“Corporate Governance and the Role of Financial Institutions”

Case Study of PECC Economies: Korea - Lessons Learned

PECC Finance Forum Material

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Korea Institute of Finance

McKinsey & Company

1 BACKGROUND

2 GOVERNANCE REFORM MEASURES

3 FUTURE TASKS AND POLICY LESSONS

OVERVIEW OF KOREA'S FINANCIAL CRISIS AND RECOVERY

Shock (Currency Crisis)

$ Liquidity Crisis

- Sudden capital outflows
- Weak economic system
- Confidence crisis

1st Phase of Restructuring

- Foreign debt rescheduling
- Public funds mobilization
- B/S restructuring
- Financial institutions closed

2nd Phase of Restructuring

- Daewoo fall-out
- Downward business cycle
- Market-based restructuring

"Where we are now"

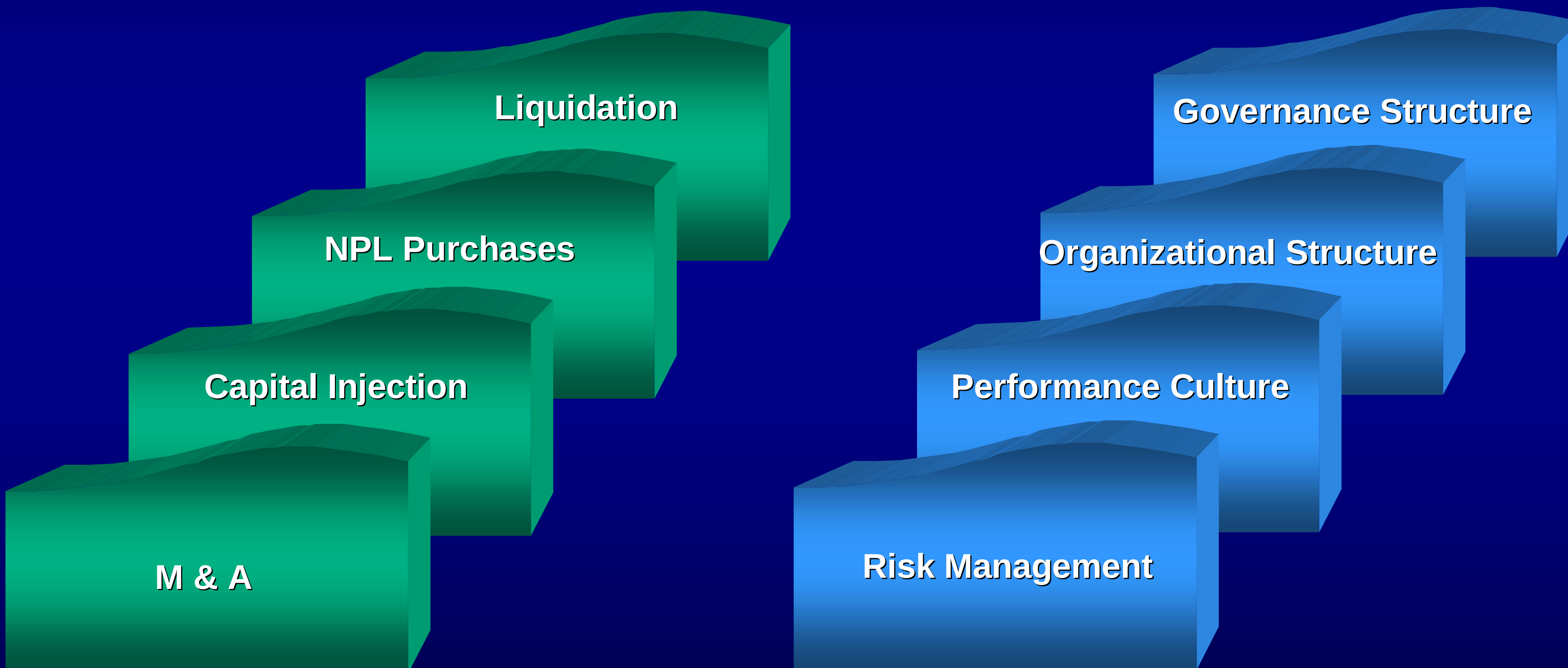
Reestablishing the Economy

- Efficient and sound financial system
- Internationally competitive corporate sector

FINANCIAL RESTRUCTURING PROCESS

B/S Restructuring

Micro-level Restructuring



BEFORE THE CRISIS, ONLY RUBBER-STAMP BOARDS EXISTED

EXAMPLE

Before the Crisis:

