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Chaebol Reform and Corporate Governance in Korea

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Abstract

After the IMF crisis of 1997, rapid chaebol reform was started by the Kim Dae-jung administration. Korean chaebol, characterized by two features; absolutely closed concentration of ownership within the family of the founder, and their highly diversified business structure, were considered as main culprits causing the IMF crisis. Chaebol reforms were initiated by two aspects; one is to destroy the traditional characteristics of chaebol, the other is to build an Anglo-American corporate governance system. Through forcible chaebol reform by the government, accountability, transparency and financial health in the chaebol were drastically improved. For example, the obligation for outside directors was enforced on large scale chaebol affiliates. However, the most important issue is whether the outside directors actually have adequate power to monitor the absolute control by the owners. The outside directors system is just an initial step. The rapid increase of foreign ownership has become one of the most important issues after the crisis; which has brought two aspects, the acceleration of the Anglo-American corporate governance system, and the risk of M&A. Defending the right of management has been a serious issue for chaebol. For the purpose of acquiring the global competitiveness, an Anglo-American corporate governance system would have to be harmonized with the traditional Korean business climate, especially the chaebol system.

Key Words: Korean Chaebol, Kim Dae-jung, Corporate Governance, Ownership Structure, Foreign Capital

1 Introduction

This paper aims to examine the background and features of corporate governance in Korean chaebols¹⁾, family-owned and family-managed conglomerates.

The traditional structure of Korean chaebol can be explained by two of their features; their absolutely closed concentration of ownership within the family of the founder, and their highly diversified business structure. This ownership concentration, which results in the lack of a proper corporate governance mechanism, has been considered by the Kim Dae-jung administration as main culprit causing the IMF crisis of 1997²⁾.

In early January 1998, President-elect Kim Dae-jung and five tycoons of Korean largest chaebols agreed to drastically reform the business practices of the chaebols. The five-points of the accord, which became the main targets of President Kim's chaebol-policies, were: a) to hold chaebol leaders more accountable for managerial performances; b) to boost managerial transparency; c) to improve financial health; d) to focus on core businesses; and e) to eliminate loan guarantees among affiliates.

A later presidential announcement in August 1999, added three supplementary items to the chaebol reform agenda: a) prohibiting the domination of finance by industrial capital; b) suppressing circular investment and unfair transactions among chaebol affiliates; c) preventing improper bequests or gifts to chaebol heirs. These "5+3" principles were aimed at the fundamental reform of the chaebol structure³⁾.

In the last few years many drastic changes have been implemented in Korean business practices, such as to improve transparency, to increase the right of minority shareholders, to reform board of directors through nominating independent directors. However, these moves have often been criticized by claiming that the Korean government is pushing the current reform program without adequate preparation or study.

The Korean government has indicated its interest in introducing an Anglo-American corporate governance system. However, it seems to be very difficult for the Anglo-American system to take root in Korean soil, which is highly characterized by the lack of dispersion of corporate stock holdings⁴⁾.

However, after the IMF crisis, the influence of foreign capital on Korean economy

1) This word "chaebol" is an original Korean pronunciation. In Japan we also use the same Chinese character. But we pronounce it "zaibatsu." So we have to make an attention to using this word (Yanagimachi 2000).

2) About the background of the IMF crisis of 1997 see these papers; Fukagawa (1999), Ko (2000, 2001), Taniura (2000).

3) Federation of Korea Industries (FKI) (2002), OECD (2001).

4) Hattori (1988).

has remarkably increased. The presence of foreign capital has been a decisive influence for the development of the Korean economy,. In this paper, the influence of foreign capital on the chaebol structure will be presented.

2 Korean Management Climate

First I will point out some characteristics of the Korean managerial climate. The first thing to note is that most of Korean Big Business takes a chaebol form, having the two aspects noted above,

- absolutely concentration of a closed ownership structure
- highly diversified business structure

These are aspects that in a sense resemble the former Japanese Zaibatsu structure.

However, in the case of Korean chaebol, the founding family realizes overwhelming stocks possession and holds the decision making right as top management. In the background, there are traditional situations such as the lack of the dispersion of corporate stock holdings. In this paper I use the term “ owner management system ” when explaining these aspects. In addition, it may be said that it is another characteristic of Korean chaebol not to have an original bank sector in its holdings.

