Improving Corporate Governance in Korea

by

Yu-Kyeong Kim

THESIS

Submitted to
School of Public Policy and Management. KDI
In partial fulfillment of the requirements
For the degree of

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ABSTRACT

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The Korean financial crisis owes largely to a corporate governance failure for large business groups (chaebols), where their inefficient resource allocation could not be checked. Effective internal mechanisms for supervision or monitoring of management were virtually absent. This paper concerns basically with the question of what the priorities for corporate governance are and how to improve corporate governance in Korea. After briefly discussing characteristics of business groups such as their ownership and management, the paper reviews the past characteristics of corporate governance, spontaneously derived from the business group. In order to devise ways to improve the current chaebol system, the strengths and weakness of chaebols are evaluated. Finally, after discussing the core of corporate governance reform, I recommend a strategy for chaebol reform. The central argument is that, in view of the weak external capital market, underdeveloped industrial development and unstable political situation, it would be better to resuscitate chaebols through improving governance structure, while addressing its weakness by radically strengthening internal discipline mechanism, rather than to break them up.

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Ⅰ. Introduction

It is hard to deny that Chaebol contributed to economic growth in the past growth phase. Diversification led to economies of scope and other synergies between businesses, and overcame imperfections in factor markets. Relations with government and Chaebol reduced market failures. Weak corporate governance was not a serious problem, since there was no separation of ownership and management and therefore no principal-agency problem. It ensured speedy decision-making.

However, chaebol system encountered difficulties under a new economic environment. While this system worked well in the previous decades of rapid economic development under the umbrella of government, its weakness began to outweigh its strengths in the period of market maturity, in the globalization era.

In other words, investors start to resist the exclusive dominance by the controlling shareholder-manager. The absence of the devices to check and balance the corporate control is expected to bring about risks more and more. As world capital market gets integrated, outside investors' role is extended and the function of capital market to supervise management is more emphasized. [1] In addition, government is changed from a partner to a reformer with respect to Chaebols.

[1] According to distribution of ownership of share, released by KSE (1999.4), the percentage of foreign investor form 18% of total share ownership in Korea, but 13.4% in Japan, 8.7% in Taiwan, 6.8% in U.S, 16.3%(U.K)

The Korean financial crisis is, to a large extent, a corporate governance failure for large business groups, where their over-leveraged and inefficient business expansion could not be checked. Effective internal mechanisms for the supervision or monitoring of management were virtually absent. As a mechanism to define relationship between the shareholders, directors and management of a company, searching for the desirable corporate governance model is a problem that confronts us. This paper concerns basically with the question of what the priorities for corporate governance are and how to improve corporate governance in Korea.

Arguments over corporate governance should start from understanding the characteristics of business group. It is because each country has its unique business group style according to its internal or external economic circumstance, and has developed corporate governance depending on its condition. Korean chaebols are no exception.

Korea's economic growth has been driven by the rather authoritarian government and large business groups. Entrepreneurs in these groups have aggressively exploited overseas markets for trading, while heavily investing in the local economy. Government guidance and intervention in the financial sector, which reduced various uncertainties prevailing in the early stage of development, were fairly effective in mobilizing resources and allocating them for the best growth performance. However, continued government intervention gave rise to moral hazards on the part of both chaebols and financial institutions and the highly leveraged growth of large chaebols. All these have been responsible for economic inefficiencies and the increased vulnerability of the economy.

The Korean financial crisis is a corporate governance failure for large business groups, where their over-leveraged and inefficient business expansion could not be checked. It was possible because effective internal mechanisms for the supervision or monitoring of management were virtually absent. Evidences confirm the concern that the real corporate governance challenge is to protect outside investor such as minority shareholders from the expropriation of controlling owners and to discipline poor management.

With regard to chaeol reform, some reformers stand by chaebol break-up through a complete separation between ownership and management. When we consider our weak external capital market, underdeveloped industrial development and weak political situation, it would be better and feasible choice to resuscitate chaebols through improving governance structure, while addressing its weakness, rather than to break them up.

When it comes to improving corporate governance, it is critical to strengthen mechanisms for internal discipline such as minority shareholder rights and outside directors as a way to control lax management by manager and to protect investors. Of course, there has been a kind of external control such as M&A and stock and capital market, as an outside discipline in developed countries. However, in the case of Korea, where external capital market is underdeveloped, it is difficult to expect that market discipline would work properly as in other developed countries. Capital market is so immature, that stock price has rarely reflected firm performance and stock market is likely to fluctuate by stock manipulation rather than firm's performance. As a mechanism of market discipline hardly exists, internal discipline would be better devices to make up demerit of corporate governance problems in Korea. So, I discuss how to develop corporate governance in Korea, focused on internal discipline

The rest of the thesis is organized as follows. In section Ⅰ, as the starting point of our debate on corporate governance, the characteristics of business groups such as its ownership structure would be discussed and then, characteristics of current corporate governance would be analyzed. Through observing three distinct types of business groups as well as corporate governance (including U.S and Germany-Japan and Korea), above assumption: each country's corporate governance has evolved in the process of overcoming challenges that corporations face, would be evaluated.

In section Ⅱ, our attention is directed to chaebol groups with the discussion of their strengths and weaknesses. In order to devise ways to improve the current chaebol system, objective evaluation for chaebols should come first. Based on such evaluation, this section discusses what should be the priorities for chaebol governance reform. In section Ⅲ, I search for strategies for corporate governance reform in Korea, on the basis of the priorities for reform in corporate governance discussed in the previous section. After briefly evaluating recent reforms, strategies for future reforms will be discussed.

Ⅱ. Evolution of Big business groups & Corporate governance in Major countries: U.S, Japan-Germany and Korea

1. Characteristics of big business groups in major countries

For the last several decades, the Korean government controlled the financial sector to channel scare resources into strategic leading sectors. Firms, mostly belonging to Chaebols in these industries, were given external capital through loans from government-controlled financial institutions. The corporate governance system today inherits its unique characteristics from growth patterns of firms during this period.

Each country has its unique business group style according to its internal or external economic circumstance, and has developed corporate governance depending on its condition. The differences in governance structure mainly come from ownership structure. It means that the question of who has a right to decide and who is responsible for is influenced by ownership structure.

Therefore, as a background to a discussion of corporate governance, I will observe the characteristics of big business groups, including the ownership structure. It is because the characteristics of corporate governance spontaneously come from the characteristics of business group structure. It will be very useful to understand why each country has developed different corporate governance system with different goals.

As each county has different history of business groups, it has developed its unique ownership or management structure. Social or economic environment such as the degree of maturity of capital market has shaped the structure of business groups. But there are a few patterns that emerge across countries such as U.S model and Japan-Germany model. I will compare characteristics of the Korean business groups such as their ownership structure and management structure to those of U.S, Japan and Germany.

1.1. Major Characteristics

Korean business groups are near to individual enterprise controlled by the head of chaebol or one professional manager in reality, even though affiliated-firms are legally independent. Despite their small ownership(less than 13%), a founder and her family maintain control through prevalent institutional ownership that constitutes a large portion of cross-holdings.[2] As leading chaebols pursued diversification strategy, for instance one chaebol engaging in everything from shipbuilding industry to dairy goods processing industries, top 10 chaebols managed at least 200 individual enterprises in 1983.[3] Late industrial countries like Korea have a tendency to diversify into unrelated production activities, because it could disperse risk and make use of insufficient resources.[4] According to a study of diversification in Korean business

[2] Joh Sung-Wook (19999) Control, Ownership, and Firm Performance:the case of Korea KDI
[3] Kim Dae-Whan & Kim Gyun (1999) Reform of Korean Chaebols, Nanam
[4] Rumelt (1974) Strategy, Structure, and Economic Performance. Havard University Press. Unrelated diversification is to diversify unpredominant or a large number of unrelated production lines.

groups in 1984,[5] top 10 groups managed 213 affiliated firms and 80% of them are unrelated production lines. On the contrary, only 10% of them were related to each other. **Japanese business groups** are connected with each other horizontally, whereas Korean Business groups are connected vertically. Japanese business consolidation went forward by three forms: cross ownership of shares, affiliated financing from banks and exchange of human resource. Even though each member is legally independent, they are linked systematically by those forms under the large business groups. CEO Committee, which consists of heads of member firms play the key role as a board of director. But this committee does not have authority to control management in each group and there is no hierarchy among groups. It means that they exist as independently as they sometimes competes each other. **U.S business groups:** conglomerates, which are consisted of unrelated multi-products, have increased a lot since 1960s.[6] They are created by M&A rather than self-diversification. Conglomerates are a kind of business groups, which the head office control unrelated business groups, acquired by M&A. But the head office is consisted of financial, legal, management affairs etc, which is not a work-site operation. The size of head office is small but component firms' autonomy is certified. Head office decides allocation of resource and exit or entry in industry.

