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May 15, 1998

To: Members of the Executive Board

From: The Secretary

Subject: **Republic of Korea—Selected Issues**

The attached paper provides further background information to the staff report on the 1998 Article IV consultation discussions with the Republic of Korea and the second quarterly review under the Stand-By Arrangement for the Republic of Korea, which will be issued shortly.

Ms. Gobat (ext. 34413) is available to answer technical or factual questions relating to this paper prior to the Board discussion.

Unless the Documents Section (ext. 36760) is otherwise notified, the document will be transmitted, in accordance with the procedures approved by the Executive Board and with the appropriate deletions, to the WTO Secretariat on Tuesday, May 26, 1998; and to the Asian Development Bank (AsDB), the Food and Agriculture Organization (FAO), the Organisation for Economic Cooperation and Development (OECD), the United Nations Development Programme (UNDP), and the World Food Programme (WFP), following its consideration by the Executive Board.

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INTERNATIONAL MONETARY FUND

REPUBLIC OF KOREA

Selected Issues

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Approved by the Asia and Pacific Department

May 14, 1998

Contents **Page**

Charts

Annex

I. Corporate Restructuring and Corporate Governance

A. Introduction

1. **In a turn of events unprecedented for modern Korea, several of the nation's largest corporate groups, known as chaebols, filed for bankruptcy protection in 1997.**[1] These corporate failures are a root cause of the financial crisis Korea has faced since late last year. The bankruptcies weakened the banking sector with a rapid rise in nonperforming loans, leading foreign banks to reduce lending to Korean financial institutions. A vicious cycle ensued: banks further reduced corporate lending, intensifying the liquidity squeeze on the chaebols and heightening the systemic risk in the economy.

2. **As Korea confronts the deepest financial crisis of its industrialization—accompanied by what promises to be a sharp economic slowdown—the question facing policymakers is what lies behind the fragility in the country's corporate sector and how these problems can be remedied.**[2] Although the sudden investor panic that swept over Korea in late October triggered the current crisis, the underlying weaknesses in the country's system of corporate governance and industrial organization have long been apparent. While addressing the weaknesses underlying the corporate sector has long been an objective of government policy, many years of strong growth permitted them to be left largely unattended. Now, however, solutions to these problems are crucial to restoring investor confidence and reinvigorating Korea's economy.

3. **Several short-term cyclical factors contributed to the current financial distress of Korean companies.** Excess capacity has plagued the manufacturing sector since the investment surge during 1994 and 1995. The growth slowdown since 1996 and excess capacity resulted in stiffer price competition. In particular, the steep price drop in semiconductors in 1996—as well as in other key exports such as steel—worsened the cash flows of the large export-oriented companies.

4. **Korean chaebols are especially vulnerable to cyclical downturns and changes in debt servicing costs because easy access to credit led to unprofitable investments and a financing structure that relies excessively on debt.** Korean companies' debt-to-equity ratios are persistently higher than in other advanced economies. Chaebols' vulnerability to

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[1]Of the thirty largest chaebols, seven filed for court protection in 1997: six before the external crisis—Hanbo, Sammi, Jinro, Kia (the eighth largest chaebol), Haitai, New Core, and Halla (the twelfth largest) in December.

[2]Korea experienced a serious recession in 1979–80 as a result of the second oil price shock and the social and political instability that arose from the assassination of President Park Chung Hee. The downturn led to similar financial problems but not of the current magnitude.

cyclical downturns is exacerbated by their ownership and financial structure that intertwines affiliates with each other under cross shareholding and debt payment guarantees. While such a structure can boost the performance of the chaebol network during periods of strong growth, during slowdowns the failure of one or two companies can lead to a chain reaction of failure in affiliated companies and even the collapse of an entire chaebol.

5. **Weaknesses in corporate governance help explain the difficulties many Korean chaebols face.** Korean chaebols have typically pursued size and growth over profitability, undertaking projects that have not increased the net present value of the company. When chaebols ran into difficulties servicing their debt, the government typically came to their rescue.

6. **Corporate governance is basic to the system of rules that underpin a market economy: in essence, it deals with how providers of outside finance, such as banks and investors, assure themselves of getting a return on their investments.** Clearly, in Korea there have been inefficiencies on the part of creditors and investors alike in assessing credit risk, screening, monitoring, and disciplining companies. Before the 1997 crisis, very little market pressure was exerted on companies to restructure through downsizing and divestitures of loss-making affiliates. All the chaebols that ran into trouble in 1997 had already been experiencing financial difficulties—high gearing ratios and negative profits—in the years preceding. Jinro, Halla, Sammi, Hanwha, and Hanil have been posting operating losses since 1993. In 1996, thirteen of the top 30 chaebols reported operating losses.

7. **Korea's weaknesses in corporate governance owed much to the close relationship that has existed among the conglomerates, their main creditors (the banks) and the government, and to the government's habit of intervening in the marketplace.** As recently as the beginning of the 1990s , the government appointed commercial bank managers and directed their lending policies. With just two exceptions, Kukje in 1985 and Woosung Construction in 1996, the government also has not allowed big businesses or nationwide commercial banks to fail. By allowing a number of chaebols to go bankrupt in 1997, the government has signaled that it is attempting to distance itself from interventions of the past.

8. **The government also has imposed regulations on capital and product markets, and on markets for corporate control (i.e., mergers and acquisitions) that have hindered market discipline.** Moreover, corporate financial statements departed from internationally accepted accounting and auditing standards. Nontransparent corporate decision-making and ownership structure have deterred outsiders from investing in Korean companies.

9. **An effective system of corporate governance and fundamental corporate restructuring are needed to ensure that scarce resources are allocated efficiently.** Institutional structures—such as transparency of corporate information, internationally accepted auditing and accounting standards, liberalized markets for corporate control, open capital markets, legal protection of investor rights, well-functioning bankruptcy proceedings,

and antitrust laws—must be in place to ensure that markets can assess risks and impose discipline. The banking system must be commercially oriented to ensure that corporations face hard budget constraints.

10. Section II of this paper describes the chaebols and their role in the economy. Section III reviews the government's role in shaping and regulating the chaebols. Section IV explains factors that have encouraged debt over equity finance. Section V describes the key elements in corporate governance. Section VI points to weaknesses in the Korean corporate governance system. Section VII discusses the reforms to strengthen the Korean corporate governance system and to promote corporate restructuring.

B. Role of Chaebols in the Economy

11. ***Chaebols are large, highly diversified business groups, typically family-owned and managed.***[3] Most were established in the post-Korean War era and have been the driving force in Korea's economic development. The top 30 chaebols dominate every sector of the economy except agriculture. Roughly two-thirds of the 100 largest manufacturing firms belong to them. In 1995, the 30 largest chaebols produced 16 percent of GDP and accounted for 41 percent of manufacturing GDP (up from 20 percent a decade ago), 5 percent of employment, about half of exports, and 14 percent of total commercial bank loans (Chart 1).

12. **The top four—Hyundai, Samsung, LG, and Daewoo—clearly stand out.** They alone produced 9 percent of GDP in 1995. They dominate key export sectors and are global competitors in electronics, shipbuilding, chipmaking, car production, petrochemicals and other areas, ranking among the Fortune 500 largest in the world.[4] Hyundai is the biggest in terms of assets. Samsung has the largest capital base, while Samsung and LG are the most profitable. All four are by international standards highly leveraged.

13. **The top four chaebol account for a significant proportion of the economy's profits.** Profits of the top four increased from 0.2 percent of GDP in 1985 to 1.6 percent of GDP in 1995 (reflecting high semiconductor prices) before falling back to 0.3 percent of GDP in 1996. In 1995, the top three semiconductor companies, Samsung Electronics, Hyundai Electronics, and LG Semiconductors, accounted for 70 percent of the top 30 chaebols' net profits. Other conglomerates have been less profitable: among the top ten, Kia has been

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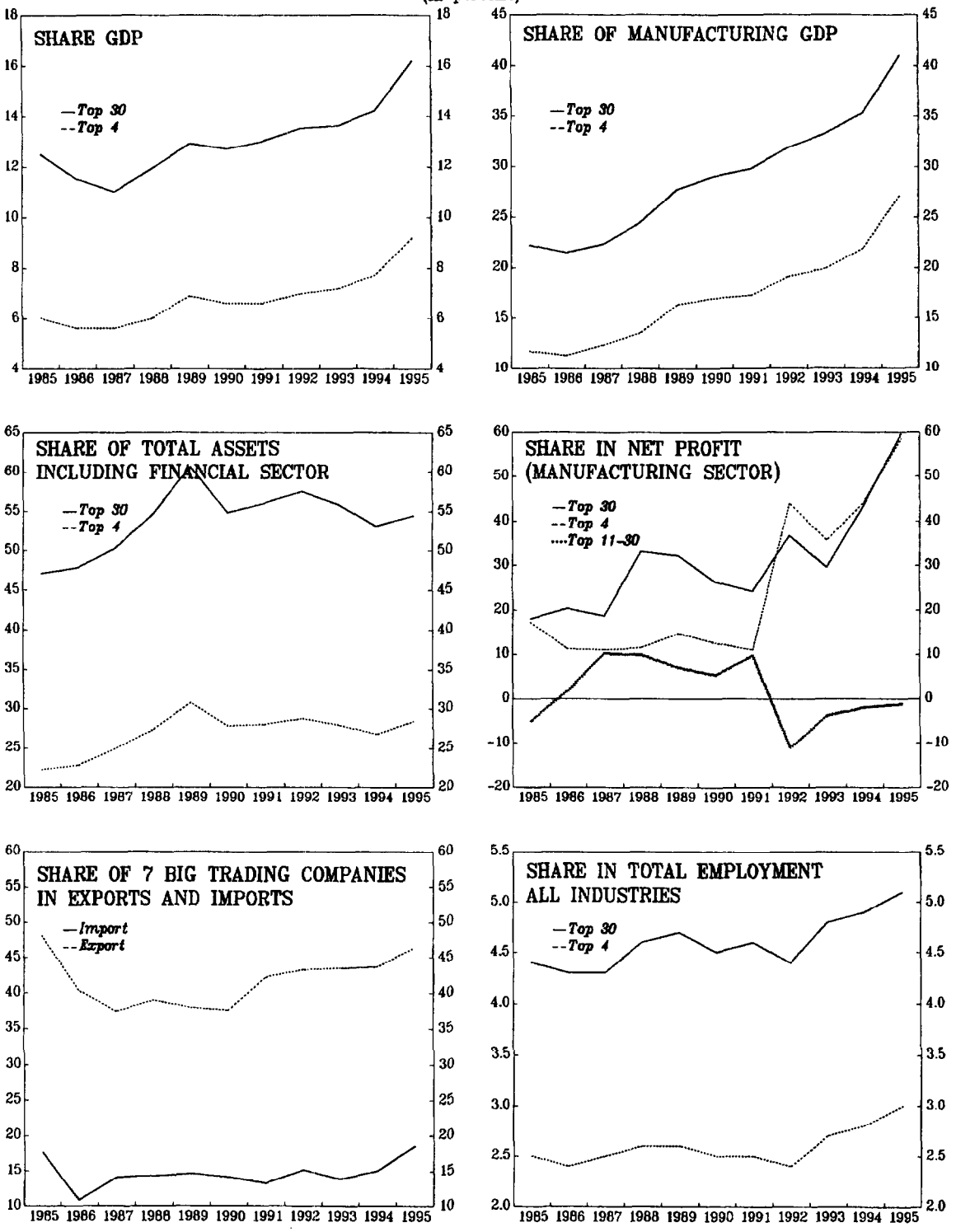
[3]The term chaebol is a direct translation of the Japanese "zaibatsu."

