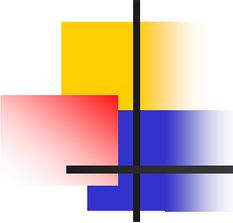


Corporate Governance: Does it matter?

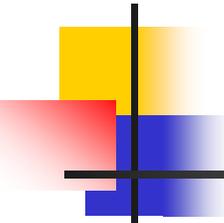
Professor Seoungpil Ahn

서강대학교
SEP Offline 특강
2010/1/20



Public portrait of Finance World

- Greed
- Most people in Wall Street “would be **willing to break law** if they believed they could make a lot of money and get away with it” and that they **care only about “making money** and absolutely nothing else”
- A Professor at UC Berkeley Business School assure commencing students that “**greed** is all **right, healthy**. You can be greedy and still feel good about yourself”.



Asian Crisis and Corporate Governance Reform

- It all started from Asian Financial Crisis in 1997-1998.
 - Corruptions, inefficient capital markets, inadequate accounting standards, poor audit systems, directors lacking training and responsibilities, politically not-free regulators and courts, unaccountable managers...you name it!
 - Rapid liberalization of Asian capital markets without proper amendments of securities laws, regulation, and disclosure practices, etc.
 - Open exposure to western capital inflows averaged \$40 billion per year in the mid 90's, followed by costly flight back.

We are not alone though....

A Crisis in Leadership



US Markets: A Breakdown in Trust

CAN YOU TRUST ANYBODY ANYMORE?

The scope of the Enron debacle undermines the credibility of modern business culture. Let's get back to basics

Essay by Bruce Nussbaum

There are business scandals that are so vast and so penetrating that they profoundly affect our most deeply held beliefs about the honesty and integrity of our corporate culture. Enron Corp. is one of them. This financial disaster goes far beyond the fall-

owable letter by Enron whistle-blower Sherron Watkins to Chairman Kenneth L. Lay in August that presciently warns of corporate corruption, subterfuge, and manipulation. She worries about the world perceiving Enron's "paid auditors as nothing more than an elaborate accounting hoax" (page 34).

The Enron debacle calls into question a host of other



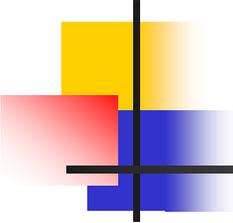
THE CRISIS IN CORPORATE GOVERNANCE

SPECIAL REPORT

Excessive Pay. Weak Leadership.
Corrupt Analysts. Complacent Boards
Questionable Accounting.

How To Fix
The System

PAGE 38



Time to act

- To restore investors confidence by providing a secure institutional platform on which to build financial markets.
- To restore social and moral responsibilities of the political and financial world.
- Improving corporate governance is a cornerstone of the process

President George W. Bush

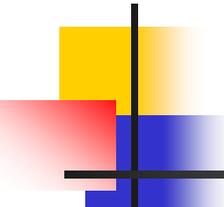


“With 80 million Americans participating as shareholders of companies, we must ensure **high standards, tough disclosure requirements and accurate information.**”

April 24, 2002

“There is a need for a **renewed corporate responsibility** in America. Those entrusted with shareholders' money must -- must -- strive for the highest of high standards.”

June 26, 2002

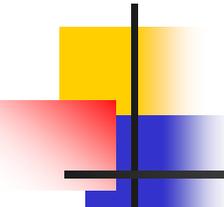


OECD Principles of Corporate Governance

The OECD Principles of Corporate Governance are the best known and most frequently cited principles. However, as stated in its preamble, the OECD Principles are non-binding and do not aim at detailed prescriptions for national legislation. Rather, their purpose is to serve as a starting point for policy makers and market participants, as they examine and develop their legal and regulatory frameworks for CG that reflect their own economic, social, legal and cultural circumstances.

- I. Rights of shareholders** – The CG framework should protect shareholders' rights.

- II. Equitable treatment of shareholders** – The CG framework should ensure the equitable treatment of all shareholders, including minority and foreign shareholders. All shareholders should have the opportunity to obtain effective redress for violation of their rights.

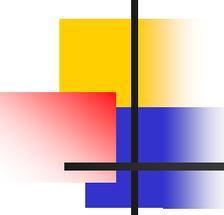


OECD Principles of Corporate Governance

III. Role of stakeholders in CG – The CG framework should recognise stakeholders rights as established by law and encourage active cooperation between corporations and stakeholders in creating wealth, jobs and the sustainability of financially-sound enterprises.

IV. Disclosure and transparency – The CG framework should ensure that timely and accurate disclosure is made on all material matters regarding the corporation, including the financial situation, performance, ownership and governance of the company.

V. Board responsibilities – The CG framework should ensure the strategic guidance of the company, the effective monitoring of management by the board and the board's accountability to the company and the shareholders.



Good corporate governance:

- Maintaining the proper balance in the distribution of rights, powers, duties and responsibilities among managers, directors and shareholders, thereby enabling the corporate enterprise to operate efficiently and create long-term value.
- It is always contextual, and must reflect the traditions, culture and market conditions in which companies are doing business.
- There is no “one-size-fits-all” formula. Different markets – US, Europe, Latin America, Asia - are at different stages of economic development and face different governance challenges.

The Corporate Governance Triangle



*The Board is responsible for resolving the structural conflicts that arise between the competing but equally valid goals of management and shareholders on the following issues:

- Control and Takeover Bids
- Capital Structure
- Corporate Governance Principles
- Compensation of Senior Management
- Nomination of Directors
- Shareholder Rights
- Corporate Social Responsibility
- Performance and Business Strategy

In the U.S. before takeovers and the rise of institutional activism, the Corporate Governance Triangle looked like this:



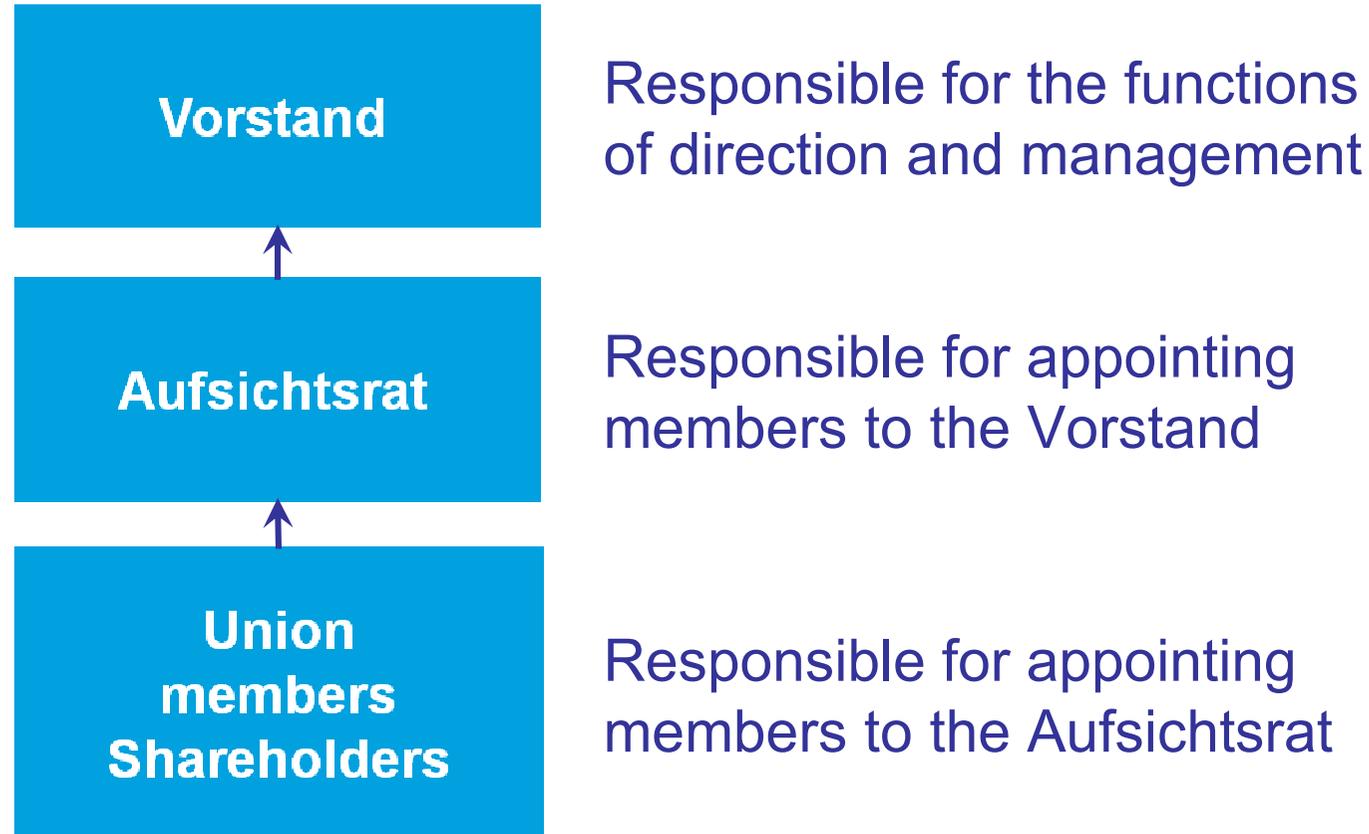
International corporate governance



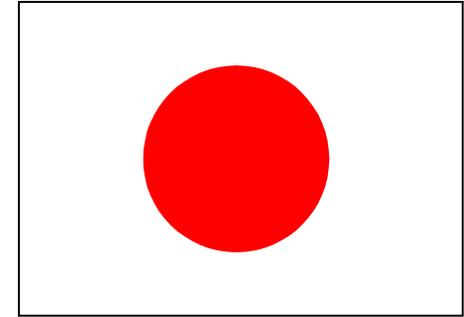
- Germany
 - Owner and manager are often the same in private firms.
 - Public firms often have a dominant shareholder, frequently a bank.
 - Frequently there is less emphasis on shareholder value than in U.S. firms, although this may be changing.

International corporate governance (Cont'd)

■ Germany: Two-tiered Board



International corporate governance (Cont'd)



■ **Japan**

- Important governance factors:
 - Obligation
 - “Family”
 - Consensus
- Keiretsus: strongly interrelated groups of firms tied together by cross-shareholdings
- Banks (especially “main bank”) are highly influential with firm’s managers

International corporate governance (Cont'd)

■ **Japan (Cont'd)**

- Other governance characteristics:
 - Powerful government intervention
 - Close relationships between firms and government sectors
 - Passive and stable shareholders who exert little control
 - Virtual absence of external market for corporate control

International corporate governance (Cont'd)

■ **Global corporate governance**

- Organizations worldwide are adopting a relatively uniform governance structure
 - Boards of directors are becoming smaller, with more independent and outside members
 - Investors are becoming more active
 - In rapidly developing market economies, minority shareholder rights are not protected by adequate governance controls

Governance mechanisms and ethical behavior

- It is important to serve the interests of the firm's multiple stakeholder groups

**Capital market
stakeholders**

**Product market
stakeholders**

**Organizational
stakeholders**

- Shareholders (in the capital market stakeholder group) are viewed as the most important stakeholder group
- The focus of governance mechanisms is on the control of managerial decisions to assure shareholder interests
- Interests of shareholders is served by the board of directors

Governance mechanisms and ethical behavior (Cont'd)

- It is important to serve the interests of the firm's multiple stakeholder groups

**Capital market
stakeholders**

**Product market
stakeholders**

**Organizational
stakeholders**

- Product market stakeholders (customers, suppliers and host communities) and organizational stakeholders may withdraw their support of the firm if their needs are not met, at least minimally

Governance mechanisms and ethical behavior (Cont'd)

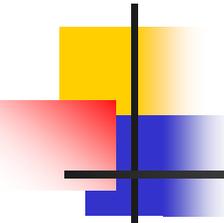
- It is important to serve the interests of the firm's multiple stakeholder groups!

**Capital market
stakeholders**

**Product market
stakeholders**

**Organizational
stakeholders**

- Some observers believe that ethically responsible companies design and use governance mechanisms that serve all stakeholders' interests
- Importance of maintaining ethical behavior is seen in the examples of Enron, WorldCom, HealthSouth and Tyco