[5] Jung Koo-Hyun (1987) Growth strategy and management structure in Korean corporations. Korean Chamber of Commerce.
[6] Kang Myeong-hun (1999) A comparative study on the Business groups: Korea, Japan and U.S, SIAS Publication

1.2. Ownership Structure

Ownership structure of **U.S and U.K** is characterized by large part of ownership on individual stockholder and institutional investor. As we can see comparisons of ownership structure in the table 1, ratio of their ownership is more than 80% from 1990 to 1991. In case of U.S, the ratio of individual stockholder and institutional investor is respectively 53.4% and 34.3% (pension-24.8%, investment company-9.5%). In case of U.K, the ratio of institutional investor is 59.9% (pension-30.4%, insurance company-18.4%, investment company-11.1%), which is higher than the ratio of individual stockholder (21.3%). On the contrary, Ownership structure of **Japan and Germany** is characterized by high ratio of mutual investment among non-financial corporations. Mutual investment between corporations makes up respectively 25% (Japan) and 39% (Germany) of total ownership. Another marked point is that the percentage of ownership by banks is fairly high. The percentage of it amount to 25% (Japan), 8.9% (Germany) respectively. Because mutual investment between corporations and ownership of financial institutions is pretty high, business environment with relationship-based system is naturally produced. In the case of underdeveloped countries like **Korea**, ownership structure is characterized by high percentage of mutual investment between chabol-affiliated firms and high percentage of shareholdings by controlling family. Despite controlling families' small ownership(less than 13 percent of largest 30 chaebol's shares on average), they in chaebol-affiliated firms retain control through interlocking ownership among subsidiaries.

According to Korea Fair Trade Commission (KFTC), the average interlocking institutional ownership exceeded 33 percent in the 1990s. Family control was possible for two reasons: First, most shareholders are small individual investors, who have not engaged in monitoring activities. About 97 percent of the shareholders in listed firms are small individual shareholders. Second, institutional owners have not played the role of monitoring firm management. [7] What is different is low percent of individual stockholder and institutional investor. They rely on loan rather than investment from banks, because they don't want to give up privileges of controlling shareholders.[8]

<Table 1> Comparisons of Ownership Structure (1990-1991)

	U.S	U.K	Japan	Germany
Financial areas	39.8	60.8	47.0	19.5
Bank	0.3	0.9	25.2	8.9
Insurance Co	5.2	18.4	17.3	10.6
Pension	24.8	30.4	0.9	n.a
Investment Co	9.5	11.1	3.6	n.a
Non-Financial areas				
Non-financial Corporations	n.a	3.6	n.a	39.2
Household	53.5	21.3	23.1	17.8
Government	n.a	2.0	0.6	6.8
Foreign Investor	6.7	12.3	4.2	17.7

Source: Federal Reserve Board, Proshare, Tokyo Stock Exchange, Deusche Bundesbanks. n.a=Not available

[7] Joe Sung-Wook & Ryoo Sang-Dai (2000) Evaluation of changes in the corporate Governance system of Korean Chaebols. KDI

[8] Kang Chul-Kyoo (1999) Competitiveness and Corporate Governance. ITBI review

1.3. Management

Management is the highest decision-making regarding how much produce, where to invest and what to sell. Decision-making authority and accountable to whom is influenced by a form of ownership structures. Large business groups of today are generally characterized by separation of ownership and management in developed countries. U.S and Japan separated ownership and management after the Second World War. [9] But it doesn't mean all the owner-management systems were abolished. It is natural for inaugurating enterprise to assume the form of owner-management system. Separation of ownership and management happen in the process of development in business groups and it is just that such a phenomenon was superior in developed countries. On the contrary, in case of late-comers, which have short history of business groups, separation of ownership and management isn't general phenomenon. Instead of it, owner-management was superior in developed countries such as Korea. But even though this is natural phenomenon, occurred in the process of development in business groups, we can't say owner-management is stable system. As we observed comparisons of development process in developed countries' business groups, it could not help adapting the necessity of change one day. [10]

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[9] 柴垣和夫, 「財閥解體と集中排除」, 『戰後改革 7』, 東京大學出版會, 1974

[10] Kim Ki-Won (1998) Sublation of Chaebol Structure and Construction of Professional management. SIES.

1. Three types of governance structure: U.S, Germany-Japan and Korea

2.1. Factors shaping corporate governance

As earlier stated, because each countries establish its own business model according to condition, the history of development in corporate governance is different from each other. All the capitalistic countries have developed business groups by adjusting to their economic, political and social environment. Then, corporate governance also has been differently formed according to the environment. Each country's corporate governance has evolved in the process of overcoming facing challenges.

Corporate governance is influenced by both internal and external factors. In terms of internal cause, all business groups have a property to maximize its interest, and to improve its efficiency by minimizing cost. It means that business groups have an attribute to develop itself according to its characteristics of corporate groups.

As I mentioned before, the differences in corporate governance mainly comes from unique ownership structure of business groups. The management structure and decision-making process vary according to whether it is numerous minority shareholder-oriented ownership structure (Anglo-Saxon model) or large stockholder-oriented one (Late-comer model), or institutional investororiented one (Japan-Deutsch model). Those three distinct business groups lead to three different corporate governance systems.

Corporations tend to develop their own mechanism to make up for demerits. Much of them come from agency problem: interest conflict between the principal and the agent. The subject of principal and agency is decided by characteristics of capitalism. For example, in case of U.S business model, based on managerial capitalism, principal is shareholder and agency is professional manager. On the other hand, in case of Korea, based on controlling-shareholder-capitalism, principal is outside investor and agency is controlling shareholder-manager.[11]

In terms of external causes, corporate governance is influenced by the degree of market growth. While the country with well-developed capital market develops corporate governance with a goal of maximizing efficiency, underdeveloped country tries to develop it with a goal of continuing to exist and to expand size.

In addition, the difference of corporate governance comes from the degree of outside intervention. Even though it natural for all the countries to have rules and regulations, however how much government interfere in management matters of the corporations is influential in corporate governance.

[11] Kim Kyun (2000) The end of Chaebol reform: Evaluation and Prospect. Trend and Prospect

If government plays a decisive role in deciding firm's entry or exit and in fund distribution, secretarial office of the controlling-shareholder manager (the group chairman) holds a more important position than the board of director.

<Table 2> Factors shaping corporate governance

Classification	Controller	Remarks
Market Discipline (External Control)	Capital Market	M&A market, Wall Street Walk
	Loan Market	Restraining influence of Credit
	Labor Market	Employee Market
	Commodity Market	Survival test in the perspective of Corporate Governance
Organization Control (Internal Control)	Board of director	Independence, Representation
	General meeting of Shareholder	Voting Right, Minority shareholder right
	Institutional Investor	Affiliated Investment
	(CEO)	(The subject of Control)
The confines of internal& External	Audit	Independence, Confidence
	Bondholder & Shareholder	Strong incentive to control management
Rules& Regulations	Government	Regulations related to Corporate governance
Social Control	Social responsibility	Social supervision& Pressure on management

Source: KDI

2.2. Three types of Corporate Governance

I argued that all the capitalistic countries have developed business groups by adjusting to their economic, political and social environment. Then, corporate governance also has been differently formed according to environment. Each country's corporate governance has evolved in the process of overcoming challenges which corporations face.

