SEOUL
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# Korea's New Economic Take-Off Critically Depends on the Financial Reforms It Will Implement

**Policy Recommendations**
**for**
**the Incoming Park Geun-hye Government**


## Seoul Financial Forum


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# Chairman's Introduction

**Over the past half century, Korea has achieved an economic progress envied by many in the world.**

**At this point, however, the Korean economy suffers from rapid deceleration of growth, growing unemployment and deterioration in income distribution. As a result, a great many Koreans are wondering how the nation will overcome these problems and achieve another economic take-off.**

**The Seoul Financial Forum shares this concern. This short report represents our efforts to recommend a course of action to overcome the current economic paralysis afflicting the nation.**

**The first chapter of the report reviews the efforts and progress the Roh Moo-hyun and Lee Myung-bak governments made for the past 10 years to turn Korea into a first-class international financial center. Chapter II outlines the major challenges facing the Korean economy. Chapter III identifies the key problems in Korea's financial sector. Chapter IV outlines the key reforms in the financial sector that the new government should implement. Chapter V suggests the ways for the new government to implement the reforms.**

**The Seoul Financial Forum sincerely hopes this report will be of some value particularly to the new team of policymakers who will undoubtedly wrestle with the problems identified in this report in the coming months.**

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# I. Financial Reform: An Evaluation of the Policies over the Past 10 Years

### 1-1. Seoul Financial Forum's recommendations for financial reforms

The Seoul Financial Forum (SFF) was founded in October 2001 by a group of leading scholar, policymakers, and professionals drawn together by a strong interest and expertise in finance as well as shared concern for the continued success of the Korean economy.

The mission of the Forum is to help Korea become a premier international financial center (IFC) in the world. It is critical for Korea to achieve this goal. For one, the financial industry itself is a high value-added industry. For another, as Korea becomes an IFC, its financial industry will become far more competitive than is the case currently. A highly competitive financial industry will in turn accelerate the transformation of Korea from a manufacturing-based to a knowledge-based economy. By making this transition, Korea's potential and actual growth will be greatly enhanced, thus providing more high value-added employment opportunities, particularly for its young citizens, and alleviating the deterioration in income distribution Korea has suffered over the past two decades.

In line with these objectives, the Forum has submitted major policy recommendations to the Korean governments. One of the more important recommendations was submitted to President-elect Roh Moo-hyun and the team that he appointed for takeover from the previous government in January 2003 entitled "Korea as an International Financial Center in Asia: Vision and Strategy." Another was submitted to President-elect Lee Myung-bak and his transition team in January 2008 entitled "Korea as an International Financial Center: Policy Recommendations for the Incoming Lee Myung-bak Government."

The key messages included in the January 2003 report submitted to Roh Moo-hyun were: For the continued economic progress of Korea, strengthening the competitiveness of the Korean financial industry was critical and the best way to achieve the necessary competitiveness was for Korea to become an IFC that is comparable to Hong Kong and Singapore by 2015. Among the measures recommended for this purpose were the change of Korea's financial regulatory paradigm from that of a positive list system to that of a negative list system and the strengthening of the resilience of the Korean economy to external shocks by broadening and deepening its foreign exchange market. The Forum recommended these key reforms to be completed by 2010. To ensure these outcomes, the Forum also recommended for the President to launch a Presidential commission for an IFC initiative within the Blue House.

The key messages in the January 2008 report submitted to President-elect Lee Myung-bak were that his government complete the policy initiative started by Roh Moo-hyun and finish the task of turning Korea into a major IFC by 2013 rather than 2015 in view of the progress being achieved by other financial centers in the world. In order to ensure the success of this initiative, the Forum also recommended that President Lee Myung-bak launch a Presidential Program Management Office and an international advisory council.

### 1-2. Evaluation of Progress under Roh Moo-hyun and Lee Myung-bak

**① Assessment of financial reforms by the Roh Government**

Soon after coming into office in 2003, President Roh accepted the IFC initiative suggested by the Seoul Financial Forum as one of the policy priorities of his government. He assigned the task of formulating the strategy for the IFC initiative and reporting of the progress of the task to the President to the Presidential Commission for Northeast Asia Era and the task of implementing to the Ministry of Finance and Economy. In line with these directives, in December 2003, the Ministry of Finance and Economy completed the first roadmap for an IFC initiative.

However, the Seoul Financial Forum found three major shortcomings in the first roadmap. First, the roadmap suggested 2020 as the target date for the completion of the IFC initiative. However, SFF found this target date highly unsatisfactory for the simple reason that not only Hong Kong and Singapore, the existing competitors in East Asia, but also Tokyo and Shanghai were making fast progress toward becoming an IFC. Second, the first roadmap concentrated on making Seoul an asset management center only. But this focus overlooked the many strengths Korea already had in the debt market, derivatives market, and private equity funds (PEF). Third, the SFF also found the division of labor for the IFC initiative between the Presidential Commission for Northeast Asia Era and the Ministry of Finance and Economy highly unsatisfactory. The Commission had no manpower and expertise in formulating the IFC initiative, while the Ministry had no strong incentives to implement the IFC strategy as it had no responsibility for directly reporting to the President the outcome.

In order to help solve these problems, the SFF issued a report in September 2004 entitled "Korea as an International Financial Hub: Policy Recommendations for Strengthening and Implementing the Government's Roadmap" and urged corrective actions on the part of the government.

In June 2005, the Roh government issued its second roadmap for the IFC initiative. This roadmap went far toward accepting most of the recommendations made by the Seoul Financial Forum. This roadmap named 2015 rather than 2020 as the target year for the completion of the IFC initiative. It also specified the debt, M&A, derivatives, and PEF markets as the fields for Korea to specialize in and designated the Minister of Finance and Economy concurrently serving as Deputy Prime Minister for Economic Affairs to be responsible not only for the implementation but also for the formulation of Korea's IFC Initiative.

The key achievements made by the Roh Moo-hyun government toward Korea's becoming an IFC include:

1. Launched Korea Exchange (KRX) integrating the Korea Stock exchange and the Korea Futures Exchange (January 2005)
2. Launched Korea Investment Corporation (KIC) for effective management of foreign exchange reserves (July 2005)
3. Implemented zero-based financial reforms (November 2005, July 2006)
4. Issued 20-year bonds to give rise to a "yield curve" for the economy (January 2006)
5. Launched KAIST Graduate School of Finance to increase the domestic supply of financial professionals (March 2006)
6. Allowed foreign companies to use KRX as a platform for primary listing (April 2006)
7. Replaced the advance permission system for capital account FX transactions with the ex-post reporting system (January 2006)
8. Announced that any remaining FX controls on capital account transactions would be removed by 2009 (May 2006)
9. Enacted the Capital Market Consolidation Act (July 2007)
10. Allowed foreign financial institutions to establish financial holding companies (August 2007)
11. Enacted the Law on Promotion and Development of the Financial Center (December 2007)

Especially noteworthy among the above measures are the enactment of the Capital Market Consolidation Act (CMCA) and the Law on Promotion and Development of the Financial Center (LPDFC). The CMCA was enacted to consolidate capital markets that had been fragmented and change the financial regulatory paradigm from the positive list system to the negative list system. The LPDFC was enacted to ensure continued progress of the IFC initiative after the Roh Moo-hyun government. With these actions, the Roh Moo-hyun government in effect completed the institutional foundation for Korea to become an IFC.

② **Assessment of policy efforts toward an IFC by the Lee Government**

While he was a Presidential candidate, Mr. Lee Myung-bak showed every enthusiasm for Korea's IFC initiative. This was not the case, however, once he was elected as President. Quite contrary to the earlier expectations, President-elect Lee Myung-bak showed little enthusiasm for his predecessor's initiative to turn Korea into an IFC. This was more than apparent when he met with the delegates of the Seoul Financial Forum on January 22, 2008. At that meeting, it was already quite clear that his government would rather place priorities on the so-called "real projects" such as "Four Major Rivers Project" than on reforms in software and services, such as finance. What's more, as the global financial crisis erupted shortly after his government came into power, it lost no time suspending financial policy reforms then underway and soon began to take actions to reinforce financial regulations and controls. For example, it soon suspended indefinitely the implementation of policies designed to liberalize capital account transactions in the FX market with a view to achieving the full convertibility of the Korean won and reversed the ex-post reporting system in FX capital account transactions to the ex-ante reporting one. Moreover, the Lee government took steps to further control both in- and out-flow of foreign capital. The key measures that have been taken under the Lee government include the following:

1. Suspension of the FX liberalization plan for an indefinite period (October 2008)
2. Introduction of pre-review system of OTC derivatives by amending the CMCA (February 2010)
3. Regulation on forward positions taken by domestic banks and foreign bank branches (October 2010, July 2011)
4. Regulation on the ELW (Equity Linked Warrant) market (November 2010, May 2011 and December 2011)
5. Imposing macro prudential stability levy on banks (August 2011)
6. Imposition of withholding taxes in capital gains in foreign investment in bonds (January 2011)
7. Introduction of hedge funds (December 2011)

With the exception of the introduction of hedge funds in December 2011, all of the policy measures taken by the Lee government definitely represented a retreat from the financial policy liberalization trend started under the Roh government.