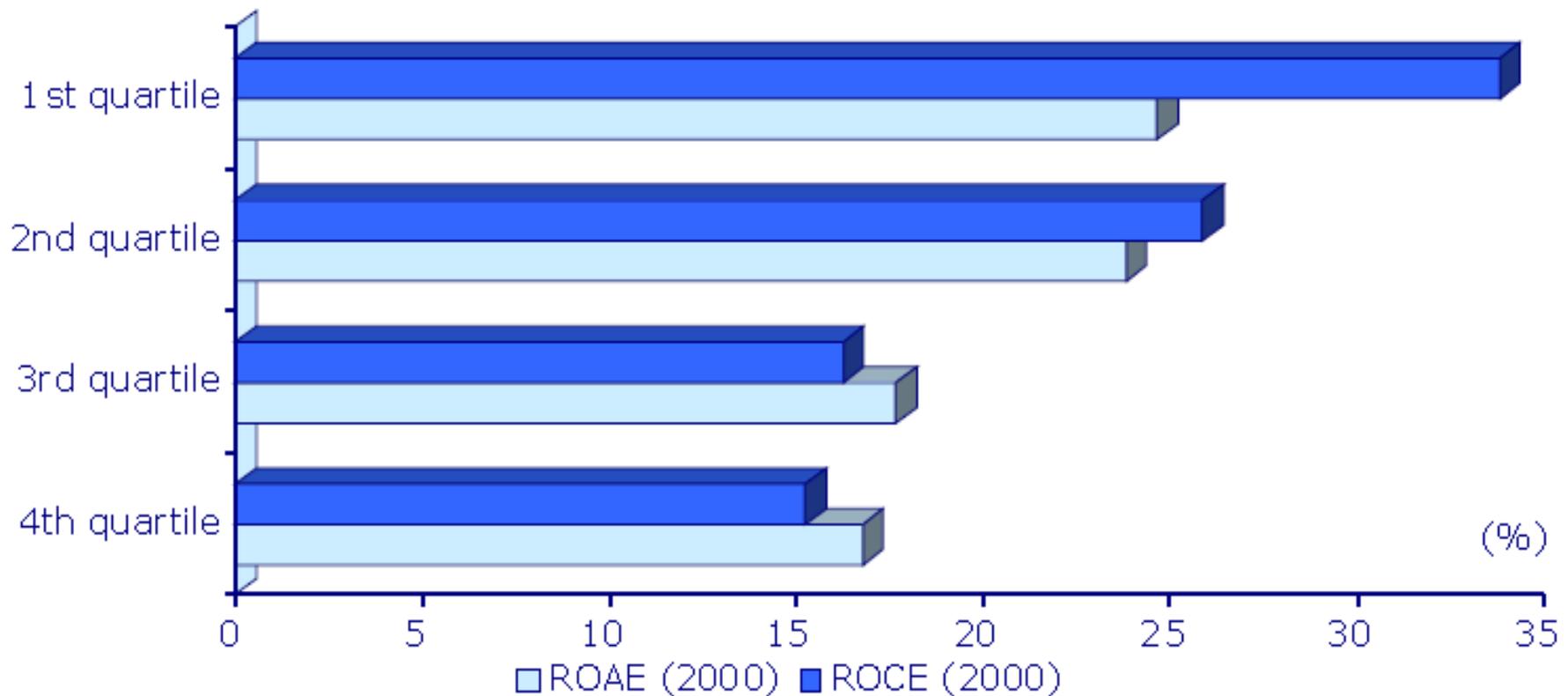
Does corporate governance (CG) really matter?

- Credit Lyonnais Securities Asia (CLSA) find that firms with better CG structure perform better than firms with poor CG structure.
 - CLSA ranked 495 largest cap stocks in 25 global emerging capital markets in 2001:
 - Highest CG scored firms: HSBC, Infosys, SIA, Li &Fung, Richemont, CLP, South Africa Breweries, Singapore Press Holdings, Wipro, and Stanbric
 - Lowest CG scored firms: Lukoil, TPSA, Isbank, Tenaga, PCCW, Hutchison, Shinhan Bank, Citic Pacific, KT Freetel and China Unicom

Return on Capital Employed (ROCE) and Return on Average Equity (ROAE)

Figure 1

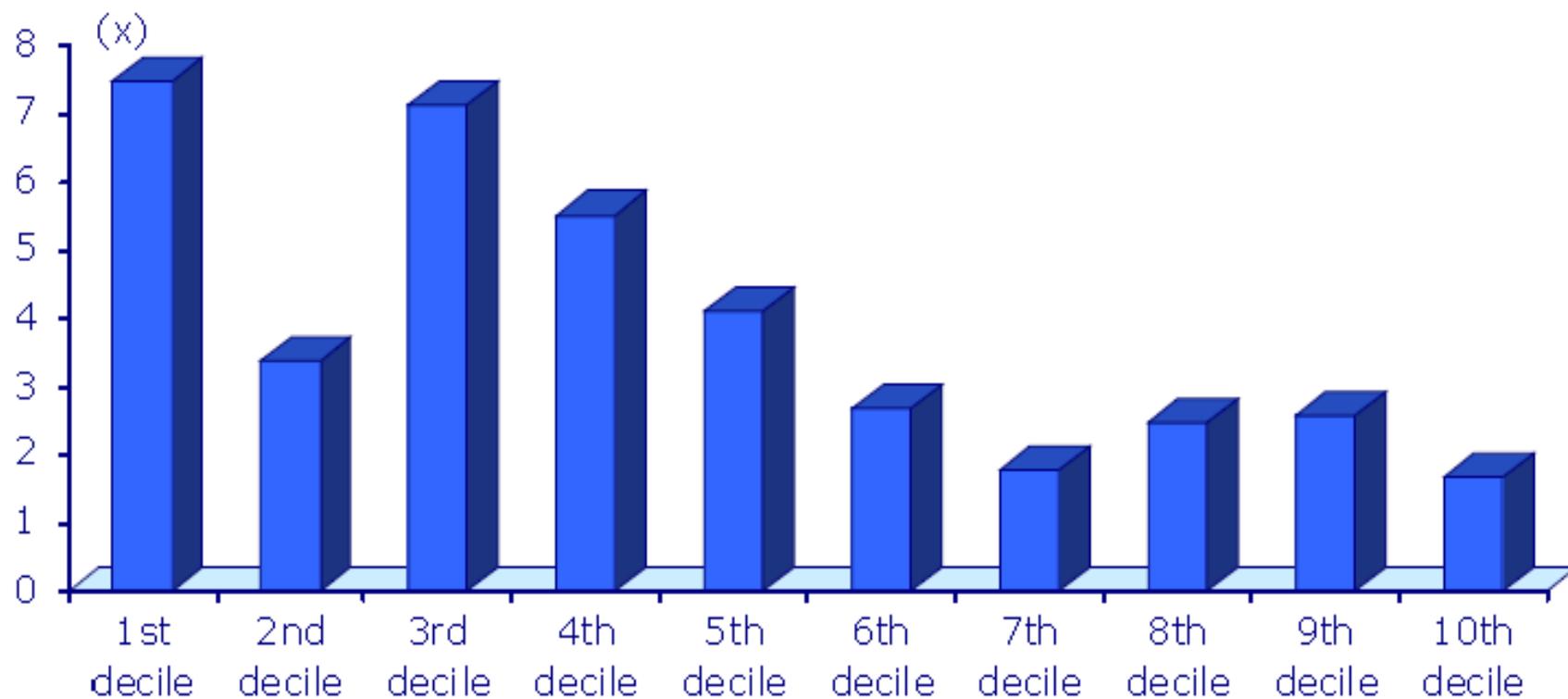
ROCE and ROAE of 100 largest GEM stocks by CG quartile

