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CEO Pay in Korea: An Intersection of Culture and Corporate Governance?

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“The superior man understands righteousness; the inferior man understands profit.”(Confucius)

I. INTRODUCTION

In the 21st century, corporate governance discourse continues on a global level. Not only in OECD countries like the U.S. and Japan, but also in less developed countries like India and Vietnam, corporate governance still attracts attention from policy makers as well as academics. Despite the diversity of countries involved, issues currently discussed in the context of corporate governance largely overlap, including outside directors, shareholder litigation, institutional investors and auditor independence. Local discrepancy does exist, however. A prime example may be executive compensation, CEO pay in particular.

CEO pay has always been an interesting topic, in the business community at least. In recent years, however, it has become a subject of serious academic research. CEO pay is being discussed not only in the U.S., but also in European countries like the U.K. and Germany. In these countries, CEO pay is becoming a hot topic because it is believed to be excessive and is being discussed from the perspective of how to restrain its unjustified increase.

CEO pay is not yet an issue in Korea, however. This may strike as a little odd given the relatively advanced state of Korean economy and the progress Korea has achieved in corporate governance since the economic crisis in 1997. Since the crisis, Korea has faithfully adopted many recipes prescribed for good corporate governance, including, among other things, outside directors, an audit committee, auditor independence and shareholder suits. It is not only the law that has been changed. Hostile takeovers and proxy fights are no longer entirely foreign terms, at least to those reading business papers. In a growing number of listed firms, outside directors are raising their voice in

the boardroom. Yet, CEO pay is rarely discussed even among corporate governance experts.

Korea's relative nonchalance to CEO pay may be primarily because it still remains minuscule. Unfortunately, we cannot find reliable statistics on CEO pay in Korea. It is widely believed, however, that Korean CEOs are not as nearly as well paid as their counterparts in the U.S. or the U.K. Let me just cite an anecdotal evidence here. Until quite recently, the CEO of a leading telecommunication firm with the sales of US\$12 billion, was paid slightly over US\$100,000. The firm's head of the IR department once confessed to me that they had hard time justifying this modest salary of their boss to institutional investors in New York. Since the company was completely privatized in 2003, the CEO compensation has been raised substantially, but still does not exceed US\$400,000 (base pay), which is even less than the half of what the company paid an actress for her role in the company advertisement in 2005.

Why does this difference in CEO pay exist (or persist)? This is the topic I want to discuss in this paper. This paper will focus on CEO pay in Korea. Although executive compensation in general has interesting aspects, the paper will deal only with CEO pay. Many elements may affect the level of CEO pay, and they may vary country to country. Regarding CEO pay, I believe culture does matter. I think, however, that corporate governance has more to do with the low level of CEO pay in Korea.

The paper proceeds as follows. Part II briefly describes the state of CEO pay in Korea. Despite the lack of comprehensive information on CEO pay, publicly available evidence all confirms that CEO pay is not substantial in Korea. Then, the question is why it is so low? This paper examines two possible reasons. First, this paper attempts a cultural explanation. Korean society is known to be still under strong influence of Confucianism. It is thus tempting to argue that the Confucian legacy affects the way Koreans think about monetary matters. Part III will deal with the role of Confucianism in determining CEO pay. Although it may be hard to deny the influence of Korea's Confucian culture, culture alone does not fully explain the current state of CEO pay. I believe Korea's corporate governance may be a more significant factor affecting the current level of CEO pay. Part IV will examine two of these factors closely related to Korea's corporate governance, i.e., existence of controlling shareholders and lack of the managerial labor market.

II. State of CEO Pay in Korea

1. Theory

Under the general corporate finance theory, CEO pay will be determined as a result of negotiation between the CEO on the one hand and the board of directors on the other. In negotiating with the CEO on this matter, the board is supposed to have the shareholder interest in mind. CEO pay is important not only because it may potentially become a significant expense item, but also (and more importantly) because if properly designed it may align the interests of the CEO and the shareholders, reducing agency costs. If this negotiation process functions properly, the CEO pay will be set at a level commensurate with her role in advancing the shareholder interest.

In the U.S. (and a growing number of countries), the level of CEO pay is regarded as too high, meaning CEO are paid more than their worth. This suggests that the pay setting process does not work as well as expected. Scholars and policy makers are discussing as to how to cure this defect. Some point out that the board does not play its supposed role well primarily because outside directors (many of them CEOs themselves) are too sympathetic to the interest of management. They suggest that the shareholders be given a greater voice in the corporate decision-making process including the CEO pay decision. Others argue that more disclosure be required to make CEO pay subject to more pressure from the capital market.

