View metadata, citation and similar papers at core.ac.uk

brought to you by CORE

provided by K-Developedia(KDI School) Repository

Korea's Economy 2008

Korea's Economic Achievements and Prospects

The Graying of Korea: Addressing the Challenges of Aging

Financial Asia Rising: Asian Stock Markets in the New Millenium

Korea's Money Market

Ingredients for a Well-functioning Capital Market

The Capital Market Consolidation Act and the Korean Financial Market

Progress in Corporate Governance

Tax Issues Affecting Foreign Invested Companies and Foreign Investors

U.S.-Korea Economic Relations: View from Seoul

U.S.-Korea Economic Relations: A Washington Perspective

Peering into the Future: Korea's Response to the New Trading Landscape

North Korea's External Resources and Constraints

The Roles of China and South Korea in North Korean Economic Change

Realistic Expectations of the Future Role of the IFIs on the Peninsula

a publication of the Korea Economic Institute and the Korea Institute for International Economic Policy

Volume 24

CONTENTS

Part I: Overview and Macroeconomic Issues

Korea's Economic Achievements and Prospects
Pyo Hak-kil 1

The Graying of Korea: Addressing the Challenges of Aging
Jerald Schiff and Murtaza Syed 7

Part II: Financial Institutions and Markets

Financial Asia Rising: Asian Stock Markets in the New Millennium
Karim Pakravan 15

Korea's Money Market
Dominique Dwor-Frécaut 21

Ingredients for a Well-Functioning Capital Market
John Burger, *Francis Warnock*,
Veronica Cacdac Warnock 31

The Capital Market Consolidation Act and the Korean Financial Market
Kim Dong-hwan 39

Part III: Structural Reform

Progress in Corporate Governance
Stijn Claessens 45

Tax Issues Affecting Foreign-Invested Companies and Foreign Investors
Henry An and David Jin-Young Lee 54

Part IV: External Issues

U.S.-Korea Economic Relations:
View from Seoul
Han Dongman 61

A Washington Perspective
Jordan Heiber 69

Peering into the Future: Korea's Response to the New Trading Landscape
Troy Stangarone 74

Part V: North Korea's Economic Development and External Relations

North Korea's External Resources and Constraints
Stephan Haggard and *Marcus Noland* 83

The Roles of China and South Korea in North Korean Economic Change
Mika Marumoto 92

Realistic Expectations of the Future Role of the IFIs on the Korean Peninsula
Bradley Babson 106

THE CAPITAL MARKET CONSOLIDATION ACT AND THE KOREAN FINANCIAL MARKET

By Kim Dong-hwan

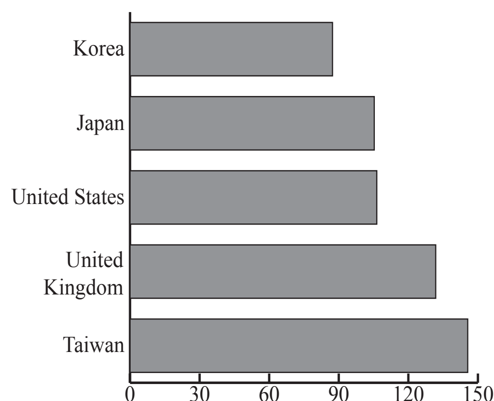
Background of the Legislation

After the Asian financial crisis of 1997, the Korean government geared up to carry out financial restructuring. As a result, the number of domestic financial institutions stood at almost half the number before 1997, but their asset size, soundness, and profitability were greatly improved. For example, the total assets of banks had increased to 1,400 trillion *won* by the end of 2006, a remarkable upgrade compared with 600 trillion *won* in 1997. In spite of the massive financial restructuring, however, the Korean financial industry is still weak in such areas as profit structure, business models, efficiency, and productivity. This is especially true for various financial institutions related to the capital market—that is, financial investment companies (FICs)—that have yet to be fully developed. By contrast, banks have played a significant role in creating a market for the private placement of debts and in the derivatives markets.

The domestic capital market has failed to grow at a rate commensurate with the pace and size of the real economy in Korea, a fact that can be easily ascertained by comparing the growth of the capital market with the extent to which other major countries have deepened their capital markets (***Figure 1***). For example, the ratio of market capitalization over GDP reached just 87.3 percent in 2005, as the domestic equity market was unable to play a significant role in economic development. By contrast, the market capitalization ratios of developed countries such as Japan, the United States, the United Kingdom, and Taiwan all exceeded 100 percent.