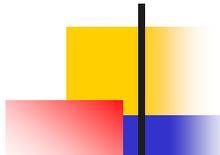


Price-to-Book (PB) Ratio

Figure 2

PB of 100 largest GEM stocks by CG decile (2000)

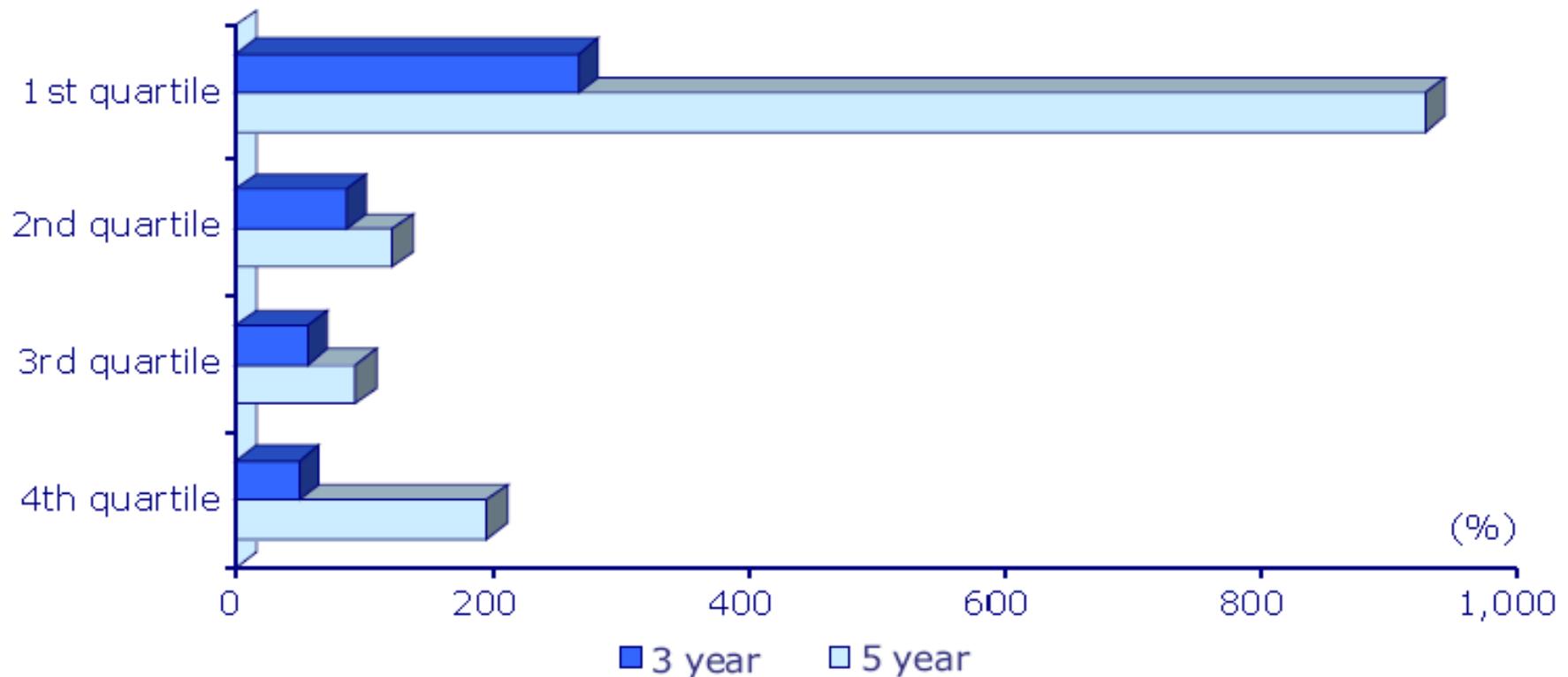




Stock market performance

Figure 3

Three- and five-year share-price performance of 100 largest GEM stocks by CG quartile



