Capital Market Reform and the Challenges Facing the New Government in Korea

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I. Korea's capital market reforms: the past 10 years

1. The new government's first moves

On 25 February 2013, Park Geun-hye took office as Korea's new president. Facing, as she does, mounting criticism for the disparities that her predecessor's pro-chaebol, pro-globalization growth model is seen as having led to and having pledged her government to pursue "economic democratization," boost employment, and improve social welfare, the new president is likely to have her work cut out devising policies that will stimulate a stagnant economy hampered by a strong currency. Nor is it clear what policies the new president will pursue on the financial front.

In this report we consider Korea's success in reforming its capital markets and the challenges it still faces on this front.

2. Korea's Financial Hub Vision and the *Financial Investment Services and Capital Markets Act*

Korea's capital market reforms gathered momentum when the IMF program it adopted following the Asian Currency Crisis came to an end in 2001 (Figure 1). However, it has to be said that the radical measures it adopted as part of the program (namely, mandatory injections of public capital to help restructure the banks and tackle their non-performing loans, a policy of encouraging foreign investment in the country, and moves to restructure the chaebol) formed the basis for the capital market reforms that followed.

Both President Park's predecessors, Roh Moo-hyun (2003–2008) and Lee Myung-bak (2008–2013), advocated a policy of turning Korea into a financial hub. This vision (of strengthening Korea's financial services industry so it could compete globally) was probably intended not only to boost Korea's financial markets but also the growth potential of the economy as a whole. In other words, the aim was not simply to improve the ability of Korea's capital markets to supply Korean industry with capital but to increase the added value of Korea's financial services industry, of which its capital markets formed a part.

Figure 1: Korea's capital market reforms: main developments in recent years

1997	IMF bailout (completed in 2001)	• Kim Dae-jung government's restructuring of the banks and injections of public money • Near-collapse of Daewoo Group → restructuring and reform of the chaebol
2003	Roh Moo-hyun government's Northeast Asian Financial Hub initiative	• Establishment of Korea Investment Corporation (KIC), complete deregulation of forex trading, etc.
2005	Establishment of Korea Exchange (KRX)	• Merger of Korea Stock Exchange (KSE), Korea Futures Exchange (KOFEX), and the KOSDAQ
2007	Announcement of amendments to Section 3 (Companies) of Commercial Code (two separate sets of amendments passed in 2009)	• Definition of "non-executive director," "supervisory board," etc.
2008	Lee Myung-bak government's Financial Hub Vision	• Seoul and Busan designated financial hubs on the basis of *Act on the Creation and Development of Financial Hubs*
	Establishment of Financial Services Commission	• Ministry of Finance's Financial Policy Division integrated in Financial Supervisory Commission
2009	FSCMA comes into effect	• Move from industry-based rules to function-based rules (covering the entire financial investment industry) • Financial investment instruments defined intensionally
2010	Seoul G20 summit	• Debate on reforming the IMF and on financial regulatory reforms aimed at dealing with the "too big to fail" problem
2011	Reading of FSCMA amendment bill	• Securities companies meeting certain conditions redefined as investment banks: to encourage industry to reorganize • Deregulation of Korea's asset management industry: to increase asset managers' independence and innovativeness • Creation of central counterparty (CCP) for derivatives • Ban on alternative trading systems lifted
	Amendments to Commercial Code (with effect from 2012)	• Executive officer system, different classes of shares, triangular mergers, etc.

Source: Nomura Institute of Capital Markets Research, from a variety of sources

One of the most noteworthy developments in this connection and one of the reforms carried out by the Roh Moo-hyun government was the establishment in 2005 of Korea Exchange (KRX)[1] through the integration of the country's three exchanges—the Korea Stock Exchange (KSE), the Korea Futures Exchange (KOFEX), and the KOSDAQ—to create "the number one capital market in East Asia." Headquartered in Busan, KRX's two stock exchange divisions are based in Seoul's Yoido district, while the futures division is based in Busan. In order to raise Busan's profile as a financial center, trading in KOSPI 200 futures and options, which used to take place on the KSE, was transferred to KOFEX, while trading in KOSPI derivatives was boosted by the integration of the three exchanges' trading systems[2].

The most noteworthy of the country's later financial market reforms was the *Financial Investment Services and Capital Markets Act* (FSCMA or "the Act"),

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1 Taki, Toshio, "Kankoku Torihikijo no Tanjou" (The Birth of KRX), Capital Market Quarterly, Spring 2005 (in Japanese).

