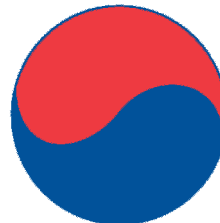


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# FINANCIAL INSTITUTIONS AND MARKETS

## “BIG BANG” ON KOREA’S CAPITAL MARKETS: REFORM LEGISLATION AND ITS IMPACT

*By Cho Sung-hoon*

### Introduction

Along with commercial banks, capital markets are an integral part of the financial systems in most capitalist economies, and their relative importance is constantly increasing. Countries around the world are making enormous efforts to enhance the competitiveness of their capital markets and investment services industries. Korea is no exception to this trend.

The macroeconomic environment of Korea is changing. First, the main driving force of Korean economic growth is the movement into high-technology-based innovative industries. For example, in 2003 the Korean government selected 10 “new growth-driving industries” including display, next-generation semiconductors, and bio-medicine. Those industries have the characteristics of high risks and high returns, and they require financing with long-term risk capital. Capital markets should be the primary source of risk capital financing because commercial banks, which are directly responsible for the stability of the whole financial system, cannot bear the amount of risk such investments require. Therefore capital market development is an essential task for the sustainable growth of the Korean economy. The rapid aging of the Korean population is another reason why capital markets should be developed. As life spans become longer, efficient intertemporal smoothing of consumption and income is becoming more important for a comfortable life after retirement for every individual. Individuals and households demand capital market products that can meet these needs.

Currently, the Korean government is processing legislation for a new, revolutionary law called the Capital Market and Investment Services Act (CMISA), which

is also called the Consolidation Act. Six existing laws governing capital markets and the investment services industry, including the Securities Exchange Act, the Futures Trading Act, and the Collective Investment Act, are consolidated into the CMISA and will be replaced by it. If the CMISA is approved by the Korean National Assembly in the spring of 2007, according to the government’s expected schedule, it will take effect in the winter of 2008, after a one-and-a-half-year preparation period.

The CMISA includes some fundamental changes to the legal environment surrounding the capital markets and investment services industry of Korea, and it is expected to bring about a great change and transformation. We can even call the CMISA legislation Korea’s version of the big bang! The impact of this big bang is expected to be most outstanding in the investment services industry. In this article, we try to assess the impact of the CMISA and identify some important challenges imposed on the Korean investment services industry to enhance its competitiveness in the upcoming totally new legal environment.

The article proceeds as follows: In the next section, the current situation in the Korean investment services industry and its legal environment are briefly described. In section 3, the core provisions of the CMISA are discussed. Challenges imposed by CMISA to Korean investment services industry are discussed in section 4, and section 5 concludes.

### Korea’s Investment Services Industry Today

After the Asian financial crisis of 1997, securities firms (broker-dealers and investment banks) in Korea be-

gan to face much fiercer competition.<sup>1</sup> Firms were allowed to freely set the level of their brokerage commissions, and price competition intensified. The explosive growth of online (cyber) trading also made the price competition even tougher. As a result, the average stock brokerage commission rate dropped dramatically from more than 50 basis points in 1999 to less than 17 basis points in 2006. Because Korean securities firms heavily rely on the brokerage business—their brokerage business accounts for more than 60 percent of total net revenue of Korean securities firms on average—this rapid drop in commission rates directly brought about a deterioration of profitability.

Securities firms are key players in capital markets, and the competitiveness of securities firms is a very important factor for capital market development. Unfortunately, it is hard to say that the competitiveness of Korean securities firms is strong. It is a pressing task for Korean securities firms to find alternative sources of revenue to compensate for reduced profitability in their brokerage businesses. This is especially important because the weakest area of Korean securities firms is investment banking, which is the area most closely related to Korea's macroeconomic needs.

Various explanations have been put forward for the low competitiveness of Korean securities firms, and one can hardly deny that Korea's legal and regulatory environment is one of the most significant reasons. First, investment products and services are very narrowly defined because of related laws. For their corporate customers and investor customers, securities firms can deal only with products that are explicitly listed in the current Securities Exchange Act. For derivatives, underlying assets upon which derivative products can be written are listed in the Futures Trading Act. As a natural consequence of this "positive

listing system" of financial products, securities firms have little incentive to develop the capability of designing innovative new financial products, which is a key success factor for the investment banking business.