As a result, Korea was left further behind Hong Kong and Singapore in the race to become a global financial center. Furthermore, Korea lost a great opportunity to catch up with global financial centers in North America and Europe during the crisis. What is more, Korea allowed places like Shanghai, which was a late comer to the race to become a leading global financial center, to draw ahead. What is most deplorable is the fact that by virtually giving up the IFC initiative Korea lost opportunities to accelerate the structural change of the economy from the manufacturing-based to the knowledge-based. It is indeed a great pity that by failing to follow up on the financial reforms started by its predecessor, the Lee government whose original intent was to revive Korea's economic momentum to high growth failed not only to prevent further deceleration of growth but also contributed much to the worsening of unemployment, deterioration in income distribution, and increasing vulnerability of the national economy to external shocks due to the growing volatility in its FX market.

## II. Four Major Economic Challenges Facing Korea

The four major problems just noted that the Lee government has not been able to address are precisely the major issues confronting Korea today.

### 2-1. Deceleration in Growth

Korea achieved an average annual growth rate of 9.2% in the 1970s, 9.8% in the 1980s, and 6.6% during the 1990s when Korea underwent the Asian financial crisis. Coming into the first decade of 2000, however, Korea's annual growth rate dropped to 4.2%. In 2011, the rate was 3.4% and in 2012, it dropped further to 2.0%. What's more serious, Korea's growth rate has not only dropped in the short term but is also expected to drop further in the coming years. In 2010, the KDI (Korea Development Institute) estimated that Korea's annual potential growth rate will drop from 4.1% in the 2001-2010 period to 3.8% in the decade of 2010s, 2.5-2.9% in the 2020s, and 1.5-1.9% in the 2030s. According to the 2012 OECD report, Korea's annual potential growth rate is likely to be 3.4% in the 2012-2017 period, 2.4% in the 2018-2030 period, and 1.0% in the 2030-2050 period. What is very disturbing is that Korea's actual growth rate may even become lower than these projections. Given these growth trends, it is reasonable to surmise that Korea's unemployment and income distribution will become worse than today.

### 2-2. Increase in Unemployment

According to official statistics in 2011, Korea's unemployment rate was 3.4%, which looks very good compared to 9% for the US and France, 7% for the UK, and 5% for Japan. However, if we were to include in the unemployment statistics people preparing for employment and people who gave up search for employment, the unemployment rate for Korea would be 8-10% according to KDI. Unemployment is most serious among youth. According to official statistics, the annual unemployment rate among youth increased from 5.7% in the 1990-1995 period to 7.7% in the 2006-2010 period. However, if those who gave up searching for jobs as well as who are preparing for employment are included in the statistics, this number would have been much higher. This can be surmised from the fact that Korea's youth employment rate of 23% is much lower than the 45% for the US, 50.9% for the UK, and 30.8% for France. The primary reason why unemployment has increased in recent years is because the manufacturing sector no longer creates employment. The employment elasticity of the manufacturing sector has steadily decreased from 0.38 in 2000 to -0.32 in 2008. The percentage of employment accounted for by the manufacturing sector dropped from 27.1% in 1990 to 16.7% in 2010. It is worth noting that while employment in the manufacturing sector declined both relatively and absolutely, Korea like many other advanced economies has failed to create enough high value-added employment in the service sector.

### 2-3. Deterioration in Income Distribution

According to Gini coefficients, Korea's income distribution, which deteriorated significantly during the 1997-98 financial crisis, began to improve through the early years of the 2000s. However, since 2003, Korea's income distribution has steadily deteriorated until now. Although there are some signs of improvement in Gini coefficient in the 2011-12 period, it is not all clear if this improvement will continue. Although Korea's current Gini coefficient is much lower than that of the US, it is worth noting that from the early 1990s to 2010, Korea's Gini coefficient deteriorated four times as fast as the US. The most decisive factor responsible for Korea's deterioration of income distribution has much to do with the rapid deceleration of growth and subsequent increase in unemployment. The fact that Korea's economic growth in recent years depended largely on the growth of capital- and skill-intensive manufacturing exports by large enterprises also goes far to explain why income distribution between those working for large enterprises and those working for small and medium enterprises has deteriorated. Globalization also explains why income distribution has deteriorated. With the progress of globalization, the industries depending on simple skill and labor intensive methods have migrated to China and Southeast Asian countries, while Korean companies depending on advanced technology-intensive industries have stayed at home. As a result, simple skilled workers at home have suffered unemployment and low wages, while highly skilled workers have continued to enjoy high wages and incomes. Another factor that accounts for the deterioration in income distribution has to do with the earlier retirement of many non-skilled workers. Unfortunately in Korea these workers have not had enough opportunities to prepare for their retirement unlike their counterparts in other advanced countries. Regardless of the causes, the deterioration in income distribution reduces the size of the middle class and aggravates the conflicts among social classes, thereby making it difficult to achieve social unity and policy consensus. Moreover, deterioration in income distribution increased demand for welfare services, threatening the health of public finance.

### 2-4. Lack of Resiliency to External Shocks

The Korean economy greatly lacks resiliency to external shocks. This has proved to be the case time and again: the 1997-98 financial crisis, the IT bubble burst in 2000, the 2008 global financial crisis, and the 2011-12 euro zone's public debt crisis. In every one of these crises, Korea's exchange rate fluctuated greatly, Korean stock prices plunged, and its growth rate dropped sharply. These in turn increased risks and uncertainties for all economic activities and asset management. Many believe that Korea's high susceptibility to external shocks is due basically to the openness of its economy. However, it should be borne in mind that economies such as Hong Kong, Chile, Taiwan, and the Philippines do not suffer as much as the Korean economy. It will be shown later that the primary reason for Korea's high susceptibility to external shocks has more to do with the limited size of its FX market, the weak competitiveness of its financial industry, and insufficient ability on the part of the government to manage financial stability.

# III. Major Problems in the Korean Financial Sector

The major problems facing the Korean financial sector fall into four categories. First, the financial sector is highly limited in its capabilities to help address the four major challenges facing the economy today. Second, the financial sector itself is not only very weak in international competitiveness but also highly underdeveloped. Moreover, the financial sector is handicapped in many ways in pursuing sufficient profits. Finally, a great deal of all these problems stems from the regulatory regime to which the sector has been subjected.

### 3-1. Limited Capabilities to Help Address the Challenges Facing the Korean Economy

First of all, the Korean financial sector is very limited in its ability to help Korea attain growth and create jobs. In 2010, the financial sector's backward linkage effect, an indicator of how much effect the growth of a given sector has on the growth of other sectors of the economy, was 1.89, substantially lower than 2.83, the average of all the sectors. The share of Korea's total employment accounted for by the financial sector fell from 4% in 2010 to 3.3% in 2011. Furthermore, in 2010 the employment inducement coefficient for the financial sector was only 9.4 persons, much lower than 23 persons, the average of all the sectors.

One important reason why the financial sector has such minimal effect on the growth and job creation for the economy stems from its highly limited capacity to provide adequate financial services for small-medium enterprises (SMEs) that account for more than 85% of total employment of the Korean economy. The financing needs of the Korean SMEs have been met for the most part through indirect financings such as loans from banks, rather than direct financing in the form of issuing corporate bonds or equities. At the end of 2011, in fundraising methods used by SMEs, bank loans accounted for 95.5%, compared to 4.7% in company papers, 4.0% in corporate bonds, and 1.8% in private financing. Commercial banks generally require SMEs to provide collateral or multi-party guarantees when they make loans to SMEs. This is one important reason why SMEs or venture firms in Korea have had difficulties raising funds although some of them have enough new technologies or business models to be financed directly. The same also goes far toward explaining why Korea has fallen short in supporting startup ventures compared to other major economies. In 2009, the ratio of venture investment to GDP in Korea was 0.09%, far lower than 0.45% for Israel or 0.17% for the US.

