

# Korean Securities Market in Transition

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## Executive Summary

Although the Korean capital market has grown remarkably in the past three decades, it lacks a firm foundation for continuous growth and development. The ratio of total stock market capitalization to the gross domestic product (GDP) remains lower in Korea than in other advanced economies, indicating that the stock market has high growth potential. However, most market infrastructure cannot support an effective market mechanism.

The Government's overall economic reform and the subsequent International Monetary Fund (IMF) bailout program in 1997 have significantly changed the capital market. Many of the reforms, including improvement of corporate governance, the accounting system, and minority shareholder protection, will affect the capital market in important ways. The elimination of all foreign exchange regulations and foreign investment ceilings will give foreign investors a greater role and bring more competition into the capital market.

To cope with the changing market environment, the securities regulatory system has undergone major changes since 1998. Four supervisory agencies were consolidated. The Financial Supervisory Commission (FSC) now supervises the entire financial sector, including banking, securities markets, and the insurance industry. However, many issues remain to be ironed out for the new system to work effectively.

### Securities Regulatory System

The most important changes in the capital market were brought about by the Financial Reform Law of 1997. The "Big Bang" style of financial reform placed the securities supervision function under the jurisdiction of FSC. Most of the supervisory functions of the Ministry of Finance and Economy (MOFE) were also transferred to FSC. However, MOFE, once the ultimate authority over financial markets, maintains some regulatory power, causing conflict and overlapping with FSC regulations. To make supervision more ef-

ficient, FSC should carry out the regulatory functions and MOFE should focus on policy making.

The securities market, trading mechanism, and regulatory system must conform with international standards. As globalization proceeds, regulations and restrictions on securities trading should be eased. To enhance the market's operational efficiency and to maintain the fairness and competitiveness of trading, a comprehensive surveillance system to detect unfair trading and fraudulent activities should be developed. Even greater emphasis should be put on developing better audit trails and on policing trader activities.

### Equity Market

Capital market institutions, such as the stock exchange, the securities dealers' association, and securities companies, do not perform their roles independently or responsibly in the initial public offering (IPO) process. They limit securities companies' business perception in underwriting and hinder the healthy growth and maturity of a self-regulatory, self-sustaining, and autonomous capital market. FSC should enforce compliance of related institutions in the IPO process. The process of going public and listing in the stock market is still overregulated, especially in the pricing of a new issue. Since the pricing of an IPO issue is the most important function in the securities market, it is recommended that remaining restrictions on IPO pricing be removed or eased.

The closed ownership structure of the *chaebol* (conglomerates) has been cited as a major cause of the economic crisis, as it prioritized tight control of the firm at the expense of economic efficiency. To attract investors to new issues, market corporate governance structure must be improved and management transparency increased. All listed companies are now required to appoint independent, outside directors to their board. For the outside directors to function as an independent checking force, however, the minority shareholders must have representation on the board. The introduction of a man-

datory cumulative voting system and the strengthening of minority shareholders' rights by lowering the threshold of share ownership (0.01 percent of outstanding shares to file a lawsuit) to a single share are therefore recommended.

Another significant influence on the corporate governance structure may come from institutional investors, specifically the investment trust companies (ITCs), which have huge holdings of domestic stocks, and foreign investors, which now have a free hand in the stock market. ITCs are now allowed to vote on the shares in their trust account (i.e., shares bought with their customers' entrusted money). However, since most of them are under the influence of either the Government or the chaebol, in order to guarantee their independence and neutrality, their voting rights should be restricted to cases where the minority shareholders' interests are seriously threatened or management acts against the shareholders' interests.

## Bond Market

The types of Government bonds must be simplified by consolidating various issues into a small number of categories in order to significantly increase liquidity in the secondary market. It is also important to standardize the issuing terms of Government bonds' coupon rates and maturities so that fungible issues can easily be added to them and a benchmark bond can be developed. To introduce a system of issuing Government bonds at the market rate, the current auction method should be altered to allow issuance of Government bonds at a discount or premium with the coupon rate fixed in advance. The primary dealer system will play a pivotal role in bond market development. Foreign securities houses should be allowed to participate as primary dealers.

The creditworthiness of issuers is not fully reflected in the yield structure of corporate bonds for two reasons: (i) corporate bond issues are backed by real estate or physical facilities and (ii) the country lacks a reliable bond rating mechanism. To improve the

bond rating system, more competition should be brought into the market by periodically disclosing the bankruptcy ratios of bonds rated by various rating agencies and by encouraging foreign credit rating agencies to participate in the bond market.

## Financial Institutions and Investors

The new capital adequacy requirement, the net operating capital ratio (NOCR), is designed to prevent securities companies from failing again. It should be applied to all securities companies without exception, and violators must be penalized promptly. An independent auditor may be employed to ensure that the rules are strictly enforced. Financial institutions should be encouraged to establish an internal risk management organization with a clearly defined role. Accounting and audit practices should be improved so that any off-balance-sheet transactions of material importance will be reported and evaluated.

Many financial institutions are still under the influence of the Government or their chaebol parent companies. Establishing a financial holding company may ensure their independence, but only after installing a safety device, such as a risk management system and firewalls between different financial institutions.

In a market downturn, ITCs customarily have supplemented lower-than-expected returns on trust accounts by drawing on their own accounts, causing deterioration of capital bases. Although it is hard to estimate the aggregate losses on the trust accounts, most large ITCs' capital bases are nearly depleted and need restructuring. One solution is to wait until the capital market recovers so that the ITCs' asset values would be higher. Although a wait-and-see policy is not a wise one, the Government has little choice as the effect of closing down a major ITC would be economy-wide and catastrophic. Deregulating the ITC industry and putting a stop to treating financial institutions as policy devices will help ITCs recover. The establishment of US-style mutual funds will help restructure and develop the asset management industry. However, restricting fund types to

closed-end ones in order to minimize shifts of funds from ITCs to newly established mutual funds could delay the industry's restructuring.

Government policy should focus on replacing most regulations on ITC management with capital adequacy requirements and making the asset management industry more competitive by applying the free market principle to entry, exit, competition, business scope, and management appointment. Investor protection and system stability are other important issues for ITCs. The book-value-based accounting system in valuation of a trust unit tends to overvalue asset prices in a bearish market, inducing customers to redeem their investment funds, forcing ITCs to sell their stocks, and bringing down prices. To protect innocent customers and to prevent large-scale redemption demands, the accounting system must be replaced by a mark-to-market valuation.

## Market Infrastructure of the Securities Market

The Korea Securities Depository (KSD) functions as the central depository, but its deposit ratio has not been satisfactory. As a higher central deposit ratio is a precondition for the wholesale dematerialization of the securities issuing system, some regulations requiring issuance of physical certificates, and the narrow definition of "securities," should be changed. Measures should be taken to enforce central deposit and dematerialization of securities issuance, including (i) defining securities to include the concept of proxy securities, (ii) promoting KSD as the central depository, and (iii) reinstating the real-name system. Korean settlement organizations should emulate their counterparts in other advanced capital markets and redefine and adjust their roles in order to integrate their settlement function.

The disappointing performance of chaebol-owned nonbank financial institutions (NBFIs) during the financial crisis suggests that they should be protected from their parent companies by measures, such as firewalls and Chinese walls, which will pre-

vent them from exchanging manpower, funds, information, and other managerial resources. As too many securities companies compete in a small market, they are encouraged to pursue fundamental structural changes in their management strategies. Since many have been established for reasons other than profit, their parent companies will be critical in deciding the fate of the troubled securities companies. To expedite the restructuring of the industry, it is recommended that the new capital adequacy requirement be strictly imposed in order to weed out inefficient securities companies.

## Introduction

The Korean capital market has grown remarkably in the past three decades. Capitalization of the stock market increased from W79 trillion in 1990 to its highest level of W151 trillion in 1994, almost a twofold increase in four years or an average annual growth rate of 17.6 percent. Due to the sluggish economy and lower stock prices, however, market capitalization has been declining steadily since 1995. Total market value fell by 40 percent in 1997 to W71 trillion from W117 trillion in 1996.

The ratio of total market capitalization to gross domestic product (GDP) remains lower in Korea than in other advanced economies. It rose from 33.8 percent in 1991 to 49.3 percent in 1994, but has been declining since then. GDP rose to W421 trillion in 1997, up by 8 percent from W390 trillion in 1996. Market value in 1997 was not more than 17 percent of GDP, down from 30 percent in 1996, indicating that the stock market has high growth potential.

The recent financial crisis and subsequent International Monetary Fund (IMF) bailout program significantly changed the capital market. The Government is accelerating overall economic reform aimed at improving the market mechanism and making the economy more transparent. It has introduced some important policy measures to allow the free-market principle to work. If the capital market is to change

substantially, however, the *chaebol* must improve their corporate governance, accounting system, and minority shareholder protection.

In order to attract more foreign capital, the Government abolished all restrictions on foreign investment in stocks and bonds in 1998. Foreign investors can now invest freely in all kinds of securities, including stocks, bonds issued by the Government and corporations, and even unlisted over-the-counter (OTC) bonds. The market for short-term financial products, such as certificates of deposit (CDs), repurchase agreements (RPs), and notes and cover bills, was completely opened to foreigners in May 1998. Foreigners' individual and aggregate investment ceilings for Korea Composite Stock Price Index 200 (KOSPI) futures and options were also removed that month. As the Government was previously so cautious about opening the capital market, these drastic changes caught the domestic financial industry by surprise and will inevitably create a more competitive environment.

Under the Financial Reform Law of 1997, Financial Supervisory Commission supervises the entire financial sector. The securities regulatory system has been undergoing major changes since April 1998.

This report (i) discusses some of the important issues facing Korean capital markets today, (ii) examines recent changes taking place in the country, and (iii) focuses on policy recommendations. It is not intended to be an exhaustive study of capital market issues. Some of the changes and policy measures discussed here are in progress and competing views exist on some of them.