2. Low CEO Pay in Korea

Unlike in the U.S., where the CEO pay is determined by the board, CEO pay in Korea is already subject to the pressure from the shareholders. Under Korean law, compensation of directors (which include the CEO) is to be determined at the general shareholders meeting (GSM). It is the general practice, however, that the GSM determines only the maximum amount of compensation available to the directors as a whole, and the actual allocation decision is delegated to the board, and in many cases, the CEO himself in effect. Although the maximum compensation figure is disclosed to the shareholders, how it is actually distributed among the directors is not. It is thus difficult to collect data on CEO pay in Korea. Various kinds of information all confirm that CEO pay remains quite modest. First, Table 1 shows the CEO pay of several listed firms that happen to disclose their CEO pay in the annual report. Table 1 shows that the CEO pay of a company is not proportionately related to the size of assets or sales. For example, although Kumho Industrial is more than 100 times as large as Coco Enterprise in terms of assets and sales, the CEO pay of Kumho Industrial is only about 4.5 times as high as that of Coco Enterprise.

[Table 1] Annual Salary of CEOs of Listed Firms (2004)

Source: Annual Reports (2005)

Second, Table 2 shows the CEO pay of two of the largest listed firms in Korea. Firm A is a telecommunication firm with the sales of US\$ 12 billion, while Firm B is a chemical company with the sales of US\$. 7 billion. According to Table 2, although on the increase since 2000, the CEO pay still remains well below US\$1 million. The situation is not particularly different in other large firms in Korea. The CEO pay in most firms is believed to be lower than the income of professionals such as top-notch lawyers and accountants.

[Table 2]

There is a notable exception, however. Samsung Electronics, a world-class producer of semi-conductor chips and cell phones and the flagship company of the Samsung Group, is now famous for its generous executive pay policy. Its pay is known to be competitive globally. In 2005, total pay for directors is ???, ??? per each. This is almost 10 times as much as the market rate in Korea. This does not include stock options. When the value of their stock options reached multi-million dollars, the news generated a great surprise and envy in the business community. Other large firms felt a strong pressure to raise their executive compensation. I will turn to the stock option issue later.

No one disputes that Samsung Electronics is an outlier. People just wonder why Samsung has adopted such a generous executive pay policy.

3. Low Interest in the CEO Pay

CEO pay as mentioned earlier is not yet an issue in Korea. The topic is rarely discussed even in the media, not to speak of academic literature. It may be partly due to the fact that CEO pay is not significantly large in Korea. One does not observe, however, virtually no sign of complaint among professional managers. Although the controlling shareholders are prevented from receiving any stock option from their companies, they do not appear particularly dissatisfied.

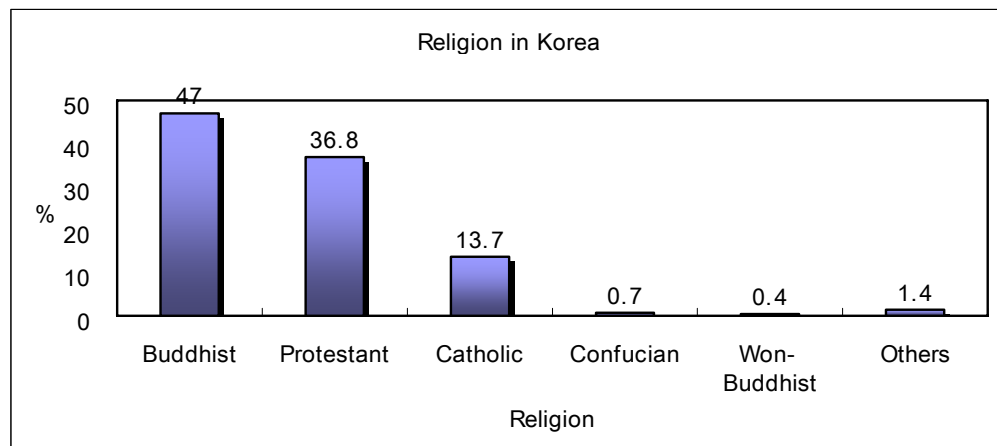
One may wonder why CEO pay remains relatively low in Korea and why it does not attract much attention. This is the issue to be examined in the next two parts.

