

Korean Corporate Governance and Firm Performance

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1. Introduction

After being touted as one of Asia's economic tigers, Korea's 1997 economic collapse shocked many people. Many argued that after the other Asian countries' crises, creditors' and investors' massive flight from the Korean currency market caused the collapse of Korea's high-debt economy. However, this argument ignores both Korea's low corporate profitability over the last decade and the fundamental causes of the financial sector's weakness. After discussing how high-debt equity ratios and low profitability helped cause the 1997 Korea economic crisis, I will examine their determinants and how poor corporate governance allowed such low profitability to occur for so long. Lastly, I discuss recent reforms and their preliminary results.

Supporters of the currency flight view point to Korea's high-debt economy over the past decade to support their argument. In comparison to other countries, Korea's debt-equity ratio was very high. Furthermore, Korea's high debt-equity ratios have been the norm for many years. In the currency flight view, although these high debt-equity ratios spurred high growth, they also left Korean firms vulnerable to fickle creditors and investors. When other Asian economies collapsed (such as Thailand and Indonesia), creditors and investors pulled their money out of Korean firms. The ensuing liquidity crisis forced many firms to default on their loans. Thus, many firms failed, and the Korean economy collapsed.

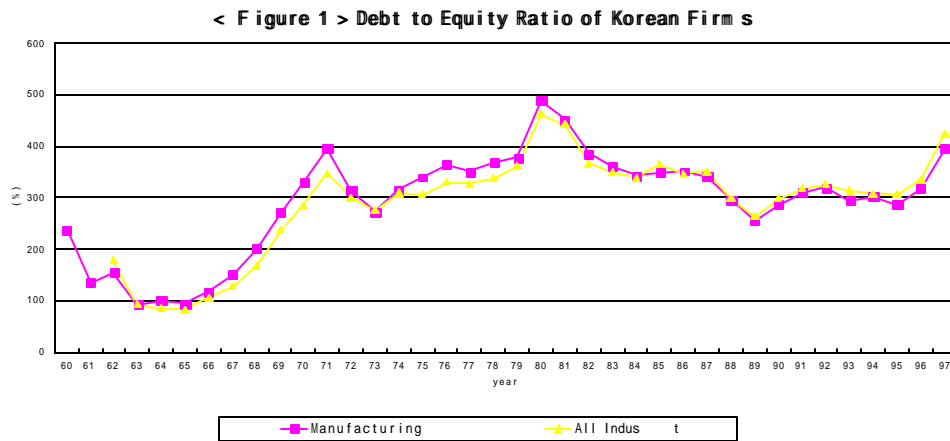
Criticisms of the above argument include a) the absence of high profits, b) the many firm failures before the collapse of other Asian economies, and c) the argument's dependence on creditors' and investors' irrationality. With high debt-equity ratios, Korean firms were expected to yield high profits on their equity. However, the average rate of return on the equity was often lower than the prevailing interest rates for loans (Joh, 1999). The return on capital had been lower than its opportunity cost. So, on average, the capital used in the corporate sector was wasted on unprofitable projects.

Korea's weak corporate governance allowed this low profitability to continue for almost

10 years before the crisis. Many firms (including six of the thirty largest conglomerates) failed before the collapse of other Asian economies simply because their low profits fell short of their required loan payments (Joh, 1999). The failure of many large firms severely weakened financial institutions. Rationally concerned about their investments and loans, foreign investors sold their Korean stocks, and foreign banks demanded repayment of the short-term loans given to Korean financial institutions (rather than rolling them over to the following year, which had been the usual practice). Foreign banks and investors exacerbated the crisis; they did not cause it.

