REPUBLIC OF KOREA

KEY POINTS

- Massive conglomerates, the *chaebol*, continue to dominate the Republic of Korea's corporate scene.[1] Before the crisis, government support and favourable access to debt finance encouraged *chaebol* growth, leading to high debt ratios and inefficient investment.

- Post crisis, the Government made strong progress on financial sector reform but corporate reform remains a major challenge.

- However, market opening and financial restructuring have exposed the *chaebol* to more competition in product and finance markets, somewhat disciplining their management and levelling the playing field for Australian business.

- In addition, authorities now stipulate higher reporting, accounting and auditing standards and make company boards more accountable to their shareholders, so shareholders, including Australian shareholders, can make better informed investment decisions and influence companies.

- In 1999, the private sector Committee on Corporate Governance issued the voluntary Code of Best Practice for Corporate Governance for listed companies; several of its recommendations are becoming laws.

- Authorities generally enforce new laws. However, a stronger media, more independent of the *chaebol* could help discipline corporates and their managers.

- Despite post crisis reforms, minority shareholders' rights remain relatively weak and most *chaebol* majority owners continue to run corporations in their own interests; hence Australian portfolio investors still need to exercise caution.

[1] Hereafter, the Republic of Korea is referred to as Korea.

The financial crisis seriously affected Korea's economy, threatening banking system stability and forcing many corporates and smaller enterprises into insolvency. The Government responded with stronger laws and regulations covering corporate and financial governance. With corporate and bank restructuring, old relationships between banks, *chaebol* and other corporates are weakening, and market reforms expose banks and corporates to more discipline from global competition. This should significantly change the corporate landscape Australian business faces in doing business, featuring greater market access, less local collusion and more transparent investment opportunities. However, due to the *chaebol's* major concentration of market power and their strong capacity to resist change not in their interest, the transition to a more rules and market based system is gradual and will take some time to complete.

CORPORATE SECTOR STRUCTURE

Large diverse conglomerates, the *chaebol*, dominate the corporate sector and operate in nearly all sectors. Families still at least partially own and manage most *chaebol*. They use cross-ownership and pyramid structures, and pre-crisis, enjoyed favourable bank treatment, often with government support. Consequently, most c*haebol* became over-leveraged and diversified into many unrelated sectors beyond their core competencies, building up excessive foreign debt and capacity in many industrial sectors, contributing to the financial crisis.

Chaebol Dominate

The top 30 *chaebol* account for 46 per cent of all Korea's corporate assets, dominating the sector. Controlling families and their companies hold around 45 per cent of equity in the top 30 *chaebol* (Asian Development Bank, 2001).[2] Often, families appoint relatives to management and list a minority of equity, thereby ensuring control. For example, the Hyundai Group lists only 16 of its 46 member companies (Asian Development Bank, 2001).

The top 30 *chaebol's* return on equity declined markedly from the mid 1990s and contracted even more sharply during the crisis (Asian Development Bank, 2001).[3] Between 1988 and 1996, Korean corporate profitability was the lowest of the nine major East Asian economies, and well below that of Germany and the United States (Woo-Cummings, 2001).[4] Declining profitability partly reflected *chaebol's* easy access to bank finance and their belief they were too large for the government to allow them to fail; this encouraged them to over-invest and over-diversify. For example, on average, the top 30 *chaebol* own more than 20 subsidiaries in diverse sectors, with few complementarities (Asian Development Bank, 2001).[5] Heavily centralised management focussed on founding family heads also reduces decision making flexibility, reducing profits.

2 Private individuals own around 40 per cent of all listed stock, and control around 30 per cent of listed companies. Corporations hold 70 per cent of controlling shares in listed companies, often through cross-ownership and pyramid structures that account for a further 20 per cent of listed equity (Asian Development Bank, 2001).

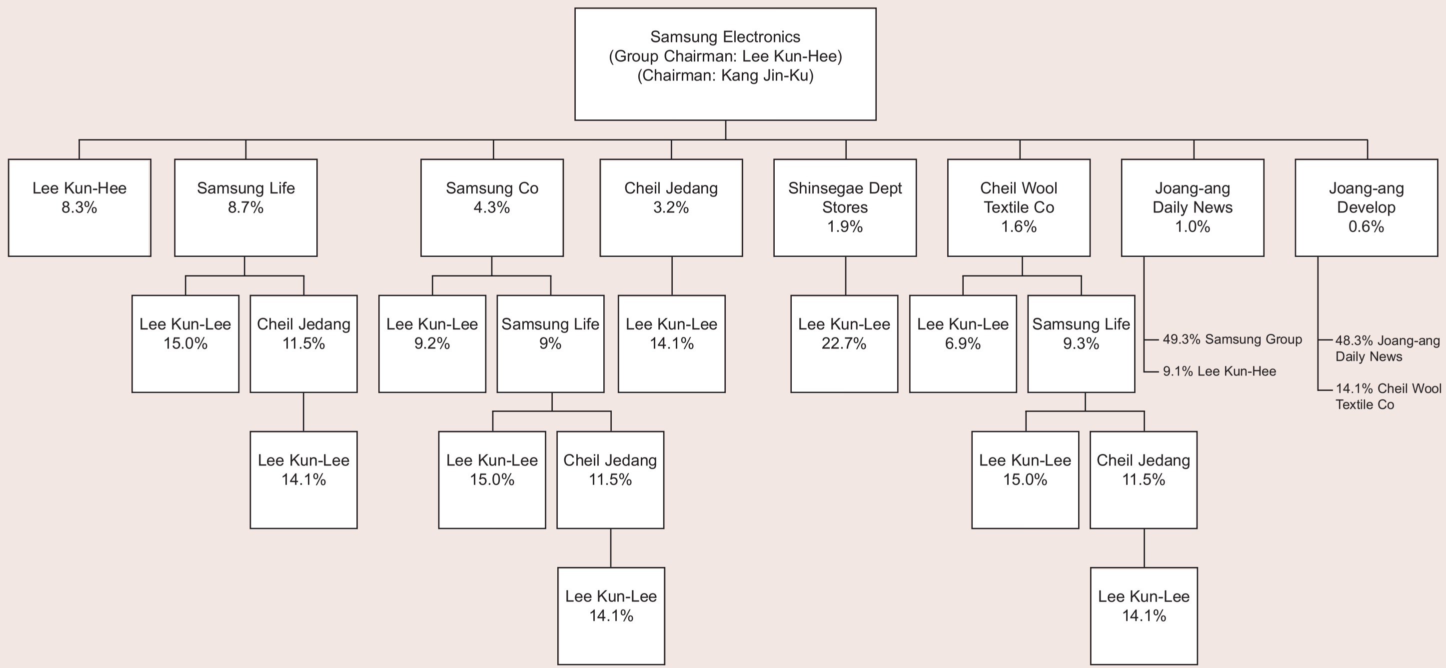
3 In early 2002, the official definition of *chaebol* was in flux, so some of these groups may no longer be defined as *chaebol*.