Korea's financial sector is also very limited in providing financial services to Korean firms undertaking large-scale overseas projects, such as the construction of plant facilities and nuclear power plants. Ever since the first oil shock of 1973, these overseas projects have made great contributions to Korea's economic growth. Until recently, however, Korea was not expected to participate in these projects with long-term financing. Korea's limitations in providing such financings are now placing Korean construction companies at a serious disadvantage in winning large-scale overseas projects. A case in point is the nuclear power project put to bids by the Turkish government. In 2011, the Turkish government called for bids for the construction of its nuclear power plant. Although Korea was highly competitive on engineering and technological grounds, it lost the first bid because it could not provide long-term financing for the project at the same time. As Korean financial institutions have not been able to provide adequate financial services for large-scale overseas projects, the needs have been met by large foreign financial firms. What's more, as Korean financial institutions lack core competence in acquisition financing and advisory services for the M&As involving large overseas corporations, these fields have been dominated by major overseas investment banks. In short, because of its limited capacity, the Korean financial sector has not been able to take advantage of such new opportunities brought about by globalization.

On the domestic front, the Korean financial sector has also failed to make significant contributions to improving income distribution for the nation. With the trend of early retirement and the aging of the population, demands for new financial products and services especially in asset management have been growing. However, the financial products and services offered by Korean financial firms have not been adequate to meet such new demands. As a consequence, income disparity between old and young generations has been growing. So far, the Korean financial institutions have also failed to provide adequate financial services for individuals and groups with low income and bad credit. Over the past few years, the government has taken the initiative to meet the needs of this particular social segment through such new lending programs as Micro Credit, Sunshine Loans (Haetsal-loans) and Seeds of Hope Loans (Heemang Holssi). It is important to note, however, that these programs are not likely to be sustained over the long run as these programs have been based more on public policy or philanthropic considerations rather on commercial considerations based on market principles. What is more, since the interest rate and other terms of the loans extended under these programs are insufficiently based on market principles, private financial firms have been reluctant to participate in providing credits for citizens with low income and low credit, which in turn has contributed to driving more of these borrowers into default situations.

Yet another similar misguided policy is underway. Since 2011, there has been a rise in Personal Debt Rehabilitation System (PDRS) filings to the court, often encouraged by agents who handle the filing process for a fee. PDRS is one of the debt relief programs available to the heavily indebted consumers. Once approved by the court, the debt amount is adjusted downward to a level that is measured in such way that the borrower can repay the loan principal over a period of 5 years in installments while interest payment is waived. Although this scheme is well designed and legitimate, there has been a worrisome increasing trend of borrowers walking away from their obligations soon after taking up a new loan. Moreover, banks are being pressured, as a kind of “social contribution,” to lend more to non credit-worthy customers at interest rates that do not cover the intrinsic risk cost and rising loan impairment charges. As banks are under increasing pressure to make such social contributions, global credit rating agencies have also voiced concern about the impact on the banking sector’s profits. This could lead to a downgrading of Korean banking sector and sovereign ratings in global markets. Furthermore, the recent discussion on the creation of a national “bail-out” fund for consumer debt (dubbed the “National Happiness Fund”) may also lead to unintended consequences as this scheme could encourage borrowers to default, hoping that the “National Happiness Fund” will bail them out. Similarly, this will also lead to a serious moral hazard problem.

In any market situation where the consumers are seriously disadvantaged vis-à-vis the producers in terms of bargaining powers, government intervention in favor of the former is justified. Generally speaking, this is the case in many markets for financial services. Simply put, it is about time that the Korean government to introduce more consumer protection in connection with many financial services. So far, however, Korea’s financial supervisory authorities and financial firms have not made sufficient efforts to protect financial consumers. Although the government has recently tried to improve the institutional environment for financial consumer protection by establishing a financial consumer protection agency under the umbrella of the Financial Supervisory Services, there have not yet been any credible actions to improve financial literacy education. If such actions are not taken soon, a large segment of financial consumers will continue to fail in choosing the proper financial services or products as have happened in the cases of KIKO and the savings banks’ fiasco. Such consumer failures will hamper not only the healthy growth of the financial sector but also that of the overall economy.

As already noted, the Korean economy has been extremely vulnerable to almost all external shocks - large or small. As witnessed during the global financial crisis in 2008 and the debt crisis in advanced economies in 2011, Korea's foreign exchange market as well as stock market reacted with extremely volatility. Such volatility increases risk to be borne by all economic players including traders in both goods and assets. This in turn makes the entire national economy less competitive in global markets.

### 3-2. Weak financial competitiveness and underdeveloped financial markets

The financial sector has failed not only in helping Korea meet the four major economic challenges, but also in strengthening its competitiveness vis-à-vis other economies. According to the 2012 International Institute for Management Development ( IMD) World Competitiveness Index, Korea's competitiveness in finance ranked 25$^{th}$, very low compared to the nation's economic size currently being ranked at 15th and its overall competitiveness ranked at 22nd. Also, according to the World Economic Forum ( WEF) Rankings of National Economic Competitiveness 2012, Korea ranked 71st in "financial market sophistication" among the 144 countries surveyed.

**① Weak financial competitiveness**

Korea's financial institutions are weak in competitiveness due to several factors: limited profit sources, lack of financial expertise, weakness in global operations, lack of risk management skills, and most of all, overall lack of flexibility in Korea's labor market .

Korean banks heavily depend on net interest margin (NIM) as the chief source of income. Currently, Korean banks' overall revenue is composed of 80.4% in interest income and 19.6% in non-interest income, which is sharp contrast to 75% and 25% of US and Japanese banks, and 55% and 45% of UK and European banks. For securities companies, brokerage commission fees account for much of their total revenue, while high value-added income from investment banking and asset management services account for only a small portion. Korea's top 5 securities companies earn about 40% of their revenues from brokerage commissions, while Goldman Sachs earns 40% and 30% of its total revenue from proprietary trading and investment banking, respectively. Korean insurance companies which are heavily dependent on the traditional insurance business have so far little income to show from any other financial banking services.

The lack of financial expertise is another cause of the weak competitiveness of Korean financial institutions. According to the IMD Rankings of National Competitiveness 2011, Korea ranked 46th in "the availability of finance skills" among the 59 countries surveyed. The proportion of financial experts to total personnel engaged in the financial sector stayed at 8.9%, much lower than 16.5% in the UK, 43.8% in Hong Kong and 51.3% in Singapore. As a result, Korean financial institutions have not been able to develop the range of financial products needed for the growth of the nation's economy through innovation and the rapidly aging population.

Korea also lacks globally competitive investment banks. While global investment banks earn more than 50% of their total revenue from the overseas business (more than 80% and 60% for Deutsche Bank and HSBC, respectively), Korean financial firms' overseas revenue accounts for 5% at most because of limited size in assets and capital, insufficient expertise, and inappreciable global operations. Reflecting this weakness, as of the end of 2011, no Korean bank was included in the world's top 25 banks on the basis of tier 1 capital whereas four Chinese and four Japanese banks were included. The transnational index (TNI) of Korean banks stood at 3.2%, while such global financial institutions as UBS, HSBC, Citi and Credit Agricole at 77%, 65%, 44%, 37%, respectively. Even Mitsubishi Bank of Japan showed significantly high 29% in the TNI. With such weak global competitiveness, Korean financial institutions have not been able to take advantage of enormous opportunities brought about by globalization.

Korean financial institutions have also been weak in risk management, particularly in liquidity management. They have tended to borrow a large amount of foreign currencies on a short-term basis when external conditions were favorable. Consequently, when external conditions deteriorate, they face difficulties securing enough foreign currency funds to pay back large external debts. Furthermore, the liquid assets retained by Koran banks to deal with potential cash outflows are not of a high-quality that can be easily converted into cash at a time of crisis.