- Stocked with company insiders, executives of its client companies, friends of the CEO
- Only 8 of its 20 directors came from outside the bank and had no or little experience or expertise on corporate governance
- No formal committees and board responsibilities
- Turnover ratio was very high (mostly less than a year)
- Board meeting was held every month, but usually for about an hour
- Often no agenda was sent to outsiders

Result (End of 1997):

- Poor financial performance: 0.97 BIS capital adequacy ratio, 17.9% NPL ratio
- Financial Supervisory Commission (FSC) seized control of the bank in early 1998
- No risk management: too much short-term foreign borrowing exposed Korean banks to a currency and a maturity mismatch
- Borrowers (especially large conglomerates) were becoming more of a risk and their average D/E ratio was over 520%: too-big-to-fail

WHY BOARD GOVERNANCE MATTERS

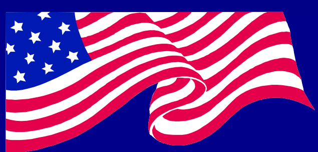
- For emerging market countries to restructure their financial systems, the creation of independent boards is imperative. They will oversee management to guarantee that operational improvements at the remaining banks endure.
- Board oversight is important in Asian countries where other sources of corporate monitoring (unskillful regulatory body, lack of information, unreliable external rating agencies, etc) are generally ineffective.
- Even a moderately effective corporate board can improve the crucial business and risk management operations of a bank in lesser time. (O.K. for the start)
- Strengthened bank boards have an important trickle-down effect in promoting good governance among corporations. In Korea, ‘board governance’ has become a factor in many banks’ credit assessment models.
- Having a good corporate board is an important driver of investment in countries that require re-capitalization to rebuild their financial systems.

Source: “Building Asian Boards,” McKinsey Quarterly 2000

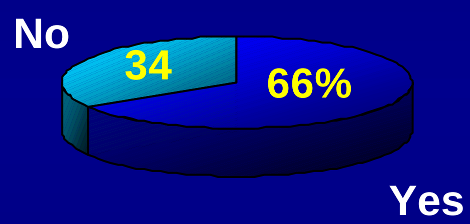
INVESTORS REWARD WELL-GOVERNED COMPANIES

For a well governed company	Would you pay more for stock?	How much more?