Second, the Korean government formally uses the term, a large scale business group, instead of chaebol. Every year, the Korean Fair Trade Commission (KFTC) announces the top 30 large scale groups from the viewpoint of regulating the concentration of economic power⁵⁾. This announcement proceeding began in April 1987 in accord with an anti-trust law. Under this regulation business groups are prohibited from cross-shareholdings with other affiliated firms along with cross-payment guarantees. From 2002, the 30 large scale groups have been categorized into two types (Table 1).

- The A type business groups; subjected to limiting their total amount of equity investment

-The B type Business Groups; subjected to limiting cross shareholdings and cross-debt guarantees.

According to the announcement in April 2003, 17 groups were categorized as A type and 49 groups as B type. Table 1 shows the top 10 largest groups of 2003. According to this table, KEPCO (No.1) and Korea Highway Corp. (No.7) are the state-owned groups. KT (No.6) and POSCO (No.10) are the privatized groups. They are former state-owned groups. And other groups, Samsung, LG, SK, Hyundai Motors, Hanjin, and Lotte are the

5) Korea Fair Trade Commission (KFTC)(2001, 2003).

Table 1 10 Largest Business Groups Under Regulatory Controls

(As of April 1st 2003. trillion won, number)

Rank	Business Group	Total Asset	Affiliates	Type of Group
1	Korea Electric Power Corp.(KEPCO)	92.1	13	both A and B
2	Samsung	83.5	63	"
3	L G	58.6	50	"
4	S K	47.5	60	"
5	Hyundai Motors	44.1	25	"
6	K T	30.8	10	"
7	Korea Highway Corp.	28.3	3	"
8	Hanjin	21.0	23	"
9	Lotte	20.7	35	B
10	POSCO	20.5	15	"

Note:
A type (17 Groups): limit their total equity investments
B type (49 Groups): limit cross shareholdings and cross-debt guarantees.
Source: KFTC (2003).

private groups; they are the chaebols; whereas KT and POSCO are not chaebol because they are not controlled by the owner family.

3 Development of Corporate Governance

A historical premise of corporate governance is that stocks are extensively dispersed with the expansion of a company's scale, so that functional separation of ownership and control occurs⁶⁾. However, in the case of Korea, this premise did not apply and the issue of corporate governance has not been seriously raised before⁷⁾. In the economic crisis in 1997, many chaebols became insolvent (Table 2). According to Table 2, we can recognize the influence of Kia group's insolvency. However, after being sold to Hyundai group, Kia

6) Nakata (1999), Uetake (1994).

7) Yanagimachi (2000, 2002). Sakuma (2003).

became a “ good ” company. However, as the chaebols were recognized as the main culprit in the crisis, the Kim Dae-jung administration initiated many government-backed

Table 2 Insolvent Chaebols

(Unit: billion won)

	Assets	Debt	Status
Hanbo	4,470	4,091	Court receivership; sale underway
Sammi	2,515	875	Court receivership
Jinro	3,898	1,917	Composition
Daenong	1,759	1,172	Court receivership
Hanshin Construction	1,326	502	Court receivership
Kia	14,186	6,624	Sold to Hyundai
Ssangbangwool	1,420	595	Court receivership
Taeil Media	1,102	588	Composition
Haitai	3,397	3,046	Court receivership; sale underway
New Core	2,803	1,215	Applied for Court receivership
Soosan Heavy	1,267	639	Court receivership
Halla	6,627	6,453	Court receivership
Chunggu	1,897	728	Court receivership
Total	46,667	28,445	

Source: OECD (2001), p.212.

policies involving reforms of the chaebol.

Two aspects of the chaebol policy in the early period of the Kim Dae-jung Administration need to be pointed out.

- (1) To satisfy the conditions imposed by the IMF and to facilitate an early lifting of IMF controls the chaebol reform programs were started with very strong political support.
- (2) Criminal investigations were launched into those chaebols seen as being responsible for the economic crisis.

In January 1998, the President-elect Kim Dae-jung had a meeting with the heads of the 5 largest chaebol and came to an agreement having five major points.