One highly important cause for Korea’s weak competitiveness in many areas of its financial sector has much to do with the lack of flexibility on the part of the management of financial institutions to adjust their workforces in response to changes in the market and technology. According to the OECD Indicators of Employment Protection 2008, Korea ranked 24th out of 40 countries surveyed, of which 30 are OECD member countries and 10 selected emerging economies, in providing employment protection. Actually, this is a gross understatement. For all practical purpose, foreign and large domestic companies including financial institutions do not have the freedom to dismiss regular full-time employees. They usually have to pay extraordinary amounts of early retirement allowances to induce voluntary resignation. The legislation to protect non-regular workers passed in 2006 has further reduced managerial flexibility in hiring and firing workers. Moreover, some Korean unions exploit anti-foreign sentiment in dealing with foreign investors, ignoring the immense contributions foreign capital has made to Korea’s economic development. All of these problems caused by strong labor unions have been particularly troublesome in the financial sector because being a knowledge-based industry the financial sector requires labor flexibility more than any other industry.

② **Underdeveloped financial markets**

If financial markets develop fully, they can play an effective role in offering funds necessary for the real sectors to grow and allow long-term financial planning for the general population. However, as Korean financial markets are still underdeveloped, they have not been able to play such roles properly.

As the foreign exchange market has been small and narrow, foreign exchange rates have fluctuated heavily even at the in- and out-flow of small amounts of foreign currency funds. Although Korea’s daily average FX trading volume increased from $35.2 billion in 2007 to $43.8 billion in 2010, it was no more than a fifth of those of advanced countries and a fourth of those of Hong Kong, Singapore and Luxemburg, all of which are far smaller than Korea in terms of economic size. Furthermore, Korea’s ratio of daily average FX trading volume to GDP stood at 5.3%, a third of advanced countries’ 15.9% and a twentieth of overall average 109.2% of Hong Kong, Singapore and Luxemburg. What is worse, the already small foreign exchange market has been getting smaller and narrower due to government’s FX controls. As of the end of the first quarter 2011, Korea’s daily average FX trading volume sharply dropped to $22.45 billion, a half of that of 2010. The rapid fluctuations of foreign exchange rates caused by the small and narrow foreign exchange market have increased unnecessarily the exchange risks for Korean companies and individuals engaged in all forms of international transactions.

For the asset management market, the number, trust deposits and trust assets of mutual, hedge and private equity funds, which steadily increased during the 2000s, has remained stagnant since 2008, while the trading volume of ELWs, which once reached 2 trillion won, has recently decreased by 90%.

Korea's capital market has been dominated by large companies. In the capital market, large companies have been able to raise funds more easily than SMES and venture firms. Moreover, as SMEs and venture firms have had difficulty being listed on the KOSDAQ market due to complicated requirements, and as there have been few transactions on the OTC free board market, SMEs and venture firms have been unable to effectively raise funds even in these two markets originally created for them. For the corporate bond market, although its size has been growing, large companies have monopolized bond issues. During the month of October 2012, large companies have accounted for 99.8% of total corporate bond issuance of 4.4 trillion won. The underdevelopment of the M&A market exclusively for SMEs and venture firms also has hampered investment in them, thus hindering their growth and innovation.

The insurance market, lacking in various products and services to meet the needs for the economic slowdown and the rapid aging of the population, has also suffered from "herd behavior." Currently, of total sales of insurance companies, the proportion of savings insurance products accounts for much higher than that of coverage insurance products. The proportion of savings insurance products of life insurance companies has reached 75-85% of their total sales. Although insurance companies are able to attract more clients and secure more assets under management by selling savings insurance products offering higher interest rates than banks, their return on assets has been decreasing due to the prolonged low interest rate trend. Consequently, they might see the reverse margin in savings insurance products at the worst. The return on assets of life insurance companies dropped from 5.9% in 2010 to 5.2% in 2011 and is expected to further drop to the 4% level in 2012, and that of non-life insurance companies is also expected to drop to the 4-5% level in 2012. If the profitability of insurance companies continues to deteriorate due to the sales strategy focused on savings insurance products, many insurance companies might face the dilemma of not paying agreed interest to clients or go bankrupt.

### 3-3. Profit motive not given full play

What is the reason behind Korea's very limited financial competitiveness and its underdeveloped financial markets? The best answer is that as far as the financial sector is concerned, profit motive has not been given full play by the nation's policymakers and regulators. To begin with, the governance system has not been allowed to be fully developed. Many Korean banks, for example, have not been allowed to have the benefit of effective majority ownership due to the regulations on the shareholdings of banks. Under current regulations, no shareholder is permitted to own more than 10% of the shares. In addition, there has been a long delay in privatizing those banks that became government owned as a result of public funds that had been injected during the 1997-98 financial crisis. As a consequence, government-directed financing practices are still widespread throughout the banking system. Under these conditions, the terms of office for management at government-owned banks in particular have shortened. As a result, many CEOs at Korean banks have been inclined toward short-term performance, neglecting the long-term interest of their institutions. One serious consequence of such practices has been poor overall financial performances of banking institutions in Korea. Currently, the market capitalization values of many Korean banks are far below the values of their shareholders' equity. This in itself is a very serious situation. What is more worrying is that new investors, both local and foreign, will be deterred by this fact. In addition, this means that the shares of the Korean banks will not be valued as assets for acquisition, and, thus, any new investment by these institutions both at home and abroad by issuing further stocks is out of question. No wonder Korean financial institutions have been limited in expanding their operations both at home and abroad.

### 3-4. Misguided regulations: the fundamental factor weakening the Korean financial sector

Most of the problems pointed out above stem from the absurd regulations that go against market principles and the inefficient regulatory regime to which the financial sector has been subjected.

**① Misguided regulations against market principles**

Since the financial crisis in 2008, advanced countries have been imposing tougher macro-prudential regulations and OTC derivatives regulations to stabilize their financial markets. Korea has also been following this trend to further reinforce financial regulations although its existing regulations were already far more stringent compared with the reinforced regulations of advanced countries. Thus, Korea has been unable to narrow the gap between itself and advanced countries in terms of regulations, making foreign creditors and investors perceive Korea as a country unfavorable to business. This is one important reason why some foreign creditors and investors have begun to consider leaving Korea.

The Capital Market Consolidation Act (CMCA) was originally intended to introduce a negative list system. Since February 2009, however, it has not been enforced as such with numerous new restrictions being applied in practice. As a result, the market-stimulating effect of the CMCA has been limited at best. Furthermore, the new amendment to the Enforcement Decree of the CMCA which took effect in September 2012 allows offshore financial investment companies to conduct financial investment business, like the issuing of derivative linked securities, without obtaining a financial investment license from the Financial Services Commission (FSC). This is contrary to the original policy intention that requires derivatives businesses to be licensed and run onshore, and inconsistent from a policy perspective where on-shoring is emphasized to ensure that complex derivatives activities are regulated onshore. Also, this measure can amount to reverse discrimination against onshore financial institutions that have already invested substantial amounts of resources and manpower in the business.

There have been rigid regulations on the sharing of customer and transaction information as well as back office functions and IT system platforms among the affiliates of global financial firms. The minimum requirements for obtaining a new business license are also excessively rigid, acting as an entry barrier. The current regulations often require financial institutions apply for one business license at a time. After the amendment of Banking Act in November 2009, foreign bank branches have to file incidental and concurrent business pre-reports to the FSC seven business days in advance before deal execution whereas these were previously deemed to have been granted automatically at the time of obtaining the banking license. The pre-report process is actually similar to the license application process taking a couple of months mainly because it is not delegated to the Financial Supervisory Service unlike other license applications. These regulations have combined to significantly hamper the business and investment activities of global financial institutions operating in Korea.

In addition, the regulators have tended to resort to the paternalistic approach rather than taking stringent sanctions against rule breaking in a transparent manner. Although the difference between the two approaches may not look very important at a first glance, the paternalistic approach undermines the rule of law that is integral to the market economy. Furthermore, as paternalism tends to serve the interests of domestic financial firms, it may give rise to international disputes sooner or later. The tendency to resort to paternalism is one additional reason why financial institutions from abroad are reportedly considering withdrawing from some of their operations in Korea. The FX controls, including the regulation on FX derivatives positions and the withholding taxes on foreigners' gains on bond investments that have been imposed since 2008, have made Korea's FX market even smaller and narrower than before. Thus, even a small change in the trading volume of foreign currencies can cause a sudden and sharp change in the exchange rates. Moreover, the Lee Myung-bak government suspended the efforts toward full convertibility of the Korean won by postponing the FX market liberalization plan indefinitely in October 2008. All these regulations and actions have combined to put the heavy burden of double currency risk on Korean financial institutions and corporations engaging in international businesses.