Corporate governance controls the competitiveness of a nation. The competition in the globalization era is defined as a competition of capitalist system or a competition of corporate governance.

In the case of U.S, ownership and management is separated and agency problem is eased through market discipline. That is, managerial efficiency is forced upon the firm through competition in the product market, financial market, market for managerial resources and market for corporate control. On the other hand, Japanese corporate governance is characterized by organizational control. Big business groups is centered on the main bank and tied together into long-term relationships through cross-shareholding among member firms. In Germany, through the practice of proxy voting, banks possess the power of control over firms. Banks participate in corporate control through membership.

2.2.1. U.S & U.K type (Market-based Model)

- **Meaning, Ownership Structure & Characteristics:** The reason why it is called a market-based model is that managers are very sensitive to reactions of market to their management activities. Dispersion of ownership is widespread and importance of institutional investor is increasing. The manager sets his goal of maximizing day-to-day profit, because he has to report firm performance regularly and it decides whether he receives compensation or not. His interest is only to find out ways to increase the stock value. Added value goes up through technological innovation and restructuring. One of the problems is agency problem between stockholders and manager.

<Table 3> Distribution chart of ownership in U.S Corporations

Year	Institutional Investor		Foreign Investor	Individual & Non-Profit institution	Others
		Pension			
1950	6.1	0.8	2.0	91.3	0.6
1970	27.3	9.2	3.2	68.1	1.4
1990	42.7	25.2	6.9	49.8	0.6
1996.9	45.6	22.4	6.1	47.7	0.6

Source: NYSE

- **The goal of corporations:** Primary goal is stockholder wealth maximization, which translates into maximizing the price of the firm's common stock.
- **Main Body& Major Discipline:** Numbers of minority shareholder is

main body. They show satisfaction or dissatisfaction through buying or selling shares, rather than participate in management by exercising their voting power. Though they charge professional manager with overall management, board of director, elected by them, monitor management. Major discipline is market and outside director.

- **Other stockholders:** Contrary to shareholder, other stakeholder such as bank, employee, custom and related corporation is at arms' length from corporate governance. For example, in the case of bank, transaction between bank and corporate is made according to interest rate. Their relation is not closely connected. Evaluation of firm performance is made by not bank but M&A market.

- **Institutional Investor:** In the past, they remained just 'silent partner' of manager and if they dissatisfied with firm performance, they settle relationship with firm by selling off shares. However, after U.S SEC reduced restrictions on institutional governance in 1992, ownership is concentrating, and institutions are becoming more active shareholder. They urge manager to manage efficiently rather than just sell off shares. Shareholder activism spread, with astonishing dismissals of CEOs in the 1990s.[12]

- **Devices to make up for demerit:** They have developed corporate

[12] Monks &Minnow (1995) Corporate Governance. Blackwell Business

governance, focused on minimizing agency problem between minority shareholder and manager. NYSE asks newly listed company to keep at least two outside directors and to establish compulsorily compensation committee.

2.2.2. Germany & Japan type (Relationship-based Model)

- **Meaning, Ownership Structure & Characteristics:** Their corporate governance is a kind of system to respect interest of various stakeholders including employee. This model is characterized by 'contractual corporate governance', because all the stakeholders are bound together through diversified holdings. It promotes stable and long-term transactions between related corporations. Because mutual investment between corporation and ownership of financial institutions is pretty high, business environment with relationship-based system is naturally produced. Shareholders expect capital gain based upon long-term growth rather than dividend yield, based upon short-term managerial outcomes. In case of Japan, stabilizing shareholders, who are related to member firms, make up 60% of whole shareholders.[13] In Germany, while percentage of cross-shareholdings is lower than Japan, holding of shares by corporations and banks is fairly high.

[13] Monks &Minnow (1995)

<Table 4> Distribution chart of ownership in Japanese corporations

Year	**Government**	**Bank**	**Corporation**	**Individual**	**Foreigner**
1990	0.6	46.9	25.2	23.1	4.2
1992	0.6	45.7	24.3	23.9	5.5
1994	0.7	44.6	23.8	23.5	7.4
1995	0.6	42.8	23.6	23.6	9.4

Source: Tokyo Stock Exchange

<Table 5> Distribution chart of ownership in German corporations

Institutional Investors		Individual	Corporates	Government	Foreign Investor
	Stabilizing Shareholder				
30	27	4	41	6	19

Source: Deutsche Bundesbank (1991)

- **The goal of corporations:** To create total wealth of all the stakeholders; shareholder, employee, bank, institutional investor, creditors, suppliers and customers. Corporate consider interest of all the stakeholders equally. They invest only one-third outside the company and invest rest for wealth of whole stakeholder.

- **Main Body& Major discipline:** In the case of Japan, major discipline is main bank. As a controlling-shareholder and creditor, bank directly participates in management by sending executive to board of directors. It is close to a supporter rather than supervisor to corporate performance. But it actively participates in management at a critical phase, and decides to liquidate or revive the company. It also could call manager to account and fire manager. In Germany, the role of bank is similar to the role of Japanese bank. It is characterized by dual board system; boards of managing directors (Vorstand), which is consist of management, supervisory boards (Aufsichtsrat), which is consist of shareholder, bank and employee. The co-determination system is a process in which employee have a right to take part in entrepreneurial planning and decision-making through representation on the supervisory board. The boards also play a critical disciplinary role when the company gets into troubles. So, we call corporate governance to be insider system, rather than outsider system like U.S.

- **Other stockholders:** On the contrary to U.S, individual shareholders don't participate in general meeting of stockholders in Japan. In Germany, most of the private investors themselves don't vote at shareholder's meeting, rather, they delegate their voting rights to their banks. [14]

- **Institutional Investor:** Institutional investor is stabilizing shareholder.

- **Devices to make up for demerit:** They have developed corporate governance, focused on minimizing contract cost.[15] The problems introduced by firm-specific investments by various stakeholders can be resolved either on a contractual basis or by changing the legal structure of

[14] Lee Young-Ki (1996) Corporate Governance of Korean Corporations in the globalization era. KDI
[15] Williamson (1985). The Economic Institutions of capitalism, Free press

control rights, or by requiring that manager and directors be accountable to stakeholders other than shareholders. [16] It becomes adventurous for shareholders, creditors, employee, managers to maintain long-term relationship with each other in order to extract full value their firm-specific investments and minimize contractual costs.

2.2.3. Korea type (Rent-seeking model) [17]

- **Ownership Structure & Characteristics:** As earlier stated, Korean firms have a highly concentrated structure of ownership and control. With this concentrated control structure of business groups, they succeed in pooling the resources of affiliated firms, creating internal market for crucial inputs like financial capital and managerial skill, information. This structure has been formed under underdeveloped capital market and government' intervention. Throughout government-led economic growth until 1980s, government intervenes in the market by instituting industrial development programs and allocating financial resources. In order to enjoy a privilege given by government, Chaebols has developed governance structure suitable for lobbing activities to win the government support. Controlling shareholder-managerialsm was more efficient for lobby. Because government's intervention give chaebols chance to acquire rent, chaebols could not help forming rent-seeking model. Corporate

[16] Blair.M. (1995) Rethinking assumptions behind corporate governance. Challenge
[17] Kang Chul-Kyoo (1999) Competitiveness and Corporate Governance.

governance of Chaebols is characterized by three factors; ▲Majority-shareholders participate in management ▲Hierarchy, based on control pyramid system ▲Absence of internal or external discipline to control manager.[18] Control pyramid system means that specific controlling shareholder, who secures the right of management in Core Company, control other subsidiaries' assets as a majority shareholder by interlocking ownership. In terms of external discipline system, government has restrained M&A by limiting mass ownership of shares and banks haven't played any role in monitoring or controlling management. In place of external and internal disciplines, government has kept intervening in entry or exit of corporate etc, as the third discipline. Furthermore, internal disciplines such as outside director, also haven't worked.

- **The goal of corporations:** As the consequence of an industrial policy geared towards obtaining scale economies, every major chaebols has pursued business in only the tried and proven industries. In order to acquire rent from government, they compete for market share rather than for profits.