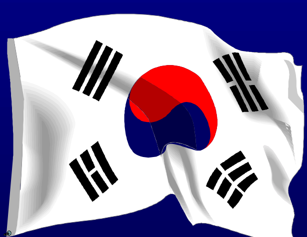
Percent premium



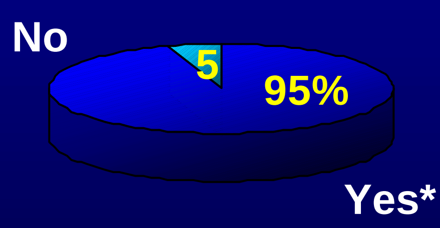
US



11 – 16%



Korean

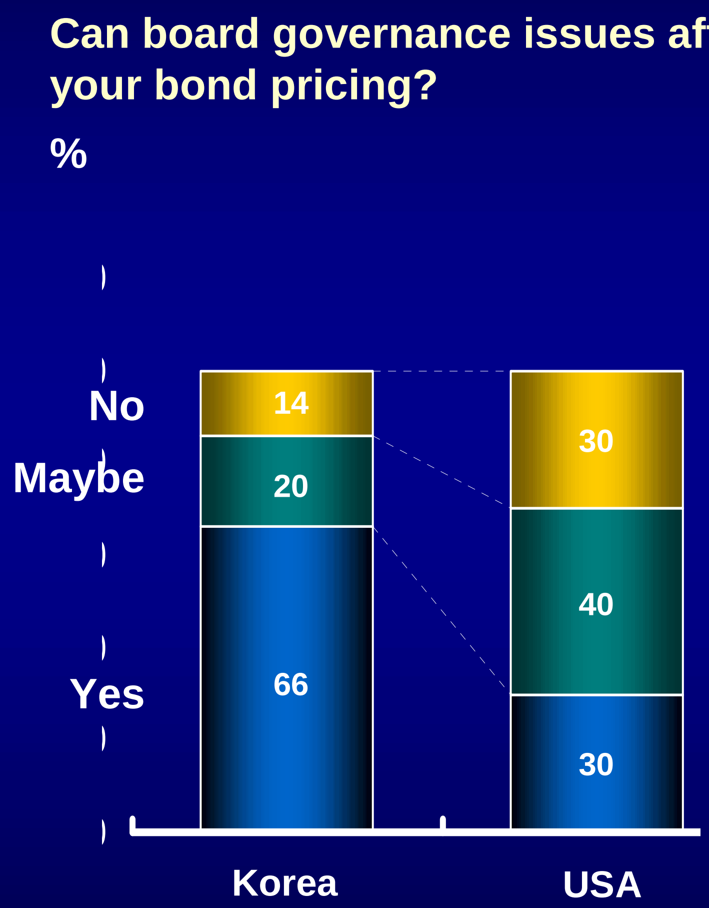


25 – 34%

Good governance will help attract more long-term capital from foreign investors

Source: Sang Yong Park (1999) using the sample of 64 institutional investors

GOOD GOVERNANCE AND BOND INVESTMENT



- **Corporate governance is more highly correlated with premium in Korea than in the US.**

"The more independent the board, the greater confidence bondholders can have that their interests are sound."

Source: Sang Yong Park (1999)

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GOVERNANCE REFORM MEASURES

Roles and Responsibilities of Board and Management

Committee Functions and Guidelines

Board/Director Evaluation and Turnover Process

Evaluation and Compensation of Top Management

ROLES AND RESPONSIBILITIES OF BOARD AND MANAGEMENT

Survey shows:

- Only 50% banks have basic description of board/committee duties but even when they exist, effectiveness is low (2.8)
- 80% do not have job description for CEO or chairmen and even if so, effectiveness is low (2.3 average)
- Unclear role division and lack of leadership hinder chairmen performance and depress board performance
- 60% of outside directors have asked for information to management. Management expressed concern for “burdensome” requests that are not shared by other directors or board
- Currently board support is done by departments that lack capacity or know-how to play liaison between management and board

Recommendations are:

- Specify board/committee duties into core board documents
  - 85% supports clear documentation of roles and duties
- If necessary to stabilize board function, combine chairmen/CEO roles
  - 66% supports consolidation of roles
- Recognize CEO’s proper power in decision making in the ordinary course of business matters and selection/evaluation of top management
  - 90% of executive directors support this point
- Specify role of chairman of board and committees to keep board/committee sufficiently informed of important agenda
- Establish corporate secretary function to assist board and management

COMMITTEE FUNCTIONS AND GUIDELINE

Survey shows:

- 60% of banks have description of committee duties on file. Effectiveness of the documentation is just about average (3.0)
- 70% of banks said no plan is in place for management evaluation
- Only 40% of banks review internal auditor reports and half review outside auditors' reports
- Reasons quoted for inactive functions include lack of committee authority to make final decisions

Recommendations are:

- Specify committee duties into core board documents
  - 85% supports clear documentation
- Clearly establish committee authority and power to make decisions
- Establish reporting procedure to the board on items delegated and processed at committee level

BOARD/DIRECTOR EVALUATION AND TURNOVER PROCESS

Survey shows:

- 47% of directors are considered below average performers in need of training or replacement
- Directors responded that 14% of outside directors need to be replaced
- No.1 reason for low performance was lack of expertise, followed by lack of participation in discussion and lack of team work
- 90% of banks do not have board/director evaluation process
- 60% of banks do not have director nomination process in place
- 70% of banks have no plan to hold education or training for directors

Recommendations are:

- Institute yearly evaluation of board/director performance
- Shorten director term to 1 year to create healthy turnover based on evaluation
  - Although directors are generally against shortening their term of director service (30% support for shortening director term to 1 year), 70% of directors favor replacing low performing directors at this year's shareholders meeting
- Add more directors with business acumen and relevant expertise
  - 70% of directors supported business minded directors
  - 82% of directors supported experts in audit and risk management committees

EVALUATION AND COMPENSATION OF TOP MANAGEMENT

Survey shows:

- Evaluation and compensation of top management did not come up as very important process in the survey (3.4 in the survey, whereas top first or second function in the U.S.)
- Directors responded that compensation generally does not reflect performance (2.2)
- 70% of banks do not have formal CEO evaluation process
- 80% of banks do not have explicit and written criteria for top management evaluation
- Even for those who have the process effectiveness is low (2.5)

Recommendations are:

- Build CEO and top management evaluation process that links performance to pay
- Introduce incentive pay structure including stock option
  - Directors recommend that base vs. performance pay be 35:65
  - Directors are strongly in favor of stock option grants to management (4.3)
- Upgrade CEO pay to reflect market value of CEO role
  - Directors responded that 3.5 Auk is the appropriate CEO pay (4.1 for major banks and 2.0 for regional banks)

SUMMARY OF MOST IMPORTANT ISSUES AND RECOMMENDATIONS

	Key issues raised from survey	Possible recommendations
Roles and responsibilities of board and management	• Board/committee duties are unclear and not specified • Chairman function is not clearly established • Information flow does not effectively inform the whole board or committee • Clear safeguard to prevent conflict of interests is lacking • (Most banks, Hanvit)	• Specify board duties into core documents • If necessary, combine Chairman/CEO roles until outside director functions stabilize • Recognize CEO's proper authority to make business decisions and to select/evaluate top managers • Specify role of chairmen of board and committees to keep board/committee sufficiently informed of important agenda • Establish rules and conventions for disclosure of all transactions involving board members or board action
Committee functions and guidelines	• Majority of bank committees are not functioning • Working guideline for director function is not in place • (Most banks)	• Establish working guideline (terms of reference) for each committee to specify duties and outputs • Clarify decision/recommendation authority of committees
Board/director evaluation and turnover process	• Nearly 50% of directors are not performing well 15% need to be replaced now • Directors lack relevant expertise and business acumen • No process exists to evaluate director/board and create healthy turnover • (Hanvit, KEB)	• Mandate yearly evaluation of board/director performance • Immediately shorten director term to 1 year to allow timely turnover • Make board/director education one of key priorities of bank boards • Add more directors with business experiences and relevant expertise
Evaluation and compensation of top management	• Evaluation process and criteria are not clearly defined • Compensation is not linked to performance • (Most banks)	• Build evaluation process that links performance to pay • Introduce incentive pay structure (stock option) • Upgrade CEO pay to reflect market value of CEO role

Source: Director surveys, team analysis

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INVOLVING PARTIES AND THEIR ROLES

Government

- MOFE: Complying with OECD Principles, and Basle Committee Rules
- FSC/FSS: Pursuing Hardware & Software Restructuring Process
- FTC: Chaebol Regulation

Corporates

Improving Transparency of Decision Process and Internal Control:

- Effective Board Composition and Reporting (or Working) Board
- Best Practice Management Skill
- Ensuring an Effective and Efficient Internal Control System

NGOs

People's Solidarity for Participatory Democracy

- Enhancing Minority Shareholder Rights: SK Telecom, Samsung Electronics
- Cumulative Voting System
- Class Action Suit

Foreign Investors

- Minimizing Government Intervention
- Long-term Strategic or Institutional Investors
- Shareholder Value Maximization