2 Hayashi, Hiromi, "Kankoku Deribatibu Shijou no Hatten to Shihon Shijou Kaikaku," (The Development of Korea's Derivative Market and Capital Market Reform), Gekkan Shihon Shijou, February 2012 (in Japanese); Hayashi, Hiromi, "Kyuusoku na Hatten o Togeta Kankoku no Deribatibu Shijou," (The Rapid Development of Korea's Derivative Market), Capital Market Quarterly, Spring 2012 (in Japanese).

promulgated in 2007 and effective since 2009. The Act integrated and rewrote the various laws governing capital markets (e.g., the *Securities and Exchange Act* and the *Futures Trading Act*) as rules governing the markets' various functions (e.g., approval, registration and prudential supervision of financial investment companies, conduct of business, and collective investment schemes). Discussions about enacting such legislation began in 2003 and were apparently influenced by the debate on Japan's *Financial Instruments and Exchange Law*, which was enacted at about the same time. However, the Act was more ambitious in that, for example, it defines the scope of financial investment instruments intensionally (i.e., using their properties) instead of extensionally (i.e., using exhaustive lists).

In February 2008, roughly a year before the Act came into effect, Lee Myung-bak became president. At the same time, the old Financial Supervisory Commission's responsibility for supervisory policy and the old Ministry of Finance's responsibility for financial policy were amalgamated in a new Financial Services Commission (FSC), while the (non-governmental) agency responsible for day-to-day oversight and enforcement, the Financial Supervisory Service (established in 1999), was also reorganized. In February 2009 the various organizations regulating the securities and investment industries (namely, the Korea Securities Dealers Association, the Korea Futures Association, and the Asset Management Association of Korea) were also amalgamated to form the Korea Financial Investment Association (KOFIA).

What distinguishes Korea's capital market reforms in recent years is the leading role played by the government and the influence of similar reforms in Japan. However, the Korean reformers' aims were more global. Also, the aim of Korea's Financial Hub Vision was more to foster the development of a cluster of financial functions that would make it easier for Korean companies to raise capital than, as in the case of Singapore and Hong Kong, create an international center where foreign companies could raise, and foreign investors invest, capital. Although the Lee Myung-bak government sought to support efforts to put Korean investment banks and Korean corporate governance on a more global footing towards the end of its term in office (e.g., by amending the Act and the Commercial Code), many of these aims have yet to be achieved—partly as a result of the global economic and fiscal disruption triggered by the collapse of Lehman Brothers, partly as a result of a global trend towards tighter financial regulation, and partly as a result of domestic public opinion[3].

II. Current state of and outlook for Korea's capital markets

1. Growing importance of direct finance

The most obvious result of Korea's capital market reforms is the growing importance of direct finance. Traditionally, Korea's financial system has been dominated by its banks. However, a breakdown of Korean companies' sources of

[3] Hayashi, Hiromi, "The Revisions to Korea's Financial Investment Services and Capital Markets Act and Korean Securities Companies' Efforts to Diversify Their Earnings," Nomura Journal of Capital Markets, Winter 2012, Vol.3, No.3.

finance in recent years shows that direct finance is now a comparatively regular source of corporate finance, bolstering it particularly in the immediate aftermath of the collapse of Lehman Brothers, when the banking system's ability to create credit malfunctioned and Korean companies issued nearly KRW70 trillion in bonds (Figure 2).

Similarly, while Koreans traditionally hold most of their financial assets in the form of cash and bank deposits, the proportion they hold in the form of marketable securities is higher than in Japan. A closer look also reveals that, whereas in 2003 (i.e., soon after Korea completed the program imposed by the IMF during the Asian Currency Crisis) Koreans held 53% of their financial assets in the form of cash and bank deposits and 24% in the form of shares, investment trusts and other marketable securities, at the end of September 2012 they held 46% in the form of cash and bank deposits and 28% in the form of marketable securities. In other words, the proportion held in the form of marketable securities has increased steadily, even if it has yet to regain the level it reached before the collapse of Lehman Brothers (34% in 2007).

In absolute terms, however, Korean personal financial assets are still under accumulation. As of end-September 2012, they stood at KRW2,450 trillion (roughly ¥210 trillion), a mere one-seventh the level of Japanese personal financial assets (roughly ¥1,510 trillion as of end-September 2012). That said, Korean personal financial assets have more than doubled during the past 10 years, showing solid growth both before and since the collapse of Lehman Brothers.

2. Stock market

One of the most frequently mentioned results of Korea's capital market reforms is the size of its exchange-traded derivative market—one of the largest in the world.