2. Crisis and corporate sector problems

High debt-equity ratios and low firm performances helped cause the 1997 economic crisis. Joh (1999) showed that the average debt-equity ratio of Korean firms has been very high for a long time and did not rise before the crisis. In 1997, the average Korean firms' debt-equity ratio was higher than other countries (Korea, 396%; US, 154%; Japan, 193%; and Taiwan, 86%).¹ As Figure 1 shows, the debt-equity ratio was always high and did not sharply increase in recent years.



source : Financial Statement Analysis

¹ For Taiwanese firms, the figure is based on 1996 data. Source: financial statement analysis for 1997

When six of the thirty largest *chaebols* (business groups) went bankrupt before the currency crisis, it triggered a cascade of non-performing loans. Starting with the default by Hanbo (ranked #14) in January 1997 well before the Asian crisis, a series of large *chaebols'* defaults raised suspicion regarding the conglomerates' survival and the fundamental soundness of the corporate sector.

<Table 1> Six Bankrupt Conglomerates Among 30 Largest *Chaebols*.

(All defaulted in 1997)

	Hanbo	Sammi	Jinro	KIA	Haitai	New-Core
Default Date	Jan 23	Mar 19	Apr 21	July 15	Nov 1	Nov 4
Ranking	14 th	25 th	19 th	8 th	24 th	28 th

Source: Shin and Hahn (1998)

Due to their size and importance,² the failure of these *chaebols* had a devastating impact on the economy, leading to a series of bankruptcies. Table 5 shows the rapid increase in the ratio of non-performing loans from 1997 to 1998.³

< Table 2> Non-performing Loans (end of period)

(Unit: trillion won)

	Dec. 1997	Mar. 1998	Jun. 1998	Sep. 1998	Dec. 1998
Precautionary	42.8	57.7	72.5	N/A	N/A
Substandard or below (A)	43.6	59.6	63.5	64.0	60.2
Bank	31.6	38.8	40.0	35.0	33.6
NBFI	12.0	20.8	23.5	29.0	26.6
Total Loan (B)	647.4	668.7	624.8	614.3	576.5
A/B (%)	6.7	8.9	10.2	10.4	10.5

Source : Financial Supervisory Commission

² Chung and Yang (1992) report that the shares of the top 5 and top 30 *chaebols* in GNP were 9.2% and 16.3% respectively. The Korea Economic Research Institute reports that in 1995 the shares of the top four and top 30 were 9.2% and 16.2% respectively.

³ Many criticize that these official numbers underestimated the true size of NPLs. Some estimate that NPLs reached somewhere between 200 and 300 trillion won. (See KDI (1998b))

2.1 Causes of high debt-equity ratio

Government incentives for large firms, firms' cross-holdings and cross-debt guarantees, and banks' loans to failing firms helped cause high debt-equity ratios.

2.1.1 Government provided incentives and bailouts for large firms

Ever since the 1960s, past Korean governments mobilized and allocated scarce capital to firms and industries (such as the light export-oriented industries and heavy and chemical industries) based on its assessment of their contribution to the nation's industrialization and modernization.⁴ The government used a compliance mechanism that effectively guided the behavior of major businesses.⁵ Through nationalized banks, the government provided targeted firms with capital at lower interest rates than time deposit rates or inflation rates until the beginning of the 1980s. Financial institutions simply implemented the government decisions and made no independent decisions. Lee (1992) argued that the Korean government operated an internal capital market and channeled subsidized credit to carefully targeted firms and industries.

However, *chaebols* were not always profitable and occasionally faced financial distress. During these occasions, the government repeatedly intervened. During the debt crisis of 1972, the government froze their debts and gave them with bailout loans.⁶ Between 1979 to 1983, firms in the heavy and chemical industry⁷ suffered from over-investment and from the depression following the second oil shock.⁸ To deal with insolvency problems associated with excessive capacity, the government gave financial subsidies and consolidated firms to create more concentrated markets. In the 1980s, the

⁴ Kim, C.Y. (1997) reports that President Park Chung Hee held monthly cabinet meetings that decided policy measures to facilitate exports. Kim also reports that exporting firms received credits at a lower interest rate and paid corporate income tax at 50% of the usual corporate income tax rate.

⁵ Jones and SaKong (1980)

⁶ For more of the 1972 government emergency measure, see Cho and Kim (1997).