## The Securities Regulatory System

### Background

The most important changes in the capital market are based on the Financial Reform Law. The Government's previous reform efforts were continuous but

ineffective, mainly due to the severe conflicts of interest among Government authorities and different financial sectors. Gradual reform was thought to be impossible, and a "Big Bang"-style reform process seemed inevitable.

MOFE drafted the law based on the recommendations of the Presidential Commission for Financial Reform. The law contains a wide range of financial reform measures, including a new regulatory system for the securities market.

The capital market's basic administrative and regulatory structure was completed in 1976, when the Securities and Exchange Law underwent extensive revision. The Securities and Exchange Commission (SEC) and its executive body, the Securities Supervisory Board (SSB), were established on 19 February 1977, pursuant to the Securities and Exchange Law. The new securities regulatory system, although quite different from the previous one, incorporates most of the old system's basic features. As financial reform is still in progress, it is important to review the background and basic features of the current securities regulatory system in order to better understand the ongoing changes.

### The New Regulatory System

The Financial Reform Law adopts a consolidated financial supervisory system, placing the responsibilities of securities market supervision under the jurisdiction of FSC, which was established on 1 April 1998. The commission is under the jurisdiction of the prime minister, instead of the minister of finance and economy, to ensure its independence and neutrality. In 1999, all separate supervisory executive bodies were consolidated into a single organization—the Financial Supervisory Service (FSS), FSC's executive arm—that now supervises the entire financial sector, including banking, the securities market, and the insurance industry. MOFE has already transferred its supervisory function over nonbank financial institutions (NBFIs) to FSC.<sup>1</sup>

Because the securities market is unique, however, its supervision will be left to the Securities and Futures Commission (SFC), an independent regulatory organization under the umbrella of FSC. SFC is headed by the FSC vice-chair and will have the authority to give executive orders directly to FSS and to monitor FSS activities.

## Regulatory Bodies and Their Roles

### MINISTRY OF FINANCE AND ECONOMY

Once the ultimate authority in the securities market, MOFE has passed on most of its supervisory functions to FSC. It maintains the authority to draft laws, regulations, and rules related to the securities market. It grants business licenses to new financial institutions. It also has the right to request financial institutions to submit necessary documents and supporting data. Hence, although its power to supervise the securities market and related institutions is limited, it can still regulate them through moral suasion or administrative guidance, which may conflict or overlap with FSC's powers.

### FINANCIAL SUPERVISORY COMMISSION

A council system organization, FSC consists of nine commissioners, including a chair and vice-chair. The chair and vice-chair are both appointed by the President. FSC has three ex-officio commissioners: the MOFE vice-minister; the Bank of Korea (BOK) deputy governor; and the KDIC president. Of the remaining four commissioners appointed by the President, one is standing, the other three nonstanding. The FSC chair represents the commission and presides over its meetings. The chair also serves as the governor of FSS, FSC's executive body. FSC is the ultimate authority in the supervision of the financial market. It promulgates and amends rules, although MOFE still maintains the authority to draft new laws and regulations. FSC also (i) enforces the laws on financial supervision, (ii) monitors and audits financial institutions, and (iii) takes appropriate disciplinary action against those who violate the law.

### SECURITIES AND FUTURES COMMISSION

A separate and independent regulatory body, SFC was established to decide on major issues related to the securities market. It inherited most of SEC's responsibilities. It is composed of five commissioners, including the chair, who is the FSC vice-chair. Four commissioners, one standing and three nonstanding, are appointed by the President on the recommendation of the FSC chair.

### FINANCIAL SUPERVISORY SERVICE

An executive body established in 1999, FSS takes orders from FSC and SFC. It executes the resolutions of commission meetings and supervises the financial markets under the direction of the commission. It consists of the governor (who also chairs the commission), four or fewer deputy governors, nine assistant governors, and one auditor.

### SELF-REGULATORY ORGANIZATIONS

The two most important self-regulatory organizations (SROs) in the capital market are the Korea Stock Exchange (KSE) and the Korea Securities Dealers Association (KSDA). KSE is a nonprofit organization with 38 regular members, including 7 foreign or joint venture securities companies and 5 special members as of April 1998. It is authorized to supervise and regulate the trading of stocks and derivative securities to ensure that the market is fair and orderly. It monitors abnormal trading activity and its member firms' and their customers' compliance with KSE rules and regulations. It cooperates with SFC in investigating suspected illegal trading, focusing on market manipulation and insider trading. However, SFC's investigative power often overlaps with KSE's, giving rise to an important administrative issue that the new securities regulatory system must resolve. SFC's enforcement power also extends to financial and operational requirements, sales practices, record keeping, and supervisory deficiencies of member firms, which is another source of conflict between SFC regulation and KSE self-regulation.

KSDA was formed in 1953 to (i) coordinate its members' activities, (ii) mediate conflict among them, and (iii) foster the securities market through self-regulation. It has not been considered satisfactory as an SRO because of MOFE's strong influence over and frequent intervention in it. As the exchange market becomes more sophisticated and specialized, Government regulation alone will not be able to cover all market activities. Self-regulation complements Government regulation. Independent and accountable SROs must thus be given an even greater role in the future. Regulatory bodies must concentrate on supervision, deregulate other aspects, and hand them over to SROs. Only then will the capital market be weaned from the Government and regulatory bodies.

## Future Challenges and Issues to be Resolved

The new securities regulatory system appears to be different from the previous one but the basic framework and content of regulation have not changed greatly. Although most of its regulatory functions have been given to FSS, MOFE retains its power to draft laws and rules. What is important is the scope and content of regulation, not who is in charge of it. The high entry barriers to the capital market, such as prohibitive license fees in mutual fund industries, discourage competition among different financial products. Regulations and entry barriers should be eased to promote competition in the financial market. Policy should encourage competition among various financial products, not among different financial agencies. The soundness of financial institutions must be strictly monitored. Regulations overlap yet are inadequate to maintain the institutions' financial soundness. One positive development is the upgrading of some standards. For example, commercial banks now have to maintain a minimum of 8 percent equity, as required by the Bank for International Settlements (BIS), and securities companies are required to have a net operating capital ratio (NOCR) of 150 percent or more,

as recommended by the International Organization of Securities Commissions (IOSCO). Visible improvement in regulation is expected soon as FSC completes the financial and corporate restructuring.

Increasing globalization of the securities market requires a regulatory system that is up to international standards. The Government should enhance the market's operational efficiency by detecting unfair trading and by preventing possible violations with an advanced and comprehensive surveillance system. KSE electronically monitors and examines all trading by member firms, their branches, and their customers using the Comprehensive Market Surveillance and Information System (COSIS), which is similar to the systems of the New York Stock Exchange (NYSE) and the American Stock Exchange (AMEX), which are the most advanced in the world.

"Securities" are defined by the Securities and Exchange Law and its Enforcement Decree.<sup>2</sup> Only those products designated as securities by MOFE or by presidential decree can be introduced into the securities market. This restriction has been a major obstacle to the development of new financial products. Derivatives such as stock index futures and options were added to the list of securities following the 12th amendment of the Securities and Exchange Law. In order to better cope with changing market conditions and to allow financial innovations to take place, the definition of securities should be as inclusive as that of US laws. The Futures Trading Act of 1995 covers futures trading but not derivative securities based on stock indexes, which may cause conflict in the derivatives market and should be addressed soon.

## The Equity Market

### Issues in the Primary Market

If the primary market is to reform its capital-raising function, corporations should be able to issue securities with the utmost freedom. Regulations on securities issuance should be eased and the initial public offering (IPO) procedure improved. A clear-cut dis-

inction should be made between the concepts of going public and of listing on the stock exchange, so that corporations can raise the necessary capital in the market without listing their securities on the stock exchange. At the same time, corporate management transparency and governance structure should be improved to protect the investing public.

## Initial Public Offering Procedure

There is no clear-cut distinction between going public and listing in Korea. All corporations that wish to list their shares on KSE must register with FSC for the purpose of either going public or registering with the OTC market—the Korean Securities Dealers Association Automated Quotation (KOSDAQ). FSC provides guidelines on corporate management and disclosure requirements before securities issuance. The documents to be filed with FSC include the list of shareholders and financial statements, which must be available for public inspection for a year. This regulation applies to the issuance of all securities, not just IPOs. It does not mean that a corporation must wait for a year before an IPO. An IPO can be initiated within or after the one-year period of public disclosure. It usually takes one to two years starting with registration with FSC.

Once corporations register with FSC, they can take one of four approaches to listing on KSE:

- List on KSE after an IPO that meets KSE listing requirements.
- List on KOSDAQ, wait until the corporation meets the stricter KSE listing requirements, and then list on KSE.
- List on KOSDAQ, then directly list on KSE.
- Skip the IPO process if the corporation is State-owned, and list on KSE immediately after FSC registration.

Since 1987, 484 new companies listed on KSE and 80 percent of the firms took the first approach, bypassing the OTC market. In 1997, however, 17 out of 23 newly listed firms chose the second approach. The third approach is usually reserved for

banks. A private nonfinancial company, a State-owned commercial bank, and three private commercial banks followed the third approach. Only two State-owned companies opted for the fourth approach.

If a corporation registers with FSC for the purpose of going public, it must select a securities company to underwrite its IPO issue, analyze its stock, and evaluate the stock price. Financial statements of the corporation for the last three years must be audited by an independent auditor; however, the most recent financial statements must be audited by an auditor designated by the Financial Supervisory Service (FSS). Then the corporation may file a registration statement on the new issue offering. To avoid any unforeseen situation, issuers discuss all relevant matters with FSC staff before filing their application. The application form asks questions related to investor protection, such as the underwriter's opinion on the issue and analysis of the stock, the opinion of the auditor, and financial statements. Last, the issuing corporation must submit to FSC a prospectus and a report on the result of the issue offering.