Source: CLSA Emerging Markets

Views of Institutional Investors: Singapore Case

- Survey senior investment managers in Singapore, year 2004 and 2005

Chart 1: Breakdown of survey responses*

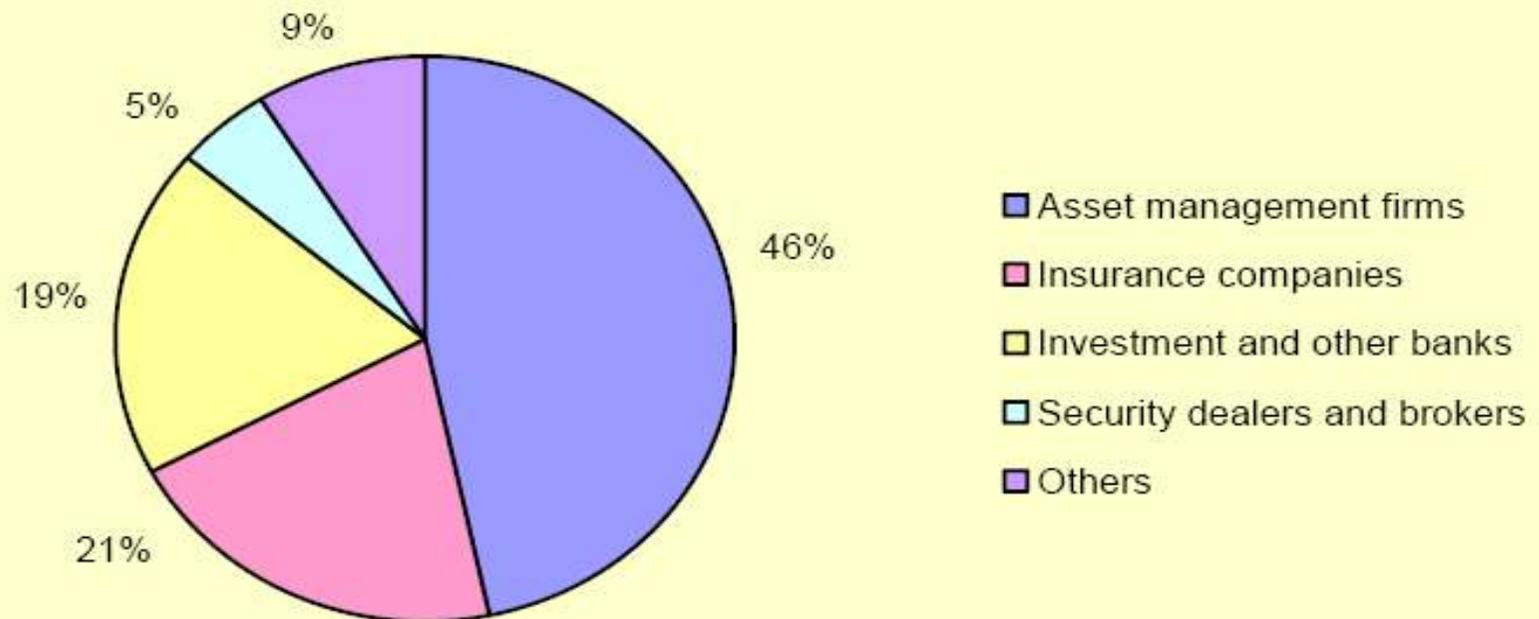


Chart 5: Factors influencing investment decisions*

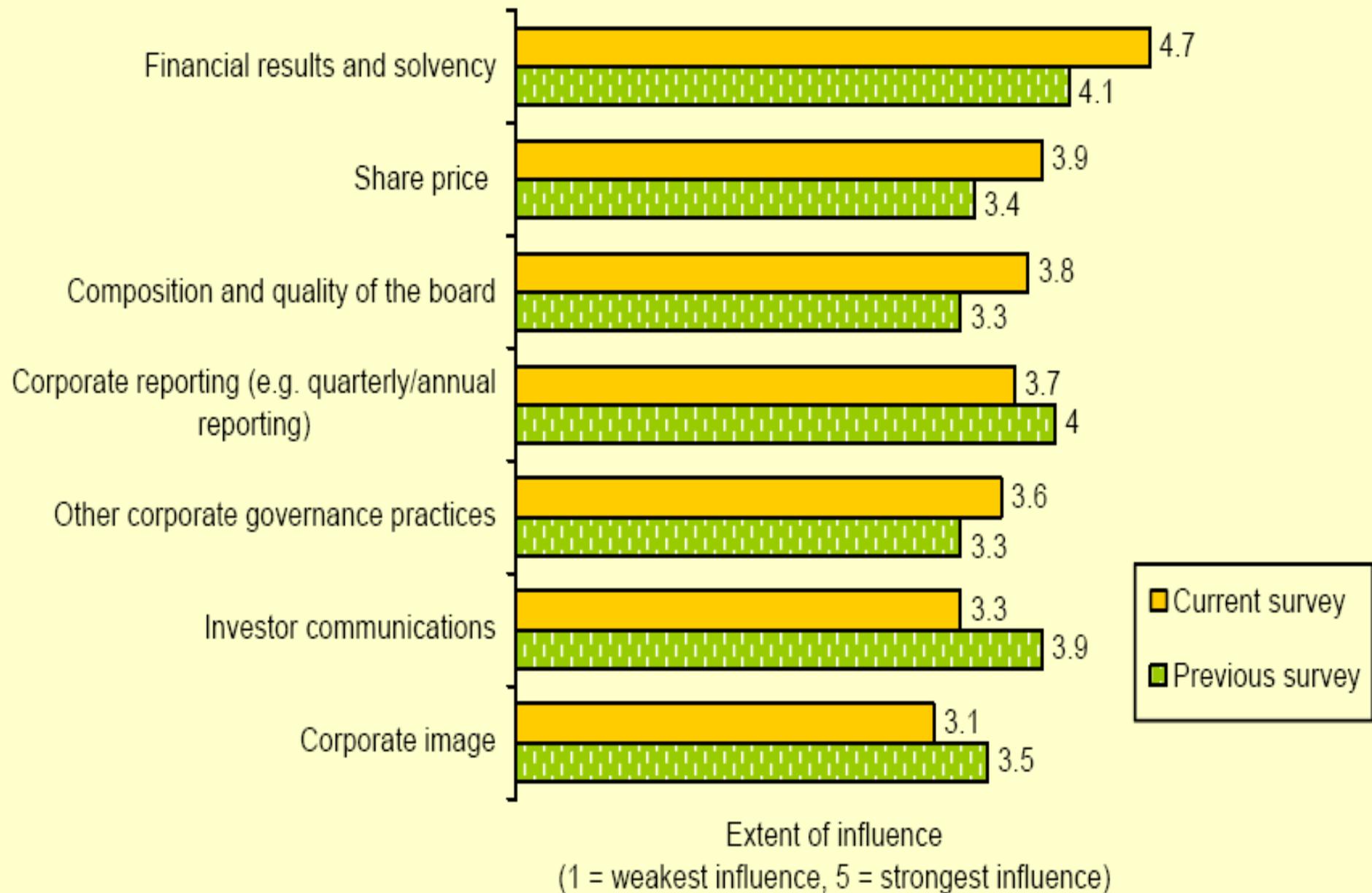


Chart 9: Extent to which the composition and quality of the board factors influence the investment decision*