⁷ These industries include power generating equipment, cars, engines, heavy electric equipment, telephone switching systems, refined copper, etc.,

⁸ Economic Planning Board (1994)

government adopted some liberal pro-competition policies, privatizing commercial banks during 1981-83, and reducing the gap in interest rates between industrial policy loans and general loans.⁹ During 1984-1988, many debt-ridden firms became insolvent, only to have the government intervene yet again.¹⁰ By providing the creditor banks with special 3% to 6% interest rate loans (the general bank loan rate was about 12%),¹¹ the government allowed them to write off bad debts, extend debt maturities, and replace existing debt with longer-term debt at a lower rate.¹² In short, the government had repeatedly given large firms preferential subsidies and bailed them out during times of financial distress.

2.1.2 Firms inflate size with cross-holdings and cross debt guarantees

Large firms received both low-cost capital for undertaking large projects and implicit guarantees from the government. So, firms had an incentive to exaggerate their true size and performance. This was particularly easy for business group firms that engaged in intra-group transactions and interlocking ownership.¹³ For example, through interlocking ownership, a firm (say A) invests its assets in an affiliated firm (say B). Through double-counting of these investments, the sum of the assets of A and B can exceed the total assets of the group.

Chaebols can also borrow more money through cross debt payment guarantees. On average, a few large and better performing firms in a *chaebol* typically guaranteed 80% of the *chaebol* firms' total debt. (Lee (1998)) Using debt payment guarantees, even poorly operating subsidiaries borrowed money easily. The total debt payment guarantees

⁹ See Table 1

¹⁰ The government revised its tax exemption law to facilitate the insolvency procedure in December 1985.

¹¹ The Bank of Korea provided six commercial banks with 1.7 trillion won between December 1985 and May 1987 and recovered only 0.37 trillion won by September 1990. See Lee, S. (1995) and Kim (1991).

¹² See Cho and Kim (1997) and Kim (1991). In total, acquiring firms and consolidating firms received subsidies worth 7.28 trillion won. Source: Ministry of Finance document submitted to Congress (1988).

¹³ At least 60% of firms subject to external auditing report that they have legally affiliated firms. See Joh

often far exceeded their total equity, raising doubts on its validity.

<Table 3> Debt Payment Guarantees of the 30 Largest *Chaebols*

(unit: trillion won)

Year	Equity (A)	Amount of Debt Payment Guarantee			Ratio (%)	
		Restriction (B)	No Restriction (C)	Sum (B+C)	B/A	(B+C)/A
1993	3.52	12.06	4.49	16.55	342.4	469.8
1994	4.28	7.25	3.82	11.07	169.3	258.1
1995	5.07	4.83	3.38	8.21	95.2	161.9
1996	6.29	3.52	3.23	6.75	55.9	107.3
1997	7.04	3.36	3.13	6.49	47.7	92.2

Source: Fair Trade Commission.

2.1.3 Loans to failing firms

Banks continued lending to high debt-equity firms as Table 4 shows. The largest 30 *chaebols* had very high debt-equity ratios (348% in 1995, 519% in 1997), some exceeding 1000%. The continuing flow of capital to large conglomerate firms, including groups with negative equity, suggest that financial institutions were not making lending decisions based on their monitoring of *chaebol* finances.

<Table 4> 30 large *chaebols*' high debt equity ratios

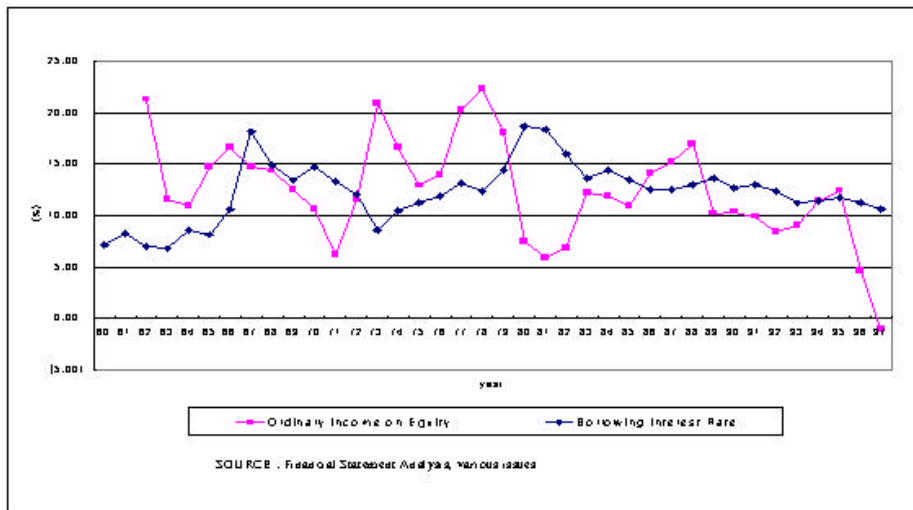
	1995	1996	1997	1998	1999	2000
Average debt equity ratio	347.5	386.5	519.0	369.1	306.6	218.7
Groups whose debt/equity ratios exceed 1000%	3	3	4	2	2	2
Groups with negative equity	0	0	2	8	5	3