[4] For instance, Hyundai Heavy Industries, Daewoo Shipbuilding and Heavy Machinery, and Samsung Heavy Industries are the world's top three shipbuilders, ahead of Japan's Mitsubishi, the fourth largest. Samsung Electronics, a subsidiary of the Samsung group, is the world's largest producer of memory chips.

CHART 1
KOREA
TOP 30 CHAEBOL
(In percent)



Source: Korean Economic Research Institute

posting losses since 1994 while Hanwha has been making losses since 1991.[5] The chaebols ranking between 10 and 30 as a group have been posting consecutive losses since 1992. These profit figures suggest that the semiconductor boom may have served to mask weakness elsewhere in the manufacturing sector.

14. **The ownership structure of the chaebols is complex, in part as a result of efforts to circumvent government regulations.** Since 1993, the KFTC has ranked the 30 largest Korean business groups in order of their total assets. Once designated to the list of the top 30 chaebols, a chaebol faces restrictions on equity investment in other firms, bank borrowing and debt guarantees across affiliates. Each company within the group is legally independent; companies are linked through cross-equity investment. However, companies have attempted to limit their equity stake in other companies to below 30 percent, mainly to avoid publishing consolidated financial statements.[6]

15. **At the core of most chaebols is the family of the founding father.**[7] The family controls the group through stock ownership and through active participation in the company's management and executive board. Although the family controls only around 10 percent of the publicly traded shares, when the cross-shareholdings of companies are included, the internal shareholding amounts to 45 percent of outstanding shares (Table 1). Thus, insiders hold roughly half of all publicly traded shares. However, as some of the outsider shareholders are closely associated with the family (managers, suppliers, customers, and friends), de facto internal control tends to be even greater than 50 percent.

16. **Family ownership is highly concentrated in one or more of the core companies.** The core companies are the group leaders and the strongest in terms of assets, sales, or profits and are the most prestigious. They include a central operational office called the planning and coordinating office, which controls the financial transactions of the entire group. This office is

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[5]The 10 largest chaebols in order of asset size are: Hyundai, Samsung, LG, Daewoo, Sunkyong, Ssangyong, Kia, Hanjin (formerly Korea Explosives), Hanwha, and Lotte. The ranking and composition of the 10 largest chaebols has not changed much since 1985.

[6]Chaebols are not required to prepare consolidated statements for the entire group. Statements are published company-by-company. However, a company must produce a consolidated statement if it owns 30 percent or more of another company and has a significant control over management in that company.

[7]Korean firms have traditionally been managed by the male family members and usually by one central authoritarian figure. The eldest sons usually inherit most of the family wealth and responsibility.

Table 1. Korea—In-Group Ownership Concentration
(In percent)

	1983	1989	1991	1992	1993	1994	1995	1996
Top 30	57.2	46.2	46.9	46.1	43.4	42.7	43.3	44.1
Family	(17.2)	(14.7)	(13.9)	(12.6)	(10.3)	(9.7)	(10.5)	(10.3)
Subsidiaries	(40.0)	(32.5)	(33.0)	(33.5)	(33.1)	(33.0)	(32.8)	(33.8)
Hyundai	81.4	79.9	60.2	67.8	65.7	57.8	61.3	60.4
Samsung	59.5	56.5	51.4	53.2	58.3	52.9	48.9	49.3
Daewoo	70.6	56.2	49.1	50.4	48.8	46.9	42.4	41.4
LG	30.2	41.5	35.2	38.3	39.7	38.8	37.7	39.7

Source: Min and Jae (1997), Korean Development Institute.

the chaebol's nerve center and operates as a de facto holding company. For some of the top chaebols, there is more than one de facto holding company.[8]

17. **Marriage connections link many of the largest chaebols to each other; Samsung and Hyundai, for example, are linked through marriage alliances.** Moreover, the marital ties track the size ranking of the firm: marriages link big chaebols with other big chaebols. Marriages also cement chaebol relations with the government. In the early 1990s, one-third of the fathers-in-law of chaebol owners were high ranking government officials.[9]

18. **The chaebols operate in a wide range of businesses** ranging from electronics, shipbuilding, and construction to publishing companies, baseball and basketball teams, ski resorts, and hotels. The five largest chaebols in 1995 had on average 40 companies competing in 30 industries. The largest chaebols do business mainly in the largest manufacturing industries (petrochemicals, shipbuilding, automobiles, electronics, etc.) and, compared with their foreign competitors, are more diversified (Tables 2 and 3).

[8]The de facto holding companies of the leading chaebols are: Hyundai Heavy Industries, Samsung Life Insurance and Samsung Electronics, LG Chemicals and LG Electronics, and Daewoo Heavy Industry and Daewoo Corporation.

[9]See Bruce Cummings "Korea's Place in the Sun: A Modern History," W.W. Norton & Company, 1997.

Table 2. Korea—Chaebols' Market Shares by Size of Manufacturing Industry, 1995
(In billions of won; number of companies; in percent)

Value of Manufacturing Shipment	Number of Industries	Number of Industries Participated By		*Chaebols'* Market Share of Shipments	
		Top 5	Top 30	Top 5	Top 30
Below 100 billion	249	2	20	0.7	5.4
100–500 billion	227	22	77	3.6	10.9
500 billion–1 trillion	64	25	45	10.4	21.6
1–2 trillion	37	19	31	15.6	29.0
Over 2 trillion	26	23	25	42.7	63.3

Source: Min and Jae (1997), Korean Development Institute.

Table 3. Korea—International Comparison of Diversification by Big Business 1/
(In percent)

Types of Diversification	Korea (1989)	Japan (1973)	United States (1969)	West Germany (1970)	France (1970)	United Kingdom (1970)	Italy (1970)
Specialized	8.2	16.9	6.2	22.0	16.0	6.0	10.0
Semi-specialized	28.6	36.4	29.2	22.0	32.0	34.0	33.0
Related	6.1	39.9	45.2	38.0	42.0	54.0	52.0
Unrelated	57.1	6.8	19.4	18.0	10.0	6.0	5.0

Source: Min and Jae (1997), Korean Development Institute.

1/ Forty-nine chaebols for Korea, 118 firms for Japan, 100 firms for the other countries.

19. **Chaebol owners have used diversification into new industries to gain size and prestige.** They have also used diversification to insulate the group from cyclical downturns in specific industries. In this sense, diversification can be a rational means of spreading the group's portfolio risk by expanding into uncorrelated lines of business. While overdiversification by the chaebols is often blamed for misallocating resources, it is noteworthy that Korean companies that diversified most are today the most successful groups, while those that

specialized during the 1960s and 1970s have disappeared.[10] Moreover, the seven chaebols that filed for bankruptcy protection in 1997 were relatively specialized, compared to the average of the top chaebols, with an average of less than 13 companies operating in 10 industries compared to the average of 27 companies in 19 industries for the top 30 chaebols (Table 4). However, the correlation does not necessarily imply that diversification is responsible for their success or failure or that it made economic sense. Government-induced distortions were also an important factor. Past industrial policy encouraged diversification because under the government's protective umbrella, chaebols were able to venture into nonrelated businesses and capture high returns in the emerging industries of a high-growth economy.

Table 4. Korea—Diversification of Bankrupt Chaebols

	Number of Industries Participated	Number of Subsidiaries	Number of Listed Subsidiaries	Number of Financial Subsidiaries
Kia	11	28	6	1
Halla	12	18	4	1
Hanbo	13	13	2	0
Jinro	11	24	4	2
Haitai	11	15	3	0
Sammi	9	8	2	0
Woosung Cons.	10	8	2	0
New Core	...	18	0	0
Average of top 30	19	27	6	2
Average of top 10	27	40	10	4
Average of top 4	31	54	14	5

Source: Korean Stock Exchange, Fair Trade Commission.

C. The Government's Role in Shaping the Chaebols

20. **The government was instrumental in shaping the chaebols.** In the early 1960s, the government decided that given Korea's narrow domestic market and poor resource endowment, it was best to pursue an outward-oriented growth policy and that large industrial firms should be the engine of export-led growth. A minimum critical size was considered essential to take advantage of synergies and economies of scale to achieve rapid growth. The government regulated interest rates, controlled credit allocation, and provided access to bank credit.

[10]See Yoo Seong Min and Lim Young Jae, Big Business in Korea: New Learnings and Policy Issues, Korean Development Institute 1997.