- (1) to boost managerial transparency
 - combine financial statements
 - disclose major financial or corporate information
- (2) to eliminate loan guarantees among affiliated firms
- (3) to improve financial health of the chaebols

- reduce the debt ratio of the whole group by the end of 1999 to less than 200%
- (4) to focus on core businesses
- get rid of non-related business diversifications and concentrate management resources in the field of their core business; increase the level of their global competitiveness
- (5) to hold chaebol heads more accountable for their managerial performance
- eliminate group chairmen unless prescribed by law
 - dissolve group headquarters, so called secretarial or planning and coordination offices, which effectively function as the coordinators of chaebol group activities
 - increase the rights of minority shareholders
 - reform boards of directors and make them more responsible
 - reinforce inheritance and gift taxes to prevent irregularity inheritances occurring

In August 1999, President Kim Dae-jung announced a further three (supplementary) principles for chaebol reform.

- (1) restrict chaebol control of the non-banking financial sector,
- (2) suppress circular investments and unfair transactions among chaebol affiliates
- (3) prevent improper bequests as gifts to chaebol heirs

As Kim (2004) noted, the “ 5+3 ” principles were aimed at fundamental reforms of the chaebol structure, namely reform involving corporate governance. Some of these principles had a direct impact on the immediate financial distress of the chaebol. To facilitate a house-cleaning of the distressed firms, the Korean government utilized methods such as court-supervised insolvencies, out-of-court settlements, and so-called “ Big Deals. ” In using these processes the Korean government also sought to rely on foreign capital as an effective means of restructuring.

As mentioned above, the chaebol heads or their family members have held absolute power based on their vast stock ownership. As one part of the reform program regarding accountability and transparency, the outside director system was forced onto most chaebol affiliates in February 1998. The outside director system is considered one of typical characteristics of the Anglo-American corporate governance system.

From January 2001, the obligation concerning outside directors was also enforced on large scale chaebol affiliates, those with more than 2 trillion won of assets. More than 1/2 of all directors had to be from outside the chaebol, and the minimum level was 3 outside directors. The qualifications and regulation of outside directors were made very strict. At well, a committee to recommend candidates for the position of an outside director was

made obligatory for all large scale affiliates.

Table 3 Distribution of Outside Directors

(Unit: %)

Number of the Outside Directors	2001		2002		2003	
	Number of companies	Share	Number of companies	Share	Number of companies	Share
1	200	31.25	193	31.33	217	34.07
2	269	42.03	279	45.29	273	42.86
3	107	16.72	69	11.20	71	11.15
4	26	4.06	34	5.52	41	6.44
5	10	1.56	16	2.60	12	1.88
6	8	1.25	7	1.14	8	1.26
7	5	0.78	8	1.30	4	0.63
8	7	1.09	4	0.65	2	0.31
9	4	0.63	3	0.49	4	0.63
10 over	4	0.63	3	0.49	5	0.79
Total	640	100	616	100	637	100
Average	2.3		2.22		2.18	

Source: Korea Stock Exchange (2003d).

As Table 3 shows, companies with 1 or 2 outside directors now are in place in about 80% of all chaebol affiliates, a consistent tendency over the past several years. Additionally, outside directors now average 2.2 (Table3) Banks generally have many outside directors, and the Korea First Bank (KFB) has the highest ratio, 92.9%. The KFB board of directors consists of 14 directors with 13 being outside directors.

In KFB⁸⁾, we can recognize the huge influence of foreign capital. The chairman of the, Board of Directors is Robert T. Barnum and the President & CEO is Robert A. Cohen. Share holders are;

8) A brief History of the KFB: In December 1997, Korea 's economy collapsed and KFB was severely impacted. Due to business failures of some of its corporate customers, a sharp increase in NPLs and the departure of customers from the Bank, it experienced many difficulties.

During this process, its workforce shrank by over 40% and it was twice recapitalized. The government took over the bank in 1997, with a view to protecting depositors, and ultimately searched for a foreign investor to rebuild it. In December 1999, the government sold nearly 51% of KFB to Newbridge Capital, a private equity firm from the U.S. This was a precedent setting transaction.

Newbridge Capital invested won 500 billion into Korea First Bank in January 2000, and appointed Wilfred Y. Horie as the Bank 's new president, followed shortly thereafter by the installation of a new management team. (<http://www.kfb.co.kr/>)

- KFB Newbridge Holdings (private) Ltd. 50.99%
- Korea Deposit Insurance Corp. 45.92%
- Ministry of Finance & Economy 3.09%

As well, 35 companies had foreign outside directors in 2003⁹⁾.