(1999)

2.2 Controlling shareholders helped cause Low Firm Profitability

With high debt-equity ratios, Korean firms were expected to yield high profitabilities on their equity. However, as Figure 2 shows, the average rate of return on the equity was often lower than the prevailing interest rates for loans. On average, the return on capital had been lower than its opportunity cost for almost 10 years before the crisis. So, the capital was, on average, wasted on unprofitable projects. The inadequate corporate governance system did not provide sufficient monitoring and discipline to end this waste.

<Figure 2 > Profitability of Korean firms



low controlling shareholder ownership. Likewise, independent firms outperformed *chaebols*. The results are consistent with the argument that controlling shareholders with a large disparity between control and ownership rights pursue their own private interests at the expense of other shareholders. For more for this, see Jensen and Meckling (1976) and Joh (2000a).

<Table 5> Determinants of Firm Profitability

	Ordinary Income/Sales	Net Income/Sales
Ownership	0.0438 (2.45)	0.0240 (1.32)
Ownership ²	0.0005 (2.01)	0.0006 (2.12)
Debt ratio	-0.0748 (-7.53)	-0.0620 (-6.51)
<i>Chaebol</i> dummy	-0.9859 (-2.32)	-0.5514 (-1.29)
Log (Asset)	0.0837 (0.37)	0.1561 (0.70)
R&D/sales	0.0526 (0.61)	0.1961 (1.00)
Export/sales	0.0165 (2.33)	0.0156 (2.08)
Advertisement/sale	0.1848 (2.03)	0.1961 (2.07)
Market share	0.0287 (2.45)	0.0166 (1.48)
Industry & time dummies	Yes	Yes
Num. Of Obs.	1925	1925
Adjusted R ²	0.1841	0.1261

Note: numbers in parentheses are t-values controlling for White's heteroskedasticity.

3. Weak corporate governance allowed low profits to persist

According to Shleifer and Vishny (1997), corporate governance defines the ways in which the supplier of finance to corporations is assured of getting a return on their investment in a firm. By defining the firm's rules, incentives and goals, management, capital suppliers and other stakeholders affect the mechanisms by which capital and resources are allocated, profits are distributed, and performance is monitored. In a

corporate governance system that operates for the benefit of all shareholders,¹⁵ management pursues maximization of firm value. Korean firms' low profits persisted because the corporate governance system did not induce firm management to maximize firm value.

Factors that contribute to weak corporate governance include: (a) no credible exit threat, (b) inadequate financial information, (c) lack of financial institution monitoring, (d) few legal rights or types of protection for minority shareholders and (e) a negligent board of directors.

3.1 No credible exit threat

Ideally, the market continuously revolutionizes from within, incessantly destroying the old firms and creating new ones, according to Schumpeter (1952). As weak firms fail, new strong firms will replace them and employ people who lost jobs. Resources are released and shifted from the dying factories and firms to entering producers. In Korea, this 'creative destruction' process was so weak that resources were not efficiently allocated

Joh (2000) showed that the Korean manufacturing sector has high turnover. The annual birth rates and death rates for company plants are both high, 14.4% and 17.7%, respectively. Using the establishment data between 1990 and 1998, the total entry and exit rates including switching plants exceed 24 percent and 32 percent, respectively. These turnover rates are higher than those of most countries are. However, the turnover rate for larger plants is much lower. Although small plants exit the market when they fail, large plants often do not (Joh, 2000). So, large firms did not face an effective exit threat. Without a credible threat to firm survival, managers had less incentive to increase firm performance. In addition, large failing firms continued to operate, taking away resources from profitable ones.