The process of going public and listing is spearheaded by FSC, not by the stock exchange, securities companies, or companies that desire to be listed. In order to develop a healthy, self-sustained, and autonomous capital market, it is important for capital-market-related institutions to fulfill their roles independently and responsibly. It is a common belief that the process of going public and listing on KSE or KOSDAQ is overregulated. FSS, which has the authority over securities companies, decides whether an applicant is fit to go public and list on KSE or to list on KOSDAQ.

This type of regulatory environment may mislead the investing public into thinking that the Government is fully responsible for firms going public and therefore for the consequences of investing in the stock market. Under the Securities Exchange Law, KSE makes a final decision on listing (Article 88) and KSDA makes a final decision on listing on KOSDAQ (Article 172). However, the fact that FSS makes all the

decisions for KSE and KSDA impedes not only the growth and maturity of the self-regulatory environment of the capital market but also the securities companies' business acumen in underwriting.

The regulatory practice on going public was developed in the early stage of capital market development, when the Capital Market Promotion Act of 1968 and the Public Corporation Inducement Act of 1972 encouraged companies to go public. While the practice influenced the market positively then, the time has come for SROs to bring harmony and autonomy to the capital market. Their supervisory and executive roles must be segregated so that they check and balance each other, enhancing the market's efficiency. Therefore, FSC regulations related to going public must be eased and the power to grant permission to enter the market placed under the jurisdiction of KSE, the market provider.

## Listing and Delisting on the Korea Stock Exchange

As the distinction between going public and listing is not clear-cut, when SFC decides that a corporation is qualified to go public, market participants interpret it to mean that the corporation is to be listed automatically in the secondary market—KSE.

Article 2 of the Securities and Exchange Law defines going public as the solicitation of an offer to acquire newly issued securities on uniform terms and conditions determined by FSC. Article 54 states that FSC may issue to a securities company such orders as are necessary to prevent excessive speculative transactions of securities or to protect the public interest or investors pursuant to the provisions of the presidential decree adjunct to the Securities and Exchange Law. FSC determines the qualification of an IPO issuer, and KSE simply rubberstamps the listing approval, although KSE is an SRO and makes a final decision on listing application.

When a listed company meets a delisting criterion, on average it takes six to seven years for it to delist. First, it is disclosed to the market that the firm

may be designated as a so-called “administrated” company, which means that the market gives it special attention for a period of time to allow it to get back on its feet. If it does not improve after the recovery period, it is finally delisted. Another reason for allowing a recovery period is to protect the firm's current stockholders by providing liquidity.

As the stock market has been troubled since the fourth quarter of 1997, administrated companies now make up 18 percent of total listed companies (136 out of 773). Since they are not immediately delisted, they pose a moral-hazard problem. Their stockholders have ample opportunity to sell off their stocks or even to speculate on various rumors. In other words, not delisting administrated companies may lead to a lack of investor vigilance and responsibility and to distortion of market discipline. An increase in the number of the administrated companies also tends to distress the general atmosphere of the market and to misrepresent the overall market trend, which may discourage potential investors. It also hinders healthy firms from listing and obtaining necessary funds from the market. Administrated companies create an oversupply of stocks in the market and thus restrain new listings. It is strongly recommended that the grace period given to administrated companies be shortened or totally abolished to allow new, healthy companies to fund profitable investment projects and to reward responsible investors.

## Improving Corporate Governance and Management Transparency

Poor corporate governance is a major culprit responsible for the financial crisis. Since most firms, especially the chaebol, are controlled by a few large shareholders, their management has not been subjected to checks and balances, resulting in inefficient overinvestment through heavy debt financing that has contributed to the crisis. The chaebol's ownership structure has long been at issue. The inside shareholding of the 30 largest chaebol averaged 47 percent as of December 1995.<sup>3</sup> The top five groups

have even greater inside shareholding on average. Inside shareholding establishes the ground for tight and closed family control, which results in economic inefficiency and a low degree of disclosure and transparency. In order to attract investors to the new issues market, corporate governance must be improved and management become transparent. The closed ownership structure has encouraged the chaebol to rely heavily on debt financing instead of equity financing. As the new economic reform plans discourage debt financing, equity financing will emerge as an alternative, requiring an improved IPO process and a more efficient secondary market.

Listed companies are now required to have boards, one fourth of whose members must be independent outside directors. As of May 1998, more than 620 outside directors had been appointed. However, since they were appointed, they are strongly influenced by the major shareholders (or the "owners"). The board must find a way to trim the majority shareholders' influence and to strengthen the role of the board meeting. Minority shareholders have virtually no representation during board meetings since the board is elected under the majority voting system. The cumulative voting system has been introduced to let minority shareholders have some representation.

To further strengthen minority shareholders' rights, the minimum share ownership required to raise issues with the company management has been reduced. Legal procedures to protect minority shareholders' interest were once restrictive and costly, but as of 25 May 1998, shareholders need to have only 0.01 percent of shares outstanding to file a lawsuit against members of the board. To call a shareholders' meeting or to inspect the company's accounting books, shareholders must have 3 and 1 percent, respectively, of shares outstanding. These thresholds must be lowered further to a single share to conform with international practice.

Another notable change in corporate governance is expected soon. In September 1998, the National

Assembly passed a law allowing investment trust companies (ITCs) to exercise voting rights on the shares they bought with their customers' money. In the past, institutional investors, including ITCs, were permitted to practice only "shadow voting."<sup>4</sup> With their huge holdings of domestic stocks, ITCs will emerge as a new influence over corporate governance. However, one critical problem remains: ITCs have a governance problem of their own—they are under the strong influence of either the Government or the chaebol. Therefore, measures to guarantee ITCs' independence and neutrality in the exercise of their voting rights should be introduced to avoid either or both Government and chaebol influence on corporate decisions.

Since May 1998, foreigners have been able to acquire, without limit, the shares of any listed company without the approval of its board of directors, except those of strategic industries such as steel, communications, and electricity. No restrictions apply to foreigners in the area of securities investment. Foreigners may acquire as many shares of both listed and nonlisted companies as they wish. Previously, the Capital Inducement Act prohibited foreigners from owning more than 10 percent of shares outstanding without board approval. The limit was gradually increased to 55 percent before it was abolished in 1998. Foreigners may now take over a company without the agreement of the company management: in other words, hostile takeover of domestic companies by foreign institutions is fully allowed. The so-called "50 percent plus 1 share" rule<sup>5</sup> has also been abolished, and MOFE approval is no longer needed to acquire large companies whose asset values are W2 trillion or more. As a result, more merger and acquisition (M&A) activities by foreign as well as domestic investors will take place in the capital market. However, domestic investors are subject to stricter regulations on their hostile M&A activities than their foreign counterparts. It is recommended that domestic investors be given the same treatment as foreigners.

## The Bond Market

The bond market has grown rapidly. As of April 1998, more than 15,000 bond issues worth over W248 trillion were listed on KSE (Table 1). Despite its size and the variety of its issues, the bond market is still in the primitive stage of development, and a market mechanism is not fully in place. As all restrictions on foreign investment were abolished in February 1998, strong reform measures are urgently needed to make the bond market more efficient and competitive. Many bonds are listed on KSE and traded OTC because investors, including foreigners, prefer them as (i) they are perceived as quality securities, (ii) their traded prices are disclosed to the public, and (iii) they are the only bonds that ITCs may include in their funds.

### Government Bond Market

Since November 1993, the Government has increased its efforts to issue bonds at interest rates reflecting market rates. However, a substantial gap still exists between the interest rates on Government bonds in the primary market and the yields in the secondary bond market. As a result, most Government bonds have to be issued by way of forced subscription to individuals or compulsory distribution to underwriting syndicates, further distorting the market mecha-

nism. For example, when individuals register their houses, they must buy Type I and Type II National Housing Bonds. When they register their cars, they must purchase Seoul and Local Subway Bonds and Local Development Bonds. Government bonds must be issued at market interest rates. Compulsory bond buying is one of the biggest obstacles to the development of the bond market.

Government bonds are issued pursuant to the Budget and Finance Law and must be approved by the National Assembly. MOFE is the issuing authority<sup>6</sup> and guarantees the payment of principal and interest on Government bonds. However, it is specific funds such as the National Debt Management Fund, Grain Security Fund, and Foreign Exchange Fund that actually issue the bonds and at coupon rates that reflect market interest rates. As a result, too many kinds of Government bonds exist in the market, each in amounts insufficient to maintain liquidity in the secondary market. The issuance and repayment of Government bonds are done by various funds and are not carried out systematically or comprehensively. Timing and size of bond issuance are determined primarily by the financing needs of the issuing fund rather than the market's overall financial situation. This lack of flexibility makes it difficult to adjust Government bond issuance to market conditions. On 20 August 1998, MOFE announced that the Grain Security Fund

Table 1: Key Statistics for Listed Bonds

End of period	Government and Public Bonds			Corporate Bonds			Total	
	No. of Issues	No. of Listed Issues	Amount Listed (W million)	No. of Issues	No. of Listed Issues	Amount Listed (W million)	No. of Listed Issues	Amount Listed (W million)
1990	24	2,648	29,049,113	1,603	4,243	22,068,214	6,891	51,117,327
1991	24	2,831	32,249,691	1,862	5,527	29,241,009	8,358	61,490,700
1992	46	2,943	32,446,520	2,070	6,496	32,696,632	9,439	65,143,152
1993	50	3,082	41,359,077	2,234	7,477	37,573,624	10,559	78,932,702
1994	56	3,712	56,620,715	2,068	7,590	45,876,385	11,302	102,497,099
1995	69	4,671	69,542,162	2,024	8,050	56,455,874	12,721	125,998,036
1996	129	5,808	102,419,220	1,977	8,762	73,120,482	14,570	175,539,701
1997	160	7,717	138,092,394	1,827	8,170	86,024,195	15,887	224,116,589
1998 <sup>a</sup>	149	7,614	157,152,426	1,760	7,693	91,017,847	15,307	248,170,273

<sup>a</sup> As of April.