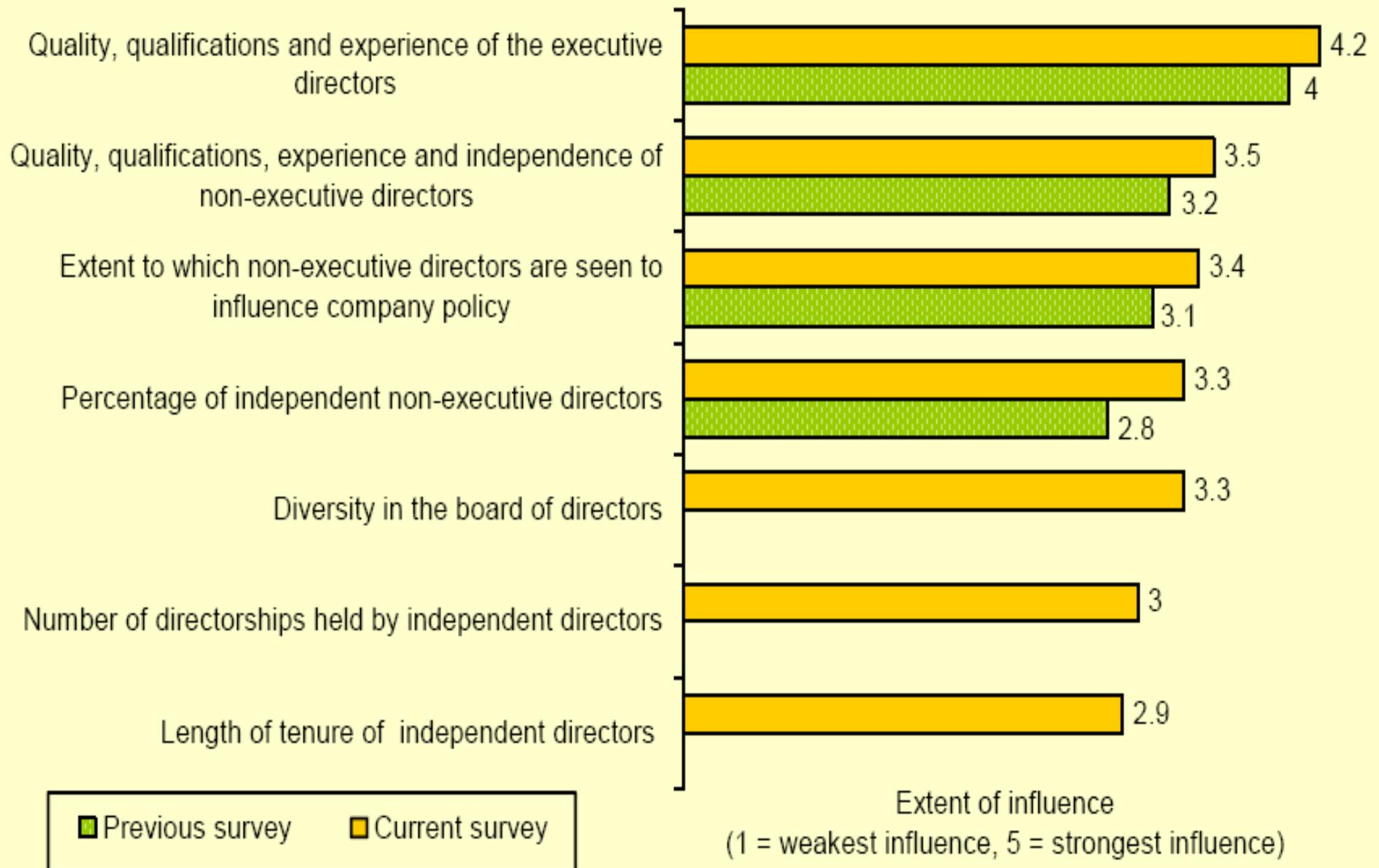


Chart 10: Extent to which other corporate governance practices factors influence the investment decision*

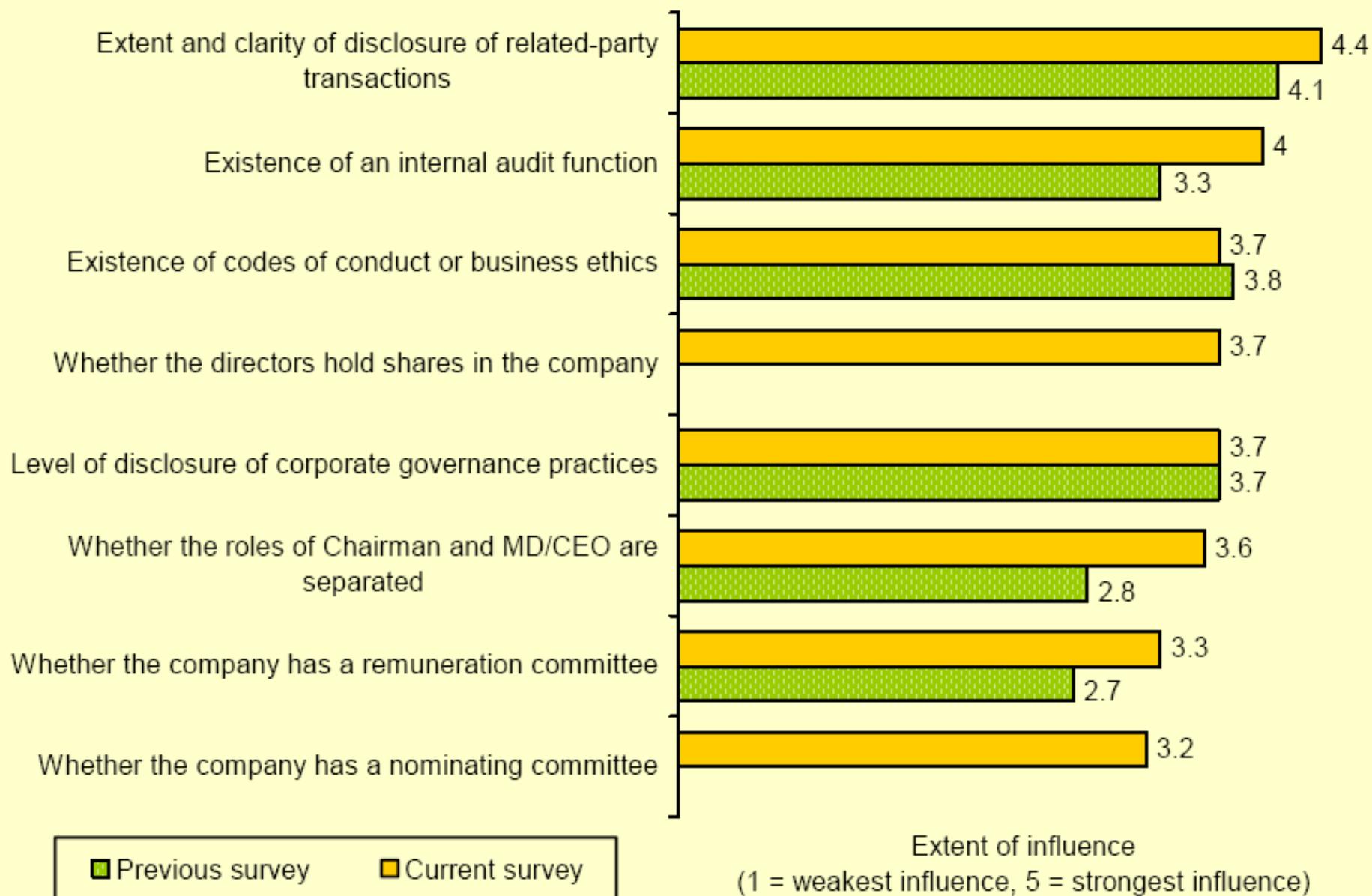
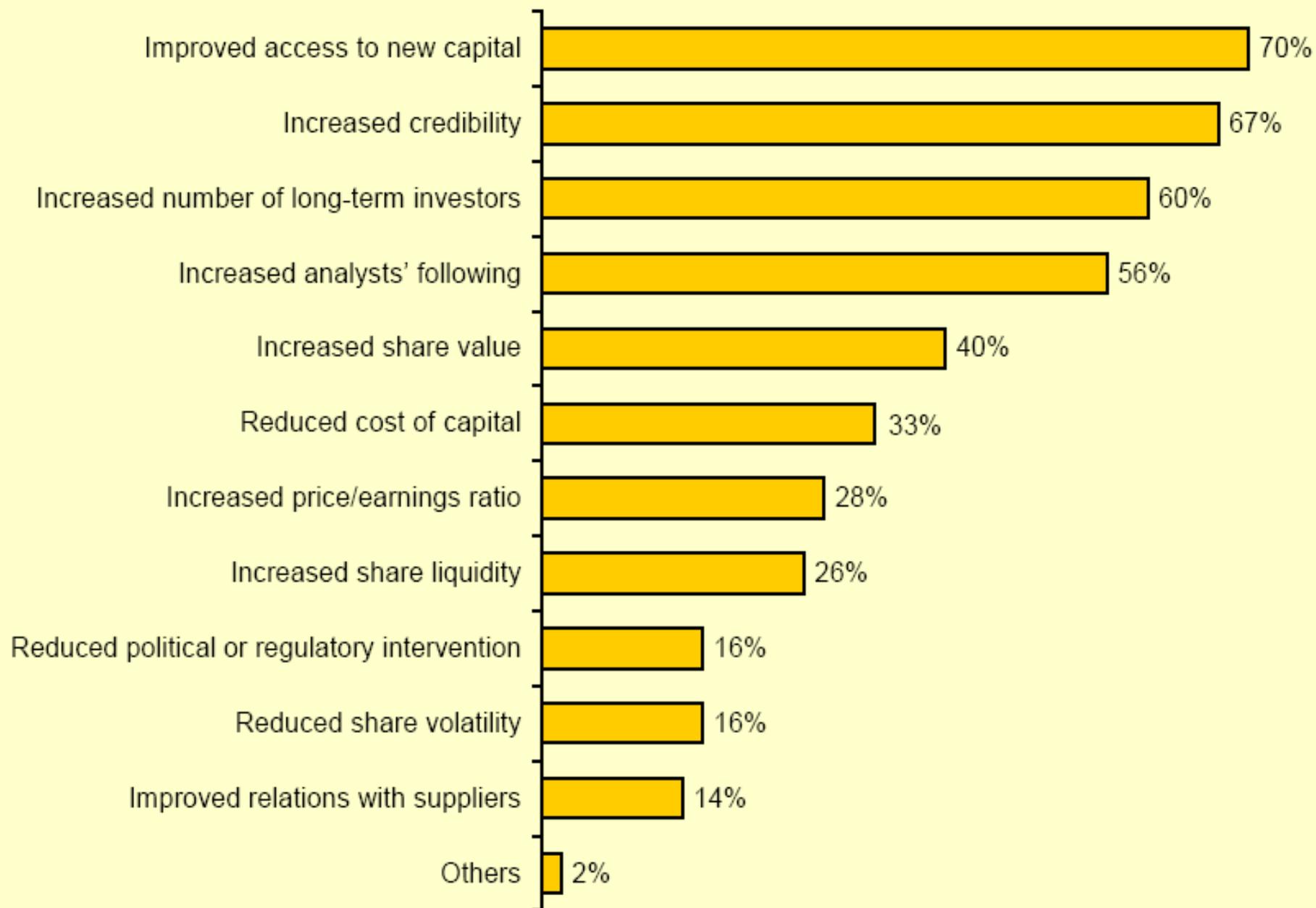
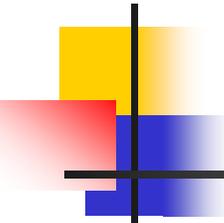