¹⁵ With financial market liberalization and globalization, shareholders' interests become most important.

<Table 6> Annual Entry and Exit Rates of Plants and Outputs 1990-1998

(unit: %)

	Continuing		Entries				Exits			
			Births		Switch-ins		Deaths		Switch-outs	
Year	Plants	Output	Plants	Output	Plants	Output	Plants	Output	Plants	Output
1990							14.2	3.7	27.0	18.8
1991	42.3	69.3	14.8	4.3	15	11.7	15.9	4.4	12.0	10.3
1992	48.2	70.2	13.4	3.8	7.5	5	15.2	7.4	15.7	13.6
1993	44.0	70.9	18.8	6.4	9.3	9.5	16.7	4.9	11.2	8.3
1994	47.4	75.5	12.4	3.1	6.4	5.1	20.4	5.7	13.4	10.6
1995	46.0	74.7	17.1	4.0	8.9	6.9	16.6	5.5	11.4	8.9
1996	49.8	74.0	12.3	3.8	8.1	6.1	18.3	5.1	11.5	11
1997	44.0	71.9	10.1	3.7	6.5	7.4	24.5	6.2	14.9	10.8
1998			16.2	3.9	19.7	11.4				
Mean	46.0	72.4	14.4	4.1	10.2	7.9	17.7	5.4	14.6	11.5

Note: The mean is a simple average over time. Source: Joh (2000)

Large firms faced a weak exit threat for the following reasons: lengthy bankruptcy procedures, an underdeveloped corporate control market and government support for weak large firms.

3.1.1 Lengthy bankruptcy procedures

There were three formal bankruptcy procedures: liquidation, composition, and corporate reorganization (similar to Chapter 11 of the US bankruptcy code). However, these formal insolvency procedures for large firms were rarely used in Korea until 1997. Lengthy proceedings, often lasting several years, invited strategic and opportunistic debtor behavior, thus reducing the attractiveness of bankruptcy alternatives for creditors

(see Table 7). Although more than 17,000 cases of insolvency were reported in 1997,¹⁶ only 490 were filed before the court. Of these, only 38 liquidations were filed.¹⁷ Moreover, the law allowed firms that owed less than 250 billion won to use a settlement procedure in which the court played a rather minor role while the debtor retained possession of its estate. Composition offered few guarantees to creditors, and 65.7% of insolvent firms (322 out of 490 cases) applied for the settlement procedure. The remaining firms applied for corporate reorganization, but their financial conditions often had deteriorated too far to restructure successfully. Koo (1998) showed that the average debt-equity ratio of these firms was 1200%.

<Table 7> Number of Cases and Duration of Bankruptcy Proceedings (1993-95)

Number of years	≤ 3	4-5	6-7	8-10	11-15	16-20	Total
Successful turnaround, conclusion	1	1	2	6	7	1	18
Failure, termination	17	12	10	8	5	0	52

Source: Court Administration Agency, recited from Koo (1998)

3.1.2. Underdeveloped corporate control market

Government regulations on mergers and acquisitions (M&A) and ownership structure also weakened the exit mechanism. Until recently, hostile mergers and acquisitions were not allowed and even friendly M&As were limited to small firms.¹⁸ Any M&A by foreigners involving over two trillion won in assets required government approval. The mandatory tender offer system required investors who bought over 25% of a firm's shares to publicly purchase over 50% of them. In addition, *chaebols'* ownership structure with large interlocking ownership by affiliated firms obstructed takeovers by outside investors. Controlling shareholders with less than 10% direct ownership have control through interlocking ownership by other firms in the same *chaebol* group.

¹⁶ Bank of Korea

¹⁷ OECD (1998)

¹⁸ In May 1998, six months after the 1997 crisis, the Korean government removed all restrictions on M&A activities.

