Restructuring and reforms in the Korean banking industry

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I. Introduction

The Korean banking industry has undergone substantial structural reforms since the 1997 financial crisis. A number of banks merged or exited, and foreign banks were permitted to enter the banking industry. Perhaps most significantly, there have been fundamental changes in the behavior of banks; they are now focusing much more on profitability and competitiveness than they did in the past. They are also assuming an increasingly important role as comprehensive asset managers.

The structural and managerial reform effort has indeed improved banks' solvency and profitability. Banks have performed better in nearly every respect and in a relatively short period of time. There has been especially marked improvement in productivity, risk management, and business process innovation. The long-held belief that "banks never fail because the government will bail them out" has nearly faded away completely. People in the financial sector are beginning to consider their occupation separately from their workplace. There has been considerable progress in financial opening and liberalization with an eye toward efficiency.

Korea is widely acknowledged to possess qualified human resources in the financial industry. They have a mastery of the latest in information technology in addition to a high level of competence in taking on board changes in global industry trends. It is primarily thanks to these resources that banks were able to stage a remarkable turnaround and revitalize their management so efficiently after the crisis.

The financial industry is a high value-added industry with great potential to create jobs and to grow quickly. Now is the time to capitalize on the progress that has been made thanks to the reforms. Banks must continue to improve efficiency and sharpen their competitive edge if they hope to prosper in the fiercely competitive global market.

II. Restructuring and Reforms in the Banking Industry

1. Banking Sector Restructuring

As financial liberalization and market opening started in the mid-1980s and accelerated in the 1990s, competition among financial institutions became fiercer, and their risk exposures widened greatly. Amid looming financial risks, the Korean economy entered a period of sluggish economic growth in the mid-1990s due to the erosion of its comparative cost advantage and problems of surplus capacity in many industries.

In the midst of such unfavorable environmental shifts, banks should have striven to improve profitability and efficiency. Instead, they sought to expand their market share without consideration for risk management. As a result, a number of banks suddenly found themselves in financial distress, and their situation rapidly worsened with a spate of large corporate bankruptcies, and an ensuing credit crunch in the market. The credit crunch, paradoxically, brought the one result that the banks feared most, i.e. more corporate bankruptcies, thereby further worsening their asset quality.

Soon after the onset of the crisis, the Korean financial authorities implemented a prompt corrective action (PCA) system. In this system, the capital adequacy ratio forms the most important indicator of the need for PCA. After an evaluation in June 1998, the authorities decided to close five banks whose Basel capital adequacy ratios had already fallen below 8% at the end of 1997. It was decided that these banks would be acquired by five healthier banks through purchase and assumption (P&A), which allows the selective acquisition of assets and assumption of liabilities. P&A was preferred to liquidation or to merger and acquisition on the grounds that the adverse effects on the related depositors, borrowers and the government, let alone the acquirers, would be smaller and that the process could be completed in a shorter period of time.

A further seven banks that had Basel capital adequacy ratios below 8% but were deemed capable of staging a turnaround were required, once their turnaround plans had been conditionally approved, to file implementation plans for management improvement with the Financial Supervisory Commission (FSC) by July 31, 1998. Items to be included in the plans were steps to strengthen their business through increasing their capital, changes in their management teams, and downsizing. The FSC's Review Team then went through these plans, modifying and supplementing them before their finalization on September 15, 1998. The seven institutions in question accordingly carried out their rehabilitation plans involving mergers, capital increases by inducement of foreign capital, consolidation with subsidiaries, and partial limitations of their banking business activities.

Healthy banks, meanwhile, were strongly encouraged to seek consolidation and develop universal banking services in order to become leaders in the banking sector. The biggest and most significant merger took place in November 2001, when Kookmin Bank and Housing & Commercial Bank merged to create Korea's largest commercial bank. Because of the strengths and market positions of Kookmin Bank in retail banking and of Housing & Commercial Bank in mortgage lending, the merger of the two banks has generated a new wave of competitive pressures and contributed to further restructuring and consolidation in the banking sector.

