from 525 to 495 because of some missing values in the control variables. The figures in the table are from their version as of October 8, 2003.

R&D/Sales	0.1635*	0.1792**	0.1853***	0.1818**	0.0980	0.0287
	(1.65)	(2.03)	(2.69)	(2.57)	(0.52)	(0.31)
Advertising/Sales	0.9561*	0.9050	0.7079	0.6774	1.7184	2.0602*
	(1.72)	(1.64)	(1.27)	(1.23)	(1.16)	(1.75)
Exports/Sales	0.0035	-0.0098	-0.0287	-0.0340	-0.0034	-0.0090
	(0.08)	(0.21)	(0.65)	(0.77)	(0.03)	(0.09)
PPE/Sales		-0.1277***	-0.1248***	-0.1200***	-0.1674*	0.6925***
		(3.02)	(3.02)	(2.92)	(1.71)	(4.59)
(PPE/Sales) ²		0.0227***	0.0215***	0.0209***	0.0225	-0.0471
		(2.87)	(2.74)	(2.65)	(1.05)	(0.68)
Capex/PPE	0.1113*	0.1174*	0.1022*	0.1022*	0.1392	0.2470
	(1.77)	(1.90)	(1.71)	(1.71)	(0.63)	(1.33)
EBIT/Sales	-0.0285	0.0000	0.0366	0.0366	0.3065	0.2134
	(0.26)	(0.00)	(0.33)	(0.33)	(1.13)	(0.66)
Market Share	0.1495	0.1373	0.0566	0.0566	0.2779	-0.5539*
	(0.97)	(0.95)	(0.35)	(0.35)	(0.73)	(1.78)
Share Turnover		0.0023**	0.0023**	0.0022**	0.0023	0.0066*
		(2.58)	(2.58)	(2.52)	(0.91)	(1.75)
Foreign Ownership		0.2817***	0.2778***	0.2778***	0.9993***	0.3637**
		(3.21)	(3.21)	(3.25)	(4.79)	(2.08)
<i>Chaebol30</i> Dummy		0.0423**	0.0425**	0.0425**	0.0491	0.0244
		(2.05)	(2.06)	(2.06)	(0.89)	(0.41)
Sole Ownership		-0.0019	-0.0020	-0.0020	-0.0071	-0.0032
		(1.05)	(1.13)	(1.13)	(1.50)	(0.71)
Sole Ownership ²		0.0000	0.0000	0.0000	0.0001*	0.0000
		(0.99)	(1.10)	(1.10)	(1.74)	(0.00)
ADR (Level 1) Dummy		-0.0415	-0.0415	-0.0415	-0.1938	-0.2121
		(0.64)	(0.64)	(0.64)	(1.59)	(1.16)
ADR (Level 2/3) Dummy		-0.0789	-0.0789	-0.0789	-0.0085	0.1932
		(0.91)	(0.91)	(0.91)	(0.05)	(0.64)
MSCI Index Dummy		0.1002***	0.1002***	0.1002***	0.3049***	0.2512***
		(3.39)	(3.39)	(3.39)	(4.22)	(2.73)
Bank Dummy		-0.1749***	-0.1749***	-0.1749***	-0.0246	0.7777
		(2.83)	(2.83)	(2.83)	(0.12)	(1.62)
Intercept Term	Yes	Yes	Yes	Yes	Yes	Yes
Industry Dummies	4-digit	4-digit	4-digit	4-digit	4-digit	4-digit
Sample Size	505	495	495	495	495	496
Adjusted R ²	0.2362	0.2561	0.2769	0.3170	0.3361	0.4861

significant²⁹. Equations (6) and (7) show that the positive correlation between corporate governance and firm value holds even when firm value is measured by market-to-book or market-to-sales.

From the simple OLS regression using our survey data, and the results from Black, Jang, and Kim (2003) using a larger data set, we conclude that corporate governance does in fact affect firms' market value. The 0.0064 coefficient on the corporate governance index in Black, Jang, and Kim (2003) implies that a worst-to-best change in CG predicts a 0.48 increase in Tobin's q. This is approximately a 160% increase in share price. It is also worth noting that the finding in Black, Jang, and Kim (2003) persists even after controlling for the endogenous nature of corporate governance practices.

Such empirical findings have important public policy implications, and we believe they provide the rationale for further corporate governance reform in the Republic of Korea.

²⁹ 21 variables shown in the table plus 41 industry dummies and an intercept term make up 63 variables.

6. Conclusions

Failure in the corporate governance of large firms has been identified as a major cause of the economic crisis that hit the Republic of Korea in 1998. An extensive set of reform measures has been introduced since then to improve the governance of large firms. This paper was prepared to review the key reform measures and evaluate the corporate governance of listed companies to determine if the reform measures had led to tangible improvements in the corporate governance of firms in the Republic of Korea.

After five years of reform, legal infrastructure concerning corporate governance of corporations in the Republic of Korea is now much more adequate and complete than in the pre-crisis era. The new system allows minority shareholders to exercise their rights more easily, requires management to provide more information about the firm more frequently, has made outside directors an important element in the board of directors and in the decision-making process, and has introduced various mechanisms designed to check abusive practices by dominant shareholders. It also prescribes stronger penalties for violations.