Therefore, corporate raiders needed to buy the sum of the incumbent controlling owners' shares, the interlocking firms' shares and one more share.

<Table 8> In-group Ownership Trends of the 30 Largest *Chaebols* (unit: %)

	'89	'90	'91	'92	'93	'94	'95	'96	'97
30 largest <i>chaebols</i>	31.5	31.7	33.0	33.5	33.1	33.0	32.8	33.8	34.5
5 largest <i>chaebols</i>	35.7	36.3	38.4	38.6	37.2	35.0	n.a.	n.a.	36.6

n.a. = not available

Source: Korea Fair Trade Commission (1999).

3.1.3. Government support for weak large firms

Before the crisis, large firms hardly faced any exit threats because of the government's implicit guarantee.¹⁹ As discussed earlier, the government had repeatedly rescued many failing *chaebols*. Because of the debt payment guarantees, poorly-performing subsidiaries can cause financial distress for high-performing subsidiaries. So, the failure of a few subsidiaries in a large conglomerate can cause a chain reaction of failures and devastate the economy. Partially due to its impacts on employment and on the overall economy, the government arranged for some banks to lend more money to these failing firms. This government behavior led to the belief that *chaebols* were "too big to fail."

3.2. Inadequate Financial Information

Inadequate financial information hinders management evaluation, thereby obstructing rewards for good managers and removal of poor managers. The market lacked accurate and reliable information on firm performance and management due to low accounting standards, lack of transparency, and government-triggered incentives for firms to exaggerate their size. Accounting standards in Korea did not meet accepted

¹⁹ Kukjae's failure in 1984 was a politically motivated exception.

international standards, so poor auditing hindered efforts to monitor and evaluate firm performance. For example, when firm A guarantees B debt payment, A need not report such action accurately, thereby hiding A's higher risk. Furthermore, with easy access to debt-financing, *chaebols* need not attract and retain equity investors through financial transparency. Indeed, withholding information from other shareholders facilitates firm control by the dominant shareholder.

It is difficult to measure how opaque the financial statements were before the crisis. However, recent auditing of financial statements by the Financial Supervisory Service reveals many flaws. On average, the review found that 72% of audits had flaws. Improper auditing ranges from minor errors to fraud. So, firm financial statements in earlier years facing less scrutiny were likely more flawed and misleading.

<Table 9> Review of Auditing of firm's financial statement 1998-2000

	Firms (A)	Improper auditing (B)	Ratio (B/A)
Regular auditing (listed firms)	97	29	29.9 %
Irregular/ Frequent auditing	6	3	50 %
Special auditing	48	46	96 %
Consigned Auditing	118	116	98 %
Total	269	194	72 %

Source: Financial Supervisory Service (2000)

3.3. Lack of financial institution monitoring

Financial institutions in Korea have not provide d adequate monitoring even though Korean firms rely heavily on debt for their financing. There are at least two reasons. Although once-nationalized commercial banks became privatized in the 1980s, the legacy of government control remained through interest rate regulation, credit policies

and government-appointed top executives. As a result, banks did not develop suitable credit evaluation and risk management techniques to make informed loan decisions. Banks did not have an incentive to monitor or discipline managers. Often, they gave loans large firms with implicit government guarantee or cross debt guarantees. Moreover, the linkage between *chaebols* and financial institutions exacerbated the problems. According to Kim (1999) *chaebols* with non-bank financial institutions show a high debt equity ratio while those *chaebol*-controlled financial institutions show a lower return on assets. This results suggests that *chaebols* were transferring resources from financial institutions to poorly performing industrial firms.

3.4. Few legal rights or protection for minority shareholders

Minority shareholders had few legal rights or protections. So, they had difficulty preventing controlling shareholders and firm managers from pursuing wasteful projects. Most shareholder rights required a minimum 5% ownership that few shareholders had. Shareholders without at least five percent ownership could not do any of the following: remove a director, file an injunction, file a derivative suit, demand a convocation, inspect accounting books, inspect affairs and company property, and remove liquidation. Over 97% of shareholders lacked these rights as they were small investors with less than 1% ownership.

