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CEO Brief

The Effect of Outside Directors on Firm Value in Korean Companies

ABSTRACT

In the aftermath of the Korean financial crisis in 1997, outside directors were first introduced into Korean listed companies, but there has been much debate over its effectiveness. The literature on the impact of outside directors on firm value has shown that outside directors in Korean companies do not effectively monitor managers. This suggests that the condition in which outside directors can indepe ndently monitor and objectively advise managers should be established to ensure that outside director's activities increase the value of an insurance company.

1. Main contents

In the aftermath of the Korean financial crisis in 1997, outside directors were first introduced into Korean listed companies in an effort to improve corporate governance, but debate over its effectiveness has been continuously raised. The purpose of the adoption of outside directors system is to prevent managers from pursuing private interests by actively monitoring management. However, outside directors in Korean companies are likely to be appointed by a CEO or controlling shareholder, thereby failing to ensure their real independence. It is difficult for outside directors to effectively monitor manager's actions if a person who has a personal relationship with manager is appointed as an outside director.

The proportion of outside directors in the board of directors in Korea listed companies is 51.3% as of 2019, and it is about 57% for Korean insurance companies (56% for life insurers and 59% for non-life insurers). Such figures are low compared to those of the board of directors in US publicly traded companies which have approximately 80% outside directors representation.

In the US, the impact of board independence on corporate decision-making has been widely examined, and most studies have shown that outside directors have a positive influence on firm value. Yermack (1996) finds that the higher the proportion of outside directors in the board of directors, the more likely the board of directors perform an effective monitoring functions, thus resulting in higher value of a firm. Rosenstein and Wyatt (1990) report a positive relationship between the appointment of outside directors and stock returns. Nguyen and Nielsen (2010) provide evidence that the impact of outside directors on firm value can vary depending upon the degree of independence of outside directors.

In contrast to the US, Korea literature finds that the proportion of outside directors in the board of directors is not positively associated with firm performance and value. 강윤식·국찬표 (2012) show that the higher the proportion of independent directors, the higher the firm value, whereas the proportion of management-friendly outside directors has no significance or negative relationship with firm value in Korean listed companies. 이창민·석우남 (2017) demonstrate that while the independence of board of directors has a positive effect on firm value in the US, there is no significant relationship between the proportion of outside directors and firm value in Korea. A study examining Korean insurance companies reveal that there was a negative relationship or no significance between the proportion of outside directors and insurers' financial profitability and firm value (한상용·문혜정 2020).

2. Conclusive Remarks

A domestic and foreign literature suggests that outside directors system in Korea, which just has 20-year history, has not been fully established relative to the US having successfully implemented a system of outside directors since 1970s.

To ensure that outside director's activities increase the value of an insurance company, the condition in which outside directors can independently monitor and objectively advise managers should be established.

Specifically, insurers should establish transparent appointment procedures for outside directors to minimize the influence of managers and controlling shareholders in an effort to enhance the independence of outside directors.

With respect to financial authorities, they may consider adopting a legal system, such as the Business Judgement Rule in the US, to clarify the responsibilities of outside directors when they do not make decisions independently.

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