Changes in the Number of Banks

January 1998-September 2005

	No. of banks as of end-1997 (A)	Exits and Mergers (B)			No. of banks newly established (C)	No. of banks operating (A-B+C)
			Exits	Mergers		
Banks	33	14	5	9	–	19
Commercial banks	26	12	5	7	–	14
Nation-wide banks	(16)	(8)	(3)	(5)	–	(8)
Local banks	(10)	(4)	(2)	(2)	–	(6)
Specialized banks	7	2	–	2	–	5

Recapitalization of the financial sector was needed to relieve a paralyzing credit crunch at the beginning of the crisis and to restore the proper functioning of banks in their role as financial intermediaries. Keenly alert to this need, the government injected a huge amount of public funds into financial institutions, totaling 167.6 trillion won (including recycled funds) from November 1997 to July 2005. Of this, some 86.8 trillion won was injected into banks. Funds were injected into troubled financial institutions for the payment of insured deposits and purposes of recapitalization mainly by the Korea Deposit Insurance Corporation, and for the purchase of NPLs (non-performing loans) by the Korean Asset Management Corporation.

The public funds were raised mainly by issuing bonds of the Deposit Insurance Fund run by KDIC (81.6 trillion won) and bonds of the Non-Performing Loans Management Fund run by KAMCO (20.5 trillion won), from government fiscal sources (20.2 trillion won), and recycled funds (40.9 trillion won). Bonds of both the Deposit Insurance Fund and the Non-performing Loans Management Fund are guaranteed by the government. To prevent possible side effects like a run-up in interest rates or a crowding-out effect through their issue in the market, the government paid financial institutions for the purchase of NPLs directly with the bonds or participated in the equity of banks by the subscription of these bonds for their recapitalization.

In order to mitigate moral hazard, the authorities assisted distressed financial institutions on the condition that the institutions made efforts to reduce costs, recapitalize themselves by inducing foreign investments, and write down the capital of existing shareholders. However, the government has been criticized for supporting nonviable institutions, for injecting excessive liquidity in some cases, and for doing too little to recover funds. Responding to this criticism, in February 2001 it established a Public Fund Oversight Committee to enhance the transparency and efficiency of fund management and expedite the recovery of funds.

Trend of Banking Industry Change

1997.12	1998.6	1999.1-6	1999.7-12	2000	2001	2002	2003	Current
Commercial		Hanvit			Woori BHC			Woori BHC (Woori) (Kwangju) (Kyongnam)
Hanil								
Peace								
Kwangju								
Kyongnam								
Chohung		Chohung	Chohung				Shinhan BHC	Shinhan BHC (Shinhan) (Chohung) (Cheju)
Chungbuk								
Kangwon								
Shinhan	Shinhan					Shinhan BHC		
Donghwa								
Cheju								
Hana	Hana	Hana				Hana		Hana
Chungchong								
Boram								
Seoul								
Kookmin	Kookmin	Kookmin			Kookmin			Kookmin
Daedong								
Longterm Credit								
Housing	Housing							
Dongnam								
Koram	Koram							Citibank Korea[1]
Kyongki								
First								SC First
Exchange								Exchange
Daegu								Daegu
Chonbuk								Chonbuk
Pusan								Pusan
Agricultural Cooperatives				Agri-cultural Cooperatives				Agricultural Cooperatives
Livestock Cooperatives								
Fisheries Cooperatives								Fisheries Cooperatives

[1] Citibank Korea was established by consolidating the fifteen branches of Citibank in Korea and Koram Bank on November 1, 2004.

Public Funds Raised and Injected

November 1997-July 2005

In trillions of won

Source	Recapitaliz-ation	Compensat-ion for losses	Repayment of deposit	Purchase of assets	Purchase of NPLs	Total
Issue of bonds	42.2	15.2	20.0	4.2	20.5	**102.1**[2]
Collected funds	7.3	2.5	7.4	6.4	17.4	**40.9**
Fiscal sources	13.9	–	–	6.3	–	**20.2**
Others[1]	0.1	0.2	2.9	0.1	1.1	**4.3**
Total	**63.5**	**17.8**	**30.3**	**17.0**	**39.0**	**167.6**

[1] Borrowing from financial institutions, deposit insurance premium, etc. [2] Deposit Insurance Fund Bonds (81.6 trillion won) and Non-Performing Loans Management Fund Bonds (20.5 trillion won).