Second, businesses that Korean securities firms can carry on are also very strictly limited by various laws. Similar to the United States and Japan, a solid firewall exists between commercial banking and investment services in Korea.<sup>2</sup> In fact, other firewalls—although these are more porous—exist for various investment services businesses. For instance, securities firms can carry on neither an exchange-traded derivatives business nor an asset management (fund) business in principle. Similarly, futures trading firms, which are governed by the Futures Trading Act, cannot also have a securities (stocks, bonds, or asset-backed securities) business. With these heavy regulations, it is difficult for Korean securities firms to pursue diverse business strategies, and this has made business portfolios of Korean securities firms quite similar regardless of the differences in firm characteristics, such as size.

The CMISA legislation is driven by the perception that there is little hope of further enhancing Korean securities firms' competitiveness under the current legal and regulatory environment. In this sense, the CMISA legislation is a landmark; it is the total overhaul, not just a partial modification, of the legal environment surrounding Korean securities firms, and it can be viewed as an epochal event. In the following section, some of the important provisions of the CMISA are described.

### **Main Provisions of the CMISA**

The CMISA is a completely new law consolidating six existing laws governing capital markets and the investment services industry of Korea.<sup>3</sup> The first im-

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1. What is called the investment services industry includes various businesses—broker-dealers, investment banks, asset management, and investment advisory firms, for example. In this article, we focus on securities firms, mainly broker-dealers and investment banking.

2. In the United States, this firewall has been lessened by the Gramm-Leach-Bliley Act of 1999, but the provision of commercial banking and investment services in a single entity is still prohibited.

3. The six laws that are consolidated into the CMISA are the Securities Exchange Act, the Futures Trading Act, the Collective Investment Act, the Trust Service Act, the Korea Exchange (KRX) Act, and the Merchant Banking Act.

portant provision of the CMISA is the change in the definition of investment products. The CMISA abandons the positive listing system, and the scope of investment products will be dramatically broadened. Under this new regime, any financial product that meets basic economic properties specified in the CMISA is recognized as an “investment product” and can be served by securities firms. Specifically, the CMISA defines an investment product as a financial product that involves the risk of the loss of invested principal. The CMISA also defines derivatives as investment products that involve the risk of liabilities additional to principal loss, and the law defines securities as investment products with no such risk. In addition, the CMISA broadens the scope of underlying assets upon which derivatives can be written into “any quantifiable risk”; for example, derivatives upon energy, weather, or emission rights will be able to be written. Under this new regime, the frontiers of product innovation for securities firms will be vastly widened.

The second core aspect of the CMISA is that the firewalls among investment service businesses are to be abolished. The CMISA allows a single firm to carry out various capital market and investment service businesses, and it calls these firms “financial investment firms.” For example, a financial investment firm can do brokerage, investment banking, derivatives, and asset management work in-house only if it gets licenses for each business. With these two huge changes in the regulatory framework, it is expected that Korean securities firms will evolve into true investment banks that can be compared in their business scope and economic functions with global players such as Goldman Sachs and Morgan Stanley. This is a major objective expected to be achieved by the CMISA legislation. Korea’s new financial investment firms can practically be viewed as investment banks.

Another important feature of the CMISA is the restructuring of the regulatory scheme. Currently, Korea’s financial regulation is structured in line with institutions. As an illustration, the Financial Supervisory Commission (FSC), a single, integrated government watchdog for financial markets and industry in Korea, and the Financial Supervisory Service (FSS), the implementation arm of the FSC, are organized in line with financial institutions such as banks, securities firms, insurance companies, and so on. Therefore when an investment service is provided by two

different institutions, regulation of the service imposed on each institution may be different, and there can be an opportunity for regulatory arbitrage. Under the CMISA, Korea’s financial regulatory scheme will be restructured to functional regulation, under which a single regulation is imposed on a single investment service regardless of the institutions that provide it.