Chart 21: Benefits to companies for enhancing corporate communications*





Credit Lyonnais Securities Asia (CLSA) Research on Corporate Governance in Asia

- In alliance with the Asian Corporate Governance Association (ACGA), CLSA issues “CG (Corporate Governance) Watch” annually.
 - Ten markets: China, Hong Kong, India, Indonesia, Korea, Malaysia, Philippines, Singapore, Taiwan and Thailand.
 - Covering more than 400 companies: largest 30-50 companies covered by CLSA for its institutional clients in each of 10 markets

Markets ranked by corporate governance

	Rules & regulations (15%)	Enforcement (25%)	Political & regulatory (20%)	IGAAP (20%)	CG culture (20%)	Country score (2004)	Country score (2003)
Singapore	7.9	6.5	8.1	9.5	5.8	7.5	7.7
Hong Kong	6.6	5.8	7.5	9.0	4.6	6.7	7.3
India	6.6	5.8	6.3	7.5	5.0	6.2	6.6
Malaysia	7.1	5.0	5.0	9.0	4.6	6.0	5.5
Korea	6.1	5.0	5.0	8.0	5.0	5.8	5.5
Taiwan	6.3	4.6	6.3	7.0	3.5	5.5	5.8
Thailand	6.1	3.8	5.0	8.5	3.5	5.3	4.6
Philippines	5.8	3.1	5.0	8.5	3.1	5.0	3.7
China	5.3	4.2	5.0	7.5	2.3	4.8	4.3
Indonesia	5.3	2.7	3.8	6.0	2.7	4.0	3.2

Source: CLSA Asia-Pacific Markets, Asian Corporate Governance Association

I. Progress of CG reform in Korea

● Korean Industrial History

■ 1997-1998 Asian Financial Crisis

- Foreign Investors pull out
- Korean Won devalues
- Loans must be called in
- Companies default



SUE	12	950	0
TMC		103	
CIRKIT	12.75	13	13
DELTA	2.10	220	2.18 -8
DRACO	1025	10.75	1025 0.25
OSS	9050	12.1	122
HANA	108	1.10	1.10 4
HIPRO	3.725	44	4.150 -0.50
KCE	142	192	198
KRP	26	2.775	2.7
BANPU	6550	6.750	6.750 -0.50
BCR	560	5.70	5.60 0.30
COOO	1625	1650	1525
EGCOMP	4525	4550	4525 2.25
LENNA	CE	43	4550 4550 450
ETEC		200	203 303 22

■ Result

- 1/3 of Chaelbols collapse due to high leverage, cross share holding and cross loan guarantees.