Figure 2: Breakdown of Korean industry's sources of finance

(Unit: KRWtrn)

	2003	2004	2005	2006	2007	2008	2009	2010	2011
Total funds raised	**89.2**	**67.8**	**109.1**	**184.2**	**184.3**	**230.4**	**152.3**	**117.1**	**145.1**
Indirect finance	**34.4**	**2.9**	**23.8**	**68.1**	**98.6**	**115.0**	**19.4**	**23.4**	**47.0**
Deposit-taking banks	41.2	14.9	20.4	60.4	92.4	106.9	11.1	4.8	33.5
Non-bank financial institutions	-6.8	-12.0	3.4	7.7	6.2	8.1	8.3	18.6	13.5
Direct finance	**28.9**	**29.2**	**52.9**	**80.5**	**54.1**	**66.9**	**95.4**	**61.5**	**63.9**
Equities	27.5	22.2	19.2	38.9	33.6	28.4	33.1	29.6	25.2
Commercial paper	-2.6	-1.9	4.1	14.5	24.5	12.9	-8.5	2.7	8.0
Bonds	-1.1	1.8	12.5	26.3	-4.8	24.6	69.6	28.4	30.0
Foreign loans	**4.7**	**8.7**	**5.7**	**5.9**	**6.4**	**8.4**	**6.1**	**4.3**	**14.9**
Other	**21.2**	**26.9**	**26.7**	**29.6**	**25.2**	**40.0**	**31.4**	**27.9**	**19.3**

(Unit: %)

(Share)	2003	2004	2005	2006	2007	2008	2009	2010	2011
Indirect finance	**38.6%**	**4.3%**	**21.8%**	**37.0%**	**53.5%**	**49.9%**	**12.7%**	**20.0%**	**32.4%**
Deposit-taking banks	46.2%	22.0%	18.7%	32.8%	50.1%	46.4%	7.3%	4.1%	23.1%
Non-bank financial institutions	-7.6%	-17.7%	3.1%	4.2%	3.4%	3.5%	5.4%	15.9%	9.3%
Direct finance	**32.4%**	**43.1%**	**48.5%**	**43.7%**	**29.4%**	**29.0%**	**62.6%**	**52.5%**	**44.0%**
Equities	30.9%	32.8%	17.6%	21.1%	18.2%	12.3%	21.7%	25.3%	17.4%
Commercial paper	-2.9%	-2.8%	3.8%	7.9%	13.3%	5.6%	-5.6%	2.3%	5.5%
Bonds	-1.2%	2.6%	11.5%	14.3%	-2.6%	10.7%	45.7%	24.3%	20.7%
Foreign loans	**5.3%**	**12.8%**	**5.2%**	**3.2%**	**3.5%**	**3.6%**	**4.0%**	**3.7%**	**10.3%**
Other	**23.8%**	**39.7%**	**24.5%**	**16.1%**	**13.7%**	**17.4%**	**20.6%**	**23.8%**	**13.3%**

Source: Nomura Institute of Capital Markets Research, from Bank of Korea data

This has been attributed to (1) the integration of Korea's capital markets in Korea Exchange, (2) the high level of participation by individual investors in the exchange-traded derivative market, and (3) the ability to trade the market's two key products (KOSPI 200 futures and options) during European and US trading hours as a result of tie-ups with the CME Group (KOSPI 200 futures) and Eurex (KOSPI 200 options). Recently, however, the turnover in exchange-traded derivatives has declined slightly as a result of a number of factors, including alleged market abuse of high-frequency trading in equity-linked derivatives (e.g., warrants) and regulatory reforms intended to give individual investors greater protection (e.g., increases in the size of contracts).

What distinguishes the cash stock market, on the other hand, is the high proportion of stocks owned by foreign and individual investors (Figure 4). The increase in the proportion of shares owned by foreigners is largely the result of Korea's capital market reforms and the unwinding of some of the cross-shareholdings held by group companies and the owners of chaebol companies. Similarly, the increase in the proportion of shares owned by individual investors has been attributed to improvements in IT infrastructure (e.g., the increasing availability of broadband connections), which encourage high levels of online trading. One problem, however, has been the relatively small size of Korean institutional investors. Another is the need to foster small-/mid-cap stocks and start-ups, and encourage IPOs as market capitalization and trading volume are both dominated by large chaebol companies.