Source: Korea Stock Exchange, May 1998.

would be merged with the National Debt Management Fund before yearend. It also reviewed the possibility of stopping the issuance of the National Housing Bond.

Government bonds are issued on the basis of “restricted auction.” MOFE announces the planned issue amount, maturity, and bond type five days before the auction and underwriting. Auction takes place on Monday and bonds are issued on Wednesday in lieu of payments. The auction is restricted in the sense that only an underwriting syndicate consisting of institutional investors (no primary dealers) participates in the auction, and the lowest acceptable price (the maximum yield) is set by the issuing authority based on market conditions before the auction. In 1999, retail individual investors were allowed to participate in bond auctioning.

In order to promote the Government bond market, it is necessary to classify Government bonds, now categorized by issues, into a smaller number of categories based on maturity. For example, Government bonds may be classified as short-term (due within one year), medium-term (maturing in one to five years), and long-term (five years or longer). Maturities range from 1 year or less for Treasury Bills and Monetary Stabilization Bonds, to 20 years for Type II National Housing Bonds. But most Government bonds mature in one to three years.<sup>7</sup> Reducing bond types will enable the Government to increase the amount per type of bond and ensure liquidity in the market.

It is also important to standardize the issuing terms of Government bonds—that is, coupon rate and maturity—so that fungible issues can easily be added to the existing bonds. Standardization of issuing terms will make it possible to increase the issuing amount for a single Government bond issue, which will eventually pave the way for the development of a benchmark bond. The standardization issue is under consideration by MOFE, and the benchmark bond will probably be the three-year National Debt Management Bond.

Since Government bonds are issued at below-market interest rates, institutional investors participating in the underwriting syndicate usually do not resell the bonds in the secondary market. Instead, they prefer to hold on to them until maturity to avoid book losses, deterring the development of the secondary market.<sup>8</sup> To introduce a system of issuing Government bonds at market interest rates, several measures need to be implemented:

- The auction method should be altered; that is, instead of issuing bonds at par by adjusting coupon interest rates according to market conditions, Government bonds should be issued at a discount or at a premium with the coupon rate fixed in advance.
- Government bonds should be issued regularly according to a prearranged schedule, not according to the issuers’ financing needs. This will enable Government bond underwriters to plan their activities in advance.
- The primary dealer system is a necessity and is to be introduced in 1999-2000. Foreign securities houses should be allowed to participate as primary dealers. Primary dealers must possess the expertise and sufficient capital to function as market makers. On 20 August 1998, MOFE announced that it would issue three-year bonds once a month and bonds with maturities of one year or less and longer than five years every two months, depending on the size of the issuance.

## Corporate Bond Market

The vast majority of corporate bonds are issued in the form of guaranteed bonds. As of end-1997, guaranteed bonds made up 85.1 percent and non-guaranteed bonds 14.9 percent of the total. Recently, however, important changes have occurred in the corporate bond market. Since the financial crisis, the issuance of nonguaranteed corporate bonds has increased drastically (Table 2). In addition, interest rates have been differentiated in terms of the credit ratings of the various issuers in the secondary market.

Payments of principal and interest of guaranteed bonds are backed and assured by a third party, usually a financial institution, while those of mortgage bonds are secured by collateral of real estate or other facilities of the issuer. However, it is customary for the financial institution guaranteeing a corporate bond issue to demand collateral of real estate from the issuer. The majority of corporate bond issues, therefore, are backed by the issuer's real estate or other facilities. This practice has caused two major problems:

- Corporations have to secure enough real estate in order to raise the necessary funds in the bond market without worrying about having their creditworthiness evaluated by financial institutions. If asset value declines sharply, as it did recently, a bond issue backed by real estate may swiftly go bad.
- There is little need to rate various bond issues as they are alike, which is another reason why bond rating is underdeveloped.

Three credit-rating agencies annually publish bond ratings of all nonguaranteed corporate bonds. A credible bond-rating system, however, does not exist in the country. To strengthen the bond-rating system, it is recommended that competition be fostered by encouraging foreign credit-rating agencies to enter the Korean market.<sup>9</sup> The bankruptcy ratios of bonds rated by various rating agencies must also be fully disclosed periodically. However, strengthening the bond-rating system will take much more than bringing foreign agencies into the bond market.

**Table 2: Composition of Corporate Bond Issuance (percent)**

Period	Guaranteed Bonds	Nonguaranteed Bonds
Dec 1997–Feb 1998	92.9	7.1
Mar 1998	55.5	44.5
Apr 1998	55.2	44.8
May 1998	44.9	55.1

Source: Ministry of Finance and Economy.

## Financial Institutions and Investors

### Risk Management System of Financial Institutions

Major factors contributing to the current financial crisis are (i) the absence of a proper risk management system for capital market institutions and (ii) the lenient application of capital adequacy requirements by the regulator. Because most financial institutions in the country pursue high-risk, high-return strategies in a fast-growing market environment, they have not paid much attention to the proper management of business risks. Financial institutions emphasized growth more than profitability, and high risk inevitably accompanied the growth-oriented strategy. Each financial institution, however, has a standard operating procedure for internal risk management. Internal regulations and directives abound, and BOK has enforced accounting and operating standards with respect to investment in derivative products by financial institutions. Accordingly, domestic financial institutions are supposed to maintain an accounting function separate from a trading function, and to impose restrictions on individual open positions, monthly loss limits, and trading limit per transaction for each dealer.

Commercial banks, among others, are implementing a risk management program called asset liability management (ALM). ALM's main purpose is to estimate the change in the asset or liability values due to market risks, including interest rate movements, and to adjust the asset and liability positions in order to control overall risk. However, ALM techniques do not provide for the possibility of extreme losses, which may occur, although with a low probability. Value-at-risk (VAR) is the new risk management concept introduced to make up for the ALM's weakness.

Failing financial institutions should apply VAR on top of ALM. Troubled domestic financial institutions, including a couple of commercial banks and dozens of merchant banks, are suffering from depleted capi-

tal bases because they failed to control risk. These institutions may go bankrupt, although the probability is low. They apparently did not think it possible that major conglomerates such as Kia or Hanbo would go bankrupt or that the baht or won would tumble so fast and to such depths.

Another reason for the high-risk exposure of financial institutions is management's lack of knowledge about the financial products and their related risks. The huge losses incurred by several securities companies in an overseas derivative investment, which almost depleted their capital bases, clearly showed how ignorant management was. Not only was the potential VAR huge, but management did not know what the employees were doing. Management also lacked the incentive to hedge trading risks because regulators have always treated financial institutions' trading losses leniently. For example, financial institutions were required to reflect less than 50 percent of their losses from portfolio investment or credit extensions. Even if regulators were aware that financial institutions violated the rules, in order not to destabilize the financial system they did not order the institutions to employ corrective measures. The regulators' short-term perspective caused moral-hazard problems for financial institutions, which took advantage of regulatory protection and leniency and pursued high-risk, high-return strategies.

The restrictive regulations on sources of financial institutions' funds also impair the capability of financial institutions to hedge their risks. There is little freedom to adjust the maturity gap between the sources and uses of their funds. For example, securities firms heavily rely on extremely short-term sources of funds such as "call money" from other financial institutions. These accounts usually have maturities of less than two working days; they are still frequently used to purchase corporate bonds with maturities of more than three years on average. The maturity mismatch between sources and uses of funds has exposed securities firms to high liquidity

and interest rate risks, mainly due to the regulation of the capital-raising sources of securities firms. Regulatory authorities did not allow securities firms to issue bonds or commercial paper, for example, and forced them to rely on short-term money markets or customer deposits.

Another problem with risk management in financial institutions, including commercial banks, is that external prudential regulations are mostly based on ex-post approaches so that authorities intervene in problematic institutions only after it is too late. This problem is mainly due to the lack of contingent action programs, such as the prompt corrective actions in the US, which require financial institutions that do not satisfy capital requirements to take diverse restructuring measures.

### Capital Adequacy of Financial Institutions

FSC introduced NOCR as a capital adequacy requirement in April 1998. NOCR, which incorporates the recommendations of IOSCO, is defined as the net operating capital over total VAR. The net operating capital is defined as equity minus fixed assets, and the total VAR is defined as the potential expected loss from market risk, credit risk, and business risk exposure. The authorities interpret NOCR over 150 percent as a sound level of capital adequacy and below 100 percent as one requiring compulsory measures to strengthen the capital base. As of end-January 1998, the average NOCR of domestic securities firms was only 102.7 percent, mainly due to the low NOCRs of the large chaebol-owned securities firms (Table 3). (For more details, refer to Appendix Table A4.) Only 17 securities companies out of 32 satisfied the NOCR requirement.

To prevent securities companies from failing, the following actions can be taken:

- The regulator should apply the new capital adequacy requirements strictly without exception. Firms that do not satisfy the criteria should auto-

matically be subject to the proper measures. To prevent regulators from balking at applying the standard operating procedures, an independent audit function inside or outside the regulatory authorities can be set up to detect and penalize misconduct.

- An internal risk management organization for financial institutions should be established. It should specify the roles of investment-related departments and the back offices.
- Accounting and audit practices should be improved so that any off-balance-sheet transactions of material importance can be reported and evaluated. Penalties for violations should be more severe.
- Restrictions on the sources and uses of financial institutions' funds should be eased and replaced by capital adequacy requirements.

