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Reforming the large business groups to promote productivity and inclusion in Korea

Randall S. Jones

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ABSTRACT/RÉSUMÉ

Reforming the large business groups to promote productivity and inclusion in Korea

Large business groups, which played a key role in Korea's economic development, are still dominant today, especially in exporting. The concentration of economic power creates a number of problems and risks. Ensuring a level-playing field between the business groups, also called *chaebols*, and SMEs and start-ups is essential to promote innovation and inclusive growth. While the business groups have long been subject to a number of special regulations, a comprehensive strategy is needed. The top priority is to improve corporate governance by strengthening the role of outside directors and protecting minority shareholders. A greater say for institutional investors and more active use of private remedies, such as class action suits, would also be beneficial. In addition, strengthening competition by reducing barriers to trade and FDI and activating a market for corporate control would lead to better performance by the groups. The ownership structure of the groups needs to be improved, notably by phasing out circular shareholding among their affiliates.

This Working Paper relates to the 2018 *OECD Economic Survey of Korea* (www.oecd.org/eco/surveys/economic-survey-korea.htm)

JEL classification: G34, L1, L2, L4, L5.

Keywords: chaebols, large business groups, Korea Fair Trade Commission (KFTC), cross shareholding, diversification, inside ownership, subcontractors, minority shareholders, corporate governance, outside directors, class action suits, ownership structure.

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Réformer les grands conglomérats pour promouvoir la productivité et la croissance inclusive en Corée

Les grands conglomérats, qui ont joué un rôle clé dans la croissance économique de la Corée, sont toujours dominants aujourd'hui, en particulier dans l'exportation. La concentration de leur pouvoir économique crée un certain nombre de problèmes et de risques. Assurer des conditions de concurrence égales entre les conglomérats, également appelés *chaebols*, et les PME ainsi que les start-up, est essentiel pour promouvoir l'innovation et la croissance inclusive. Bien que ces conglomérats soient depuis longtemps soumis à un certain nombre de réglementations spéciales, une stratégie globale est nécessaire. La priorité absolue est d'améliorer la gouvernance d'entreprise en renforçant le rôle des administrateurs externes et en protégeant les actionnaires minoritaires. Un plus grand intérêt pour les investisseurs institutionnels et une utilisation plus active des recours privés, tels que les recours collectifs, seraient également bénéfiques. En outre, le renforcement de la concurrence en réduisant les obstacles au commerce et à l'investissement direct de l'étranger et en activant un marché pour le contrôle des entreprises conduirait à une meilleure performance de ces groupes. La structure de l'actionnariat des groupes doit être améliorée, notamment en éliminant progressivement la participation circulaire parmi leurs filiales.

Ce Document de travail a trait à *l'Étude économique de l'OCDE du Corée*, 2018 (http://www.oecd.org/fr/eco/etudes/etude-economique-corée.htm).

Classification JEL : G34, L1, L2, L4, L5.

Mots clés : chaebols, grands conglomérats, Commission coréenne de la concurrence (KFTC), participations croisées, diversification, propriété interne, sous-traitants, actionnaires minoritaires, gouvernance d'entreprise, administrateurs extérieurs, recours collectifs, structure de l'actionnariat.

TABLE OF CONTENTS

REFORMING THE LARGE BUSINESS GROUPS TO PROMOTE PRODUCTIVITY AND INCLUSION IN KOREA 6

The historical context: the origins and contributions of the large business groups 8
The large business groups played a key role in Korea's development 8
The role of the business groups in the 1997 financial crisis 10
The current role and characteristics of the large business groups 11
A large number of affiliated firms operating in a diverse range of sectors 12
A high share of inside ownership 13
A high share of trading within the large business groups 15
An increasing role for the large business groups in the financial sector 15
Mixed profitability results 16
The problems and risks associated with the large business groups 17
Growth of the business groups through diversification 17
Market concentration by the business groups 18
The concentration of management control 20
Unfair treatment of subcontractors 22
Political problems related to the business groups 22
Evolution of the policy framework to control the business groups 22
Policies to promote specialisation by the large business groups 23
Policies to protect SMEs and promote co-operation with large firms 23
The ban on cross-shareholding and debt guarantees 25
Restrictions on intra-group support and pursuit of personal interest 26
Restrictions on the voting rights of insurance and financial companies in the business groups 26
Policy directions to reform the business groups 26
Strengthening competition 27
A market for corporate control 29
Preventing unfair subcontracting practices 30
Improving corporate governance 30
Strengthening the role of institutional investors 36
Private enforcement of corporate governance 37
Improving the ownership structure 38

REFERENCES 40

Tables

1. Number of large business groups 12
2. Listed firms play a key role in the large business groups 13
3. Inside ownership is high in Korea's large business groups 15
4. Diversification of the business groups 17
5. The market position of firms affiliated with the large business groups in 2015 18
6. Key regulations imposed on the large business groups 23
7. Evolution of the Shared Growth Index 24
8. The number of cases handled by the Korea Fair Trade Commission 28
9. The quality of corporate governance in Korea does not compare favourably in Asia 33
10. Background of outside directors 35

Figures

1. The share of the large business groups is edging down 6
2. The price earnings ratio of Korean firms is relatively low 7
3. International comparison of business groups' share of stock market capitalisation 8
4. The number of firms affiliated with the top 30 business groups has risen steadily 10
5. Intra-group shareholding in the Samsung group in 1997 10
6. The largest business groups are increasingly dominant 12
7. Ownership and control in business groups 14
8. Inside ownership has been trending up 14
9. Intra-group trading is substantial for many firms in the large business groups 15
10. The share of financial firms in the large business groups has risen 16
11. There is a wide variation in the profitability of firms affiliated with the groups 16
12. The value added of the top 50 companies 18
13. The market shares of the business groups by industry 19
14. Company profitability is influenced by intra-group trading 20
15. Company profitability is influenced by the structure of ownership 21
16. Korea has scope to liberalise product market regulation and barriers to trade and investment 29
17. The share and number of outside directors is rising gradually 31
18. Factors influencing the probability of outside directors being replaced 34

Boxes

Box 1. A comparison of Korean and Japanese business groups 9
Box 2. The gap between ownership and control in the business groups 13
Box 3. Korea Commission for Corporate Partnership policies to promote shared growth 24
Box 4. Israel's approach to dealing with large business groups 27
Box 5. Korea's corporate governance framework 31
Box 6. Recommendations to reform the large business groups to promote productivity and inclusion 39

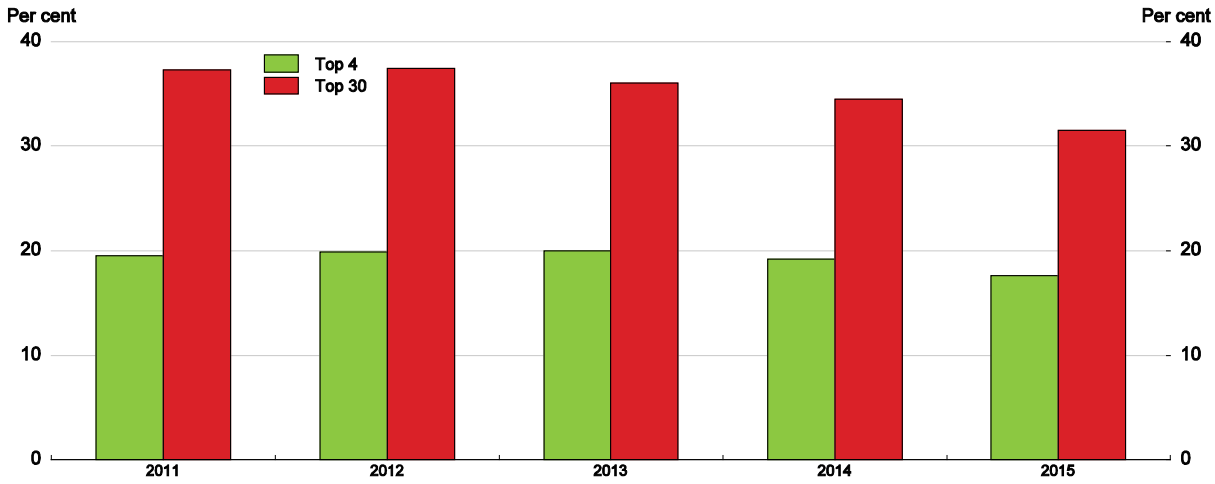
REFORMING THE LARGE BUSINESS GROUPS TO PROMOTE PRODUCTIVITY AND INCLUSION IN KOREA

By Randall S. Jones[1]

Korea's large business groups, often referred to as *chaebols*, have played a key role in the country's rapid economic development. They remain leading players, with the top 30 groups accounting for about two-thirds of shipments in Korea's manufacturing and mining sector and a quarter of sales in services. Their share of total national sales has edged down since 2011 as export growth slowed, but is still big at 32% (Figure 1). The groups consist of a large number of legally independent firms operating in a wide range of unrelated industries under the direction of owner families, whose control is cemented by equity holdings between the affiliated firms. The largest groups, Samsung, Hyundai Motor, SK and LG, had an average of 70 companies in 2017 and accounted for nearly half of stock market capitalisation.

Figure 1. The share of the large business groups is edging down

Sales by the large business groups as a share of total national sales



Source: Korea Fair Trade Commission.

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The large groups are leading the current upturn in exports. However, the "trickle-down effect" to the rest of the economy has weakened as they have become increasingly internationalised and have shifted their product mix to more capital and technology-intensive products. The top 30 business groups accounted for only 2.7% of employment in 2017.

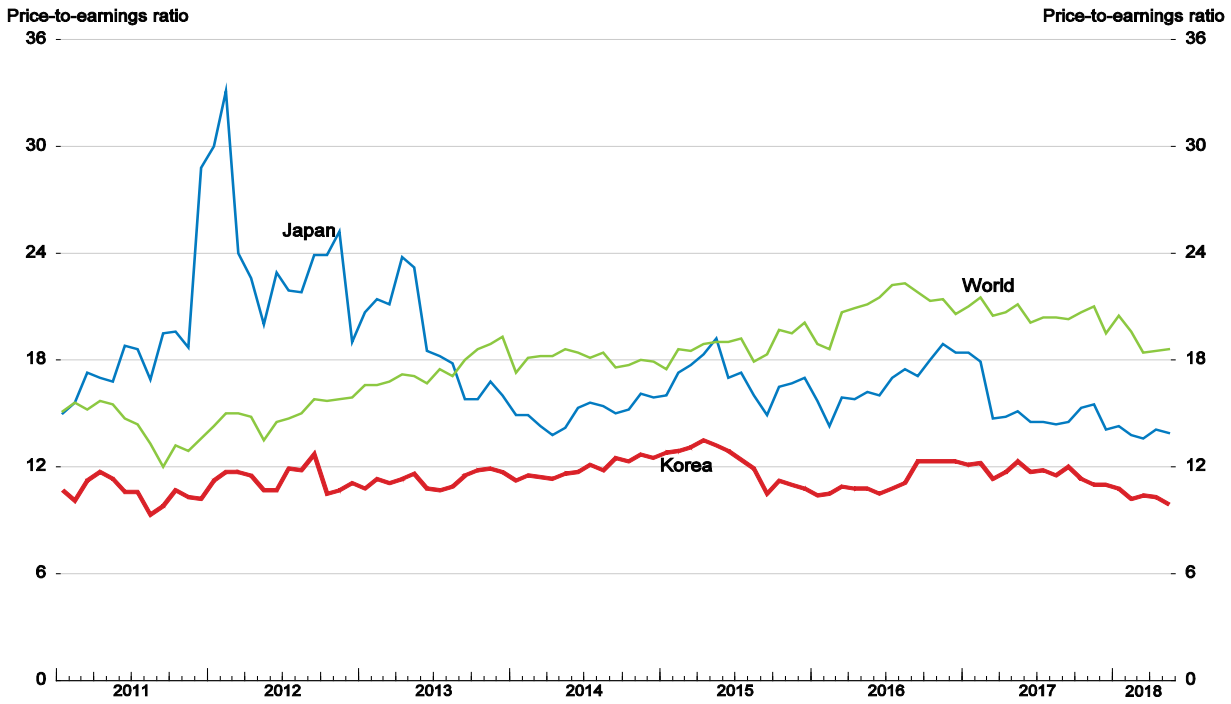
Despite their important contributions to Korea's economic development, the powerful role of the large business groups raises a number of concerns. The concentration of economic power may stifle entrepreneurship and the creation of start-ups, and lead to unfair trade practices against independent small and medium-sized enterprises (SMEs). Moreover, the groups' subsidies to weak affiliated firms can hinder

1. Randall S. Jones is head of the Japan/Korea Desk in the Economics Department of the OECD. He would like to thank OECD Economics Department colleagues Robert Ford, Hyunjeong Hwang, Eun Jung Kim, Vincent Koen, Jae Wan Lee, Patrick Lenain, Mathilde Pak, Alvaro Pereira and Haruki Seitani, as well as Chung-a Park (OECD Directorate for Financial and Enterprise Affairs) and officials from the Korean government, for valuable comments and/or discussions. Special thanks go to OECD Economics Department colleagues Lutécia Daniel for technical assistance and Sisse Nielsen for technical preparation.

competition. The result is a misallocation of resources that has a negative effect on productivity for the national economy and on inclusiveness by reducing opportunities for other firms and potential entrepreneurs. Moreover, weak corporate governance and the concentration of power in the owner families of the groups allow them to manipulate intra-group transactions and financial flows to promote their own interests at the expense of affiliated companies and their shareholders, thereby worsening the distribution of income and wealth. Finally, the links between affiliated firms in the groups create a risk of chain bankruptcies and financial instability.

The problems related to the large business groups are reflected in the low price-earnings ratio of Korean companies in the stock market relative to their global peers (Figure 2) – the so-called "Korea discount". During the first half of 2018, the global price earnings ratio was nearly double that in Korea. If weak corporate governance allows owner families to favour their own interests over the profitability of some affiliated companies, it is rational for investors to pay less for their shares.

Figure 2. The price-earnings ratio of Korean firms is relatively low



Source: Bloomberg.

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The legacy of support and protection provided by past authoritarian governments has led to questions about the legitimacy of the business groups (Jwa, 2002). Much of the public criticism stems from openly egregious practices, such as tax avoidance and the use of presidential pardons to free executives convicted of corruption. The concentration of power and wealth has also led to corruption based on the long-standing ties between the business groups and political leaders, such as the scandal that played a role in the impeachment of Korea's previous president.

Given the problems associated with the large business groups and the traditional model of growth driven by exports by the large business groups, the government aims to shift Korea's economic paradigm to growth led by SMEs and start-ups (2018 *OECD Economic Survey of Korea*). Faced with such problems and risks, President Moon promised in May 2017 to "put chaebol reform at the forefront" of his agenda (The National Interest, 2017).

Unravelling the complex entanglements between firms belonging to the business groups and between government and business to create a new growth paradigm is a tremendous challenge that cannot be achieved quickly. Measures that weaken the competitiveness of the large groups could undermine economic growth in the medium term, making it important to carefully implement reforms. The objective should be to increase productivity and inclusive growth by levelling the playing field between the business groups and other firms, while avoiding policies that penalise success. This paper begins with an overview of the contributions of the large business groups to Korea's economic development and their role in the 1997 financial crisis, followed by an analysis of their current situation. The problems and risks associated with the business groups are discussed in the third section. The fourth section explains the framework developed during the past 35 years to limit the power of the business groups and make them more efficient. The paper concludes by proposing directions for reform. Specific recommendations are presented at the end of the paper in Box 6.