I. Progress of CG reform in Korea

● Fallout of Asian Financial Crisis

- Recognition that dominant shareholder held little equity
- Weak monitoring of managers
- Weak transaction regulation
 - Illegal diversion of funds
 - Illegal accounting practices
- Asset stripping of insolvent firms
- IMF bail out



I. Progress of CG reform in Korea

Economic Reform

- Reasons for reform
 - Conditions of IMF bail out
 - Election platform of President Kim Dae-jung
 - Increasing political pressure and activism from minority/small shareholders
- Reform Covers
 - Corporate Governance
 - Laws of Insolvency
 - Mergers and Acquisitions
 - Accounting Transparency
 - Financial Regulation

I. Progress of CG reform in Korea

Economic Reform

- Legislation Affected
- The Commercial Codes
 - Securities Exchange Act
 - Monopoly Regulation and Fair Trade Act
- Reform also strengthened enforcement

I. Progress of CG reform in Korea

Economic Reform Policy after the Economic Crisis

- “Four Economic Reform Policy”(1998)
 - Corporate reform
 - Financial reform
 - Labor reform
 - Public sector reform
- “5 Plus 3”Corporate Reform Principle
 - Agreement between Government and Chaebols
 - Improving corporate governance is a key policy

I. Progress of CG reform in Korea

“5 Plus 3” Corporate Reform Principle

- **Five Principle Policy (February 1998)**
 - Improving financial structure (reduction of debt)
 - Building competence core for chaebol groups
 - Enhancing transparency
 - Removing cross debt guarantee
 - Enhancing accountability of controlling shareholder & mgt.
- **Three Additional Principle (August 1999)**
 - Reducing circuitous equity ownership and unfair transaction among affiliated companies
 - Improving corporate governance of non-bank financial institutions
 - Strengthening gift and inheritance taxation

I. Progress of CG reform in Korea

New Regulations to Improve CG

- **Outside Director**
 - Required for all listed companies on KSE & KOSDAQ
 - More than 25% of the board should be outside director
 - For company with asset larger than 2 trwon (\$1.7bil), more than 50% of the board (2001) should be outside director
- **Outside director candidate nomination committee**
 - Mandatory for company with asset larger than 2 tr. won
 - More than 1/2 should be outside director

I. Progress of CG reform in Korea

New Regulations to Improve CG

- **Audit Committee**
 - Mandatory for company with asset larger than 2 trwon
 - 2/3 of the committee should be outside directors
- **Improved Disclosure**
 - Combined financial statement for companies with asset larger than 2 tr won (\$1.7 bil)
 - Electronic disclosure system introduced
- **Cross share ownership prohibited**
- **Cross debt guarantee prohibited**

I. Progress of CG reform in Korea

New Regulations to Improve CG

- **Limitation on equity holding of affiliated companies**
 - No more than 25% of net asset value
 - Applies to chaebol groups with asset greater than 5 trilwon (\$4.2 bil)
- **More Regulation on Related Party Transactions**
 - Related party transactions greater than \$8.3 million
 - Board should approve it
 - Should be disclosed immediately

I. Progress of CG reform in Korea

New Regulations to Improve CG

- Limit on Equity Ownership by Foreigner Removed
- Hostile Takeover Barriers Removed
 - M&A specialized fund allowed
- Holding Company Introduced
 - Holding company's debt to equity ratio should be less than 100%
- Cumulative Voting in Election of Directors
 - Opt-out system

I. Progress of CG reform in Korea

New Regulations to Improve CG

- **Increased Responsibility of Controlling Shareholder**
 - Fiduciary duty of directors
 - Liability of shadow director (controlling shareholder who does not seat on the board)
- **Mandatory Compliance Officer**
 - Investment Trust Co. & Mutual Fund
- **Integrated Supervisory Agency Established**
 - “Financial Supervisory Commission”
- **Minority Shareholder’s Rights Strengthened**

I. Progress of CG reform in Korea

Positive Changes in Corporate Governance

- Increased awareness on corporate governance
- Disclosures are more reliable
- Related party transactions decreased
- Investor relation is active
- New court rulings sets the standard
 - Derivative lawsuit:
 - Korea First Bank: \$33.3 million
 - Samsung Electronics Co.: \$81.4 million
 - Court ruling against “lack of business judgment”

I. Progress of CG reform in Korea

Positive Changes in Corporate Governance

- Good corporate governance practicing companies
 - KookminBank, POSCO, KT, Samsung SDI
- Active institutional investors
 - National Pension Fund
- Positive steps by controlling family
 - CJ Group chairman JH Lee gives up warrants worth of \$92 million
- Shareholder activism brings practical changes
 - PSPD : NGO shareholder activists group

II. Current issues in CG reform

Current Issues

- Old habits are hardly changing
 - Mindset of controlling family is the same
 - Persistent moral hazard
- Resistance from establishments
 - Political uncertainty
- Enforcement of regulation is not effective
- Independence of outside director in question
- Capital subsidy through financial institutions

II. Current issues in CG reform

Current Issues

- **Expropriation of minority shareholders**
 - **Discounted Convertible Bond, Bond with Warrant**
- **Management control descended to 3rd Generation**
 - **Off-shore paper company operation**
 - **Equity issuance to family members using CB and BW**
- **Entrenched ownership structure**
 - **Control via ownership by affiliated companies**
 - **Pyramidal and circuitous ownership**

II. Current issues in CG reform

● Current Issues

Source of Controlling Power

Top 10 Chaebols: Public and Private Companies

	Controlling Shareholder & Family	Affiliated Companies	Shares under Family Control
1997	9.54%	29.29%	39.57%
1998	7.82%	35.36%	44.16%
1999	5.76%	40.99%	48.07%
2000	4.30%	38.79%	44.72%
2001	4.29%	38.94%	47.61%

II. Current issues in CG reform

● KCGF (Korea Corporate Governance Fund)

● JANG HA-SUNG FUND

To invest, not to abandon

Private Equity fund

To reform Korean CG

To protect shareholders' rights



● LIMITATIONS

1

Off-shore
fund

2

Funding
source is
not clear

3

Company
selection
problem

4

Only for CG
What about
Profit ?

5

Non –
professiona
l

III. Top CG in Korea

● Top CG companies in Korea

● KT&G

Top 10 Good CG Company in Asia

- CLSA(Credit Lyonnais Securities Asia



1. Secure the right of Shareholder

1) Clearly regulate the right of shareholders

2) No big share holder : No conflict between big and small share holder



III. Top CG in Korea

● Top CG companies in Korea

● **KT&G**

2. Board of Director

1) Separate Ownership & Management

2) Outside company directors **10** (total **13**)

- Active meeting (attendance **92%**)

- Clear election by share holders

- Specialty & Independence

- Professor (**3**), Government (**2**), Management (**1**), Lawyer (**1**),
Laboratory (**1**), Religion (**1**)

III. Top CG in Korea

● Top CG companies in Korea

● **KT&G**

3. Public Announcement

- Accurate & occasionally (more than 50% English P.A. out of all Korea market)

4. Effective auditors

5. Profit Sharing

- High level of dividend earning rate : 7%
- High level of dividend disposition : more than : 50%
- Increase Treasury Stock