

Corporate governance reform in Korea

8th July, 2011

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Following the 1997 financial crisis, corporate governance reforms and government-initiated corporate restructuring were implemented in Korea.



In the past, the internally appointed board members tended to act as rubber stamps and failed to monitor the actions of the controlling shareholders. However, rapid economic growth in the absence of properly functioning corporate governance can increase the vulnerability of the economy to external shocks, as evidenced by the 1997 crisis. The reform, following the crisis, aimed at rectifying failures in corporate governance by enhancing the board's monitoring function, along with other measures such as increasing management/CEO accountability, protecting (minority) shareholder rights, and improving managerial transparency and information disclosure.

The introduction of outside director(s) is a major feature of the changes to board regulation, which is similar to the requirement under the *Sarbanes-Oxley Act* of 2002 in the US. There were two major waves of reforms in relation to board structure in Korea. The first wave was largely aimed at establishing a foundation for the introduction of an outside director system, along with streamlining business focus among major large business groups. The second wave sought mainly to legalise the requirement for the improvement of corporate governance, including the outside director system.

In February 1998, the *Listing Act* was amended to require all listed firms excluding the Korean Securities Dealers Automated Quotations (KOSDAQ) to appoint at least one outside director and to ensure that no less than a quarter of their board members were outside directors by the time of the firm's annual general meeting in 1999. This means that the minimum number of outside directors for listed firms is one and the number of additional outside directors required is

determined by the existing board size.

The second wave of reforms included amendments to the *Securities and Exchange Law* in March 2001 and December 2003. These revisions stipulate by law the 1998 *Listing Act's* requirement for outside directors (Art. 54.5) for all listed firms on both the Korea Exchange and the KOSDAQ (except for some venture capital companies). These 2001 and 2003 amendments, based on the recommendations in the September 1999 Principles of Standard Corporate Governance and the Code of Best Practice of Corporate Governance, require:

- (i) Large listed corporations to establish an Audit Committee and an Appointment Committee under the BOD comprised mainly of outside directors. A large firm is defined as a firm with an asset size of 2 trillion won (approximately 2 billion US\$) or more;
- (ii) The 2001 amendment also requires that no fewer than half the board members of large firms should be outside directors; and
- (iii) The 2003 amendments stipulate that large firms listed on the Korea Exchange and KOSDAQ should have at least three outside directors and at least half the positions on the board should be filled by outside directors.

Listed firms began to appoint outside directors in 1999. In particular, the proportion of listed firms with at least one outside director increased substantially from 34 per cent in 1999 to 62.3 per cent in 2000. This significant rate of increase was repeated in 2003 and 2007. In 2007 around 94 per cent of listed firms appointed at least one outside director, which represented a 60 per cent increase over 1999. The most common number of outside directors per firm was two. The term of an outside director in Korea is usually 2-3 years, and an appointment can be renewed for one more term.

These changes seemingly moved the governance system away from a relationship-based insider model towards an outsider model. Seeing the traditional relationship-based model as one cause of the 1997 crisis, the Korean government heavily favoured a move to the Anglo-American system. According to the traditional classification, this new governance measure is largely in line with the Anglo-American outsider model in contrast to the traditional bank-dominated relationship-based insider model.

The institutional reform itself, however, does not necessarily guarantee the [smooth 'function' of new system](#) ^[1]. This is why we need to consider constraining factors when we evaluate the policy reform. Korean listed firms have experienced a significant change in corporate governance within a short period of time, which is unprecedented in the world. Even in Anglo-American economies, whether or not a board with a majority of outside directors has the power to monitor and replace top-level executives has been controversial. The controlling shareholders of *chaebols* ('business conglomerate') in Korea have strong power and it creates the agency problem between controlling shareholders and the other stakeholders, particularly minority shareholders. Circular cross-ownership between affiliates creates more managerial power for controlling shareholders than legal ownership. One may argue that the development of a corporate governance system is driven by the complementary institutions in the country

outside the firm. The path dependence resulting from sunk costs and the entrenched interests in the prevailing system are also a source of resistance to change. The effect of improved corporate governance on economic growth is also complex. This is because the risk-sharing (and thus more demand for capital from the firm) caused by improved investor protection may have a trade-off relationship with long-run increased interest rates associated with the higher demand.

It will be interesting to observe rigorous evidence about whether or not the dramatic change in corporate governance system initiated-by government in Korea has contributed positively to attract more investors to capital markets and to economic growth. The evidence of the Korean case will provide important policy implications for other economies, particularly where family-run businesses dominant such as in East Asia and some European countries.

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[1] smooth 'function' of new
system:

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