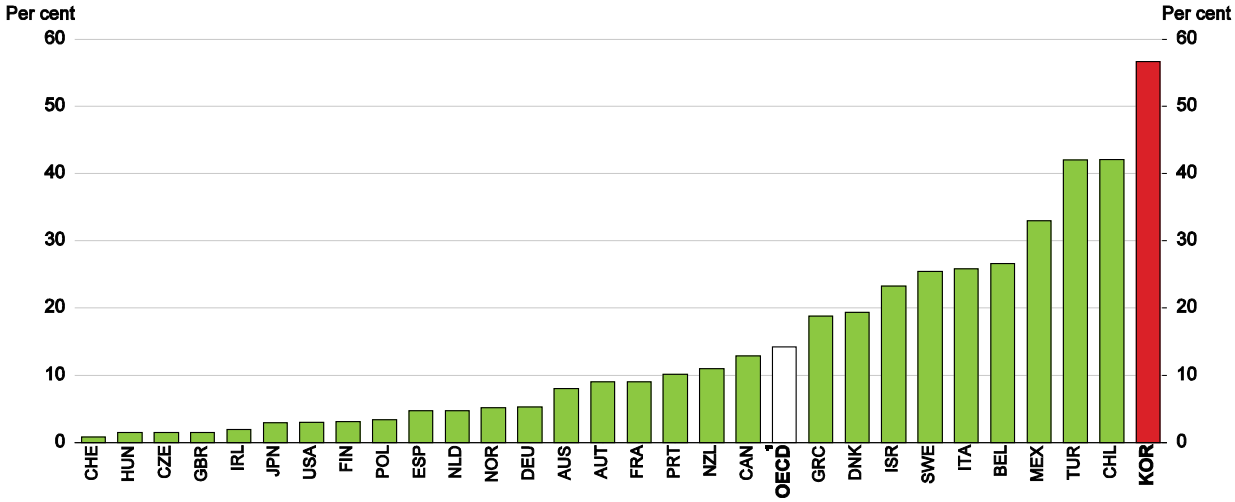
The historical context: the origins and contributions of the large business groups

The large business groups played a key role in Korea's development

Business groups are often considered to be detrimental to economic efficiency in advanced economies. The so-called "conglomerate discount" has been found in a number of countries, including the United States and the United Kingdom (Berger and Ofek, 1995). However, in Korea and a number of developing countries, they played a positive role by reducing co-ordination failures and serving as institutional substitutes for imperfect markets for product, capital and labour (Lim and Morck, 2016). The groups' ability to share financial and human resources and technology across affiliated firms contributed to their success. Compared to other countries, the share of business groups in Korea is large: firms affiliated with the groups accounted for 57% of stock market capitalisation in 2010, compared to an average of 14% for 29 OECD countries in the study (Figure 3). Business groups also play a major role in Turkey, where they developed due to imperfect markets and government industrial policy (Güven, 2017). Business groups tend to be most prominent in emerging economies, notably in China, Hong Kong, China, India and Chinese Taipei (Bebchuk, 2012).

Figure 3. International comparison of business groups' share of stock market capitalisation

The combined share of firms affiliated with business groups in 2010



1. A simple average of the OECD countries shown in the figure.

Source: Masulis et al. (2011).

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Korea's development has been described as a "*chaebol*-led industrialisation strategy" (Ahn, 2010). Many of the large business groups, which are often compared to *zaibatsu* and *keiretsu* in Japan (Box 1), began as small family enterprises prior to World War II (seven of the top 22 groups in 2000) and during the

1950s (11 groups). Many were led by outstanding entrepreneurs, such as Chung Ju-young (Hyundai) and Lee Byung-chul (Samsung). The government relied on this select group of business leaders to accelerate growth and exploit scale economies (Lim, 2010). In particular, during the Heavy and Chemical Industry drive in the 1970s, the government designated certain industries as priorities, as well as the companies to enter the targeted industries (Amsden, 1989). In addition, it ordered firms to merge or be acquired to implement its five-year development plans (Moon, 2016). Companies affiliated with the groups enjoyed advantages not available to independent firms. The chosen firms were protected from domestic and foreign competition and were provided loans at preferential interest rates through the commercial banks, which were state-owned (Kim et al, 2004). Government support and protection went hand-in-hand with government control and guidance.

Sales by the top 30 groups in Korea increased from 31% of GDP in 1975 to 100% in 1985 (Ministry of Strategy and Finance, 2013). The groups also led the export drive that boosted exports from 3% of Korea's GDP in 1960 to 37% in 1981. The number of firms affiliated with the top 30 business groups increased from 493 in 1987 (an average of 16 per group) to 819 (an average of 27) in 1997 (Figure 4). Over the period 1970-2000, 40% of the business groups' additional firms were in unrelated industries (Lim and Morck, 2016). The diversification of the groups may result in complex shareholding structures (Figure 5) and a sharp rise in economic concentration. However, expansion by business groups into the same markets led to fierce competition between them (Kim et al., 2004). In sum, the business groups were partners with the government in Korea's economic take-off.

Box 1. A comparison of Korean and Japanese business groups

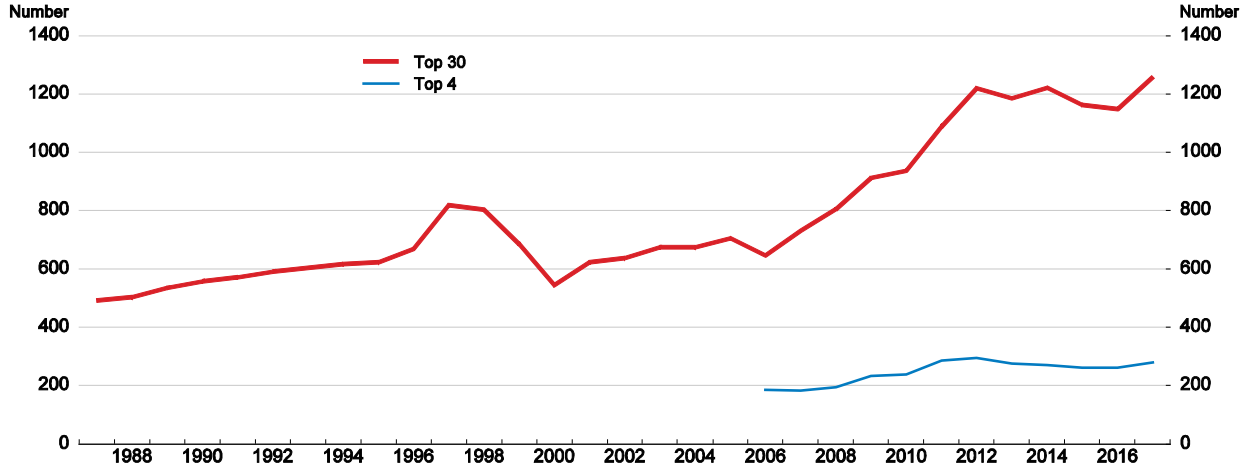
Korean business groups are often compared to the pre-war *zaibatsu* in Japan. Indeed, *zaibatsu* is written using the same Chinese characters (財閥) as *chaebol*. As with *chaebols*, *zaibatsu* were characterised by centralised family control and a large number of affiliated companies operating in a wide range of industries. After World War II, the US occupation authorities made a partially successful attempt to disband the *zaibatsu* to promote competition. Shares owned by the parent companies were put up for sale, and individual companies in the *zaibatsu* were freed from the control of parent companies. However, co-operation among firms formerly belonging to the same *zaibatsu* continued.

The pre-war business groups gradually evolved into today's *keiretsu*, which maintain existing business ties between the *zaibatsu* firms. *Keiretsu* share some similarities with Korean business groups, notably interlocking equity ownership among group affiliates. However, the major difference is that while Korean business groups have a family-dominated pyramidal ownership structure, *keiretsu* are characterised by mutual ownership among friendly companies. The different structures emerged from differing financial environments between Korean business groups, which are not allowed to own banks, and the *keiretsu*, which are. Cross-country evidence suggests that family groups with pyramidal structures, which allow them to leverage their internal capital, developed in Korea and other countries as a response to restricted access to external capital (Masulis et al., 2011). Japanese firms, which do not face the same limitations on access to external capital, rely on *keiretsu* as a way to share risks. The structure of Korean business groups lies between the *zaibatsu* and the *keiretsu*.

The organisational differences between Korean and Japanese business groups led to different styles of business operations. *First*, the banks at the centre of *keiretsu* discourage the affiliated firms from diversifying into unrelated industries and instead stress mutual assistance, notably long-term customer-supplier connections (Whitley, 2014). Owning part of a supplier company promoted mutually beneficial relations. *Second*, in the absence of controlling families, *keiretsu* firms rely on professional management based on internal promotion.

Despite those differences, the business groups in both Japan and Korea rely on intra-group trading, rather than arm's length transactions. Outsiders criticise this approach for limiting competition and hurting minority shareholders. With the development of capital markets and increased international openness, the cost of arm's length transactions has fallen. Consequently, the disadvantages of business groups are beginning to outweigh the advantages. Indeed, there are signs that *keiretsu* are weakening in the face of cost-cutting pressures in a deflationary environment and the increasing openness of the Japanese economy. The changes are most apparent in globalised industries, such as cars.

Figure 4. The number of firms affiliated with the top 30 business groups has risen steadily



Source: Korea Fair Trade Commission.

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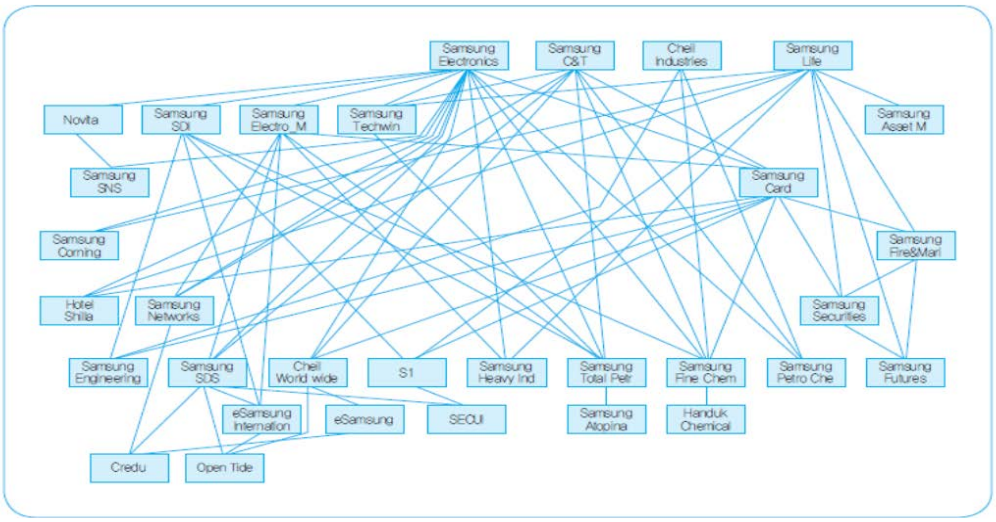
The role of the business groups in the 1997 financial crisis

The business groups were a key factor behind the 1997 financial crisis. During thirty years of fast growth, Korea had failed to adequately develop the rules and principles of a market economy (2000 *OECD Economic Survey of Korea*), including an effective corporate governance framework. The weakening of government control and guidance of the business groups, particularly after Korea's "democratisation" in 1987, and the "too big to fail" mentality was an explosive combination. It drove a corporate spending spree prior to the 1997 crisis, as business groups focused more on market share and size than on profitability, while failing to control risks, including those related to exchange rates and interest rates. The ownership structure and conflicts between shareholders contributed to their poor performance (Joh, 2003). By 1997, the average debt-to-equity ratio in the top 30 business groups was 518% while the return on assets was only 0.7%, below the cost of capital (Lim, 2003). Over 1992-96, three-quarters of Korean companies destroyed shareholder value (Kim and Kim, 2008).

Figure 5. Intra-group shareholding in the Samsung group in 1997



Source: Ministry of Strategy and Finance (2013).

The owner families of the large business groups tended to favour debt financing, which enabled them to maintain control. Financial liberalisation in the 1980s and 1990s increased their borrowing opportunities. When the commercial banks were privatised in 1982, the government imposed an 8% ceiling on business groups' ownership of banks to prevent them from becoming an easy source of in-house financing. However, the ownership regulation did not apply to local banks or non-bank financial institutions (NBFIs), such as insurance companies, securities companies, mutual savings and finance companies, and merchant banks. Most NBFIs were founded in the early 1980s, and a majority were under the control of the business groups by the mid-1980s. In particular, the business groups controlled all of the merchant banks and insurance companies and three-quarters of the investment and finance companies (Ministry of Strategy and Finance, 2013), providing "private vaults" that allowed the groups to build empires by taking over other companies or setting up new firms. Government supervision of NBFIs was lax; even basic prudential regulations, such as capital adequacy regulations, were absent prior to 1997. The opening of the capital account created new opportunities for the business groups to increase their leverage and size through overseas borrowing.

By end-1999, 14 of the 30 top business groups in 1997 had gone bankrupt or entered workout programmes. Debt guarantees between firms in the same group led to chain bankruptcies. The number of firms affiliated with the large groups declined by a third over 1997-2000 (Figure 4), as the groups closed, merged or sold affiliates to raise cash in the wake of the crisis. The government's decision to allow the collapse of Daewoo, the second-largest group, was intended to end "too big to fail" once and for all (Eichengreen et al., 2015). The crisis resulted in more government involvement in corporate affairs as the authorities organised workouts. Meanwhile, the liberalisation of barriers to imports and foreign direct investment increased competitive pressure on the business groups.

The current role and characteristics of the large business groups

The government has applied a number of rules to the largest business groups (see below). The threshold at which groups are subject to such regulations has varied over time. From 1993 to 2001, regulations were applied to the top 30 groups regardless of their size. Large business groups were officially defined in 2002 as those with total domestic assets of over KRW 2 trillion (USD 1.9 billion) (Table 1). The threshold was raised to KRW 5 trillion in 2009 and to KRW 10 trillion (USD 9.3 billion) in 2017. The number of large business groups increased by about half over 2002-16 (43 to 65), even though the threshold for being classified as a large group was 0.3% of GDP in both 2002 and 2016. This suggests that the corporate sector still finds the business group approach to be attractive despite the restrictions and rules imposed on them.

Exports from the large business groups played the key role in Korea's recoveries from the 1997 Asian financial crisis and the 2008 global recession, aided by a sharp depreciation in the Korean won in both cases. Consequently, the share of the top 30 groups in national sales edged up through 2011. However, the upward trend has since been reversed, with this share falling from 37% to 32% in 2015 (Figure 1), reflecting the decline in export volume growth from an annual rate of 11.4% over 2001-11 to 2.6% since 2011. The rising share of services in the economy, where large business groups are less prominent, also puts downward pressure on their share of total national sales. Another factor is the globalisation of the business groups. The share of their production taking place overseas rose from 16.8% in 2009 to 22.1% in 2014 and their domestic employment is falling. Nevertheless, the number of firms affiliated with the top 30 business groups rose in 2017 (Figure 4).

As the top four business groups are increasingly powerful, there is strong public demand for government reform measures focusing on them. Together, they accounted for 52.7% of the assets and 69.4% of the profits (Figure 6), as well as 54.6% of the sales of the top 30 groups. Their share in each category has risen since 2011. This section looks at the diversification of the business groups, their ownership structure, intra-group transactions, role in the financial sector and profitability.

Table 1. Number of large business groups[1]

Year	Number of large business groups	Criterion: domestic assets (in trillion won)[1]	Domestic asset criterion as a per cent of GDP
2002	43	2.0	0.3
2003	49	2.0	0.2
2004	51	2.0	0.2
2005	55	2.0	0.2
2006	59	2.0	0.2
2007	62	2.0	0.2
2008	79	2.0	0.2
2009	48	5.0	0.4
2010	53	5.0	0.4
2011	55	5.0	0.4
2012	63	5.0	0.3
2013	62	5.0	0.3
2014	63	5.0	0.3
2015	61	5.0	0.3
2016	65	5.0	0.3
2017	31	10.0	0.6

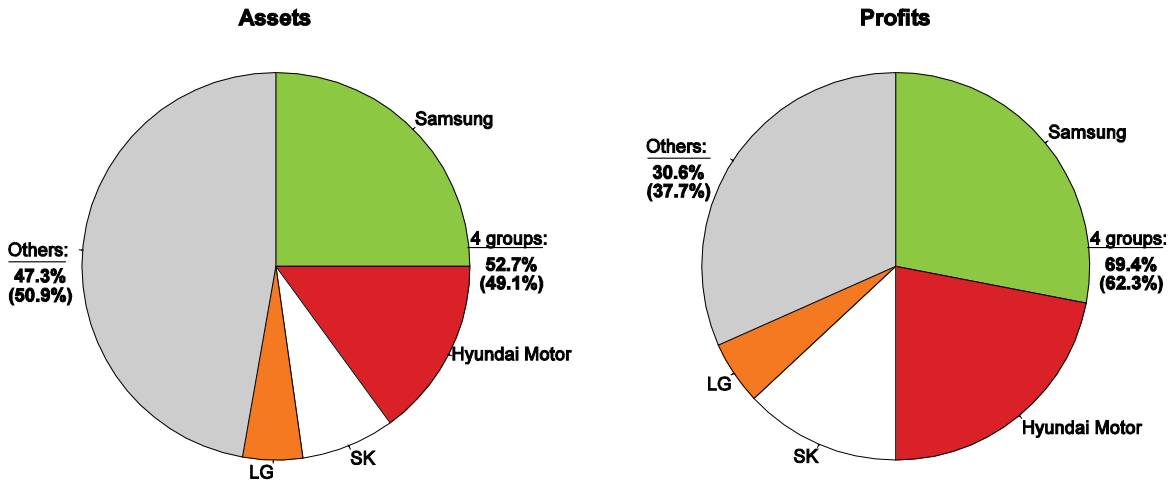
1. The groups that are subject to a special set of regulations, such as the prohibition of cross-shareholding.
Source: Korea Fair Trade Commission.

