CHAEBOL REFORM – STEERING BETWEEN SCYLLA & CHARYBDIS

Op Ed by Dr Rory Knight

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JOONGANG SUNDAY

JoongAng Sunday is the Sunday edition of the leading Korean language daily newspaper JoongAng Ilbo. It is one of the three largest newspapers in South Korea. The paper also publishes an English edition, Korea JoongAng Daily, in alliance with the International New York Times.

In undertaking chaebol reform President Moon has embarked on a perilous journey not unlike that of Homer's hero Odysseus who found himself caught between the whirlpool Charybdis and the monster Scylla. Too little reform could incur damaging political fall-out, too much could lead to unintended consequences involving high economic costs. He would be well advised to navigate a cautious course.

The view from outside

The author recently led the 10th Sir John Templeton Investment Roundtable, an annual event bringing together a group of leading international investors to ponder the world economy and global investment opportunities. Asia loomed large in its discussions and, while there was optimism about opportunities in the region, particularly in Korea, a major concern surfaced about the poor treatment of minority shareholders there. Participants identified a divide between countries with a (largely British-derived) common law system and those operating under (largely European-based) civil law codes, the former being exemplified by Singapore, Hong Kong and Malaysia, the latter by Korea and Japan. The comparison was not at all flattering, those countries under civil law were considered to be the least friendly to minority shareholders.

The international investors at the roundtable were particularly anxious about four features of companies specific to Korea:

1. The complexity of corporate structures exemplified by the chaebols where extensive cross-holdings result in a few shareholders owning a disproportionally low number of shares exercising control - a control exercised moreover without a corresponding commitment of capital
2. A lack of transparency in decision-making with boards far too compliant to management
3. The lack of voice for minority shareholders
4. The low dividends paid by companies.

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The upshot, they concluded, is that many international investment opportunities are needlessly and wastefully being lost by Korean companies. Not surprisingly, there exists a Korean discount since dividend yields in Korea are substantially below most other markets.

Certainly there is a lot at which to point the finger of blame among the chaebols. They dominate the economy with the top four constituting more than 50% of Korea's stock market capitalization and starve smaller firms of capital. chaebol managers have little incentive to look after shareholders, sitting comfortably behind retained earnings that only grow firms at uneconomic rates of return. Chief executives serve for inordinately long periods which argue an absence of mechanisms to regulate poor performance. The recent practice of management using treasury stocks to vote, together with the perception that the Korean National Pension Service (NPS) acts in concert with chaebol management has caused cries of foul from activist investors. Boards of directors appear to be ineffective. In the financial year 2016 outside directors voted against management in less than 1% of nearly 4,000 board decisions!

This landscape repels international investors. The Korean stock market pays excessively low dividends, being

22nd out of the 24 largest stock markets by dividend yield with an average below 2%. Cross-holding structures and a lack of transparency allow families and other groups to control companies with considerably less than a 50% stake, sometimes below 10%. This appears unfair from an Anglo-American perspective based on the principle of 'one share one vote'. Not surprisingly, most foreign investment is concentrated in the four largest firms, and there is very little international interest indeed outside the top 100 companies. The average foreign holding in the top quartile of KOSPI is around 50% in comparison to 6% for the whole KOSPI population.

Why such a bad press?

There is no denying that the chaebols have recently had a terrible press. Samsung and Lotte, two of the big four, were implicated in the Park scandal which culminated in President Moon's election on a ticket of fundamental chaebol reform. "Without chaebol reform,' ran his campaigning mantra, 'no economic democracy and no economic growth'.

President Moon has now issued his proposals for reform, appointing Professor Kim Sang-jo, the so-called 'Chaebol sniper', (perhaps the Schwarzeneggerian title, 'The Terminator', might be more appropriate) to lead a new Korean Fair Trade Commission (KFTC), thus signaling he is serious about taking the chaebols head-on. President Moon's proposals include the introduction of electronic proxy voting. (To date only 37% of companies have adopted the electronic proxy voting system which is designed to strengthen minority shareholder rights. Moreover, in 2016, 90% of shareholders meetings took place in the last 20 days of May, making it impossible for many shareholders to attend in person.) Other proposals include extending legal liability, thus encouraging class action rights to hold directors more accountable, and strengthening corporate governance regarding auditor appointments, the independence of directors and the mandatory appointment of employees to boards. Going further, there are plans to restrict companies from voting treasury stock in mergers to prevent controlling shareholders from consolidating too much power.