4 Corporate profitability is measured as the real return on assets in local currency.

5 Korea does not permit holding companies.

SAMSUNG CORPORATION CONTROLLED BY LEE KUN-HEE

The figure shows the principal shareholders in Samsung Electronics, Korea's second largest company prior to the crisis.[6]



Source: La Porta et al., 1998.

6 Post-crisis corporate restructuring may have somewhat changed this structure.

Chaebol transactions further reduced profits for small outside investors. Often, subsidiaries conducted related party transactions and off-balance sheet guarantees, without external shareholder consent (Asian Development Bank, 2001).

Debt Rather than Equity

Traditionally, *chaebol* have preferred debt rather than equity financing, as it minimised dilution of founding family control as the *chaebol* grew. Although Korean law effectively prevented cross-ownership between *chaebol* and banks, producing widely dispersed bank ownership, the Government pressured banks to lend to the *chaebol* (Nam et al., 1999). Hence, banks often ignored sound credit analysis and lent to politically well connected large firms, with implicit government guarantees (Naughton, 2001).[7] In addition, many *chaebol* owned finance companies and merchant banks, providing ready access to debt finance. Hence, in 1997, the top 30 *chaebols'* debt to equity ratios averaged 519 per cent, increasing outside investor risk. After the crisis, ratios fell to 237 per cent by April 2000; however, by international standards, debt to equity ratios remain high (Nam et al., 1999; East Asia Analytical Unit, 1999a).

Direct Financing Markets Weak

The corporate sector's strong bias towards debt financing inhibited Korea's share market from developing. In 2000, at 36 per cent of GDP, Korea's stock market capitalisation was the region's third smallest. Liquidity also is modest, as *chaebol* firms hold rather than trade their cross-held shares (Naughton, 2001).[8]

Government an Important Player

The Government owns part, or all, of nearly 200 enterprises, in key infrastructure and production sectors.[9] Laws granting public enterprises exclusive trading rights or monopoly powers deter new firms from entering these markets. Before 1997, even though all banks were privately owned, the Government appointed the major banks' CEOs, effectively controlling their lending portfolios to ensure they supported national development priorities. Government financing and *chaebol* bail outs were designed to promote rapid industrial growth and Korean competitiveness.

Chaebol Reduce Product Market Competition

The scale and market power of *chaebol* groups present significant barriers to new players seeking to enter most markets. The four largest *chaebol* supply close to 60 per cent of manufacturing output in many markets, suggesting significant scope to collude to deter new entrants (Bird, 1997). *Chaebol* also are vertically integrated and reduce competition by owning many firms supplying their major

7 Consequently, banks' returns on equity and assets are low compared with US and European banks.

8 Instead of listing more shares, the *chaebol* accessed corporate bond markets; since the crisis, bank reluctance to lend has accelerated this trend (Naughton, 2001). However, the highly concentrated bond market means prices are volatile and investor risks high; in 1998, the five largest *chaebol* issued almost 80 per cent of traded bonds (Zielinski, 1999).

9 Local authorities own and control a further 298 firms.

companies with inputs and materials. For example, the LG Group diversified into the plastics industry to secure quality packaging for their cosmetics products, thereby reducing opportunities for other plastics producers (East Asia Analytical Unit, 1999a).

MARKETS BECOMING MORE COMPETITIVE

Increasingly, more open financial and product markets influence Korean corporate behaviour. Restructured and particularly foreign owned banks are more reluctant to lend at government direction, although in some cases they are still forced to comply (Truman, 2001). Developing capital markets now compete more with banks to attract funds. Corporate restructuring gradually is paring back the *chaebol* system, providing more opportunities for new domestic and foreign, including Australian, entrants. Foreign portfolio investment, including institutional investors' participation in the share market, is rising rapidly. Meanwhile, the Government is deregulating markets, reforming competition policy and liberalising the foreign investment and trade regimes, with significant opportunities for Australia.

CHAEBOL LOOK ELSEWHERE FOR FUNDS

Since the crisis, bank and corporate collapses and restructuring, as well as tighter prudential controls have made banks less willing to fund the *chaebol*, forcing them to use bond and share markets for finance. The entry of institutional investors is adding depth to direct finance markets, increasing their viability for outside investors. As a result of the crisis, *chaebol* also lost some control over finance and trust companies, an important source of debt finance.