② **Inefficient financial regulatory framework**

The financial supervisory function is divided into two organizations; the Financial Services Commission (FSC), which formulates policies on domestic financial supervision, and the Financial Supervisory Service (FSS), which implements supervision. This division has resulted in supervisory inefficiency and inconsistency between policies and supervision. Under this dual framework, supervisory deficiencies and market imperfection brought out in the course of performing supervision and examinations have not been adequately reflected in the subsequent formulation of supervisory policies. Likewise, the market information that the FSS has obtained in the course of implementing supervision has not often been effectively communicated to the FSC. Furthermore, many FSC officials serve in the FSC on a rotation basis with officials at the Ministry of Strategy and Finance (MOSF). As a result, many of them do not continually serve at the FSC and thus lack expertise in financial supervisory policies.

Established to take over the power to formulate domestic financial policies from the MOSF, the present FSC has the responsibility for financial policies aimed at developing the financial sector as well as financial supervision designed to strengthen the financial soundness of banking institutions and protect financial consumers. As has been seen in the series of savings bank scandals in recent years, however, priority has been given more to financial policies than to financial supervision, thus impairing the efficacy of financial supervision.

Moreover, the current division of functions between the MOSF responsible for formulating international financial policies governing foreign exchange rates and reserves on the one hand and the FSC responsible for formulating domestic financial policies governing the market and industry is no longer viable in the globalizing world where the boundary between international and domestic finance is being blurred.

It is also important to note that to date Korea has not paid due attention to the need for macro-prudential supervision, which is taking on greater importance in the world as a tool to mitigate systemic risk in the financial markets. The FSS has yet to move away from its preoccupation with micro-prudential supervision over individual financial institutions, and the Bank of Korea (BOK) and the Korea Deposit Insurance Corporation (KDIC) have been playing their roles in macro-prudential supervision to a limited extent.

Financial consumer protection as well as education should be part of the institutional fabric of the financial markets, but this has not yet happened in Korea. While there has been some progress in financial consumer protection with the improvement of relevant regulations, substantial efforts for consumer education have yet to be undertaken. In an effort to protect financial consumers, the FSS has recently organized the Financial Consumer Protection Bureau under its umbrella. However, critics point out that there are inherent conflicts of interest in one institution, the FSS, taking responsibility for both consumer protection and prudential regulations. Under this arrangement, there is a danger that consumer protection will be given less attention than prudential regulations.

# IV. Financial Reforms: Key Agenda and Recommended Actions

The financial reform agenda the incoming government should adopt must address the four major economic challenges facing Korea and strengthen the competitiveness of the Korean financial sector. As the agenda for financial reforms include many issues that are interconnected, an organic approach is needed.

## Strengthen Financial Support for Economic Growth and Job Creation

### 4-1. Develop the Financial Sector to create high value-added jobs

① **Develop Korea into an IFC to create high value-added jobs** If Korea becomes an IFC comparable in scope to Singapore and Hong Kong today, at least 480,000-640,000 high value-added jobs will be created in various financial subsectors, including FX trading, international banking, fund management, and the issuing and underwriting of international bonds; and in related service sectors, including accounting, legal services, and business and management consulting.

② **Improve labor market flexibility:** In spite of some efforts on the part of the Korean court to increase room for adjusting workforce by management, Section 1 of Article 24 of the Labor Standard Act still does not allow management to lay off workers for greater managerial efficiency. Any layoff still requires an emergency situation to adjust workforce under this provision. As a result, financial institutions tend to minimize or avoid new recruitments. Hence, Section 1 of Article 24 of the Labor Standard Act must be abolished to give financial institutions more freedom to lay off in the short run but create more jobs in the long run by allowing timely adjustment to market and technological developments.

### 4-2. Increase financial support for SMEs and venture firms

In order for the Korean economy to sustain growth and create jobs through continued innovation, it is essential that SMEs and venture firms accounting for more than 85% of the nation's employment should develop vigorously. To this end, the following actions should be taken:

① **Expand the participation of private financial institutions in the management of the rating agency specializing in SMEs and venture firms:** Currently, financial institutions provide most of the loans for SMEs and venture firms on a secured basis. This practice should be changed so that SMEs and venture companies obtain their financings mostly on a non-secured basis. To this end, it is essential for the rating agency to acquire the ability to evaluate the technological capabilities and business potentials of SMEs and venture firms concerned. However, Korea Enterprise Data (KED) that was established as the rating agency specializing in SMEs and venture firms has operated as a subsidiary of the Korea Credit Guarantee Fund. As a result, it has limitations in collecting the information on SMEs and venture firms because private financial institutions are quite reluctant to share their data with KED with whom they share little common interest. Thus, expanding private financial firms' participation in the management of KED would enable KED to collect more information to evaluate SMEs and venture firms more efficiently.

② **Create a new capital market for use exclusively by SMEs and venture firms:** In order to foster innovative SMEs and venture firms, a new capital market for use exclusively by SMEs and venture firms should be established so that they can raise funds more easily.

③ **Promote "technology cooperation network loans":** The "technology cooperation network loans" refer to the loans SMEs can obtain on the basis of the credit of large companies with whom they develop technologies jointly. This would contribute not only to the greater ability of credit available to SMEs but also to the mutual development of large companies and SMEs.

④ **Develop the M&A market for SMEs and venture firms:** One reason why investment in venture firms has been stagnant is that primary investors have had difficulties in withdrawing their original investment for investment opportunities elsewhere. One way to solve this problem is to develop the secondary market for initial investment in SMEs and venture firms. To address this problem, the government should encourage the development of small- and medium-sized M&A advisory firms and expand M&A matching funds.

⑤ **Streamline the roles of the Industrial Bank of Korea (IBK) and the Small & Medium Business Administration (SMBA):** So far, the IBK and the SMBA have concentrated on providing policy-based financing for SMEs. From now on, however, they should focus on helping SMEs cultivate their abilities to make use of market-based financing. In this regard, policymakers will do well to benchmark the role played by the Business Development Bank of Canada (BDC). The BDC, Canadian equivalent to the IBK, has produced good results in helping SMEs cultivate their abilities to make use of market-based financing rather than offering them financing directly.

⑥ **Provide flexible support for startup ventures:** In order to promote startup ventures, policymakers will do well to benchmark how the Israeli government has supported startup ventures. After a simple review of their business models, the Israeli government offers $200,000-300,000 in loans to the startup ventures if they have any chance of success. If the venture is successful, the loan is repaid. Should the venture fail, the loan is forgiven without any stigma. This feature has gone far in removing any stigma that goes with a failed venture. Before extending the loan, however, the Israeli government requires the venture to have a managerial board recommended by or acceptable to the government that include one technology expert, one management expert, and one financial expert.

### 4-3. Strengthen project financing capabilities for large-scale overseas projects

Despite their advanced technologies in large-scale overseas projects, Korean companies have had difficulties in raising funds for the projects due to the lack of financing support by domestic financial institutions. In order to help Korean companies regain their comparative advantage in large-scale overseas projects, Korean financial institutions should strengthen their core competence in providing financial services for such projects on their own or in cooperation with foreign investment banks. To this end, the following two actions should be taken.

① **Enlarge the capital of the Ex-Im Bank:** In order to help finance large-scale overseas projects, the capital of the Ex-Im Bank should be continuously enlarged.

② **Strengthen investment banking capabilities of domestic financial institutions and encourage them to advance into the global market:** Most of all, efforts should be made to enhance domestic financial firms' capabilities in financial advisory and arrangements, project feasibility analysis, and global networking for distribution of financial products. To this end, the government needs to promote domestic financial firms to enlarge their size and to advance into the global market (for more details, please refer to paragraph 4-11. "Foster global financial institutions with investment banking capabilities" below).

### 4-4. Give full responsibility for policy-based finance to Korea Finance Corporation, making it concentrate on R&D and regional development

Basically, Korea Finance Corporation (KFC) should assume full responsibility for all policy-based financings while private banks provide market-based financings. To this end, the following actions are needed:

① **Give full responsibility for all policy-based financings to KFC:** All of the policy-based financing functions, currently scattered over various agencies, should be integrated and offered systematically under the exclusive responsibility of KFC. KFC should take full responsibility for welfare-oriented financing for the low income class as well.

