Organisation for Economic Co-operation and Development

Organisation de Coopération et de Développement Économiques

in co-operation with

the Korea Development Institute

and with the co-sponsorship of the Government of Japan
and the World Bank

Conference on

"CORPORATE GOVERNANCE IN ASIA: A COMPARATIVE PERSPECTIVE"

Oh-Seok Hyun
Director, General Economic Policy Bureau
Ministry of Finance & Economy

Korea's Corporate Governance System

Under the Remedies

Seoul, 3-5 March 1999

Ladies and Gentlemen:

Let me first say how pleased I am to be the panel discussant at the Conference on Corporate Governance in Asia organized by the Organization for Economic Co-operation and Development (OECD) in co-operation with the Korea Development Institute (KDI).

I imagine that all of us here today oversee the evolution of the Asian crisis since its onset. At this time last year, several Asian countries as well as Korea had already begun to feel the downward slide of socio-economic conditions as a result of the foreign exchange crisis.

As the financial crisis deepened and spread, even relatively healthy economies in the region, in terms of “fundamentals”, have not been immune to economic downturn. In order to manage effectively the crisis, deep analyses on the causes of the economic crisis will be set in as a first agenda on the table. In this context, I will draw first on the causes for the financial crisis in Korea.

1. Causes for the Financial Crisis

There is little question that Korea’s crisis was rooted in the near depletion of foreign currency reserves. Nonetheless, the latent structure of the crisis owes to other more fundamental flaws in the Korean economy. Domestic origin of the crisis can be traced back to long-standing structural weakness of the Korean economy, although one should acknowledge the exogenous effects of the epidemics of the Southeast Asian crisis.

Structural reform is a task that Korea has long put off. In fact, Korea’s failure to address structural imbalances, in combination with its poorly managed transition toward full economic integration in the years before the financial crisis, amounted to a kind of disaster in waiting. Once the crisis hit, international investors became acutely aware of the lack of transparency in Korea’s economic system. The economy was then subject to a sudden and severe drop in confidence on the part of the international financial community. Korea is now seeking to redress this situation.

2. Flaws in Korea's corporate governance: the backbone of the crisis

Before turning into the Korea's efforts to improve corporate governance, I would like to briefly touch upon structural flaws in its corporate governance system.

The most critical fault line on the path to the crisis was the rapid build-up short-term domestic and foreign debt to finance the investment boom of the large conglomerates, known as *chaebols*, in the 1990s. By the end of 1997, Korea's thirty largest *chaebols'* average debt to equity ratio had soared to over 500 percent, 100 points higher than in 1996 and the five previous years. Such traditionally high leveraging reflected, among others, the *chaebols'* pursuit of rapid growth on a global scale by diversifying into "prestigious" capital intensive, high-risk industries.

This strategy had seemed to be successful in the 1970s and 1980s, when Korean companies were able to achieve scale economies and establishing extensive distribution channels was pivotal to increasing shareholder value. Given the limited size of domestic equity market and preferential access to credit from docile banking sector, this strategy left the *chaebols* with excessively-leveraged balance sheets and ill-prepared for the rigorous global competition. Economic slowdown initiated by a sharp drop in export prices in those sectors that have over-capacity triggered a serial bankruptcy in 1997. The surge in insolvencies had a devastating impact on the financial sector, and shaken financial market confidence.

These problems are closely related to weak corporate governance. Those weakness are summarized in four folds: i) the concentration of corporate ownership, ii) the lack of transparency, iii) the limited role of financial institutions, and iv) the deficiency in foreign direct investment.

- A relatively high level of internal ownership creates the reluctance of owner-managers of companies to rely on equity finance, which would reduce their control. In theory, this corporate structure has advantages by reducing agency costs. Given their important role in the economy, however, implicit government's role as an insurer or underwriter of large investment projects surfaces a moral hazard, which encouraged the *chaebols* to expand their businesses faster and in a riskier manner than otherwise. At this point, the legacy of "too-big-to-fail" is involved in.