A large number of affiliated firms operating in a diverse range of sectors

The large business groups continue to grow and diversify by adding new firms. The number of affiliates of the top 30 groups nearly doubled over 2006-12, with the groups outside the top four accounting for most of the increase (Figure 4). Still, the number of firms affiliated with the top four groups averaged 70 in 2017, compared to 38 for the rest of the groups in the top 30. Most of the affiliates are unlisted. Of the firms belonging to the top 65 business groups, i.e., those that were subject to special regulations, only 14.3% were listed on the stock market in 2016 (Table 2). Listed firms are bigger, accounting for two-thirds of sales and capital and 57.9% of assets of the 65 groups.

Figure 6. The largest business groups are increasingly dominant

The shares of top four business groups as a share of the top 30 groups in 2017 (2011 is shown in parentheses)



Source: Yonhap News, 21 May 2017.

StatLink http://dx.doi.org/10.1787/888933738958

A high share of inside ownership

The Monopoly Regulation and Fair Trade Act defines a business group as a set of legally independent firms that are under *de facto* centralised control by the "same person" as defined in two presidential decrees: *i)* a person who "exercises influence on the concerned company's business activities through appointment of directors or in other ways"; and *ii)* a person who, together with relatives (referred to as the owner families) and affiliated companies, owns 30% or more of the company, and no one else owns more shares (Ministry of Strategy and Finance, 2013).

Table 2. Listed firms play a key role in the large business groups

Year	Firms in the business group[1]			Listed firms' share of assets, capital and sales[2] (%)		
	Total number	Of which, listed firms	Share of listed firms	Assets	Capital	Sales
2011	1 553	238	15.3	66.2	69.7	74.4
2012	1 832	256	14.0	62.0	65.3	68.5
2013	1 768	255	14.4	57.3	64.7	67.5
2014	1 678	247	14.7	57.0	64.3	67.3
2015	1 696	249	14.7	58.2	65.8	67.5
2016	1 736	248	14.3	57.9	65.6	67.9

1. The number of business groups subject to the restriction on cross-shareholding rose from 55 in 2011 to 65 in 2016 (Table 1).
2. As a percentage of the total for the business groups.
Source: Lee and Park (2016).

Through intra-group shareholding and a pyramid structure, the owner family can exert considerably greater control (voting rights) over affiliated companies than their ownership (cash flow rights) implies (Box 2). Group strategy is usually overseen by a central planning office answering to the owner family that can override the interests of the shareholders of the affiliated companies. Most business groups also have a centralised R&D centre to promote innovation in the affiliated firms and share human resources. The close relationship between affiliated firms leads to considerable spillovers among them. For example, the announcement of a credit rating change and earnings by one firm in the group influences the valuation of other affiliated firms (Joe and Oh, 2017; Bae et al., 2008).

Box 2. The gap between ownership and control in the business groups

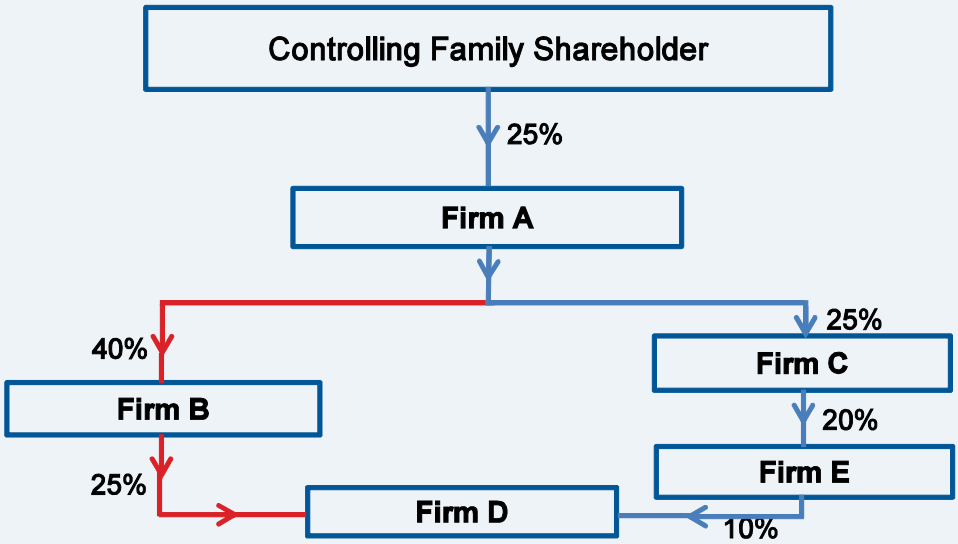
In the example of a simple business group shown below (Figure 7), the owner family holds 25% of the shares of firm A. Firm A holds 40% of the shares of firm B, which in turn holds 25% of firm D. In addition, firm A owns a 25% stake in firm C, which owns a 20% direct stake in firm E. Firm E holds 10% of firm D. Cash flow rights of the owner family in firm D are calculated as the indirect ownership through firms A and B and through firms A, C and E:

- Cash flow rights in firm D through firms A and B = 25% * 40% * 25% = 2.5%
- Cash flow rights in firm D through firms A, C and E = 25% * 25% * 20% * 10% = 0.125%

The total indirect ownership, as represented by cash flow rights, is thus 2.625% (2.5% + 0.125%).

The owner family's control is represented by voting rights, which can be measured by its representation on the board of firm D. These rights are measured as the minimum holding of the owner family in the control chain, which is 25% through firms A and B, reflecting the fact that the board of one firm can have a significant effect on the board of another affiliated company. The cumulative voting rights in firm D also include the family's 10% indirect stake through firm E. Total voting rights are thus 35%. The gap between control (35%) and ownership (2.625%) in firm D is thus large at 32.375%. The greater the complexity of the business group structure, the greater the gap between control (voting rights) and ownership (cash flow). The greater the gap between control and ownership, the lower is firm profitability as owner families can use their influence for their private benefit, with a negative effect on the firm (Joh, 2003).

Figure 7. Ownership and control in business groups

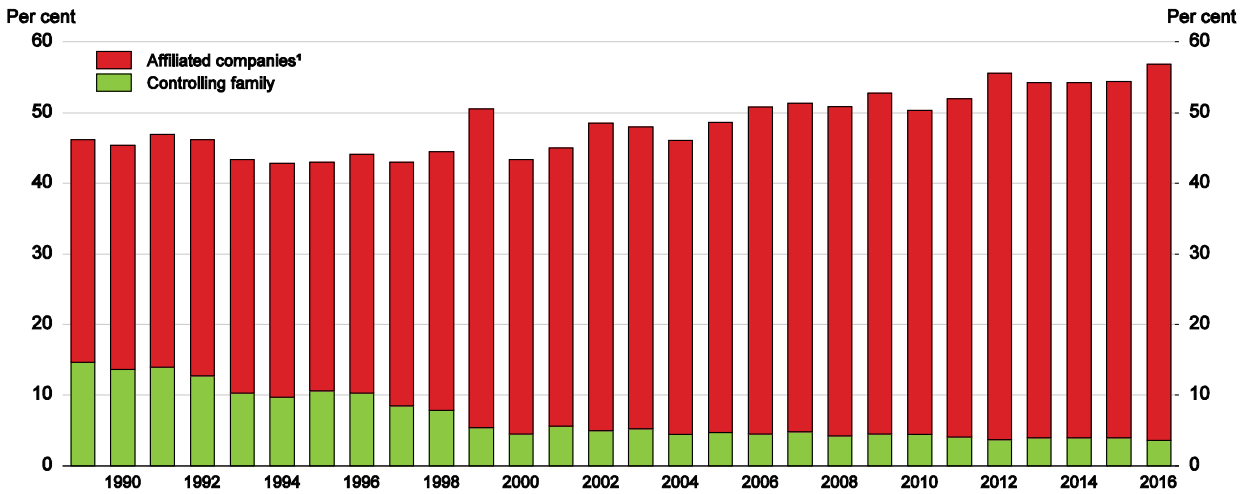


Source: Killeen and Kumar (2016).

Inside ownership – the combined shares of the owner family, affiliated companies and other insiders – is a measure of the controlling power of the owner family of the group. The share of the owner family has been on a downward trend, falling from 16% in 1989 to less than 4% in 2016 for the top 30 groups (Figure 8). Owner families typically hold a significant portion of shares in only one or two core firms in the group, usually those with reliable cash flow and high market value. The fall in the share held by the owner families has been more than offset by a rise in the share of affiliated firms from 31% to 51% over the same period. The inside ownership share was much higher in unlisted firms (80%) than in listed firms (48%) in 2015 (Lee and Park, 2016).

Figure 8. Inside ownership has been trending up

Inside ownership is the share of business groups held by the controlling family and affiliated companies



1. Includes other inside owners, who accounted for 2-3% over 2011-16.

Source: Korea Fair Trade Commission.

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The owner-family share is particularly small in the top four groups, falling to only 2.0% in 2017 (Table 3). However, they maintained control through the share held by companies affiliated with the group.

Table 3. Inside ownership is high in Korea's large business groups

Percentage of ownership in 2017 held by:

	Family head	Other relatives	Affiliated companies	Other insiders	Total
Top four groups	0.9	1.1	48.6	1.9	52.5
Middle groups (5th-10th)	0.9	2.3	60.2	3.1	66.5
Lower groups (11th-30th)	3.7	3.0	43.4	4.9	55.0

Source: Korea Fair Trade Commission.

A high share of trading within the large business groups

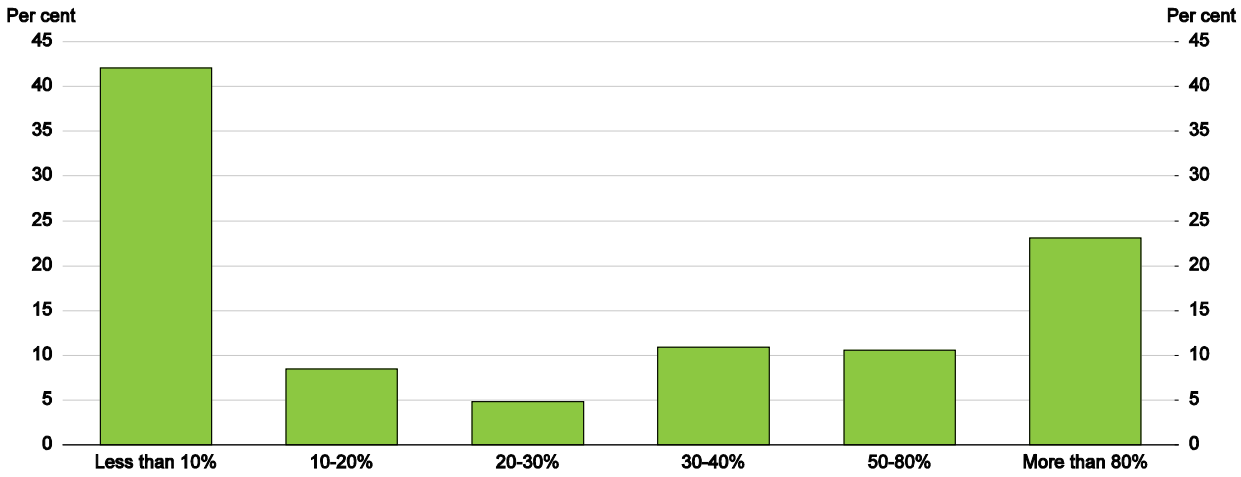
A significant share of the firms affiliated with the business groups trades extensively with sister companies in the same group. In 2015, trading within the group account exceeded 80% of sales for 23% of firms belonging to a business group and between 30% and 80% for another 20% of group-affiliated firms (Figure 9). However, intra-group trade accounted for less than 10% of sales at 42% of firms affiliated with the groups.

An increasing role for the large business groups in the financial sector

The number and size of financial firms affiliated with the large business groups has been rising. Financial firms' share of assets in the groups increased from 21% in 2010 to 36% in 2015, though the expansion in capital is much less (Figure 10). Financial affiliates can be used to assist troubled affiliates. One well-known example occurred in the Dongyang group. When non-financial firms in the group ran into financial trouble in 2013, Dongyang Securities sold commercial paper and corporate bonds issued by those firms to outside investors. When the non-financial companies went bankrupt and their commercial paper and corporate bonds became worthless, as many as 50 000 investors protested, arguing that Dongyang Securities had not provided full information. A guideline aimed at preventing such cases is to be introduced in 2018.

Figure 9. Intra-group trading is substantial for many firms in the large business groups

Percentage of affiliated companies by share of intra-group trading in total sales in 2015[1]



1. For the 1 736 firms affiliated with the top 65 business groups. Intra-group trading is defined as the share of a firm's purchases and sales with firms affiliated with the same business group as a share of their total purchases and sales.

Source: Lee and Park (2016).

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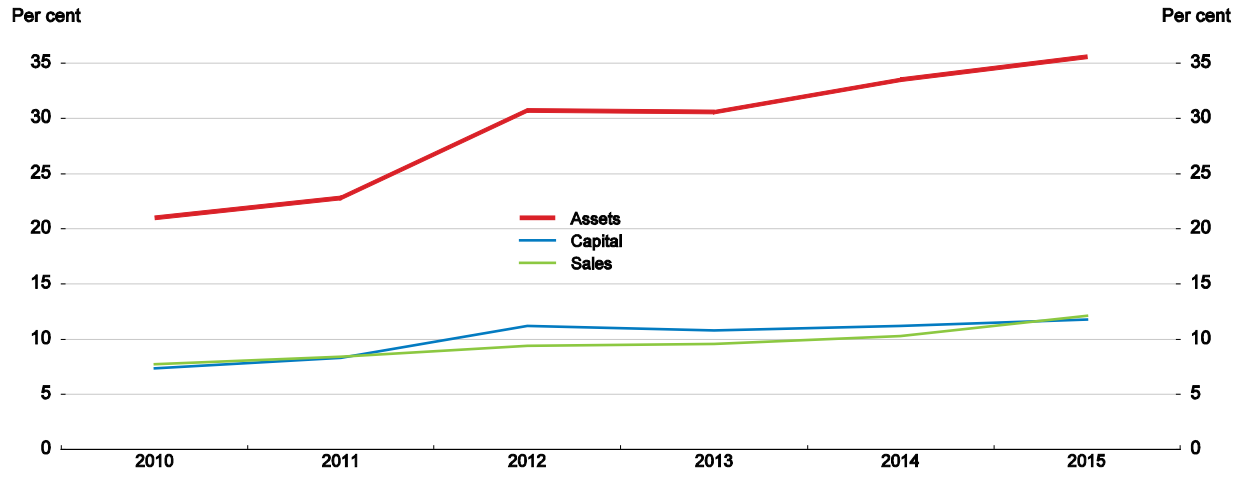
Figure 10. The share of financial firms in the large business groups has risen

Share of assets, capital and sales of financial firms affiliated with the business groups[1]



1. For the 1 736 firms affiliated with the top 65 business groups (*i.e.* those that are subject to the restriction on cross-shareholding).
Source: Lee and Park (2016).