Corporate financing through capital markets also continues to shrink; the amounts of financing through equities and corporate bonds have decreased to 7 trillion *won* and 48 trillion *won,* respectively—almost half the levels of five or six years ago. Moreover, domestic FICs are far less developed than domestic commercial banks in their business size, restructuring performance, and profitability. For example, return on equity (ROE) of commercial banks was 19.6 percent in the middle of 2005 (***Figure 2***), which is greater than that of securities companies and asset management companies by 12.5 percent and 14.1 percent, respectively.

Figure 1: **Equity Markets in Selected Countries, 2005 (market capitalization/GDP, percentage)**

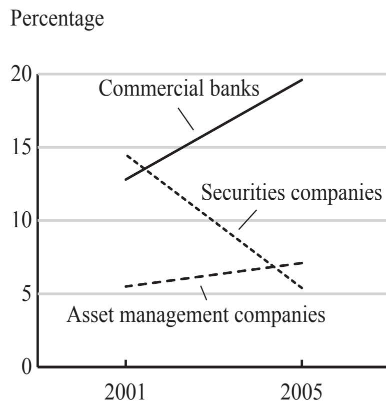


Source: Financial Investment Services and Capital Markets Act (Seoul: Ministry of Finance and Economy, 2007), www.mofe.go.kr/.

There are also some deficiencies in the existing financial regulatory regimes for FICs. For example, different regulations are applied to the same function, such as financial investment services (FISs) and financial investment products (FIPs), when carried out by different types of financial institutions. FICs cannot supply FISs and FIPs freely if they are not specifically enumerated in the law. And the existing financial regimes are not equipped with sufficient measures to protect investors from the misfeasance of FICs.

For these reasons, the Capital Market Consolidation Act (CMCA), that is, the Financial Investment Services and Capital Markets Act, was promulgated on 3 August 2007, and is scheduled to enter into effect in February 2009. This law will integrate the existing 14 financial business laws, such as the Securities and Exchange Act, the Futures Trading Act, and the Trust Business Act, into one.

Figure 2: **Profitability by Financial Services Sector in South Korea (Return on Equity), 2001 and 2005, percentage**



Source: Financial Investment Services and Capital Markets Act (Seoul: Ministry of Finance and Economy, 2007), www.mofe.go.kr/.

Major Changes Made by the CMCA

The CMCA aims to:

- Comprehensively define the concept of FIPs by integrating the existing laws concerned,
- Allow FICs to operate more than two FISs,
- Take proper measures to protect investors,
- Strengthen regulations on unfair transactions in the capital market,
- Raise the competitiveness of FICs through specialization and extension, and
- Improve and maintain the institutional groundwork for facilitating the capital market as well as for developing the financial industry.

Generally speaking, the purposes of the CMCA are twofold. One is to improve the efficiency of the domestic capital market through improvements in the regulatory regime that promote not only innovation of FIPs and FISs but also competition among FICs. The other is to enhance the reliability of the capital market by protecting investors from misfeasance or negligence on the part of FICs, enhancing the transparency of FICs' internal decision-making process, and strengthening the rights of shareholders. In short, the CMCA is intended to further upgrade the domestic capital market, which means the creation of a capital market "big bang" in Korea. The CMCA is expected to bring about four major changes.

Shift to a Functional Regulatory Regime

The existing institutional regulatory regime will be changed into a functional one by adopting a "same regulation for the same function" approach; that is, the same regulation will be applied to the same financial function without regard to the type of FICs that are running FISs and providing FIPs. First, various sorts of FISs stipulated in the existing 14 kinds of financial business laws will be classified into six categories of financial businesses according to their economic nature, which includes dealing, arranging deals, management of collective investment assets, discretionary and nondiscretionary investment advisory services, and trust services.

Prudential regulations, such as those specifying capital adequacy and restrictions on transactions with major shareholders, will be streamlined and applied to all FICs. And general regulations such as duty of good faith, prohibition of loss compensation, and the KYC (know-your-customer) rule will be applicable to all FISs. At the same time, individual regulations will be formulated by taking into account the unique nature of each FIS; for example, dealers should not make self-contracts, and discretionary and nondiscretionary investment advisory firms should not make loans.

Introduction of a Comprehensive System

The existing positive-list regulatory regime will be revised into a negative-list, or comprehensive system, with a broad-based definition of FIPs. Until now, FICs could deal only in legally enumerated securities and derivatives, which are the only ones that enjoy investment protection. For example, there are 21 items of eligible securities, including government bonds, municipal bonds, special bonds, corporate bonds, stocks, investment certificates, beneficiary certificates, mortgage-backed securities, equity linked warrants, and equity-linked securities. But the CMCA will rewrite the definition of FIPs to encompass all kinds of securities and derivatives having investment value.