- Associated intrinsic flaws come from the lack of transparency. Due to the complex ownership structures in *chaebols* and cross-guarantee practices among their affiliates, it is hard to grasp their business activities and financial positions only with their financial statements.

- Another problem rises from the lack of supervision from financial institutions. Financial institutions as a debt provider should actively monitor and supervise debtors in commensurate with their exposures. The weakness of competitive pressures and the absence of corporate governance system to monitor their own performance neglect the role of financial institutions in governance agents.

- The limited existence of foreign direct investment exacerbates Korea's corporate governance. Until recently, foreign direct investment has not been able to function as potential entrants or raiders, nor as active shareholders in publicly held corporations. Otherwise, foreign direct investment would play a role as a governance agent.

3. Strategies for economic restructuring

Against this backdrop, the Korean government has launched its rigorous efforts to restructure the economy from the onset of the crisis. Most notables in the progress Korea has made are the reforms in the financial sector. With the exit of non-viable financial institutions and injection of fiscal resources, Korean banks were able to obtain a clean bank status with BIS ratios of 10 to 13 percent.

Having made substantial progress in financial sector reform, a more focus on restructuring is put on the corporate sector. This somewhat overlapping sequencing of reform has been guided in large measure by the fact that Korea does not have a well-developed capital market. It has been necessary to secure the soundness of Korea's financial institutions first so that they would then be in a good position to deal with their corporate clients. Yet, unlike financial sector reform, whereby the government has taken responsibility for enforcing more strict regulatory and prudential standards, the bulk of corporate sector restructuring, under the principle of a market economy, must be initiated by the corporations themselves.

In addition, labor and public sector restructuring has also been rigorously pursued to give each sector the flexibility and efficiency to keep up with other sectoral reform.

4. Reforms in corporate governance

The corporate governance reforms have been led by the creditor banks under the Five Principles of Corporate Restructuring agreed between the government and the business leaders in January 1998. The government limited itself to assist the private sector initiative by providing the legal and institutional framework of the five principles: i) enhancement of corporate governance, ii) prohibition of cross-guarantees between business affiliates, iii) improvement of corporate financial structure, iv) business concentration on core competence, and v) responsibility reinforcement of governing shareholders and management.

Let me update the progress Korea has made so far for the improvement of corporate governance.

Transparency and accountability

The most important vehicle toward corporate governance reform is the improvement transparency. To this end, a number of improvements have been made in the accounting system. The most important accounting reform was the requirement for corporations to produce combined financial statements (CFS), beginning in fiscal year of 1999. Without CFSs, it is hard to assess the extremely complicated web of intra-group transactions. In addition, Korean “Generally Accepted Accounting Practices” (GAAP) was revised to be more in line with the international accounting standards. Another movement Korea has made was the reinforcement of independence of external auditors. Top thirty chaebols and all listed companies were required in February 1998 to organize “independent audit committee” represented by minority shareholders and creditors.

Another improvement associated with the corporate governance reform was the reinforcement of accountability of the management. The outside director system was introduced in order to rectify the practice of illicit control of the firm through proxy equity participation. Appointed by the shareholders meeting from among revered personalities, the outside director represents the interests of minority shareholders and the public interest at large. All listed companies are required to appoint outsider directors, and by October 1998 all 752 companies appointed 764 outsider directors.

Associated improvements made are the allowance of voting rights to institutional investors in September 1998. The threshold for stockholder derivative suit was lowered from 1 percent to 0.01 percent of total shares.

In addition, laws were revised in December 1998 to regard a major shareholder as a de factor director. This system is expected to impose legal accountabilities on major shareholders.

Exit of non-viable firms

The first step to address the exit of non-viable firms was the amendment of bankruptcy related laws in February 1998. The focal point of such revisions was the simplification of legal proceedings for corporate rehabilitation and bankruptcy filing. Included are the facilitation of market exit of non-viable firms and better representation of creditor banks in the resolution process.

Also, the creditor banks established a formal review committee to assess the viability of 313 client firms showing signs of financial weakness, in May 1998. Upon completion of their evaluation, creditor banks listed 55 firms as non-viable, of which 20 are affiliated with top five chaebols, and 31 with top sixty-four. Creditor banks denied new credit and cross-subsidy bailout to effectively exit these 55 non-viables out of the market.