- **Main Body& Major discipline:** Some core companies are usually at the top of the ownership pyramid of business groups, and they play a role similar to pure holding company. Decision at the top tend to be made by owners automatically, especially strategic and financial decisions in the hands of single owner.

- **Other stockholders:** Shareholder without at least five percent ownership

[18] Hwang In-Hak, Lee In-Kwon (2000) Chaebols structure and Chaebol Policy. KERI

could not do any of the following: remove a director, file an injunction and derivative suit, inspect affairs and company property etc. Banks were controlled by government. The tight control of the financial sector by government was needed for mobilizing capital and for channeling it into the strategic target industries.

- **Institutional Investor:** Institutional investor is not stabilizing shareholder like Japan or Germany. Their share make up 13.6% lower than other countries such as U.S, Japan. However, foreign investor' ownership of share is increasing faster than others. They ask firm to meet the needs of global standard. [19]

- **Devices to make up for demerit:** In the new economy environment, the principal-agency problem is shifting from relationship between government and firms to relationship between manager and other stakeholders. This system needs a new mechanism of corporate governance to resolve conflicts of interests among various corporate stakeholder and minimizing agency costs. The owner-manager practice is believed to have an advantage in enhancing responsible management and in reducing agency problem between owner and management. However, there exists a strong case of serious conflict or agency problem between controlling-shareholder and minority-shareholder. Problem is

[19] Lee Young-Ki & Lim Young-Jae (1999) Korea's corporate Governance: Issues and Reforms. KDI

that Korean system doesn't have well-functioning mechanism to moderate agency problems. A mechanism of market discipline such as M&A hardly exist. The internal control and monitoring system is deficient. Board of directors isn't independent from management and internal auditors are dependent on the principal owner-manager.

<Table 6> Comparison of Corporate Governance types

	U.S	Germany	Japan	Korea
Distribution of ownership	-Diffusion of ownership -Absence of controlling shareholder -Increasing institutional investor	-Strong influence of bank	-No individual majority shareholder -Mutual investment between member firms -Stable shareholder -Strong influence of bank	-Majority shareholder -Cross ownership of share -Increasing importance of minority shareholder& institutional investor
Characteristics of Ownership	-Liquidity	-Stable & long-term relationship	-Stable & long-term relationship	-Unstable & Short-term pattern
Governance Structure	-Strong manager, weak owner - Manager control -Institutional investor as a silent partner	-Dual board system -Bank participate in supervisory board -Strong influence of bank	-Mutual control between member firms -Joint ownership & dispersed power	-Concentrated ownership& control by majority shareholder -Strengthened control through mutual investment
Function of Director	-Representative of minority shareholder can appoint director -Increased case, which dismiss manager	-Dual board system -Supervisory board elect or dismiss and monitor manager	-Weak board of director	-Lack of representation -Insufficient function of board to supervise manager

	U.S	Germany	Japan	Korea
Ownership& management	-Separation of ownership & management -Management by professional manager(CEO)	-Separation of ownership & management -Co-determination by labor& management	--Separation of ownership & management -Extinction of majority shareholder after dismantlement of Zaibatsu	-No separation of ownership & management -Majority shareholder managerialsm -Family control& ownership
Discipline	-Capital market (M&A, Stock price)	-Bank control management by participating in board -Insufficient function of capital market -Capital market in its infancy	-Horizontal control between member firms -Main bank as a supervisor -Insufficient function of capital market	-Weak function of supervision -Deficient role of bank -Insufficient function of capital market
The Goal of management	-Maximize interest of shareholder	-Create total welfare of all stakeholder	-Consider interest of all the stakeholder	-Obtain scale of Economies
Corporate& Bank	-Separation of bank& business	-Bank control business	-Close relationship between bank& business	
Role of institutional investor	-Begin to be involved in reshuffle of manager	-Stabilizing shareholder	-Stabilizing shareholder	-No stabilizing shareholder

Ⅲ. Priorities for Corporate Governance Reform in Korea

1. Evaluation of Cheabol structure

Korean corporate governance structure is characterized by the fact that the controlling-shareholder has an absolute control of management, hierarchy based on control pyramid system, and absence of internal or external discipline to control manager.

To a large extent, Korea's economic growth has been driven by the rather authoritarian government and large business groups called chaebols. Entrepreneurs in these groups have aggressively exploited overseas markets for trading, local construction and more investment. Chaebols have contributed a lot to the upgrading of the nation's industrial structure. Government guidance and intervention in the financial sector, which reduced various uncertainties prevailing in the early stage of development, were fairly effective in mobilizing resources and allocating them for the best growth performance.

However, continued government intervention gave rise to moral hazards on the part of both chaebols and financial institutions, weakening of the financial sector, and the highly leveraged growth of large chaebols. All these have been responsible for economic inefficiencies and the increased vulnerability of the economy.

In order to analyze strengths and weakness of chaebols, I will follow Nam (1999) in categorizing behavioral characteristics into four: diversification, concentration of Economic power, weak governance and relation with government and other chaebols. [20]

1.1. Diversification

Diversification of chaebols' business portfolios has begun since the 1950s as they acquired privatizing public enterprises and absorbed failing firms. In the 1970s, they were strongly urged to undertake capital-intensive heavy and chemical industry projects and to absorb failing firms with attractive incentives and implicit risk-sharing by the government. Also, constrained by the small domestic market, and motivated by huge capital gains from real estate holdings, they moved constantly to newly emerging industries. Cross-shareholding and an easy access to bank credit through cross-guarantees among the subsidiaries have facilitated the highly leveraged business diversification. Chaebols have been aggressive in developing new products and markets and undertaking other large and risky projects. Because government provide concessional loans and serve as a risk-sharing partner. These factors have encouraged investment and helped the economy grow fast. But, these factors reducing investment risk for chaebols have been like a double-edged sword. There has been a tendency that investment risk is inadequately assessed and investment efficiency is low. Competition among chaebols has been targeted at maximizing their market

[20] Nam Sang-Woo (1999) Korea's Economic crisis and Corporate Governance. KDI School

shares rather than profit. The practices of cross-gurantees of debt repayment and cross-shareholding also serve as an exit barrier for inefficient subsidiaries, while they lead to chain bankruptcies among constituent subsidiaries.

1.2. Concentration of Economic power

The largest five chaebols accounted for 27% of the total mining and nanufacturing shipment in 1995. The size of chaebols may not be a source of concern as long as they do not impair competition. However, many chaebol-affiliated corporations often have a market-dominating power in their business lines. Making use of this position, these firms may be involved in practices that constrain fair competition. Chaebols may be also infringe on the interests of smaller or non-affiliated firms, whose access to the credit of banks and other financial institutions is limited as chaebols preempt the credit with the cross-guarantees of debt repayment among their subsidiaries. Concentration of economic power also tends to promote moral hazard on the part of chaebols. With all the subsidiaries linked together financially sector and the economy. These financial linkages and exit barriers are certainly a serious problem for the stability and efficiency of the economy.

1.3. Weak Governance

The ownership and governance structure of chaebols has the advantage of overcoming the typical principal-agent problem of modern enterprises. The largest shareholder has full management control. His shareholder’s equity share, including those of relatives and others in special relations, is usually less than 10% of the total. The pattern of corporate ownership and control has a serious governance problem in that the outside shareholders interests are not adequately protected or represented. The chairman or owner-manager may seek their interests maximized. Managerial control in chaebols is concentrated in the chairman, without much delegation to the managers of individual subsidiaries. Proper monitoring functions expected of the board of directors or outside shareholders have largely been missing. This lack of effective countervailing power has often led to grossly inefficient investment as well as abuses of conflicts of interest through various internal transactions among subsidiaries and other means.

1.4. Relation with government and other chaebols

Markets fail when information is missing or investments show economies of scale, externalities, interdependence among themselves. In this case, contest-based competition may be a solution to the problem of coordinating investment decisions by the government. Chaebols are natural partners of the government in this arrangement, given the associated institutional costs of coordination and the financial capability of the firms. The government has often allocated major industrial projects among business groups on the basis of business-government exchange of information and coordination among chaebols as well as a set of explicit or implicit rewards and rules. It tended to create group-oriented atmosphere and encourage vigorous competition among business groups. In the absence of clear rules and strong institutions for the administration of the contest, there are such risks as collusion, impaired competition and rent-seeking behavior. Aggressive competition among chaebols has often been for market share and size rather than profit, which has been responsible for wasteful over-investment or duplicative investments.

