Creating New Corporate Governance System for Korean banks: Lessons from French banks' Cases

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Ⅰ. Introduction

1. Bringing up major issues and objectives of research

Less than 1 year after becoming an OECD member, Korea encountered an economic crisis (so-called "IMF era"). It has been traced to ❶the indiscriminate investment by large conglomerates ignoring their core competencies, ❷excessive leveraged management ❸government's excessive interference and regulatory measures deviating from market economy principles, and ❹a weak corporate governance system lacking of "checks and balances" with no clear identification of the various stakeholders.[1] This view also sparked active debate about the corporate governance system of the Korean banks, including whether industrial corporations should be permitted to own banks equity without restriction.

The IMF-Korean government agreement on financial assistance, which focuses on the restructuring of the financial sector including the improvement of corporate governance system of financial institutions especially banking industries, has advocated the adoption of U.S-type of BOD structure "self-appointed" as the "Global Standard". Some critics say that it is not effective to unilaterally force one country's governance system upon other countries. The mere introduction of U.S-type of system into Korea does not necessarily contribute to increasing the efficiency of Koran businesses' management and sharpening their competitive edge. The indiscriminate adoption of the system of the other country differing from Korea in social, cultural background, and economic environment is more likely to cause uncontrollable confusion and inefficiency(W.H.Lee,98, pp.1-6). Accordingly, the most common position is that Korean businesses should correct and improve problems associated with the past Korean management practices while adopting some features of the

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1) D.S.Cho(1998), Restructuring of the Korean economy and companies: Booz Allen &Hamilton (1997), Korea Report: Mckinsey(1998), Productivity-led growth for Korea : SERI(1998), The status-quo and problems of Korean market economy

"Global Standard" which in fact is a U.S standard.

The objective of this research intends to come up with ideas for improving the corporate governance system of the Korean banks. To do so, I will analyze in depth characteristics of the French corporate governance system less known than its U.S.-type counterpart.

Therefore this research starts by bringing up three major issues as follows;

1) What causes the corporate governance system of Korean banks to be weak? What are the major issues?
2) What are differences between corporate governance systems of advanced countries including U.S and European countries?
3) What are major characteristics of the corporate governance system of French banks, which has a management environment similar to Korea? And which efforts should be placed to improve corporate governance system of the Korean banks?

2. Research Framework

In this research, I reviewed literature related to the corporate governance and analyzed cases of the corporate governance system of French banks.

Section 1, dealing with characteristics of corporate governance in Korean banks, will discuss what makes external control mechanisms, especially government, so important in Korea. Then I will compare it with that of advanced countries.

In section 2, I will review differences between advanced countries' corporate governance systems, and their causes from the standpoint of each country's business outlook and institutional environments using recent studies and survey data. Particularly, I will analyze characteristics of the corporate governance system of European countries, which are less known to Korea.

In section 3, I will analyze characteristics of the corporate governance system of French banks. Assuming that some features of the French system may be applied to Korea, I will analyze ❶characteristics of the past corporate governance system, ●causes that led to its transformation from the vertical point of view, ●characteristics of the present corporate governance system, on which nation, business outlook, and economic realities are properly reflected by using Societe Generale's case.

Section 4 is a conclusion. In this section, I will present the future direction for improving the corporate governance system of Korean banks.

Ⅱ. Contemporary and emerging issues of corporate governance in Korean banks

1. What has made corporate governance an essential factor for businesses' success?

In 1990's, the corporate ownership structure and the corporate governance system have emerged as the most controversial issue under the name of the "Corporate Governance Revolution" in capital markets of advanced western countries, where ownership diffusion is very wide. In general, corporate governance deals with the ways in which suppliers of finance (shareholders) to corporations assure themselves of getting a high return on their investment (Schleifer and Vishny, 97, pp.737-783; D.S.Cho, 98, pp.158-201).

The corporate governance system has been of a great importance for the following reasons,

First, corporate failure does not come from the result of unbalance in the management, BOD, and audit function, but from an inefficient decision-making system. The existing "Management-Corporation" model turned out to be inappropriate (John Pound, 95, pp.22-33). Under the "Management-Corporation" model, the professional top management sets directions for the business and directors and shareholders follow. The governance structure under this system merely elects top management, supervises business performance, and replaces management if its performance falls short of the planned goal (Robert W Lear, 98, p16). The "Corporate Governance" model puts first enhancing the efficiency of decision-making system through electing directors with expertise, defining directors' role according to the corporate's future strategy, and developing an incentive system for aligning shareholders and management objectives.

Second, capitalism has evolved from "Family Capitalism" to "Public Investors Capitalism" in a phased manner (U.K.Lim, 89,p12). Over the years, as firms grew, public offerings of stock led to wide diffusion of ownership and made it impossible for most owners to directly manage their interests in a firm. Therefore institutional investors began to make the efficiency of the corporate governance system a yardstick for valuating corporations (Don O'Neal, 98, pp.814-815)[2].

Third, today's corporate management system and market environment can be divided into customers, product markets and capital markets, and corporate governance market. More and more people throughout corporate organizations are keenly aware of the importance of customer and product market thanks to customer-centered management, which has been vigorously launched as part of the management innovation. In recent year, it has been widely accepted that a major variable determining the competitive edge of each country's businesses is the corporate governance system (W.H.Lee, 98, pp.1-6).

Accordingly, the recent debate over corporate governance system is focused on how the corporate governance system is increasing corporate's competitive

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2) In June 1997, calPERS, the largest U.S. public pension fund, proposed the principles of good corporate governance. The principles include: ● A majority of the BOD members should consist of independent outside directors. ● Certain key committees should consist entirely of independent directors. ● The BOD should adept written governance principles and reevaluate it at least every 2 or 3 years, etc. It is remarkable that calPERS showed its international influence on management not only to the U.S. For instance, calPERS issued the report stressing the reforms of 4 countries corporate governance (France, United Kingdom, Germany, and Japan), and especially calPERS cited that these countries ongoing reform of corporate governance may well be affected by a recent development in the U.S even if the national differences exist in cultures and institutional environments.

edge[3] and on whether the ideal corporate governance structure exists.