That is, every financial product will be classified as a FIP or non-FIP according to the possibility of loss on the invested principal; non-FIPs such as deposits do not entail the possibility of principal loss. FIPs will be reclassified into general financial products such as securities and risky financial products such as derivatives, according to the possibility of loss exceeding principal. Securities are defined as financial products with a risk of losing the invested principal, and derivatives are defined as investment products with the risk of incurring liabilities in addition to loss of the invested principal. Derivatives will be classified into exchange-traded and over-the-counter (OTC) derivatives according to the trading channel, such as a stock exchange. Hence securities, OTC derivatives, and exchange-traded derivatives are included in the revised concept of FIPs.

The scope of underlying assets of derivatives and securitized derivatives will also be broadened in order to encompass all FIPs and other natural, environmental, and economic risks in addition to the existing underlying assets such as currencies, commodities, and credit risk.

Expansion of Business Scope

The CMCA will allow FICs to conduct all six FISs under one roof by eliminating the business functions that have been strictly separated among different FISs. At the same time, the CMCA will establish a Chinese wall between these six FISs in order to prevent conflicts of interest caused by concurrent execution of FISs. Sales networks will be expanded by applying an "introducing broker" system that allows brokers to sell FIPs entrusted by FICs; this system offers investors a variety of channels to FIPs, and brokers will solicit investment by connecting investors and FICs.

The scope of asset management services will also be diversified by expanding collective investment scheme (CIS) vehicles and CIS-managed assets. In addition to existing forms such as investment trusts and limited companies and partnerships by private offerings, CIS vehicles will be expanded to the extent permitted under the civil or commercial codes: limited liability companies and limited partnerships by public offering, anonymous partnerships, and general partnerships. The scope of CIS-managed assets will be expanded from assets such as securities, futures, real estate, tangible property, commercial paper, insurance claims, and fishing and mining rights to include assets with any investment value, such as intellectual property rights. The CMCA will also allow FICs to offer retail payment services and registered foreign exchange transactions.

As the scope of business is expanded, the regulation will be stricter; for example, the process of application for authorization and registration will become rigorous, especially when FISs and FIPs are risky and clients are not professional investors.

Upgrading the Investor Protection Mechanism

The CMCA will upgrade the investor protection function by eliminating loopholes in the existing investor protection provisions and by institutionalizing investor protection regimes in line with global standards. The CMCA will introduce a regulation on investment solicitation, under which FICs are obligated to provide investors with detailed explanations of the underlying risks of FIPs when they are soliciting investment. FICs will be held liable for losses and damages incurred by investors in the event of noncompliance with the provided guidance. The CMCA will introduce the KYC rule: prior to solicitation, FICs should interview and profile potential investors to obtain information such as their net worth, the purpose of their investment, and their investment experience.

Investors are divided into two groups—professional and nonprofessional investors—depending on their financial capacities to take on investment risks. A principle of suitability will be applied to the nonprofessional investors who are relatively weak in risk taking and hedging; FICs will be obligated to protect investors, offer investments tailored to investor profiles, and act in good faith and provide thorough explanations about the investments. For professional investors, the protections will be less stringent. Investment solicitation through real-time methods like visitation and phone calls will be permitted only when investors authorize it because unsolicited calls or unwanted solicitation may infringe on the privacy of potential investors.

FICs should establish a system to prevent conflicts of interest, which are defined as actions that pursue the interests of FICs or other investors at the expense of the interests of certain investors. To prevent conflicts

of interest, FICs are obliged to set up internal controls to disclose any conflict of interest to investors and to create separate organizations or prohibit employees from holding more than one position if serious conflicts of interest are deemed to exist.