<Table 7> Positive and Negative evaluations of Chaebols

Characteristics of Chaebols structure	**Positive**	**Negative**
Diversification	-Reduced investment risk -Economies of scope& other synergies -Overcoming imperfections on factor markets	-Investment inefficiency -Exit barriers(cross-subsidization) lead to inefficient in-group resource allocation -Financial instability
Concentration of Economic power	-National pride: globally recognized brand names	-Fair competition impaired -Exit barrier (Too big to fail)
Weak Governance	-No principal-agent problem for controlling shareholders -Speedy decision-making	-Serious governance problem for outside shareholders -Poor supervision monitoring lead to inefficient investment
Relations with government and other Chaebols	-Market failures(Investment indivisibilities or interdependence, etc) reduced -Contest-base vigorous competition among Chaebols	-Competition for market share -Corruption& rent-seeking behavior

Source: Nam (1999)

2. Priorities for corporate governance reform in Korea

Some reformers insist *chaebols* should be dismantled through a complete separation between ownership and management. While we devise ways to improve the current Chaebols system, we should not give up all the advantages of Chaebol system for the sake of international competitiveness. We have to focus chaebols reform on not killing chaebols but resuscitating chaebols through improving governance structure. We have to develop advantages of Chaebol to the utmost and make up for disadvantages.

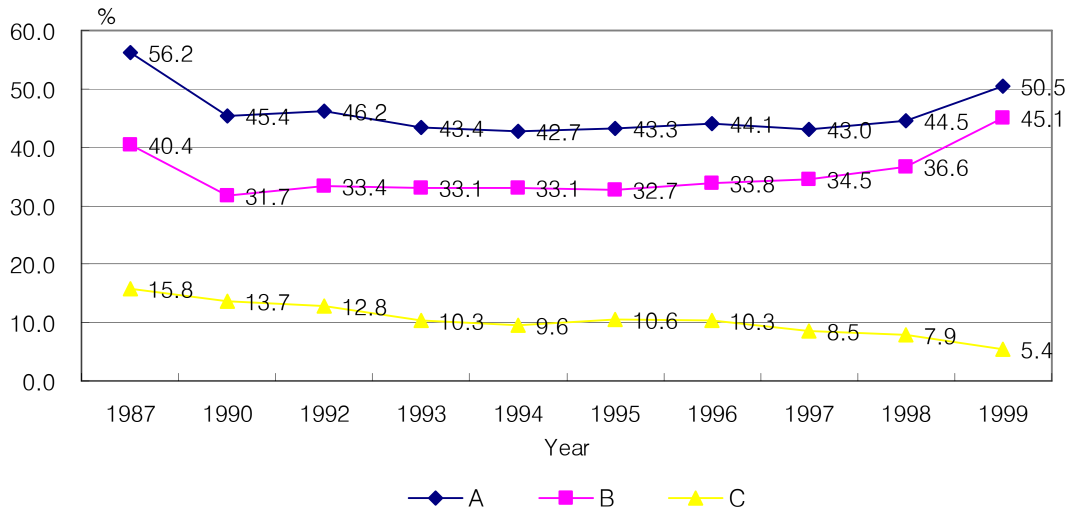
2.1. Problems of Chaebol break-up

The first reason we should not break up chaebol is that we are below the level of developed countries, in terms of industrial development. In the case of developing countries, which is characterized by family-based business groups, long-term investment, based on in-group shareholder ratio is still indispensable to economic growth. Furthermore, when we take our weak external capital market into account, dismantling chaebols by removing in-group shareholder ratio would not be a desirable choice. Chaebol breakup might take away not only positive function of internal capital market, but also the role of long-term stabilizing shareholder. We have to use advantages of internal capital market and stable long-term shareholder to the fullest. Even though Korean chaebol have a serious problem, namely that majority-shareholder managers control the entire member firms by acquiring high in-group shareholding ratio, we should preserve its advantages, while addressing its weaknesses. If internal disciplines such as manager-monitoring system are established, on the contrary, in-group shareholder could contribute to growth in company as stable shareholders. As a stable shareholder, main banks and affiliated firms in Japan or Hausbank in Germany not only enable a long-term investment but also play a role as both a majority-shareholder and an active investor to monitor inefficient management. The key to chaebols reform is to lead in-group shareholder to play a role as a stable shareholder and at the same time, to play a role as an active investor to monitor inefficient management.

Secondly, because external capital market is underdeveloped in Korea, it is difficult to expect that market discipline such as M&A would work properly as in other developed countries. In Korea, stock market is so immature that stock price has rarely reflected firm performance. Some firms made a fortune by clever manipulation of stock market rather than firm performance. In advanced market economies, corporate ownership has been dispersed with the firm's growth. Corporate ownership has usually been dispersed as firms finance the necessary capital for growth through the capital market. However, it will take a long time for capital market to play a proper role as an outside discipline in Korea.

Thirdly, chaebol break-up is far from feasible in Korea. First of all, political power is not sufficiently strong to promote reform perfectly. Even though the government has tried to dissolve concentration of economic power or improve weak governance by establishing rules and laws, it has faced difficulties in implementing reform. Entrenched interests such as chaebols chairman or some organization which speaks for them continue to ask the government to relax restrictions on their activities such as mutual investment among the affiliates. Little stretch of imagination is needed to suspect that powerful families would invest heavily out of their surplus profits to perpetuate the *status quo*. Once grown to be powerful, large family business enterprises, both individually and collectively, are widely believed to have interfered in the political process for their interests. They have developed a close symbiotic relationship with the political circle by giving huge political contributions in exchange for implicit promise of protection and support. The consequence was delays in putting all the necessary institutions in place, which are essential for developing an efficient capital market and allowing the separation of ownership and management through more effective corporate monitoring and disclosure. In essence, required institution building is likely to have been impeded not only by the culture deeply imbedded in these societies but also by the conscious efforts of the vested family interests. Another avenue of political influence is the ownership of mass media by some chaebols, and the possibility of their manipulation of public opinions. In order to observe how difficult economic reforms are realized, let us look at the change of ownership in 30th chaebols.

<Figure1> Ownership trends of the 30th largest chaebols



Note: Interlocking institutional ownership (A) =

In-group shareholding (B)+Owner(and his family) shareholding(C)

Source: Korea Fair Trade Commission (2000)

As we can see in above figure 1, majority shareholder's equity through interlocking ownership among subsidiaries increased from 44.5% in 1998 to 50.5% in 1999. On the contrary to our expectation, the percentage has increased since 1998, when government started to make efforts to implement various reforms. We can guess that they control and manage firm as before, without regard to corporate restructuring, promoted by government since IMF crisis.

2.2. The core of corporate governance reform

2.2.1. To solve inefficient resource allocation: over-investment problem

As stated earlier, competition among chaebols have been for market share and size rather than for profit, which has been responsible for wasteful over-investment or duplicative investments. It brought about inefficient allocation; resources are not optimally allocated within business groups. When we regard chaebols business groups as one entity, the group chairman holds the power to allocate resources through cross-holding. A company is expected to decide to pay a dividend, when they do not have any investment opportunity to make profit more than opportunity cost. But the head with the control over idle cash flows tends to reinvest within business groups rather than pay dividend, because his interest lies in expanding his business (empire building) Of course, this growth-oriented allocation style is appropriate in the high economic growth phase, when there are many investment opportunities to achieve high IRR. At that point, interest of investors do not conflict with manager so much. However, when it goes to the economic maturity phase from the growth phase, this system might bring about inefficiency, if there is no system to check the manager.

The head of Chaebol, who has a goal to maximize power over management and scale of his organization, supplies idle funds to member-firms, which have more opportunities of investment. This deformed allocation customs is possible, because he controls all the firms within the business groups and discipline system such as bank doesn't work.