② **Concentrate policy-based financings on R&D and regional development:** As policy-based financings should not conflict with the norms of the WTO, they should be offered only to long-term R&D and regional development projects.

## Strengthen the Role of the Financial Sector in Promoting National Welfare

Although the promotion of national welfare should, in principle, be provided through government funding, the private financial service sector - to the extent that it does not undermine market economy principles - can also contribute to the betterment of public welfare across many dimensions. The following measures are required for the private financial sector to better play this role.

### 4-5. Improve the pension and health insurance system

① **Strengthen public-private partnerships to build a sounder social safety net:** Because government public finances alone cannot fund all welfare needs and enhance the soundness of the social safety net on its own, private insurance must become an important pillar underpinning the social safety net.

② **Greater tax benefits and income tax deductions for private pension/health insurance products:** Greater tax benefits for private pension plans should be provided as an added incentive for individuals to prepare for post-retirement. Income tax deductions should be given to premiums paid under private health protection plans (medical indemnity insurance or long-term care insurance). Alternatively, the existing ceiling on income tax deductions for coverage insurance policies should be raised.

### 4-6. Promote the availability of financial products and services that meet the welfare needs and demands of an aging society

① **Encourage the design and supply of diverse products that meet the needs of the aging population**: Developing such diverse products as “substandard annuities” (a pension plan that provides higher annuity payments to high-risk annuitants with serious medical impairments), “advanced life deferred annuities” (a pension plan where a share of one’s retirement assets are deferred and paid as annuity income at an advanced old age, such as 80), and “medical expense insurance for the aged” must be encouraged. Moreover, the government should try to promote the wide use of “private reverse-mortgage loans,” which are less competitive compared to similar products provided by the Korea Housing Finance Corporation and highly risky for private lenders.

② **Manage longevity risk**: Financial institutions should be encouraged to develop diverse financial products such as “longevity swaps” that help hedge longevity risk. The long-term government bond and inflation-linked bond markets need to be fostered to provide investment vehicles to fit the increasing duration of pension fund management. Also, in order to ensure the stability of private insurance, an evaluation system needs to be implemented to determine whether "arbitrary uninsured benefits" such as new medical technologies can be covered by insurance or not.

③ **Provide comprehensive financial planning services**: In order to help individuals manage their assets and debts efficiently, comprehensive financial planning services need to be provided. To this end, it is essential to train financial planners with expertise and ethics as well as to establish a self-regulatory organization to control their expertise and ethics.

### 4-7. Expand market-driven financial services for low income individuals

① **Promote market principles in micro credit lending:** The key objective of micro credit policies should be to ensure that a continuous supply of credit is made available based on market principles and without the support of government guarantees. A market-friendly approach is required so as to provide differentiated micro credit products by demand and risk type and charge different rates depending on the credit quality of the borrowers. If a private financial institution is required to provide micro credit policy-based loans, the government should make up the loss.

② **The Korea Finance Corporation to be in charge of micro credit lending for welfare purposes:** Apart from regular micro credit offered by private financial institutions based on market principles, KFC should take full responsibility for micro credit policy-based loans offered to serve welfare objectives.

### 4-8. Avert the risk of moral hazard and widespread default in consumer debt

An industry wide task force should form a partnership with the government to find long-term solutions, particularly for the unusually large secondary financial sector (comprising about 50% of consumer debt assets) that have provided most of the high interest-rate loans. Solutions should centre around debt guarantees and debt restructuring of delinquent debt, facilitated through policy banks and supported by the private sector banks on a reasonable and sustainable economic basis. The Korea Asset Management Corporation (KAMCO) would be well suited to lead such an initiative, given its successful experience in fully recovering public funds it used to purchase non-performing loans.

## Make a Financial Sector Resilient to External Shocks

### 4-9. Achieve full liberalization of the foreign exchange market and full convertibility of the Korean won

① **Eliminate FX regulations that restrict foreign currency liquidity**: The current government restrictions on the foreign exchange market should be eliminated to allow the exchange rate to be determined by market fundamentals. Additional measures are also required to increase the breadth and depth of the foreign exchange markets (spot, forward, and derivatives). The new Basel III liquidity requirements are likely to spark competition for high-quality liquid assets among banks around the world, having an adverse impact on cross-border foreign currency liquidity flows. Therefore, the current measures that restrict cross-border foreign currency liquidity flows, such as the ceiling on FX forward positions as well as the withholding tax on foreign investor's bond holdings, should be eliminated.

② **Achieve full convertibility of the Korean won:** While Korea has a more liberalized and flexible capital market than other emerging economies, the local capital market is still categorized as an emerging market, rendering it vulnerable to sudden movements of capital and market volatility in times of crisis. In order to reduce abrupt capital movements and market fluctuations, the Korean capital market must be upgraded to advanced market status. For this to happen, the lack of full convertibility of the won, which is the biggest obstacle barring Korea's inclusion into the developed market index, must be resolved. To this end, the Korean won must be made fully convertible and internationalized so that it can be used as an offshore settlement currency. This would prevent the distorted ballooning of the NDF (Non-Deliverable Forward) market being observed today as well as the extreme contraction of the foreign currency spot market, while also acting as a trigger for local financial institutions' overseas expansion. Given these numerous benefits, the full convertibility of the Korean won should be the most critical reform agenda for the incoming administration. This is why the full convertibility of the won should be accomplished by 2015 at the latest. Finally, considering Korea's geopolitical position, the full convertibility of the Korean won must be achieved before the Chinese yuan becomes fully convertible.

### 4-10. Pursue market-based foreign exchange policies and improve the foreign currency management system

① **Pursue market-based foreign exchange policies:** The FX rate should be determined by the market according to supply and demand. Moreover, the government must not intervene unless there is a national crisis or emergency.

② **Improve the government's foreign currency liquidity management system:** The current quantitative regulations on foreign currency liquidity need to be changed to qualitative ones, with financial institutions encouraged to retain sufficient highly liquid assets for stress situations at their discretion. It may be necessary to consider adopting Basel III's Liquidity Coverage Ratio (LCR) and Net Stable Funding Ratio (NSFR) requirements earlier than indicated in the original timeline (e.g., 2015 and 2018, respectively). Also, our early warning system must be improved by incorporating results from qualitative assessments for greater predictability of foreign currency liquidity crises. Finally, stress testing and contingency funding plans must be devised and implemented by each and every one of the financial institutions to guard against the possible deterioration of external conditions.

## Strengthen the Competitiveness of Financial Institutions

### 4-11. Foster global financial institutions with investment banking capabilities

① **Allow mega financial institutions and universal banking:** The commercial banks that have become government-owned since the 1997-98 financial crises should be returned to full private ownership within the shortest period of time. In addition, these banks should be encouraged to expand in size during the privatization process. Bigger size will help attract world-class human resources particularly in the investment banking area among other high value-added areas, which in turn will help strengthen the overall competitiveness of local financial institutions in areas including investment banking. However, since the Capital Market Consolidation Act (CMCA) was not implemented in keeping with its original intention, universal banking in Korea still remains a hope. As long as Korean financial institutions are not allowed to operate as universal banks, it will be in effect difficult to attain both the size and competitive strength. Hence, regulations restricting universal banking should be eased so that local financial institutions can make dramatic improvements in their high value-added investment banking capabilities. Once the current regulations are relaxed, local financial institutions will be able to offer attractive services to customers at the lowest rates possible, along with high value-added and customized financial solutions, which is in fact what global financial service providers with universal banking licenses are already doing today. Easing the regulations on universal banking will be a big boost in diversifying the income mix of local financial institutions while also producing greater stability in terms of risk management.

② **Encourage financial institutions to advance into the global market**: Local financial institutions must break away from the saturated domestic market and advance into the global market where diverse opportunities lie for generating profits. The government must facilitate the overseas expansion of local financial institutions. With many local companies already enjoying a competitive advantage in fields such as overseas infrastructure projects, local financial institutions must step up and provide the financial services that are required so that they can fully realize their potential. To this end, the extra foreign exchange risks currently borne by local financial institutions must be reduced by making the Korean won fully convertible. Furthermore, regulations that apply to foreign corporate entities (overseas subsidiaries) under Article 27 of the Financial Holding Companies Act Enforcement Decree, such as a cap on share ownership, the credit exposure limit, and collateral requirements for credit facilities, should be relaxed. For example, local financial institutions are required to provide collateral when extending a line of credit to an overseas subsidiary in which its interest does not exceed 80%. With joint consortium acquisitions on the rise, however, a possible revision of the shareholding threshold down to 51% ought to be seriously considered.