III. CULTURE: CONFUCIAN LEGACY?

Culture may play a significant role in determining people's perception of money, and thus the level of CEO pay. A country's culture is composed of many elements, and so is Korea's culture. Compared with other industrialized nations (even with fellow Asian countries), a Confucian legacy is more conspicuous in Korea. It is thus tempting to say that Confucianism leads to the low level of CEO pay in Korea.

Table X shows the distribution of Korean population by religion. The table shows that a majority of Koreans are either Christians or Buddhists, and that Confucianism accounts for mere 0.7 percent of the population. One should note, however, that this low figure does not necessarily mean a weak influence of Confucianism. Unlike a full-fledged religion, Confucianism does not recognize God or life after death. Emphasizing various human relationships and values to be pursued in daily life, Confucianism is more like a way of life. Thus Confucianism does not necessarily conflict with other religions. Many of those who go to church or temple try to follow in everyday life what Confucius taught more than twenty-five centuries ago.

[Table 3] Religion in Korea



Confucianism is composed of diverse elements and has many schools. Generally speaking, it takes for granted human relationships such as those between the king and the subjects, the parents and the children, the teacher and the students, and the husband and the wife. While respecting existing hierarchies among human beings, Confucianism

emphasizes moral obligations of those who enjoy a superior position in these human relationships.

In the Confucian tradition, business activities do not enjoy a high status. Indeed, of the four traditional occupations (learned men, farmers, artisans and merchants), merchants were listed at the bottom level. In the books of Confucianism, pecuniary matters were largely ignored or despised. Confucius himself was known to be relatively silent as to profits. Like Confucius, a proper *yangban*, an upper class man of old Korea, was not supposed to touch and even talk about money. In the Yi dynasty, when a *yangban* has to enter into a transaction, it was customary to let one of his servants execute it on his behalf. Only appropriate occupations for a *yangban* were government service or farming. For a *yangban*, working for someone else for a salary was a foreign idea. To negotiate a salary before he takes up a job was even more foreign to him. Doing something for an incentive was regarded as vulgar.

During the last century, Korean society has undergone a transformation in many respects. The Confucianism has lost much of its grip on Korean people. Descendents of the *yangban* class are now roaming about the world, selling everything from TVs to cars. Growing up under Confucian influence, a Korean CEO may be still bound its core lessons. One must not overestimate this influence, however.

Admonition against money is not limited to the Confucianism alone. It is easy to find such examples in the Bible. One of the most famous passages in the Bible may be: "Then Jesus said to his disciples, I tell you the truth, it is hard for a rich man to enter the kingdom of heaven. Again I tell you, it is easier for a camel to go through the eye of a needle than for a rich man to enter the kingdom of God."(Matthew 19:23-24) One of the principal teachings of the Buddhism is to give up on all kinds of attachment. A monetary pursuit does not go well with this teaching.

Confucian influence may provide a partial answer to our question about CEO pay. But corporate governance seems to play a bigger role in this matter.

IV. CORPORATE GOVERNANCE

1. CEO Pay and Corporate Governance

As Coffee forcefully demonstrates, difference in the ownership structure results in difference in the kind of scandals. In a country with dispersed share ownership, a corporate scandal typically involves an accounting fraud. On the other hand, in a

company with the controlling shareholder, the controlling shareholder's attempt to extract a private benefit of control(PBC) often leads to a major scandal.

This difference in share ownership structure may engender yet another by-product. The existence of controlling shareholders may affect CEO pay in two different respects. First, the owner-manager may feel less need to insist on a large salary especially if he enjoys a huge private benefit of control. Second, the existence of controlling shareholder may serve as a negative factor in developing the managerial labor market in Korea.

2. Controlling Shareholders and the Private Benefit of Control

A. Private Benefit of Control

Except for a small number of banks and former government-owned firms, even the largest firms in Korea are managed, or closely monitored at least, by the controlling shareholder. The controlling shareholder is widely believed to enjoy a substantial PBC. A PBC may arise from various sources. The controlling shareholder may receive a kickback from those who deal with the firm under his control. Or, as is disclosed in a recent business scandal, he may have his son (or son-in-law) establish a firm and allow it to deal with the firms under his control on unduly favorable terms.

Information on the PBC is kept secret and not available to those other than his most trusted subordinates. Although no one knows the size of the PBC, it is believed to be substantial. It is then not surprising that the controlling shareholder is less keen on the amount of his official pay. One may then presume that in a country the higher the level of PBCs, the smaller the amount of (and the level of interest in) CEO pay. The most powerful example that illustrates the interchangeability of CEO pay and the PBC may be a recent scandal involving one of the oldest business dynasties in Korea. In this case, the controlling family is found to manage a family slush fund with kickbacks from their trade partners. The fund has been distributing monthly a set amount to each member of the family just like an informal monthly pay.