21. **In the 1970s, as part of its industrialization drive, the government encouraged large companies to invest in chemicals and other heavy industry.** It identified the industries it considered strategic, such as shipbuilding, petrochemicals, steel, consumer electronics, automobiles, and construction. Large firms that invested in these industries received preferential access to subsidized bank loans and foreign exchange, tax breaks on export earnings, and tariff exemptions on imports used for export production. The fastest expanding companies in terms of market share and exports were rewarded with wider access to subsidized loans.[11]

22. **Chaebols were also protected from competition.** The government erected barriers against new entry by domestic firms through business licensing and capital controls, and against foreign entry by restrictions on foreign direct investments. Monopolistic behavior such as cartels, collusion, and price setting were tolerated. During this period—spanning the 1960s and 1970s—the close ties between the government and chaebols strengthened.

23. **However, the government's industrial policy had negative side effects: subsidized bank lending encouraged inefficient investment decisions, a weak financing structure among large corporations, limited access by small- and medium-sized firms (SMEs) to bank credit, and an inefficient banking sector.** The nationwide commercial banks—owned at the time by the government—had no role in screening credit. Refusing a loan was difficult, even if the company's credit standing was poor. The lack of autonomy made banks more concerned about securing collateral than evaluating credit risk. This in turn caused large companies to raise their holdings of real estate to offer as collateral. Banks also preferred larger firms as they usually had a smaller default risk because of government backing.

24. **Recognizing that serious financial weaknesses had developed in the largest conglomerates, the government imposed a credit control system in the mid-1970s.** It encouraged chaebols to raise capital on the stock market. Each chaebol was designated a main bank whose principal function was to examine the chaebol's plans for improving its financial structure and set ceilings on working capital.[12]

25. **Following the deep recession in the early 1980s, the government again reassessed its industrial policy.** The chaebols were held partly responsible for the recession and were accused of imprudent real estate acquisitions and unwise business expansions. In addition,

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[11]Subsidized loans (so-called policy loans) accounted for 60 percent of total bank loans in 1979, but had declined to 4 percent by end-1996.

[12]For a survey on the government's intervention in the financial sector and on commercial banks' role in supporting chaebols, see Sang-Woo Nam and Dong-Woo Kim "The Principal Transactions Bank System in Korea" in *The Japanese Main Banking System: Its Relevance for Developing and Transforming Economies*, edited by M. Aoki and H. Patrick, Oxford University Press, 1994.

their highly leveraged financing structure made them vulnerable to economic downturns and external shocks like the second oil price shock. Many large companies that had invested in heavy industry—including such actively promoted industries as shipbuilding and overseas construction—ran into problems servicing their debt, leading eventually to corporate insolvencies and a deterioration of bank assets. The concentration of bank credit and high leverage among chaebols were seen as structural problems that had to be addressed.

26. **A more balanced economic structure and a reduction in the concentration of economic power among the chaebols became objectives of the government's economic policies during the 1980s.** In an effort to strengthen the chaebols' financing structure and reduce their excessive reliance on bank loans, the government liberalized access to the domestic stock and bond markets. The government also tightened the credit control system. A ceiling was set on chaebols' share in banks' total credit. The government further restricted chaebols' real estate acquisitions and investment in new businesses and pushed them to lower their debts by raising new capital in the stock market and selling assets. As a result, bank loans steadily began to be replaced by stock and bond issues, with the debt ratios for the top 30 chaebols falling from 571 percent in 1985 to 381 percent in 1990. By the end of the 1980s, equity financing accounted for 25 percent of total corporate external financing, bond issuance 13 percent while total bank loans (including second-tier financial institutions) 36 percent.

27. **The government privatized the banking system in the early 1980s.** While chaebols were prohibited from acquiring commercial banks, they were allowed to acquire controlling stakes in nonbank financial institutions. Chaebols have used their affiliated nonbank financial companies (merchant banks, short-term finance companies, and insurance companies) to finance their activities within the group (Table 5). This financing has allowed them to circumvent credit control restrictions on commercial bank lending. By 1993, the 30 largest chaebols owned a total of 64 financial subsidiaries. In part because of the restrictions, the share of the top 30 chaebols in total bank loans declined from 24 percent in 1988 to 14 percent in 1995, while during the same period their share in lending by nonfinancial institutions increased from 33 percent in 1988 to 39 percent in 1995.

Table 5. Korea—Chaebol Ownership of Nonbank Financial Institutions (1990)
(In percent)

	Top 5	Top 10	Top 30
Life Insurance Company	36.5	36.5	38.4
Securities Company	26.3	36.5	63.1
Merchant Banking	12.8	23.3	23.3
Short-Term Finance Company	7.2	10.1	29.9
Mutual Credit & Savings	1.2	1.6	4.7

Source: Min and Jae (1997), Korean Development Institute.

28. **The government actively engaged in the restructuring of industries and large corporations.** Under the Industrial Development Law of 1985, nine industries were classified as in need of restructuring and 80 corporations were restructured between 1986 and 1988.[13] The government either exerted pressure on banks to rescue troubled companies, bailed out the troubled conglomerate outright, or forced an industrial consolidation by requiring a financially sound company to merge with a weak one. In return, the government provided merging companies with preferential loans, debt restructuring, and/or special tax treatment, and imposed restrictions on new entry and investment in those industries undergoing restructuring. In the process, the troubled company's main bank typically assessed the health of the company while the Office of Banking Supervision coordinated the terms of financial support agreed upon between the main bank and acquiring company. The Ministry of Finance would sign off on the restructuring agreement. Meanwhile, the Bank of Korea typically extended subsidized loans to the banking sector to alleviate pressure stemming from nonperforming loans and corporate restructuring.[14]

29. **The aim of the government's intervention was to prevent large corporate failures from spilling over to the financial system.** However, the current crisis suggests that this strategy may ultimately have proved counterproductive because government intervention served to undermine market discipline by encouraging companies to overinvest, as well as banks to extend loans without properly assessing credit risks. Extensive government intervention may also have contributed to the Korean financial system being relatively underdeveloped by industrial economy standards.

30. **In the 1980s, the government shifted its policy from supporting large companies to restricting chaebol's economic power and enforcing competition policies.** In 1987, the government prohibited cross-equity investments between firms belonging to chaebols and limited equity investment in other firms by companies belonging to a top 30 chaebol to 40 percent of the investing company's net assets. This ceiling was lowered to 25 percent at the end of 1994, and firms were given a three-year grace period to comply. To encourage greater market discipline, the government streamlined business licensing practices, eliminated

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[13]For more on the government's industrial restructuring program, see "Korea—Managing the Industrial Transition,"A World Bank Country Study, Volumes I and II, 1992.

[14]All measures to rationalize certain industries as stipulated under the Industrial Development Act have expired and since 1992 no industry has been designated for rationalization.

industrial targeting,[15] enforced antitrust rules, and eased foreign entry into certain protected industries.[16]

31. **Having neglected small- and medium-sized enterprises (SMEs) during the 1960s and 1970s, the government encouraged their establishment in the 1980s.**[17] Certain industries were set aside for SMEs and commercial banks were to direct one-third of new net lending to SMEs, which not only provided credit to SMEs but also served to reduce the concentration of bank loans to large firms.

32. **Despite these measures, chaebols continued to expand vigorously in the second half of the 1980s.** One reason was that they were well positioned, as large export manufacturers, to benefit from the favorable external environment between 1986 and 1988, commonly referred to as the "three lows": low U.S. dollar against the yen, low oil prices, and low interest rates.

33. **In 1992, the government introduced further measures regulating the chaebols:** the government limited cross-debt guarantees among firms belonging to the top 30 chaebols to 200 percent of the guarantor's equity capital, and chaebols were encouraged to specialize in three core businesses (the so-called specialization policy) with the aim of improving their profitability by restraining "reckless diversification." In these selected core businesses, the chaebols were exempted from bank credit controls and equity investment regulations. Not surprisingly, the chaebols selected at least one core business with large financing requirements. (The top five all selected a petrochemical company as one of their core companies.) Companies commonly circumvented the rules and transferred resources within the group to take advantage of the exemptions.[18]

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[15]Interest subsidies on directed lending were eliminated or reduced. Under the Law on Industrial Development, state support in the form of policy loans to the following six industries was removed: iron and steel, petrochemicals, nonferrous metal, textiles, machinery, electronics, and shipbuilding.

[16]The Monopoly Regulation and Fair Trade Act was enacted in 1980 to eliminate cartels, price fixing and other monopolistic practices. The easing of foreign entry was codified under the Foreign Investment Law of 1987.

[17]In the manufacturing sector, SMEs are broadly defined as firms with less than 300 employees; in the service sector, as those with less than 20 employees. SMEs relied primarily on retained earnings and the curb market as a source of funding where interest rates were substantially higher than commercial bank lending rates (see Eun Mee Kim "Big Business, Strong State," State University of New York Press, Albany N.Y., 1997).

[18]The specialization system was abolished in 1997.

D. High Leveraging

34. **Notwithstanding the efforts to improve their financing structure, large Korean companies continue to rely on debt as their main source of financing.** This stems in part from their low retained earnings and their reluctance to dilute ownership (Chart 2).[19] Of the total 819 companies affiliated with the top 30 chaebols, only a fifth were listed in 1996.

35. **Debt ratios are extraordinarily high in Korea.** The debt ratio of most chaebols exceeds 400 percent. In 1997, 15 percent of the top 30 chaebols' affiliates had debt ratios in excess of 500 percent.[20] The stock of debt of the top 30 chaebols amounted to W 357 trillion (85 percent of GDP) at the end of 1997 (Annex I). The debt is also highly concentrated: the top 5 chaebols account for roughly two-thirds of the top 30 chaebols' debt and 45 percent of Korea's corporate debt. The ratio is high not just for chaebols but for the manufacturing industry as a whole compared with other industrial countries (Table 6).

Table 6. Korea—International Comparison of Average Debt-Equity Ratios in the Manufacturing Sector
(In percent)

	Korea				
	Manufacturing	30 chaebols 1/	United States	Japan	Taiwan Province of China
1991	307	403	147	209	98
1992	319	426	168	202	93
1993	295	398	175	202	88
1994	303	403	167	196	87
1995	287	388	160	196	86
1996	317	450	154	187	...