The government found itself forced to nationalize several commercial banks in the process of financial restructuring after the financial crisis in 1997. The major objectives of privatization of the state-owned banks have been to promote competitiveness of the banking industry by securing the introduction of management accountability through private ownership and to seamlessly recoup the public funds injected for financial restructuring. Strengthening market discipline by minimizing the scope for government intervention served as another reason.

The government, along with Korea Deposit Insurance Corporation (KDIC), has privatized four nationalized banks (Korea First, Cheju, Seoul, and Chohung) since 1999 by selling its equity stakes in them. In December 1999, the government sold a 51% stake in Korea First Bank to Newbridge Capital. In April 2005, the government also sold its entire remaining equity participation to Standard Chartered Bank, which had already bought Newbridge Capital's stake in Korea First Bank's equity capital. Cheju Bank and Chohung Bank were acquired by Shinhan Financial Holding Company Group as its subsidiaries in April 2002 and July 2003, respectively. Seoul Bank merged with Hana Bank in November 2002.

2. Banking Sector Reforms

Strengthening Prudential Regulation

The authorities strengthened prudential regulation of banks to improve their soundness and stability, bringing them into line with international best practice. New regulations, once introduced and revised in the banking sector, were promptly applied in other parts of the financial sector with slight modifications to reflect the particular characteristics of each type of financial institution.

As a first step, a PCA (prompt corrective action) system was introduced in April 1998. PCAs allow the financial supervisory authorities to automatically issue an order to a particular financial institution whenever management conditions fall below a preset level. This system helps maintain financial soundness and stability and minimizes the social costs arising from financial distress or bankruptcy.

Secondly, the criterion for classification of banking assets as substandard was changed from those non-performing for six months to those non-performing for three months (Sep. 1998). The criterion for classification as precautionary was also changed from those non-performing for three months to those non-performing for one month (Sep. 1998). And forward-looking criteria (FLC), which are standards for classifying asset soundness based on the future payment capacity of borrowers, were introduced for banks (Dec. 1999).

Thirdly, to reduce the risk resulting from large credit exposures to a single entity, the ceiling on credits to a single individual or juridical person, as well as a single large business group, and ceilings on large credits, were lowered for banks (Apr. 1999). In detail, the ceiling on credits to a single individual or juridical person and that on credits to a single business group were brought down from 45% of bank's equity capital to 20% and 25%, respectively, and the definition of "large credits" to a single individual or juridical person, whose total amount is limited to five times a bank's equity, was narrowed from 15% of a bank's equity capital to 10%.

Framework of Prompt Corrective Actions

As of the end of September 2005

Section		Enforcement		
		Management improvement	**Management improvement**	**Management improvement**
Triggering requirements	Financial Ratios	<Banks, merchant banks> • BIS capital ratio:	• below 6%	• below 2%
		<Mutual savings banks> • BIS capital ratio:	• below 3%	• below 1%
		<Insurance companies> • solvency margin ratio: below 100%	• below 50%	• below 0%
		<Securities companies> • equity capital ratio: below 150%	• below 120%	• below 100%
	Evaluation of management status	• composite rating: 3rd grade or above • component rating of asset quality or capital adequacy: below 4th	• composite rating: below 4th	–
	Other reasons	• if obviously adjudged to meet the above mentioned requirements, due to serious financial incidents or bad loans	• (same as left-hand column) • if it fails to faithfully implement its management improvement plan	• if judged as a distressed financial institution • if deemed either to be unable to or not to be implementing its management improvement plan
Measures		• improvement in manpower and organizational management • cost reduction • restrictions on investments in fixed assets, entries into new business areas, and new capital investments • disposal of non-performing assets • restriction on dividends • arrangement of special loan loss provisions	• closure, consolidation, or restriction on the establishment of business offices • reduction of organizational size • restrictions on holding risky assets and disposal of assets • divestiture of subsidiaries • demand for the replacement of directors • partial suspension of business (including measures at the recommendation stage)	• retirement of all or part of the issued stocks • suspension of duties of top management • mergers or entry into FHCs as subsidiaries • transfer of all or part of business • suspension of business for up to six months (including measures at the requirement stage)