By definition, the controlling shareholder can take advantage of this PBC only as long as he exercises his control. In most firms in Korea, controlling shareholders are somehow involved in management. Even when he is involved in daily operation, it is not easy for the controlling shareholder to extract money from his companies without assistance of a few trusted employees. In selecting top managers, the controlling

shareholder thus tends to place as much emphasis on loyalty as on competence. This makes lateral hiring of executives more difficult.

B. Monitoring by the Controlling Shareholder

In a growing number of larger firms, it is customary for the controlling shareholder, often called the chairman, to delegate daily operation to his trusted subordinates. On important issues at least, most of these senior managers are known to seek approval from the controlling shareholder. In this sense, they are not really CEOs in the real sense of the word. The performance of a firm may then be more dependent on the chairman than on his professional managers. It is thus not surprising that the chairman does not want to pay much to his managers.

C. Firms under Professional Managers

If the existence of the controlling shareholder is an obstacle to a higher pay, managers in a firm with dispersed ownership should be paid more. Now, Korea has a small number of large firms under professional managers. They include POSCO (one of the largest steel manufacturers in the world), KT (leading telecom firm) and KB (the largest commercial bank in Korea). Most of these firms are former government-owned firms that have been privatized after the economic crisis.

Although comprehensive data are not available, it is generally believed that the CEO pay in these firms is not particularly high compared with the CEO pay in *chaebol* (family-controlled conglomerate) firms under the control of the controlling shareholder. Relatively speaking, bank CEOs are better paid. But it may be due to the fact that the CEO pay in the financial sector is higher than in the industrial sector.

It is not clear why the CEO pay in these firms with dispersed ownership is as low as in *chaebol* firms. Is it because CEOs of such firms also enjoy a private benefit of control? Probably not. Although not entirely impossible, it may be far more difficult for CEOs of such firms to get away with ill-gotten gains. Unlike controlling shareholders, CEOs enjoy far less power. First of all, the reign of each CEO is shorter on average. While controlling shareholders remain in power unless and until the firm goes bankrupt, CEOs normally serve only one or two 3 year terms. Second, it is also difficult for a CEO of such firm to keep his abuse of power secret for long. There is a long line of people in and outside the company coveting the top job. Any kind of CEO corruption can be taken advantage of by these potential competitors.

What is more persuasive in explaining the low CEO pay of former government-owned firms may be outside pressure. When these firms were under the government control, the pay of CEOs, who were regarded as quasi public servants, was kept low. After these firms were privatized, they are free, in theory, to raise the pay level as high as they would like. Indeed, these firms have been increasing the CEO pay since the privatization in general. These firms are faced with obstacles, however. First, the CEO pay raise in such firms is frowned upon by the government as well as the general public. The privatization of these firms was not without controversy. The government does not want to let the general public realize that one of the first changes emerging in these firms after the privatization is pay raise. Although the government does not own any share in these firms, their view still counts as they have so many means to make the CEO's life hard.

Another big obstacle is pressure from employees. In most such firms, one of the most pressing challenges of the CEO is to cut labor costs, especially by massive layoff. It would take an enormous amount of courage for the CEO to raise his own compensation while firing his employees. In order not to invite labor unrest by further antagonizing the employees, the CEO may give up on pay raise.

These obstacles, however, will not stay forever. As time passes, these firms feel less inhibited in setting the level of CEO pay. In the long term, the CEO pay in these firms may be more influenced by the market.

3. Absence of a Market for Professional Managers

In theory, one's pay should be set in such a way to compensate for her opportunity costs. If the CEO enjoys other job opportunities, the company should pay her a higher pay to compensate for these lost opportunities. In Korea, however, the CEO market is still very weak, if not totally absent. In *chaebol* firms, which account for most of the larger firms in Korea, it is still rare to recruit a CEO from outside. For the controlling shareholder selecting his CEO, loyalty is high on the list of criteria. As his CEO is supposed to undertake all sorts of sensitive tasks for him, an outsider may not be as comfortable as his long-time subordinate.

It is not necessarily easy to find competent professional managers of leadership caliber. In the presence of the interventionist controlling shareholder at the top, professional managers have less opportunities to make significant management decisions on their own and to develop leadership qualities.