In the short run, policy measures to strengthen the capital bases of financial institutions should be seriously considered. Financial institutions need not only the resources to liquidate their bad loans, but also the funds to fulfill the minimum criteria for capital adequacy. To secure the resources necessary for restructuring is not easy. The Government plans to issue bonds amounting to several billion dollars both in domestic and foreign capital markets. It can use them to develop the domestic bond market, especially the Government bond market. The Government also allows foreigners to own and manage domestic financial institutions. But major M&A deals are not yet on the horizon as foreign investors still fear uncertainty in the financial market.

Capital market institutions also face the harder task of introducing advanced financial techniques and expertise, including an internal risk management system. Because of increasing competition, they have to find their niche to differentiate themselves from other companies, especially since the financial market is now wide open and the entry barrier, which was the last regulatory protection for the industry, is coming down fast under the Government's financial reform plan. As shown by the huge losses that some financial institutions have suffered from investing in derivative products in East Asian countries, competing in the international market requires more than management's strong will to internationalize or to enter new areas of investment.

The overall governance of capital market institutions should be reevaluated since their management malpractices are closely related with their governance structures. Most securities companies are owned by either commercial banks or industrial firms. They are failing partly due to too much Government intervention and partly due to their excessive risk taking. The problem is that commercial banks are unable to manage securities companies and that industrial firms tend to use their securities subsidiaries as a channel for corporate financing. In other words, the financial market desperately needs financial conglomerates that are independent of Government and industrial firms before it can proceed to the next stage of development. The establishment of the financial holding company under discussion by policymakers may be one measure to expedite the growth of financial groups.

**Table 3: Nonperforming Loans and Net Operating Capital Ratios of Securities Firms, as of end-January 1998**

Type of Ownership	Total Loans (W billion) (A) <sup>a</sup>	Nonperforming Loans (W billion) (B) <sup>b</sup>	Nonperforming Loan Ratio (%) (B/A)	Net Operating Capital Ratio (%)
Chaebol-owned	6,381	1,090	17.1	88.6
Non-chaebol-owned	4,107	655	15.9	120.3
<b>Total Value/Average Ratio</b>	<b>10,488</b>	<b>1,745</b>	<b>16.6</b>	<b>102.7</b>

<sup>a</sup> Total loans include guarantees on corporate bonds, claims on debts, receivables, and credits.

<sup>b</sup> Nonperforming loans include losses and doubtful and substandard loans minus recoverable parts of each loan.

Source: Financial Supervisory Commission.

## Financial Problems of Investment Trust Companies and the Asset Management Industry

In recent years, especially after the financial crisis of 1997, the asset management industry has suffered from massive financial problems. Two institutions—ITCs and the commercial banks through their trust accounts—have dominated the asset management industry. The trust business of commercial banks is somewhat different from the ITCs'. Unlike ITCs, commercial banks maintain just one trust account, depending on the type of trust product. Customers thus have a limited choice of products. Because the trust accounts are open-ended, returns on trust savings vary due not only to changes in the value of invested assets, but also the addition of new assets to existing ones as more customers purchase the units. Bank trust accounts can also extend loans to corporations or individuals. To prevent head-to-head competition between ITCs and commercial banks, however, MOFE controls the maturities of commercial banks' trust products.

ITCs have not been immune to the economic downturn, particularly the shocks from the financial crisis.<sup>10</sup> Their dire financial situation dates back to the early 1990s. After KOSPI hit over 1,000 points in April 1989, it began to slide down by about 12 percent a month on average over the next couple of months. Worried that the downward trend would continue, the Government decided to intervene directly in the stock market by infusing W3 trillion through institutional investors, including ITCs. However, KOSPI dropped below 500 by end-1992, incurring huge capital losses for those involved in the stock market support program. ITCs have also suffered due to their large interest payments on loans. The original borrowing rate was 3 percent, well below the market rate of more than 14 percent. Later, however, the rate was increased to 8 percent, and then to market rates after the loans were rolled over. The capital losses and interest expenses incurred over the last seven years are estimated at over W8 tril-

lion, contributing to the negative equity base of ITCs in 1997 (Table 4).

To supplement the lower-than-expected returns, ITCs sometimes meet customers' redemption demands by drawing on their own accounts, thereby bearing the losses and worsening their financial status. This practice is closely related to accounting rules used to evaluate a fund. ITCs had not adopted mark-to-market rules and, as a result, the value of the funds they manage was not subject to periodic evaluation. Thus, most ITCs' capital bases have been depleted, with total equity of negative W1,637.7 billion as of end-1997. Only too late, the Government started to enforce the mark-to-market valuation method in 1998. However, the full implementation of the mark-to-market rule has been deferred until the year 2000.

One of the main reasons for ITCs' poor performance is related to their governance and internal management system. Until June 1998, individual share ownership of ITCs has been limited to less than 10 percent of the total shares issued, with some exceptions. In case of the two largest ITCs, major shareholders are commercial banks, each owning less than 6 percent. Still, these commercial banks have not been able to exercise any control over the management of ITCs mainly due to the fact that MOFE directly controls ITCs' management. Former MOFE officials have frequently been appointed as top managers of ITCs. Their major concern is to achieve fast growth rather than increase profitability and competitiveness. Although ITCs are commercial entities (and are, in fact, among the most capitalistic of organizations), they are frequently exploited as a Government policy device, and no managers or shareholders have dared to refuse the roles imposed on them. The situation is no better for regional ITCs jointly owned by industrial firms. They are sometimes exploited as a source of funds for their major shareholders despite regulatory restrictions, and their financial position fluctuates along with the financial situation of corporate borrowers.

**Table 4: Financial Structure of Investment Trust Companies, as of end-1997 (W billion)**

<b>Assets</b>		<b>Debt and Equity</b>	
Cash and due from banks	2,659.2	Beneficial certificates	85,610.4
Securities	70,740.6	Securities investment savings	481.2
Stocks	5,820.9	Borrowings	5,505.3
Bonds	64,919.7	Others	12,596.4
Others	29,155.8	Total debt	104,193.3
<b>Total assets</b>	<b>102,555.6</b>	Total equity	(1,637.7)
		<b>Total debt and equity</b>	<b>102,555.6</b>

Source: Bank of Korea, 1998.

Despite the increasing losses and worsening financial situation of the investment trust industry, the Government cannot close down ailing ITCs as it would send unbearable shocks throughout the financial market. A major ITC has assets of over W25 trillion, and closing down just one would have economy-wide, catastrophic effects. Asset prices would drop, dragging down overall asset values of domestic financial institutions, including already-troubled commercial banks. The industry has long suffered due to the direct and indirect intervention of regulatory authorities, and poor governance and management structure. These problems will not disappear overnight.<sup>11</sup>

One thing the Government can do without spending a huge amount of capital is to deregulate the industry, especially in the areas of governance, management, and business scope. Despite the series of “promises” by MOFE to deregulate the industry, the Government still exercises too much influence over ITC management, and regulations governing the operation and development of funds are too restrictive. Its interventionist policy reflects the Government’s old habit of regarding financial institutions as a policy tool. It recently announced a plan to deregulate restrictions on ITC ownership and to introduce company-type trust funds similar to US mutual funds. The establishment of mutual funds will definitely help to restructure and develop the asset management industry.

In order to diversify the types of trust funds, MOFE recently introduced the Securities Investment Law, which prescribes the establishment of US-style mutual funds. Under the law, anyone, Korean or foreigner, with a minimum capital of just

W1 billion, can establish a securities investment company and sell its equities to the public. The company may list its stock on the stock exchange so that shareholders can cash out their investment through the sale of stock. Investment of the trust funds is limited to securities and call loans; loans to corporations and investment in real estate are prohibited. Borrowing and issuance of bonds in the call market are not allowed; provision of debt guarantee or mortgage is also prohibited. The maximum investment in each security is limited to 10 percent of total investment funds available, and to 10 percent of the total value of the subject securities outstanding. Investment in securities issued by related parties to the fund is also limited. A special type of mutual fund, the corporate restructuring fund, is allowed to bolster investment in corporations that need structural changes. It is not subject to the investment restriction applied to other mutual funds unless the object investment companies belong to the 30 largest chaebol. The duration of funds should be more than one year, and more than 50 percent of such funds need to be invested in small- and medium-size firms. Any capital gains on their investment are not subject to taxes.

The restriction of the fund type to a closed-end one reflects MOFE’s concern over the possible shift of funds from ITCs to the newly established mutual funds. As the redemption of their investment is restricted, the share of mutual funds in the asset management industry is expected to be limited.

The Government should focus on the capital adequacy requirement that could replace most regu-

lations on ITC management. To be reborn as a true commercial entity, the asset management industry needs the free-market principle to work in the areas of entry, exit, competition, business scope, and the appointment of management. ITCs should also change their management practice. Many ITC customers still expect fixed returns from their trust contracts due to the ITCs' confusing advertising strategy. The practice originated from management's objective of fast growth in contract amounts, which eventually imposed costs on ITCs themselves in a bearish market.

Another issue in the investment trust industry is investor protection and system stability. Since most of the funds are subject to redemption before maturity, market downturns, or rumors of failing ITCs could ignite massive runs on funds for redemption. Faced with their customers' requests, ITCs would be forced to sell their stocks and bonds, expediting a free fall in asset prices in a vicious circle. Part of the reason for large-scale redemption is the current book-value-based accounting system in the valuation of a trust unit. In bearish markets, asset prices of a unit tend to be overvalued, inducing customers to redeem their investment money before the unit's value deteriorates. To protect customers and prevent large-scale redemption requests, the mark-to-market valuation system should be introduced.

Illegal transfer of funds or securities between bank and trust accounts has caused severe financial problems for commercial banks. Such transfers are executed to maintain the return profitability of each account. Since accounting is based on the book valuation of each account, it tends to delay the proper evaluation of a unit. As a result, not only holders of bank or trust accounts are likely to suffer, but also the financial stability of the entire banking system. Behind the banks' efforts to stabilize returns on trust accounts also lies customers' perception of trust products not as an investment but as having fixed returns, an expectation supported by the implicit guarantee by banks of a minimum level of return.