Improving Transparency of Financial Institutions' Management

Inadequate disclosure and opaque decision making were often cited as reasons for the Korean financial system's low credibility. Thus, in April 1998, the FSC introduced new disclosure requirements, including mandatory disclosure of information on the value of NPLs, on credit and risk management systems, and on audit results. Six months later, it established unified disclosure standards for financial institutions, stipulating that balance sheet information should be reported twice annually, and it set stronger penalties for false or dishonest disclosures. A quarterly disclosure system[1] for banks was subsequently introduced in September 1999.

In all financial institutions, outside directors, of which there should be at least three, should make up at least half of the total membership of the board of directors (Jan. 2000), and an audit committee must be established (Jan. 2000). A system calling for compliance officers was also introduced (Apr. 2000). In order to strengthen accounting standards, the accounting treatment of financial institutions' holdings of marketable securities has been changed to a mark-to-market system (Jun. 1998-Mar. 2000).

Introduction of Financial Holding Companies

Legislative provisions for financial holding companies have been introduced to strengthen financial institutions' competitiveness through enlargement of their scale and scope of business (Nov. 2000). For enforcement of the Financial Holding Company Act, the FSC/FSS introduced the "Regulation on Supervision of Financial Holding Companies" that sets forth authorization criteria for financial companies seeking to become an FHC or a subsidiary of an FHC (Dec. 2000). Since the introduction of the legislation, Woori Financial Group (Mar. 2001), Shinhan Financial Group (Sep. 2001), and Dongwon Financial Group (May 2003) have been established.

Improvement of Financial System and Financial Infrastructure for Restructuring

The government revised relevant financial legislation, including the Depositor Protection Act, the Act on the Structural Improvement of the Financial Industry, and the Banking Act, to promote financial restructuring at the end of 1997. In consequence, the KDIC and the KAMCO firmly established their presence in the market, and PCA enforcement was strengthened.

In January 1997, the government introduced legislation for a capped partial guarantee system that limited the maximum payment payable to an individual depositor to 20 million won, but in December 1997, the deposit insurance system was changed to a blanket guarantee system to soothe the financial instability caused by the financial crisis. However, with moral hazard emerging on the part of financial institutions and their depositors, the deposit insurance system shifted back from a blanket guarantee system to a capped system in January 2001. Meanwhile, when the partial guarantee system was adopted, the maximum amount of payment to an individual depositor was raised from 20 million to 50 million won.

In a bid to provide diverse fund-raising measures for financial institutions and corporations, the government introduced asset backed securities (Sep. 1998), mortgage backed securities (Apr. 1999), and a mutual funds system (Sep. 1998). In addition, to strengthen the transparency and the prudential regulation of financial institutions, reform ownership structure, and improve disclosure and accounting systems, the government revised financial legislation to bring it in line with international standards.

III. Developments and Changes

1. Enhanced Asset Quality

One of the changes most apparent within the banking system as a whole is banks' restructured balance sheets.

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[1] Detailed matters for disclosures include organization and personnel, finance and net losses/profits, sources and uses of funds, soundness, profitability and productivity indicators, management guidelines, and risk management.

Through the injection of public funds for the purchase of NPLs and the recapitalization of banks, along with their own efforts to reduce NPLs, banks' soundness has been considerably enhanced. As a result, the NPL ratio of commercial banks declined 11.6 percentage points, from 13.6% at the end of 1999 to 2.0% by the end of 2004.