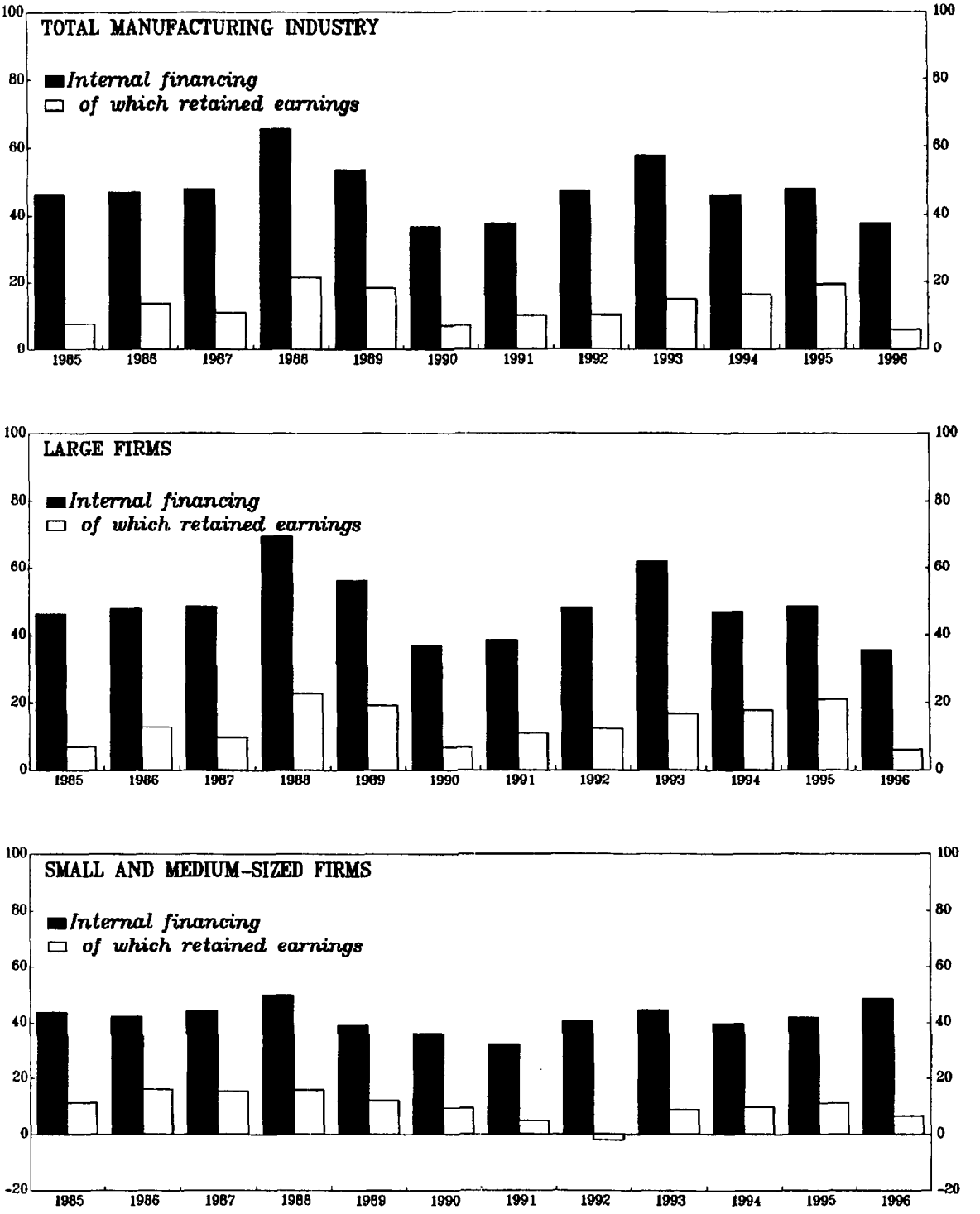
Sources: Fair Trade Commission; Financial Statements Analysis, Bank of Korea; U.S. Census Bureau Quarterly Financial Report for Manufacturing, Mining, and Trade Corporations; and The Quarterly Report of Enterprises, Ministry of Finance, Japan.

1/ Nonfinancial subsidiaries of 30 largest chaebols.

[19]Also other factors can encourage debt financing, such as tax advantages and firm size. Large firms may have more stable cash flows, an established credit history, more tangible assets, and hence higher collateral values. See S. Chaplinsky and G. Niehans "Do Inside Ownership and Leverage Share Common Determinants?," Quarterly Journal of Business and Economics, 1993, Vol. 32 No. 4.

[20]The debt ratio could actually be even higher because the debt figures do not accurately capture liabilities to nonbank financial institutions, in particular, merchant banks. The commercial bank debt is well documented as banks had to report to officials their lending to chaebols. However, merchant bank lending was not subject to the same controls.

CHART 2
KOREA
MANUFACTURING INDUSTRY FINANCING STRUCTURE
(IN PERCENT OF TOTAL FINANCING)



Source: Data provided by the Korean Authorities.

36. **The major part of this debt is domestic, rather than foreign, and is predominantly short term.** At end-1997, total corporate debt is estimated at US$500–600 billion, of which US$60 billion is external debt. Overseas subsidiaries of Korean corporations are estimated to have held another US$35 billion in external debt. The liability structure is strongly skewed toward current liabilities and away from long term or deferred liabilities (Chart 3). Current liabilities (less than one year) accounted for 60 percent of total liabilities and roughly half of nominal GDP in 1996. Most of the short-term debt is borrowing from financial institutions (indirect financing) and issuance of promissory notes (Chart 4). Corporations have resorted increasingly to the capital markets for longer term financing. By 1996, the value of corporate bonds was equivalent to roughly 20 percent of GDP and the stock market capitalization to 30 percent of GDP (Chart 5). The high debt burden has also resulted in high debt servicing costs. Interest expense in the manufacturing sector averaged 5–6 percent of sales, roughly three times more than in Germany, Japan, and Taiwan Province of China (Table 7).

Table 7. Korea—International Comparison of Interest Expense-to-Sales Ratio in the Manufacturing Sector
(In percent)

	Korea	Germany	Japan	Taiwan Province of China
1986–90	4.9	1.2	1.9	2.0
1991–95	5.8	1.7	1.7	2.2
1992	6.3	1.9	1.7	2.3
1993	5.9	1.9	1.6	2.2
1994	5.6	1.5	1.4	1.7
1995	5.6	1.4	1.2	...
1996	5.8	...	...	...

Sources: Financial Statements Analysis, Bank of Korea; Monthly Report, Deutsche Bundesbank; and Economic Statistics Annual, Bank of Japan.

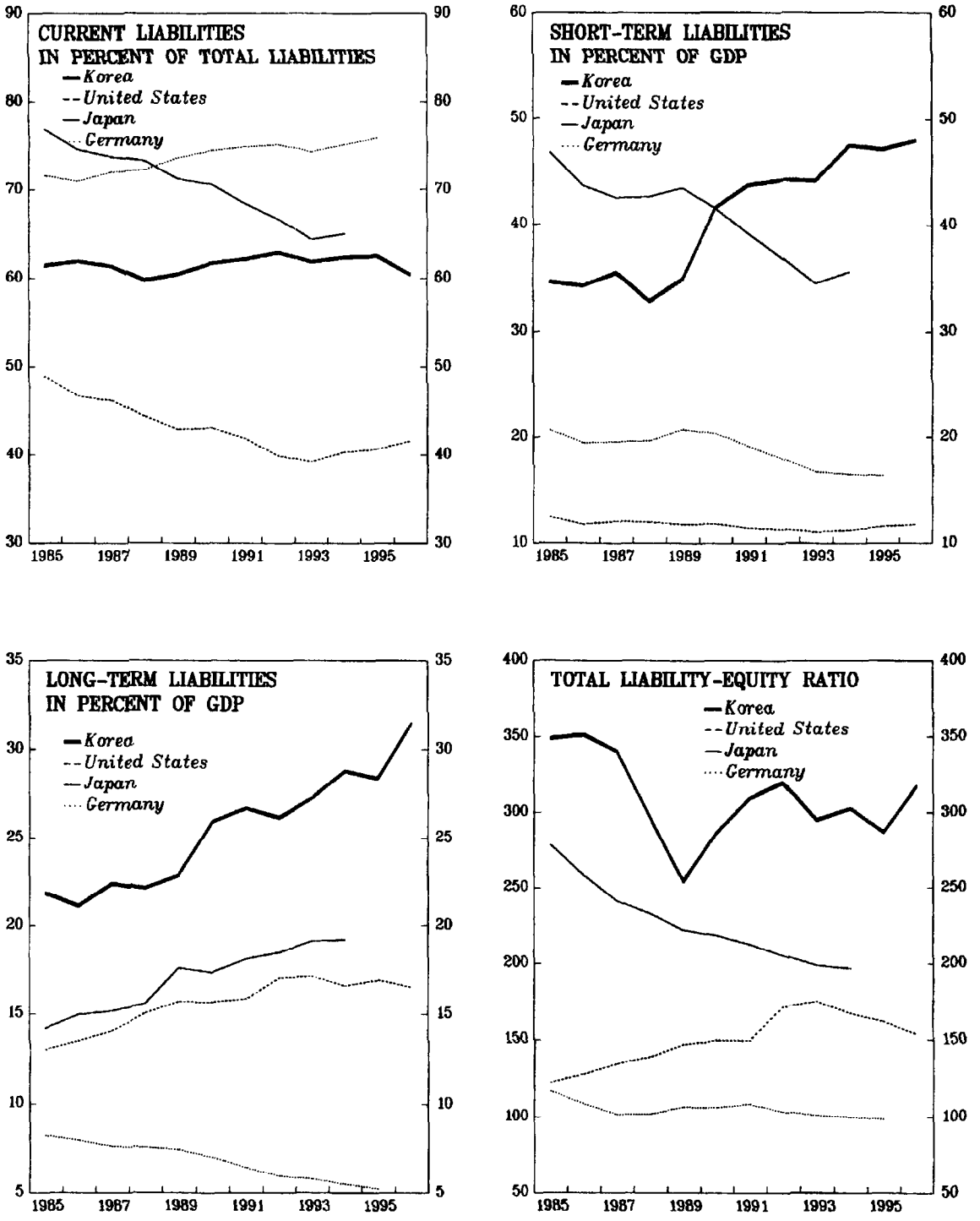
37. **High leverage and excessive short-term debt makes Korean companies vulnerable to economic downturns, changes in financing costs, and changes in creditor perceptions.** When highly leveraged companies face at the same time limits on their ability to borrow, the debt service burden can lead to excessive adjustments in investment and employment, to fire sales, and finally to bankruptcies or liquidations.[21]

[21]See R. Cantor, "Effects of Leverage on Corporate Investment and Hiring Decisions," Federal Reserve Board New York, Quarterly Review, 1990; B. Bernanke, J. Campbell and T. Whited "U.S. Corporate Leverage: Developments in 1987 and 1988," Brookings Paper on Economic Activity 1:1990 and B. Bernanke and J. Campbell "Is There A Corporate Debt Crisis," Brookings Paper on Economic Activity 1:1988.