There is no doubt that reform measures have led to significant improvement in the practice of firms on the issues related to corporate governance. Most listed firms appoint outside directors. The board of directors now actually discusses important issues, unlike in the pre-crisis era. Minority shareholders can recommend their own candidates for outside directors to GSM. There are signs that directors are more aware of their legal responsibilities in board meetings. Our survey results clearly indicate that corporate governance practices have improved compared to those before 1998.

However, the survey results also suggest that there remains a fairly wide gap between the laws or the spirit behind the laws and reality. Many outside directors are not independent of the management. Boards of directors have a limited power in making-decisions on such key issues as selection or removal of the CEO, evaluation of the performance and remuneration of the CEO, and the selection of outside directors. The practices of large firms on related party transactions and the disclosure of information also often appear to fall behind the intent of the new laws.

These survey results are consistent with the recent findings about the practices of many corporations in the Republic of Korea. SK Global has recently been found to have accumulated an astronomical amount of deficits over a long period and to have committed illegal accounting practices to hide the fact. Other companies associated with the SK, Hyundai, and other groups were also found to have been involved in illegal diversion of money or illegal accounting practices by dominant shareholders or managers loyal to them. These and other findings, as well as the survey results, clearly suggest that there remains room for improving the corporate governance of large firms in the Republic of Korea.

One area in which improvement in corporate governance can be made within a relatively short period of time is enforcement. It seems obvious that criminal and civil penalties for serious violations of laws and regulations on corporate governance are not effectively enforced, thereby giving dominant shareholders and managers working for them incentives to continue abusive practices.

However, we believe that the core of the corporate governance problem of large corporations in the Republic of Korea lies in the *chaebol* system that allows dominant shareholder to acquire and maintain control of many large firms through borrowing by affiliated firms and cross-shareholding of affiliated firms, with only a small investment of their own money. It is important to realize that this system did not evolve as a result of market forces. Rather, the *chaebol* system emerged as a by-product of the policy choice of past governments. So long as the *chaebol* system continues, dominant shareholders

will be able to appoint most of the directors and dominate the board and GSM with a small investment of their own and it will be difficult to make boards more effective and truly protect the rights of shareholders.

It will be difficult to build and operate large firms successfully based upon the *chaebol* system in the future, as doing so would imply continued forced subsidies from banks and the expropriation of corporations by dominant shareholders. It would be inefficient to let dominant shareholders of existing *chaebol* firms run those companies in the old way, as it would probably result in expropriation of the firms at best, and eventual bankruptcy at worst. It would be unwise and probably unrealistic to try to force banks to keep lending large amounts of money to *chaebol firms* so that the dominant shareholders of the existing *chaebols* can maintain and expand their control over large firms, as the banks will end up insolvent once again. Thus, it seems clear to us that the Republic of Korea needs to find a new model of ownership and control for large firms.

In this context, there are several recent developments that are worth paying attention to. First, the Kim Dae Jung Administration privatized three large public enterprises by installing in them an Anglo-American corporate governance structure. Thus, POSCO, KT, and KT&G became the first three large firms in the Republic of Korea to be owned and controlled by neither a *chaebol* nor the government³⁰. Institutional investors are the main shareholders of the three privatized companies. There exists a suspicion that absence of an agent who plays the role of an owner, such as a *chaebol* family or the government, will eventually lead to inefficient outcomes, similar to the one that occurred to Kia before the financial crisis. On the other hand, some experts believe that the model for the three firms will eventually prevail in other large firms that are currently controlled by *chaebol* families or the government.

Second, there still are several large firms that can be privatized if the government decides to do so. There are several large commercial public enterprises that have not been privatized. In addition, there are large firms that were affiliated with some *chaebols* but became insolvent and ended up becoming subsidiaries of the banks owned by the government, though debt equity swaps. The corporate governance model that the government chooses in privatizing commercial, public enterprises and subsidiaries of government-owned banks will have a crucial impact on the future corporate governance model of large firms.

Third, there has been a steady movement within the government, most notably within KFTC, to reduce cross-shareholdings among firms affiliated with the *chaebols*, which is the main mechanism by which *chaebol* families control a large number of firms and a large amount of assets with only a relatively small investment of their own. KFTC has been urging *chaebol* groups to form a holding company structure in which cross shareholding does not occur. Recently, KFTC announced a plan to amend the Regulation of Monopoly and Fair Trade Act to exempt business groups that formed a holding company structure, or which do have good corporate governance structures, from the application of regulation on investment in other companies³¹.

Fourth, there is a movement within the government to erect a more effective firewall between industrial capital and financial institutions, to install a more profit-oriented governance structure in government controlled financial institutions, and to give institutional investors a more prominent role in corporate governance of large firms. In addition, financial regulation has been steadily strengthened since the economic crisis.

If the government privatizes large commercial public enterprises and former insolvent firms in a way that does not depend on the *chaebol* system, while at the same

³⁰ POSCO became a fully private company in 2001. KT and KT&G were privatized in 2002.

³¹ Currently, business groups are under a regulation that prohibits them from investing in other firms in excess of 25% of their net asset value, although some exceptions are allowed.

time continues its effort to make the financial market more efficient, models similar to the one installed in POSCO, KT, and KT&G may prevail in the corporate sector in the near future. It is more difficult to predict a corporate governance model that will prevail in the financial market, as the financial market is still unstable and as there exists uncertainty about the direction of policy of the Korean government toward the financial market and the relationship between the financial sector and the real sector. However, we believe that the model that is consistent with the principle of a market economy, and that will ultimately prevail, is the one that is based upon an ownership structure in which institutional investors play a key role.

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