2. Debate over Korean corporate governance system in embryo stage

In developed countries, there has been active debate over speedily improving the corporate governance system in response to the changing management environment, while Korean business circles have rather minimized the scope of it and rarely put discussed issues into practice. Basic issues debated were limited to which system is superior in the industrial sector; owner's management system or professional management system[4], whether the industrial capital should be allowed to own the equity of banks without restriction.

But the debate over improving the corporate governance system has been going on for a long time in Korea. In an attempt to prevent deep-rooted collusion of the businesses and politics related to the slush fund scandal in the early 1990's and improve the management system, the "Globalization Promotion

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3) A typical study and survey discovered that the traditional model rendered the board of directors as "Legal Formality" and "Watchdog", but new governance model is emerging whereby the BOD brings its collective knowledge and experience to the tasks of improving management performance and building competitive edge (How Corporate Boards Create Competitive Advantage, Ram Charan, 1998). The weekly magazine, Business Week, annually published the ranking of best BOD on the basis of BOD's independence, BOD's sense of responsibilities to shareholders, and BOD's quality. One interesting thing is that there is not much difference in this ranking and the other ranking based on MVA.

4) Recently a discussion about following subject took place: "Is the Korean-specific ownership management system not superior to the professional management system?" It is true that the ownership management system has laid bare many negative aspects, but it has fixed as the typical governance system for the Korean businesses up to now. This is because many inevitable factors forced Korean businesses to pursue the congruence with the given management environments, and the ownership management system contributed to the growth of Korean businesses despite the negative evaluation about it. Since this is a reality, it is desirable to accurately understand advantages of the system and wisely operate it by harmonizing it with the realities, instead of evaluating the ownership management system and the professional management system from the standpoint of mutual replacement.

Committee", which was organized by the Korean government, proposed many ways to develop the corporate governance system in 1995 including ❶the introduction of outside director system, ❷the improvement of outside independent audit system, ❸the protection of minority shareholder's right, and ❹the strengthened role of institutional investors. Along with these measures, some past problematic management practices have repeatedly been pointed out such as: ❶the "Fleet-Type" management practice forced by large conglomerates (so-called, Chabeol) and ❷cross repayment guarantees among affiliated companies. However, the debate over these issues ended up with a mere "Desk Theory" due to the difference in perspective between the government and economic circles, which should have taken the lead in renovating an outdated system, and their conflicting arguments on ways and timing to promote the renovation. So, private sector's voluntary efforts to improve the corporate governance system with laws unchanged had the limitation and was the only hope before the IMF-administrative economy was put into effect at the end of 1997 in consideration to enormous clout the Korean government traditionally holds over industrial and financial sectors.

3. Korean corporate governance system under the standard of governance system's mechanism

There are basically two types of control mechanism: internal and external. These control systems are designed to bring the interests of management and other stakeholders into congruence (Walsh and Seward, 90, pp.421-458; D.S.Cho, 98, pp.158-201). This classification method, which includes macro environment factors to respond to changing external environment and management subject factors[5], nearly concurs with the classification of stakeholders

5) According to the Koontz & Weihrich's model (1990) regarding the management as the process of input, transformation, and output, this model classified the management into three different categories such as ❶ input and output, ❷ the internal management system related to the process mediating this, ❸ macro management and management subject groups determining the principles of internal management system's domination and operation.

(management subject groups) which is central in corporate governance. Internal controls include boards of directors, labor unions, and minority shareholders, while external controls are market forces, mergers and acquisitions, and government regulations (K.H. Chung, H.C.Lee and K.H.Jung, 97, pp.66-71; D.S.Cho,98, pp.158-201).

First, the Korean economic system once credited as the economic growth model for developing countries. But it featured a government-led closed economic system. The existing "Quasi-Internal Organization" among the government, banks, and industrial businesses resulted in the artificial control over private sectors by the government, but not by the market mechanism (J.C.Lee, 98, pp.113-155). For example, Korea had to develop key industries and enforce policies giving special favor to export-oriented manufactures because of its limited capital resources for economic growth even though series of 5-year national economic development plans earmarked which industries would get most capital investment.[6] But the government did not give up intervening in private businesses' management and only changed its control method from the direct intervention over industrial sector to the indirect intervention through banks in an effort to continue its control (prime rate applied to the industrial policy loan have been removed since the mid 1980's, and the government-led industrial policies have begun to wither since the second half of 1980's.).

Second, the BOD is supposed to play a curbing role in the management decision-making, free from management's interference, according to the basic spirit of Korean commercial law (that is, BOD members should protect the interests of stakeholders.). In realty, however, almost all BOD members of Korean banks comprised government-approved directors and those of industrial corporations comprised owner-appointed directors since the outside independent

6) This policy is rooted in the "*five-year Economic Development Plan*" the Korean government had implemented. It developed the plan as follows: Fertilizer and Petroleum industry (1962-1966), Steel industry (1967-1971), Export-oriented Light industry (1972-1976), Heavy and Chemical industry (1977-1981), Electronic and Automobile industry (1982-1986).

director system has not taken root. As a result, the BOD's decision-making usually lacked justness, reasonableness, and democratic nature.

Third, labor unions, particularly, in European countries are actively participating in the management as BOD members, while Korean counterparts have failed to play their role as an axis of internal control system because of the lack of expertise and their adherence to pursuing their own interests (K.H. Chung, H.C.Lee and K.H.Jung, 97, p67).

Fourth, minority shareholders have been too fragmented to emerge as a force with which management has to deal even though they own about 70% of the total outstanding stock of publicly traded chaebol companies. What makes matters worse, there has not been an effective legal framework to protect the interests of minority shareholders.

Fifth, financial institutions were perceived as major stakeholders for Korean industrial sector due to its important financing role. In Japan and Germany, banks play a major role in corporate governance as a majority shareholder of large companies. In Korea, however, the government limited the role of financial institutions as mere fund providers. As a result, banks as a major stakeholder failed to develop their capacity to monitor management performance of industrial firms.

Finally, the market-based control mechanism of M&A was not vitalized in Korea because ❶the capital market has not grown enough to handle M&A and ❷many regulatory measures stood in the way of M&A. As a result, nonviable businesses have been kept afloat. Instead, policy loans and debt write-offs by financial institutions have facilitated the acquisition of ailing businesses.