Bank Reform

Eventually, post crisis restructuring should produce a more market based banking sector, but in the short term, the Government is deeply involved in the banking system and some old practices continue. By December 1999, authorities had liquidated 199 financial institutions, including banks, merchant banks and leasing companies, and suspended a further 68 licences; eventually, this should increase discipline on remaining institutions. Some banks merged with stronger banks, including three major commercial banks. The Government owns close to one third of the sector after recapitalising the remaining banks, but it has announced it will sell these shares as soon as the market recovers, introducing new independent owners.[10] Although the Government allowed some major *chaebol* like Daewoo to fail, it developed rescue packages for others, pressuring banks to participate. The Government recognises it eventually must withdraw from the banking system to facilitate bank independence, boost shareholder influence over management, improve depositor protection and discipline the *chaebols'* use of funds (Nam et al., 1999).

[10] However, since the crisis, under Banking Act amendments, banks can own 15 per cent or more of a corporation's equity with Financial Supervisory Commission approval, instead of the previous 10 per cent (PricewaterhouseCoopers, 2001). This may strengthen bank and *chaebol* relationships, weakening lending quality.

In April 2000, the Government banned the *chaebol* from using their finance companies as 'private safes'; authorities also nationalised two *chaebol* finance sources, Korea Investment Trust Company and Daehan Investment Trust Company.

Foreign Bank Entry

Since the crisis, authorities have liberalised rules on mergers, acquisitions and foreign entry, so foreign banks can enter the market. In 1999, Newbridge Capital purchased 51 per cent of Korea First Bank, appointing the first foreigner to run a Korean bank. In 2001, Korea First refused to participate in the state driven roll over of *chaebol* bonds; it was the only bank to refuse. It argued the roll over was not commercially sound, and its refusal underscored its independence from government and the corporate sector (*Far Eastern Economic Review*, 15 February 2001, p. 54).

In April 2001, Korea's two strongest banks, Kookmin and Housing and Commercial Bank, merged with combined assets of US$123 billion. Goldman Sachs, Kookmin's largest shareholder, will own 16.6 per cent of the new bank. ING Barings, Housing and Commercial's second largest shareholder, also will own a large share of the new bank (*South China Morning Post*, www.scmp.com, 16 May 2001). By January 2002, foreigners now own a total of 72 per cent of Korea's largest bank; this should markedly improve prudential standards.

Increasing bank independence and foreign ownership should over time improve incentives for sound borrowing and investment by Korean corporates, though new bank shareholders will need to become more active in bank management for this to occur. However, analysts believe the Government can benefit from easing limits on bank shares strategic investors can own, privatising nationalised banks faster and withdrawing completely from bank decision making (Asian Development Bank, 2001). Australia's financial institutions and services providers are well placed to pursue opportunities in this sector, both as potential investors and to provide more advanced management systems for banks upgrading their risk management capacity.

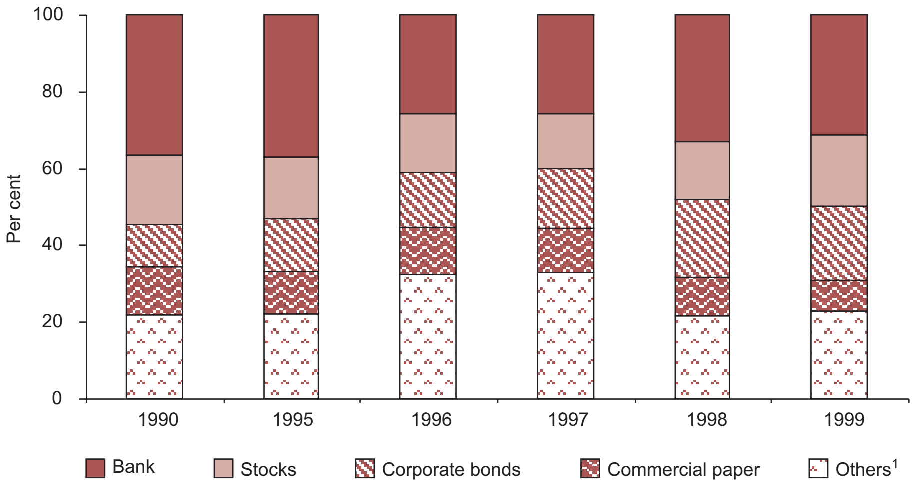
Share Markets More Important

Korean firms now prefer internal and equity financing over debt financing, although most equity issues are rights issues (Asian Development Bank, 2001). Gradually, banks' share in supplying finance is decreasing (Figure 8.1). Over time, a bigger and more liquid share market should reduce the cost of equity raising and increase opportunities to impose shareholder discipline on corporates (Naughton, 2001). Between January and August 2001, the top four *chaebol*, Samsung, Hyundai, LG Group and SK Group, raised Won 1.9 trillion on the stock market, nearly 11 per cent more than in the same period a year earlier.

Figure 8.1

Bank Finance Down, Direct Finance Up

Shares of Alternative Corporate Fund Raising Sources



Note: 1 Others includes trade credits, bills payable and borrowing from the government.

Source: Kim et al., 2000.