Investor protection is expected to be stronger under the CMISA. New devices for investor protection such as the know-your-customer rule and the suitability principle are introduced, and the disclosure rules get additional refinement in the CMISA. By differentiating (presumably) more sophisticated institutional investors from ordinary retail investors, the regulatory burden of financial institutions for investor protection is expected to become more rationally balanced.

### **Challenges to Korean Securities Firms**

The CMISA is expected to bring about huge changes and transform the capital markets and investment services industry in Korea. Securities firms’ business models will be much more diverse, and this may provide stronger incentives for mergers and acquisitions in the investment services industry. Therefore the structure of these industries under the CMISA will be very different from the current structure. Some securities companies will evolve into true investment banks (that is, financial investment firms) in the sense that they will function as a total financial solution provider for corporate and investor customers. Those financial investment firms will be able to provide much more custom-tailored products or solutions to meet diverse needs of individual customers. The risk-bearing capacity of the whole Korean financial sector, including commercial banks and insurance companies, will be enlarged as these investment banks play more active roles as risk bearers. But it is important to remember that the CMISA meets only the minimum conditions necessary for all these changes and developments. Korean securities firms need to deal with some important challenges and tasks in order for the CMISA to bring about a real big bang.

First, the economic functions of Korean financial investment firms should be upgraded. The current economic function of Korean securities firms is simple brokering, even in the investment banking business. Investment products are predetermined by law, and

companies issue those predetermined investment products (securities) to raise capital. Investors simply put their money in those products. In this process, all that investment bankers in Korean securities firms do is link issuing companies and investors. Korean financial investment firms should be able to provide a more sophisticated function, a sort of asset transformation. Investment bankers should be able to devise and provide products for raising capital that meet the issuing companies' needs. Financial investment firms buy those products with their own money and provide issuing companies with capital. Therefore, financial investment firms bear a great deal of market risk. They make products bought from issuing companies into other investment products that can meet diverse investors' preferences through various financial engineering techniques, and they sell those products to investors. In this process, financial investment firms transform the risk-return profile of investment products; that is the key feature of the asset transformation of financial investment firms. With this asset transformation, financial investment firms can hedge their market risk. It is often mentioned that the key factors in Goldman Sachs's incomparable competitiveness as an investment bank are its cutting-edge techniques for this asset transformation.

The asset transformation function of financial investment firms naturally requires quite an aggressive attitude toward risk, but Korean securities firms appear to be excessively risk averse. According to the FSS, the average level of the capital adequacy (net capital requirement) ratio, the prudential regulation measure for securities firms in Korea, is about 600 percent and well above the regulatory hurdle of 150 percent. Korea's three biggest firms, which are widely believed to be closest to evolving into financial investment firms, are even more risk averse; their average capital adequacy ratio is above the 700 percent level. In comparison, the average level of the capital adequacy ratio of the two biggest Japanese securities firms is below 300 percent. That is, Korean securities firms take much less risk than Japanese firms and (most likely) global investment banks like Goldman Sachs

and Morgan Stanley. This shows that Korean securities firms have adequate capacity for additional risk taking at the current level of equity capital. It also implies that enhancing the efficiency of equity capital utilization is a more pressing task than simply increasing the size of equity capital of Korean securities firms. The asset transformation function of financial investment firms will affect their revenue composition, and principal investment increasingly will be an important source of revenue. Although principal investment still accounts for only a small portion of the revenue of large securities firms in Korea, it is already a major source of revenue of major global investment banks. For example, trading and principal investment accounted for 66 percent of total net revenue for Goldman Sachs and 31 percent for Morgan Stanley in 2005.<sup>4</sup> But there is a dark side in principal investment. Increased principal investment leads to increased exposure to market risk and to increased volatility in cash flow, which may have a negative effect on the market valuation of financial investment firms.

