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Understanding Korean Capitalism: *Chaebols* and their Corporate Governance

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Abstract

*Chaebol*s, Korean[2] big business conglomerates, have had a huge influence in the global economy and in Korean society and politics. Some stress the significant contribution *chaebols* have made to the unprecedented rapid development of the Korean economy, while others highlight their concomitant problems such as cronyism, corrupt relations with government, and economic concentration. Although such problems seem to have been reduced in recent years thanks to institutional pressures enacted by the Korean government after the financial crisis of 1997, the pending reforms of the *chaebol* system are still important issues that permeate political and economic debate in Korea.

In what follows, we will explore the unique characteristics of the *chaebols*, their relations with government, and the virtues and vices of this Korean capitalist model that does not operate along the lines of its European and Anglo-American counterparts.

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[2] The Republic of Korea will henceforth be referred to as Korea.

The particularities of the *chaebol* structure

A *chaebol* generally refers to a collective of formally independent firms under the single common administrative and financial control of one family. It literally means a group or party of wealth: chae (財) means wealth or fortune, and bol (閥) means a group or party. While there is no consensus, most scholars agree that a *chaebol* is defined by three business structural traits: it consists of many affiliated firms operating in a diverse number of industries, ownership and control of the group lie in a dominant family, and the business group accounts for a great percentage of the national economy (See Table 1).

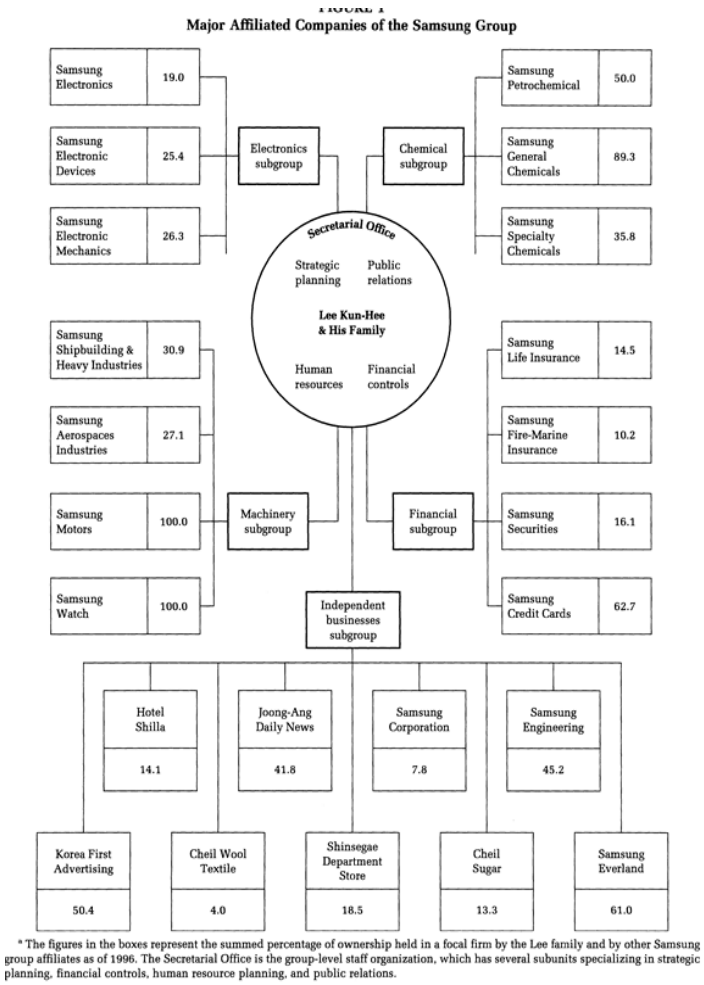
Table 1. Chaebols and their shares within the Korean GDP

		2009	2010	2011
Asset / GDP	20 largest groups	75.3%	78.6%	85.2%
	5 largest groups	46.5%	49.9%	55.7%
Sales/ GDP	20 largest groups	75.3%	78.6%	85.2%
	5 largest groups	46.5%	49.9%	55.7%

(KisLine, 2012)