CHART 3
KOREA

STRUCTURE OF LIABILITIES: MANUFACTURING SECTOR

(In percent)

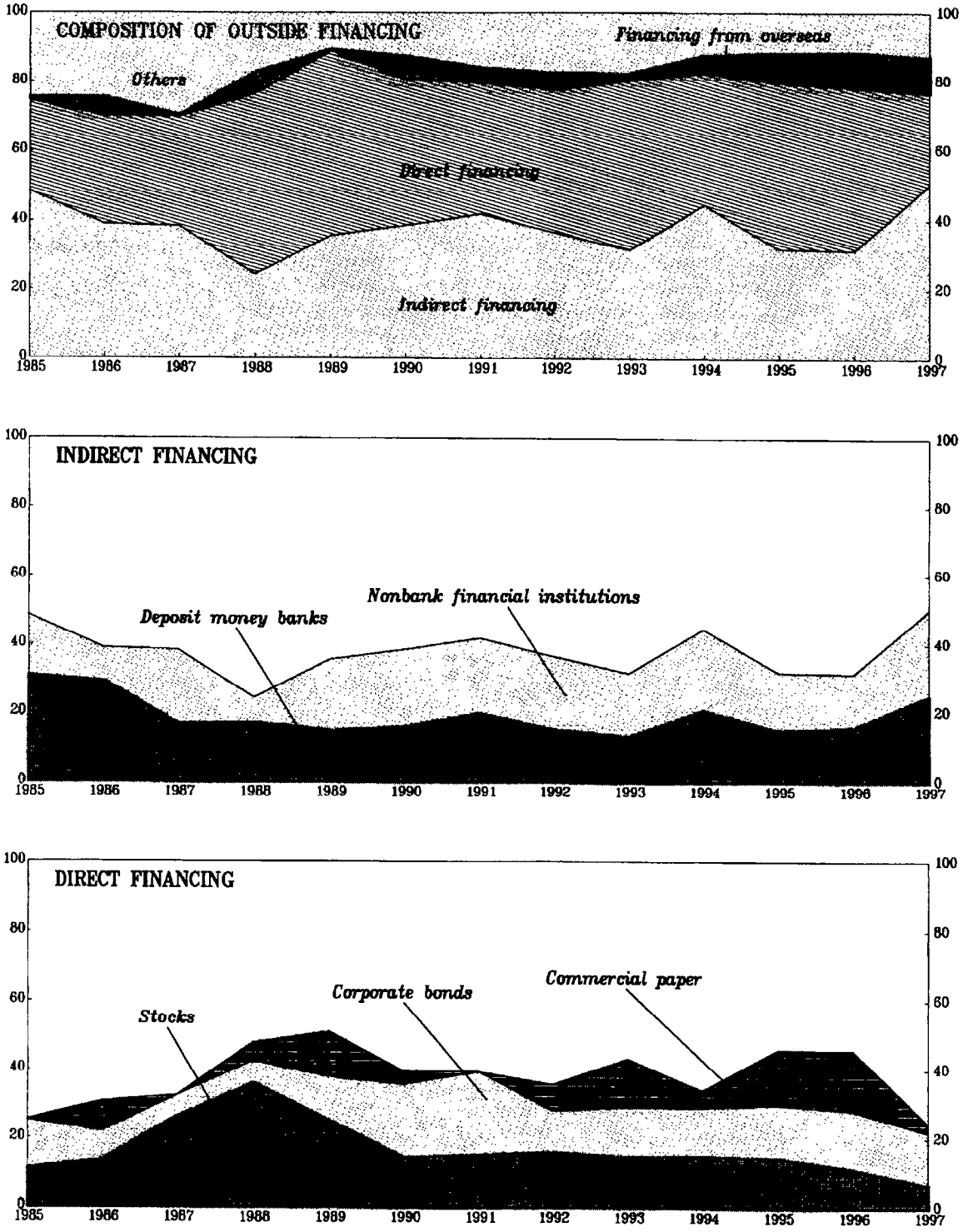


Sources: Data provided by the Korean Authorities; OECD Financial Statistic Part 3; Monthly Report of the Deutche Bundesbank, various issues; U.S. Census Bureau, Quarterly Financial Report for Manufacturing, Mining and Trade corporations.

CHART 4
KOREA

MANUFACTURING INDUSTRY OUTSIDE FINANCING STRUCTURE 1/

(IN PERCENT OF TOTAL OUTSIDE FINANCING)

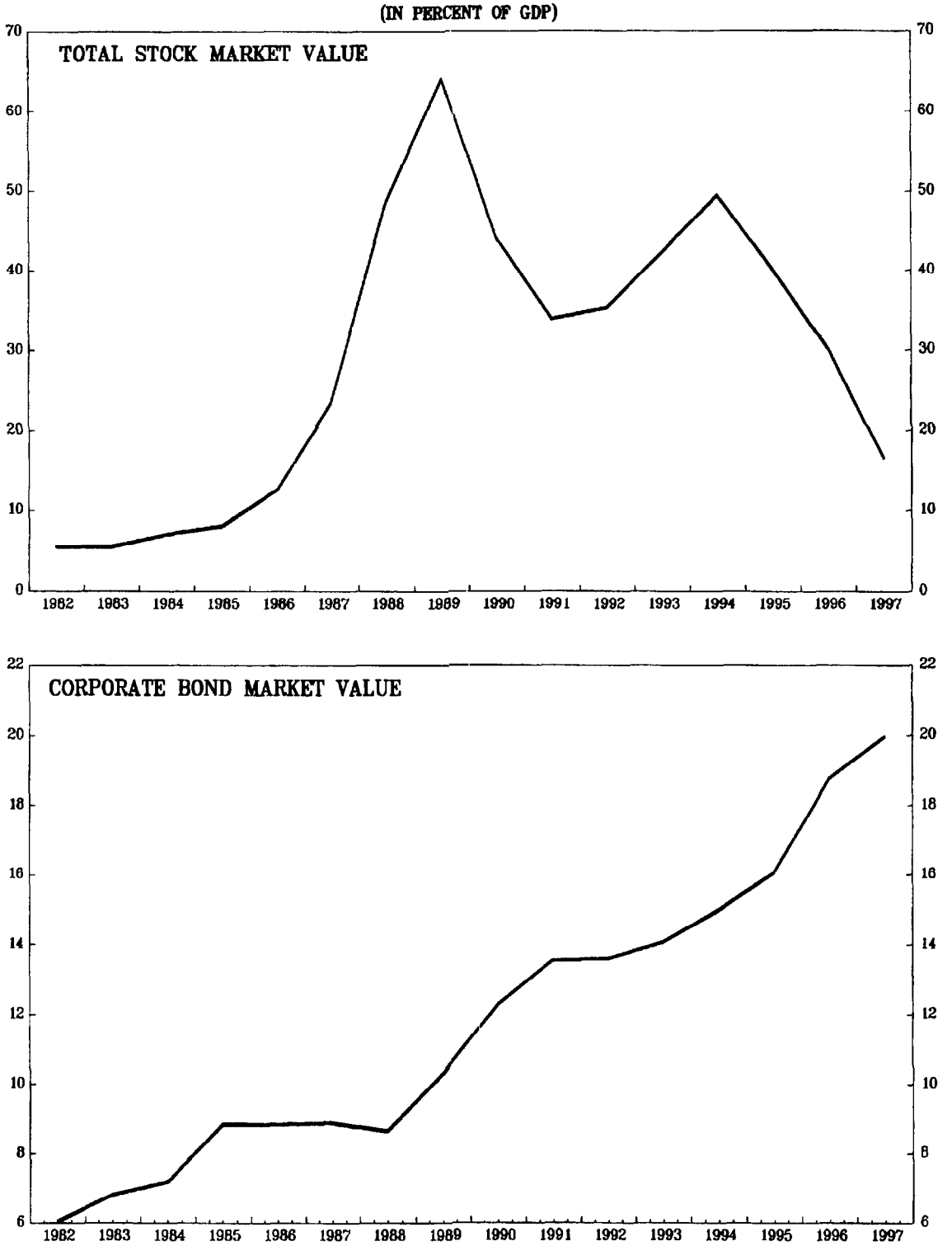


Source: Financial Statement Analysis, Bank of Korea

1/ 1997 data refer to averages of first two quarters.

CHART 5
KOREA

STOCK AND CORPORATE BOND CAPITALIZATION
(IN PERCENT OF GDP)



Sources: Korea Stock Exchange

38. **All the chaebols that ran into trouble in 1997 had already been experiencing sizable financial stress in the preceding years, and so were vulnerable to the shocks that occurred over the course of 1997.** They were more indebted than the average of the top 30 chaebols (Table 8). Jinro, Halla, Sammi, and Hanwha have been posting operating losses since 1993 (Table 9). Because of their high debt levels, most were facing debt-servicing costs in the range of 15 to 20 percent of sales, substantially above the average for the top 30 chaebol (9 percent of sales) and the manufacturing sector (6 percent of sales) in 1996. Poor investment decisions financed by short-term borrowing were the main source of financial distress.[22]

Table 8. Korea—Debt Ratios of Bankrupt Chaebols
(In percent; end of period)

	1993	1994	1995	1996
Kia (KFB)	410	445	420	525
Halla (KEB)	1,525	3,630	2,960	2,070
Hanbo (KFB)	...	500	750	...
Jinro (CBK)	2,030	2,825	2,520	3,700
Haitai (Chohung)	755	525	510	660
Sammi (KFB)	970	3,320	3,300	...
Woosung Cons. (KFB)	825	970	...	...
New Core (KFB)	...	...	925	1,225
Average of top 30	400	405	390	450
Average of top 10	330	340	320	380
Average of top 4	305	305	310	350

Source: Bank of Korea, Fair Trade Commission.