4. Main issues in corporate governance system of Korean banks

1) External board system for Korean banks

Past Korean banks' management paradigms and their performance management factors, which faithfully followed governments policies and pursed growth rather than profitability[7]. Banks attached a greater importance to customers' recognition of their trade names and the coverage of their branch network throughout the country than differentiation of products and prices. Banks' mistaken perception that the government would never let banks tumble has also fanned the nonviability of some banks. The government tacitly provided such a protection in exchange of strict respect of its imposing regulatory measures on banks. Artificial protection and regulatory measures produced a keen competition for increasing the number of branches, an inefficient utilization of manpower, the lack of centralized system reasonably determining the extension of credit line to customers, and the expansion of investment in highly risky assets.[8]

Korean banks seemingly have the ownership structure of investor capitalism, in which individual minority investors and institutional investors own most of the equity. But a close look reveals that the government is still stepping into banks' affairs through the stock market stabilization fund, non-bank institutional investors, and large business conglomerates that have been under its control (although the government does not have direct ownership). The government contributed a considerable portion of paid-in capital to start commercial banks even after they were privatized. The ceiling of equity, which industrial corporations and institutional investors are allowed to hold, also indicate that

7) IMD's 1997 report on "*National Competitive Advantage*" noted that Korean manufacturing industry's competitive advantage ranks 26th in the world, while that of the Korean financial industry marks 44th, the lowest ranking in the world. Also, Boston Consulting Group compared ROA and ROE of three top- ranking Korean banks and U.S banks including City bank, Chase Bank. As a result, it turned out that the average of the Korean bank's ROA and ROE was only one eighth and one fifth of U.S bank's averages respectively (as of 1995).

8) ❶Even small-mid sized regional banks have an average of more than 100 branches each. ❷Banks compute the required manpower as of the end of month when the amount of business is at its peak and utilization of part-timers falls short of expectation. ❸The ratio of their investment in marketable securities is about 30% based on total available operating assets (the average between 1990 and 1995).

most commercial banks' actual owner is the Korean government.

Besides putting first priority on distributing capital to export-oriented manufacturers, separate accounting regulations for financial institutions made it impossible for the government and banks to accurately measure performance. Worst of all, the government wielded its power by intervening in banks' personnel affairs through the direct or indirect participation in equity and ad hoc legislation. To correct these practices, the government had organized the "Bank President Recommendation Committee" in an effort to encourage banks to deal with their personnel affairs autonomously, but it almost ended up as failure because the government did not stop meddling in banks' personnel affairs. Therefore the government's intervention only contributed to having banks' management pay more attention to politics rather than performance.

2) Powerful influence of executive board of directors above board of directors

The type of the Korean banks' BOD was divided into the "board of directors" and the "board of executive directors" according to the revised banking law introducing the non-executive director system in 1997. It seems to have the structure of European "two-tiered board" system. But the board of executive directors has the highly decision-making function over board of directors in Korea (the bank's CEO doubles the chairman of BOD) in consideration of the articles of banks and relevant laws specifying the number of meetings called for, matters for decision, and information reported to two organizations. Therefore Korean bank's BOD is not playing its main role of check-and balance in the process of making decision differing from advanced countries' BOD system, in which clearly defines roles of BOD and executive committee and gives decision-making authority to BOD mostly composed of independent outside directors.

3) Non-executive director system transformed into honorary body

The latest studies of the relationship between BOD structure and businesses' success constantly confirm that a BOD structure mainly composed of outside directors is more efficient (Martin J. Conyon, 98, pp.146-157). External rating agencies, which evaluate how much the BOD is advanced, also highly values the ratio of independent outside directors in BOD (calPERS, 97; Wharton School of Business, 97). The outside director system requiring that businesses elect most of BOD members among independent outsiders is designed to have such BOD play a watchdog's and policeman's roles for protecting the interests of stakeholders (especially shareholders) and surveiling whether businesses fulfill their legal and ethical obligations (Ian Fraser, 98, pp.74-78).

The advanced countries' outside director system took root after going through long debate and trial and errors.[9] Its system strengthens outside directors, position by minimizing number of executive directors including CEO and COO as BOD members, or limiting the decision-making right of executive directors participating as BOD members.

Non-executive directors are recommended or elected by representatives of shareholders and BOD pursuant to the Korean banking law providing that 50% of BOD members consist of non-executive ones. Shareholders have the right to elect non-executive directors representing them in the order of equity holding of the issued stocks with voting right except those lacking qualifications specified in relevant laws.[10]

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9) Listed companies should have more than three outside directors (1960), the audit committee should comprise only outside directors for stock-listing (1979) of U.S, Caldbury (1992), Greenbury (1995), Hampel Report (1995, 1998) of United Kingdom, Vienot report (1995) of France all stress strengthening the outside directors role.

10) The Korean banking law prescribes in detail the requirement of BOD members qualifications. These regulations are almost similar to those of advanced countries outside directors. However, one unique thing of such regulations is that representatives of 5 large conglomerates based on credit amount and institutional investors can not be elected as non-executive directors. According to the revised regulations of relevant laws, outside director system was adopted in 1998, and beginning 1999, listed companies are required to fill more than one-fourth of total directors with outside directors.

First, some people are elected as non-executive directors representing industrial companies, which are majority shareholders and also have large scale of debt. They are prone to pay more attention to pursuing such parties interest than to suggest constructive opinions for improving the management performance. This makes it difficult for them to maintain financial independence.

Second, non-executive directors elected or recommended by the BOD have relatively high expertise, while those representing shareholders lack expertise in relevant fields.

Therefore such non-executive directors lacking expertise may not perform their role in organizing the expert committee comprising non-executive directors. They are only rubber-stamps of resolutions of the BOD afterwards.

4) Nominal operation of the committees

In advanced countries, BODs have 5 to 7 sub-committees.[11] It has been the general convention that except for CEO, all committee members are outside directors. Their function is primarily focused on strengthening BOD's role of monitoring and surveiling management activities through advising, arranging the information reported to the BOD in advance.

However, Korean banks' loan committee, ALM, and personnel affairs committee consist only of executive directors, and are under the direct control of the director & deputy president, not the BOD. This makes it difficult to insure responsible management, to enhance expertise, and to reflect non-executive directors' and shareholders' opinions on banks' policies. Moreover, almost all Korean banks do not have audit committee, nomination committee, and compensation committee, which are the trademark of advanced countries'

11) The type of committees, which are usually established and operated, includes the audit committee, compensation committee, nomination committee, executive committee. More than 90% of U.S. companies as of 1997 are operating compensation committee and nomination committee. In France, about 75% of 40 CAC companies are operating audit committee and nomination committee in the wake of Vienot's recommendation (The Internal Auditor (Oct.98), p12; Joel Chernoff (Sep.97), p16).

corporate governance system.