The Basel capital adequacy ratio of commercial banks increased from 7.0% at the end of 1997 to 11.3% by the end of 2004.

Trend of NPL[1] and BIS Capital Adequacy Ratios of Commercial Banks

%

	1997	1998	1999	2000	2001	2002	2003	2004
NPL ratio	6.1	7.4	13.6	8.8	3.3	2.4	2.7	2.0
BIS ratio	7.0	8.2	10.8	10.5	10.8	10.5	10.4	11.3

[1] NPLs are assets that are classified as substandard or below.

2. Enhanced Profitability

In conjunction with their enhanced asset quality, the profitability of banks has significantly improved. Commercial banks continued to pile up large deficits after the crisis until 2000 because they suffered from the losses incurred by non-performing loans, but they have shown profits since 2001.

Strikingly, commercial banks recorded a total profit of 6.4 trillion won and had an average ROA of 0.9% and ROE of 18.0% in 2004. One of the most crucial elements for the improvement of profitability is that it has been possible to reduce new provisions against bad loans. The build-up of interest bearing assets and non-interest income from fees and commissions also contributed to improving banks' profitability.

Trend of Profitability of Commercial Banks

	1997	1998	1999	2000	2001	2002	2003	2004
Net profit (in trillions of won)	–3.9	–12.5	–6.0	–2.8	3.6	3.4	0.7	6.4
ROA (%)	–0.9	–3.3	–1.3	–0.6	0.8	0.6	0.1	0.9
ROE (%)	–14.2	–52.5	–23.1	–11.9	15.9	11.7	2.0	18.0

3. Increase in Banks' Share of the Financial Market

Banks were faster off the mark than non-bank financial institutions in resolving bad assets and capitalization, largely because the intensive financial restructuring was undertaken with a focus primarily on banks rather than on non-bank financial institutions immediately after the outbreak of the financial crisis in 1997. As a result, funds in the financial market flowed into banks owing to the public's renewed heightened confidence in them. Meanwhile, banks increased household lending actively, focusing on housing finance loans backed by housing collateral, which carry a low credit risk and capital requirement burden.

Accordingly, the share of loans made by banks in total loans in the financial market rose from 39.2% at the end of 1997 to 71.7% at the end of 2004, while the share of non-bank financial institutions dropped from 60.8% to 28.3% during the same period.

Trend of Bank and Non-Bank Financial Institution Lending

In trillions of won, %

	1997	1998	1999	2000	2001	2002	2003	2004
Bank	242.9 (39.2)	233.8 (41.6)	273.0 (49.0)	328.7 (57.0)	366.8 (60.0)	516.8 (69.7)	586.5 (71.8)	609.4 (71.7)
Non-bank[1]	377.5 (60.8)	328.2 (58.4)	283.9 (51.0)	247.6 (43.0)	244.2 (40.0)	224.3 (30.3)	230.3 (28.2)	240.4 (28.3)
Total	620.4	562.0	556.8	576.2	611.0	741.1	816.8	849.8

The numbers within parentheses represent shares in total loans in the financial market.

[1] Merchant banking corporations, mutual savings banks, credit unions, community credit cooperatives, securities finance, life insurance companies, postal savings and insurance, investment trusts, and other depository institutions.

There was an underlying shift from corporate lending toward household credits. As a result, the share of household credits rose from 20.0% at the end of 1997 to 55.0% at the end of 2004.

Two factors underlie this shift. One is the development of the capital markets and the increasing availability of direct financing for corporations with good credit. The other is the change in the risk appetite of commercial banks. As banks recognized the importance of credit risk management, they sought to reduce loan concentrations by introducing exposure limits on corporate loans. This led them increasingly to emphasize an expansion of their household credits.