New regulations liberalising initial public offers, IPOs, mergers and acquisitions, and foreign portfolio investment are boosting the share market. IPOs plunged after the financial crisis, but in 2000, rebounded to a record 179 IPOs; all were issued on the KOSDAQ, Korea's equivalent of the NASDAQ (Figure 8.2) (Naughton, 2001).[11]

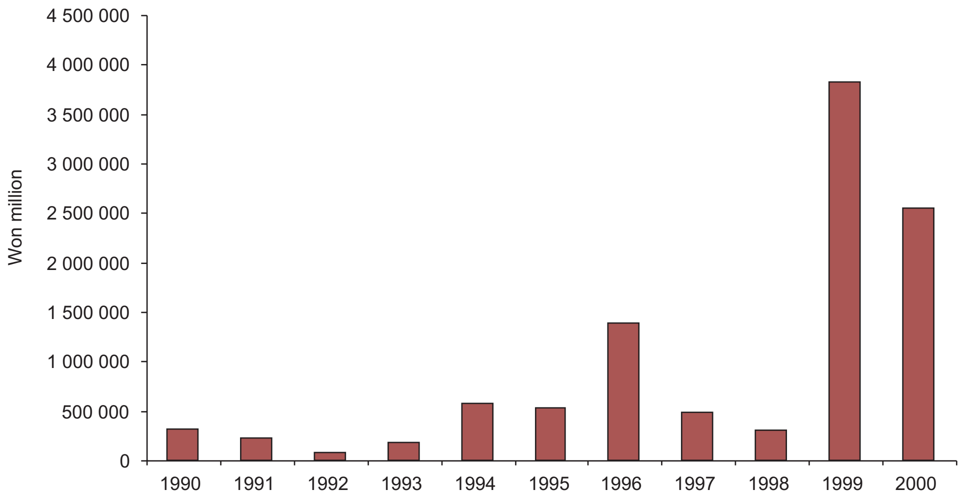
Foreign penetration of the share market increased gradually in the lead up to the crisis (Figure 8.3); since then, it has exploded to around 35 per cent in 2001 (Naughton, 2001). Some *chaebol*, including Samsung and POSCO now feature foreign equity ownership in excess of 50 per cent.

[11] The KOSDAQ was formed in 1996 to facilitate corporate financing for knowledge based ventures, high technology companies and small to medium sized enterprises. Since the crisis, its existence has assisted in the restructuring process. The KOSDAQ's trading volume has increased 460 fold since 1998, but fell with the dot.com crash (KOSDAQ, 2001).

Figure 8.2

Initial Public Offerings Skyrocketing

IPOs, Annual, Won millions, 1990-2000

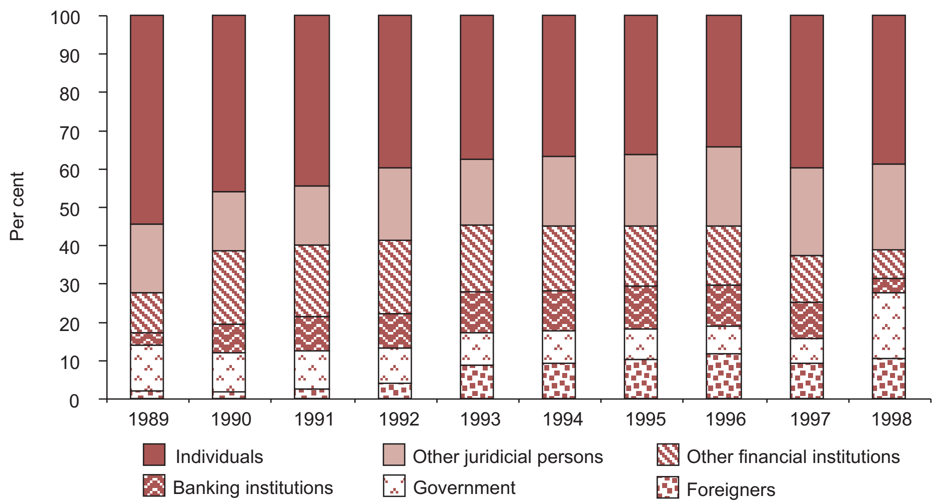


Source: CEIC, 2002.

Figure 8.3

Shareholdings in Korean Public Listed Companies, 1989-1998

Individuals' Roles Drop, Foreigners' Roles Expand



Source: Institutional Analysis, 2001.

Share market regulatory reforms should boost new local or foreign entrants' capacity to contest corporate control, boosting competitive pressure on corporate management. These allow outside shareholders to challenge dominant shareholders' ownership of listed companies. Since 1998, investors have not needed mandatory approval to acquire more than 10 per cent of a listed stock (Asian Development Bank, 2001). The Government also abolished the regulation forcing investors seeking 25 per cent of a listed company's shares to offer to purchase over 50 per cent of the shares; this had provided powerful protection for chaebol family owners (Naughton, 2001).

Rise of Institutional Investors

Increasingly prominent pension funds, life insurers and investment trusts should further develop capital markets. In 1999, Korea's life insurance market was Asia's second largest, with 45 companies. Also in 1999, authorities allowed mutual funds to operate and several financial institutions established corporate pension fund accounts. Since the crisis, several firms have left the market and new foreign entrants are improving standards of risk management (World Trade Organization, 2000).

Increasingly, civil society groups and domestic institutional investors agitate for better corporate governance. New reforms allow securities companies and investment trusts to exercise voting rights over their shares; this should strengthen their activity. Ha-sung Jang, Professor of Finance, Korea University, leads the People's Solidarity for Participatory Democracy that promotes minority shareholders rights, seeks board representation on listed *chaebol* and has launched several derivative suits against errant corporates (Black et al., 2000).

Reforms allowing foreign institutional investors to access local share and bond markets also should improve corporate governance. From 1997, authorities allowed foreigners to invest in shares and, from 1998, in bonds. Foreign investors also no longer face limits on investments in financial and non-financial institutions' domestic money market instrument issues (Institutional Analysis, 2001). Foreign institutions show evidence of scrutinising their investments more than Korean shareholders do. For example, US fund managers with a 10 per cent stake in SK Telecom succeeded in ending intra-group financial transfers and appointing independent directors (Ihlwan, 1998).

Foreign managed funds also operate in Korea. In 2000, French owned fund manager, Indocam Asset Management Asia, opened a representative office in Seoul, planning to distribute its products to Korean investors (Naughton, 2001). In 1998, under a state led pilot program, 25 domestic financial institutions invested Won 1 trillion in three foreign managed balanced funds (Asian Development Bank, 2001).