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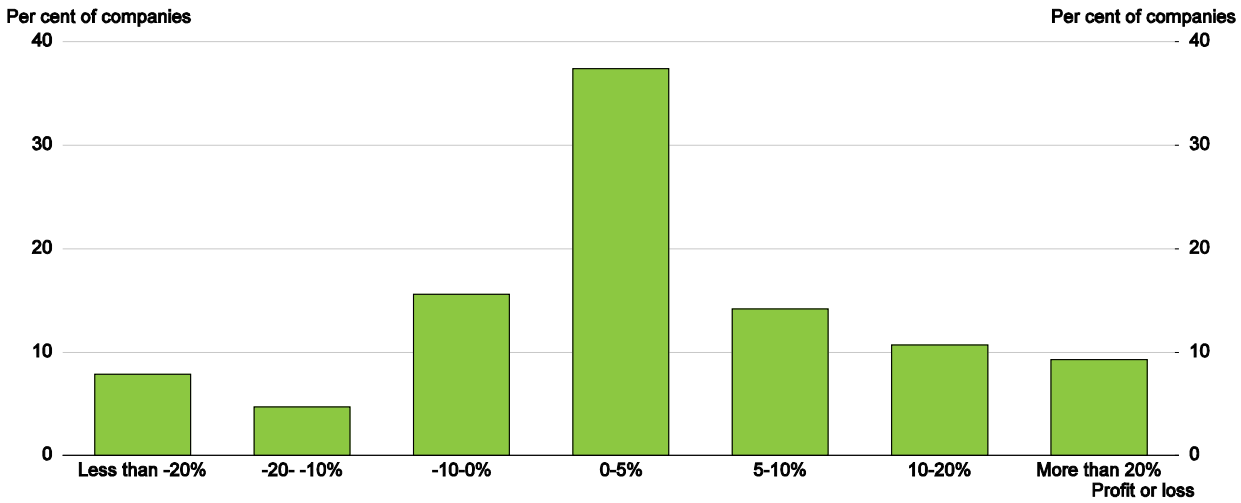
Mixed profitability results

There is considerable diversity in the profitability of the firms affiliated with the large business groups. While one-fifth of firms had profit ratios of at least 10% of sales in 2015, 28% recorded a loss (Figure 11). The largest share of firms had profits of less than 5% of sales. Overall, profitable business groups accounted for 89% of total sales by the groups (Lee and Park, 2016). Strong profitability has allowed the groups to accumulate cash. Between 2010 and 2014, the cash reserves of the top 30 groups rose by more than 50%, from KRW 330 trillion to KRW 500 trillion (33.6% of GDP), while their fixed investment increased by only KRW 2 trillion (Hyung-A Kim, 2017). The significant rise in cash reserves amid sluggish investment spending raises concern that the success of the groups is not effectively trickling down to the rest of the economy in the form of investment and employment.

Figure 11. There is a wide variation in the profitability of firms affiliated with the groups

Percentage of companies by profit or loss as a share of sales in 2015[1]



1. For the 1 736 firms affiliated with the top 65 business groups (*i.e.* those that are subject to the restriction on cross-shareholding).
Source: Lee and Park (2016).

StatLink http://dx.doi.org/10.1787/888933738749

The problems and risks associated with the large business groups

Korea's rapid economic development has weakened the rationale for the large business groups. The legacy of the partnership between government and the groups, which proved successful in accelerating economic development, has impeded the transition to a full-fledged market economy. As noted above, business groups have served as substitutes for imperfect markets. As emerging economies have improved their economic institutions, the role of large business groups in many emerging economies has been reduced (Hoskisson et al., 2005). However, in Korea, large business groups continue to play a dominant role. One of the major complaints against the business groups is that their diversification into a wide range of business lines stifles the growth of SMEs and the creation of new firms, resulting in a narrow base on which to build Korea's economic future (Jones and Lee, 2018). This section discusses three aspects of the concentration of economic power: *i)* the dominance of the business groups in the national economy and in certain business lines, which can reduce competition and efficiency; *ii)* the concentration of economic power in the owner families; and *iii)* the link between power concentration and corruption.

Growth of the business groups through diversification

The large business groups are often criticised for "octopus-style" diversification (Ministry of Strategy and Finance, 2013). Affiliates of the 65 top business groups operated in 59.5% of the 1 131 business lines in 2015 (Table 4). The average number of business lines tended to be highest for the largest business groups. Despite extensive diversification, the main business activity of each business group accounted for 55.8% of the group's total sales.

Table 4. Diversification of the business groups

In 2016 for the 65 business groups that were subject to special regulations

Ranking	Average number of industries[1]	Average number of products in mining and manufacturing[2]	Percentage of sales in the group's main industry[3]
1 to 5	83.2	61.0	61.3
6 to 10	100.4	92.3	51.5
11 to 15	59.6	38.3	43.1
16 to 20	78.8	35.7	47.1
21 to 25	33.0	29.3	69.4
26 to 30	34.4	7.3	54.7
31 to 65	26.9	17.1	63.6
Simple average	59.5	40.1	55.8

1. Number of industries that the business groups participate in among the total of 1 131 industries in the manufacturing, mining and service sectors, based on unit 5 of the Korea Standard Industrial Classification (KSIC).

2. Based on unit 8 of the KSIC.

Source: Data provided by Jaehyung Lee.

In principle, the entry of new firms strengthens competition, thereby boosting productivity (OECD, 2015a). From the perspective of business groups, diversification may be rational, as it creates opportunities for economies of scope, reduces the risk of bankruptcy, lowers transaction costs and facilitates the use of idle resources. Another motivation is to compete with other business groups (Park et al., 2008). Diversification into unrelated industries increased the advantages of using the business group structure by creating economies of scope and reducing risk, according to some studies (Kim et al., 2004). However, the creation of new firms can be used to increase the wealth of the owner families and provide tax-free inheritances to the children and grandchildren of the founder, leading to the misallocation of capital and greater inequality. The benefits of diversification in emerging economies may dissipate over time and eventually become a disadvantage (Lee et al., 2008). A recent study by a public research institute found that the slowdown in Korea's allocative efficiency since 2011, which is a major cause of slower total factor

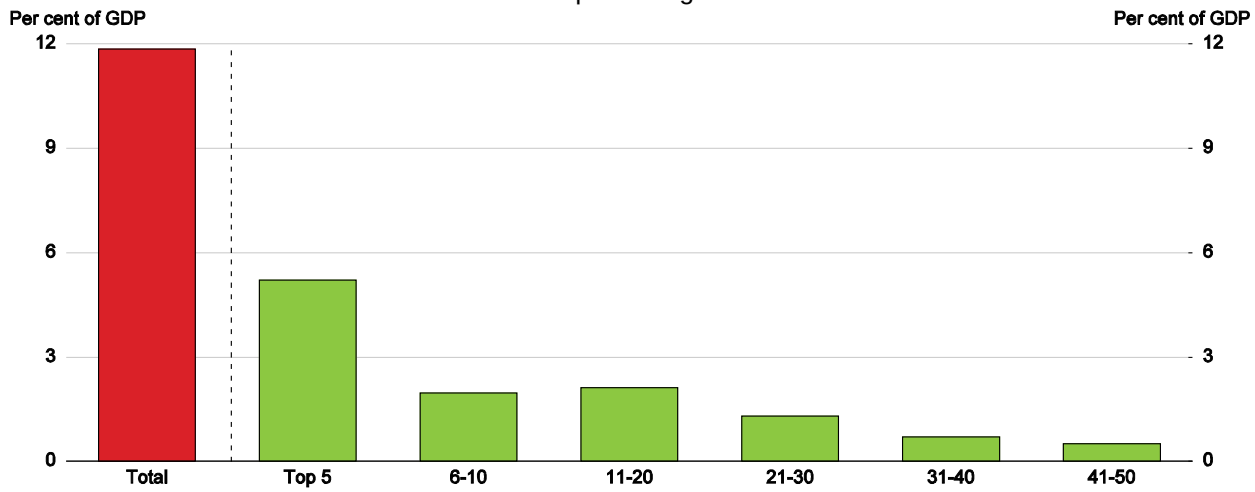
productivity growth, is primarily observed among affiliates of the large business groups (Cho, 2018). A decline in allocative efficiency, measured by the covariance between firms' productivity and market share, indicates that resources are being excessively allocated to low-productivity firms, while the opposite is true for high-productivity firms. One reason is that the rate of firm exit among firms affiliated with the large business groups is relatively low.

Market concentration by the business groups

As noted above, sales by the top 30 groups accounted for 32% of total national sales in 2015 (Figure 1). Although data on the value-added produced by the business groups is not available, the 50 largest companies in Korea – of which 49 belong to the business groups – accounted for nearly 12% of GDP in 2013, with the top ten accounting for more than 7% (Figure 12). They include Korea's largest electronic firms (Samsung Electronics and SK Hynix) and car producers (Hyundai Motors and its affiliate, Kia Motors). Of the ten largest firms, seven belong to the four largest business groups.

Figure 12. The value added of the top 50 companies

Value added as a percentage of GDP in 2013



Source: Kim (2015).

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In business lines where the groups had at least one affiliate among the top three in terms of market share, the average market share of the top three firms was 52%, compared to 44% in business lines where firms affiliated with the groups were not among the top three. A business group affiliate held the largest market share in 24.8% of the 1 131 total business lines in the manufacturing and service sectors in 2015 (Table 5). These business lines accounted for 53.3% of all industry sales, with a markedly higher share of sales in manufacturing (69.7%) than in services (46.8%), suggesting some degree of market power, especially in manufacturing. However, most of these firms are multinationals engaged in fierce international competition for market share and facing foreign firms in Korea's increasingly open domestic market.

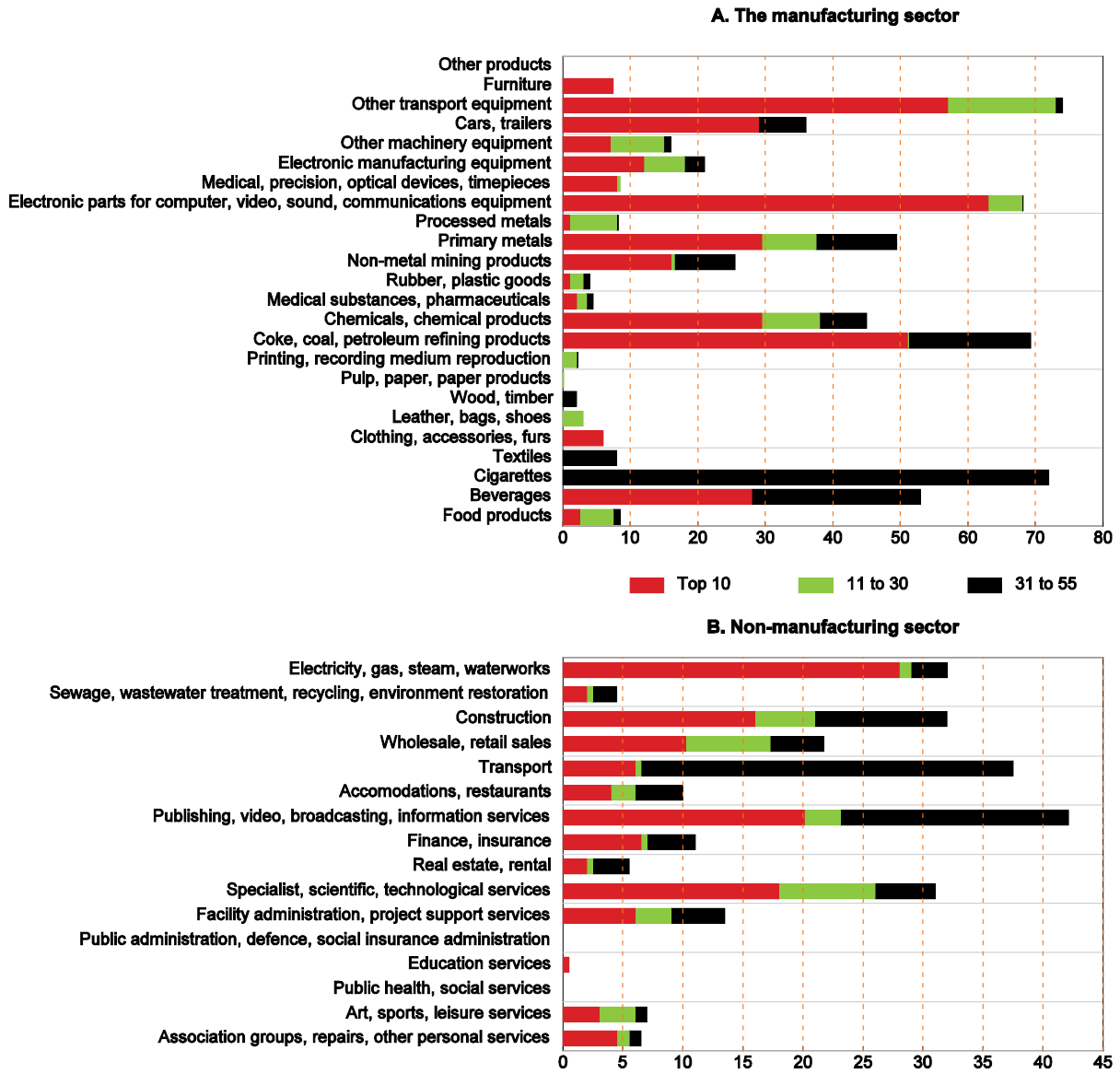
Table 5. The market position of firms affiliated with the large business groups in 2015

A business group affiliate ranks:		1st	2nd or 3rd	Other	Total
All industries	Number of industries (%)	24.8	10.9	64.3	100.0
	Sales (%)	53.3	10.2	36.5	100.0
Manufacturing	Number of industries (%)	24.7	8.6	66.7	100.0
	Sales (%)	69.7	7.4	22.9	100.0
Services	Number of industries (%)	24.9	12.5	62.6	100.0
	Sales (%)	46.8	11.3	41.9	100.0

Note: The study covers 1 131 industries based on the Korea Standard Industrial Classification (KSIC).
Source: Data provided by Jaehyung Lee.

Dividing the manufacturing sector into 24 industries shows that the top 55 business groups (those subject to the restriction on cross-shareholding) in 2011 had a combined market share of more than 50% in six key industries: beverages, cigarettes, coke/coal/petroleum refining products, primary metals, other transport equipment and electronic parts, computers, and video/sound/communications equipment (Figure 13). Their overall strong role in manufacturing reflects the government's emphasis on developing export industries. However, in more than half of the 24 manufacturing industries, the business groups' combined market share was less than 10%. Outside manufacturing, the groups play a smaller role. Only 28% of their sales are in services, where they face restrictions in some industries (e.g. banking), while some industries are primarily in the public sphere (e.g. education and health). In addition, there are restrictions on the entry of group-affiliated firms into some business lines to protect SMEs (see below). While the market share of the groups did not exceed 50% in any of the 16 service industries, it did surpass 30% in five: broadcasting and publishing, transport, construction, utilities and technical services (Panel B).

Figure 13. The market shares of the business groups by industry[1]



1. In 2011 for the 55 large business groups subject to the restriction on cross-shareholding.

Source: Lee (2014).

StatLink http://dx.doi.org/10.1787/888933738787

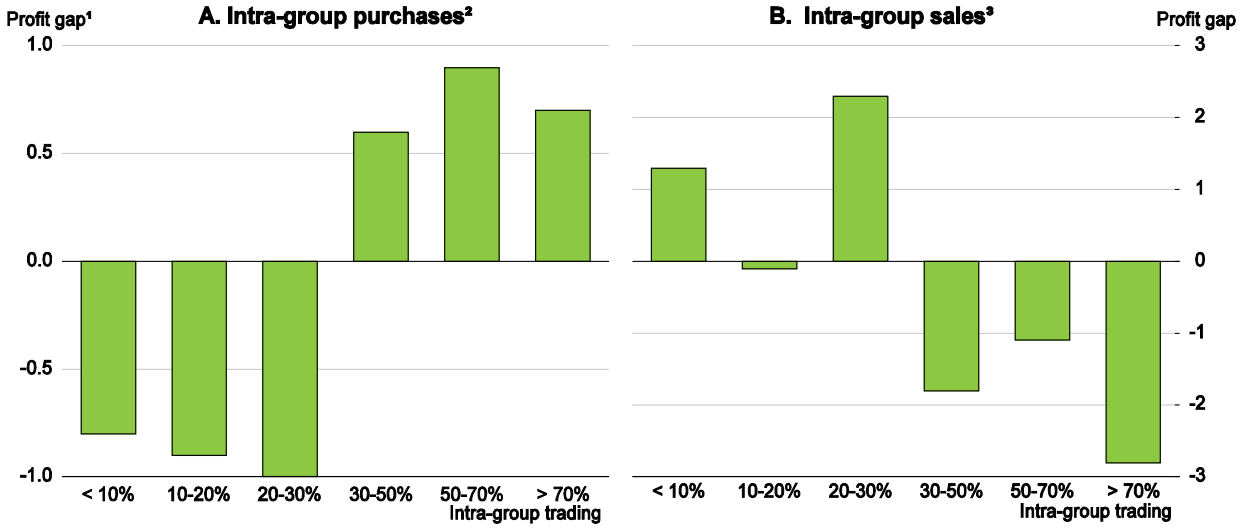
The concentration of management control

The major problem with the business groups is not their size, but the concentration of management control in the owner families. The gap between the owner family's share of ownership of the group and the total inside ownership share – 50.5 percentage points in the case of the top four groups (Table 3) – distorts the ownership structure and creates an agency problem between the controlling shareholder and minority shareholders (Box 2). Owner families can thus control firms in which they have few or no shares. The larger the gap between cash flow rights and voting rights, the greater the incentive for the owner family to pursue personal interests rather than maximise shareholder value (Byun et al., 2018). There is considerable empirical evidence linking large gaps in voting rights and cash flow rights with poor shareholder returns (Black et al., 2006). The agency problem resulting from the gap between cash flow rights and voting rights is the major reason for the undervaluation of equity prices, the so-called Korea discount (Figure 2) (Killeen and Kumar, 2016).