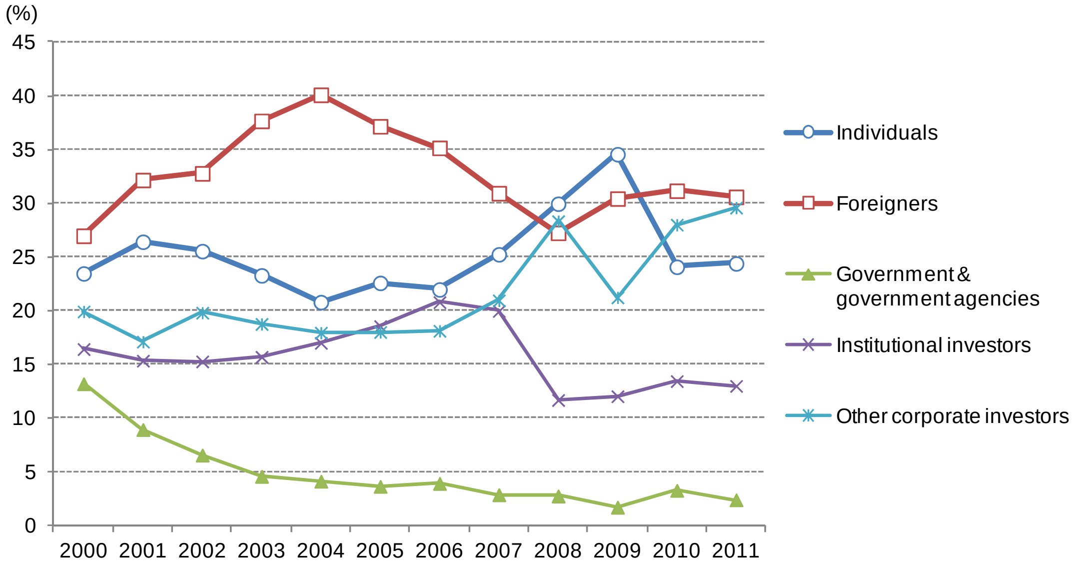
Another controversial issue, this time with regard to market infrastructure, is how to encourage competition (e.g., by means of alternative trading systems (ATS)) in a market monopolized by Korea Exchange. This is one of the main issues for the FSCMA amendment bill, which has yet to be enacted.

Figure 3: Breakdown of Korean personal financial assets (KRWtrn, %)

		Cash/ deposits	Insurance/ pension reserves	Equities/ equity stakes	Investment trust beneficiary certificates	Other marketable securities	Other	Total
2003	(KRWtrn)	617.7	252.9	190.9	42.7	49.8	15.9	1170.0
	(Share)	53%	22%	16%	4%	4%	1%	100%
2004	(KRWtrn)	624.1	281.6	204.3	64.1	57.8	13.9	1245.8
	(Share)	50%	23%	16%	5%	5%	1%	100%
2005	(KRWtrn)	672.3	306.8	286.8	81.4	51.3	15.4	1413.9
	(Share)	48%	22%	20%	6%	4%	1%	100%
2006	(KRWtrn)	717.3	345.8	290.8	110.0	57.4	13.0	1534.2
	(Share)	47%	23%	19%	7%	4%	1%	100%
2007	(KRWtrn)	732.8	391.8	368.6	167.6	51.7	11.5	1724.0
	(Share)	43%	23%	21%	10%	3%	1%	100%
2008	(KRWtrn)	790.9	424.2	273.9	122.9	69.5	15.8	1697.2
	(Share)	47%	25%	16%	7%	4%	1%	100%
2009	(KRWtrn)	883.6	476.6	367.4	130.6	89.5	15.4	1963.1
	(Share)	45%	24%	19%	7%	5%	1%	100%
2010	(KRWtrn)	986.8	534.7	438.7	98.9	113.6	15.2	2187.9
	(Share)	45%	24%	20%	5%	5%	1%	100%
2011	(KRWtrn)	1069.4	590.1	418.5	84.6	124.0	16.7	2303.4
	(Share)	46%	26%	18%	4%	5%	1%	100%
2012Q3	(KRWtrn)	1115.3	653.5	437.4	86.7	139.6	17.4	2449.9
	(Share)	46%	27%	18%	4%	6%	1%	100%