Others

- World Bank, ADB, etc
- International Consulting Firms

SWEEPING CHANGES IN BOARD OPERATIONS: H&CB CASE

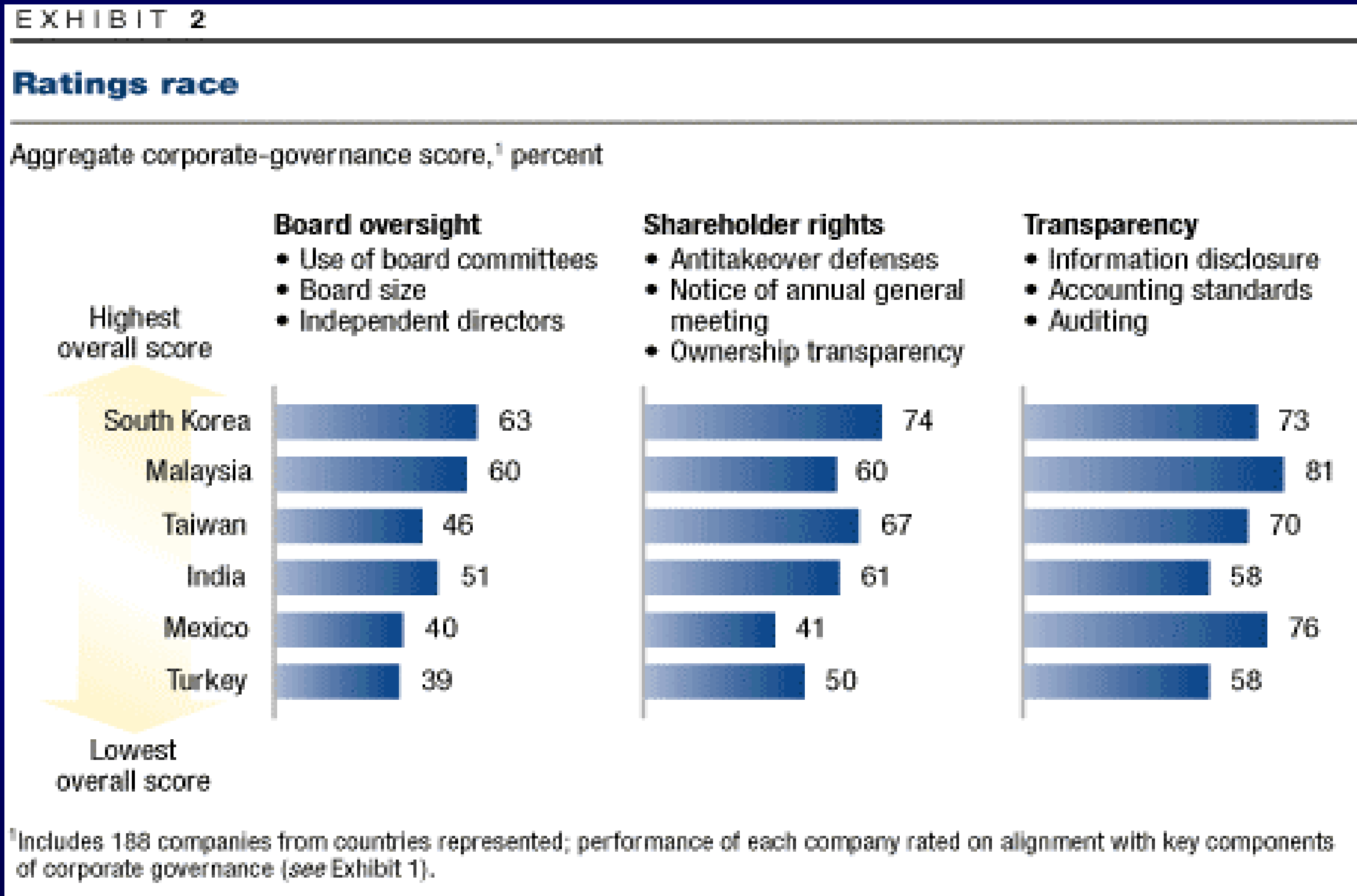
- Board composition and operation based upon best practice guidelines
  - The new board is dominated by independent outside directors*
    - *retail-company CEO, financial expert, overseas banker, venture CEO

- The new board's Impact on H&CB
  - Rated as having 'very good' board governance (Jardine Flemming)
  - Handling of Daewoo bankruptcy:
    Cutting its exposure by 75%, Realistic provisioning
  - Enhancing transparency
    Introduction of a new 'forward looking criteria' one year ahead of schedule
    Listing at NYSE by complying with US GAAP

- The first bank to pay its CEO largely with stock options
  - Aligning the interests of management with the interests of shareholders

Source: "Building Asian Boards," McKinsey Quarterly 2000

ASSESSMENT OF CORPORATE GOVERNANCE AMONG COUNTRIES



Source: McKinsey Quarterly, 2002

CHALLENGES AHEAD

- Meet the shortfall of the shortage of qualified directors
- Adopt tailor-made governance structure for each bank
- Introduce more incentive compatible mechanism for both board and management (retainer/meeting attendance fee, stock option)
- Clarify R&R of the board in accordance with strengthened laws and regulations (director insurance)
- Enhance transparency by ensuring effective internal control systems (audit committee, compliance officer, disclosure)

CHALLENGES AHEAD *(CONTINUED)*

- Install high quality boards in large conglomerates
- Enhance the role of institutional investors by developing capital markets
- Improve institutional settings with regard to minority shareholder rights (class action suit, cumulative voting rights, proxy voting)
- Ensure financial holding company’s governance structure
- Tighten regulatory monitoring on governance (CAMGEL)

POLICY LESSONS

- **Let Governments promote better board governance when market checks are absent on corporate behavior**
  - **- Deep capital markets with activist investors**
  - **- Rating agencies**
  - **- Effective, well-trained regulatory examiners**
- **Adopt a ‘Do it/Fix it’ approach than to wait until all of the optimal conditions are met**
- **Understand qualified board members are in short supply and seek out best practice examples and guidelines**
- **Start with the area in which governments have greatest control to make initial implementation easier**

Source: “Building Asian Boards,” McKinsey Quarterly 2000

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