However, controls on many local institutional investors currently reduce their role in improving corporate governance. The Government has imposed limits on many large local institutional investors like public employee and teacher pension funds' portfolio holdings, limiting their capacity to increase discipline on corporates (Asian Development Bank, 2001). Also, many managed funds are associated with the troubled *chaebol,* reducing public confidence in their security. In 2000, Daewoo's collapse prompted large outflows from managed funds, reducing total funds under management to US$132 billion from US$215 billion in 1999. Distribution of managed funds is limited to securities companies; other channels including direct distribution, life insurance companies and financial planners are prohibited. Also, strict regulations enforce a strong degree of product homogeneity, penalising innovative providers like Australia's Macquarie Bank.

CHAEBOL UNDER PRESSURE

Government and market forces are pressuring the *chaebol*, so they are less able to over-invest and diversify, and exploit minority shareholders. Over time, these measures also should reduce *chaebol* market power, increasing local and foreign companies' capacity to enter Korean markets. In 1998, the Government announced several initiatives to force *chaebol* restructuring, curb their market power and improve corporate governance, including:

- requiring the largest *chaebol* to undertake voluntary workouts, including converting debt to equity and selling non-core subsidiaries and other assets; these sales should disperse *chaebol* ownership (Woo-Cummings, 2001)
- banning cross-guarantees of loans of *chaebol* group companies
- banning cross-ownership between companies if it restricts competition and limiting to 25 per cent companies' investment in group firms
- removing incentives for *chaebol* to retain non-core businesses
- exempting or reducing taxes on asset transactions, encouraging merger and acquisition activity, asset sales and business asset swaps
- introducing new listing rules for holding companies, assisting restructuring
- starting a corporate restructuring fund and easing requirements for public offerings.[12]

However, several of these reforms were to take effect by 1 April 2002, but due to *chaebol* pressure, the Government has reneged on some commitments, including waiving the 25 per cent investment limit for affiliated core businesses and easing cross equity restrictions. Also, bans on cross equity investments and debt payment guarantees only will apply to firms with assets over Won 2 trillion, reducing significantly the number of firms affected. Finally, all *chaebol* will be allowed to invest in SOEs as they are privatised.

Nevertheless, recent *chaebol* failures, including Daewoo, under debts of US$80 billion in 1999, force the *chaebol* and their investors to accept government guarantees no longer exist. This increases incentives for other corporates to use funds wisely and forces rationalisation.

[12] The Won 1.5 trillion restructuring fund should support investments in small and medium companies and independent large corporations that do not belong to *chaebol*.

'Big Deal'

The Government's 'Big Deal' initiative aimed to reduce *chaebol's* excessive sectoral diversification, but its competition and corporate governance outcomes are mixed. The Government encouraged *chaebol* to exchange non-core production facilities among themselves for assets closer to their core competence.[13] Consequently, Samsung swapped its automotive unit for Daewoo's consumer electronics unit so Samsung now holds 60 per cent of the domestic consumer electronics goods market; Daewoo took over Ssangyong; and LG Group sold its semiconductor unit to Hyundai (Woo-Cummings, 2001). However, this rationalisation is government inspired rather than market driven and the outcomes may produce dominant domestic producers, deterring new entrants. Hence, this initiative could worsen corporate governance outcomes, unless foreign producers can provide competition Korean markets now lack.

RESCUE OF HYNIX

In 2000, when Hyundai manufacturer Hynix Semiconductor lost Won 2 trillion, its debt to equity ratio rose towards the 200 per cent limit. Although the company sold non-core assets, including a basketball team and the company headquarters and raised Won 464.5 billion, in June 2001, it was unable to borrow further. Instead it issued US$1.25 billion in shares on international equity markets. Before the issue, Hynix undertook major corporate governance reforms. Majority owners, the Chung family, resigned from the board and relinquished all voting rights, although they retain their financial holdings until 2003. All ten board members now are outside directors.

Source: *South China Morning Post*, www.scmp.com, 16 July 2001.

CHAEBOL TO FACE GREATER COMPETITION

Since the crisis, privatisation, deregulation, trade, foreign investment and competition policy reforms have increased competition in product markets and discipline on managers.

Privatisation and Deregulation

The Government is reviewing its level of ownership and regulation of markets. By December 1999, the number of state owned enterprises had fallen to 91 from 108 in 1997. The Government also sold all but a small share of POSCO, the world's largest steel producer; and by December 2000, its share in the communications sector was around 33 per cent, down from 100 per cent (World Trade Organization, 2000).

Reforms in other sectors, including utilities, are increasing competition although government monopolies and subsidised tariffs continue. In transport, the Government has lifted several entry

13 In 1998, under combined government and market pressure, the number of Korean firms fell by 4.3 per cent and productivity increased by 13 per cent (World Trade Organization, 2000).

restrictions on maritime services, aircraft handling and transportation (World Trade Organization, 2000). Deregulation also has improved market entry in the distribution and construction sectors, and the revised 1998 Telecommunications Business Act allows new, including foreign, entrants (World Trade Organization, 2000). The Government is reviewing energy subsidies for farmers and manufacturers.

Trade Reforms

Gradually, the Government is relaxing import restrictions, with the average applied most favoured nation tariff now 13.8 per cent, down from 14.4 per cent in 1996. Industrial tariffs average 7.5 per cent but agricultural products are high at 50.3 per cent. Average bound tariff rates also fell sharply, led by the bound tariff for motor vehicles dropping from 80 per cent to 8 per cent in December 1999, and falling tariffs on telecommunications equipment (World Trade Organization, 2000).[14] Growing imports increase competitive pressure on Korean corporates (Figure 8.4).