Owner families use a pyramidal structure in business groups to facilitate transfers of wealth between affiliated firms for their personal benefit, a practice referred to as "tunnelling". Intra-group transactions are used to take wealth away from firms where owner family ownership is low to firms where it is high, benefitting the owner families at the expense of smaller investors (Bae et al., 2002). Such transfers are accomplished through intra-group transactions of goods and services at prices that differ from market levels in order to favour key affiliated firms in which the owner families are large shareholders. The average profit rate in firms in which intra-group purchases accounted for more than 30% of their total purchases in 2015 was higher than the overall profit rate in the business group to which they belong (Figure 14). However, when a firm's intra-group sales surpassed 30% of their total sales, its average profit rate fell below that of the group. Support can also be provided to affiliated firms through financial and asset transactions, such as selling land at inflated prices.

Figure 14. Company profitability is influenced by intra-group trading

The profit gap[1] in group-affiliated firms, classified by intra-group trading shares in 2015



1. The profit rate in individual firms minus the profit rate in the business group to which they belong. A positive number thus means that a firm is more profitable than the business group.

2. The share of a firm's purchases from firms affiliated with the same business group as a share of their total purchases.

3. The share of a firm's sales to firms affiliated with the same business group as a share of their total sales.

Source: Lee and Park (2016).

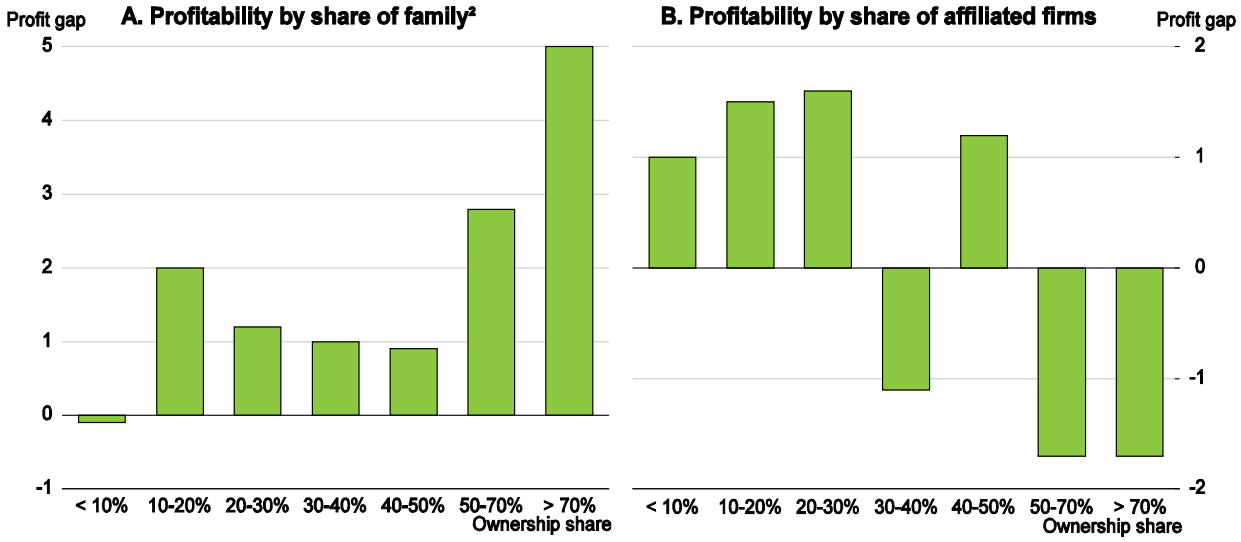
StatLink http://dx.doi.org/10.1787/888933738806

Firms in which the owner families have high ownership stakes have high rates of intra-group trading and a large profit margin, suggesting that the owner families are seeking personal gains through internal trading (Lee and Park, 2016). In 2015, firms in which the controlling shareholder and his children had an ownership share of more than 70% had profit rates 5 percentage points higher than the overall profit rate for the business group (Figure 15). In contrast, the profit rate in firms in which the controlling shareholder and his children owned less than 10% was slightly below the group's profit rate. High rates of ownership by affiliated companies had a negative effect on a firm's profits: if that share was above 50%, the firm's profit rate was significantly below the profit rate for the group.

One motivation for tunnelling is to transfer wealth to children and avoid the 50% inheritance tax. For example, the heir apparent for leadership at one large group realised extraordinarily high returns by investing in group companies that subsequently won major contracts with other firms affiliated with the group. In another case, the advertising and marketing firm in one of the large groups reaped 47% of its earnings via intra-group trading in 2011. A child of the group chairman held a 40% stake in the company. Such strategies come at the expense of minority shareholders. In addition, shareholders can be disappropriated by M&As designed to restructure the groups and pass control to the next generation (Killeen and Kumar, 2016).

Figure 15. Company profitability is influenced by the structure of ownership

The profit gap[1] between group-affiliated firms, classified by ownership shares in 2015



1. The profit rate in individual firms minus the profit rate in the business group to which they belong. A positive number thus means that a firm is more profitable than the business group.

2. The chief of the business group and children.

Source: Lee and Park (2016).

StatLink http://dx.doi.org/10.1787/888933738825

In addition to its impact on income distribution, intra-group trading can promote inefficiency by shielding affiliated firms from the chill winds of competition. Moreover, the option of borrowing from affiliated financial institutions saves them from having to compete with other firms for funding (Lim, 2013). Such support can reduce productivity growth by keeping inefficient firms alive and deterring the entry of more efficient competitors. More than 10% of Korea's capital stock in 2013 was sunk in non-viable ("zombie") firms, defined as those more than ten years old with an interest coverage ratio of less than one for more than three consecutive years (Adalet McGowan et al., 2017).

Unfair treatment of subcontractors

Concerns about the concentration of economic power include unequal trading relationships between large firms and their subcontractors. Large firms have been accused of making easy profits by cutting costs through unfair terms of trade with subcontractors, rather than focusing on innovation to create new demand (Lee, 2017). In practice, subcontracting is a method for two firms to share risks. For subcontractors, the arrangement provides a steady market and eliminates the need for marketing (Yun, 1999). The sales and total assets of subcontracting firms have been found to increase in line with the large enterprises that they supply. However, an increase in the large firm's profits by KRW 1 trillion (USD 926 million) leaves the subcontractors' profits virtually unchanged. This suggests that the profits of subcontractors are fixed, while large firms that bear the risk take the increase in profits (Chang and Woo, 2015).

Political problems related to the business groups

The concentration of economic power has strengthened the political influence of business leaders, resulting in corruption (Eichengreen et al., 2015). Korea's government-business co-operation has also generated a culture of rent-seeking that is difficult to overcome (Jwa, 2002). Many politicians have relied on political and financial support from the business groups. Korea's democratisation in 1987 increased the power of the big business groups by introducing competitive elections, without limits on firms' financial contributions to politicians. When politicians tried to control the business groups, they became powerful adversaries. As the conglomerates grew richer, their influence expanded to the judicial system and the media. Newspapers are financially supported by advertising revenue from the business groups, making journalists hesitant to investigate or criticise corporate malfeasance. Meanwhile, the groups have ingratiated themselves with the judiciary by dangling future employment opportunities in front of judges and lawyers (Financial Times, 17 September 2017). The new government pledged that the "collusive link between politics and business" will completely disappear and promised to end the use of presidential pardons for corrupt executives (Korea.net, 2017).

Evolution of the policy framework to control the business groups

The fifth five-year development plan (1982-86) emphasised market-based competition and corporate governance, reflecting concern about the rapid growth of the business groups, and its impact on lagging sectors of the economy. The 1980 Monopoly Regulation and Fair Trade Act stated that one of its objectives was to "prevent excessive economic power concentration". In 1987, four measures were added to Chapter 3 of the Act on "Suppression of Economic Power Concentration": *i)* prohibition on establishing holding companies; *ii)* prohibition of cross-shareholding; *iii)* a ceiling on the total amount of equity investment; and *iv)* restrictions on the voting rights of financial and insurance companies belonging to business groups (Table 6). The rules were enforced by the Korea Fair Trade Commission (KFTC). However, sustained economic growth through 1997 reduced the urgency of reform of the business groups. Moreover, the large business groups had become well entrenched.

The 1997 crisis sparked reforms to enhance transparency and accountability. Still, the government has found it difficult to limit the role of the business groups while pursuing other objectives, namely: *i)* the promotion of business investment and economic growth; *ii)* the facilitation of corporate restructuring; *iii)* the promotion of international competitiveness; and *iv)* the protection of the property rights of incumbent owners. Three of the four anti-concentration measures introduced in 1987 were abolished or relaxed after the 1997 crisis (Ministry of Strategy and Finance, 2013), despite the business groups' key role in triggering the crisis. In addition, not all policies that were implemented achieved their objectives, as the groups have been adept at outmanoeuvring government regulations and frustrating their effectiveness. In particular, the groups have circumvented the ban on cross-shareholding by increasing circular shareholding (in its simplest form, firm A holds shares in firm B, firm B holds shares in firm C and firm C owns shares in firm A). This section provides an overview of the key measures imposed on the business groups.

Policies to promote specialisation by the large business groups

The government introduced a "specialisation policy" in 1991 to limit the diversification of the business groups by inducing them to concentrate on core activities. The top five groups were encouraged to pick three core businesses, while the smaller groups could choose two. The groups were exempted from regulations, such as limits on investment, in their core activities. This policy, though, was generally ignored by the groups, who correctly viewed it as interference in their affairs and continued to expand the number of their affiliated firms. This was followed by the 1998 "Big Deals", in which the government strongly urged the largest groups to swap affiliates in eight key industries to make the groups more focused on core areas (1999 *OECD Economic Survey of Korea*). To the extent that these policies were effective, they limited competition and protected incumbent firms.

Table 6. Key regulations imposed on the large business groups

Type of regulation	Date imposed
Prohibition of cross-shareholding	April 1987
Restriction on the voting rights of affiliated financial and insurance companies[1]	April 1987
Prohibition on the creation of holding companies[2]	April 1987
Ceiling on the total amount of equity investment by firms in business groups[3]	April 1987
Specialisation policy to encourage greater focus on core activities	1991
Prohibition of debt guarantees	April 1993
"Big Deals" – swaps of the groups' firms in eight key industries	July 1998
Requirement to disclose large-scale intra-group transactions[4]	April 2000
Requirement to disclose important matters related to non-listed companies	April 2005
Requirement to disclose business group's status	June 2009
Restriction on the pursuit of personal interests	February 2014
Prohibition of new circular shareholding	July 2014

1. It was relaxed in 2002, when they were allowed to vote on important matters in the general meeting of stockholders, though their voting rights could not exceed 30% of the gross number of stock issues. The limit was lowered to 15% in 2008.
2. A company is defined as a holding company if its only or main business is to hold the stocks of other firms and control their business. The ban was lifted in 1999 and a number of groups have adopted a holding company structure, which led to a large rise in the voting rights of the owner families. The holding company must own 20% of listed firms and 40% of non-listed firms.
3. Aimed at curbing reckless expansion, the ceiling was initially set at 40% and lowered to 25% in 1994. It was raised to 40% in 2007 and then abolished in 2009. It was re-established in 2011 and then abolished again in 2012.
4. Business groups must disclose large-scale intra-group transactions in advance and they must be approved by the board of directors.

Source: Korea Fair Trade Commission.

Policies to protect SMEs and promote co-operation with large firms

Beginning in 1979, the "SME-only Industry Designation System" prohibited large companies from participating in or entering certain industries identified as most appropriate for SMEs. However, to promote economic development, the government decided to abolish the system in 2006. In 2010, the Korea Commission for Corporate Partnership (KCCP) was established by large firms and SMEs to promote win-win growth between large firms and SMEs and to protect SME business areas. The KCCP is a private, non-profit organisation funded by the large business groups, the government and SMEs. The KCCP includes a president and less than 30 board members, including executives from large firms and SMEs, and experts from academia and research institutes.

The KCCP's fundamental objective is to create "a new business ecosystem" based on "synergic partnership and co-operation" and "shared values and mutual growth between conglomerates and SMEs" (Korea Commission for Corporate Partnership, 2016) (Box 3). The KCCP has designated about 100 business lines for SMEs in both manufacturing and services, such as restaurants, bakeries and car repair, based on

agreement between SMEs and large firms (2016 *OECD Economic Survey of Korea*). The KCCP recommends that large firms not enter the designated business areas for three years, and this can be extended for another three years. If large firms are already operating in the designated areas, they are to refrain from increasing output, facilities and market share (OECD, 2017a). The KCCP monitors compliance twice a year and announces the results. If large firms violate the agreement, the KCCP issues correction recommendations.

Box 3. Korea Commission for Corporate Partnership policies to promote shared growth

As part of its efforts to create a new business ecosystem, the KCCP established "a Shared Growth Working Committee" to develop models for each sector. In addition, the KCCP, together with the KFTC, produces a "Shared Growth Index", often referred to as the Win-Win Index. In 2016, the Win-Win Index graded 155 large companies that have deep ties with SMEs, based on two components. *First*, the KFTC provided a quantitative assessment of large firms' fairness in contracting with SMEs and their co-operation with SMEs. *Second*, the KCCP surveys more than 12 000 SMEs concerning the behaviour of the 155 large companies in three areas (Table 7):

- Their fairness in contracting arrangements with SMEs (a maximum of 40 points).
- Their co-operation with SMEs, including large firms' financial contributions to SMEs through the KCCP (a maximum of 30 points). The funds provided by the large firms are aimed at helping SMEs increase R&D, develop their labour force, raise their productivity and enter overseas markets.
- Their attitude towards SMEs, including their management environment, recognition and understanding of SMEs, approach to expansion and shared vision (a maximum of 30 points).

Table 7. Evolution of the Shared Growth Index

The performance of large companies by type of co-operation with SMEs and sector[1]

A. The index by category

	2013	2014	2015	2016	Change over 2013-16[2]
Trading relationship with SMEs	87.8	88.4	88.8	87.5	-0.3
Degree of co-operation with SMEs	52.6	57.1	60.4	58.5	5.9
Management system	74.4	77.3	77.9	75.2	0.8
Total	75.9	79.4	82.3	80.3	4.4

B. The index by industry

	2013	2014	2015	2016	Change over 2013-16[2]
Manufacturing	77.1	79.5	82.3	79.0	1.9
Foodstuffs	70.8	76.0	79.1	79.8	9.0
Construction	75.0	79.1	80.9	82.7	7.7
Wholesale and retail	70.7	77.6	80.2	79.3	8.6
Home shopping	72.7	71.5	78.9	80.5	1.6
Department stores	74.1	79.2	79.2	79.9	5.8
Telecommunications[3]	85.8	90.6	97.8	93.8	8.0
Total	75.9	79.4	82.3	80.3	4.4

1. The number of large firms in the index increased from 100 in 2013 to 155 in 2016.
2. The change in the score in percentage points.
3. Telecommunications in 2013 is calculated as the weighted average of the communication and information service sectors.

Source: Korea Commission for Corporate Partnership.

The 155 firms are rated as excellent, good, satisfactory and unsatisfactory. Public enterprises are also evaluated but the results are not made public. The government gives benefits to firms with high rankings, such as exemptions from KFTC investigations of violations of competition law, priority in receiving government contracts and expedited immigration procedures for their executives. Moreover, highly-ranked firms receive positive publicity. Given the impact of the ranking, 78 large firms have created specific offices to deal with the Win-Win Index.

