Economic Modelling 47 (2015) 145–155

Contents lists available at ScienceDirect

Economic Modelling

journal homepage: www.elsevier.com/locate/ecmod

Corporate governance, regulation and foreign equity ownership: Lessons from Korea

Byung S. Min [a,*], Robert G. Bowman [b,c]

[a] Griffith University, Australia
[b] University of Auckland, New Zealand
[c] University of Queensland, Australia

ARTICLE INFO

Article history:
Accepted 21 February 2015
Available online 7 March 2015

Keywords:
Corporate governance in emerging markets
Foreign equity ownership
Regulatory reform
South Korea

ABSTRACT

We investigate whether the introduction of a mandated independent director system affected firm ownership structure in South Korea, where the governance system changed significantly after the 1997 financial crisis. Results indicate that foreign investors place considerable value on the appointment of independent directors. An increase in foreign ownership, associated with an improvement in the corporate governance system, occurred after controlling home bias and firm size. Further, the positive effect of an outside director system on foreign ownership was greater for independent firms than it was for conglomerates (chaebols) and their affiliates. The results are robust under a range of endogeneity tests.

1. Introduction

A dramatic change in corporate governance systems in South Korea (Korea hereafter) following the 1997 financial crisis has drawn the attention of both researchers and policy makers. Previous studies have largely shown the positive effects of corporate governance improvements on firm value (Choi et al., 2007; Kim et al., 2010; Black and Kim, 2012; Min and Verhoeven, 2013, among others). While these studies have improved our understanding of the effects of governance mechanisms on shareholder wealth, an equally important aspect is to understand the effect of certain corporate governance mechanisms in attracting foreign investment. Corporate governance mechanisms, including outside directors, reduce investment risk to foreigners by decreasing the costs of monitoring manager's/controlling shareholder's exploitation of minority (foreign) shareholders (Shleifer and Vishny, 1997; Bebchuk and Weisbach, 2010) and business partners (Luo et al., 2009). "In (a shareholder value) environment, independent directors are more valuable than insiders. They are less committed to management and its vision. Independent directors can be more readily mobilized by legal standards to help provide the public goods of more accurate disclosure and better compliance with law." (Gordon, 2007: 1465) Improving the independence of the board has a subsequent effect of attracting foreign investors. The home bias proposition and transaction cost theory provide further support for this view. They suggest that foreign investors prefer firms that have governance systems similar to those in their own countries (Dahlquist et al., 2003; Karolyi and Stulz, 2003; Bell et al., 2012). Further, on a broader level, the existence of a home bias is to the disadvantage of developing economies as it is consistent with under investment from developed economies and thus inhibits the expansion of globalization.

In the context of Korea, we investigate whether a dramatic change in the corporate governance system affected foreign equity ownership. In particular, we investigate whether foreign investors responded positively to the appointment of outside directors, indeed a core element of the changes to the corporate governance system following the financial crisis.

In the aftermath of the 1997 Asian Financial Crisis, the Korean government implemented a series of regulatory reforms that had a significant impact on corporate governance structures and increased the independence of boards of directors. The objective, as suggested by corporate governance literature (Adams, 2011; Armstrong et al., 2012), was to strengthen corporate governance systems as a means to improve managerial monitoring, transparency and accountability. In parallel with these new regulations and changes was the removal of most restrictions on foreign ownership of Korean companies.

The reforms in Korea have been the catalyst for numerous studies. Choi et al. (2007) study Korea over the period 1999 to 2002 and find the presence of outside directors and the level of foreign ownership impact positively on firm valuation. Other studies looking at firm value impacts include Black and Kim (2012), Cho and Kim (2007), Kim (2007) and Min (2013).

However, none of these studies explore the effect of outside directors on foreign ownership. Two studies come closest to remedying this omission. Rhee and Lee (2008) find that foreign ownership increases when outside directors have advanced foreign degrees, affiliations with government organizations and experience in the relevant industry. Kim et al. (2010) show that diffuse ownership and a firm's efforts to implement better corporate governance lead to higher levels of foreign ownership.

* Corresponding author at: 170 Kessels Rd, Nathan, Brisbane, Qld 4111, Australia, Tel.: 617 3735 5248.
E-mail address: b.min@griffith.edu.au (B.S. Min).

http://dx.doi.org/10.1016/j.econmod.2015.02.030
0264-9993/

Our empirical results indicate that an improvement in corporate governance, measured by the appointment of outside directors, helps to attract more foreign equity ownership. The *within-estimate* shows a strong positive association between the two variables. We demonstrate further that for our study period, causality runs from the change in board independence to the increase in foreign investment. We also demonstrate that the positive effect of the outside director system on foreign ownership is greater for independent firms than it is for chaebols, suggesting that foreign investors discount the effectiveness of outside directors for chaebols. The increase in foreign ownership is also closely associated with firm size, which may proxy for the home bias factor. Our findings are important in suggesting prescriptions for success in the process of globalization.