In order to allocate resource optimally, investment funds have to be allocated to affiliated firms, only if they are expected to make profit. However, if external capital market is so undeveloped and the head, who controls the internal capital market, attaches great importance to growth than to profitability, resource allocation within internal capital market might be seriously distorted.

It is rare for a publicly held company to acknowledge its mistakes and carry out restructuring by itself. [21] Furthermore, as internal capital market restricts investment of idle cash flows to member-firms, internal capital market is likely to allocate funds more inefficiently than external capital market. In the end, supervision and discipline are required, in order to solve agency problem between chaebol chairman and investors with investment allocation of idle cash flows.

2.2.2. Investor protection

With regard to corporate governance, there are a lot of perspectives on

[21] Jensen, M (1993) The Modern Industrial Revolution, Exit, and the Failure of Internal Control System. Journal of Finance

corporate governance such as agency perspective and stakeholder perspective etc.[22] According to their views, they approach corporate governance problem differently and suggest different solution on corporate governance. Traditional comparisons of corporate governance systems focus on the institutions financing firms rather than on the legal protection of investors. Bank-centered corporate governance system, such as Japan and Germany are compared to market-centered systems, such as the United States and the United Kingdom. Relatedly, relation-ship-based corporate governance, in which a main bank provides a significant share of finance and governance to each firm, is contrasted with market-based governance, in which finance is provided by large numbers of investors and in which takeovers play a key governance role.

These institutional distinctions have been central to the evaluation of alternative corporate governance regimes and to policy proposals for improvement. In the 1980s, when the Japanese economy did good job, bank-centered governance was regarded as superior because far-sighted banks enable firms to focus on long-term investment decisions. But, in the 1990s, as the Japanese economy collapsed, evaluation was totally reversed. Japanese banks, instead of facilitating governance, collude with enterprise managers to deter external threats to their control and to collect tents on bank loans.[23] In the recent assessments by Edwards and Fischer (1994), German

[22] Lee Young-ki & Lim Young-jae (1999) Korea's corporate Governance: Issues and Reforms. KDI

[23] Weinstein and Yafeh (1998) On the costs of a bank-centered financial system. Journal of

banks are likewise downgraded to ineffective providers of governance. Market-based systems, in contrast, rode the American stock market bubble of the 1990s into the stratosphere of wide support and adulation.

However, the classification of financial systems into bank and market centered is not fruitful. One way to do this is by looking at the actual outcomes. It is easy to classify Germany as bank-centered because its banks influence firms through both debt and equity holdings and its stock market is undeveloped. But what about Japan, which boasts both powerful banks with influence over firms and a highly developed and widely-held equity market with thousands of listed securities. More generally, La Porta et al. (1997) show that, on average, countries with bigger stock markets also have higher ratios of private debt to gross domestic product, contrary to the view that debt and equity finance are substitutes for each other. The prevalent financing modes generally do not help with the classification.

Another reason that the classification of financial systems into bank and market centered is not fruitful is that the reliance on either the outcomes to classify corporate governance regimes misses the crucial importance of investor rights. Investor protection problem is correlated with agency problem between controlling-shareholder manager and minority shareholder. Simon Johnson and Peter Boone (2000) [24] show that managerial agency

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[24] Simon & Peter. (2000) Corporate Governance in the Asian financial crisis. Journal of Financial Economics. They attribute the Asian crisis to weakness of legal institutions for

problems can make countries with weak legal systems vulnerable to the effects of a sudden loss of investor confidence. Countries with only weakly enforceable minority shareholder rights are particularly vulnerable. If such a country experiences even a small loss of confidence, outside investors reassess the likely amount of expropriation by managers and adjust the amount of capital they are willing to provide. The result can be a fall in asset values and a collapse of the exchange rate.

To summarize, bank-versus market centeredness is not an especially useful way to distinguish financial systems. Investor rights work better to explain differences among countries, and in fact are often necessary for financial intermediaries to develop.[25] Corporate governance is a set of mechanism through which outside investors such as shareholder and creditors, protect themselves against expropriation by the insiders. Most of all, strong investor protection may be a particularly important manifestation of the greater security of property rights against political interference in some countries. Empirically, strong investor protection is associated with

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corporate governance. This paper presents evidence that the weakness of legal institutions for corporate governance had important effect on the extent of depreciations and stock market declines in the Asian crisis.

[25] Rafael La Porta, Florencio Lopez-de-silanes(2000) Investor Protection and corporate Governance. Journal of Financial Economics. All financiers depend on legal protection to function. According to them, a method of financing develops when it is protected by the law that gives financiers the power to get their money back. Germany and some other German civil law countries have developed banking systems because they have strong legal protection of creditors, particularly of secured creditors. Without such rights German banks would nave much less power. The United Kingdom also has a large banking and public debt sector, again because creditors have extensive rights, as well as a large equity market. To sum up, all the outside investors, be they large or small, creditors or shareholders, need rights to get their money back. Investor rights are a more primitive determinant of financial development than in the size of particular institutions.

effective corporate governance, [26] as dispersed ownership of shares, and efficient allocation of capital across firms. Using investor protection as the starting point appears to be a more fruitful way to describe differences in corporate governance regimes than some of the more customary classifications such as bank- or market-centeredness.

Rafael & Florencio (2000) shows the benefits of reform with a goal of investor protection in corporate governance. The benefits would be to expand financial markets, to facilitate external financing of new firms, to move away from concentrated ownership, to improve the efficiency of investment allocation, and to facilitate private restructuring of financial claims in a crisis. In general, expropriation is related to the agency problem described by Jensen and Meckling(1976), who focus on the consumption of perquisites by manager and other types of empire building. It means that the insider use the profits of the firm to benefit themselves rather than return the money to the outside investor.

Like this, corporate governance means the effectiveness of mechanisms that minimize agency conflicts involving managers, with particular emphasis on the legal mechanisms that prevent the expropriation of minority shareholders.[27]

[26] See Rafael La Porta (2000)
[27] Shleifer, A., Vishny,R.(1997) A survey of Corporate Governance. The Journal of Finance.

How well protect investor is the key point to develop corporate governance in Korea. Majority shareholder managers have been in complete control of whole the in-group shareholders without mechanism to control them in Korea. Resources are not optimally allocated within business groups. In order for in-group shareholder to play a role as both an active investor and supervisor, finally in order to allocate resource optimally, what is the most desirable way to develop corporate governance? To strength manager-monitoring and investor-protection functions should be the goal of reform in corporate governance.

Ⅳ. Strategy for Corporate Governance Reform in Korea

1. Strategy of Chaebols reform

As stated above, the core of reform in corporate governance lies in solving inefficient allocation by strengthening manager-monitoring and investor-protection functions. The Korean financial crisis owed to a large extent to a corporate governance failure in large business groups, where their over-leveraged and inefficient business expansion could not be checked. The key of chaebols reform is to lead in-group shareholder to play a role as a stable shareholder and at the same time, to play a role as an active investor to monitor inefficient management by strengthening manager-monitoring system and investor protection.

Then, what kinds of policy and institutional measure are necessary in order to achieve these goals, namely, to solve agency problem between majority shareholder and investor? With regard to agency problem, the current Korean government has improved internal corporate governance by strengthening the right of shareholders and the accountability of controlling-shareholder.

Strengthening shareholder rights:

The minimum shareholder requirement to exercise shareholder's right such as the right to file derivative suits, to dismissal of directors and internal monitors, to review accounting book, to call for a general shareholder meeting have been reduced. (See Table 8) For example, any shareholder with 0.01 percent of firm ownership can file a mismanagement derivative suit. Despite the lower threshold, monitoring by individual small shareholders remains costly. Unlike the previous system, through which the entire board was chosen by a simple majority of shares, a cumulative system allows greater representation of minority shareholders on the board. Hoping that outside directors will supervise firm management more critically, the government requires that at least 50 percent of board members be outside directors and extended the requirement to privately held financial institutions. It also requires that outside directors compose at least 25percent of the board of directors of publicly traded firms. With regard to institutional investors, their role is enhanced. Shadow voting is abolished and ceiling on bank's equity investment in individual corporations is increased from 10% to 15%.