Another important and possibly more stable source of financial investment firms' revenue is expected to be wealth management or private banking services. The market for wealth management is growing rapidly around the world. The average annual growth rate in the number of high-net-worth individuals—those who own more than \$1 million in financial assets—has been 7.6 percent over the past 10 years. Korea witnessed the highest growth, 21.3 percent, in 2005.<sup>5</sup> Wealth management can generate stable and recurring fee revenues, and it may have a positive effect on market valuation. Under the CMISA, financial investment firms can serve customers with a much greater variety of investment menus, and the potential of the wealth management business looks large.

The investment services industry is known to be one of the industries that is most dependent on human capital, and the quality of employees is one of the most important success factors of financial investment firms. Labor productivity of Korean securities firms is still lower than that of global investment banks.

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4. These data are drawn from annual reports and the U.S. Securities and Exchange Commission Form 10-K filings of each firm.

5. *2006 World Wealth Report* (Capgemini and Merrill Lynch, 2006).

The average net revenue per employee of the three biggest Korean securities firms is about \$300,000, half that of three global investment banks (Goldman Sachs, Morgan Stanley, and Merrill Lynch) in 2005. Compensation is a key to recruiting and retaining a qualified labor force, and the compensation level of Korean securities firms is also lower than the levels of the global investment banks. In 2005, average compensation and benefits per employee of the three biggest Korean securities firms totaled about \$100,000, which was about one-third of the \$272,000 average for the three global investment banks cited earlier. In Korean securities firms, employee compensation is a relatively small part of operating expenses compared with global investment banks. Compensation and benefits account for only 18 percent of total operating expenses of the three biggest Korean securities firms while they account for more than 62 percent in the three global investment banks. This implies that Korean securities firms are rather passive in their investment in human capital development. In short, there is a vicious circle of low productivity–low compensation in Korean securities firms, and this must be changed to a virtuous circle of high productivity–high compensation.

First, it is necessary to raise the level of compensation in order to provide sufficient incentives for qualified and productive manpower. Second, the compensation scheme should be improved in order to be more closely linked to performance and productivity. It is necessary to devise performance measures that can show the true productivity of employees as exactly as possible. And there is an important caveat to be considered in designing performance measures: the possibility of conflicts of interest. One well-known example of this is the performance measure for retail salespersons of the broker-dealers. Many broker-dealers and securities firms in Korea use as a performance measure the trading value generated in customers' accounts for each salesperson because the brokerage commission revenue for broker-dealers is set as a percentage of the trading value. This naturally gives salespersons an incentive to increase the trading value and frequency of trades—in other words, churning. The interests of customers, firms, and firms' employees conflict with each other in many cases. Securities firms should put a clear priority on their customers' interests, and this should be reflected in their performance measures. Employee turnover is very

high in the Korean investment services industry, and therefore there is little incentive for individual securities firms to develop their human capital. This makes industry-wide efforts and cooperation toward training well-equipped and productive manpower more important.

The CMISA is now in the process of being finalized as legislation in the National Assembly of Korea. Even though most people agree with the necessity for the CMISA, individual firms in the investment services industry are inevitably facing uncertainty about the legal environment. It is the government's top priority, which can be accomplished through the prompt passage of the CMISA, to minimize the legal uncertainty faced by the industry.

## Conclusion

Every government in every part of the world is making enormous efforts to develop capital markets because well-functioning capital markets are without question an indispensable financial infrastructure for economic prosperity. Reform of the legal and regulatory framework is an important part of those efforts, and there are many such examples: the Financial Services Act (1986) and Financial Services and Markets Act (2000) in the United Kingdom; Financial Services Reform Act (2001) in Australia; Financial Instruments and Exchange Law (2006) in Japan; and the Gramm-Leach-Bliley Act (1999) in the United States. The CMISA in Korea is also one of those reform efforts. The CMISA legislation is based on the perception that it is hardly possible to enhance the competitiveness of Korea's capital markets and investment services industry under the current legal and regulatory regime. Therefore the CMISA is only a fulfillment of a necessary condition and the first step in the long journey toward a capital markets big bang in Korea. For the big bang to take place, active responses and aggressive efforts for change on the part of the capital market participants, especially firms in the investment services industry including securities firms, are essential.

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