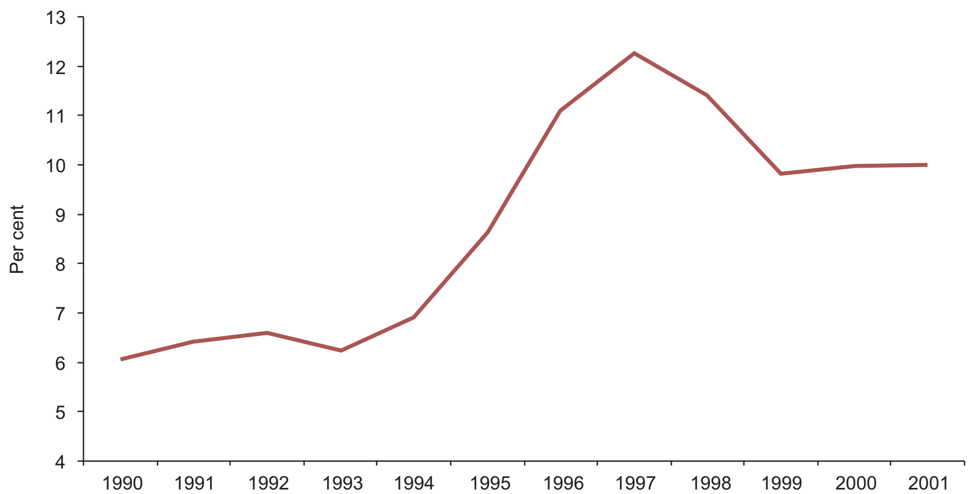
Foreign Investment Reforms

The 1998 Foreign Investment Promotion Act removed limits on foreign investment in Korean companies, increasing competition for the right to manage listed firms. Foreign companies no longer need permission to acquire over 33 per cent of a company's equity, allowing hostile takeovers. Hence, foreign direct investment now accounts for much more manufacturing activity than before the crisis (Figure 8.5). Foreign companies are significant in automotives, banking, insurance and the retail sector.

Figure 8.4

Imports Increasing Competition

Consumer Imports as a Share of Consumer Spending, 1990-2001



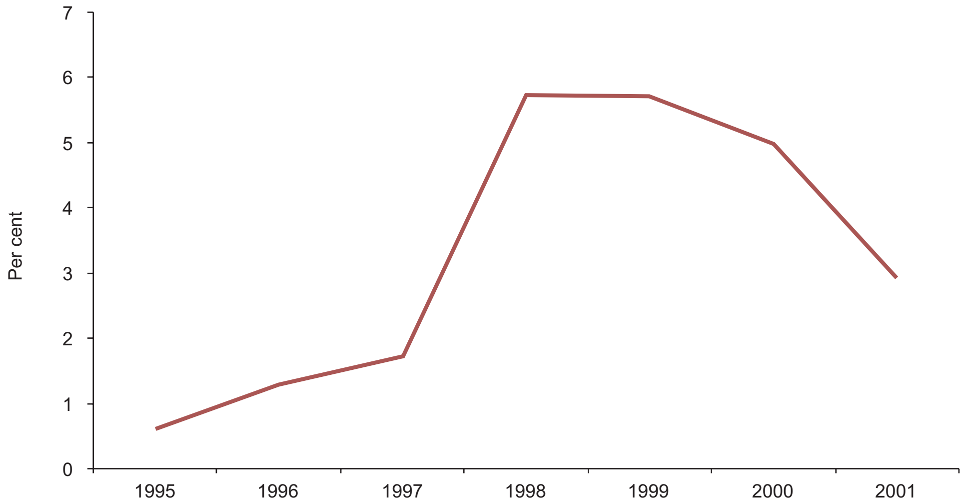
Source: CEIC, 2002.

14 Beef and rice still face quantitative restrictions, but anti-dumping actions have declined markedly since 1996-97 and technical barriers now align with international best practice, improving market access.

Figure 8.5

Foreign Investment Increasing Competition

Manufacturing FDI including as a Share of Manufacturing GDP, 1995-2001



Source: CEIC, 2002.

However, although direct and portfolio investment is increasing strongly from a low base, the *chaebol* still dominate many sectors, deterring foreign entry (World Trade Organization, 2000). Also, foreign direct investment remains restricted in radio and television broadcasting, news agency activities and gambling (East Asia Analytical Unit, 1999a). Despite this, since the crisis, more domestic firms see foreign firms as the main source of competition (Korea Institute for Industrial Economics and Trade, 1999).[15]

FOREIGNERS DRIVING DAEWOO

Since the Daewoo *chaebol* collapsed, car maker Daewoo Motor has looked for a foreign buyer. The company sacked one third of its workforce, forced its overseas businesses to be self supporting and secured more than US$2 billion in government support to prepare itself for sale to foreign investors. General Motors launched a formal bid in May 2001; however, it did not want the truck and bus factories. Following earlier sackings, the General Motors bid raised the ire of union groups. In September 2001, it signed a memorandum of understanding with Daewoo's main creditor, Korea Development Bank, reportedly to inject US$400 million into a new joint venture, tentatively named GM-Daewoo Motor. Potential foreign investors are watching the outcome to see what challenges new foreign entrants in key Korean markets face. However, if Daewoo's domestic market share continues to decline it may become less attractive, delaying the deal.

Source: *Korea Economic Daily*, english.hankyung.com, 21 September 2001.

[15] In 1996, 71 per cent of firms perceived domestic producers as the main competitors; in 1998, this fell to 63 per cent.