<Table 8> Minimum required equity shares for the exercise of rights (%)

	Commercial Code[1]	Securities and Exchange Act[2]
Petition for dismissal of a director/auditor	3(5)	0.5 (0.25)
Petition for injunction of director's illegal acts	1(5)	0.5(0.25)
Derivative suits	1(5)	0.01
Proposal of agenda for a shareholders' meeting	3(-)	1(0.5)
Request for convening a shareholders' meeting	3(5)	3(1.5)
Right to inspect account books	3(5)	1(0.5)
Right to corporate affairs and property	3(5)	3(1.5)
Petition for dismissal of liquidator	3(5)	0.5(0.25)

Notes: [1] In the parentheses are rules before the revision in December, 1998.
[2] In the parentheses are for corporations with paid-in capital over 100billion won. Source: Nam et al. (1999)

Enhancing management accountability:

The legal liabilities of major shareholders involved in management were strengthened to raise accountabilities in 1998. The government strengthened the responsibilities of each firm's board of directors while requiring controlling shareholders to be treated of 752 listed firms had assigned 764 outside directors as of October 1998.

1.1. Evaluation of recent reforms

1.1.1. Weak shareholders' right

Almost all the relevant articles in the laws pertaining to corporate governance do not sufficiently protect shareholder's rights. There still remain much limitations in the legal protection of shareholders rights. In the case of derivative suits, which are suits by shareholders launched against executives who cause damage to company property, 0.01% of equity shares are required for the exercise of rights by law. However, this minimum requisite is so high that it is difficult to bring an action. In fact, as a result, such derivative suits have been rare. The class action lawsuit, which is a suit by shareholders launched against company which caused damage to shareholder value, has not yet been established, even though a debate over the need for class action suit started more than ten years ago. The securities class action lawsuit also has not yet been introduced.[28] According to KSE and FSS, unfair transactions, which may be subject to securities class action lawsuit, are increasing year by year. Also, since their size is becoming larger, investors are suffering financial losses.

<Table 9> Unfair transaction regarding securities

	1996	1997	1998	1999
Stock manipulation	37	34	21	77
The number of usage of closed information	18	35	72	71
Investors	1,465	1,329	1,915	2,951
Average trade amount per a day (billion won)	4,868	5,558	6,604	34,816

Source: KSE (2000)

Even though the problem of infringement on investors' right is extremely serious now, a section of government and business circles are trying to reduce the scope for application of securities class action lawsuit. For example, they are promoting the bill to limit its scope for application only to large business groups with assets worth two trillion won or more. But, in reality, among companies involved in stock manipulation from 1998 to Aug 2001, corporations with assets worth two trillions won or more are merely 2.2% and the rest is company with assets worth less than two trillions.[29] In addition, among companies indicated by FSS, regarding window dressing etc, corporations with two trillions won are merely 8.7% and the rest is company

[28] The securities class action lawsuit is now supposed to be introduced on the regular section of the National assembly 2001.
[29] SPPO, FSS.

with assets less than two trillions from 1998 to Aug 2001. It means that the restrictive bill promoted by government and business circle is highly unlikely to be effective.

1.1.2. Lack of independent outside director

With regard to outside directors, government required that at least 1/2 of the directors be outside directors for large listed corporations since 2001. However, their role has still many limitations: vague selection procedures and no special tasks or little information sharing etc. In order to enable selecting of outside directors who represent minority shareholders and is independent from owner-manager, cumulative voting is recognized (for shareholders holding more than 3%) for the selection of board members. However, it is banned at more than 70% of listed companies in reality.[30] It is because corporations could exclude it according to their own articles of association. In order to enforce cumulative voting, corporations should not be allowed to exclude cumulative voting.

1.1.3. Absence of management accountability

When it comes to how much management accountability has been improved, we are able to observe the degree of improvement by looking over the frequency of unfair transactions among affiliates of a group. It is because

[30] Nam (1999)

the case of unfair management would be reduced, if there was better internal discipline to monitor and supervise management. As I stated above, the case of unfair transaction such as stock manipulation with regard to stock price management is increasing. Most of these cases indicted by the Prosecution are stock manipulation and usage of insider information by manager etc.

<Table 10> Types of case unfair transaction indicted by the prosecution

	1997	1998	1999	2000	Total	Component Ratio
Stock manipulation	9	5	11	6	31	24.9%
Usage of insider information	1	6	20	1	28	22.2%
5% Rule violation	4	5	18	0	27	21.3%
The executives do not report existing state of share holding	0	4	13	0	17	13.3%
Short-term trading profit	1	2	10	0	13	10.2%
Others	1	3	8	0	12	9.9%
Total	16	25	80	7	128	100%

Source: Recited Lee Young-kyeo& Jeong Seung-chang (2000) Actual condition of stock management and unfair transaction in listed companies. IKSA

In addition, absence of management accountability is shown by the fact, majority shareholder's equity through interlocking ownership has increased from 44.5% in 1998 to 50.5% in 1999, regardless of reform. Owner-manager still control and manage firm as before.

1.2. Priorities for future reforms

As the power of the chaebol head comes from complete control of in-group shares that are owned by other affiliates of the group, we need to establish a much stronger control system than now. In order to enhance management accountability, class action lawsuit should be introduced as soon as possible. Application scope for securities class action lawsuit should not be curtailed.

With regard to investor protection, it is necessary to make board of directors include more outside directors, who substantially speak for minority shareholder and investors. Without exception, cumulative voting should be applied to all the companies compulsorily. In addition, minimum required equity shares for the exercise of minority shareholder rights such as derivative suits have to be lower than now. Then, original function of general shareholders' meeting and board of directors would be recovered.

However, even these legal measures may not be sufficient to provide investor protection if the chaebol head exercise complete control of management by controlling the in-group shares. Since the in-group shares represent fictitious capital created on the basis of the assets of the entire shareholders, it is unfair and inefficient to allow the chaebol head to exercise control over them. Therefore, outside directors rather than chaebol head should be given the right to control in-group shares. Also, in order to prevent the head's indiscreet management such as inefficient resource allocation, exercising votes about large investments should require outside directors' approval. These measures can put corporate governance right from the root.

To summarize, in the area of corporate governance, much effort has to been directed toward protecting minority shareholders and disciplining poor management. It includes reshaping of the board of directors, making basic shareholder rights easier to exercise, and exposing management control challengeable in the market. Though it would take some time, they would go a long way toward restraining controlling shareholders from expropriating outside shareholders and, thus, reducing the private gains expected from management control.

2. How to promote reform

I discussed policy proposals for reform above. But it is also important to how to implement reform properly. When we look back upon our past, the biggest obstacle to reforms is resistance from vested people. Because we have lots of obstacle to carry out reform in Korea, we have take methodology into account.

When we look at our situation, we easily find that the political opposition to such change has proved intense. Governments are reluctant to introduce laws that are expected to surrender to the financiers the regulatory control they currently have over large corporations. As I analyzed factors, influenced on corporate governance, government is the more significant factor to decide corporate governance in Korea, rather than external or internal disciplines. Political situation influences significantly on the degree of development and direction of the reform. Another objection to reform comes from the entrenched economic interests such as the head of chaebol. In Korea, their power of influence is as impregnable as politician and government. Insiders oppose corporate governance reform and the expansion of capital markets. It is because existing large firms finance their own investment projects internally or through captive or closely connected banks.[31] Poor corporate governance delivers the insiders secure finance, secure politics and secure markets. In short, they have an interest in keeping the system as is.

When we consider this special condition in Korea, in order to achieve reforms, the regulatory mechanisms of enforcing shareholders and creditor rights need to be radically improved with the reform of legal system. In an interview with Professor, Jang Ha-Sung at Korea University professor, he also is concerned about this problem.

"I criticized the MDP as not being real reformists, but the GNP opposes reform. The Korean economy is at a critical turning point. If Korea wants to stay as it is today, we need no further reform, but if we want to advance…. I would like to see some clear vision in the presidential election, but I have not heard any significant words (On transparency and accountability in corporate governance) from any candidates. I am very concerned. We are heading into uncertainty."