5) Unsatisfactory role of internal statutory auditor

If the corporate governance system is made up of three pillars including BOD, general shareholders meeting, and auditors, the recent trend is to strengthen the audit committee. Recent studies on the audit system stress that ❶the internal audit organization should be considered a separate one (Edward A. Weinstein, 98,p40) and ❷internal auditor act as the secretary to the audit committee (Robert W Lear, 98,p16) in order to insure the independence of the audit committee as well as external accounting firm.

But Korean banks didn't have a separate audit committee, and only appoint the internal statutory auditor. The function of internal auditor contributes to increasing the efficiency of control and surveillance in the decision-making process afterwards. In particular, the audit authority of Korean banks is stronger than that of industrial sectors in which auditors are non-executive, but it is doubtful whether Korean banks' audit function maintains independence and expertise. For example, most of auditors of commercial banks are from the government, the central bank, or in-house executive directors.[12] This indicates that they are not free from the influence of their management or the government.

6) Unclear division of status of in-house executive directors and senior officers

The Korean banks have not drawn a clear line between responsibilities of in-house executive directors and senior officers. For example, all executive directors (named registered directors) hold the status of both executive board of directors and BOD members while executing their main role as officer. Under this conflicting system, the total number of BOD member exceeds the optimum

12) In a bid to secure the independence of internal auditor, some Korean commercial banks are working out the personnel administration system designed to fundamentally block auditor and executive directors from changing their posts from one to another crosswise. According to the past personnel administration practices which has been going on, the post of internal statutory auditor has been on the same grade as those of director& deputy president or executive vice president.

level, thus making it difficult to have in-depth discussions. In addition, directors cannot fulfill their proper obligations of surveiling or monitoring whether other directors are appropriately performing their job because of potential problems with the internal hierarchy.

Second, too many executive directors and hierarchical dependence among them in Korean banks produce unnecessary positions, organizations for each of directors and a long decision-making process. For example, the director & deputy president covers all of bank's affairs in the capacity of CEO's assistant instead of performing in-charge roles. This is why critics say the position of director & deputy president was artificially created to make him the "Second Man". Banks are also organized too much by deposit and loan base not by customer or service base, and trends to generate positions artificially by personnel base, resulted in banks' failure to converge their competences.[13]

7) Lack of management's performance evaluation system

According to the U.S business literature, compensation linked with performance is rated as the most efficient driving force for controlling top management. In order to avoid that senior executives award themselves pay raises that are not congruent with shareholder interests, top management pay have to be managed by a remuneration committee mainly comprised of outside directors (Martin J Conyon, 98, pp.146-157). Moreover, in order to motivate management to improve their performance through the compensation, evaluation criteria should be based on the EVA, but not on earning-based-measure which ignores the capital opportunity cost and make it difficult to compare by periods and companies (Justin Pettit, 98, pp.49-53)[14]. But Korean banks lack such a

13) In 1998, *Shinhan Bank*, the one of the most respected successful banks in Korea, reorganized its organizations on the basis of customer and service functions before other banks. Other banks are expected to follow suit. In addition, the director & deputy president, who controlled the overall businesses in the capacity of CEO in the past, will directly control field departments as the in-charge of business divisions, or be examined the alternative to abolish its post by the movement of small and mid sized regional banks.

management's performance evaluation system. When electing the management, banks have been mainly dependent on qualifications checklist defined by supervisory agencies including the government, but they have disregarded performance they were responsible for. Under such practices, they have not felt it necessary to define evaluation criteria internally, and moreover the functional organization structure made it difficult to provide the specific evaluation criteria. The absence of criteria for evaluating the management performance barred them from introducing performance-based compensation. The compensation system fixed on an annual basis regardless of performance sometimes resulted in "Black Money Scandal" by some managements who were unsatisfied with their compensation.

Ⅲ. The analysis of corporate governance of French banks

1. Country's pattern of corporate governance

Despite the recommendation unveiled by G7 countries to stabilize global financial markets for macroeconomic policy, corporate governance and accounting (Crossborder Monitor, Nov.98), and the prominence of the U.S type corporate governance system so-called "Global Standard", each country is moving toward creating its own type of corporate governance system because each nation's cultural environment, economic structure, and institutional environments are different. To examine how, one has to understand each country's business situation, history, values and culture. Governance systems can be divided into the U.S and British-type of valuing shareholders' wealth and the German, French-type of treasuring the interests of all stakeholders (and not only shareholders but also employees and the community).[15]

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14) EVA= (Rate of Return-Cost of Capital)*Capital

15) Even in U.S, which treasures the maximization of shareholders' wealth as the highest value, presents its new view that the corporate governance system should be reevaluate from the stakeholder standpoint: ❶ Effective corporate governance requires careful

Torbin Pederson in "European Patterns of Corporate Ownership"(1997) pointed out that regulations and institutional environments differ from country to country, and these affect the corporate governance in a number of ways (for instance, U.S banks are prevented by legislation from holding large stakes in industrial companies whereas German or French banks are not constrained at all). As a result, different corporate governance will continue to coexist and the process of convergence will be very slow.

Deminor's report (1997) rated 140 companies in five European countries on rights and duties of shareholders, BOD structure and BOD committees. In this report, he said it is exaggerated to state that U.S BOD system strongly influenced European governance systems. He also argues the German "two-tiered board system" and French BOD system with a majority of independent outside directors are more effective than that of U.S (Lowengard, Mary, 97,p35).

1) Characteristics of British and U.S corporate governance system

British and U.S corporate governance system are based on a unitary business outlook stressing the maximization of shareholders' wealth. The equity of both countries' corporations is widely diffused among a great number of shareholders. But equity ratio of institutional investors' (financial institutions and pension funds) is higher than that of individual investors, and it gives institutional investors more influence over BOD. As outside directors' power is getting stronger, the trend is prevailing that the roles of chairman of BOD and CEO are separated. In addition, minority shareholders are actively performing their function of checking and surveiling the management by means of proxy voting practice respecting the "One-Share, One-Vote" Standard.