Source: Nomura Institute of Capital Markets Research, from Bank of Korea data

Figure 4: Ownership of Korean stocks



Source: Nomura Institute of Capital Markets Research, from Korea Exchange data

3. Bond market

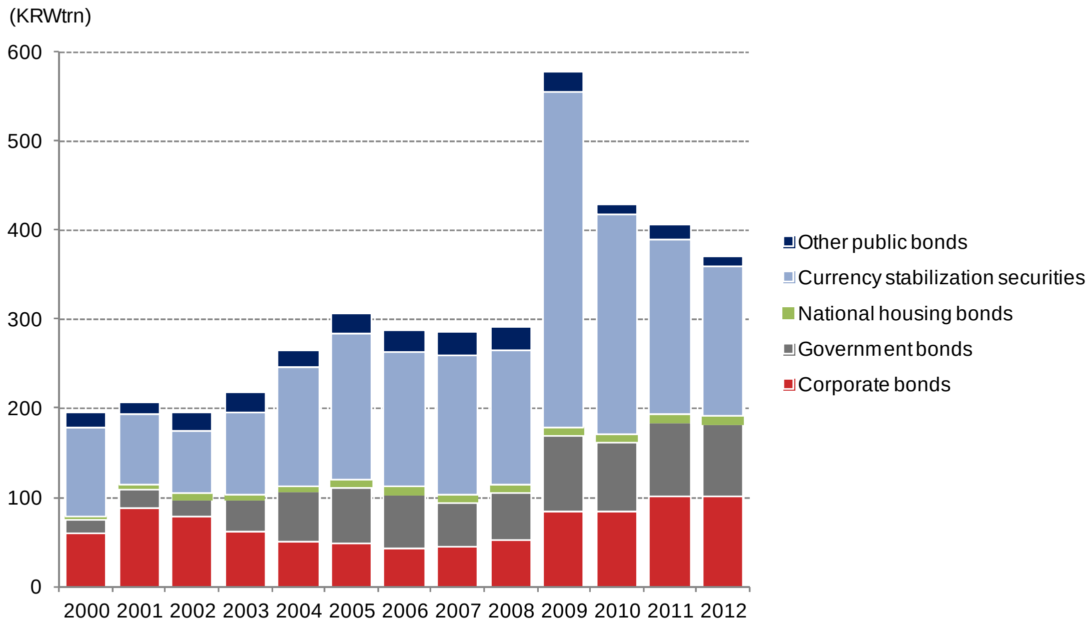
Until the Asian Currency Crisis, the growth of Korea's bond market was driven by corporate bonds as the government pursued a balanced budget policy. Reflecting this, the benchmark was three-year corporate bonds.

Following the Asian Currency Crisis, however, a number of measures were adopted to encourage the development of a market in government and public bonds (e.g., greater transparency of the issue process and the adoption of a primary dealer system). Since then, Korea's government bond market has seen solid growth. There has also been active issuance of corporate bonds (e.g., by banks and credit card issuers), and there is now also a nascent market in asset-backed securities (Figure 5).

Various reforms have been undertaken to increase activity in the secondary bond market and make the market more efficient. In addition, efforts have been made to attract investors. A key role in this has been played by KOFIA, Korea's equivalent of the Japan Securities Dealers Association. Since April 2010, KOFIA has operated FreeBond, a dedicated system that enables OTC bond market participants to discover quotes for trading or brokerage and negotiate with counterparties, while, since February 2010, it has operated BondMall, a website (www.bondmall.or.kr) intended to give individual and small investors easier access to information on corporate bond prices. KOFIA also develops and releases bond price index data that can be used, for example, by asset management companies to originate their own index-linked bond ETFs[4].

4 See Korea Financial Investment Association, "2012 Capital Market in Korea."

Figure 5: Korean bond issuance



Note: "Corporate bonds" includes asset-backed securities. "Currency stabilization securities" are bonds issued by the Bank of Korea to enable it to control the money supply and conduct open market operations.