Table 4 Outside Directors in Major Chaebols

(Unit: %)

	2002				2003			
	Number of companies	Total Number of Directors	Number of Outside Directors	Ratio of Outside Directors	Number of companies	Total Number of Directors	Number of Outside Directors	Ratio of Outside Directors
Samsung	14	109	46	42.20	14	108	46	42.59
Hyundai Motors	6	46	22	47.83	6	44	21	47.73
S K	9	70	26	37.14	11	84	29	34.52
L G	14	87	38	43.68	15	104	46	44.23
Hyundai	6	38	19	50.00	4	27	12	44.44
Hanjin	7	52	23	44.23	7	48	23	47.92
K T	1	15	8	53.33	1	15	9	60.00
Hanwha	4	35	15	42.86	4	25	10	40.00
Doosan	4	50	22	44.00	4	44	20	45.45
Dongboo	6	43	13	30.23	7	45	15	33.33
Total	71	545	232	42.57	73	544	231	42.46

Source: Korea Stock Exchange (2003d).

From Table 4 the distribution of outside directors in major chaebols can be ascertained. In the case of Samsung's 14 companies, they are obligated to elect outside directors and 46 outside directors are now in place (Table 4). Similar situations can be seen in the other chaebols.

However, there are still some problems that need highlighting. The most important

9) Korea Stock Exchange (2003d).

issue is whether the outside directors actually have adequate power to monitor or to object to the absolute control or decision making by the chaebol heads. Likewise, the lack of a market or a system to supply outside directors needs to be considered. The framework for outside directors was formed rapidly and forced on the chaebols by the Kim Dae-jung government; as a result it is difficult to determine if the outside directors system is functioning well.

4 Ownership Structure and Foreign Capital

We can determine some characteristics of Korean stock distribution from viewing the placements of shares and their market value (Table 5 & 6).

Table 5 Stock Distribution by Investor Type (Number of Shares)

(Unit :%)

Investor	1998	1999	2000	2001	2002
Government	17.32	17.71	12.65	7.31	7.41
Banks	3.58	3.50	5.38	11.48	17.77
NBFLs	6.19	10.17	10.42	7.71	6.82
Corporations	19.89	17.27	19.99	20.32	21.03
Individuals	38.79	38.98	37.74	38.52	35.43
Foreigners	10.39	12.37	13.80	14.66	11.54
Total	100	100	100	100	100

Note: NBFLs=Non-Bank Financial Institution

Source: Korea Stock Exchange, *Stock*, March, 2003.

Table 6 Stock Distribution by Investor Type (Market Value)

(Unit :%)

Investor	1998	1999	2000	2001	2002
Government	19.72	16.43	14.35	8.14	5.66
Banks	3.09	2.97	2.59	6.60	5.51
NBFLs	10.56	13.94	13.24	9.15	10.34
Corporations	19.78	19.11	19.60	17.16	20.15
Individuals	28.87	25.87	20.04	22.32	22.33
Foreigners	17.98	21.69	30.19	36.62	36.01
Total	100	100	100	100	100

Note: NBFLs=Non-Bank Financial Institution

Source: Korea Stock Exchange, *Stock*, March, 2003.

After the IMF crisis of 1997, the composition of ownership has undergone changes. Government ownership has declined because it has promoted privatization of state-owned or state-controlled banks and large scale companies such as POSCO. Bank ownership of shares saw a rapid increase after 2000. Foreign investors now hold around 12~15% of shares, but they have increased their share of the market value from 17.98% (1998) to 36.01% (2002). The rapid increase of foreign ownership has two aspects. One is positive; the acceleration of the Anglo-American corporate governance system. The other is negative; considered to be the risk of mergers and acquisitions.