Hopefully, though, the KFTC will work pragmatically and not seek to impose a doctrinaire approach. While many of President Moon's proposals seem eminently sensible taken in isolation, a wholesale onslaught on the chaebols could have unintended consequences. If reforms damage the chaebols too severely there could be a significant adverse impact on share prices - which ironically could end up punishing minority shareholders. The baby should not be thrown out with the bath water.

Korea has developed its own distinct corporate structure in response to the needs of the economy, and overall it has served the country well. It would be wise to develop a brand of corporate governance compatible with the way the system has developed and in line with its natural ecology rather than superimposing an alien template. Indeed the larger firms in Korea have already begun to implement many of their own reforms, including streamlining shareholder structures towards the vertical holding company structure common elsewhere. They are taking their first, baby steps to improve transparency and encourage greater foreign investment. Samsung's recent change in dividend policy has been well received by the markets. Ironically it is Korea's smaller companies outside the top 100 where the real problems lie and which demand greater efforts to improve their treatment of minority shareholders.

While there are certain small measures which collectively could have a large positive effect and avoid the unintended consequences of sudden large scale reform (the government, for instance, could immediately implement measures such as electronic proxy voting to demonstrate its commitment) it would be better not to act too precipitously in the hot winds of current public opinion. The KFTC under the leadership of Professor Kim should consult widely including with international investors. It would be better to develop a principles-based approach rather than a rules-based approach. The KFTC could after due process develop a set of guidelines for good corporate governance which meets with the wide acceptance of all stakeholders and particularly the chaebols. The aim should be to create a legal context which encourages better governance practices rather than delivering diktats that punish the chaebols for their past behaviour. Providing public praise for good practice can be a far more effective approach than pillorying poor practice.

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The NPS with its Won 564 trillion in assets has two key roles to play in the reform process. Firstly, it is welcome that the scheme has set a target to increase its international investments from 27% at present to 40% within five years which will reduce the overpowering dominance of its domestically held funds. Secondly – and more broadly - as an independent body the NPS has the power of moral suasion to encourage better governance practices in the boards of companies in which it is invested. This approach would be far more effective in convincing boards to act in their self-interest for the benefit of all shareholders than imposing rules by fiat. The model of CALPERS in the United Sates is an excellent example of how governance might be improved through the guidance of a large shareholder body.

Boosting international investment in Korean securities will also be crucial. Although there are no direct restrictions in Korea on foreign investment, in practice there is a significant brake on the ability of foreign investors to access Korean securities. Korean companies, for instance, are considerably under-represented in the sets of depositary receipts in foreign markets (DRs) available in New York and London, either in the form of American depositary receipts (ADRs) or global ones (GDRs). These depositary receipts are instruments which theoretically could make it easy for foreign investors to invest locally in shares in Korea - where crucially they are deemed to be a local instrument.

But there are only nine Korean companies with ADRs listed on the NYSE. Samsung and Hyundai Motors are not available as ADRs to the US market at all, which means they are effectively shut out from many classes of US investors. Korea operates its own system run by the Korean Securities Depository (KSD) which limits the amount of shares that may be traded, so inadvertently preventing depositary receipts being created without management consent in the shape of so-called 'unsponsored DRs'. This limited two-way market in DRs is largely unique to Korea. While the KSD undoubtedly provides a first-class service only a small change would be needed to bring its practices into line with international norms and thereby encourage a much stronger flow of foreign investment.

So in a nutshell, dismantling the chaebols wholesale is neither feasible nor advisable. Instead, a constructive dialogue, led by a commission of the KFTC and involving broad consultation, could encourage Korea to develop its own brand of governance, one that would allow the chaebols to thrive in a much more effective, streamlined and transparent way. Hopefully President Moon like Homer's Odysseus will steer a successful passage through this process unscathed. Let the journey and the healing commence.

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