## Organizational Efficiency of the Korea Stock Exchange

The financial crisis and IMF's demands to adopt measures to enhance the financial market's efficiency forced KSE to restructure itself. KSE had been criticized for having too many employees for the number of securities listed and the volume of trading, compared to NYSE, for example. As trading has been fully computerized since 1997, KSE should reallocate its personnel to other areas such as market surveillance and self-regulation of its members. As of this writing, KSE has reduced its personnel by approximately 20 percent.

## Redefining the Role of the Korea Securities Finance Corporation

As capital market deregulation proceeds, the Korea Securities Finance Corporation (KSFC) loses the reason for its existence. For its own survival and for the increased efficiency of the stock market, KSFC's functions and roles must be redefined. One major problem of KSFC is that its source of funds depends on the very capital market institutions it is supposed to help. Securities firms, for example, are required to deposit a certain portion of their customer deposits in KSFC at below-market rates, and get financing from KSFC at a higher rate than their deposit rates. In other words, KSFC works as an intermediary whose functional role is dubious, while it imposes extra intermediary costs on capital market institutions.

To expand the funding base of KSFC, the authorities allowed it to open branches and receive deposits from the general public. Depositors were given a preferential privilege to participate in IPOs, which were usually priced at a discount. Now, however, the stock market has long been stagnant and IPOs are priced at their market value. The merits of the securities deposit have thus disappeared and KSFC's funding base is rapidly shrinking. For example, in 1997 alone, customer deposits decreased by more than W1,225 billion, contributing to the sharp drop in KSFC's total assets.

## Market Infrastructure of the Securities Market

### Improvements in the Trading System of the Korea Stock Exchange

The opening and internationalization of the stock market raised the issue of conformity of its trading mechanism with that of other countries. In order to become compatible with the international transaction system, KSE has changed its overall trading mechanism, including the clearing and settlement system, and introduced new types of ordering systems and after-hour trading sessions. One major improvement is the introduction of the market order. Previously, only limit orders were allowed. The new system is not exactly the same as NYSE's; a KSE market order, for example, is an order to be executed at the best price available offered by the other side of the transaction.

### UNFAIR TRADING IN THE SECURITIES MARKET

Despite the introduction of COSIS in 1995 and other related efforts of KSE, unfair trading activities, including insider trading, are still major concerns for KSE, regulatory bodies, and victimized investors. "Concerted trading," for example, is conducted by a group of investors who try to boost the stock price of a firm by spreading false information or by issuing massive buy orders. Of the hundreds of cases of concerted trading reported, only a couple have been officially investigated and reported to the judicial authorities for legal action. KSE and other regulatory bodies not only found it difficult to determine whether concerted trading was illegal or not, but they were also reluctant to report illegal trading because of the potential adverse effects on overall market sentiment. Unfair or illegal trading activities, however, tend to increase the volatility of related stock prices and, in the long run, weaken the investor base as disappointed, innocent investors eventually leave the market. Unfair trading activities must be curtailed at all cost.

### UNDERDEVELOPED OVER-THE-COUNTER MARKET

Even though the number of firms listed on KOSDAQ (KSDA's OTC market) has increased to over 300, daily trading volume is still small; total annual trading volume barely amounts to that of several days' trading on KSE. One reason for the illiquidity of the OTC market is that the major shareholders (so-called "owners") of newly listed companies are unwilling to fully open them to outside investors for fear of a threat to their control. Another reason for the weakness of the OTC market is that the financial market is still bank-oriented even though direct financing of corporations has steadily increased over the last two decades. Direct financing has slowed since the early 1990s mainly due to the bearish stock market, which has also affected the OTC market. As a result, emerging firms find it hard to gain access to capital markets, which hinders the establishment of new venture firms.

### Enforcement of Central Deposit and Dematerialization

Central deposit and dematerialization of securities would simplify the overall securities transaction process and make it more transparent and efficient. However, individual investors' demands for securities for their personal bearing, and related laws that require the issuance of physical certificates, hinder dematerialization. As of end-1997, the proportions of listed stocks and bonds deposited with KSD are 72.7 and 75.4 percent of the total issues of stocks (shares) and bonds (values), respectively. These are low compared with the central deposit ratios of other advanced countries, which range from 85 to over 95 percent. KSD deposits are low because investors are extremely sensitive about exposing their identity and financial asset holdings to the public and the Internal Revenue Service. Another reason for the low deposit ratio is the narrow definition of "securities" in the Securities Exchange Law. Accordingly, short-term financial products such as CDs are deposited with KSD on an individual contract basis between inves-

tors and KSD, based on MOFE authorization of such business as a complementary business of KSD.

A higher central deposit ratio is an important precondition for the introduction of full-scale dematerialization of the securities-issuing system. Issuing securities in the form of paper not only incurs huge costs for issuing, depositing, and transferring, but also increases the possibility of loss or theft. KSD is considering measures in cooperation with MOFE to enforce central deposit and dematerialization. The imperatives are, among others, (i) the expanded definition of securities, including the concept of proxy securities that will replace existing securities; (ii) the stronger legal status of KSD as the central depository; and (iii) the introduction of a full-scale real-name system.

## Streamlining the Settlement Organization

In the securities market there exist multiple settlement organizations for various types of transactions. The official settlement organization for KSE securities transactions, including stock index futures and options, is KSE itself, while KSD is the official settlement entity for KOSDAQ transactions. Multiple settlement bodies incur extra costs for the participants, including separate deposits of settlement guaranty money, and increase settlement risks. As in other countries, where the general trend is toward the integration of settlement organizations, in Korea adjustment of the roles of settlement organizations is in order. To reduce the settlement risk, KSD is considering a change in the settlement system, including the introduction of real-time gross settlement (RTGS) or a combination of RTGS and the net settlement system.

## Depository Fee System

The current fee system for the depository and other related services provided by KSD can be characterized as nondiscretionary. Fees are paid mainly according to the amount of securities deposited without differentiating among specific types of services

provided, amount of services needed, number of service time blocks in a day, etc. The system causes overconsumption of certain services and unfair sharing of depository and settlement costs among the service users. As of this writing, KSD was considering the introduction of a new fee system based on a marginal-cost concept, which would incorporate the policy objective of dematerialization of securities issues by imposing higher costs on the deposits of physical securities while subsidizing the deposit demands in electronic register form.

## Ownership Structure of Securities Companies

Securities companies can be divided into three groups depending on their ownership structures: (i) subsidiaries of the chaebol that are closely controlled by related companies, (ii) entrepreneurs usually specializing in financial businesses, and (iii) subsidiaries of financial institutions.

Group (i) accounts for about half of the securities companies; groups (ii) and (iii) make up the rest. However, they do not differ much in business strategy and performance. The chaebol's securities companies are at an advantage, especially in the underwriting business. For example, despite the 5 percent restriction on the proportion of underwriting of securities issued by their related companies, firms in the first group boast of above-average performance in the underwriting business due to the implicit collusion among chaebol-owned securities companies: they barter underwriting among themselves to circumvent restrictions. However, their overall performance is below average. The average return on equity was only 1.36 percent for those belonging to the 30 chaebol and 2.74 percent for the others from 1991 to 1996.

The below-average performance of the chaebol's securities companies has three important implications on the relationship between financial institutions and real sector firms. First, the chaebol's managerial expertise has not necessarily worked in the case of financial institutions. This is partly due to the chaebol's

risk-seeking management orientation, which clashes with the conservative culture required of financial institutions. Many chaebol-owned securities firms are in trouble today due to their aggressive investment strategy in the area of portfolio investment.

Second, financial institutions owned by industrial firms have been perennially exploited by their parents as private sources of funds. Many cases of cross-subsidy from securities companies to their related companies are in the form of favored financing, support of stock prices, and favored guarantees on loans or corporate bond issues.

Third, and most important, due to their governance structure, NBFIs owned by industrial firms have not satisfactorily allocated financial resources or monitored the management of real sector firms. Korea is one of the few countries that allow industrial firms to own and control major NBFIs, including securities companies, merchant banks, and insurance companies. The disappointing performance of chaebol-owned NBFIs suggests that measures are needed to protect them from their parent companies, such as installing firewalls and Chinese walls that will prevent the two entities from exchanging manpower, funds, information, and other managerial resources.

## Restructuring the Securities Industry

In addition to regulatory restrictions and the depressed stock market, the stagnant securities industry suffers from too much competition. Its Herfindhal Index, which shows an industry's competitiveness, has been about 0.07, which means that too many securities companies are competing to meet too little demand. Many academic researches suggest that there exist economies of scale in the Korean securities industry, implying the possibility of increased efficiency for larger securities companies.

Securities firms have every reason to pursue fundamental structural changes in their management strategy, organization, manpower, and branch operations. In the process, the roles of their parent companies will be critical. The chaebol are in the securities busi-

ness partly to facilitate their own financing activities despite the industry's low returns. Commercial banks have established securities subsidiaries to expand their own business scope and to utilize the economies of scope and scale. These parent companies are now seriously evaluating the pros and cons of maintaining securities subsidiaries, and one urgent issue is whether or not to inject additional capital into failing securities subsidiaries. The restructuring in the securities industry will depend on the financial soundness of the parent companies and the position of securities subsidiaries in their overall business portfolios. To expedite restructuring, the regulator should apply the new capital adequacy requirement strictly in order to weed out inefficient securities companies.

## Summary and Policy Recommendations

### Securities Regulatory System

The Financial Reform Law introduced a consolidated supervisory system, placing the securities market supervision function under the jurisdiction of FSC. Most of MOFE's supervisory functions have been transferred to FSC. However, MOFE, once the highest authority in the financial market, has been desperately trying to maintain some of its regulatory power. For example, besides the authority to draft laws and rules, it has the power to grant business licenses to financial institutions and to request financial institutions to submit necessary and supporting documents, causing conflict and overlapping with FSC regulations.