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balancing of the interests of customers, suppliers, the community, employees and the general public (Curtis C. Verschoor, 98,pp1509—1516). ❷ It is important to balance the interests of stakeholders since that businesses are the property of all who invest in them (Amitai Etzioni,98,pp679-691).

2) Characteristic of the German corporate governance system

German corporate governance system is featured by the ownership of the equity of many industrial businesses by banks in the first. The second is the dual outlook (economic and social) on businesses, which strives to harmonize the interests of all interested parties. The third is characterized by the "two-tiered BOD system"(Charkham, 94). Most of public enterprises' equity is owned by private sector including individual and institutional investors even though public and private businesses coexist at the same time, and the current German corporate governance structure provides little room for the government to intervene in the private sector. But employees are allowed to participate in the management according to the "Co-determination Act" which was enacted in 1976. The German BOD system takes the form of two-tiered board system divided into the management BOD (Vorstand) and the supervisory BOD (Aufsichsrat). The supervisory board comprising representatives of employees and shareholders is mainly responsible for nominating member of management BOD and surveiling their activities (K.H. Chung, H.C.Lee and K.H.Jung, 97, pp.79-80).

2. Characteristic of the French corporate governance system

1) Traditional features for corporate governance

The roots of the corporate governance system are to be found in ❶French government's active intervention in the market economy system (Charkham, 94; A.Alcouffe and C.Alcouffe, 87), ❷high level of industrial concentration by the existence of "Corporate Group" connecting industrial and financial companies by means of cross- shareholding, and ❸stress on harmonizing the interest of various interested parties including employees and shareholders.

First, the ownership, control, and structure of large firms were extensively affected by shifts in state policy in the series of nationalization of early 1980s, restructuring of the nationalized firms, and the privatization waves in 1986-1998 and 1993-1996 (A.Alcouffe and C.Alcouffe, 97, pp.85-103). But state-owned enterprises have monopolies in railroad, electricity, and tobacco industries even after privatization. The state also participates and exercises supervision in joint ventures with the private sector.

Second, the existence of holding companies, originally established by industrial companies to overcome financing constraints, helps to explain the frequency of cross-shareholdings and dominant majority ownership. Under this complicated governance system, majority shareholders are able to naturally control affiliated businesses under the hat of holding company. Thanks to the wide diffusion of equity, the "Technocratic control", under which independent outside directors can exercise greater influence than they could in the past, is emerging as an important concept. However, most of French corporate governance system still has the form of majority ownership (Alain Alcouffe and Christiane Alcouffe, 97, pp.85-103).

Third, the concept of "Social Interest", some would say fiction, brings together different interests in such a way that "Efficiency and Solidarity" can be reconciled (J. Saint-Hours, 94, p13). Therefore the emphasis is placed more on employees in France, while in Anglo-Saxon countries the emphasis is for the most part placed on the objective of maximizing shareholders' value (Herve Letreguilly, 98, pp.18-22). These unique French values treasuring the social interest contributed to producing its own governance system differing from those of other countries (Alain Alcouffe and Christiane Alcouffe, 97, pp.85-103).

2) Turn around and reform of corporate governance

Under the article 98 of French Company law of 1966, BOD is vested with the most extended powers to act in every circumstance in the name of the company, while the very same expression is used to qualify the top management's authority, with which he can exercise many prerogatives over other governing organs-namely shareholders' meetings and board of directors.[16)]

16) French proposed legislation permit firms to divide the jobs without having to create separate supervisory and management boards. More and more French companies have adopted two-tiered boards. For instance, One-fifth of CAC 40 companies have split the

This law clearly leans in favor of centralizing power in top management hands and limiting the representation of minority shareholders on BOD.[17] With the cross-shareholding practices, this generated "Interlocking Directorships" in which two businesses elect BOD members from one another. In 1985, the French court gave a strict decision on "Dormant Directors" explaining pleas. Main breakpoints also followed to induce a sense of needed reform. The first that Credit Lyonnais recorded a huge deficit (186 million FF of accumulated loss that tax payers had to pay for), but was not liquidated because it was state-owned enterprise and employed over 50,000 persons. The second that Paribas was successfully transformed into a investment bank from a retailing bank after replacing its management. The third that increase of foreign investment in French businesses has awakened the French to a sense of serious problems with the "Interlocking Directorships" and government intervention (Tess Read, 98, pp.172—173; Andrew Osterland, 97, pp.40-42).

The need to reform the corporate governance system culminated when the Marini's report and Vienot's report (1995) insisted on not imposing any regulations on corporate governance. Marc Vienot, former CEO of Societe Generale bank, did make a number of suggestions that the mission of BOD should be to place the company's interest first above those of employees and shareholders. He also recommends that directors are more financially dependent on their performance through shareholding, and they are asked to reduce the "Interlocking Directorships" practice. Moreover, companies should increase composing ratio of independent directors having no ties either with top management or the company. Finally, the most notable recommendation was for BOD to set up committees for audit, nomination and compensation of BOD members (Herve Letreguilly, 98, pp.18-22).[18] The French government through

jobs of chairman and chief executive officer in 1997 up from 7% in 1996 (Joel Chernoff (Sep.97), p16).

17) French companies use double-voting rights and voting limitations far more extensively.

18) According to the survey that ranked countries by 10 key indicators in four BOD

"The Commission des Operations de Bourse" (*COB*[19]) did not hesitate to amend its regulations to make room for Vienot Report recommendations: composition of BOD and specialized committees (COB Bull. April 1996), creation of audit committee (COB Bull. January 1998). In the process of reforming the corporate governance system, it is very important that key parties, not regulatory agencies, make a mutual agreement. In 1985, the National Council of French Employees (CNPF) and the French Association of Private Business (AFEP) made the agreement on "Boards of Directors of Listed Companies". The agreement provided the guidelines (which is tantamount to external regulations) that have to be observed, on how to operate the corporate governance system including listed companies' BOD. The key contents of this agreement are that most of BOD members should consist of outside directors representing all interested parties: ❶corporate's representatives or individuals who have no financial interest including shareholding with affected companies, ❷corporate's representatives who have transacted with affected companies through cross-shareholding, and ❸representatives for employees and institutional investors. The agreement also made a suggestion that directors should not accept appointments to the BOD member of more than five listed companies outside their company.