The improvement in the Index since 2013 is due to higher scores in the "Degree of co-operation with SMEs" category, which reflects financial contributions to SMEs through the KCCP (Table 7). Other aspects of their performance (sub-contracting behaviour and attitude toward SMEs) showed little change. By sector, the largest improvements were in foodstuffs, wholesale and retail and telecommunications, while little change occurred in manufacturing.

Over 2004-14, SMEs increased their share of value-added in light industry (77.9% to 84.6%) and in heavy industry (39.4% to 41.3%). However, it is doubtful whether three to six years of restrictions on entry or expansion by large firms will significantly narrow the productivity gap between SMEs and large companies. Indeed, SME labour productivity fell from 55.0% of that in large firms in 1980 to 32.5% in 2014. However, preventing the entry of large firms in important markets, many in services, and restricting their expansion in markets where they are already operating reduces aggregate productivity and consumer welfare. Rather than reducing their domestic opportunities, the government should make the domestic market attractive for all firms (2014 *OECD Economic Survey of Korea*). Removing excessive regulation on all firms, including those affiliated with the business groups, would strengthen competition and boost productivity in SMEs and the service sector (Jones and Lee, 2018).

The ban on cross-shareholding and debt guarantees

Financial links between affiliated companies in business groups though shareholding and debt guarantees can exaggerate business cycle fluctuations and create financial instability through chain bankruptcies. Although groups sometimes grow through the acquisition of existing firms, it is common for firms in a business group to acquire a large portion of the stocks issued by newly created companies. Cross-shareholding between two companies in the same group has thus been prohibited since 1987. This might be better described as a ban on "reciprocal equity investment" in which two firms in the same group own shares in each other.

However, the impact of the prohibition on cross-shareholding has been undermined by the sharp increase in circular shareholding. Cross-shareholding and circular shareholding allow owner families to control more affiliated companies by creating "fictitious capital" that enables them to secure more shares with voting rights that exceed the amount of their capital. When a business group expands by having its member companies acquire stocks of a member-to-be company, the capital is fictional in the sense that it exists only in accounting books, with no corresponding funds brought into the group. Although the business group's total amount of capital appears to increase, the additional capital cancels each other out in the consolidated balance sheet of the business group. Moreover, the fictional capital would be erased if the two companies were merged. In sum, the rule against cross-shareholding led to a more complicated and less transparent form of intra-group shareholding.

In addition, cross-shareholding and circular shareholding help the second and third generations of the owner family to inherit management rights without bearing additional financial costs, and impedes the restructuring of insolvent companies by providing unfair support to them. In sum, the expansion of a business group through the cross-shareholding and circular-shareholding undermine the transparency of the governance structure by creating a complicated shareholding structure. This less transparent ownership structure makes it difficult to identify where the capital comes from and where it goes, while increasing the possibility that a crisis in a specific company may be capable of triggering the collapse of an entire business group.

The growth of the business groups in the 1970s and 1980s was fuelled by the ability of their affiliated companies to borrow more and on better terms than other enterprises. Part of this advantage was based on debt guarantees from sister companies that reduced the risk to lenders. The Limitation on Debt Guarantees was enacted in 1993. It was reinforced in 1998 to prohibit any firm in a business group from giving debt guarantees to affiliated firms, with a few exceptions, such as for finance and insurance companies and to promote international competitiveness. This regulation has achieved visible results in reducing debt ratios and systemic risks ((Ministry of Strategy and Finance, 2013). Moreover, it has reduced the disadvantage to firms not belonging to business groups, particularly SMEs.

Restrictions on intra-group support and pursuit of personal interest

The Monopoly Regulation and Fair Trade Act prohibits unfair support between affiliated companies if it undermines fair competition in the market. For example, trading goods and services at prices that are not offered to other entities is not allowed. The business groups are required to regularly submit details of trade between affiliates to the KFTC and to make a public notice in the stock market if the firms engaged in trading are listed. The amendment of the Commercial Act in 2012 strengthened board procedures concerning intra-group trading and required listed companies with assets of over KRW 500 billion (USD 463 million) to appoint "compliance officers" to ensure that they observe the law on intra-group trading (OECD, 2017b).

The competition law was amended in 2014 to restrict the pursuit of personal interests by large shareholders in the business groups, even if such actions do not undermine fair competition in the market. It applies when a firm in a group provides support to an affiliated company in which the owner family owns at least 30% in the case of listed firms and at least 20% if it is unlisted. The rule covers all actions that result in unfair gains for owner families, including: *i)* funding support; *ii)* providing assets or commodities; *iii)* provision of human resources; and *iv)* unfair trading. Monitoring by the KFTC was enhanced by these measures. In addition, intra-group transactions can also be subject to gift taxes.

Despite the new rule, internal trading by 91 companies controlled by owner families increased 26% over 2014-16 (Nikkei Asian Review, 2017). To expand the coverage of the law, the government is considering cutting the ownership threshold on listed firms from 30% to 20%, which would be helpful. In addition, a new organisation to handle intra-group trading is to be set up within the KFTC. However, the business groups have evaded such regulations, for example by lowering the shareholding ratio of the owner families in their affiliates. Moreover, they can increase trading with offshore affiliates in order to avoid regulations on intra-group deals, given the difficulty of monitoring international transactions.

Restrictions on the voting rights of insurance and financial companies in the business groups

In 1986, financial and insurance companies belonging to the large business groups were prohibited from exercising their voting rights in the stocks of affiliated companies in which they owned shares. The regulation was aimed at preventing the business groups from expanding their control of non-financial companies by increasing the shares held by their affiliated finance and insurance companies. However, the business groups complained that the regulation left them vulnerable to hostile takeovers by foreign investors. The regulation was virtually eliminated in 2002 to allow financial and insurance affiliates to exercise their voting rights on critical matters in general meetings up to a ceiling of 30%. This increased the control of owner families and allowed business groups to expand via their financial or insurance companies ((Ministry of Strategy and Finance, 2013). The limit on exercising voting rights was lowered to 15% in 2008.

Policy directions to reform the business groups

The scandal involving a large business group and former President Park Geun-hye raised doubts over the effectiveness of the framework created over the past 35 years to deal with the groups and increased support for reform (Lee, 2017). Reform should not aim at destroying the groups but instead to create a framework in which competitive firms grow, regardless of whether they belong to a business group, and shareholder rights are respected. The restructuring of business groups should not be delayed over short-term concerns about employment and output. For example, the decision by a consortium of creditors, led by the state-owned Korea Development Bank, in September 2017 to support highly-indebted Kumho Tires (a member of the Kumho-Asiana business group) sends the wrong signal to the business groups.

Regulation is a second-best approach to control the entrenched power of the large business groups as it can weaken economic dynamism. Moreover, its effectiveness can be limited due to the ability of the business

group to evade regulation. As noted above, the prohibition on cross-shareholding has been undermined by other types of intra-group shareholding, while regulation of intra-group transactions is difficult to enforce. Moreover, a regulatory approach cannot anticipate new types of harmful actions taken by the business groups. Once such actions occur, it takes time for the authorities to analyse the economic effects and to implement corrective measures. In addition, regulations can prevent actions by the business groups that would have been beneficial. Finally, some of the regulations aimed at the large business groups, which are often intended to help SMEs, can have a negative impact on the economy as a whole (Jung, 2016).

Given the inherent weaknesses of relying on regulation, it should be supplemented by a comprehensive approach to improve the business groups. *First*, strengthening competition – international and domestic – would force business groups to become more efficient in order to survive. Stronger competition should include a more active market for corporate control and measures to address unfair subcontracting practices by the business groups. *Second*, Korea needs a framework that enhances internal and external monitoring of the business groups, including improved corporate governance and a larger role for institutional investors. *Third*, greater use of private remedies, such as class action and derivative suits, is needed to protect the rights of minority shareholders. *Fourth*, the ownership structure of the groups should be improved, which is the approach taken in Israel (Box 4).

Box 4. Israel's approach to dealing with large business groups

Business groups in Israel are defined as three or more firms operating in at least two different lines of business under the control of the same entity. Most groups are holding companies that own shares in listed subsidiaries that in turn have their own subsidiaries, with some pyramids having as many seven levels. The use of pyramidal structures has allowed a limited number of business groups to control a large proportion of the Israeli economy (OECD, 2016a). In 2012, 24 business groups controlled about a quarter of the nearly 600 listed companies. The top ten groups accounted for 41.3% of total stock market capitalisation, compared to 46.8% for the top four groups in Korea in 2017 (Bebchuk, 2012). In addition, many combined financial and non-financial enterprises.

The gap between the voting rights of the controlling entities and their cash flow rights, which were often very small, created problems as in Korea. Consequently, the incentives for those in control were not well aligned with shareholders. Those controlling the pyramids could fully capture private benefits, for example by tunnelling resources through intra-group trading, while bearing only a small fraction of the negative effects on cash flow rights. While Israel has rules with respect to interested party transactions, it is not possible for such rules to address all the ways in which private benefits can be extracted by those in control. In addition, the large role of business groups limited competition, thereby driving up the price of basic goods. In the face of protests, the government established a committee that proposed reforms that were incorporated in a new Law for Promotion of Competition and Reduction of Concentration, which was passed by the Parliament in 2013.

Under the new law, the groups were given four years to flatten the pyramids to no more than three levels (not counting the controlling group). The groups could meet this intermediate requirement by selling their holdings, going private, merging, etc. The deadline prompted many transactions as groups that failed to meet the 10 December 2017 deadline faced force sales by a trustee. According to a government study, only 13 groups had more than three levels by September 2017 compared to 67 in 2010. The large number of transactions reportedly created significant opportunities for new players (Herzog, 2017). This law is a significant change from the previous approach aimed at neutralising the negative effects of concentration, such as improving corporate governance. At the same time, corporate governance is to be upgraded by introducing the election of outside directors by minority shareholders and allowing the audit committees to supervise interested party transactions.

The Concentration Law requires that groups shed another layer of subsidiaries by December 2019, leaving them with just two. In addition, a ban on large companies holding both financial and non-financial enterprises takes effect in December 2019. The number of transactions remains high as the groups prepare to comply with the new rules.

Strengthening competition

Among firms affiliated with business groups, the gap between the cash flow rights and voting rights of the owner family is smaller for those operating in competitive markets (Byun et al., 2018). Product market competition is thus an important disciplinary mechanism that reduces the concentration of economic power by limiting the ability of owner families to pursue the private benefits of control. The positive effect of

competitive markets on the ownership structure of a firm is stronger the weaker the firm's market power. Given the weakness of corporate governance in Korea (see below), product market competition is a valuable tool to discipline owner families. Moreover, it encourages them to improve corporate governance practices to promote the survival of affiliated firms.

To strengthen competition, product market liberalisation is a priority. Korea's score in the most recent OECD indicator of product market regulation (PMR) was the fourth most stringent in the OECD (Figure 16). The pace of regulatory reform in Korea has failed to keep up with the OECD area since 2008, when Korea's PMR was the sixth most stringent. The rise in the total number of regulations through 2013 was centred on services; the number applied in the service sector was more than four times higher than in manufacturing (Park et al., 2014).

Lowering barriers to international trade and investment fortifies competition, as firms that cannot compete in the global market downsize, while those that can, expand production. Although Korea has pursued trade liberalisation through a number of free trade agreements, its index of barriers to trade and investment was the second highest in the OECD area in 2013 (Panel B). Such barriers help to explain why the stock of FDI as a share of GDP in Korea was the second lowest in the OECD area at 13% in 2016.

The strength of competition also depends on the enforcement of the Monopoly Regulation and Fair Trade Act by the KFTC. Competition policy has been emphasised, with the KFTC budget rising by 46% since 2010 and the number of actions taken against cartels and economic power concentration rising (Table 8). The KFTC has aggressively enforced laws related to cartels (Yun et al., 2016) and individuals can be punished for cartel activity with fines of up to KRW 200 million or, in principle, with three years in prison. In addition, penalty surcharges are often imposed. Raising the penalties for cartel behaviour may promote competition. The increase in the penalty on repeat offenders from a maximum of 50% of the basic levy to a maximum of 80% in 2017 is a step in the right direction. In addition, allowing class action suits (see below) against cartel activity could reduce illegal behaviour.

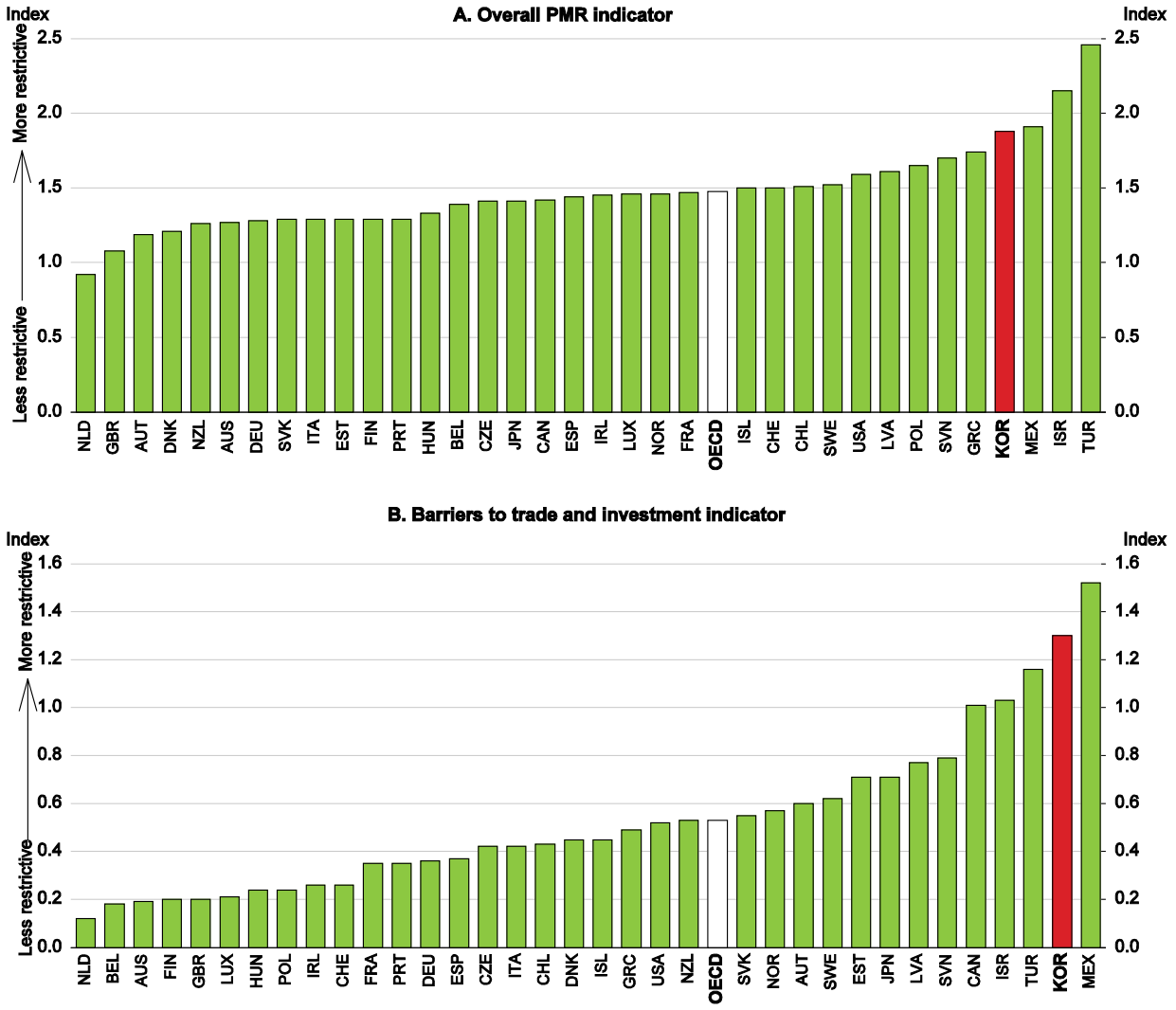
Table 8. The number of cases handled by the Korea Fair Trade Commission

Number of cases with an outcome tougher than a warning[1]

	2011	2012	2013	2014	2015
Abuse of market dominance	0	1	0	0	4
Mergers and acquisitions	21	37	21	39	24
Economic power concentration	7	7	15	20	46
Cartels	45	30	33	61	70
Prohibited act of enterprise organisations	51	18	21	20	26
Unfair business practice[2]	138	77	38	30	36
Total	262	170	128	170	206

1. For violations of the Monopoly Regulation and Fair Trade Act.
2. Includes unfair international contracts and resale price maintenance.
Source: Korea Fair Trade Commission.