Table 7 Largest and Foreign Stockholders

(As of December 31, 2003. Unit: %)

Company	Largest Stockholder		Ratio of Foreign Stockholders
	Name	Ratio	
POSCO	POSTEC	3.77	66.71
Hyundai Development	Chung, Mong-gu	17.02	59.80
Samsung Electronics	Lee, Kun-hee	15.31	57.30
Cheil Communications	Samsung Corp.	26.55	54.29
Daelim	Daelim Corp.	34.96	51.71
Hyundai Motors	Hyundai Mobis	23.71	51.25
Shinsegae	Lee, Myung-hee	32.57	48.89
SK Telecom	S K	35.06	47.02
K T	NPC	28.77	45.37
Shindoricoh	Woo, Suk-hyung	44.72	45.04

Note: POSTEC :Pohang University of Science and Tecnology
Source: Korea Stock Exchange (2004a).

Table 7 shows comparisons of the largest and foreign stockholders. In POSCO, Hyundai Development, Samsung Electronics, Cheil Communications, Daelim, and Hyundai Motors, foreign stockholders hold over 50% of shares, huge blocks of foreign shareholdings.

Also of note is that individual ownership in 2002 was 35.43%, a figure that has been

slowly declining since the crisis of 1997. By numbers of shares, individual ownership occupies the largest ratio; however, by market value, the ratio for foreign investors is much bigger than that for individual shareholders (Tables 5 & 6)¹⁰⁾.

Table 8 Internal Ownership of the 10 Largest Business Groups (Total)

(Unit: %)				
Ownership	2000	2001	2002	2002
Chaebol head and family	11.30	8.97	8.64	8.72
Affiliated companies	31.46	32.35	32.91	32.27
Corporate equity shares	3.84	4.65	4.27	3.93
Total	46.60	45.97	45.82	44.92

Source: Korea Stock Exchange (2004b).

Table 9 Internal Ownership of the 10 Largest Business Groups

(Unit: %)				
	2000	2001	2002	2003
Samsung	22.39	22.46	22.64	23.18
L G	40.29	34.39	32.85	32.07
S K	42.78	43.16	41.76	39.33
Hyundai Motors	45.73	45.44	46.55	43.54
Hanjin	44.00	43.36	40.57	37.18
Lotte	49.25	49.39	55.44	56.85
Hanwha	48.83	49.45	48.84	45.32
Kumho	42.46	54.41	60.24	61.96
Doosan	68.92	53.32	51.33	50.94
Dongboo	61.33	64.26	58.03	58.03
Total	46.60	45.96	45.83	44.92

Source: Korea Stock Exchange (2004b).

Tables 8 and 9 show the internal ownership of the 10 largest chaebols; the tables show that the chaebol heads have maintained their control through shares held by affiliated companies even though their own individual shares have been reduced. The ratio of chaebol head and family ownership in 2002 is only 8.72% (Table 8) but the total ratio of internal ownership is round 45%. However in 2003, the largest group, Samsung, has just

10) Korea Stock Exchange (2003b, 2004a).

23.18%, which is the lowest ratio of the 10 large chaebols (Table 9). In the case of Samsung 's 2003 data, the ratio of chaebol head, Lee Kun-hee, and family ownership is only 0.32%, and that of affiliated companies is 18.85%; corporate equity shareholding is 4.01%¹¹⁾. Therefore, defending their right of management has been a serious issue for chaebol heads and their families. Indeed, it remains an urgent issue that the right of management is reinforced through raising internal ownership¹²⁾.

5 Conclusions

After the 1997 financial crisis, the influence of foreign capital has become stronger, especially as it effects the creation of the Anglo-American system of corporate governance. Drastic changes have brought about the disappearance of many chaebols; in part because of their lack of global competitiveness. Here, we must point to the disappearance of Daewoo and Hyundai groups, not only because of economic factors but also political ones. It is essential that the program of severe reform of the chaebols be continued, not by the Korean government but by chaebol themselves, with the aim of acquiring and reinforcing global competitiveness.

However, creating an Anglo-American corporate governance system will be difficult without an understanding of the Korean business landscape that such governance must be imposed on. Factors, such as the traditional aspects of chaebols¹³⁾, the stance of the Korean government that is characterized by its forcible intervention into the management of chaebols, and the issue of radical labor unions¹⁴⁾. It is, however, essential that the Anglo-American corporate governance system be harmonized with the Korean business landscape if an internationally competitive corporate society is to flourish in Korea.

11) Korea Stock Exchange (2004b).

12) Korea Stock Exchange (2003a, 2003c).

13) Yanagimachi (2001a, 2001b).

14) Harrori and Matsumoto (2001).

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Revised February 25, 2004

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