Source: Nomura Institute of Capital Markets Research, from Bank of Korea data

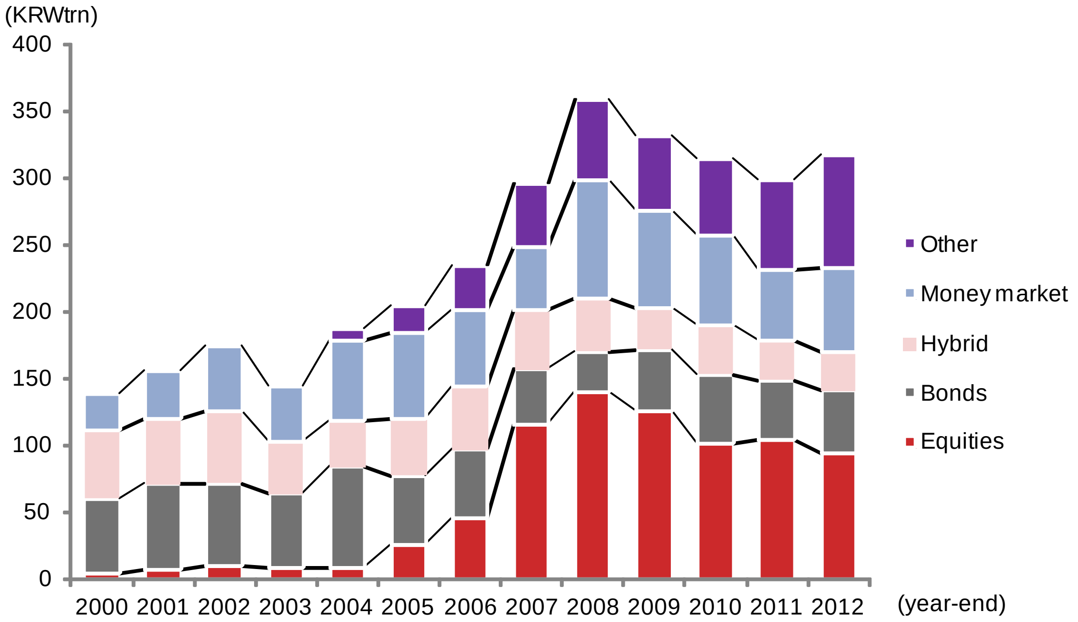
4. Investment trust market

As a result of a series of regulatory reforms, including the *Indirect Investment Asset Management Business Act* (promulgated in 2003 and subsequently amended several times) and FSCMA (promulgated in 2007), Korean investment trusts have (1) undergone a transformation from specialist companies engaged in both asset management and sales to securities companies, with securities companies and banks both able to sell investment trusts under the same regulatory system, and (2) their assets have become diversified and are no longer restricted to marketable securities.

As of end-2012, Korean investment trusts had a total net asset value (NAV) of roughly KRW317 trillion. As a result of the regulatory reforms, their NAV saw solid growth until the mid-2000s, accounting for a growing proportion of personal financial assets. However, as a result of a number of factors, including the collapse of Lehman Brothers, it has remained at roughly the same level (KRW300 trillion or roughly ¥25 trillion) for the past few years (Figure 6). As far as investment trust sales channels are concerned, banks accounted for a growing share until the collapse of Lehman Brothers. Since then, however, their sales have failed to grow, while securities companies have become an increasingly important sales channel once again, accounting for roughly 60% of new sales[5].

[5] See Footnote 4.

Figure 6: Korean investment trust market: assets under management (year-end)



Note: "Other" includes derivative funds, real estate funds, funds of funds, and special asset funds.
Source: Nomura Institute of Capital Markets Research, from KOFIA data

Much has recently been made of the need for more sophisticated and efficient asset management as well as greater investor protection. As a result, since 2011, the government and KOFIA have sought to wind up small investment trusts with a net asset value of less than KRW5.0 billion (roughly ¥350 million), a goal they have largely achieved[6].

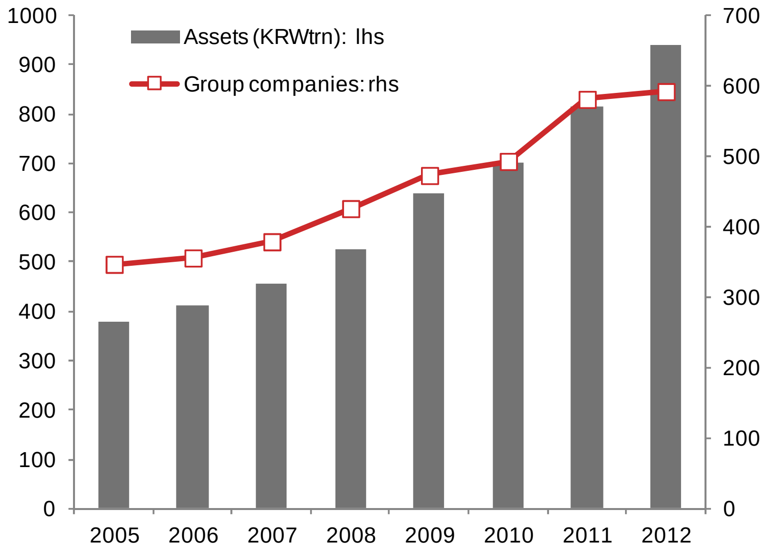
III. "Japanization" of Korean economy and capital market reform

1. Korea's chaebol a growing presence once again

One of the most eagerly awaited tasks facing the new government of President Park is the reform of the chaebol. The total assets of Korea's 10 largest chaebol continued to grow while President Lee Myung-bak was in office, topping KRW900 trillion by mid-2012 (Figure 7). Although the direct ownership of group companies by their owners has declined, the proportion of chaebol shares owned by insiders has, if anything, increased recently as a result of cross-shareholdings by affiliates (Figure 8).