Pro-competition Action Stronger

While *chaebol* still dominate many markets, since the crisis, authorities have tried to reduce their market power by strengthening competition and anti-cartel legislation and its enforcement. For example, in 1998 and 1999, the Government revised the 1980 Monopoly and Fair Trade Act covering monopolistic market structures and extended the legislation to cover all firms.[16] Under the 1999 Omnibus Cartel Repeal Act, authorities disbanded or investigated 20 cartels, though another 38 cartels remain active. During April 1999 alone, authorities investigated eight state enterprises for illegal activities and throughout 1999, the Fair Trade Commission identified 324 firms in 129 markets as dominant enterprises, subjecting them to regulations on the abuse of market dominance. A September 1999 probe into illegal internal trading in *chaebol* affiliates resulted in Won 3.7 billion in fines (World Trade Organization, 2000).

Despite this concerted action, small new entrepreneurs still report it is difficult to break into markets the *chaebol* dominate, or even new markets, like e-business, where market positions are less established (*Associated Press*, www.ap.org, 12 May 2001).

CORPORATE REGULATIONS IMPROVE PLAYING FIELD

The crisis sparked aggressive government reform of Korea's corporate governance framework and increased management transparency.[17] In 1999, the private sector Committee on Corporate Governance issued a voluntary *Code of Best Practice for Corporate Governance* for listed companies; several recommendations now are laws. However, the need for major business culture change and in some cases resistance from strong corporate interests mean companies will need considerable time to fully meet new standards.

TRANSPARENCY

Post crisis efforts are improving corporate transparency, albeit from a low base, and should promote better, more performance based investment.

Financial Reporting

In 1999, the Government upgraded transparency requirements under the Korean Commercial Code. Listed firms' annual reports must include details of business goals and strategies, financial conditions, shareholder rights, cross-shareholdings, cross-debt guarantees and directors' compensation. Firms also must report to the securities regulator any event likely to affect share prices, including dealings benefiting insiders and transactions that alter corporate control. Corporations with significant foreign

[16] The Korean Fair Trade Commission enforces the legislation in all sectors except telecommunications, where the Korea Communications Commission is responsible.

[17] Bob Graff, Jeongshin Hwang, Ju-won Jin and Haidi Wilmot, PricewaterhouseCoopers and PricewaterhouseCoopers Legal, contributed to this section.

ownership must report both in Korean and English. The top 30 *chaebol* must report their accounts on a consolidated basis. Under the Code of Best Practice for Corporate Governance, each quarter, corporations must disclose their compliance with the code (PricewaterhouseCoopers, 2001).

Accounting Standards

In December 1998, authorities brought the Korean Accounting Standards broadly into line with international accounting standards. The Financial Supervisory Service introduced new standards on segment reporting, valuing assets at market values, accounting for derivatives and consolidating accounts. The private sector controlled Korea Accounting Standards Board harmonises Korean standards with international ones.[18] Korean accounting standards still differ somewhat from international standards as they do not have to disclose the fair value of financial assets and liabilities, or financial institutions' liabilities by sector (PricewaterhouseCoopers, 2001).

Compliance with standards generally still needs strengthening. A recent survey indicated almost half of all listed companies did not consult international accounting standards and only 10 per cent followed all international accounting standards. Despite this, auditors gave qualified opinions on only 7.4 per cent of firms. Furthermore, despite stricter auditing standards in 2000, the number of qualified opinions fell (Asian Development Bank, 2001).

Auditing

In 1999, the Securities and Futures Commission brought auditing standards into line with international ones. Traditionally, Korean company boards appointed only internal auditors; however, under the Commercial Code, corporations must establish either an audit committee or statutory internal auditor, not both (PricewaterhouseCoopers, 2001). Since December 1999, large public corporations, institutions with government ownership and financial institutions have been able to use audit committees with independent members. An audit committee must consist of at least three directors; two must be independent (Asian Development Bank, 2001). The voluntary Code of Best Practice for Corporate Governance also recommends firms establish audit committees, with two thirds of the members independent (PricewaterhouseCoopers, 2001).

Since December 2000 the Financial Supervisory Service audited companies suspected of engaging in deceptive reporting; before this, it randomly audited companies. On-site inspections complement document submissions and all parties involved in deception face increased penalties.

External audit firms must audit listed and registered company accounts before they are published. Since 1998, a committee comprising internal auditors, outside directors and creditors has selected the auditing firm. Almost all firms now appoint an external auditor independent of the company (Asian Development Bank, 2001).

[18] In 1999, the Korean Government entered into a project with the World Bank to improve Korean standards, creating the Korea Accounting Standards Board, operating under the Korea Accounting Institute.

MINORITY SHAREHOLDERS' RIGHTS

In 1999, authorities strengthened minority rights under the Korean Commercial Code, introducing lower voting thresholds for shareholders passing resolutions and encouraging minority shareholders to participate in management. These changes offer shareholders more opportunities to influence management, although many *chaebol* resist shareholder activism.

Listing Rules

Since 1998, all listed companies must allocate 25 per cent of their board seats to outside, independent directors and make timely disclosure of major corporate transactions. Listed companies must disclose large transactions involving financial derivatives and major decisions including investment and debt guarantees exceeding 10 per cent of company stock (PricewaterhouseCoopers, 2001).

In 2000, authorities amended the *Securities and Exchange Act*, applying penalties to companies disclosing inaccurate information. In August 1999, authorities suspended Daewoo Metal stock from trading because the company did not faithfully disclose details of its convertible bonds, and in November 1999, authorities suspended Sepoong stock from trading. If a company has two inaccurate disclosures in one year, it is an 'unfaithful disclosure company'; one more incident within six months leads to delisting. In November 2000, Hansol Telecom became an 'unfaithful disclosure company' for not disclosing a supply contract of more than 10 per cent of its sales (PricewaterhouseCoopers, 2001).