Trend of Shares by Sector in Bank Lending[1]

%

	1997	1998	1999	2000	2001	2002	2003	2004
Corporate loans	63.8	63.6	61.9	56.5	48.9	45.5	45.6	43.5
Large companies	25.0	22.9	19.0	16.3	10.4	7.6	5.9	5.4
SMEs	38.7	40.6	42.9	40.2	38.4	38.0	39.7	38.2
Household loans	20.0	18.3	34.3	39.0	49.1	52.9	53.0	55.0
Others[2]	16.3	18.1	3.8	4.6	2.0	1.5	1.3	1.4

[1] Excludes trust account lending. [2] Loans to public and other legal entities.

4. Increased Market Concentration Resulting from Mergers

Market concentration has risen greatly due to mergers between banks, but not to such a degree as to raise concern over the weakness of market competition. CR3 (Concentration Ratio 3) rose from 24.7% at the end of 1997 to 48.6% at the end of 2004, but this is still much lower than the 70% level which is the criterion for prohibition of abuse of market dominance. The Hirschman-Herfindahl index (HHI) was 1,209 at the end of 2004, but this is well below the 1,800 which is the United States Department of Justice's yardstick for a concentrated market.

Trends in Market Concentration Indexes[1] of Banking Market[2]

	1997	1998	1999	2000	2001	2002	2003	2004
CR1 (%)	8.9	9.8	11.8	13.1	23.2	22.7	21.1	19.5
CR3 (%)	24.7	27.0	33.5	35.6	46.4	46.3	49.5	48.6
HHI	569	628	755	822	1,158	1,185	1,248	1,209

[1] Total asset basis. [2] Commercial banks, industrial banks, and agricultural·fisheries cooperatives.

Despite the rise in market concentration indexes, market competition has been fiercer in some ways due to struggle for market leadership among nation-wide commercial banks. The government, the BOK, and the supervisory agency have continued to pay close attention to the state of market competition, keeping a close eye on the significant changes in the financial landscape brought about by, for example, the birth of megabanks from mergers between domestic banks, or the acquisition of domestic banks by prominent foreign banks.

5. Increased Market Share of Foreign-Owned Banks

During the restructuring process, the government pursued a policy of encouraging the entry of foreign banks. All the regulatory obstacles that stood in the way of foreign entry have been eased, and as long as foreign banks are able to prove the soundness of their management and funding resources, they can enter the banking industry. In addition, foreign investors, including financial institutions, saw the Korean banking industry as a very attractive market.

Thus, since the financial crisis in 1997, there have been frequent cases of foreign capital participating in the domestic banking industry by outright acquisition or by taking a capital stake.

There are a number of positive effects of the entry of foreign banks in the domestic banking industry. Even if domestic economic conditions were to deteriorate substantially (e.g. in case of a financial crisis), there would be little possibility of bank runs on foreign banks with high credibility. Furthermore, the presence of foreign banks would reduce the likelihood of hoarding as depositors would be able to transfer their deposits from ailing domestic banks to the large foreign banks. In addition, even in the downturn phase, foreign banks are able to provide credit to borrowers readily thanks to their ability to raise funds from parent banks. Moreover, foreign banks use advanced risk management skills, which are absorbed by domestic banks. They are also likely to stand ready as counterparts when domestic banks want to enter into risk hedging transactions.

At the same time, there are some negative effects from foreign capital participation in the Korean banking industry. Foreign banks have a tendency to avoid lending to borrowers with comparatively high risks, such as small and medium-sized enterprises (SMEs) and start-ups. They also tend to emphasize short-term, performance-oriented management due to their focus on stockholder value.

IV. Future Tasks

Korean banks' improved profitability is attributable to the recovery of asset quality and the asset growth achieved through early restructuring initiatives. In view of this, it is still too early to say whether their profitability has become stable. For Korean banks to successfully meet the challenges of the ever-evolving financial environment and acquire global competitiveness, much effort and systemic improvement is still needed.

1. Risk Management and Risk-Based Supervisory Systems

In the new financial setting, a comprehensive management system must be created for the varying credit, liquidity, and market risks, together with other risks. Gaining the confidence of the markets by preemptive action to cut potential losses to investors and other shareholders through improved risk management skills is not a goal but a necessity. This goes hand in hand with the exercise of effective internal controls.