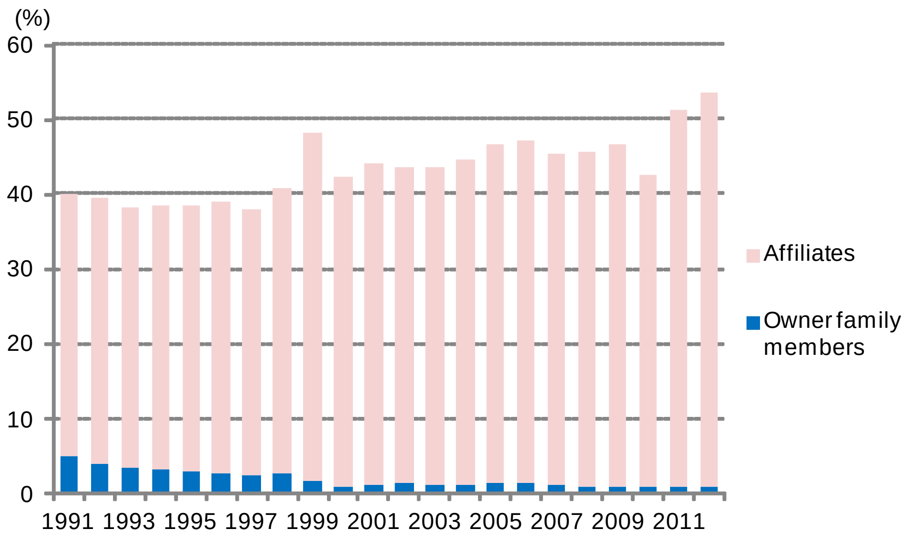
[6] Nomura, Akiko, "Kankoku no Shoukibo Toushi Shintaku Seiri no Ugoki," Capital Market Quarterly, Spring 2012 (in Japanese).

Figure 7: Assets and number of group companies of 10 leading chaebol



Source: Nomura Institute of Capital Markets Research, from Korea Fair Trade Commission data

Figure 8: Internal ownership of 10 leading chaebol



Source: Nomura Institute of Capital Markets Research, from Korea Fair Trade Commission data

While there has been growing public criticism that the growth of the chaebol has widened social disparities and sapped the economy's strength, there is also a realization that the chaebol have fueled economic growth and that some globally competitive chaebol have drawn foreign investors to the Korean stock market. There is therefore a risk that putting too much political and regulatory pressure on the chaebol could paralyze Korea's financial markets or make them less competitive[7]. Much has also been said about the need for better corporate governance by the

[7] "Peeling back the power of Korea's chaebols", Asiamoney, March 2013.

chaebol. However, it has also been pointed out that large chaebol companies have often been more willing to adopt some corporate governance reforms (e.g., the appointment of non-executive directors and the creation of supervisory boards) than have SMEs[8].

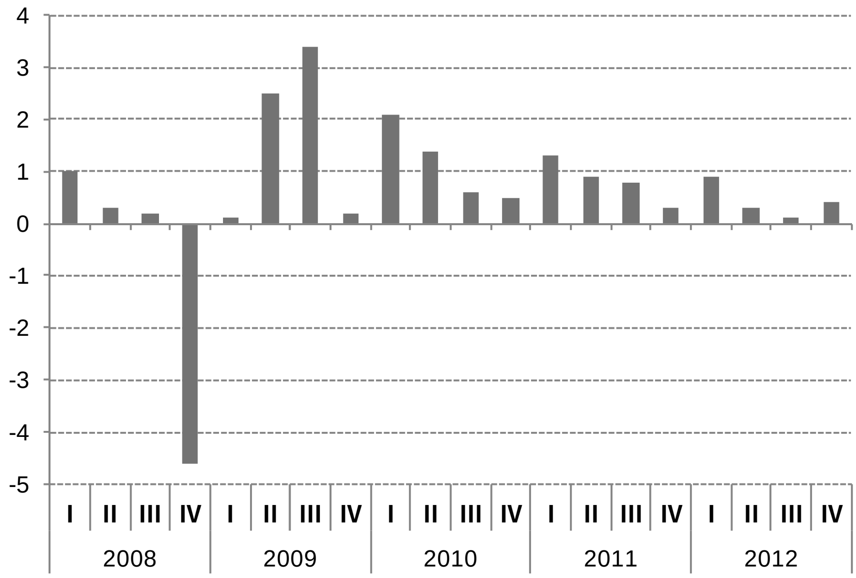
It will therefore be interesting to see how President Park's government approaches the somewhat paradoxical problem of how to make the chaebol more transparent and how it sets about reforming the market so as to revitalize the country's SMEs.

