

Development of Financial System and Corporate Governance in Korean Business Groups

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Purpose & Main Theme

Purpose

- To investigate the evolution of corporate governance in Korean business groups before and after the 1997 financial crisis

Main Theme

- We have identified three institutional factors which have to do with the linkage between corporate governance and financial system, and evaluate how the factors changed over time.

Government Attitude

Ownership Change

Growth of Civil Society

Before the 1997 Crisis

- Owner–Control System endorsed by the government
- Corporate Governance was not an important issue for Korean groups before the 1997 Crisis.

- Neither Banks nor Stock market exerted monitoring and corporate control function properly.

Banks

- Banks were very passive in screening, monitoring and corporate control.

- Government deeply involved in the allocation of resources

- ▷ Considerable portion of banks' top management from Ministry of Finance and Economy.

- ▷ Various kinds of policy loans distributed through banks via the government's policy priorities.

- No need for banks to perform active role in many of the loans processing.

- From the early 1980s financial liberalization has been pursued simultaneously with financial market opening

- Despite financial liberalization and financial market opening, the corporate governance did not show any sign of improvement mainly because the government still intervened heavily in the credit allocation.

- The government regarded firms, especially big business groups, as the agent of its economic policy

Stock Market (I)

- In the 1960s almost all affiliates of business groups were not listed that time.
- From the late 1960s IPO increased due to “Capital market promotion act” introduced in 1968 and “Public corporation inducement act” in 1972.
- But, the corporate governance was not an important issue for Korean business groups during 1970s and 80s because;
 - Outside investors were not allowed to possess the ownership above a certain threshold
 - Firms did not rely heavily on the stock market to finance their investment
- The growth of stock market and the number of IPO in the 80s and 90s resulted in the decrease of the share of major shareholders

Stock Market (II)

- **Despite these development**, the monitoring function of the stock market was still weak, because there were
 - **No** manager's incentive schemes related to market performance
 - **No threat of takeover**
 - **Lack of** market infrastructure necessary to effective monitoring and corporate control such as credible rating agencies, respectable institutional investors, transparent accounting and disclosure requirements
 - High proportion of the shares possessed by the affiliates of business group implying no threat to the governance structure

Stock Market (II)

- Evolution of the ownership structure of affiliates of the thirty largest conglomerates during 1991 to 2004.

Year	Major shareholder (A)	Affiliates (B)	Controlling shares (A+B)	Number of observation
1986	15.66	33.30	48.96	77
1987	15.56	25.49	41.05	105
1988	10.27	15.81	26.08	104
1989	13.90	17.01	30.91	133
1990	13.29	21.58	34.87	154
1991	11.81	18.24	30.05	152
1992	12.96	30.19	43.15	299
1993	11.56	28.58	40.15	320
1994	11.39	28.38	39.77	325
1995	12.24	27.36	39.60	316
1996	11.72	27.39	39.11	322
1997	15.68	29.23	44.91	384
1998	12.96	32.70	45.66	314
1999	11.90	26.91	38.80	226
2000	13.04	28.68	41.72	249
2001	9.54	36.13	45.67	285
2002	8.29	39.82	48.11	297
2003	8.80	41.05	49.85	283
2004	9.60	38.65	48.26	254
Average	11.88	30.09	41.97	242.05

Source: Kim (2012) p. 83-84

Consequence of weak corporate governance and monitoring

- The debt to capital ratio was very high

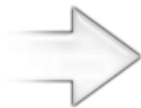
- At the end of 1997, 396.3%(Manufacturing Firms) and 405.8%(Thirty Largest Groups)

- NPL accumulated very quickly

- At the end of 1997, 5% according to Korean gov. 43% according to IMF

- Few exit of weak corporations

- No corporate restructuring initiated by banks



Breakout of the crisis

After the 1997 Crisis

- The 1997 crisis has dramatically changed the nature of corporate governance.