Note: Main bank of the group are shown in parentheses; CBK-Commercial Bank of Korea, KFB-Korea First Bank, KEB-Korean Exchange Bank.

[22]Haitai's failure is blamed on its expansion into retailing; Kia's on its expansion into construction and steel; Jinro's on its expansion into brewing; and Halla's on bank financed construction of a new shipyard that began operating in 1995. Sammi's problems stem from the takeover of specialty steel plants in the U.S. and Canada at the end of the 1980s, while Hanbo's resulted from overextending itself in building a new steel mill that was to begin operations in mid-1997.

Table 9. Korea—Net Profit of Bankrupt Chaebols 1/
(In billions of won)

	1993	1994	1995	1996
Kia	22	-56	-68	-129
Halla	-60	-68	6	23
Hanbo	88	71	-48	--
Jinro	-75	-72	-185	-157
Haitai	21	2	-3	36
Sammi	-171	-172	-125	-252
Woosung Cons.	-12	-21	2	...
New Core	...	...	14	20
Average of top 30	37	108	198	12
Average of top 10	132	314	597	85
Average of top 4	310	739	1439	268

Source: Bank of Korea.

1/ Excluding financial institutions and overseas subsidiaries.

39. **It was not until Hanbo's bankruptcy early in 1997 that creditors realized that the government was willing to break from past policy and let poorly managed big businesses fail.** In the aftermath of the Hanbo and Kia collapse, rolling over short-term debt became increasingly difficult, especially for firms rumored to have unsound balance sheets. Cash started to dry up from second-tier financial institutions (i.e., merchant banks) who began tightening credit and calling in their unsecured short-term loans.

40. **Debt financing also has been encouraged by internal financial arrangements within chaebols themselves—the cross debt guarantee system.** The conglomerates guarantee bank loans and other forms of corporate debt among their affiliates. The total value of the debt payments guaranteed by the affiliates of the top 30 chaebols amounted to W 70 trillion at end-April 1997, or to 91 percent of the top 30 chaebols' total equity capital (Table 10). This cross-debt guarantee system can impede firm restructuring and create systemic risk in the corporate sector. In good times, loss-making companies can be kept afloat by the rest of the group. In bad times, loss makers can drag down the healthy companies. The system also promotes unfair competition: less profitable affiliates enjoy access to bank credit that does not truly reflect their credit risk. The system also weakens the group's capital base as creditors can make claims against the guarantor in the case of insolvency. The government limited the use of debt guarantees in 1993; the debt guarantees could not exceed 200 percent of the guarantor's total equity capital. The limit was further lowered to 100 percent in 1995. Chaebols were given a three year grace period to meet the new limit.

Table 10. Korea—Debt Guarantees of the Top 30 Chaebols
(In trillions of won, unless otherwise stated)

	1993	1994	1995	1996	1997
Stockholders' equity	35.2	42.8	50.7	62.9	70.5
Debt guarantee	165.5	110.7	82.1	67.5	64.9
Debt guarantee in percent of equity	469.8	258.1	161.9	107.3	92.2

Source: Fair Trade Commission.

E. Corporate Governance: A Cross Country Perspective

41. **The upsurge in interest in corporate governance is a recognition of the importance of good governance to strong corporate and economic performance.** Poorly performing companies may reflect a weak corporate governance system that leaves unwise management decisions unchecked. This can lead to bankruptcies, social hardship, and lower potential growth. Good corporate governance is unquestionably in the public interest and maximizing shareholder value is also congruent with the interests of other stakeholders such as employees, suppliers, and customers.

42. **Although no single model of corporate governance has yet gained universal acceptance, there are essential elements to good corporate governance.** Good corporate governance should provide incentives for managers to act in ways that raise the firm's net present value and assure creditors and investors an adequate return. It should also give investors and creditors an effective means to monitor and discipline managers. It further should provide investors—small or large, creditors or shareholders—legal protection of some basic ownership right such as the right to claim collateral and the right to exercise power over management.[23] The United States, for instance, protects minority shareholders' rights (small investors) by allowing them to sue directors for violations of fiduciary duty and auditors for negligence.

43. **It is central to good corporate governance that financial statements are reliable and transparent.** When making investment decisions, investors and creditors must be confident of the accuracy and openness of the information released by corporations. In most advanced economies, the reliability and accuracy of financial statements are in part assured by the use of external auditors and accounting and auditing standards in line with international

[23]See Andrei Shleifer and Robert W. Vishny, "A Survey of Corporate Governance," NBER Working Paper 5554, 1997 and Colin Mayer, "Corporate Governance, Competition and Performance," OECD Economic Studies No. 27, 1996/II.

best practices. An internationally-recognized accounting standard is necessary so investors can assess corporate data and make cross-country comparisons on corporate profitability and prospects. In most advanced economies, there are substantial market-driven rewards to producing and disclosing accurate financial statements.

44. **Large shareholders often play an important role in corporate oversight.** They can include institutional investors such as mutual funds and pension funds, as in the United States, or banks, as in Japan and Germany. With a substantial ownership stake, an investor can exert enough voting power to influence corporate policies and change management—either through outright purchase of the company, greater board representation, or proxy challenges.

45. **In the United States, active investors historically have exerted strong influence over corporate policies.**[24] Because of the dispersed ownership of U.S. corporations, outside corporate monitoring has typically been exercised by active investors taking substantial equity positions. In the 1980s, so-called corporate raiders exerted pressure on management through acquisitions, including leveraged buyouts and hostile takeovers, or by directly assuming board control. In the 1990s, institutional investors have taken a less aggressive but still effective stance by exerting oversight through board representation or the pursuit of longer-term initiatives aimed at ensuring companies are well-governed.[25]

46. **In Japan and Germany, banks play a key governance role as large creditors.** Unlike in the United States,[26] they enjoy significant control rights; they can vote large blocks of shares by proxy; they can sit on boards of directors; and they can directly own an equity stake in the firm. In Japan, companies with main banks are more likely to replace management

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[24]An active investor goes beyond simply buying and selling securities to take actions against a company to raise its value. These typically involve exerting significant influence over corporate policy or taking control of the company. See L. Gordon and J. Pound, "Active Investing in the U.S. Equity Market: Past Performance and Future Prospects," a report prepared for The California Public Employees' Retirement System, Gordon Group, Inc. 1993.

[25]The California Public Employees' Retirement System, the world's fourth largest public pension fund, targets underperforming companies, takes a substantial equity position in them, and seeks to change their governance by pressuring the board through direct negotiations and public voting challenges. Studies confirm the role of institutional investors in the United States and find a strong positive correlation between institutional ownership and corporate performance. See J. McConnel and H. Servaes, "Additional Evidence on Equity Ownership and Corporate Value," Journal of Financial Economics, 27 1990.

[26]In the United States, the role played by banks and other financial institutions in corporations was curtailed by the 1933 Glass-Steagall Banking Act, which restricted financial institutions' equity holdings in nonfinancial companies.

in response to poor performance than those without.[27] In Germany, companies with large shareholders tend to have a higher turnover of directors, and companies with large bank shareholdings tend to show better performance.

47. **Depending on the regulatory framework, banks and other large creditors can be quite effective overseers.** Creditors can: scrutinize a borrower before extending credit, monitor the credit relationship, advise borrowers who run into payment problems, repossess collateral in case of default, and push a firm into restructuring or bankruptcy.

48. **Corporate boards are equally central to corporate governance.** Board directors are elected by and are accountable to shareholders—the legal owners of the firm. They are responsible for monitoring managers and making sure they act in the company's best interest. In the United States and Canada, corporate codes generally require directors to act in the best interest of the corporation. Corporate law in both countries makes directors personally liable to shareholder lawsuits if they fail in their fiduciary duty.

49. **Independence and well-defined responsibilities are key to the effective board oversight of management.** The board exercises its oversight through several avenues: its access to comprehensive internal information (management must report periodically to the board, and boards may ask for special reports); its appointment of managers; its monitoring to prevent mismanagement; and its ongoing advisory role. The credibility of the board is best enhanced by its independence. U.S. firms with boards dominated by outside directors are more likely to replace their CEOs following unusually poor financial performance than are firms with boards dominated by insiders; boards also tend to replace the CEO in cases where the CEO does not serve as both president and chairperson of the board.[28] The New York Stock Exchange (NYSE), for instance, requires that listed members have at least two outside board directors and that the audit committee be composed of outside directors. Similarly, Canada's Business Corporation Act requires that there be a minimum of two outside directors on the boards of public companies.

50. **In some countries, stock exchanges have encouraged companies to disclose their corporate governance systems.** The Toronto Stock Exchange (TSE) has designed a "best practice" corporate governance code for its listed companies. The code includes a baseline

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[27]In Japan, firms that have a close relationship with their main banks are less affected when under financial distress than firms without a main bank. Main banks tend to provide financial support and replace management. See T. Hoshi, A. Kashyap and D. Scharfstein "The Role of Banks in Reducing the Costs of Financial Distress in Japan," Journal of Financial Economics 27, 1990.

[28]See M. Weisbach "Outside Directors and CEO Turnover," Journal of Financial Economics, 20 (1988) and R. Morck , A. Schleifer, and R. Vishny, "Management Ownership and Corporate Performance: An Empirical Analysis," Journal of Financial Economics, 20 (1988).

minimum of information on: compensation, appointment and nomination policies for senior management and directors, length of director terms, number of outside directors, and composition of nomination and auditing committees of the board. The TSE has made it mandatory that listed companies disclose annually their corporate governance with reference to the TSE guidelines and explain any differences between the company's code and TSE's "best practice."

