Breaking South Korea's 'Too Big to Fail' Doctrine

By Edward M. Graham

The U.S., Japanese and European Union chambers of commerce recently feted the South Korean government for improving the treatment of foreign investors. Certainly there is a lot to celebrate. Transparency will undoubtedly improve with the adoption of the EU-developed International Accounting Standards. South Korea is developing class-action shareholder lawsuits against large businesses with accounting irregularities. The government is also leading political parties, the business sector and NGOs to sign a Social Covenant Against Corruption.

But the celebration may be premature. Despite progress in adhering to international business standards, there is reason to ask if South Korea will come through on its promises.

Foreign investors in South Korean companies—no matter the size of their stake, no matter how vocal they are—are still astonished to find that they can be considered passive investors. Recently, the Korean Government put into effect a requirement that foreign investors with stakes of more than 5% in any listed company must announce in advance if they intend to challenge the company's management decisions—an obvious ploy to protect incumbent executives from shareholder challenges. These investors were required to state the source of their funding by the end of the first week of April. Other more draconian requirements have been aired but not yet put into effect.


Roh Moo Hyun

The South Korean antitrust regulator, the Fair Trade Commission (KFTC), gave large conglomerates a one-year grace period before a reform law goes into effect preventing them from making large investments in other firms, including their affiliates. This enables incumbent management of chaebols to issue large blocks of new stock and to sell them to "allies" in the event that foreign or other "minority" shareholders seek management changes, thus diluting the votes of those shareholders. The overall result is that chairmen of many South Korean companies are still free to act by fiat, as though they are majority shareholders, without fear of being outvoted by outside shareholders.

Thus, for example, the SK chairman ousted a cousin from management who had an outstanding performance record and was supported by outside investors. The chairman did it despite being a minority shareholder. The KFTC reports that the chairmen and immediate family members of the leading 10 chaebols wield an average of 49% of the voting rights in their conglomerates, while owning an average of only 4.63% of the group companies. In short, the staying power of the current Roh Moo Hyun government's push for reform of corporate governance is in question.

> ***South Korea's future must look less like SK and Hynix, and more like Hyundai.***

President Roh rode to power with labor backing by campaigning to reform the "chaebols"—conglomerates of often radically dissimilar enterprises in which a single family can dominate the holding company. But international investors are more concerned that chaebols subsidize failure. When one enterprise fails, managers often bolster it with capital transfers from stronger firms within the chaebol. If criticism of this practice arises, chaebol managers often sell shares to friendly interests to buttress their managerial rights and fend off shareholder activism.

This is allowed to happen in large part because South Korea still suffers from the "too big to fail" doctrine. When falling global prices for chips plunged Hynix Semiconductor to the bottom of the red-ink bowl in 2000, government-owned banks led a restructuring of the company's $7.1 billion debt. Hynix stayed afloat despite a continuing string of staggering losses. Despite government claims to the contrary, in the absence of government direction to the banks to bail out Hynix, the firm likely would have been liquidated.

Reform of the financial sector has gone far—but many transactions still lack transparency. When a major firm fails or even totters, a constituency of creditors instantly emerges to urge bailouts or subsidies. South Korea has been slow to learn the central lesson of Japan's painful experience—bailing out failing firms exerts a considerable drag on economic growth.

Eight years after the 1997 financial crisis and the first International Monetary Fund demands for reform, some chaebols are succeeding brilliantly, some are foundering, depending on the extent to which they embrace reform.

At the bright end of the reform spectrum is a surviving firm from the Hyundai chaebol, the now independent Hyundai Motor Car Company. Though still overstaffed, Hyundai is bidding to be among the world's top global automotive companies. What is the Hyundai Motor formula for success? It cut itself loose from the chaebol. Had it stayed in the fold, Hyundai's resources likely would have been used to prop up other members of the group, including the failed Hyundai Engineering and Construction firm and the troubled semiconductor manufacturer, Hynix.

Samsung Electronics is in the middle of the reform spectrum, a good company still bound by chaebol economics. One reason, according to Korean press reports, is fear that the founding family will lose control to foreigners; foreign investors hold more than 50% of the shares of this firm, and rumors abound in Korea that foreigners might seek to relocate its headquarters to the United States.

At the lackluster end of the reform spectrum is Hynix again, the product of the merger of two weak chaebol affiliates, Hyundai Electrical Industries and LG Semiconductor. If one designed a company to produce debt and red ink, Hynix Semiconductor would be a world leader. As noted, it remains in business only because of government pressure on lenders and creditors, over the protests of the EU and the U.S. Congress.

One hears many South Koreans complain that foreign investors are not vocal enough. But in one high-profile case foreign investors were very vocal, only to find their outspokenness the target of the punitive new law on meddling with management. Consider again SK Corp., whose chairman, Chey Tae-won, has faced resignation demands from Dubai-based Sovereign Asset Management group, which owns almost 15%. The nephew of the founder, Mr. Chey was convicted for his role in a 2003 multi-billion-dollar accounting scandal in an oil-trading affiliate, SK Networks. After spending a few months of a multi-year sentence in jail, Mr. Chey is out on bail—and still running the company.

President Roh, a human rights lawyer long hostile to chaebol cronyism, may find the next phase of his reform agenda to be daunting. Now politicians are challenged to squarely face the fact that effective reform will also require some workforce reduction—in short, to take on the very labor unions that are at the core of the current administration's political base. This is an especially difficult challenge for the government because South Korea lacks a social safety net for the unemployed.

Reform is never easy. It must often be forced by crisis. One thing is clear: South Korea's future economy must look less like SK and Hynix, and more like Hyundai.

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