If the CEO has an option to start his own business, it may functionally serve as a kind of the managerial labor market. First of all, it is difficult to secure funds for a start-up firm. Running a small- and medium-sized firm is tough as most of the business sectors are heavily dominated by *chaebol* firms. Not many former CEOs have succeeded in their new role of owner-manager.

One may have mixed feelings for professional managers in Korea. They certainly are the ones who have benefited most from the phenomenal success of Korean economy. They are lucky to go all the way up to the top of the firm's hierarchy. During the last twenty to thirty years, the companies they started working for have grown into major players in the international marketplace. In terms of personal wealth, professional managers are not as fortunate as their firms. Although they could reach their status through a tough competition, they could remain on the job not for long. Most of them must leave in their mid-50s, unless they could make CEO. Although these select few certainly belong to the upper class, they cannot achieve significant wealth with their pay alone.

IV. CHANGES: STOCK OPTION

Like many other things in Korea, the CEO pay is also changing. As mentioned earlier, in a small number of large firms, the CEO pay has been on the rise since the economic crisis. Perhaps the most conspicuous change in this regard is the spread of stock options. Stock option was first allowed in the late 90s. As of 2002, 118 out of 675 listed firms have stock options available for their managers and employees. Table 4 provides statistics on the use of stock options.

[Table 4] To be provided later.

Table 4 shows the use of stock option exploded in 1999 and 2000. More than 80% of the stock options were granted during these two years. It is during this period that Korea had its own dot.com boom. The KOSPI index rose from 587.57 (January 1999) to 1059.04 (January 2000). Primarily with a carrot of stock options, start up firms could attract for the first time in history many young talents, even from *chaebol* firms. To stem the exodus of their core employees, the controlling shareholders of established firms had to grant stock option to their employees. Samsung Electronics, the flagship company of the Samsung group, was a prime example. Stock options became common in the financial sector.

Stock options brought sudden wealth for many people. In Samsung Electronics, many top executives earned tens of million dollars, which was unheard of for professional managers. For example, Vice-Chairman Yoon of Samsung Electronics made more than US\$ 14 million, in 2005 alone, by exercising a part of his stock options. This caused an enormous amount of envy in the business community. Other firms had to follow suit.

Stock options may produce not only envy but also hostility. President Kim of Kookmin Bank, who was smart enough to receive all his compensation in stock options, could later earn more than US\$ 10 million from his stock options. To placate the rising criticism from the general public and the government, he had to donate half of his gain for philanthropy. There is yet another example showing public unease against stock option. The board of Woori Bank, a bank saved by the injection of public funds, decided to grant to Chairman Hwang a stock option of [??] shares, which was later found to be excessive from the government's perspective. Although Chairman Hwang had to give up the lucrative CEO position at Samsung Securities, an affiliate of the Samsung group, to rescue the troubled government-owned bank, this was heavily criticized by the media as a greedy attempt to pursue a private interest with tax money. As the government disclosed its resolve to oppose this stock option proposal at the general shareholders meeting, Chairman Hwang 'volunteered' to give up on all his stock options.

The expansion of stock options and controversies regarding a sudden, unjustified wealth led a backlash against stock options. In 2005, the law was changed to make the general shareholders meeting, not the board, decide on the stock option proposal. About the same time, the Samsung group announced its new policy to exclude stock options from its compensation package.

V. TOPICS FOR FUTURE EMPIRICAL RESEARCH

The lack of interest in the CEO pay has resulted in the lack of empirical research. It seems that there is much room for empirical research in this field. Potential topics for research include:

- Whether or not the level of CEO pay rise as the country's corporate law is strengthened to restrain the private benefit of control?
- Whether or not the level of CEO pay is higher in firms without the controlling shareholder?

-Whether or not the more developed the market for managers becomes, the higher becomes the CEO pay?

-Whether or not the higher the portion of foreign shareholders, the higher the percentage of stock options in the CEO pay package?

-Is the CEO pay on the increase in Korea? If yes, what are the reasons for such increase?

VI. CONCLUDING REMARK

The CEO pay is an issue which may potentially be related to culture. A Confucian legacy may have something to do with the level of CEO pay in Korea. It seems, however, that the status of corporate governance is more relevant on the level of CEO pay. In Korea, the existence of the controlling shareholder is believed to be a significant element restraining the CEO pay. If the controlling shareholder disappears or if his private benefit of control shrinks with the reform of corporate law, the CEO pay may rise. If the CEO pay still does not go up, we will then have to seek other explanations. Then we may have to conclude that the legacy of Confucianism is stronger than expected.