F. Weakness in Korea's Corporate Governance [29]

51. **Korean corporate governance is marked by a lack of both internal and external monitoring of management decisions.** Owners/managers have been shielded from market discipline. Banks, as the chaebols' largest creditors, have tended not to exercise proper oversight. To be sure, internally controlled companies have certain advantages: lower agency costs (i.e., lower monitoring costs as managers and owners are almost the same), longer-term commitment to stakeholders (employees, suppliers), and quick decision-making. But there are clear disadvantages as well. Managers/owners may be reluctant to take difficult but necessary actions. Without outside monitoring, unwise business decisions by managers/owners can go unchecked. It is noteworthy that those chaebols with the largest share of family ownership were the same ones that went bankrupt in 1997 (Table 11).[30]

Table 11. Korea—Internal Ownership of Top 30 Chaebols in 1996

		Shareholdings of Family and Relatives					
		Less than 5 percent	5 to 10 percent	10 to 20 percent	20 to 30 percent	30 to 50 percent	Over 50 percent
Total internal ownership	20-30 percent	Lotte	Keukdong	--	Kia	--	--
	30-40 percent	Ssangyong Haitai	LG Hanhwa Daelim	Sammi Hamil Pyoksan			
	40-50 percent	Samsung Kumho	Daewoo Kohap	Jinro, Sunkyung Hanjin, Doosan Donghu, Hyosung Kolon , Donghu			
	Over 50 percent	--	Dongyang Hansol	Hyundai Dongkuk	Halla	New Core	Hanbo

Source: Korea Fair Trade Commission.

[29]The author benefited from discussions with the OECD staff on Korean corporate governance.

[30]Halla, New Core, Hanbo, and Kia had family shareholdings exceeding 20 percent; the first three had internal shareholdings (family plus cross shareholdings) that far exceeded the average of the top 30 chaebols. Hanbo with 90 percent was virtually internally owned.

52. **The lack of transparency in chaebol balance sheets contributes to weak corporate governance.** Because consolidated financial statements (also called combined financial statements) are not required for the entire group, it is all but impossible for investors to penetrate the internal finances of the chaebol, exercise reasonable oversight and identify which business lines are creating added value. Besides the debt guarantees, chaebols tend to transfer net profits from strong to weak affiliates and are known to trade goods and services among each other at prices that are not market-based.

53. **Korea also has not fully adopted internationally accepted accounting practices and auditing standards.** Korean accounting practices, which the Korean Security and Exchange Commission (SEC) regulates, deviate from generally accepted accounting practices (GAAP), resulting in corporate financial statements that are regarded as being rosier than those which international standards would produce. Government regulations have weakened auditing standards. The SEC determined the rates of remuneration, the size of auditing firms and time requirements for audits, which in turn set the scope of actual audits.[31] Class-action lawsuits are not permitted against accountants and auditing firms for professional fraud and negligence. Nor is there private sector, self-regulating or voluntary oversight as in the United States, where the American Institute for Certified Public Accountants (AICPA), which is funded by the accounting firms, sets and imposes generally accepted accounting practices and auditing standards.

54. **The ownership and management structure of Korean companies—largely family owned and controlled—has contributed to weak corporate governance.** Managers/ owners are also not legally accountable for poor management decisions. The founding father or his heirs bears no legal responsibility for poor management decisions. He controls the core companies and from there directs the operations of the entire group, but is not de jure director of the group, and therefore is not responsible for management decisions. Through the system of cross shareholding, a family can control vast assets while putting very little of its own capital at risk.

55. **Boards have likewise proved inadequate in corporate oversight.** They lack independence, and their seats are filled typically by insiders such as family members and managers. The large family shareholdings and cross-shareholdings of affiliates enable management to dominate shareholder meetings and control director appointments and hence corporate decisions, since most small shareholders do not attend.

56. **Outside directors are almost nonexistent.** Of the top 20 listed companies on the Korean Stock Exchange, only two public corporations (mostly retired government officials)

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[31]Korean auditing firms rarely, if ever, issue anything but a "clean" opinion on a corporation's financial statements. Any suggestion by an auditor that some qualification may arise may often be met by heavy—and successful—lobbying of the auditing firm by the corporation and other clients.

and four commercial banks have a majority of outside directors, compared to an average of 3 inside and 9 outside board directors for publicly held U.S. corporations in the Fortune 1000.

57. **Korean corporate boards are often large and unwieldy and their responsibilities to shareholders ill-defined.** Samsung electronics has 59 board directors and Hyundai Motors has 71. The top 20 companies on the KSE have an average of 25 board members. This far exceeds the size of U.S. corporate boards (13 directors on average for listed U.S. companies with $5 billion or more market value in 1996). Unlike in most OECD countries, the Korean commercial code does not explicitly specify directors' duties.

58. **In Korea, outside acquisitions have been infrequent, and until December 1997, foreign equity investment has been heavily restricted.** Takeover threats could impose external control on managers. Takeovers typically are motivated by management inefficiencies in the targeted company as well as by potential synergy gains. Regulations limiting hostile domestic takeovers were liberalized only in 1997,[32] while foreign hostile takeovers were still prohibited in 1997. Even friendly takeovers of a large company with assets in excess of W 2 trillion, where the company's board and shareholders agree to be acquired by foreign investors, required government approval. Moreover, restrictions on labor dismissals during mergers and acquisitions have deterred takeovers.

59. **Institutional investors in Korea are also hindered in monitoring corporate management.** Several classes of institutional investors such as investment trust companies and the trust accounts of the commercial banks are restricted at shareholder meetings. They are prohibited from swinging a deadlocked vote—the so-called shadow voting rule. In addition, shareholders have not been active in monitoring and expressing their views because of the relatively high thresholds on exercising their rights.[33] Further, most insurance companies are largely owned by chaebols. Through their marriage linkages, chaebol-owned insurance companies are more likely to collaborate with other chaebols.

60. **The main creditors of chaebols have not exercised effective discipline.** Korean commercial banks, unlike their Japanese or German counterparts, have no presence on Korean corporate boards and generally are not large shareholders of listed companies, although they may hold up to 10 percent of a company and have large outstanding claims on listed

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[32]Until 1997, an individual shareholder could not own more than 10 percent of a company. This rule was lifted for domestic investors, but replaced by a minimum tender requirement: investors wanting to acquire more than 25 percent of a company had to make a bid and obtain at least half of the outstanding voting shares.

[33]In Korea, shareholders have the right to sue a director on behalf of the company (so-called derivative suit) with 1 percent of outstanding shares, the right to make proposals at the shareholder meetings, to elect an internal auditor and the right in inspect the books with 3 percent of outstanding shares.

companies. Indeed, the banks' high credit exposure to ailing companies indicates that they themselves suffer from serious weaknesses in corporate governance.

61. **A creditor's effectiveness in disciplining management depends on the extent to which it can enforce its legal rights in court.** In Korea, the government's history of bailing out large firms has undermined the effectiveness of courts in enforcing financial contracts and in deciding on a company's fate.[34] Courts not only lack experience and expertise in dealing with large bankruptcies, they also are less inclined to enforce creditors' rights. In the case of large companies, courts typically put management's or government's interests ahead of rational economic criteria in judging a company's health.[35] Hence, liquidations have been rare. Of those companies that went bankrupt in 1997, not one has been liquidated (Table 12). They are all operating either under court receivership or court mediation. Moreover, under court receivership, the court freezes all liabilities, including secured debt, making it all but impossible for creditors to repossess collateral. Although creditors vote on the reorganization plan, they have almost no say in its design and have limited access to information. Bankruptcy proceedings are protracted (at least two years to complete after applying), imposing a considerable strain on creditors, companies and courts.

G. Conclusion and Reform Agenda

62. **The Korean economy and its conglomerates are at a crossroad.** The past model of government-directed industrialization brought tremendous economic progress, but also contained inherent flaws and is no longer suited to Korea as an advanced economy in globalized markets. Clearly, a new paradigm is needed to achieve the next phase of dynamic growth. The key is not to replace one set of failed interventions with another, but to create the laws, institutions, and financial markets that will impose market discipline on corporations.

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[34]Korea has bankruptcy laws similar to the United States Bankruptcy Code. The Korean bankruptcy system permits both reorganization and liquidation (Bankruptcy Act). There are two reorganization proceedings: (i) the Composition Act—analogous to Chapter 11—permits existing management to remain in control while undergoing reorganization (court mediation); (ii) the Corporate Reorganization Act allows a court appointed receiver to take charge of the business while the company is undergoing rehabilitation (court receivership). If rehabilitation fails in both proceedings, then liquidation usually follows.

[35]Not all bankruptcy filings have been orderly. Kia, for instance, was a case where the interests of creditors, government and management clashed: Kia's management, backed by its trade union, filed for composition to maintain management control as it feared Kia Motors would otherwise be sold to another domestic car company. However, its creditors and the government wanted it to file for reorganization. To avoid a stalemate and possible liquidation, the government encouraged Korea Development Bank, Kia's largest creditor, to swap its debt for equity, thereby becoming Kia's largest shareholder. Kia, under new management, subsequently applied for reorganization.

Table 12. Korea—Current Status of Bankrupt Companies

Group Name 1/	Current Status	Company Name
Hanbo (22)	- Five under court receivership	- Hanbo Steel, Hanbo Co., Hanbo Energy, Sang-A Pharm., and Hanbo Const.
Sammi (6)	- Two under court receivership - Two applied for court receivership	- Sammi Co. and Sammi Steel - Sammi Metal Products and Sammi Fine Ceramics
Jinro (22)	- Eight in court mediation procedures	- Jinro Co., Jinro General Foods, Jinro Const., Jinro Coors Brewing, Jinro Mass-Merchandising, Jinro Industries, Samwon, and Chong-ju Jinro Department Store
Dainong (21)	- One under court receivership - One involved in court mediation procedures - One applied for court receivership	- Dainong Co. - Metro Product - Dainong Heavy Ind.
Kia (28)	- Five applied for court receivership	- Kia Motors, Asia Motors, Kisan, Kia Intetrade, and Kia Steel
Haitai (15)	- Four applied for court mediation (four companies) and court receivership (five companies) revoked	
New-Core (18)	- Nine involved in court mediation procedures	- New Core, Si Dae Const., Si Dae Circulation, Newtown Construction, Si Dae Chuksan, Si Dae Mul San, Newtown Interior, New-Core Total Project, and Newtown Development
Halla (8)	- Four involved in court mediation procedures - Two applied for court receivership	- Mando Machinery, Halla Cement, Halla Const., and Halla Pulp & Paper - Halla Engineering & Heavy Ind. and Halla Merchant Marine

1/ In parenthesis, number of affiliates (excluding overseas subsidiaries) in the group.