- The transformation of the corporate governance in Korea after the 1997 crisis can be attributed to the combination of three factors:

Government Initiatives

Ownership Changes

Growth of Civil Society

Government Initiative

- The government no longer plays the role of the guardian of controlling shareholders because their mismanagement was considered as one of the main causes of the crisis.
- The intervention of the government in the management of banks significantly reduced.
- The gov. initiated institutional changes:

1 Actions aiming at overcoming financial vulnerabilities of corporations and bank

- Forced reduction of leverage ratio,
- Elimination of cross-guarantees,
- Ability of chaebol to exercise power over financial affiliates restricted,
- Prohibition of direct ownership links for affiliates of chaebol, and
- Recapitalization and restructuring of banking system.

Government Initiative

- The gov. initiated institutional changes:

2

Legal and regulatory changes which directly improved the corporate governance

- Minority shareholder rights strengthened by lowering the threshold for various shareholder initiatives,
- Outside board of directors introduced,
- Fiduciary duty of corporate directors introduced,
- Cumulative voting for directors allowed ,
(In practice, very few companies introduce the cumulative voting in the articles of incorporation)
- External auditors and corporate accounting officers subject to stiffer penalties,
- Approval by the board of directors required for related-party transactions.
- Introduction of economic criteria for evaluating applications for corporate reorganization,
- All forms of mergers and acquisitions, including hostile takeovers by foreigners, permitted,
- Amendment to the Commercial Code to make managers and controlling shareholders more accountable to minority shareholders.

Ownership Change (I)

- Foreign ownership increased with the abolishment of ceiling on foreign shareholdings in individual companies in 1998.
- Foreign ownership is the more pronounced the bigger is the size of business group.

* The proportion of foreign ownership according to the size of business groups

	2001	2002	2003	2004	2005	2006	2007	2008
Four largest	21.71	22.32	24.73	28.19	26.25	24.23	22.11	17.82
5th to 10th	4.80	5.07	11.49	15.77	19.43	18.90	15.30	11.30
11 th -20th	14.82	13.34	19.98	23.88	18.06	16.66	15.94	11.20
Below 21th	7.72	11.78	12.88	13.01	13.59	13.18	12.79	9.42
Total	14.79	15.20	18.96	21.77	20.09	18.70	17.02	13.02

Source: Kim (2012) p. 114

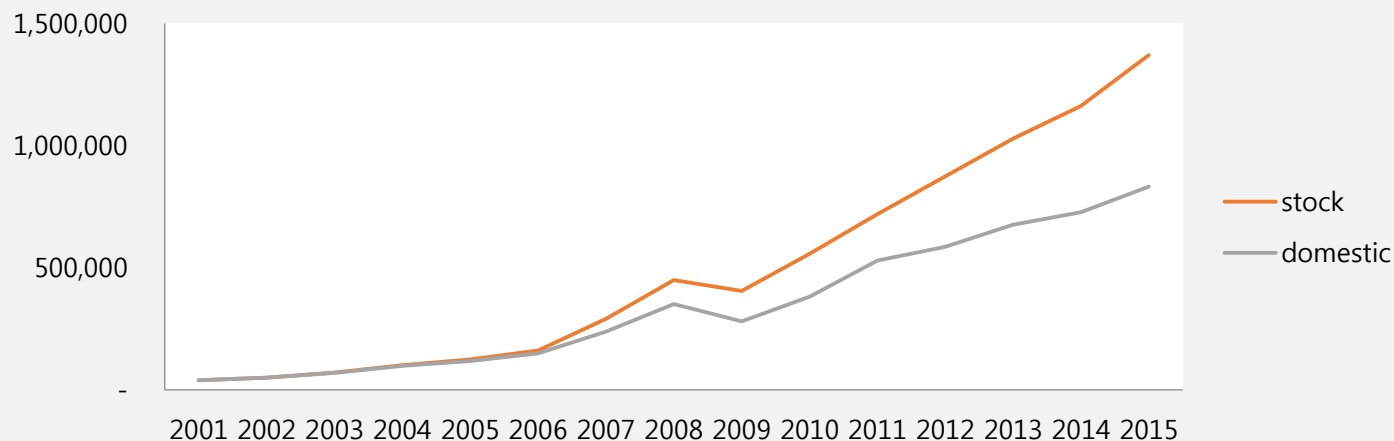
- The effects of foreign investors on the corporate governance in Korea are not clear-cut.
 - Park et al. (2004): There exists a positive correlation between foreign ownership and firm value.
 - Rowe and Lee (2011): foreign investors increase their ownership in the firms with good corporate governance.