3.5. Negligent board of directors

Without a significant exit threat and little financial institution monitoring, internal monitoring and discipline becomes more important. The board of directors should monitor and discipline managers, thereby mitigating the opportunistic behavior of controlling shareholders. However, the board of directors did not. Because board members were elected through separate majority votes, minority shareholders lacked representation on the board of directors. The controlling shareholders selected all the directors and, hence, controlled them.

We have indirect evidence that the board did not represent all the shareholders' interests and did not monitor controlling shareholders. Before the crisis occurred, over 75% of firms polled said that they rarely or never considered the minority shareholders' opinion in selecting directors and auditors. In practice, board members were accountable only to the controlling shareholders as small shareholders with less than five per cent of ownership could not remove them. Consequently, they did not hinder controlling shareholders from pursuing their private benefits.

<Table 10> Degree of Influence of Minority Shareholder Opinion in Selecting Directors and Auditors

(unit: %)

Type of firm	Always	Often	Sometimes	Rarely	Never
Owner-manager	6.2	6.2	12.5	31.3	43.8
Hired manager	2.9	5.7	14.3	40.0	37.1

Source: Jun and Gong (1995).

4. Effects of recent corporate governance reforms

4.1. Major Changes

Since the crisis occurred, several measures have been introduced to improve corporate governance system including more credible exit threats for large firms, mandated outside directors, and increased roles for boards of directors.

Many large conglomerates including Daewoo, which was ranked second in 1999, have fallen to insolvency procedures. Although the government continues to try to rescue some *chaebols* (e.g., Hyundai), these failures signal a new government policy of non-intervention in the corporate sector. So many failing *chaebols* were losing so much money that the government may have lacked the funds to save them from bankruptcy.

<Table 11> Large *chaebols* under insolvency procedures

(as of 1999. 8)

	Daewoo	Donga	Halla	Kohap	Jinro	Anam	Haitai	Kangwon	Shinho
Type	Workout	Workout	Reorgani- zation	Workout	Composi- tion	Workout	Composit- ion	Workout	Workout
Rank	2	11	17	18	22	23	24	26	29

In addition, all M&A's including hostile takeovers and foreign takeovers have been legalized. Compared to 1997, the number and amount of M&A's especially by foreign firms have skyrocketed in 1999 (see table 12). In short, large failing firms face more credible exit threats than before.

<Table 12> M&A trends before and after the crisis

	Total Cases	Cases by foreigners	Amount (Billion \$) by foreigners
1997	418	19	0.84 B.
1999	557	168	8.8 B.
Change (%)	139 (33.2%)	149 (784%)	7.86 B. (935%)

Source: Korea Fair Trade Commission (1998, 2000)

The government has lowered the minimum shareholding requirements for many shareholder rights (see table 13). Now, any shareholder with 0.01% of firm ownership can file a derivative suit. Despite such changes, monitoring by individual small shareholders remains unlikely mostly due to the free-rider problems associated with the public good property of monitoring.

<Table 13> Key Items of Minority Shareholders' Rights

	Former Commercial Code	Amendments	Securities and Exchange Act
Requesting Removal of a Director	5%	3%	0.5% (0.25%)
Right to Injunction	5%	1%	0.5% (0.25%)
Derivative Suit	5%	1%	0.01%
Shareholder's Proposal	-	3%	1% (0.5%)
Demand for Convocation	5%	3%	3% (1.5%)
Inspect Account Books	5%	3%	1% (0.5%)
Inspect Affairs and Property	5%	3%	3% (1.5%)
Requesting a new liquidation receiver	5%	3%	0.5% (0.25%)

Note: Appraisal rights of general shareholders' meeting convocation and shareholder proposals estimated on the basis of voting stocks.

Numbers in parentheses show the case of corporations with more than 100 billion won paid-in capital at the end of the most recent business year.

