30th Asian Shadow Financial Regulatory Committee Statement

July 6, 2017 – Seoul

Corporate Governance, Regulation and the Impact of Chaebols on the International Competitiveness of the Korean Economy

The Committee notes the views of OECD and many foreign investors on the outdated Korean corporate governance system and alludes to this getting in the way of making progress for further growth of the Korean economy. Among Asian countries, Korea is ranked very poorly in its corporate governance. In particular the literature and investors cite various side-effects like the collusive ties between businessmen and bureaucrats and politicians, and unfair business transactions and practices, and sub-optimal allocation of corporate resources to keep the controlling Chaebol families in charge despite their small stake-holdings in the groups they control. In Korea, more than 95% of listed firms are controlled by families including the Chaebols, as against 75% in Hong Kong, 70% in European countries and 10% in the United Kingdom. Since the 2008 global financial crisis, guidelines for Korean institutional shareholders as well as institutional investors in advanced markets have been put in place for them to try to exercise their voting rights, including helping to maintain checks and balances between companies and investors and ensure efficient management of corporate capital. Still the system is badly managed and poorly implemented, as documented[1] by Professor Kyung Suh Park of Korea University, a past president of the Korea Corporate Governance Service and a member of this committee, including:

- **inadequate penalties on managerial misconducts;**
- **substantial private benefit of control through related party transactions (RPTs), multiple compensation packages from affiliated companies and appointment of under-qualified family members as senior executives;**
- **tunnelling penalised at the corporate level only;**
- **reluctance of high-paid family members to be executive directors;**
- **poor awareness by investors on shareholder rights.**

The Committee notes these shortcomings have persisted because of the self-serving practices of Chaebols despite the existence of existing laws and regulations.

The Committee acknowledges that Chaebols, Korean family controlled conglomerates, were instrumental in Korea's rapid industrialization and economic growth in the post-war era. However, their activities have since become a constraint, mainly because of the impact of their circular and interlocking ownership structure and non-transparent activities. As a result Korean corporates have under-performed as reflected in the comparative P/E's of ten major economies including the US, Japan, China and Hong Kong, where it was lowest in each of the years from 2011 to 2017.

[1] The Corporate Governance of Korean Firms and Policy Issues; September 2015

The Committee welcomes the initiative on the new coordinated corporate governance system consisting of new legislation, the corporate governance acts for financial companies, the proposed revision of the Commercial Act for all listed companies, and the launching of the new Stewardship Code. To improve and ensure their effectiveness in practice, as already indicated in many academic and investor studies, Korean companies will need to take a number of actions, including the following:

1. **Conduct an independent third-party evaluation of board performance**
2. **Incorporate a policy on board diversity, including board representation to reflect the geographical footprint of their major businesses**
3. **Develop a comprehensive and continuous dialogue between investors, including foreign investors, and independent non-executive directors**
4. **Separate Chairman and CEO positions. Chairman to be independent and non-executive. Where the Chairman is executive, to appoint a strong lead independent non-executive director**
5. **Institute a "comply or explain" rule on a compulsory basis**
6. **Require the audit, nomination and remuneration committees to comprise, where possible, wholly of independent non-executive directors; or the majority being independent non-executive directors**
7. **Regular and timely disclosures and transparency on all corporate matters in accordance with global best-practice, in particular much greater transparency and disclosures in RPTs and M&As, share buy-backs, dividend policies, and individual director and senior management remuneration.**
8. **Effective regulations to mandate the cancellation of treasury shares after buy-backs to avoid risk of conflict of interest and the dilution of minority shareholdings**

The Committee suggests that much more needs to be done to improve corporate governance standards in Korea. In the final analysis, Korean firms, especially the Chaebols, need to step-up their dialogue with regulators, institutional investors, and better organized minority shareholders. The Committee strongly believes that a market-based corporate governance system can function to promote a more innovative and competitive Korean economy. This simply means that the authorities need to ensure that the supervisory and administrative machinery can effectively implement laws and regulations that are transparent and disclosure-based, rather than merit-based which involves the value judgement of bureaucrats.