2. An aging society with low interest rates and low economic growth

Recently there has been a lot of talk in Korea that the strength of the currency and the decline in interest rates could bring about structural economic reforms. In particular, there have been repeated reports in the media since the autumn of 2012, when the Korean economy slowed markedly, that the Korean economy has succumbed to the "Japanese disease" (i.e., the problems created by a strong currency compounded by prolonged low growth and low interest rates, falling property prices, and mounting bad debts). In addition, concern in the country's financial services industry also appears to be mounting (Figure 9).

Although the economic situation in Korea, where, for all the talk of a "strong currency," the won is trading, against both the dollar and the yen, well below the level at which it stood before the collapse of Lehman Brothers and, for all the talk of "low interest rates," inflation stands at 1.3–1.4%, the Bank of Korea's policy interest rate at

Figure 9: Korea's real GDP growth rate (q-q, %)



Source: Nomura Institute of Capital Markets Research, from Bank of Korea data

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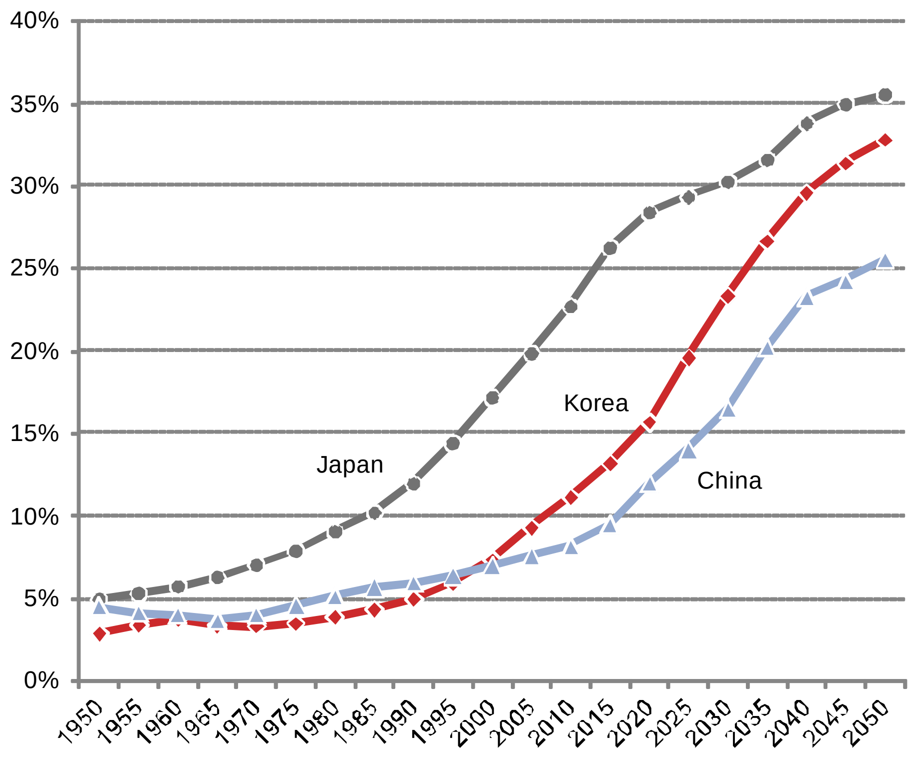
8 Kwon Sehoon, “Issues on the Independent Directors in the Korean SMEs”, Capital Market Perspective 2011 Vo3, No.3 (Korea Capital Market Institute).

2.75%, and long-term interest rates at 3%, strikes us as very different from deflation in Japan, there is no denying that Korean industry is dominated by the chaebol and that there is a lot of concern about issues such as household debt (in the form of housing loans) and societal aging. In particular, the ratio of the over-65s to the population as whole is similar to that in Japan, albeit with a 25-year lag, topping 10% in 2005–2010 and set to rise sharply to 20% by 2025 and 30% by 2040 (Figure 10).

While it remains to be seen how President Park's government, which has not adopted market-oriented policies, approaches these problems, it may well be that it finds itself having to carry out more sweeping market reforms as well as being challenged over the success of the reforms it has already carried out. Similarly, Korean securities and asset management companies are likely to face calls to overhaul their existing business model and to give better advice to both issuers and investors in order to survive. It will therefore be interesting to see what happens.

Figure 10: Over-65s as percentage of total population: Japan, Korea and China (actual and expected)



Source: Nomura Institute of Capital Markets Research, from United Nations, *World Population Prospects*, (2010 Revision (incl. estimates))