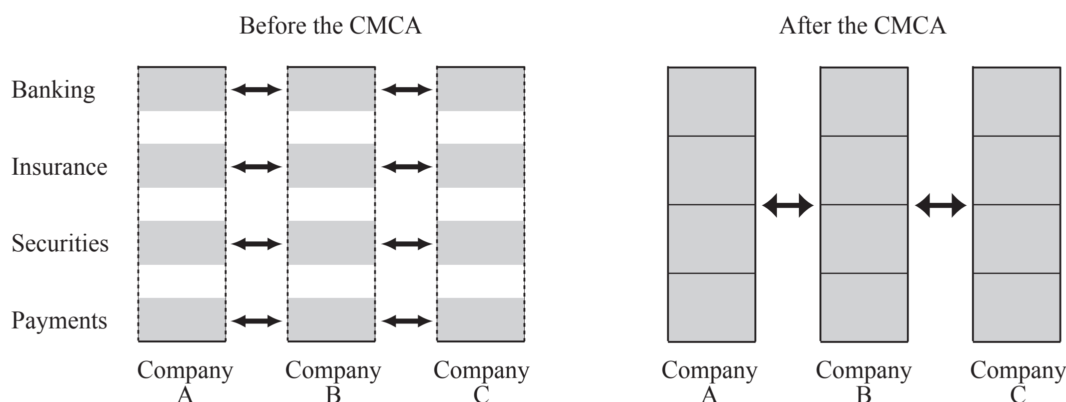
Influence of the CMCA

The CMCA is expected to expedite a convergence and consolidation of FICs, during which advanced investment banks (IBs) or a few securities-oriented financial groups with global competitiveness are expected to appear and realize economies of scope and scale in the capital market. A single FIC will be able to create synergy from service integration and strengthen competitiveness by offering a multitude of FIPs because it can conduct all IB business and expand opportunities by sharing customer information from each respective business under one roof. For example, corporate financing activity such as arranging mergers and acquisitions can be carried out more efficiently and generate higher profits if the firm can invest some of its own funds or funds raised from its asset management business.

Of course, banks and insurance companies would not remain idle spectators. They would seek to acquire FICs, such as securities or asset management companies, as cash cows that would be expected to improve their growth and profitability via revenue diversification and business magnification. During this process, a few bank-oriented financial groups and insurance-oriented financial groups are expected to appear in order to occupy the "blue ocean"—i.e., the FISs created by the CMCA. These kinds of financial groups would also try to set up business models in line with advanced IBs and become leading competitors in the domestic capital market. At the same time, a cluster of small and medium-size commercial banks, insurance companies, and FICs could then emerge, through cross-shareholding or in the weaker form of a strategic alliance, and pursue the leaders by competing and cooperating with each other. Foreign capital will penetrate the domestic market and merge with FICs that are allowed to offer various financial services, including retail payment services.

There are expected to be structural changes in financial market competition. The existing fragmented market competition will evolve into an integrated one (see ***Figure 3***) that would accelerate competition between different types of firms such as banking vs. commerce and domestic vs. foreign. Competitive integration between banks and securities companies, insurance and asset management companies, and securities and asset management companies would both deepen and widen the domestic capital market. Competition for niche markets would also heat up because the CMCA would stimulate revision of the existing positive-list regulations, including the Bank Law and the Insurance Business Law, into negative-list and functional regulations under which every financial institution

Figure 3: **Structural Changes in Competition in Korea, before and after the Capital Market Consolidation Act (CMCA)**



Source: Author's concept, 2006.

would enter niche markets in pursuit of profit opportunities, regardless of size and business area, FIC, or non-FIC.

The influence of institutional investors would increase as FICs become bigger and focus their business on underwriting, even if their business models are currently concentrated on brokerage. Equity and bond markets would flourish as FICs reinforce their financial intermediary functions through developing and offering a variety of custom direct and indirect FIPs. Deregulation of CIS vehicles and private equity funds would also reinforce the financial intermediary functions of FICs, which would help foster many innovative small- and medium-size firms and venture businesses. The asset-backed securities and derivatives markets would flourish as demand for derivatives and securitized derivatives increase in order to meet the demands for risk taking and hedging.

The influence of the CMCA on financial consumers would be positive because the investment products and channels would be more diverse and consumers would recognize the risk of their investments. However, financial consumers and FICs might be involved in legal disputes if the positive effects of diversification are offset by insufficient or misleading explanations about investment responsibility or risk. Despite the negative effects, the weight of equity among total financial assets held by households is expected to rise to 6–7 percent in 2010 (***Table 1***).

The CMCA may also have some negative effects on the money market and banks. The CMCA is accelerating a "money move" toward securities and fund markets before its entry into force, which may increase the liquidity risk of the short-term money market by increasing the volatility of securities companies' call loans and by reducing the availability of bank credit. A drastic move from bank deposits to cash management accounts of securities companies may further lower the growth and profitability of banks, which have been suffering from a structural decrease in net interest margin and a "race to the bottom" in the fee business, such as fees for bank trusts.

Furthermore, the trust business of banks will be weakened as the CMCA consolidates the Trust Business Act under which banks could have operated bank trusts as fee businesses. Banks will encounter obstacles in the conduct of derivatives business because they must obtain a new license as prescribed by the CMCA; now they cover 98 percent of the OTC derivative market and can sell listed products such as deposit derivatives and bond derivatives as ancillary businesses without an additional license.