Source: Joh (1999)

After the crisis, outside directors are mandated and their role has been strengthened. But the situation has not changed much. In 1999, more than 73% of the board members selected were recommended by the controlling shareholders. Moreover, the overall activity of outside directors is disappointing. Their agenda approval rate are very high, exceeding 99%. Moreover, when the boards have to approve transactions involving controlling shareholders, the attendance rate is very low. In short, the oversight role of the boards of directors is still limited.

<Table 14> Selection of outside directors

Recommended by	Controlling shareholder	Main creditor	Employee	Others
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Ratio	343 (73.8%)	25(5.3%)	20 (4.3%)	77(16.6%)
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Source: Korea stock exchange, 2000, 11

< Table 15> Outside directors' attendance and approval rate

Agenda approval	Board Attendance	Other involvement
99.3%	66.0%	6.2%

Source: Korea stock exchange, 2000

<Table 16> Directors' Attendance rate classified by agenda category

Immediate public disclosure	One-day disclosure	Transactions with controlling shareholders	Others
61.4%	52.7%	36.6%	47.5%

Source: Korea stock exchange, 2000

4.2. Effects of Reform

It is too early to evaluate the full effects of corporate governance reforms on firm performance. Nevertheless, stock prices provide an initial guide. The rise and fall of stock prices likely reflect investor beliefs regarding the reforms.

Using a multi-factor model analysis of daily stock market return between each *chaebol* and its affiliated firms for the largest 25 *chaebols* between January 1996 and December 1999, Joh and Ryoo (2000) showed that *chaebols'* subsidiary firms' stock prices vary more independently than before. This result suggests that investors believe that the subsidiaries are behaving more independently than before. However, changes in the stock prices of the 5 largest *chaebols'* subsidiaries still highly correlate with their affiliated firms. This result suggests that investors believe that firms in the 5 largest

chaebols still maintain their tight inter-connections and act as entities rather than as independent firms.

Joh and Ryoo (2000) also examined the extent of a controlling shareholder's private gains. Since they are difficult to detect, the proportional voting rights premium (PVRP) is used. PVRP is the difference in common stock price and preferred stock price divided by the preferred stock price. Common stocks have voting rights and lower dividends. In contrast, preferred stocks have no voting rights but receive higher dividends. Thus, the premium increases during corporate control contests over a firm (e.g. M&As) when control rights are sought or when a shareholder can reap private gains through control-ownership disparity. Otherwise, the PVRP will be smaller. For example, the average PVRPs in the U.S., Sweden, and the UK are 5.3 percent, 6.5 percent, and 13.3 percent, respectively.

In contrast, the PVRP has been very large in Korea with wide fluctuations. The average PVRP was around 95 percent of a common share in 1996. Because takeover threats were almost non-existent due to legal constraints, the premium before the crisis mostly represents private benefits. The average PVRP in 1999 after restructuring was lower than in 1996, but still around 81 percent. In contrast, This result suggests that investors believe controlling shareholders' private gains are still high, but smaller than before the crisis.

5. Conclusion

High debt-equity ratios, long-term low firm profitability and a weak corporate governance system helped cause Korea's 1997 economic crisis. High debt-equity ratios stemmed from government policy, firms' inflation of their size and negligent bank lending. Government industrial policy pushed development of specific industries and gave special incentives to large firms. Firms then inflated their apparent size through crossholdings and cross debt guarantees. Moreover, government-directed banks continued lending money to low profitability firms. As a result, many large firms had

huge debt-equity ratios.

Low firm profits were caused partially by unprofitable investment in affiliated firms. Control-ownership disparity and *chaebol* organization correlated with low profitability, suggesting that controlling shareholders exploited these unprofitable investments for private gains. Moreover, Korea's weak governance system allowed such low profitability to persist for nearly ten years. Factors that contribute to the failure of corporate governance include: (a) no credible exit threat, (b) inadequate financial information, (c) lack of financial institution monitoring, (d) few legal rights or types of protection for minority shareholders and (e) negligent boards of directors.

After maintaining high debts and low profitabilities for a long time, the Korean corporate sector experienced massive failures in 1997. Partially prompted by changes in government policies regarding the corporate governance system, including letting many of the largest *chaebols* to fail, the corporate sector has been under pressure to change its goals from size maximization to value maximization.

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