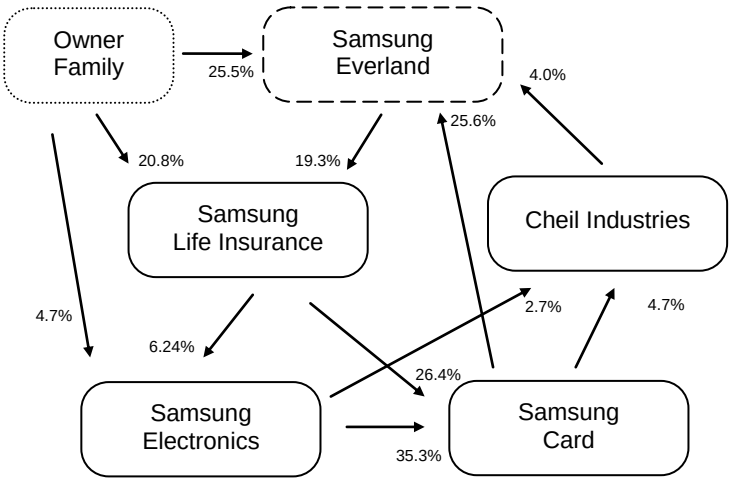
Chaebols, ostensibly run by professional managers responsible for individual firms within the conglomerate, are actually controlled by a single *chongsu*, an unofficial or unappointed general manager who makes the final corporate decisions for the entire syndicate. He acts as supreme blockholder and also as a representative of the owner family. *Chongsu* in Korean literally refers to a general head. As an example, Mr. Lee, *chongsu* of the Samsung *chaebol* (depicted in figure 1), holds a mere 0.57% of the overall group shares, and his family, only 1.07% of the entire group's stocks (see figure 2). He has no formal power position in the group. He is not chairman of the board, nor CEO of any of the main affiliates of the group, yet he exerts control through Samsung's vast cross shareholding.

Figure 1. Samsung's *Chaebol* structure prior to the 1997 crisis



* The figures in the boxes represent the summed percentage of ownership held in a focal firm by the Lee family and by other Samsung group affiliates as of 1996. The Secretarial Office is the group-level staff organization, which has several subunits specializing in strategic planning, financial controls, human resource planning, and public relations.

Figure 2. The *Chongsu* and Cross-Shareholding at Samsung in percentage



Explanation:

The Lee family controls the Samsung group with 1.67% of the overall group shares. This is possible through the cross-shareholding structure of the *chaebol* group. Its main vehicle for corporate control is Everland (an amusement park private firm).

(Depicted structure based on information provided by Kisline, 2012. Data as of October 2012)

Cross-cultural comparisons: Western conglomerates and Japanese *zaibatsus*

In Western countries, a firm becomes a conglomerate through mergers or acquisitions of several enterprises engaged in unrelated lines of business as regards to raw material sources, product development, production technology, or marketing channels. GE, for example, is a common stock traded company in the New York Stock Exchange and operates in different areas of business: aviation, capital, energy, healthcare, home & business solutions, and transportation. The GE board monitors and controls all subordinates. More than two-thirds of their directors are independent under the New York Stock Exchange guidelines[3]. As opposed to *chaebols*, there is no dominant owner or owner family, some room for the autonomy of professional CEOs is allowed, and a strict governance system (the role and responsibility of a board of directors) prevails.

In a completely different setting, ***zaibatsus*** are Japanese business groups that came into being prior to the First World War. After the Second World War, *zaibatsus* were disbanded by the ruling U.S military administration in Japan. *Zaibatsus* then evolved into ***keiretsus,*** affiliations of firms whose CEOs would regularly hold collaborative meetings. The *keiretsu* system consists of bank-dominated industrial groups in which the bank center functions as a capital provider and through which a monitoring function is instituted. *Chaebols* share many characteristics with *keiretsus*, having descended from the same *zaibatsus.* A member firm of a *chaebol* group is called a *kyeyol* (the Korean pronunciation of *keiretsu*). Unlike the *keiretsu* however, the *chaebol* lacks a corresponding external monitoring function. The *kyeyol* firms are placed under the direct control of the group's central planning office, which is in turn controlled by the group's founding family members.

In the Korean regulatory environment, *chaebols* have pursued an alternative to the *keiretsu*'s bank-centered financing system by devising internal market transactions, especially payment guarantees and collateral provisions. Structurally, *chaebols* are also more family-held, hierarchical, centralized, and rely more on government relations than their Japanese counterparts. There is a reason for these differences. Korean *chaebol*s were deliberately created to become champions of a fast growing economy, while the *zaibatsus* grew in response to the need for procurement of military supplies that followed Japanese expansion in the 1930s. Also, in terms of *family ownership*, blood relations are of utmost importance in Korean society, while in Japan, the family *name* carries more weight and thus, an adopted child can become the primary heir. Finally, ownership and management are virtually separate

[3] Source: GE website (accessed October 2012)

and no single family controls the group in the Japanese *keiretsus*, as opposed to the tight family control that characterizes the *chaebol*.