Table 1: **Structural Change of Household Financial Assets in Korea, 2005 and 2010 (est.) in billions of *won* and percentage**

Financial assets	2005		2010 (est.)	
	Billions of *won*	Percentage	Billions of *won*	Percentage
Cash	37,346	3.3	51,796	3.3
Deposits	626,879	54.9	819,256	51.5
Life insurance and pensions	234,665	20.6	379,861	23.9
Short-term bonds	8,318	0.7	19,366	1.2
Long-term bonds	106,362	9.3	97,897	8.2
Equity	62,827	5.5	90,831	6.2
Other	65,491	5.7	83,305	5.7

Source: Korea Institute of Finance, 2007.

Some Remaining Issues

Several issues still remain. The first of these—integrating all financial services laws on the basis of the negative-list and functional approach created by the CMCA—can be addressed in an amendment to the CMCA, but the other remaining issues should be resolved before the act goes into effect.

First, unlike the CMCA, the existing financial regulations applied to non-FICs such as banks and insurance companies are based on the positive-list and the institutional system. These kinds of dual or heterogeneous regulation systems might generate an uneven playing field or regulatory arbitrage. If banks (or insurance companies), for example, choose to run financial investment services, they would be regulated by both the CMCA and the Bank Law at the same time. Banks, unlike securities companies, cannot freely develop and

sell derivative products because they are restricted by the positive-list banking laws. To solve these dual-regulation problems, all the financial services laws applied to FICs and non-FICs should be integrated based on the negative-list and the functional approach created by the CMCA.

The full integration of financial business laws will need to proceed according to principle-based approaches in order to guarantee legal consistency in regulatory objectives and instruments, facilitate fair and transparent competition, and ensure balance and stability in the financial system. The new Consolidation Law should define the core business of each financial institution, under which all kinds of financial businesses can be concurrently run except the core business. This approach would also help reduce systemic risk and prevent the adverse effects of a reckless rush into universal banking.

Second, the CMCA would permit securities companies to run a retail payment service with the proviso that agency banks undertake its net settlement process, which might give rise to some problems. There are two kinds of payment systems: wholesale and retail. The former adopts the real-time gross settlement (RTGS) method, which does not fail to settle all transactions but entails high liquidity costs. The latter adopts the net settlement or deferred net settlement (DNS) method, which can save liquidity costs but has the fatal defect of possible settlement failure and systemic risks. It is the very reason that the CMCA adopts the provisos. However, such a conditional permission for securities companies' participating in the retail payment system does nothing but give them the right to a free ride on the finality of the payment system, that is, protection of principal and immediate payment, which might threaten the stability of the entire financial system.[1] There are no countries where securities companies can directly participate in the payment system. This is because retail payment services linked with demand deposits and loans are one of the traditional banking services.[2]

Third, the CMCA permits in-house FIC management of all six categories of FISs with a certain level of a firewall. However, the firewall provisions between securities companies and asset management companies are too abstract to prevent the conflicts of interest caused by unfair use of customers' information and property. Hence, it could be necessary to install more concrete and effective prevention measures, especially against the in-house management of collective investment assets by securities companies. Because on-site supervision over conflicts of interest is almost impossible, it might be better to not permit in-house management of collective investment assets.

Fourth, the existing trust business act is to be abolished and integrated into the CMCA. When this happens, all kinds of trust businesses will be classified as financial investment services and carried out by FICs. It is unreasonable to regard every trust business as a financial investment service, however, because many trust businesses do not engage in financial investment services. Most trust businesses should be promoted and regulated by the commercial code; at most, the CMCA can regulate the investment trust business.

Dr. Kim is Chief, Financial Industry Research Division of the Korea Institute of Finance.

1. The payment system is often compared with a two-sided market; that is, a system operator supplies a platform or a network, on which network users such as drawers and payees meet together. The properties of the payment system can be explained by network externalities and economies of scale. These two properties can make the market fail since the former causes a free rider problem and the latter a natural monopoly. In the case of a retail payment system, securities companies—network users—do not want to bear the cost for making the system safe, they only want to enjoy its benefits.

2. E. G. Corrigan, "Are Banks Special?" Annual Report, Federal Reserve Bank of Minneapolis, 1982; Mark W. Olson, "Are Banks Still Special?" (paper prepared for conference of the Institute of International Bankers, Washington, D.C., 2006).

Korea Economic Institute
1201 F Street, N.W. Suite 910
Washington D.C., 20004

PRESORTED STANDARD
U.S. POSTAGE
PAID
PERMIT #3777
WASHINGTON, DC

Korea's Economy