Shareholder Representation

Shareholders with 3 per cent of an unlisted company's stock or 1 per cent of a listed company's stock may call a shareholders' meeting to determine major issues, including removing directors.[19] While listing rules allow cumulative and proxy voting, companies' articles of incorporation may circumvent this and currently often do. Furthermore, postal voting is not allowed (PricewaterhouseCoopers, 2001). Despite other reforms, these provisions considerably weaken minority shareholder rights.

Board Structure and Duties

Since the crisis, the Government has strengthened requirements for independent directors to sit on boards; previously this was not normal custom. The Code of Best Practice for Corporate Governance recommends half of all board directors be independent, and the *Securities and Exchange Act* specifies at least 25 per cent of listed company board directors be independent. From 2001, under the *Security Transaction Act*, half of listed company boards with capital over Won 200 billion must be independent. By June 2001, an estimated 30 per cent of listed company board directors were independent, up from 11 per cent in 1998 (PricewaterhouseCoopers, 2001). Changes to the Commercial Code allow companies with less than Won 500 million in paid-up capital to choose the number of directors, independent and otherwise.

[19] If a company's capital is over Won 100 billion, 0.5 per cent of shareholders can call such a meeting.

The Commercial Code requires directors to perform their duties under the law and provides for shareholder derivative suits. Since 1999, shareholders with only 0.01 per cent of outstanding shares have been able to file derivative lawsuits against management. Consequently, shareholder activism is growing, with outstanding suits demanding compensation for losses due to mismanagement. The Government may introduce shareholder class actions, although the business community fiercely opposes this measure.

PEOPLE'S SOLIDARITY FOR PARTICIPATORY DEMOCRACY

People's Solidarity for Participatory Democracy is a non-government group that asserts people's authority over the *chaebol.* In 1997, it allied with a Korea First Bank minority shareholder group in a successful derivative law suit against the failed bank's former management. The court found the Korea First Bank management lent illegally to bankrupt Hanbo Steel.

In another suit, People's Solidarity for Participatory Democracy claim Samsung Electronics issued convertible bonds to its chairman's son, transferring company money to the family at a discount. The non-government group also attends the annual meetings of Samsung Electronics, SK Telecom, Daewoo Corporation, Hyundai Heavy Industry and LG Semiconductors, to urge corporate governance reforms, including adopting cumulative voting for electing directors.

Source: PricewaterhouseCoopers, 2001; People's Solidarity for Participatory Democracy, 2001.

CREDITORS' RIGHTS

Pre-crisis creditors' rights were relatively weak and despite stronger bankruptcy laws, slow enforcement through the courts is retarding Korea's restructuring and economic recovery.

Bankruptcy Laws

The financial crisis revealed weaknesses in Korea's bankruptcy and corporate restructuring regimes. Hence, in 1998, the Government amended bankruptcy laws simplifying legal proceedings for corporate rehabilitation and bankruptcy filing, streamlining provisions for non-viable firms to exit markets and improving creditor bank representation during resolution (PricewaterhouseCoopers, 2001). In 1998, authorities also attempted to expedite court insolvency proceedings, granting district courts exclusive authority to process cases (PricewaterhouseCoopers, 2001). However, court delays and a desire to preserve capital adequacy mean most banks negotiate with distressed debtors to restructure loans; only occasionally do banks file for receivership (Asian Development Bank, 2001).

Nevertheless, by September 1998, corporate restructuring had increased firm bankruptcies to 20 000, double pre crisis levels. As well, by July 1998, bank led voluntary workouts involved 210 financial institutions under Corporate Restructuring Agreements. Threats of bankruptcy or foreclosure are motivating company participation. The Financial Supervisory Service drives corporate restructuring, regulating and supervising Korean financial institutions (PricewaterhouseCoopers, 2001). The Corporate Restructuring Coordination Committee arbitrates cases where agreement fails; usually, creditor bank delegations oversee defaulting firms' management.

Bank Supervision

In 1998, the Financial Supervisory Service, then Commission, became responsible for supervising banks, insurance companies and security companies. It introduced a series of post crisis capital adequacy and loan loss provisioning reforms which strengthened prudential control (East Asia Analytical Unit, 1999a; East Asia Analytical Unit, 1999b).

COMPLIANCE

Increasingly active minority shareholders and prudential institutions and independent courts enforce better compliance with new standards, codes and regulations. However, long delays persist in the courts and close media and *chaebol* links weaken media scrutiny of *chaebol* behaviour.

Legal System

The rise in successful minority shareholder cases against corporates demonstrates the Korean court system is relatively independent. Importantly, in July 2001, seven former Daewoo executives were imprisoned for up to seven years and fined Won 26 trillion (about US$23 billion) for falsifying accounts and diverting company funds (*South China Morning Post*, www.scmp.com, 25 October 2001). These were the first custodial sentences handed out for corporate fraud and are an important indicator corporate governance should continue to improve.

Media

Chaebol directly or indirectly own much of the media, possibly weakening its willingness to scrutinise corporate behaviour; media outlets also are heavily reliant on *chaebol* advertising. For example, Samsung owns the daily *Joongang Ilbo* and Hyundai owns the daily *Munhwa Ilbo*. The Federation of Korean Industries, incorporating all the major *chaebol*, owns the *Korean Economic Daily*, or *Hankyung*, after taking it over from Hyundai in 1980 (Backman, 1999).

IMPLICATIONS

The Korean Government recognises weak corporate governance was central to Korea's severe financial crisis and since the crisis, has strengthened the regulatory environment and enforcement. Over time, new reforms, corporate restructuring, deepening capital markets, foreign bank entry and greater local and foreign market competition should weaken *chaebol* dominance and improving standards of corporate governance. This will be important to reduce Korea exposure to risky corporate borrowing and profligate investment at the expense of minority shareholders and hence any recurrence of the financial crisis. However, for this to happen, strong political will and institutions are vital in confronting powerful vested interests and ensuring a timely transition to a rules based business model.

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