### 4-12. Acquire world class human resources for financial services

① **Improve immigration-related regulations:** Regulations on immigration should be revised to make it easier to recruit professionals with core competencies from abroad. The Immigration Act, in particular, should be amended so that qualified professionals can obtain permanent residency permits regardless of their local employment status. This would be a key policy change that can help Korea develop into a high value-added knowledge-based economy.

②**Strengthen the role of the Korea Banking Institute and graduate schools specializing in finance:** Training programs need to be enhanced to increase the local supply of world-class financial professionals. To this end, the role and curricula of the Korea Banking Institute needs to be fine-tuned and enhanced in addition to the establishment of more graduate schools specializing in finance.

③ **Benchmark the Netherlands and Luxembourg**: Policy initiatives carried out in the Netherlands and Luxembourg over the past 20 years should serve as a model for Korea when pursuing the reforms mentioned above.

### 4-13. Improve the corporate governance of financial institutions

① **Revamp business practices and policies related to executive tenures within financial institutions:** The tendency to target short-term results among financial executives should be discouraged by lengthening their tenure and easing restrictions on consecutive terms. These institutional improvements should help financial institutions secure a long-term revenue base. It should be borne in mind that the average tenure of CEOs at key global financial institutions runs normally 10-15 years.

② **Privatize government-owned financial institutions in the shortest period of time:** The financial institutions currently owned by the government including Woori Bank as well as its affiliated banks, the Korea Development Bank and the Industrial Bank of Korea, should be privatized soon so as to reduce undue government influence on personnel appointments and management.

③ **Ensure the voting rights of institutional investors other than the National Pension Service (NPS):** Although there is room for valid debate over the voting rights to be exercised by the NPS, it is advisable for all other institutional investors to exercise their full voting rights. This will lead to more effective ownership among key shareholders while reinforcing responsible business practices by management. As for the voting rights of the NPS, there is a valid fear that it might lead to "pension fund socialism."

#### 4-14. Enhance the crisis management capabilities of financial institutions

① **Enhance the resilience of banks to losses:** In order to strengthen market confidence in the solvency and liquidity of the banking sector, Korean bank's capital and liquidity ratios should be raised to meet Basel III requirements as soon as possible in addition to proactive efforts to ensure asset soundness through stronger micro and macro-prudential oversight.

② **Enhance the role of the insurance industry in risk management:** The role of the insurance industry as a steward for national risk should be enhanced by expanding the role of private insurance in the health insurance and pension markets while expanding the coverage of natural disaster protection.

### Improve a Regulatory Environment to Increase Investment and Innovation

A regulatory environment to promote investment and innovation should be created to strengthen the competitiveness of the financial industry and further develop the financial markets. Several foreign financial institutions have reportedly chosen to withdraw from Korea, mainly due to regulations (e.g., ELW regulations). These developments highlight the importance of financial regulatory reforms, an essential consideration in local financial industry and markets.

#### 4-15. Change the regulatory paradigm

① **Shift from a "positive list system" to a "negative list system":** While the primary purpose of the Capital Market Consolidation Act (CMCA) was to introduce a negative list system, the enforcement decree still allows a positive list system. The regulatory paradigm should be shifted from a positive list system to a full-fledged negative list system in both name and substance for the Korean financial market not only to gain global credibility but also to ensure that market mechanisms function efficiently as a catalyst for innovation.

② **Allow financial subsectors to compete with each other:** In the same vein, the regulatory framework should be transformed to allow the three main financial subsectors, namely the banking, financial investment, and insurance sectors, to compete with each other while each is allowed to retain its core businesses, thus better equipping them to compete against global financial institutions.

**4-16. Encourage maximum input from market participants while enforcing strict market discipline**

① **Encourage maximum input from market participants in rule making:** Industry representatives should be encouraged to participate not only in formulating new rules and regulations but also in evaluating existing rules and regulations. Self-regulatory organizations (SROs) should also be given significant roles and responsibilities. Financial institutions should be encouraged to self-report regulatory breaches.

② **Enforce strict market discipline:** Although market autonomy must be respected, strict disciplinary action should be taken in the event of a breach of law instead of arbitrary “paternalistic” approaches. Ailing financial companies that need to be shut down should be exited from the market in an effective manner including M&As.

**4-17. Strengthen the capacity of the regulators**

① **Recruit foreign regulatory experts:** Foreign experts should be actively brought on board as financial regulators and supervisors especially in new areas of global finance to enhance the quality of regulations and supervision.

② **Expand opportunities for overseas training for regulators:** The capabilities of regulators need to be improved to match global levels through various overseas training programs. Those who participate in such training programs should not suffer any disadvantages.

**4-18. Enhance regulatory consistency and transparency**

① **Reduce dependence on “window guidance” by regulators while encouraging compliance based on written documents for greater consistency and transparency.**

② **All official written regulatory rules should be available in both Korean and English.**

**4-19. Minimize entry barriers caused by business licensing practice**

① **Adopt a “business registration system”:** The current regulatory practice requires explicit licensing. This practice should be revisited to allow voluntary registration in areas where the failure of a financial institution does not have systemic implications.

② **Adopt a multiple license system:** In the financial and investment sector, the current regulations require a financial institution to apply for one business license at a time. These regulations should be changed to allow the institution to apply for a multiple business license at the same time.

③ **Relax minimum requirements for obtaining a new business license**: Minimum requirements for obtaining a new business license should be relaxed as they are excessively rigid, effectively acting as an entry barrier.

④ **Adopt a central business licensing process:** To ensure an efficient business licensing process, the role of the FSS Financial Hub Korea should be expanded to act as an exclusive central "go to" office for all license applications. While the FSS department in charge of license applications should continue to process applications, Financial Hub Korea should act as a facilitator like KOTRA's "InvestKorea" supporting foreign direct investors.

**4-20. Relax regulations on the business activities of global financial firms**

① **Relax regulations on the back office function and sharing of IT systems:** Global financial institutions in Korea should be given more operational flexibility in terms of sharing IT system platforms with their group affiliates, and local entities should be allowed to delegate certain back office functions to regional hubs or to global shared service centers.

② **Relax regulations on sharing customer and transaction information among affiliates of global financial firms for the purpose of data processing:** For data processing purposes, the sharing of client and transaction information between onshore financial institutions and their offshore affiliates should not be subject to prior written client consent. This change would be in line with the practice followed by most countries. However, "adequate safeguards" may be provided for the protection of privacy with regard to the transfer of personal data,.

## Establish an Efficient Regulatory Framework

**4-21. Integrate FSC and FSS into one organization**

The FSC and the FSS need to be integrated to ensure supervisory efficiency and to relieve the inconvenience faced by the industry due to redundant financial supervision.

A word should be said on the characteristics of the integrated financial supervisory body. There is a need to consider whether the integrated financial supervisory body may be established as a public non-governmental entity like the BOK in order to reduce bureaucratism while ensuring the neutrality of financial oversight. While there may be a controversy over whether governmental authority can be entrusted to a public non-governmental body under the direction of the President, there are also concerns that the recruitment and retention of financial supervisory experts might be difficult if the financial supervisory body were to operate as a government agency due to its compensation scheme. It should be recalled, however, that the Monetary Policy Committee, a non-governmental body, exercises the authority to issue currency and the Korea Communications Commission, also a non-governmental body, exercises what is a governmental administrative power.

Under the integrated financial supervisory framework, the FSC would function as a Board of Directors making final policy decisions from which government officials would be restricted. They could be given, however, the right to attend and speak as is the practice with the Monetary Policy Committee.

**4-22. Integrate the domestic and international financial policy functions**

By transferring the domestic financial policy function of the FSC to the Ministry of Strategy and Finance (MOSF), the integrated FSC can focus on its financial supervisory policy function while the MOSF can manage both domestic and international financial policies in an integrated manner. This will help keep both the financial policy function and the financial supervisory function in check while greatly helping the neutrality of financial oversight.