Banks need risk management systems that cater to their particular needs. To make risk management effective, management accountability must be specific and clearly spelled out. At the same time, banks need to set up their compensation systems in line with risk management performance. Moreover, they should cultivate the training of professionals capable of designing object-centric databases for the more sophisticated risk management systems. There must be a constant flow of investment to bring together risk management model analysis, regulatory interpretation, and technological expertise.

Despite the wide array of measures that have been taken to improve financial supervision so far, the improvement of the supervisory system is a never-ending task. The supervisory system should be preemptive and risk-based, should allow for early warning, and should be market-friendly. In other words, financial supervision should start with preemptive risk management of financial institutions and markets using forward-looking criteria. Risks detected in the process of monitoring should be grasped swiftly and decisively, and supervisory resources should be reallocated towards those parts of the financial sector where the greatest risks are found to reside. Financial supervision should proceed, in a market-friendly way, with a series of activities such as early detection, accurate assessment, and optimal control of risks exposed in the markets, and should implement prompt corrective measures decisively to avoid failure.

The supervisory agency has set year-end 2007 as the target date for the implementation of the new Basel Capital Framework (Basel II), taking into consideration the potential effects of the new accord on the domestic economy and financial markets, and the progress of domestic banks' preparations for the implementation. All domestic and foreign banks operating in Korea are to come under the new capital adequacy framework. The selection of the methodologies to be used for calculation of the capital requirement is to be left to each individual bank.

The implementation of Basel II is expected to upgrade the level of risk management of domestic banks and thereby promote their sound management and competence, along with their financial stability and economic growth, in the long run. However, there are also some concerns about a potential increase of the capital burden on banks, a contraction of financing for SMEs financing and of the securitization market in response to heightened risk management, increasing pro-cyclicality, etc. Taking these concerns into account, the Korean financial authority will deliberate how to set the national discretion items of Basel II when making the national rules for the new accord. These efforts will help minimize the possible negative impacts of Basel II on the domestic financial market. Korean banks have been striving to upgrade their risk management systems and increase their capital levels, aided by improved profitability in the last few years. All in all, the choice of year-end 2007 is expected to give domestic banks sufficient time to cope with these issues and prepare for the full implementation of the new accord.

2. Business Diversification and Profitability

Banks came to a clear recognition of the importance of sound management in the course of overcoming the financial crisis. Thus, they have since managed their assets with a focus on stability and profitability. The share of household loans rose remarkably, mainly owing to the great expansion of loans secured by housing collateral, while the share of corporate loans, which carry comparatively higher credit risk, dropped. The share of low-risk bonds, such as treasury bonds and monetary stabilization bonds, in total securities investments also rose. Banks' behavioral changes in asset management contributed to their enhanced profitability and asset soundness. However, these phenomena also raised concerns that the efficiency of funds allocation to the national economy as a whole could be worsened since banks' assets now suffer from an over-concentration in a specific sector.

Accordingly, the function of banks' fund distribution to the national economy as a whole needs to be revitalized. It is becoming more important for banks to avoid cut-throat competition in specific asset markets and to generate new lucrative business activities by specializing in business areas of comparative advantage on the basis of their business characteristics. For example, it is helpful for large banks to expand their investment banking and international finance business, while small and medium-sized banks should specialize in relationship banking such as lending to SMEs. In addition, the credit derivatives market needs to be galvanized and brought to a level of sophistication where banks can manage credit risk effectively, in line with the implementation of Basel II at year-end 2007.

Strategically, banks need to heighten their profitability by securing appropriate interest rate spreads and performing better in terms of fee-based income. Banks not only should step up their credit review and ex post management to prevent additional bad assets, but also be sure to maintain appropriate interest rate spreads that incorporate borrowers' credit risks.

New financial products and services must be developed to provide convenience to customers while improving profitability. Banks should have a system that identifies and discerns customer needs to provide products and services accordingly. For banks to be competitive in today's market, in which information revolves around the customer, they must develop specific products and carry out marketing initiatives to create more value through deep data mining and customer analysis.