Our analysis builds on a large existing literature in finance and contributes to it in a number of ways. First, we relate corporate governance to foreign portfolio investment and further relate that link to its positive impact on globalization. Second, existing studies focus largely on developed economies with stable corporate governance systems. We examine the effect in an emerging market of substantial changes to governance structure on foreign ownership. We show empirically that an improvement in corporate governance systems can facilitate capital mobility across countries. This finding is particularly relevant for emerging markets where capital costs in domestic markets are generally higher than in international markets. Third, we show that the link between improved corporate governance and foreign investment is not demonstrated for chaebol companies, where there is likely to be concern about the potential for influence by independent board members. Fourth, we carefully deal with the potential endogeneity in the relationship between improvements in the independence of boards and increases in foreign investment. The most common sources of estimation biases are from omitted variables, measurement error and reverse causality. We employ a within estimator and a dynamic panel model to deal with the omitted variable problem and firm-specific fixed effects, and instrument variable methods to address the reverse causality issue. Further we confirm our findings by changing model specifications. In addition to the single-equation models we use simultaneity equation models to confirm the results of the instrument variable methods as well as the measurement errors. We also checked the robustness of our main finding using a matching method.

The remainder of this paper is organized as follows. The following section reports changes in the regulatory reforms that focus on the introduction of the outside director system and deregulation on foreign equity ownership. Then we document existing theories to formulate empirical hypotheses. Section 4 explains our methodology including data descriptions. Main estimation results combined with a number of robustness checks are reported in Section 5. In particular, we focus on the possibility of endogeneity arising from omitted variables and reverse causality combined with self-selection. The final section contains the conclusion.

2. Regulatory reforms

2.1. Changes in the corporate governance system

There are three distinctive features of the government-initiated regulatory reforms of the corporate governance system in Korea. First, the restructuring of board of directors (BOD) composition requires the appointment of outside directors for publicly traded firms. Before the reforms, board members in Korea were typically appointed as part of a seniority-based promotion scheme (Kim and Briscoe, 1997), which is similar to the situation in Japan. This tradition had negative implications for corporate monitoring by boards. Board size could become too large to be efficient, resulting in coordination failures, as confirmed by Yermack (1996) and Eisenberg et al. (1998). The promotion-linked board structure also often results in another layer of hierarchy within the BODs. Thus, the check and balance mechanisms could fail to work, and board members could become a rubber stamp for management decisions.

The amendment of the Listing Act in February 1998 requires companies listed on the Korea Exchange to have at least 25% outside directors on the BOD. To insure the independence of outside directors, the Act clarified the conditions for outside directors by excluding the current and former employees of a company, family or friends of controlling shareholders (CSHs), and anyone who had a business relationship with the firm/business group.

Further to this statutory requirement, the announcements of a Code of Best Practice for Corporate Governance in September 1999 and February 2003 influenced amendments to the Securities and Exchange Act in March 2001 and December 2003 respectively. Large listed corporations with assets greater than 2 trillion won (approximately 2 billion USD) must establish an Audit Committee and an Appointment Committee under the BOD, with its members comprised mainly of outside directors. The 2001 amendment also requires that no fewer than half the board members of these large firms be outside directors.

Second, the reform of the corporate governance system was government driven, with the assistance of the International Monetary Fund and the International Bank for Reconstruction and Development who supplied bail-out funds following the 1997 crisis. The impetus for change was exogenous.

Third, the change in the governance system was from a relationship-based insider model towards an outsider model. Seeing the traditional relationship-based model as one cause of the 1997 crisis, the Korean government opted to move closer to the Anglo-American system. In particular, the introduction of an outside director system was revolutionary to the existing system. The corporate reforms following the crisis addressed many issues such as strengthening controlling shareholders' legal responsibility, shareholder activism, independence of the audit committee, allowing a holding company system (mainly for chaebols), and reliable and transparent accounting/management information. In addition to this internal element of governance, the Korean government allowed (hostile) mergers and acquisitions as a method of improving governance systems through market monitoring. However, the introduction of the outside director system has become one of the most important elements of the reform (Cho and Kim, 2007; Choi et al., 2007; Min, 2013).

2.2. Changes in foreign ownership restrictions

In addition to the reform of the corporate governance system to strengthen the monitoring function of boards and protect minority shareholders' interests, the government also relaxed its restrictions on foreign investment.

Foreign investors play a particularly important role in emerging markets because their participation promotes development by supplying capital, spill-over of technology and managerial know-how, and competition to improve the efficiency of the markets (Bekaert and Harvey, 2000; Bekaert et al., 2001).

Korea first relaxed its restriction on foreign portfolio investment (FPI) in 1992 to allow foreign investors to own (in aggregate) up to 10% of most listed companies. The reforms in May 1998 further relaxed regulations governing foreign investment in Korean firms, except for those industries that involve national security concerns or cultural considerations, such as the mass media. Foreigners could purchase up to 50% of the outstanding shares of most public corporations.

The data on foreign investment, shown below in Table 1, indicates steadily increasing investment by foreigners over our sample period of 1999 through 2003. The increase in foreign investment unfolded progressively, so that the investment decisions would have reflected full consideration of the developing improvements in corporate governance.

3. Theory and hypotheses

Prior research shows that investors exhibit a home bias; they are reluctant to make cross-border investments (Dahlquist et al., 2003;