In addition, the creation of a market for corporate control cannot be neglected. In a sense, the most powerful mechanism to improve corporate governance is corporate takeovers since inefficient management are disciplined. One of the important leeways to activate those takeovers is the promotion of foreign direct investment. To this end, foreign direct investment climate was improved in May and October 1998 through revisions of related laws and all kinds of mergers and acquisitions were allowed in May 1998.

Financial structure

In order to rectify corporations' reckless borrowings, top 64 largest companies had signed financial pacts with their respective creditor banks. The pacts required those companies to reduce their debt to equity ratios under 200 percent. New cross guarantees were prohibited in April 1998, and all the existing cross guarantees should be eliminated by March 2000.

For the effective implementation of those measures, the development of domestic capital market will be imperative. To this end, the requirement for public offerings were eliminated in February 1998, and corporate restructuring fund, amounting 1.6 trillion won, was launched in October 1998. In addition, many companies are actively looking foreign partners.

Business swaps

Another element of the corporate governance involves business swaps between top five *chaebols* to streamline over-investment and enhance efficiency in such key industries as semiconductors, petrochemicals, aerospace, rolling stock, power plant equipment, vessel engines, and refining. In December 1998, the top five reached an agreement on much of deals and are currently working on closing the rest of deals.

Following the December 7th agreement, the "Big Five" signed financial pacts with their respective creditor banks that called for dramatically reducing the number of their subsidiaries from 272 at the end of 1998 to 136 by the end of 2000. In addition, the top five pledged to slash their debt to equity ratios and improve their financial structure by asset sales, recapitalization, and foreign capital inducement of US$ 28.8 billion.

All five *chaebols* have already eliminated all cross-debt guarantees within each group. *Chaebols* pledged to enhance management transparency by shifting the management control to the board of directors, appointing outside directors and independent auditors for their affiliates, and preparing for filing group-wide combined financial statements.

Future policy directions for corporate governance

Towards the end of 1998, institutional frameworks for economic restructuring were successfully built. 1999's restructuring policies focus on the software aspects of reform. That is, global standards in the banking and corporate sectors will be applied, management will be renovated, and transparency will also be strengthened.

Against this background, the Korean government will monitor the progress of chaebols' restructuring, including business swaps, and improvement of financial structures. By the end of this year, debt to equity ratios of top 30 *chaebols* will be reduced under 200 percent. Cross debt guarantees will be eliminated by March 2000.

Another important dimension involves the streamlining of bankruptcy laws. Although those laws were revised in 1998, they still have a room for further development for the expeditious exits of non-viable firms and rehabilitation of insolvent but viable companies.

In addition, as the OECD Corporate Governance principles are expected to be adopted, an emphasis will be given for the introduction of a more advanced corporate governance system and the improvement of transparency.

To this end, a Committee on the Improvement of Corporate Governance, launched in February 1999, will study Korea's corporate governance practices and devise a proposal for Korea's corporate governance to be in line with global standards. Associated are reinforcement of role of board of directors, institutional investors, and creditor financial institutions in monitoring management.

Accounting standards will also be subject to improvement. An independent body in charge of establishing new accounting standards will be organized in coming June. Also, the role of outside auditors will be reinforced.

4. Conclusion

Ladies and Gentlemen:

One year has passed since the economic crisis. We have much to reflect upon in terms of both the challenges the crisis has posed and the steps we are taking to resolve them.

By dint of hard work and struggle, we are now seeing some light at the end of tunnel in terms of recovery. However, it is still very much a jungle out there. As for corporate governance, much rigorous works will be necessary for Korea to reach a level of advanced economies.

In the face of these conditions, Korea will remain firm in its drive to improve Korea's economic system, including corporate governance. In this respect, the draft OECD Corporate Governance Practices will be very valuable. We are actively assessing those Practices and reform our corporate governance system.

In closing, let me say my sincere gratitude to the OECD, KDI, World Bank, and the Government of Japan for their excellent preparation of this Conference.

Thank you.