3) Characteristics of the ownership structure of French banks and its external regulations

The ownership of French banks can be divided into French industrial companies,

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categories: BOD structure, voting rights, disclosure and takeover defenses, France showed the greatest advances in corporate governance practices. French improvement in the scoring came largely from the growing number of companies splitting the roles of chairman and CEO, using international accounting standards more than Germany and Japan, rising ratio of creating compensation and nomination committee, being ahead of U.S and United Kingdoms BOD in view of composing ratio of outside directors among BOD members. Nearly 75% of BOD members of French companies composed of outside directors (Joel Chernoff (Sep.97).p16).

19) The French equivalent of the U.S SEC

French institutional investors, employees, and public and other investors even if each bank has a different mix. This ownership structure is closely related to the BOD structure of French banks.

First, the industrial capital is classified as a separate shareholder group due to widely prevailing cross-shareholding practice between financial institutions and industrial corporations, and has the same opportunity for participating in bank's management as the one granted to other institutional investors.

Second, most French banks have a "Stable Shareholders Group" which can help prevent hostile M&A against banks and stabilize the management (The equity ratio of this group for total equity of banks has been lower than in the past and each bank has a different structure. This is typified by the ownership structure of *BNP* privatized in 1995[20]) In a broad sense, however, institutional investors and industrial corporations in France, who have had long-term transaction relations or cross-shareholding with banks, can be included in this group.

Third, businesses have generally performed IR (Investor Relation) activities for minority shareholders, but the minimum equity needed to exercise shareholders' right was increased from 0.5% to 1%.[21] Although this has been lowered again to 0.5% around some banks, this measure was mainly aimed at curbing minority shareholders' excessive intervention in the management and thus stabilizing management. Moreover most banks recognize shareholders, who hold more than 5% of total equity with voting right, as "Majority Shareholders". For example, if minority shareholders failed to observe legal procedures for exercising their right, banks would deprive them of their voting right at majority shareholders' request.

20) They comprise leading French industrial companies including Elf, Renault, Vivendi, and multinational companies including GE and foreign institutional investors including Dresdner Bank and Kuwait Investment Authority. Their equity is equivalent to about 11% of total equity (as of Dec.1997).

21) Legal announcement published on May 20, 1998 in the Bulletin des Annonces Legales Obligatoires

Fourth, employees' participation in capital as a majority shareholder has become common even though employees' equity share varies with banks. The prevailing trend today is that banks have a system electing two or three non-executive outside directors representing employees' interest regardless of their equity share of capital. Employees' shareholding is usually higher if it is based on the equity with voting right.[22]

3. Characteristics of Societe Generale's corporate governance system

1) Structure of ownership and Board of Directors

The French economic magazines' analysis of many kinds of management indicators reveal that *Societe Generale* (the Bank) leads the French banking industry.[23] Its ownership structure as of June 30, 1998 indicates that employees are the largest shareholder and that shareholding by foreign investors including Japanese, U.S, and German institutional investors is relatively high. Characteristics of the Bank's BOD structure connected with its ownership structure can be summarized as follows (as of June.1998):

First, of BOD's total 18 members, three are the Bank's representatives including CEO who doubles chairman of BOD. Unlike other banks, two others are the Bank's former CEO (Mr. Marc Vienot) or executive, but are not management committee's members.

Second, Outside directors consist of 15 members: ❶3 directors elected by

22) In case of *Societe Generale*, of which employees are its the largest shareholders, employees' equity-holding ratio is equivalent to about 7.4% of total capital, but the ratio is about 9.7% if it is based on shareholding with voting right (as of June.1998).

23) L'USINE NOUVELLE (1998.10) ranked the banks based on the size of total assets, profit, and the number of employees as of 1997. L'EXPANSION ('98.11) also published the ranking of banks based on the size of total assets, profit, the number of employees, and the size of shareholders' equity. As a result, *Societe Generale* ranked second. Particularly, the Bank changed the ranking with *BNP* because the Bank recorded the outstanding growth in assets, profit, and shareholders' equity. The Bank marked the growth of about 34.8% in the size of assets over the prior year. In 1997, the Bank marked 13th among world banks on the basis of total assets (Source: FITCH IBCA).

employees, ❼ independent directors[24] having no significant shareholding or other significant financial interests with the Bank, ❸ directors[25] who are an executive of company whose Board members include an employee or an officer or a permanent representative of the Bank, and ❷ directors[26] who are representatives of majority shareholders of the Bank. The Bank's outside directors are evenly elected among persons representing each shareholder group, but more than half of those are "Independent Outside Directors" being free from interest with the Bank, shareholders, and employees. Thus they can adopt an objective and fair perspective.

2) Outside directors' active participation in management through committees

The Bank is operating committees mainly composed of outside directors according to the agreement between CNPF and AFEP.

First, the "Nomination Committee" consists of 4 directors: 1 representative of management (Honorary chairman) and 3 members of compensation committee. It makes proposal to the BOD for the appointment of new BOD members and for the replacement of senior officers, especially in the case of an unexpected vacancy.

Second, the "Compensation Committee" consists of 3 independent outside directors. It is responsible for making proposals to the BOD for the remuneration of senior officers and for the granting of stock purchase or subscription options.

Third, the audit committee has three members: 2 independent outside directors and 1 representative of significant shareholding or other financial interest, are neither senior officers nor employees of the Bank. It gives advice

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24) Independence means having no significant shareholding or other financial interest, no significant commercial relations with the company, and no dependent on the company.

25) Those directors consist of representatives of AGF and Commercial Union, which are its major shareholders as French institutional Investors, and the chairman of Rhone-Poulenc, which has the cross-shareholding.

26) They are representing Meiji Life and Pernod-Ricard, which are the Banks majority shareholders (The representative of Meiji Life is foreigner).

on the appointment or the renewal of the statutory auditors. They review the draft of financial statements, risk control and ethical compliance. Therefore the audit committee[27] totally controls coordinates the Bank's audit function, even though two or three different external accounting firms independently audit financial statements, and the separating internal regulatory compliance officer checks the adequacy of internal control procedures, the compliance with external regulatory regulations and ethical rules according to general audit practices in French companies.