Figure 16. Korea has scope to liberalise product market regulation and barriers to trade and investment



Note: The indicators are for 2013. The OECD Indicators of product market regulation are a comprehensive and internationally-comparable set of indicators that measure the degree to which policies promote or inhibit competition. Empirical research shows that the indicators have a robust link to performance. The indicator, which ranges from zero (most relaxed) to four (most stringent), is available for 33 OECD countries. The overall indicator is based on more than 700 questions.

Source: OECD Product Market Regulation Statistics (database); Koske et al. (2015).

StatLink *http://dx.doi.org/10.1787/888933738844*

A market for corporate control

Strengthening competition should include activating the market for corporate control. Takeovers – or the threat of them -- are an external control mechanism that can lead to improved firm performance, better corporate governance and the departure of incompetent managers. The market for corporate control in Korea is not active and successful hostile takeovers are still extremely rare (Byun et al., 2018). Moreover, there has never been one involving foreign investors. Even while deploring the concentration of economic power, public opinion in Korea has viewed business groups as “national treasures” that must be protected from foreign investors ((Ministry of Strategy and Finance, 2013). Business groups have lobbied for protection from takeovers, for example by arguing that their affiliated financial and insurance companies should be able to exercise voting rights (Lim, 2013).

The rule prohibiting foreigners from acquiring stocks of a company without the consent of the board of directors was abolished in 1998. However, given the inside ownership share of over 50% on average in the business groups, hostile bids are not a viable option to acquire control of firms affiliated with the groups. The misalignment of control and ownership, together with legal and socio-political impediments, have protected firms in business groups from hostile takeovers. Business groups are seeking protection of their managerial rights through such measures as poison pills, which can allow existing shareholders to buy new shares at below-market prices when faced with hostile M&A bids. Multiple voting rights for certain shares, such as those held by the owner families, would allow them to maintain control over management despite their small stakes. Multiple voting rights were proposed by the government in 2008, but ultimately rejected on the grounds that they would enhance owner families' control over the business groups. Measures to protect incumbent management should be carefully balanced with the goal of activating the market for corporate control.

Preventing unfair subcontracting practices

KFTC monitoring of subcontracting relationships has resulted in around 1 000 actions stronger than a warning in most years. In 2013, Korea introduced the possibility of treble damages against firms that violate subcontracting laws. However, in practice, treble damages have never been imposed, as small firms hesitate to rupture their relationship with large firms. The Fair Transactions in Subcontracting Act recently introduced a system that rewards informants who provide evidence against companies suspected of violating the Act. The underlying problem is the monopsony power of large firms, suggesting that subcontractors need to find more buyers to boost their bargaining position. In Japan, the internationalisation of supplying firms has eased problems with unfair subcontracting relationships.

Improving corporate governance

Good corporate governance is not an end in itself. Instead, it is a means to create an environment of market confidence and business integrity that supports capital market development and corporate access to equity capital for productive long-term investments. The quality of a country’s corporate governance framework is therefore of decisive importance for the competitiveness of its business sector and economic efficiency (OECD, 2017b).

The core problem in Korea’s corporate governance is the control of the owner families, despite their low ownership share, over group-affiliated firms and their shareholders. The weakness of minority shareholder rights magnifies the impact of the misalignment of ownership and control. As noted above, important decisions tend to be made by the owner family, rather than by the firms’ CEO, who is responsible to the shareholders. To reduce the problems created by the gap between ownership and control, Korea needs an incentive and monitoring system to ensure that the CEOs work in the interest of their shareholders rather than the owner families of the business groups. The regulatory framework discussed above has not been able to achieve that objective, making it essential to improve corporate governance (Box 5).

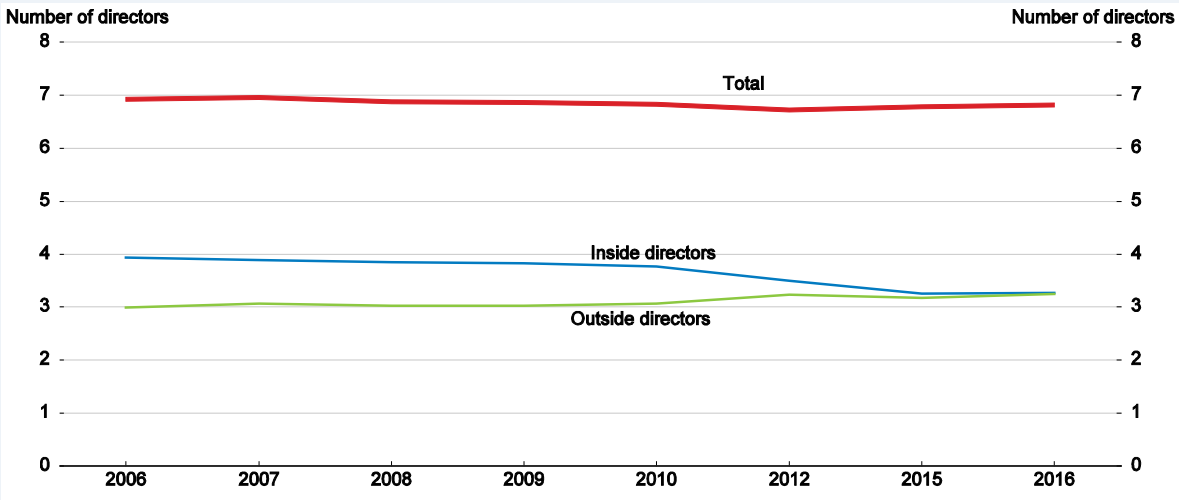
Box 5. Korea's corporate governance framework

Korea had no effective system of corporate governance prior to the 1997 crisis. Most firms were family controlled and run. Their corporate boards, which were required by law to "monitor" management, consisted primarily of management. Corporate governance was unable to prevent business groups from pursuing growth and market share at the expense of profitability and shareholder value. Minority shareholders had few rights. They were required to own 5% of the company to bring a lawsuit against the firm or to examine corporate accounts (Kim and Lee, 2012).

The "Memorandum of the Economic Programme" with the IMF in 1997 stated that "The government recognises the need to improve corporate governance and the corporate structure". Given the role of the business groups in causing the 1997 crisis, measures to improve corporate governance focused on the groups. Reform emphasised improving the accountability and transparency of management through both internal and external monitoring mechanisms. The improvement in corporate governance has been largest among newly-privatised companies and financial institutions with large foreign ownership shares. However, firms affiliated with the business groups have resisted change. In fact, there has been a backlash by some of the business groups against reforms (Kim and Kim, 2008).

Internal mechanisms focused on empowering the board of directors as a way to protect minority shareholders. In 1998, all listed companies were required to appoint at least one outside director, comprising at least a quarter of the board, on the grounds that outside directors would be better at monitoring companies than inside directors. In 1999, the share was raised to at least half of the total directors, effective in 2001, in firms with more than KRW 2 trillion (USD 1.9 billion) in assets (around 100 firms at the time). Companies above the asset threshold experienced significant share price increases even before the new rule went into effect (Black et al., 2006). In 2004, the requirement was changed from at least half to a majority of the board. By 2016, outside directors accounted for 48% of the boards of firms affiliated with the business groups. This was accomplished primarily by reducing the number of inside directors, leaving boards relatively small at an average of less than seven directors (Figure 17).

Figure 17. The share and number of outside directors is rising gradually[1]



1. In firms affiliated with the large business groups.

Source: Economic Reform Research Institute (2017).

StatLink http://dx.doi.org/10.1787/888933738863

Outside directors must meet independence criteria, which essentially require being independent from the company in terms of ownership, kinship, employment and business relations during the preceding two years. The largest shareholder and his family or those with a share of more than 10% are not eligible to serve as outside directors. In addition, companies with over KRW 2 trillion in assets must create a committee to recommend candidates for outside directors, so as to limit the controlling shareholders' influence on the appointments. More than half of the members of that committee must be outside directors. Outside directors accounted for 59.2% of total directors of companies listed on Korea Stock Exchange with over KRW 2 trillion in assets and 36.6% for listed companies below that threshold in 2017.

Audit committees were introduced in 2000 to replace internal statutory auditors, and made mandatory for firms with more than KRW 2 trillion in assets. This also increased the number of outside directors, as the committee had to have at least three members, of whom two-thirds were outside directors. Since 2004, at least one member of the committee has to be "financially literate". Appointments to audit committees tend to increase a firm's stock price, particularly when

the director is independent and financially literate. However, firms that replace a member of the committee are typically viewed as opportunistic, resulting in a decline in their stock price (Choi et al., 2014).

Reforms have also aimed to protect minority shareholders, in part by reducing the number of shares necessary to initiate the removal of a director and inspect corporate accounts. In 1997, the Commercial Law was amended to require board members to put the company's interests above their own. Class action suits related to securities, which require a minimum of 50 shareholders whose aggregate equity in the company is 0.01%, have been allowed since 2005 in certain cases, such as damages arising from false disclosure and claims against auditors of financial records. Such suits are also allowed in the case of unfair securities practices, including insider trading and market manipulation (Lee, 2015). In 1998, the Commercial Act was amended to reduce the ownership threshold required for a derivative suit, which increased minority shareholders' rights. In addition, the required aggregate equity to file a derivative suit for shareholders in non-listed companies was also reduced from 5% to 1% of shares. As for listed companies, the ownership requirement has remained unchanged since 1998: shareholders must maintain 0.01% of aggregate equity of the company for a minimum of six months. Private enforcement was credible enough in enforcing director liability that it resulted in a surge in purchases of liability insurance by directors. In 1999, a cumulative voting system was introduced, which would allow shareholders with less than 3% of shares to elect a director. However, the system is not mandatory and most companies have changed their charters to prohibit cumulative voting.

External monitoring was also upgraded, based in part on strengthened disclosure requirements. Key external monitors in Korea include non-governmental organisations (NGOs) and foreign shareholding groups, which increased in importance after the lifting of the ceiling on foreign shareholding in 1999. Foreign investors have introduced the notion of shareholder capitalism (Kim and Lee, 2012) and have launched hostile takeovers bids, though none has been successful (Kim and Kim, 2008).

The Asian Corporate Governance Association ranked the improvement in Korea's corporate governance over 2010-16 as the largest among the 11 Asian economies studied (Table 9). However, there is still scope for improvement, as Korea remained in eighth place in 2016, ahead of China but behind India. In particular, Korea's corporate governance culture ranked low compared to the other economies (Panel B). Even as a rising number of Korean firms grow into world-class companies, their corporate governance lags behind best practices. Reforms should focus on strengthening boards of directors, limiting the power of CEOs and protecting the rights of minority shareholders.

Upgrading corporate boards by strengthening outside directors

Most outside directors are appointed by the firms' management and the owner families of the business groups – the very people that they are supposed to supervise. In addition, 40% of listed firms had three or more members of owner families on the board in 2012 (CLSA and ACGA, 2012), making it difficult for outside directors to prevent actions against the interests of minority shareholders. Moreover, the CEO in most Korean firms is also the chair of the board of directors. Outside directors rarely vote against management proposals. Of 9 101 agenda items proposed to directors of 100 large Korean firms over 2010-12, there were only 33 instances (0.4% of the total) in which at least one outside director cast a dissenting vote (broadly defined to include conditional consent) (Kim and Lee, 2015). Other studies report a similar proportion (Chun, 2017). These results cast doubt on the independence and effectiveness of outside directors. Some business leaders argue that it is a foreign concept that does not fit well in Korea's corporate culture (OECD, 2017b).

Around a quarter of outside directors have a personal connection with the CEO, defined as coming from the same region or high school. Regional rivalries, which reflect conflicts between ancient kingdoms, are particularly strong in Korea. For example, following the 1997 financial crisis, a survey of firms in the Seoul capital regions found that workers from a certain region faced a higher rate of layoffs despite little difference in their qualifications (Kang and Lee, 2007). Outside directors with a personal connection to the CEO are less likely to dissent and have a lower attendance rate at board meetings, particularly when there are other "friendly" outside directors to support the CEO. This suggests that outside directors with a connection to the CEO are more willing to abandon their fiduciary duties and leave decisions to inside directors, who are typically from the company management or an affiliated company (Kim and Lee, 2015). Moreover, most

outside directors tend to be passive to avoid being labelled as "trouble makers", and losing their value in the market for outside directors (Song, 2008).

Table 9. The quality of corporate governance in Korea does not compare favourably in Asia

A. Overall score[1]

	2010	2012	2014	2016
1.Singapore	67	69	64	67
2.Hong Kong, China	65	66	65	65
3.Japan	57	55	60	63
4.Taiwan	55	53	56	60
5.Thailand	55	58	58	58
6. Malaysia	52	55	58	56
7. India	49	51	54	55
8. Korea	**45**	**49**	**49**	**52**
9. China	49	45	45	43
10. Philippines	37	41	40	38
11. Indonesia	40	37	39	36
Average	52	53	53	54

B. Corporate governance performance by category in 2016[1]

	Total	Rules & practices	Enforce-ment	Political & regulatory	Accounting & auditing	Culture
1.Singapore	67	63	63	67	87	55
2.Hong Kong, China	65	63	69	69	70	53
3.Japan	63	51	63	69	75	58
4.Taiwan	60	54	54	64	77	50
5.Thailand	58	64	51	45	77	50
6. Malaysia	56	54	54	48	82	42
7. India	55	59	51	56	58	49
8. Korea	**52**	**48**	**50**	**53**	**70**	**41**
9. China	43	38	40	36	67	34
10. Philippines	38	35	19	41	65	33
11. Indonesia	36	35	21	38	58	32
Average	54	51	49	53	71	45

1. Based on 95 questions. Australia, which was included in the study as a benchmark, had a score of 78 in 2016, higher than the 11 Asian economies shown.

Source: CLSA and Asian Corporate Governance Association (various years).

A recent study categorised firms by the personal connections of their outside directors to the CEO and the turnover of CEOs. In companies where personal connections ranked in the top quartile, the probability of the CEO being replaced is not affected by the firm's performance relative to other firms. For boards where the personal connections were in the bottom quartile, the CEO of a poorly-performing firm is eight times more likely to be replaced than the CEO of a company where personal connections were in the top quartile. In firms where an outside director made at least one dissenting vote, the CEO of a poorly-performing firm is five times more likely to be dismissed (Lee, 2016). CEOs and the controlling owner families limit monitoring by nominating outside directors with whom they have personal connections, thus reducing their effectiveness.

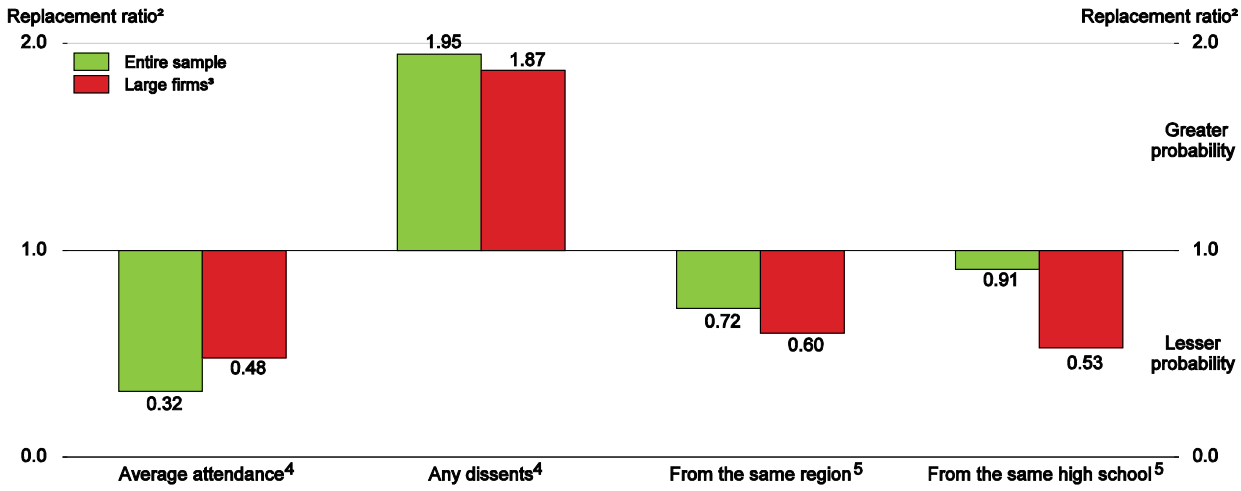
Moreover, outside directors who cast dissenting votes are nearly twice as likely to be replaced as those who never oppose agenda items (Figure 18). However, the tenure of outside directors also depends on their links to the CEO. The probability of outside directors from the same region as the CEO being dismissed, regardless of their voting record, is 60% of that for other outside directors in large firms. For those from the same high school, the probability of replacement is only half of those from different schools. Finally, CEOs minimise the impact of outside directors by addressing sensitive issues when there is a vacancy among them (Kim and Lee, 2015).