Historical overview: the *chaebol* and its role in the Korean economy

The development of the *chaebol* system sped up during Jung-hee Park's rule (1961-1979), during which preferential treatment was given to certain companies to promote economic growth. Following the pattern established by the all too powerful Ministry of International Trade and Industry in Japan, the new Korean government created its first national champions through the selection of big winners and great performers among the Korean firms and awarding them with exclusive projects, especially in the military and construction industries. It also channeled funds to them through vast array of measures like tax reductions and export subsidies or loans without collaterals and by acting as their credit guarantor.

In the 1980s, *chaebols* grew to become multinational businesses beyond the control of the state which no longer needed state financing and assistance. In fact, they grew to the extent that they had "excessive and redundant industrial capacity", and as their participation in the global market increased, weaknesses in their corporate governance were exposed. The government gradually started increasing regulatory policies[4] over the big conglomerates in order to stymie the harmful effects they were starting to create in the Korean economy. In 1993-1997, under Kim Young-sam's democratic government, a growing anti-*chaebol* campaign emerged. President Kim upgraded the Fair Trade Commission to the ministry level and several *chaebol* chairmen, including Lee Kun Hee of Samsung and Kim Woo Jung of Daewoo, were prosecuted for bribing former presidents.

When the Asian Crisis broke in 1997, the *chaebols* lost the support of the South Korean banking sector, which quickly went bankrupt. The ensuing liquidity difficulties forced the conglomerates to turn to the government for help, which itself in turn had to appeal to the IMF for a $57 billion loan. In August 1999, the Daewoo group was allowed to go bankrupt, clearly signaling that the age of unwavering guarantees and political favors for *chaebols* was over. Nevertheless, the realization that being 'too large to fail' was a fiction did not fully set in among the *chaebol* executives.

Under the scrutiny and assistance of the IMF, the situation started to change. The regulatory framework was strengthened and the business environment became more globalized: the Korean Stock Exchange (KSE) was opened to foreign investors, which led to an increase in direct financing in Korean firms via the stock market while the volume of indirect financing

[4] Among them, the *Monopoly Regulation and Fair Trade Act*, which regulated cross shareholding, excessive loan reliance, and speculative practices made by the *chaebols*

such as bank loans decreased. For the *chaebols*, this led to the rise of a shareholder-oriented management paradigm and shareholder activism. Moreover, government efforts toward the improvement of corporate transparency forced big *chaebol*s to prepare combined financial statements in order to enhance the transparency of the investments and transactions among the affiliated companies therein. The government also revised Korean financial accounting standards to align them with international accounting standards (IAS). Ultimately, Korean firms began to realize the importance of transparency and credibility in raising capital in the markets.

Pitfalls of the *chaebol* system

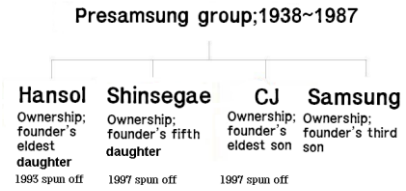
Cross-shareholding, where companies within the same group own each other's shares, is pervasive in the *chaebol* system. As the primary instrument of control exerted by *chongsus* on their *chaebols*, it obstructs the supervision of the group by third parties and presents clear principal-agent problems.

- Due to easy access to domestic bank loans, ***chaebols* tend to overinvest or make dangerous investments**. It has been shown that[5] *chaebol*s have higher market-value-based debt ratios than their non-*chaebol* counterparts, and that[6] they continue to make capital expenditures even in declining industries.
- *Chongsus* are pushed to make **investment diversifications that are not in line with financial rationality**. The reasons for these decisions vary and include: avoiding the *economic* or *political risk* of losing control over the *chaebol* (e.g. making an investment through a brand new firm instead of making use of the existing affiliates, in order to enhance a transfer of power to a heir or relative), increasing the *chongsu's overall image or position* in society and his political influence, facilitating the *succession* of property to his descendants or *accruing managerial power* by creating more firms. The impact of this investment diversification on performance is unclear.
- **Shareholders suffer from internal trading or "tunneling"** among *chaebol* affiliates: in this practice, firms buy products from sister companies even when non-affiliated firms offer better rates. Some point out that *chaebol*s seem to pursue policies emphasizing profit stability rather than profit maximization. Both phenomena have the same consequences: they damage the interests of shareholders of a particular firm by allocating resources or profits to a different company of the group.