Then, what can be done to achieve the goal of reform? To organize discussion, I

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[31] Mayer (1988) New issues in Corporate Finance. European Economic Review

follow Coffee (1999) and Gilson (2000) in drawing a distinction between legal and functional convergence.[32] Legal convergence refers to the changes in rules and enforcement mechanisms toward some successful standards. To converge to effective investor protection in this way, we require extensive legal, regulatory reform such as securities and company law etc. We need radical changes in the legal system in order to improve investor protection. There may be significant complementarities between various laws in protecting minority shareholders: For example, securities law can mandate disclosure of material information while company laws enable minority shareholders to act on it. To establish legal protection of investors is realistic alternatives in Korea.

Marginal reform may not successfully achieve the reformer's goals. In part, the existing corporate governance arrangements benefit both the politicians and the entrenched economic interests, including the families that manage the largest firms in Korea. Corporate governance reform must circumvent the opposition by these interests. Reform of investor protection is politically feasible in some circumstances, and can bring significant benefits: to expand financial markets, to facilitate external financing of new firms, to move away from concentrated ownership, to improve the efficiency of investment allocation, and to facilitate private restructuring of financial claims in a crisis.

[32] Coffee,J., (1999) The Future as history: the prospects for global convergence in corporate governance and its implications. Northwestern Law Review. Gilson,R.,(2000) Globalizing corporate governance:convergence of reform or function. Stanford University, Stanford,CA.

Ⅴ. Conclusion

The discussions on corporate governance, have intensified since the IMF crisis, and took on the flavor of reforming the global financial architecture. Transaction Cost Economist began to handle corporate governance. They said that the competitiveness of firms is directly affected by governance structure of corporate.[33] While corporate structure is closely related to transaction cost, it is important to find out desirable governance structure to be able to minimize transaction costs.

Since the IMF crisis, Korean enterprises have faced changes, namely the so-called globalization: deepening integration to the world market for both products and productive factors, particularly, external liberalization of capital transactions. As world capital market gets integrated, outside investors' role is extended and the function of capital market to supervise management is more emphasized. In addition, investors start to resist the exclusive dominance by the controlling shareholder-manager. The absence of the devices to check and balance the corporate control is expected to bring about more and more risks. In addition, government is changed from a partner to a reformer with respect to Chaebols.

While globalization has brought new opportunities, the economies have also been under increasing competitive pressure. The implications were the needs to improve fragile corporate governance, which had been seriously neglected. Big business

[33] Williamson (1996) The Mechanisms of Governance, Oxford University Press

could no longer rely on corruptive symbiosis with the government that effectively protected the interests of controlling families from being challenged. Big business should pay more attention to minority shareholders and other stakeholders.

The Korean financial crisis is, to a large extent, a corporate governance failure for large business groups, where their over-leveraged and inefficient business expansion could not be checked. Effective internal mechanisms for the supervision or monitoring of management were virtually absent. These groups pursue the goal of long-run wealth maximization of the controlling families. This goal would generally deviate from the profit maximization of a business group or its member subsidiaries. It is so because the interests of controlling families can be furthered at the expense of outside shareholders mainly through the internal transactions among subsidiaries. If the deviation is substantial, efficiency in group-wide resource allocation will be compromised. The discussions seem to confirm the concern that the real corporate governance challenge is the agency problem of how to protect outside shareholder from the expropriation of controlling owners. The expropriation is not just a distribution problem between controlling and outside shareholders, since much of the distorted resource allocation is occurring before corporate profits are determined. It is necessary to put basic corporate governance mechanisms in place and ensure their effectiveness.

The biggest problem of chaebols is that resources are not optimally allocated within business groups. This deformed allocation customs is possible, because chaebol manager controls all the firms within the business groups and discipline system such as bank doesn't work. It is possible because controlling-shareholder manager exercise despotic management and control through interlocking ownership between subsidiaries. Overlapping investment, which is pointed out an internal cause of IMF crisis, was possible by that despotism. To make matter worse, absence of internal discipline such as board of directors, and external discipline such as bank brought about chaebols' overlapping investment.

When we debate chaebol problem, some reformers insist it should be dismantled through a complete separation between ownership and management. However, we had better devise ways to improve the current Chaebols system than give up all the advantages of Chaebol system. We have to focus chaebols reform on not killing chaebols but resuscitating chaebols through improving governance structure. We have to develop advantages of Chaebol to the utmost and make up for disadvantages.

There is several reason chaebol break-up is unrealistic alternative: First of all, in the case of developing countries, which is characterized by family-base business groups, long-term investment, based on in-group shareholder ratio is still indispensable to economic growth. We have to use advantages of internal capital market and stable long-term shareholder to the full. Even though Korean chaebol have a serious problem, which majority-shareholder managers control whole the member firms by acquiring high in-group shareholding ratio, we should make use of its advantage, by taking away its weakness. Secondly, external capital market is so undeveloped in Korea; it is so difficult to expect that market discipline such as M&A would work properly like other developed countries. Break-up is far from reality in Korea. The insistence to dismantle chaebols by removing in-group shareholder ratio isn't desirable choice, when we take our weak external capital market into account. We have to use advantages of internal capital market and stable long-term shareholder to the full. If internal disciplines such as manager-monitoring system are established, on the contrary, in-group shareholder could contribute to growth in company as stable shareholders. Lastly, political power is not enough strong to promote reform perfectly. Even though government tried to dissolve concentration of economic power or improve weak governance by establishing rules and laws, they have faced difficulties to implement reform. They must have developed a close symbiotic relationship with the political circle by giving huge political contributions in exchange for implicit promise of protection and support. The consequence was delays in putting all the necessary institutions in place, which are essential for developing an efficient capital market and allowing the separation of ownership and management through more effective corporate monitoring and disclosure.

With regard to reform in corporate governance, efficient resource allocation and investor protection should be two major cores of reform in corporate governance. The Korean financial crisis is, to a large extent, a corporate governance failure for large business groups, where their over-leveraged and inefficient business expansion could not be checked. Competitions among chaebols have been for market share and size rather than profit, which has been responsible for wasteful over-investment or duplicative investments. It brought about inefficient allocation; resources are not optimally allocated within business groups. The head of Chaebol, who has a goal to maximize power over management and scale of his organization, supplies idle funds to member-firms, which have more opportunities of investment. This deformed allocation customs is possible, because he controls all the firms within the business groups and discipline system such as bank doesn't work. The problem has been most serious in family-controlled and extensively diversified business groups. In the end, supervision and discipline are required, in order to solve agency problem between chaebol chairman and investors with investment allocation of idle cash flows. In order for in-group shareholder to play a role as both an active investor and supervisor, finally in order to allocate resource optimally, what is the most desirable way to develop corporate governance? To strength manager-monitoring and investor-protection functions should be the goal of reform in corporate governance.

Government reform efforts have often gone beyond instituting proper governance mechanisms to interfere in the organizational structure of business groups or impose certain rules geared to protecting minority shareholders. Even though the current Korean government has improved internal corporate governance by strengthening the right of shareholders and the responsibility of controlling-shareholder, much effort has to been directed toward protecting minority shareholders and disciplining poor management.

In order to enhance management accountability, class action lawsuit should be introduced as soon as possible. Application scope of securities class action lawsuit should not be curtailed. With regard to investor protection, it is necessary to make board of directors include more outside directors, who substantially speak for minority shareholder and investors. Without exception, cumulative voting should be applied to all the companies compulsorily.

However, even these legal measures may not be sufficient to provide investor protection if the chaebol head exercise complete control of management by controlling the in-group shares. Since the in-group shares represent fictitious capital created on the basis of the assets of the entire shareholders, it is unfair and inefficient to allow the chaebol head to exercise control over them. Therefore, outside directors rather than chaebol head should be given the right to control in-group shares. Also, in order to prevent the head's indiscreet management such as inefficient resource allocation, exercising votes about large investments should require outside directors' approval. These measures can put corporate governance right from the root.

Though some of these measures might be delayed by entrenched interests, the integration of capital markets and extended role of outside investor makes such reforms more likely today than they have been in last decades.

-The end-

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