While independence is important, it is not sufficient. Business and financial expertise also matters (Agrawal and Chadha, 2005). Among outside directors on the boards of firms in Korean business groups, the share with a background in business management and finance fell from 33.1% in 2006 to 21.3% in 2016 (Table 10). The largest share of outside directors is from academia, suggesting a lack of business expertise. In addition, the share of former government officials (excluding those who are lawyers) rose to 23.4%. Among former officials, the largest shares were from the National Tax Service, the Ministry of Strategy and Finance and the KFTC, which is responsible for regulating the groups (Chun, 2017). This suggests that an important role of outside directors is to communicate with the government rather than monitor the firm.

Nevertheless, the increased number of outside directors appears to have improved board monitoring and boosted firms' valuation. One study found that firms in which outside directors account for half of the board, the firm's share price was 40% higher (Black et al., 2006). Another study shows that firms with a high share of inside ownership and boards dominated by insiders improved their performance by adding outside directors that are truly independent and actively involved in the firms' affairs (Choi et al., 2007). A recent study by the Corporate Governance Service found that a firm's value is closely correlated with its performance in six areas of corporate governance: *i)* auditing systems; *ii)* board procedures; *iii)* minority shareholder rights; *iv)* ownership structure; *v)* disclosure; and *vi)* related-party transactions (Hyungsuk Kim, 2017).

Figure 18. Factors influencing the probability of outside directors being replaced

Top 100 non-financial firms over 2010-12[1]



1. For which information on their outside directors' attendance and voting records by item is available.
2. The "replacement ratio" is the conditional probability of an outside director being replaced in the next term. A ratio above (below) 1.0 means that the probability of replacement is higher (lower) than for the entire sample. For example, a value of 2.0 means that the probability of replacement is two times higher than for the entire sample, while a value of 0.6 indicates that it is only 60% as high.
3. Defined as having more than KRW 2 trillion in assets.
4. During the preceding year.
5. As the CEO.

Source: Kim and Lee (2015).

StatLink http://dx.doi.org/10.1787/888933738882

Another benefit of independent outside directors is that it makes firms less likely to participate in cartels. Corporate boards in cartel firms have a higher share of outside directors with personal connections to the CEO and they serve longer terms, allowing collusion to persist (Lee, 2016). Strengthening the independence of outside directors thus serves as a deterrent to collusion.

Table 10. Background of outside directors

Percentage of total

	2006	2007	2008	2009	2010	2012	2015	2016
Management and finance	33.1	31.1	29.7	27.8	29.7	24.0	23.3	21.3
Government officials	18.9	19.6	20.1	18.6	21.0	24.0	21.7	23.4
Legal profession	13.3	14.3	13.2	14.3	12.9	15.2	13.6	12.7
Academia	27.1	27.7	29.3	30.8	28.6	30.5	31.2	32.4
Accountants	2.3	1.9	2.7	3.1	2.7	2.2	2.6	2.6
Journalists	2.9	2.5	2.4	2.8	2.8	2.6	4.2	4.4
Politicians	--	--	0.4	0.6	0.6	0.3	1.8	1.5
Other	2.4	2.9	2.3	2.0	2.0	1.2	1.7	1.7
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

Source: Hyungsuk Kim (2017).

The role and independence of outside directors would be strengthened by:

- Requiring a larger share of listed firms to create special committees to recommend candidates for outside director. Since 2011, the Commercial Act mandates such committees for firms with more than KRW 2 trillion in assets. Such firms accounted for only 150 of the nearly 2 000 listed firms in 2016.
- Limiting the membership of the committees to recommend outside directors to outside directors and allowing the committee to set the remuneration of outside directors to limit the influence of CEOs.
- Having the committee that recommends outside directors propose more than one candidate, while providing sufficient information on nominees.
- Requiring an objective evaluation and disclosure of outside directors' board activities.
- Strengthening the definition of independence imposed on outside directors. For example, the requirement that outside directors must not have had an economic relationship with the firm, its management, controlling shareholder or related companies during the preceding two years could be lengthened.
- Providing training for outside directors, as many have limited expertise (Table 10).

Limiting the power of CEOs to evade monitoring by the board

Some of the measures above would limit the power of the CEO and enhance the independence of the board of directors. However, the turnover of CEOs from owner families is not related to firm performance, regardless of the board's independence, suggesting that improvement of corporate governance will be limited in such situations (Lee, 2016). At a minimum, the posts of CEO and chair of the board should be separated. In 35 jurisdictions surveyed by the OECD, ten require the separation of the two posts, while another ten recommended separation through a "comply or explain" approach (OECD, 2017b).

Protecting minority shareholders

It is also important to support minority shareholders' engagement in corporate governance. Although insiders account for more than half of the ownership of group-affiliated firms (Figure 8), the ownership of remaining shares is quite dispersed. The number of shareholders exceeded 5 000 in more than half of listed companies in 2013 (Chun, 2017). The agency problem in most listed companies is between controlling and minority shareholders.

The OECD Principles of Corporate Governance (OECD, 2015b) state: "Shareholders should be able to vote in person or in absentia, and equal effect should be given to votes whether cast in person or in absentia". However, in Korea, some firms use a range of mechanisms to discourage minority shareholder participation: *i)* holding annual general meetings (AGM) on the same day – 924 firms out of around 2 000 listed firms held their 2017 meeting on 24 March; *ii)* prohibiting non-shareholders from serving as proxies in voting; and *iii)* bundling multiple resolutions into a single vote. In Korea, the rules on convocation and distribution of information for the AGM are not adequately enforced for unlisted companies (OECD, 2013). The limited time available for proxy solicitations also restricts shareholders' ability to vote. In addition, firms have been able to use "shadow voting" by requesting the Korean Securities Depository to cast votes on behalf of non-participating shareholders in the same proportion as the overall vote at the AGM. A quorum could thus be reached relatively easily without minority shareholder votes that may not support management. In 2017, 641 firms, about a third of listed firms, requested shadow voting. Shadow voting was abolished at the end of 2017.

Such practices have impeded minority shareholders' ability to influence company decisions and the selection of board members. Electronic voting was introduced in 2010 to make it easier for minority shareholders to vote their shares, and is now used by over a third of listed companies. Mandating the use of cumulative voting, which is currently optional, would enhance the power of minority shareholders. Making both electronic and cumulative voting mandatory is part of the revision of the Commercial Act that is pending in the National Assembly.

Treasury shares are often used by a company to protect management rights (Kim, 2009). When a company repurchases its shares, they may either be cancelled or held for reissue. If not cancelled, such shares are referred to as treasury shares, which are not entitled to receive a dividend and have no voting rights. Selling the treasury shares is effectively the same in financial terms as issuing new shares. With the approval of the board, treasury shares can be sold to friendly shareholders, in contrast to issuing new shares, which must be allocated to existing shareholders, leaving voting rights unchanged. The sale of treasury shares has been a common tactic of Korean firms to protect management rights to the detriment of minority shareholders (Cho, 2017).

Improving transparency and disclosure

Laws requiring financial disclosures by firms should be reinforced to prevent accounting fraud. As part of the government's accounting reform efforts, the Act on External Audit of Stock Companies was amended in 2017. Under the Act, companies and accounting firms are subject to tougher regulations, and a penalty (with no upper limit) on accounting fraud has been introduced. Moreover, the Securities and Futures Commission now has authority to designate an external auditor of all listed companies in principle. In addition, audit committees should be strengthened. Such committees are mandatory for firms with more than KRW 2 trillion in assets and two-thirds of the committee members should be outside directors. The Act on External Audit of Stock Companies grants audit committees the power to designate an auditor, uncover accounting fraud and take countermeasures as appropriate.

Strengthening the role of institutional investors

Effective corporate governance requires oversight by all stakeholders, including institutional investors, defined as non-bank organisations or persons trading securities in quantities large enough to qualify for preferential treatment. In Korea, institutional investors account for about 13% of total market capitalisation. Institutional equity ownership, especially by foreigners, has been found to enhance firm performance (Choi et al., 2007). However, most domestic institutional investors in Korea are not active in corporate governance, in part because they are affiliated with the business groups or have business ties to them (Kim and Lee,

2012). In addition, the practice of shadow voting limited the role of institutional investors. As noted above, shadow voting was abolished at the end of 2017.

A Stewardship Code was introduced on a voluntary basis in December 2016 to encourage institutional investors to effectively exercise their voting rights on key business decisions at companies in which they invest. It aims to enhance investor returns, support sustainable growth of capital markets and reduce the "Korea discount". Institutional investors are advised to join the Code. Thus far, around 90 institutional investors have adopted or plan to adopt the Code. However, some complain that the rule that requires them to disclose their stock holdings of 5% or more in a listed firm within five days of trading could weaken their investment strategy. Some smaller firms also worry about the costs of monitoring their implementation of the Code.

The effectiveness of the Code will be enhanced by the decision of the National Pension Service (NPS), the dominant institutional investor, to join in 2018. The NPS manages the National Pension Fund, the third largest in the world at USD 495 billion (30% of GDP). Moreover, it accounts for 5.5% of market capitalisation in Korea and is the largest institutional investor in many listed firms. The NPS has not been active in initiating shareholder proposals, such as board nominations, in order to avoid direct government intervention in private firms (OECD, 2012a). The chairman of the NPS has been put on trial because of the decision by the National Pension Service Investment Management (NPSIM) to support a controversial merger of two firms in a major business group. Reforms to protect the NPSIM and its chief investment officer from political pressure are a prerequisite for a more active role in corporate governance.

Private enforcement of corporate governance

Given the shortcomings of monitoring mechanisms, such as corporate governance, the market for corporate control and institutional investors, private enforcement – notably shareholder lawsuits – is needed to deal with misbehaviour by management. Considering the structure of ownership and control in Korea, private enforcement may be more effective than relying on outside directors to improve corporate governance. Such an approach is used to complement public supervision and enforcement in some OECD countries (OECD, 2013). One advantage of private enforcement is that it can recover losses for investors, while public enforcement only imposes fines.

Private enforcement is particularly important in the case of related-party transactions, an area that is difficult for supervisors to monitor and enforce rules. This is a key issue in Korea, where 58% of firms report significant related-party transactions, the second highest among 29 jurisdictions surveyed (OECD, 2012b). As noted above, related-party transactions between affiliated firms in business groups are forbidden if they undermine fair market competition. Intra-group transactions related to directors and the owner family must be approved by two-thirds of the board of directors, who have a fiduciary duty to protect their company's interests. Given that outside directors have to account for a majority of the board of directors in large firms, this implies that the transactions must be approved by some outside directors, underlining the importance of their independence.

The rules on intra-group transactions only have teeth if those hurt by such transactions can successfully pursue legal action. In the United States, rules covering related-party transactions are primarily enforced through private litigation, typically alleging a violation of fiduciary duties by directors. Shareholder lawsuits in such cases are based on strong disclosure requirements (OECD, 2013). The OECD Principles of Corporate Governance call for disclosure concerning related-party transactions.

Class action suits – a legal action initiated by one or more shareholders to seek recovery of damages on their own behalf as well as other similarly situated shareholders – is the key tool to enforce the fiduciary duties of directors and controlling shareholders. When ownership is widely dispersed and the cost of

litigation is substantial, it is not economically viable for a few individual shareholders to initiate litigation, as the potential recovery would typically not cover the cost of litigation (OECD, 2013). A second private mechanism against intra-group transactions is a derivative suit – a suit brought by shareholders on behalf of the firm. Korea is considering the introduction of multiple derivative suits, which allow shareholders of a subsidiary to take action on behalf of the holding company that owns the subsidiary.

Although Korea introduced class action lawsuits in 2005, only eight cases have been launched thus far. Meanwhile, derivative suits have been similarly underused by shareholders, with most suits filed by NGOs. Reforms are thus needed to make shareholder lawsuits an effective remedy for minority shareholders subject to malpractice and negligence by board members. *First*, the success of shareholder suits in the United States is due in part to an active and extensive set of plaintiff attorneys who are capable of and interested in pursuing cases in which there is a realistic prospect of success (OECD, 2013). Korea has fewer attorneys and most large law firms also represent the large business groups, making them hesitant to argue shareholder lawsuits against important clients. *Second*, the litigation costs borne by the shareholders may discourage suits. For example, if shareholders lose a case, they have to pay the legal costs of the defendants as well as their own. *Third*, rules to prevent frivolous suits that lead to settlements between defendant managers and plaintiff attorneys may be too strict (Song, 2008).

Improving the ownership structure

Owner families choose ownership structures to maintain their control rights over the business group and maximise their benefits (Byun et al., 2018). Stronger competition will help improve the ownership structure by narrowing the gap between the owner families' cash flow rights and voting rights, as discussed above. Improved corporate governance will also reduce the problems associated with the ownership gap by reducing the owner families' control over the board of directors. However, the progress toward stronger competition and better corporate governance is likely to be gradual and evolutionary. Achieving the government's goal of significant reform of the business groups requires directly improving the ownership structure. One step would be to phase out circular shareholding. In 2014, the business groups were prohibited from increasing circular shareholding. Currently, four large business groups report ten cases of circular shareholding, down from 93 in 2017. Given the difficulty of such a reform for some business groups, circular shareholding should be phased out gradually. The ban on direct shareholding in 1987 set a three-year grace period to meet the rule and it was achieved without market turbulence. While phasing out circular shareholding would improve the allocation of capital, it remains essential to upgrade corporate governance to cope with other forms of intra-group shareholding.

Expanding the use of holding companies increases transparency and the accountability of the owner families. The ban on holding companies, which are now required to hold 20% of listed companies and 40% of non-listed companies, was lifted in 1999 to facilitate corporate restructuring. The shift to a holding group structure requires the business groups to unwind circular shareholding and separate financial and non-financial businesses. Nevertheless, by 2010, 12 of the large business groups had adopted a holding company structure. However, the owner families' power was strengthened by the shift to holding companies, as they increased their voting rights by 2.4 times at no cost ((Ministry of Strategy and Finance, 2013). To insure that the shift to a holding company structure does not increase the power of the owner families, the conditions should be tightened by raising the ownership requirements. A bill to raise the minimum share for holding companies to 30% for listed companies and 50% for non-listed companies is pending in the National Assembly.

Box 6. Recommendations to reform the large business groups to promote productivity and inclusion

- Strengthen product market competition by relaxing barriers to imports and inward foreign direct investment and liberalising product market regulation.
- Reinforce the role of outside directors by enhancing the criteria for independence.
- Reduce the role of management in nominating outside directors.
- Require that outside directors comprise more than half of the boards of all listed firms.
- Phase out existing circular shareholding by firms belonging to the same business group.
- Make cumulative voting (which would allow minority shareholders to elect directors) and electronic voting (which would help minority shareholders to vote their shares) mandatory.
- Follow through on the government's pledge to not grant presidential pardons to business executives convicted of corruption.

Further recommendations

- Reinforce the monitoring role of institutional investors, particularly the National Pension Fund, in part by active implementation of the new Stewardship Code and the end of shadow voting.
- Implement reforms to encourage the use of class action suits and derivative suits, particularly to address the problem of intra-group trading, and introduce multiple derivative suits.
- Increase the penalties on cartel behaviour and allow class action suits against cartel activity.
- Remove obstacles to an active market for corporate control as insider ownership is reduced.
- Effectively implement the guideline to restrict intra-group transactions involving financial and non-financial firms and make clear to investors the risks of purchasing such financial products.
- Require objective evaluations of outside directors.
- Raise the ownership requirements for the creation of holding companies.
- Improve financial disclosures by corporations and prevent accounting fraud by increasing disclosure requirements and strengthening audit committees.

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