[5] Kim & Paul (2009)
[6] Ferris, et al (2003)

- The **most senior positions in the group or affiliates are not filled meritocratically** but through "the tyranny of the owner family". Power is usually passed on to the eldest male son or the favored heir. The split of the Samsung group before the Asian Crisis is a good example of this nepotism - see Figure 3 below.

Figure 3. Separation and expansion of a *chaebol*: The Samsung case



The sociopolitical edge of the *chaebol* system

Since the Park administration, public perception of *chaebols* has moved from passive to increasingly negative, and, particularly since the crisis of the 90s, the public has tended to focus on the preferential status *chaebols* have received from the government and on the widespread corruption. The fall of the Hanbo group revealed the high-level corruption that had granted Hanbo entry into the steel industry and had allowed it to continue expanding despite its problems. Meanwhile, despite its higher manufacturing capability, Hyundai had been consistently denied entry into the same industry. The Hanbo case revealed how large sums of money flowed from big businesses to politicians and top bureaucrats. Ranging from slush funds to illegal donations to presidential candidates, these cash flows were often tied to particular projects in areas such as urban planning and government procurement. The Hanbo scandal was the first clear signal that there had been a fundamental transformation in the state-business relationship in Korea, a path that had paved the way for a particular mode of crony capitalism of which the costs have not been fully understood nor tackled. In recent years, the public image of *chaebol*s has continued to deteriorate under accusations of fraud, corruption, price-fixing schemes and other free competition-damaging practices.

Virtues of the *chaebol* system

Why are *chaebols* still around despite such a long list of maladies? The *chaebol* system has some particular benefits, described below:

- The particular type of leadership developed by the *chongsu* can translate to specific management advantages, especially when **a charismatic leader develops a clear-cut vision** which is then implemented through carefully designed plans.

- Success in political **lobbying**, developing social capital, and raising the support of government and political leaders.
- A high degree of **entrepreneurship** which is economically effective: *chaebols* are aggressive in launching new products, new product lines, buying and merging with existing corporations and entering new domestic and international markets.
- Varied, but very **sound management systems**: some *chongsu*s are autocratic, while others are more group-oriented. Samsung and Hyundai, for example, are vertically organized, while others are more horizontal.
- A tendency **to risk aversion**, which helps to guard the financial health of the group.
- **Agility of decision-making**: *chongsu*s usually lead the CEOs of affiliated firms through regular meetings. All decisions related to CEO successions and large scale investments are discussed there. Furthermore, most *chaebol*s have official or unofficial control towers for the group, so called 'strategy departments' or 'president rooms'[7]. While this practice is forbidden, it is nevertheless prevalent for the majority of *chaebol*s. The head of the 'president room' or 'strategy department' is a kind of family servant who follows the Japanese tradition of having servants working for the *shogun*. Employees in these units are usually promoted to CEO positions in affiliated firms. They are typically regarded as precious human resources in the *chaebol* and are easily promoted.
- **Long-term perspective in management**: blood-related executives tend to behave more responsibly and pursue longer term strategies, as opposed to professional CEOs who are inclined to follow more immediate, short-term goals. It is not strange, then, to see how in 2008, big conglomerates like Toyota in Japan returned to the old strategy of keeping relatives in charge of affiliate companies after some years of professional appointments.
- The **internal capital and labor market *chaebol*s generate for affiliated companies**: mutual assistance, know-how, skilled labor and executives flow throughout the group. All these elements turn *chaebols* into quick movers when settling in developing countries where limited capital and skilled labor is offered, as it minimizes transaction costs through the use of internal markets[8].

[7] For instance, the strategy department of the Samsung group is located within the Samsung Electronics affiliated company, but it oversees the whole group, acting as an internal controller in charge of reporting to the *chongsu*.
[8] On this last point, it is important to see how internal markets in business groups can substitute for or complement the imperfect external markets by distributing scarce resources efficiently among affiliated firms within the same business group, or by decreasing transaction costs between suppliers and purchasers using vertical integration.

Concluding remarks

It is commonly understood that the *chaebol* system has been particularly effective in generating economic development in the form of a non-Western model of state-driven economic growth that presents similarities (and differences) with its East Asian counterparts. In the case of Korea, the reason for the *chaebol*s' success can be found in idiosyncratic elements of economic policy and the institutional and economic development that shaped the country over the last 60 years. To this day, this particular form of corporate governance – which allowed the *chaebol*s to succeed as drivers of wealth creation – remains highly relevant.

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