A word should be said on the relationship between the MOSF and the integrated FSC. The MOSF should have the power to propose laws, while the newly integrated FSC would oversee supervisory regulations. The MOSF, which has the power to propose bills to be enacted into law, should keep the integrated FSC in check. If the MOSF is the sole administration agency empowered to enact and amend all financial laws, conflict may arise between the intent of economic policies versus the intent of supervisory policies, possibly making it difficult to execute supervisory measures in a timely manner. Therefore, in order to ensure flexibility in the enactment and amendment of laws, the origination of financial laws needs to be divided into laws dealing with national financial policies versus laws dealing with the financial market and business, with the latter being handled by the integrated FSC.

**4-23. Create a macro-prudential supervisory framework**

Macro-prudential soundness is the joint responsibility of four bodies: the BOK whose primary function is managing inflation, the MOSF which has responsibility for financial and fiscal policies, the integrated FSC which is in charge of supervisory policies and enforcement, and the KDIC, the primary protector of the nation’s depositors. Because they are jointly responsible for ensuring the macro-prudence of the financial system, a legal deliberative body composed of the four institutions should be instituted.

**4-24. Creating a “Financial Consumer Protection Agency” separate from the FSS requires consensus building**

Broadly speaking, there are two opinions on the separation of the financial consumer protection agency from the macro-prudential supervisory body (the integrated FSC). Financial institutions voice concerns that the separation could lead to an extreme deterioration of the business environment, while some scholars welcome the separation on the ground that a single supervisory body having oversight for both consumer protection and macro-prudential regulations could result in a lack of interest for consumer protection and a possible conflict of interest. As the opinions are still sharply divided, more in-depth consensus building is required.

**4-25. Enhance financial literacy through systematic financial education**

Presently, the Korea Association of Economic Education (KAEE) takes responsibility for the nations’ financial education. However, as the KAEE has authorized public and private organizations to manage their own financial education programs, effective and systematic financial education has not been provided. The OECD suggested basic principles and effective measures for financial education to its member countries, while the US government established the Financial Literacy and Education Commission chaired by the Treasury Secretary to directly manage a nationwide financial education program in which 20 governmental agencies participate. Referring to OECD’s suggestions and benchmarking the US, the Korean government needs to establish a consistent control tower to directly manage the financial education program and to build up an organic private-public partnership for effective financial education.

## V. Priority Tasks That Should be Launched by the New Government

### 5-1. Reinstate the IFC initiative

In order to strengthen Korea's financial competitiveness and develop the efficient financial markets, wide ranging reforms are required. To ensure the success of these reforms, we should define becoming a world-class global financial center as our final goal. Such a goal will serve as a guidepost for planning and evaluating our efforts. This was the basic reason why the Seoul Financial Forum suggested becoming a world-class IFC as the final goal.

The Lee Myung-bak government, however, abandoned this goal in 2008 on the excuse that the most urgent task facing the nation was to overcome the immediate difficulties. As a result, the nation lost an effective guidepost. In the absence of such a guidepost, the nation lost the directions for its efforts to basically restructure the national economy from the manufacture-centered economy to high value-added service-based economy. Thus, what the nation needs at this point is to reinstate the IFC initiative as a national goal and to redefine a roadmap that includes an overall timetable to achieve a world-class financial hub, a reform agenda that should specify the essential tasks to be performed, and a detailed timeline for each of the major reform tasks.

### 5-2. Create a Presidential Project Management Office (PPMO)

To effectively implement this roadmap, a control tower is needed. Because the scope of financial reforms required to become a global financial hub is very broad, it is necessary to involve all ministries. This is why a Presidential Project Management Office (PPMO) is called for. Clear and strong presidential leadership is absolutely essential in order to manage change arising from reform and for policy coordination. In order to realize presidential leadership, it would be ideal to have a committee empowered under the auspices of the President to orchestrate wide-ranging policy changes and coordinate policy measures among different ministries. The PPMO would be chaired by the President and composed of ministers from relevant government ministries, Chairman of the FSC, Governor of the BOK, and a number of experts from the private sector. If a Deputy Prime Minister for Economic Affairs is to be introduced by the new government, the Deputy Prime Minister could chair the PPMO on behalf of the President. The three main roles of the PPMO should include the following:

- Control tower: The PPMO's responsibilities should include the design and execution of policies, monitoring progress and implementing adjustments to policies when necessary. Basically its role would be to implement, manage, and monitor policy goals.

- Trouble-shooter: The PPMO should also play the role of a trouble-shooter that can promptly and effectively coordinate conflicting interests between the government and numerous private sector organizations.

- Performance evaluator: To achieve the policy goal in a satisfactory manner, the PPMO should support all agencies in accomplishing their respective tasks and be empowered to extend appropriate recognition for the achievements of individual agencies.

### 5-3. Create an International Advisory Council for Korea as an IFC

To gain maximum support for the IFC initiative from the international community and to mobilize foreign expertise, it would be wise to create an International Advisory Council to assist the President and the PPMO.

## VI. Concluding Remarks

The number one priority for Korea at the moment is to create high value-added jobs. For this task, strengthening the competitiveness of the financial industry is more important than ever. A competitive financial sector itself generates many high value-added jobs and, more importantly, the greater the competitiveness of the financial industry, the faster the structural transition into a high value-added economy. If this transition can be carried out smoothly, it will not only help restore growth but also lead to greater employment while improving income distribution.

Thus, the primary purpose of this report is to highlight ways to quickly strengthen the competitiveness of our financial sector. We sincerely hope the new government will put the IFC initiative back on the national agenda.

# APPENDIX

## Seoul Financial Forum

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**Background**

The Seoul Financial Forum was founded in October 2001 by a group of practitioners, policy makers and scholars with interest and expertise in finance and concern for Korea's future economic success.

The primary purpose of the Forum is to help Korea emerge as a major international financial center in North-East Asia.

To this end, members have worked together over the past 11 years not only to develop and refine the vision and strategy for Korea to become a major international financial center, but also to urge the Korean government to adopt and implement the vision and strategy. The Forum will continue to inform the Korean leadership and public on the benefits that the country will derive from becoming a regional financial center and the appropriate actions that are required to realize this vision.

With its international membership, the Forum meets at least once a month with either in-house or guest speakers to discuss key developments in both domestic and international financial markets. From time to time, the Forum organizes and presents seminars and conferences for its members as well as for the interested public.

The Forum is a non-profit organization registered with the Ministry of Finance and Economy. All donations to the Forum are tax-deductible.

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**To Contact Us**

For any inquiries, please contact the following :

**SEOUL FINANCIAL FORUM**

Telephone : +82-2-761-6002

Fax : +82-2-318-1002

Email : sff@nsi.or.kr

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# The Charter of the Seoul Financial Forum

The charter of the Seoul Financial Forum states :

**Article 1** This organization will be known as the Seoul Financial Forum.

**Article 2** The Forum is comprised of practitioners, policymakers and scholars with interest and expertise in finance and concern with Korea's future economic success.

**Article 3** An individual or organization acquires membership only on recommendation by the Membership Committee.

**Article 4** The purpose of the Forum is to help Korea emerge as the premier regional financial center in North-East Asia.

**Article 5** To this end, the Forum shall engage in activities designed to develop ideas and strategies useful for Korea to emerge as the premier regional financial center; stimulate interest in and discussions on the vision for developing Korea into a regional financial center among professionals as well as the general public; and help leadership in Korea appreciate the enormous benefits the country will derive from being a regional financial center and take actions appropriate to attain the goal.

**Article 6** The Forum shall meet at least once a month with either an in-house or guest speaker(s) addressing any of the following:

I. Benefits and costs of being a regional financial center
II. Policy and institutional changes as well as strategies useful for Korea and Seoul to develop into a regional center
III. Key developments in the domestic as well as international financial markets
IV. New policy issues arising from these developments
V. Ideas on new financial products and innovations
VI. Business opportunities in Korea and the region

In addition, the Forum will organize and present seminars and conferences as needed.

**Article 7** The regular monthly meetings shall be open to members only. The seminars and conferences may be open or closed to the public depending on the nature of the subjects covered or speaker(s).

**Article 8** The Forum will elect one Chairman for two-year term and two Vice Chairmen for three-year terms. The Forum will also elect up to three Directors for three-year terms. These officers will constitute the Governing Board for the Forum. The Board may hire an Executive Director at a modest salary.

**Article 9** The Forum's activities will be financed by membership dues, donations from individuals and organizations that endorse the goal and programs of the Forum plus income from seminars and conferences.

***Adopted at the Inaugural Meeting, October 31, 2001***

# Board of Trustees