3) Management Committee[28]

The Bank's management committee comprising in-house executive directors only is mainly involved in determining management strategy and major management issues. It has few members in view of the reduction of executive directors being responsible for management, decision-making in depth, and integration of organizations for the Bank's larger organization.

For example, two chief executives are responsible for the Bank's affairs including finance, internal audit, management supporting, human resources, IT, I.R, retail banking, the international, and finance business. The retail, the international and finance functions are operated in the form of business divisional-type organization, and the number of management committee including the in-charge of those divisions totals only five.

Second, CEO, who is also chairman of the BOD, has advisors who performed professional advice on management beyond playing an honorary or secretarial

27) In case of *BNP* ranked 3rd in the French banking industries as of 1997, functions, which the *Societe Generale's* audit committee performs, are divided into the financial statement committee, internal audit and risk management committee, international advisory committee, credit committee. According to the recommendations of CRB Regulation 97-02 on Internal Controls, senior officers are no longer members of audit committees, but they and their colleagues are allowed to attend meetings whenever necessary.

28) Based on as of June.1998

role. It has become a general phenomenon that they actively participate in the Bank's management although they are not management committee members.[29]

Third, the Bank has separated organizations related to the asset management as its subsidiary (the other subsidiaries have also been specialized in credit rating company and emerging market fund company.). The Bank appears to have made the organization related to above functions its separating subsidiaries in a bid to minimize the risk involved in investment, increase the efficiency and enhance expertise in managing customers' assets.

4) Directors Charter

The BOD principles of the Bank clearly define BOD's function, responsibilities for BOD operation and outside directors' responsibility. The BOD periodically reviews the Bank's strategy and the principles used for fixing market limits. It examines the Bank's management structure and the transactions that are liable to have a significant impact on the Bank's financial performance. Besides the above BOD principles, the Bank also published the "Directors Charter" describing BOD members' rights and obligations. The "Directors Charter" informs directors of their rights and duties, the minimum number of share (150) each director (elected by the Shareholders' meeting) should hold personally, the methods for allocating attendance fees, and etc. Also, the BOD has taken due note of the fact that directors should not accept appointments to the BOD for more than five listed companies outside the Bank based on the agreement between the CNPF and AFEP.

5) Shareholders' Consultative Committee

The Bank has set at 0.5% the minimum shareholding necessary to exercise shareholders' right in spite of recent amendment to relevant laws changed

29) *BNP* has three advisors. One of them concurrently is the BOD and the management committee member.

needed minimum shareholding from 0.5% to 1%.

The Bank also has a "Shareholders' Consultative Committee", differently functioning from the existing communication department. This committee's members consist of 4 management members including CEO and representatives of individual minority shareholders elected in consideration of their occupation and regional ties. They regularly meet three or four times a year and publish items discussed at shareholders' request except for confidential ones.

Ⅳ. Conclusion; improving corporate governance system of Korean banks

1. What lessons from the French case?

The French corporate governance system has been rated as more advanced than the German system and comparable to that of the U.S. The reform of the French corporate governance system properly accommodates the "Global Standard" based on the respects of market principles, private-led reforms, and the balancing power of all interested parties.

1) Respect for market-driven principles and private-led reforms

Government's excessive intervention in the economy in the past is considered the number one problem. Foreign investors, who have increased their investment in French companies, also demand a more open and transparent governance system with less interlocking interests. The reform drive was led by private businesses around the Vienot committee in which they set standards and norms acceptable to all parties in advance of the government's legislation. This indicates that the government's role has been changed from the controller's one of leading the market economy to the cooperator's one of making the market economy smoothly operate.

2) Proper accommodation of the "Global Standard" based on French intrinsic social values

Stakeholders theory, which says the interest of all interested parties of businesses as well as shareholders should be properly considered, constituted the backbone of Vienot's recommendations. That is, the corporate governance system should be designed to ultimately pursue businesses' performance rather than unilaterally seek maximization of shareholders' wealth. When designing the corporate governance system, it may be necessary to actively benchmark advantages of best practices including the U.S, but one must take into account local economic environment, social, and cultural values. These views were reflected in the efforts to establish the efficient BOD structure by checking the power of top management, blocking majority shareholders authority from

〈Table IV-1〉 Comparison of roles of management subject groups of French and Korean banks on corporate governance system

Classification	France	Korea
BOD structure	- Outside directors include all those representing stakeholders group, but independent outside directors occupy over 50% of entire outside directors - Recent trend of separating CEO & chairman of BOD (One-Board and Two-tiered Board system co-exist) - Audit committee, nomination committee, and compensation committee with a majority of outside directors	- Non-executive directors' role fall short of expectation (Outside director system introduced in 1998, separating from non-executive director system) - CEO doubles the chairman of BOD - Weak committee organizations (Comprising in-house executive directors and officers only except for "Bank President Recommendation committee", and most of them under the control of director & deputy president, not by the BOD)
Ownership structure & Shareholders' right	- Recognition of concept of private majority shareholders ("Stable Shareholder Group" is characterized by its intent to protect management's right) - Industrial corporations own equity of banks (Traditional cross-shareholding practice)	- Virtually government plays the largest shareholders' role - Industrial corporations not allowed to own equity of banks (Same person or institution's shareholding ceiling prescribed by relevant laws)

Ownership structure & Shareholders' right	- Double-voting rights and voting limitation. Minimum equity-holding for exercising their right exist (However, these are resolved by banks' specific consultative committee)	- Laws for protecting the minority shareholders' right revised (Minimum equity holding ratio for exercising their right to be reduced 0.05% from 2000)
Audit function	- 2 or 3 external auditors - Separate internal audit organization operated (However, audit committee totally performs the role of coordinating internal and external audit)	- Single external auditor, and single statutory internal auditor - Internal auditor's independence falls short of expectation due to change of auditor's post from that of executive directors or government's influence over election
Government's Control	- Few government's interventions and some agreements among interested parties are respected	- Excessive intervention in banks' management (virtually the real "Owner") through legislation

growing too strong, and especially strengthening independent outside directors' authority.