63. **Progress is being been made to improve the framework for corporate governance through legislation passed by the National Assembly in February 1998.** A key element is more transparency in the corporate decision-making process and more reliability of financial information. To this end, the Act on External Audit of Joint-Stock Corporations was amended to bring forward to 1999 (from 2000) the requirements that: all financial statements of listed companies must be prepared and audited in accordance with international best standards; conglomerates must issue combined financial statements for the entire group. In addition, all listed companies must have an auditor selection committee composed of outside directors, shareholders and creditor representatives. The government has also agreed to let the Korean Institute for CPAs take eventual responsibility for setting the professional standards that will regulate auditing and accounting.

64. **Directors are expected to play a more active role in corporate oversight.** The Ministry of Justice has set up a working group that will reform the corporate code, and will more clearly specify directors' fiduciary duties. Allowing shareholder class action suits against directors of public companies is being considered. To increase board independence, the KSE now requires all public companies to have at least one outside director; it is expected that the requirement that one-quarter of the board be outsiders will be in place in 1998.

65. **Smaller shareholders' rights were strengthened to provide better oversight.** In February 1998, the voting restrictions on investment trust companies and trust accounts of commercial banks was removed. The minimum shareholding required to make proposals, inspect company books, and initiate legal action against a company director, was lowered from 1 to 0.05 percent. These thresholds will be further lowered in June 1998.

66. **Restrictions of foreign participation in domestic equity, mergers, and acquisition have been eased.** Aggregate and individual ceilings on foreign ownership and listed Korean shares were raised to 55 and 50 percent, respectively. The government's approval requirement on friendly foreign acquisitions of large Korean companies (excluding strategic industries such as defense and telecommunications) was abolished. The ceiling on shares in nonstrategic companies that a foreign investor can buy without the company board's approval was raised from the current 10 percent to one-third, so as to facilitate hostile takeovers. The tender offer requirements and equity investment restrictions on chaebols were removed. The government will prepare comprehensive takeover guidelines by end-July 1998.

67. **The problems created by the system of cross payments guarantees are also being addressed.** New cross guarantees are prohibited from April 1998 and the existing guarantees are to be eliminated by March 2000.

68. **Laws on bankruptcy were amended in February 1998 to expedite bankruptcy procedures, including deadlines for court processing of reorganization plans and for the conclusion of reorganization.** To ease the overall burden on the judicial system a special administrative body was established. Clear economic criteria were established for courts to

assess a company's viability. Further, the creditor's role in the reorganization process was strengthened.

69. **Some chaebols have begun to restructure their operations**, they have: frozen investment projects, laid off workers, sold off real estate and affiliated companies, sought foreign partners for mergers and acquisitions (Table 13). Large corporations have also substantially downsized senior management and boards: the average board size of the top 20 listed companies fell to 8 end-March, down from 18 at end-1997. The board's composition has changed, reflecting the KSE's new listing rule. 505 listed companies appointed 667 new outside directors at this year's annual shareholders meetings. Foreign influence at shareholders' meetings has also gained some ground. This reflects in part the rise in foreign ownership of listed companies. Foreign investors now own 19 percent of Korean shares, up from 15 percent at end-December 1997. In an unprecedented case for Korea, foreign institutional investors (Tiger Fund, Oppenheimer, and Scudder) pressured SK Telecom's Board into appointing three outside board directors, two of which were selected by the investors. It was also agreed that the consent of at least two out of the three outside directors would be required on certain specific issues.[36]

70. **Looking ahead, more needs to be done, particularly to accelerate the pace of corporate restructuring and address the high leverage of corporations.** Restructuring should be based on market principles. A key will be pushing forward financial sector reforms. Strong banks, capable of assessing the prospects and credit worthiness of individual corporations and commercially-oriented in their lending, are essential to impose a hard budget constraint. It is envisaged that banks will need to play a central role in the restructuring of corporate debt and in guiding the strengthening of corporate balance sheets. Together with improving corporate governance, the ongoing efforts to reform the financial system should bring about more market discipline to spur the corporate restructuring.

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[36]For instance, whenever SK Telecom undertakes a financial transaction with another company in the SK group or makes an overseas investment exceeding 5 percent of its paid-in-capital, at least two outside directors would have to approve the transaction.

Table 13. Status of Mergers and Acquisitions in Korea, December 1997-March 1998[1]

	Company	Purchaser	Note	Price
Hyundai Electronics	Symbios Logic	Adaptec (USA)	Agreed	US$55 mn
Samsung Electronics	Audio Division	Saehan Group	In progress	
Samsung Heavy	Construction equipment division	Volvo (Sweden)	Agreed	US$700 mn
Ssangyong Group	Automobiles	Daewoo	Sold	W 1.7 tn
	Paper & Pulp	P&G (USA)	Sold	US$230mn
	Marriott Hotel (USA)	Sun Stone Hotel (USA)	Sold	
	Inriverside Cement (USA)	Texas Industry (USA)	Agreed	
Kia Motors	Asia Motors	Scania (Sweden)	Negotiating	
Hwa Sung	HS Parker HS Air Conditioning	Parker Hannifin (USA)	Sold JV	W 19 bn
Daesang	Lysene unit	BASF (Germany)	Sold assets	US$600 mn
Hanwah group	Hanwha NSK	NSK (Japan)	Sold off shares	
	Real estate owned by Hanwha Stores		Negotiating	
	Hanwha Energy		Negotiating	
	Hanwha BASF	BASF (Germany)	Sold	W 100 bn
	Hanwha Securities	Regent Pacific	25 % of equity	W 50 bn
Halla Group	Camco	Bosch (German)	Sold off shares	
	Real estate owned by Halla Concrete		Negotiating	
	Hall Venture investment			
Honam Food	Bottling Assets	Coca Cola (USA)	Sold assets	W 48.5 bn
Woosung Food	Bottling Assets	Coca Cola (USA)	Sold assets	W 38 bn
Doosan Group	OB Brewery's bottling asset	Coca Cola (USA)	Sold	US$423 mn
	Office building at Uljiro	Hana Bank	Negotiating	
Kolon Group	Fanuc Korea Corp.	Fanuc (Japan)	Sold off shares	W 23 bn
	Insurance Company	Met Life (USD)	Sold off JV stake	
Kohap Group	Ulsan Film Plant	European Multimedia (Germany)	Sold	
DongAh Group	Real estate, Parent company		Negotiating	
Daesang Group	Lythin Business		Negotiating	
Tongyan Chemical	Dongwoo Semiconductor	Sumitomo (Japan)	Sold off shares	
Sinsegae	Price Club	COSCO (USA)	Sold off share/ Negotiating	
Daeyu Sec.	*Daeyu Sec.*	*Regent Pacific (H.K.)*	*22% of equity*	*W 14 bn*
Dongyang H.I.	Dongyang Elevator	United Technologies, Otis Elevator	50% of equity	unknown
Oriental Chemical	Dongwoo Pure Chemicals	Sumitomo	Sold off JV stake	W33.5 bn
Kyeopyung Group	Korea tungsten and Mining's Tungsten Carbide tools division	Iscar (Israel)	Sold 80% of equity	W 150 bn
Haitai Group	Korad (JV ad agency)	Oglvy and Mather (USA)	Sold stake	W 20 bn
New Core	Main store at Seoul		Negotiating	

Source: SBC Warburg Dillon Read

[1]The table only shows the largest mergers and acquisitions that have taken place since December 1997. The Ministry of Finance and Economy has registered 400 cases since December 1997 that they classify as inward foreign direct investment.

Korea: Capital Structure of the 30 Largest Chaebols, 1997
(Excluding Financial Institutions; end of period)

(In billions of won)

	Assets	Sales	Equity	Debt	Debt/Equity Ratio
Hyundai	72,415	78,690	10,670	61,745	578.7
Samsung	63,536	66,939	13,492	50,044	370.9
Daewoo	51,791	49,570	9,055	42,736	472.0
LG	51,435	58,344	8,491	42,944	505.8
SK	29,019	30,167	5,109	23,910	468.0
Hanjin	19,037	10,408	1,889	17,148	907.8
Ssangyong	14,930	20,812	2,988	11,942	399.7
Manhwa	12,056	11,192	917	11,139	1,214.7
Kumbo	10,232	5,163	980	9,252	944.1
Dong-A	8,770	4,508	1,907	6,863	359.9
Lotte	8,842	7,873	2,794	6,048	216.5
Hanla	8,552	6,158	-570	9,122	-1,600.4
Daelim	6,688	6,574	1,090	5,598	513.6
DooSam	6,585	3,690	954	5,631	590.3
Hamsol	6,094	3,183	1,219	4,875	399.9
Yosung	5,244	6,283	928	4,316	465.1
Kohap	5,155	3,256	901	4,254	472.1
Kolon	4,812	4,915	902	3,910	433.5
Donguk-Steel	4,594	3,280	1,084	3,510	323.8
Dongbu	4,375	3,572	998	3,377	338.4
Anom	4,300	2,446	269	4,031	1,498.5
Jinro	4,253	1,618	-536	4,789	-893.5
Dongang	3,152	2,280	625	2,527	404.3
Maitai	3,747	3,259	234	3,513	1,501.3
Sinho	3,045	1,932	392	2,653	676.8
Daesang	2,842	1,598	380	2,462	647.9
New-Core	2,845	2,478	151	2,694	1,784.1
Gupyung	2,626	1,373	488	2,138	438.1
Kangwon	2,665	3,381	561	2,104	375.0
Saehan	2,659	1,603	512	2,147	419.3
Total	426,296	406,545	68,874	357,422	507.5

Source: Fair Trade Commission.