- The evidence does not imply that the increase of the ownership of foreign investors improve the corporate governance.
- But, given that foreign investors prefer firms with better corporate governance, the presence of foreign investors might indirectly provide incentives for managers and controlling shareholders to improve the corporate governance.

Ownership Change (II)

- The increase of equity investment of national pension plan is impressive in 2000s.
- Even though the voting right of institutional investors was recognized in 1998, the voice of institutional investors in exercising voting right is still conservative
- Institutional investors will play increasingly more important and active role in the corporate govern

* <Figure 1> Evolution of equity investment of national pension plan (Billion Won)



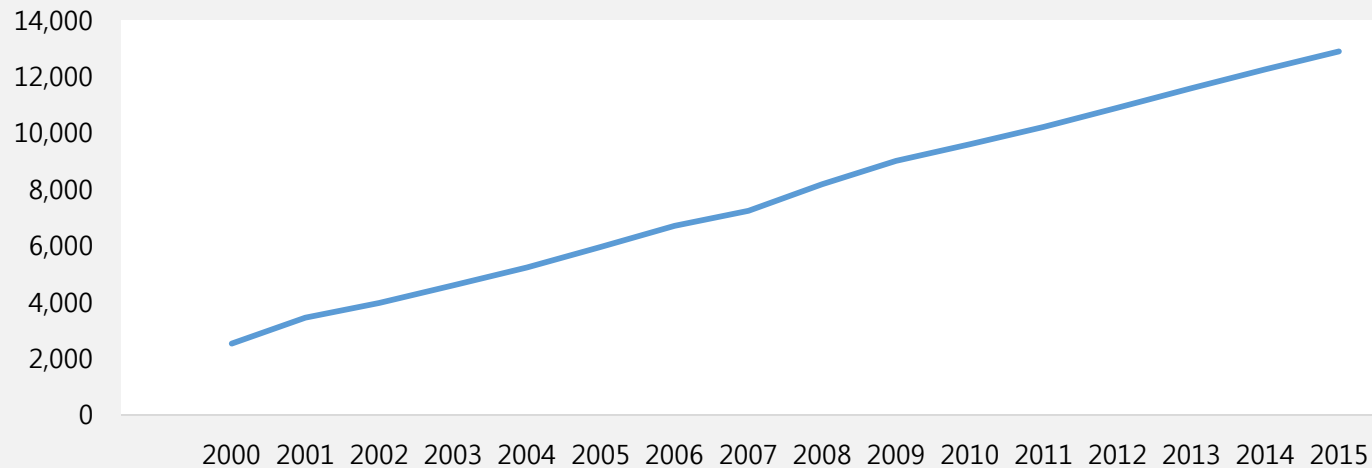
Source: National Pension Service

Growth of Civil Society

- The growth of NGOs contributed to improve the corporate governance

- They have been requiring transparency of business groups and eradication of cozy relations between business and politics.

* <Figure 2> Increase of the number of Non-Profit Organizations



Source: Statistics Korea

The Crisis of Corporate Governance for Controlling Shareholders

- The ability to control the groups at their will decreased substantially and the threat of hostile takeover became real

- The ways to overcome the “Crisis”

- To manage the business respecting profit maximization principle.
- To rely on the shareholding of affiliates of the group

- ▷ But this method is constrained by the ceiling on the total amount of equity investment
- ▷ This regulation, which had been introduced in 1986, was abolished in 1998 to facilitate corporate restructuring after the crisis, reintroduction in 2001, and abolished again in 2008.
- ▷ New formation of circular shareholding is no more permitted since 2014

Remaining problems and Challenges for the Future

- Controlling shareholders' excessive control rights in spite of the ban to form new circular shareholdings



It is necessary to find ways to strengthen the rights of outside investors through the reinforced role of institutional investors, both domestic and foreign.

- Good rules, but poor implementation



It is necessary to find ways to increase the effectiveness of the rules

Ex.) Limited role of outside directors to protect the minority shareholders
→ To change the appointment process?

- Confusion of social value system after 2008 GFC



How to harmonize reinforced accent given to the “social responsibility of large business groups” and the “shareholder maximization principle” which has been the motor of the improvement of corporate governance since the 1997 crisis?