2. Basic direction for reforming the corporate governance system of Korean banks

1) Thorough observance of market economy principles

The government-led restructuring of financial institutions in accordance with the 1997 agreement with IMF focused on the improvement of the external governance system including the disappearance of nonviable financial institutions, the creation of "Super Bank" aimed at sharpening the banking industry's competitive edge, and the whopping replacement of management.[30]

30) The Korean government is proceeding with the overseas sale of *Korea First Bank, Seoul Bank*. External agencies also performed the management diagnosis on 25 Korean commercial banks in 1998. As a result, 5 banks were ordered out of business, 7 banks received management improvement order, and 3 banks received management improvement recommendation. Also the Korean government implemented the plan for creating *"Super Bank"* through the merge of many commercial banks because the

As the government-led "Big Bang" for Korean banks almost nears completion, the debate has shifted to method of strengthening the internal control mechanism in order to guarantee the soundness, transparency, and stability of banks.

The debate is primarily focused on extensive reform including the improvement of banks' ownership structure,[31] which serves as the major variable determining the governance system. The Korean government is dragging its foot in not reforming regulations including ownership structure, contrary to its public declaration that the Korean government would guarantee banks' autonomous management. As a result, the piecemeal recent discussion and effort about only changing BOD structure is likely to end up with producing the "Vehicle without wheels".

The Korean government needs to realize that it is necessary to provide banks with environment under which they can autonomously transform their governance system in strict accordance with the market principles.

2) Both sides of the coin: changing unconventional thinking of banks' ownership structure

Voices of remorse are heard here and there that it would have been impossible for the Korean banks to extend astronomic amount of credit to insolvent businesses if its real owner had really run banks. When the discussion about reforming Korean banks took place, the business circles have been complaining about "the absence of banks' real owner". This complaint squarely runs counter to the Korean government's paradoxical slogan stating

government is well aware of the need to recover the external credibility and take advantage of the economy of scale. According to the *"Banker"*, no Korean banks were included in 100 largest world banks on the basis of total capital as of the end of 1996.

31) According to a typical study advocating the economic theory, ownership concentration provides majority shareholders with incentives to take an active interest in the firm and to monitor its management (Demsetz and Lehn, 85, pp.1155-1177; Shleifer and Vishny, 86, pp.461-488).

that a certain amount of restrictions should be continually imposed on banks because banks owned by large conglomerates are highly likely to be "Private Coffer".

Before debating over the Korean banks' ownership structure and the combination of industrial capital and financial capital, various restrictions on shareholding have to be relaxed or improved first otherwise banks' voluntary efforts to improve their governance system will end as an empty slogan. For example, if restrictions prescribing the requirement of BOD members' qualifications (representatives for institutional investors and 5 largest business groups based on credit amount are barred from being elected as BOD members) are blindly maintained, it will cause abnormal shareholding practices and run counter to banks' autonomous management. In other words, provided BOD's and auditor's functions are strengthened from the dimension of separation of majority shareholders' powers, negative side-effects the government and other external agencies worry about will not materialize. In a first attempt to remove past financing practices and restrictions through government control over Korean banks, it's the time to relax restrictions on the banks' equity holding.

3) Balancing powers of three management axes for banks' responsible management system

Along with improving above external mechanism of Korean banks, a responsible management system can be successfully worked out by improving internal corporate governance mechanisms, if the balanced 3 pillars' management powers or rights are materialized. These three pillars of management in the corporate governance system include the general shareholders meeting, the BOD, and auditors. In due consideration of fact that Korean banks are trying not to elect management under the governments influence and implications from the top management's sovereign role of some successful banks' demonstration, it appears to be more convincing to focus on the three pillars (BOD, auditors, and management) for further discussions.

First, the outside director system is the key element to strengthen BOD function. However, in Korean banks, it is not easy to differentiate between the function, status of non-executive directors and those of outside directors. Therefore, it is desirable to unify the dual existence of external directors into outside directors. In most developed countries, majority shareholders (including industrial corporations and institutional investors) have customarily sent outside directors to businesses (including banks), in which they have invested, to exercise their right as shareholders. It is necessary to drop current regulations barring them from being elected as outside directors. Another look into the aforementioned French bank's case indicates that it is important to appoint outside directors representing all interested parties and increase the proportion of independent outside directors among BOD members. The introduction of outside director system and the greater ratio of outside directors in the BOD do not necessarily guarantee transparent and responsible management. But banks need to provide the system enabling them to elect outside directors who can represent interested parties since banks' have more interested parties than other businesses. And the "Optimum Number" of "Independent outside directors" greatly contributes to realizing the check-and-balance function in the BOD.

Second, in spite of the government-ownership management system of Korean banks, the management of *Shinhan Bank and Hana Bank have* displayed excellent leadership and done their best to have autonomous human resource practices in their banks. Despite the differences in the two banks' ownership structure, their management is quite professional and these cases awaken the fact that the professional management is key for banks' future growth and survival. Introduction of performance-based evaluation and compensation systems for banks' management are also critical and must replace old practices of electing banks' management on the basis of external connection with politics or external agencies.[32] Performance-based evaluation system should include

32) An evaluation on management based on the objective assessment of their job perfor-

the establishment of separate committees like the "Nomination Committee" or the "Compensation Committee" with a majority of outside directors. Banks must reorganize into business divisions or units based on customer or service to easily evaluate the management performance, and change to an incentive-oriented compensation system stressing the proportion of performance-based pay and stock option.

Third, in relation to introduction of the "Audit Committee" system into Korean banks, separating from the internal audit organization, some overlapping of similar function and conflict between these two organizations are likely to create some confusion. Accordingly, respective roles have to be clearly defined in advance, and it seems to be more urgent to secure the independence of the current internal audit organization and strengthen its role rather than establish an audit committee. Banks need to prevent auditor and executive directors from exchanging their position. Banks also need to have internal auditor actually conduct the internal audit to level up internal process rather than merely expose malpractice. Internal auditor should have the right to nominate or recommend the external auditor (accounting firm), so that it can play its role as sponsor and coordinator. Finally, it is desirable for internal auditor to regularly report its findings to the BOD.

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mance carries a very significant meaning in Korean banks in connection with the succession program for CEO. It has been the convention that the director & deputy president succeeds the CEO if something make CEO unable to perform his job since the management mind the criticism against the past practice of the "Parachute-style personnel administration" led by the government. Given some realities that undeveloped external professional market and difficulty of breaking the traditional practice of electing CEO in internal organization, the Korean banks need to provide the succession program for CEO in advance by thorough evaluation of management's job performance. This will help build up the bank's professional management system.

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