To avoid overregulation and overlapping of regulations and to make supervision more efficient, FSC should perform the regulatory function and MOFE remain as the policymaking body. Although MOFE should maintain its authority to draft laws and regulations in certain areas, its legislative power should be kept to a minimum; the National Assembly can better serve as the legislative authority.

The opening and internationalization of the securities market have raised a new issue: the trading

mechanism and regulatory system must conform with international standards. As globalization proceeds, existing regulations and restrictions on securities trading will have to be eased. To enhance the market's operational efficiency and to maintain the fairness and competitiveness of trading in such a globalized market, advanced techniques to detect unfair trading and fraudulent activities should be developed. More comprehensive surveillance systems in the securities market are required. Although COSIS, currently employed by KSE, is modeled after the most advanced market surveillance systems of NYSE and AMEX, it still lacks some of the most advanced features of these world-class surveillance systems. Even greater emphasis should be put on developing better audit trails and policing trader activities to enable the securities market to survive in the globalized market.

The narrow definition of "securities" has been a major obstacle to the development of new financial products. Derivative securities such as stock index futures and options were added to the list of securities following the 12th amendment of the Securities and Exchange Law. Although the Futures Trading Act of 1995 also covers futures trading, it does not cover derivative securities based on stock indexes (i.e., stock index futures), which may cause conflict and confusion in the derivatives market and should be addressed soon in view of the establishment of a new futures exchange in 1999. For the securities market to better cope with changing market conditions and allow financial innovations to take place, the concept of "securities" should be inclusive, as it is in the US,<sup>12</sup> rather than specifically "listed" in the law.

## Equity Market

### INITIAL PUBLIC OFFERING PROCEDURE

The process of going public and listing has been led by FSS since 1999. FSS decides whether or not a firm is qualified to go public and list on KSE and KOSDAQ, and the rest of the IPO proceeds virtu-

ally automatically. As a result, the stock exchange, securities dealers' associations, securities companies, and the firms to be listed do not perform their roles independently or responsibly. The procedure also limits the securities companies' business percipience in underwriting, impeding the healthy growth and maturity of a self-regulatory capital market. It must be changed if a self-sustaining and autonomous capital market is to develop. The power to decide whether or not a security should be listed must remain with KSE. FSS's responsibility should be limited to deciding whether or not an institution involved in an IPO is violating the law.

### LISTING AND DELISTING ON THE KOREA STOCK EXCHANGE

When a listed company gets into serious trouble and meets one of the delisting criteria, it is designated as an administrated company in order to allow it to recover and to protect stockholders by providing liquidity. However, statistics show that not many administrated companies get back on their feet. Allowing them a grace period causes the following serious problems:

- It takes an average of six to seven years to delist a company, putting unnecessary strain on the market. A grace period also limits opportunities for healthy firms to list their shares and obtain funds from the stock market.
- Leaving administrated shares on the market for an unnecessarily long period creates moral-hazard problems and unjustified speculation, damaging the general atmosphere of the market.

The grace period should therefore be shortened or totally abolished.

### IMPROVING CORPORATE GOVERNANCE AND MANAGEMENT TRANSPARENCY

The closed ownership structure of companies, especially the chaebol, has been cited as a major cause of recent economic hardship as it sacrifices eco-

conomic efficiency. In order to attract investors to the new issues, the market corporate governance structure must be opened and management transparency increased. KSE now requires that one fourth of the directors of listed companies' boards be independent outsiders. In order for the outside directors to function as an independent checking force, the minority shareholders must be represented on the board through a cumulative voting system. They should also have the right to file a lawsuit by virtue of ownership of a single share, and not of 0.01 percent of outstanding shares as required now, in order to help them voice issues against the management and the controlling shareholders.

Another significant influence on corporate governance structure may come from institutional investors (specifically ITCs) and foreign investors. ITCs are allowed to exercise the voting rights on the shares in their trust account. With their huge holdings of domestic stocks, they will emerge as an influential group in corporate governance. However, since the majority of ITCs are under the influence of either the Government or chaebol, it is necessary to introduce some restrictions on their exercise of voting rights in order to guarantee their independence and neutrality. For example, their voting rights may be limited to cases where minority shareholders' interests are seriously threatened or the management is found to have acted against the shareholders' interests. Foreign investors, with their complete freedom in the stock market, can exert a strong influence on corporate decisions as well. However, domestic investors, who are now discriminated against, especially in the area of hostile take-overs, should be given the same treatment as foreigners if the market is to function efficiently.

## Bond Market

### GOVERNMENT BOND MARKET

Due to inflexible issuing methods, there are too many kinds of Government bonds, limiting liquidity in the

secondary market. The various issues must be consolidated into a smaller number of categories. The issuing terms of Government bonds (coupon rate and maturity) must be standardized so that fungible issues can easily be added to existing bonds. Standardization of issuing terms will eventually lead to the development of a benchmark bond by making it possible to increase the issuing amount for a single Government bond. The three-year National Debt Management Bond will best serve as the benchmark bond.

Government bonds can be issued at the market rate if the auction method is altered to allow these bonds to be issued at a discount or premium with the coupon rate fixed in advance. Timing of a bond issue should also be done according to a schedule, not according to the issuers' irregular financing needs, enabling Government bond underwriters to plan their activities. Recently, the Government announced that it would issue three-year bonds once a month, and bonds with maturities of one year or less and longer than five years once every two months, depending on the size of the issuance. This is a change in the right direction. Finally, a primary dealer system, which should include foreign securities houses, should be introduced in 1999-2000 as market conditions have recently become favorable (e.g., market interest rates are at their lowest in many years).

### CORPORATE BOND MARKET

Since a corporate bond issue is usually backed by real estate or physical facilities, the issuers' creditworthiness is not fully reflected in the yield structure of corporate bonds. Another, perhaps more important, reason why issuers' creditworthiness has not been properly differentiated is the lack of a reliable bond rating mechanism. To improve the bond rating system, it is recommended that more competition be brought into the market by disclosing the bankruptcy ratios of bonds periodically rated by various rating agencies and by encouraging foreign credit-rating agencies to participate in the bond market.

## Financial Institutions and Investors

### CAPITAL ADEQUACY OF FINANCIAL INSTITUTIONS

To prevent securities companies from failing again, the following preventive measures should be taken:

- NOCR should be applied to all securities companies without exception. A firm found to be violating the rule should be penalized promptly. An independent auditor may be employed to oversee rule enforcement.
- Financial institutions should be encouraged to establish an internal risk management organization whose role is clearly defined.
- Accounting and audit practices should be improved so that any off-balance-sheet transactions of material importance are reported and evaluated. Severe penalty should be imposed on any violation.
- Restrictions on the sources and uses of funds of financial institutions should be eased and replaced by capital adequacy requirements.

Many financial institutions are still under the influence of Government or industrial conglomerates. To assure their independence, they may establish a financial holding company, which, however, should have its own limitations and safety devices, such as a proper risk management system and firewalls between different financial institutions.

### FINANCIAL PROBLEMS OF ITCs AND THE ASSET MANAGEMENT INDUSTRY

The asset management industry, especially ITCs, has been hard hit by the recent financial crisis and economic downturn. Since ITCs have been supplementing the lower-than-expected returns on their trust accounts by drawing on their own accounts, much of their capital base has been depleted, resulting in an aggregate equity of negative W1,637.7 billion. Worse, they have borrowed heavily from other financial institutions using their customers' trust accounts as collateral. It is difficult to estimate the aggregate potential

losses on trust accounts. The poor performance of ITCs has been blamed on two factors: (i) book-value accounting rules applied to the evaluation of funds, and (ii) Government control over the governance and internal management system of ITCs. This financial mess has to be cleared up. One possible solution is to wait until the capital market recovers so that the asset values of ITCs increase. Although this wait-and-see policy is not wise, the Government has little choice as the effect of closing down a major ITC would be economy-wide and catastrophic.

Deregulation of the ITC industry, especially in the areas of governance, management, and business scope, coupled with the abandonment of the old concept of treating financial institutions as policy devices, will help ITCs immensely to overcome their difficulties. The recent announcement by the Government that it would ease restrictions on ITC ownership and introduce a US-style mutual fund is thus welcome. The establishment of mutual funds will definitely contribute to the restructuring and development of the asset management industry. However, the operation of the mutual funds is too restrictive to have any major impact on the industry's current problems. For example, restricting funds to the closed-end type, thus constraining the redemption of investment funds, is designed to minimize a possible adverse effect on ailing ITCs, such as the possible shift of funds from ITCs to the newly established mutual funds. This kind of policy casts doubt on the Government's will to change the asset management industry. It is recommended that the asset management industry be restructured as a purely commercial entity with minimal regulations and restrictions.

Government policy should focus on replacing most regulations governing ITC management with capital adequacy requirements. To be reborn as a true commercial entity, the asset management industry must be guided by free-market principles in the areas of entry, exit, competition, business scope, and the appointment of management. ITC management prac-

tices also need major changes. Many ITC customers still expect fixed returns from their trust contracts due to the ITCs' confusing advertisement strategy, whose objective was fast growth and which eventually imposed costs on ITCs themselves in a bearish market.

Investor protection and system stability are also important issues for ITCs. Due to the adoption of book-value-based accounting in valuation of a trust unit, asset prices tend to be overvalued in a bearish market, inducing customers to redeem their investment funds, which forces ITCs to sell their stocks in a sluggish market, expediting price decline. To protect innocent customers and to prevent large-scale redemption demands, the current book-value-based accounting system must soon be replaced by a market-to-market valuation.

## Market Infrastructure of the Securities Market

### ENFORCEMENT OF CENTRAL DEPOSIT AND DEMATERIALIZATION

In the securities market, the issuance of physical certificates not only incurs high costs of issuing, depositing, and transferring, but also increases the possibility of loss or theft. Recent trends show that paperless security issuance is becoming more common in advanced capital markets. A high central deposit ratio is a precondition for the introduction of full-scale dematerialization of the securities issuing system. Currently, KSD functions as the central depository, but its deposit ratio has not been satisfactory. Some regulations that require the issuance of physical certificates, and the narrow definition of "securities," among others, have hindered the dematerialization of the securities issuance system. Stronger measures—(i) a wider definition of securities, including the concept of proxy securities; (ii) the promotion of KSD's legal status as the central depository; and (iii) the reinstatement of the real-name system—should be taken to enforce central deposit and dematerialization of securities issuance.

### STREAMLINING THE SETTLEMENT

#### ORGANIZATION

Multiple settlement organizations exist in the securities market. Considering that the general trend in advanced capital markets is the integration of settlement organizations, the role of related settlement organizations in Korea must be redefined and adjusted. It is also strongly recommended that the settlement system be overhauled by, for example, including RTGS or a combination of RTGS and the net settlement system.

#### DEPOSITORY FEE SYSTEM

The current nondiscretionary depository fee system causes overconsumption of certain services and unfair sharing of depository and settlement costs. To avoid these problems, a new fee system based on the concept of marginal cost should be introduced. It should also incorporate the policy objective of dematerialization of securities issues by imposing higher costs on the deposits of physical securities while providing subsidies to the deposits in electronic register form.

#### OWNERSHIP STRUCTURE OF SECURITIES COMPANIES

Industrial companies are permitted to own and control major NBFIs, including securities companies, merchant banks, and insurance companies. Their aggressive management policies, however, clash with the conservative nature of financial institutions. As a result, many NBFIs owned by industrial companies have failed. The disappointing performance of chaebol-owned NBFIs suggests that they should be protected from their parent companies by measures, such as installing firewalls and Chinese walls, that will prevent the two entities from exchanging manpower, funds, information, and other managerial resources.

#### RESTRUCTURING THE SECURITIES INDUSTRY

As too many securities companies compete in a too-small market, they are encouraged to pursue fundamental structural changes in their management strat-

egies. Since many were established for reasons other than profit, the roles of their parent companies will be critical in deciding their fate. It is recommended that the new capital adequacy requirement be strictly imposed in order to weed out inefficient securities companies.

## Notes

<sup>1</sup>NBFIs are of 18 types. They may be classified into five categories according to their activities: development, savings, investment, insurance, and others. NBFIs include investment trust companies, merchant banking corporations, securities companies, leasing companies, life insurance companies, mutual savings and finance companies, credit unions, etc. All, except securities companies and insurance companies, were once under the direct supervision of MOFE, which has surrendered its supervisory authority to FSC.

<sup>2</sup>The term “securities” in the Securities and Exchange Law, which was wholly amended by Law No. 2920, 22 December 1976, and most recently amended by Law No. 4701, 5 January 1994, means any of the following:

- (i) Government bonds;
- (ii) municipal bonds;
- (iii) bonds issued by a corporation organized under a special law;
- (iv) corporate bonds;
- (v) certificates of contribution issued by a corporation organized under a special law;
- (vi) stock certificates or instruments that represent preemptive rights;
- (vii) stock certificates or instruments issued by a foreign government or corporation, which have similar characteristics as items (i) to (vi);
- (viii) depository receipts based on stock certificates or instruments issued by a foreign government or corporation and approved by the President; and
- (ix) other certificates or instruments designated by presidential decree that are similar to or related to those referred to in items (i) to (viii).

Mortgage-backed securities and asset-backed securities can be considered as securities according to either or both items (i) and (ix).

<sup>3</sup>Inside shareholdings include those undertaken by the owner, the owner’s family, member firms, nonprofit organizations, and the Employee Stock Ownership Plan. A comprehensive study by UngKi Lim shows further details of the ownership structure of the chaebol. See Lim (1998).

<sup>4</sup>In shadow voting, institutional investors simply cast their votes according to the exact proportions reached in the shareholders’ general meeting. Thus, it has no influence on the decision made at the general meeting.

<sup>5</sup>The “50 percent plus one share” rule states that when a company, or an individual, or group of individuals acquires more than 25 percent of the outstanding shares of a company, 50 percent plus one share must be purchased through a tender offer. This is to discourage hostile takeovers. As the rule has been abolished, more active foreign mergers and acquisitions of Korean companies are expected.

<sup>6</sup>While MOFE is the issuing authority of Government bonds, the Budget Office has long been resistant to large bond issues as it is averse to deficit budgeting. Its reluctance is an important factor hampering the development of the Government bond market.

<sup>7</sup>Treasury Bills have a maturity of one year and are issued by MOFE to finance budget deficits. Monetary Stabilization Bonds have a variety of nine different maturity structures of 14, 28, 63, 91, 140, 182, 364, 371, and 546 days. They are issued by the Bank of Korea to control the money supply. Trading of the bonds is inversely related to the number of days that have passed since their issuance.

<sup>8</sup>Current accounting standards and regulations are somewhat vague on the valuation of marketable and investment securities. Article 65 (Valuation of Marketable Securities), Clause 2 states: “Among marketable securities, bonds shall be recorded at purchase cost plus incidental expenses, determined by the specific identification, weighted average or moving average method. If the market value differs from the acquisition cost, bonds *can be* recorded at market value.” Article 67 (Valuation of Investment Securities), Clause 5 states: “...government bonds, public bonds, corporate bonds, etc., which are held for long-term investment purposes and acquired at costs different from their par value, shall be stated in the balance sheet at cost less amortization...of the difference between the cost and par value over the remaining term of the bonds.” Thus, current accounting rules do not require financial institutions to access the bonds at market value although recent securities regulations introduced the market-value evaluation of investment securities. The rules will change in the year 2000.

<sup>9</sup>Moody’s Investor Service, a world-renowned rating agency, signed a contract to set up a joint venture with the Korea Investor Service.

<sup>10</sup>For a discussion of ITCs’ organization and functions, refer to the Appendix.

<sup>11</sup>One possible solution to the ITC problem is to wait until the capital market recovers and ITC asset values increase.

Since the top priority of financial reform is the banking sector, ITCs will be dealt with later on. The main reasons for this stepwise approach are that (i) restructuring might cause economic shockwaves and (ii) the Government and private sector can mobilize only so much restructuring funds.

<sup>12</sup>Refer to the US Securities and Exchange Act of 1934, Section 3. The term "security" means any note, stock, treasury stock, bond, debenture, certificate of interest or participation in any profit-sharing agreement or in any oil, gas, or other mineral royalty or lease, any collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or in general, any instrument commonly known as a "security"; or any certificate of interest or participation in, temporary or interim certificate for, receipt for, or warrant or right to subscribe to or purchase, any of the foregoing; but shall not include currency or any note, draft, bill of exchange, or banker's acceptance which has a maturity at

the time of issuance of not exceeding nine months, exclusive of days of grace, or any renewal thereof the maturity of which is likewise limited.

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Appendix

## Capital Market Institutions in Korea: Organization and Functions

### KOREA STOCK EXCHANGE

Established in February 1956, the Korea Stock Exchange (KSE) has played a central economic role as the country's sole exchange.<sup>1</sup> It is a nonprofit organization, with 38 regular members and 5 special members as of April 1998. The regular members are 31 domestic securities firms, 3 joint ventures between domestic and foreign investors, and 4 foreign securities firms, which were allowed membership since 1991. Regular members have the right to trade securities on the exchange, make claims on KSE properties, and vote at general meetings. They are eligible for membership on the Board of Directors. Special members' only right is to trade on the exchange. KSE has two affiliates—the Korea Securities Depository (KSD) and the Korea Securities Computer Corporation (KOSCOM). It reports to and cooperates with the Ministry of Finance and Economy (MOFE) and Securities and Futures Commission (SFC).

KSE's major function is to provide a market for trading of securities, including stocks, bonds, and Korea Composite Stock Price Index 200 (KOSPI) futures.<sup>2</sup> As an official intermediary and provider of the capital market, KSE regulates and supervises member firms, evaluates applications for listing in the primary market, and monitors securities trading to maintain a fair and orderly secondary market.

The entire process of securities trading, from ordering to settlement, was computerized by 1996, and the trading pits and out-cry system have disappeared.

<sup>1</sup>KSE was formerly a Government-owned organization. It was privatized in 1988.

<sup>2</sup>After a long debate as to where the stock index futures should be traded, KSE was chosen over the alternative of establishing a separate futures exchange, and KOSPI futures began trading on KSE in May 1996. The main argument for utilizing the existing exchange, other than the consistency of trade between the spot and the futures, was its economic feasibility, since no other futures product was expected to be introduced in the near future.

As of January 1998, 776 firms were listed on KSE and 952 listed securities were traded with a total market capitalization of W106.2 trillion.

### KOREA SECURITIES DEALERS ASSOCIATION

Established in 1953, the Korea Securities Dealers Association (KSDA) is a self-regulatory organization (SRO). Its regular members are securities firms; its associate members are securities-related financial institutions, including banks and investment trust companies. It is financed by membership fees and funds earmarked from the securities trading fees.<sup>3</sup> KSDA has seven departments, four offices, and four branches.

KSDA promotes the welfare of member firms, coordinates conflicting interests among its members, and assists KSE in keeping the capital market efficient and orderly through self-regulation. It tries to maximize the welfare of its members by moving ahead of the official regulatory authorities in terms of setting the rules for its members' activities, and represents their interests vis-à-vis the senior regulatory bodies. In particular, KSDA enforces the Fair Practices Rules on member firms' investment solicitation and transaction intermediation, and operates the Investor Protection Center to mediate any problems between investors and member firms.

Above all, it regulates the over-the-counter (OTC) markets, including listing, delisting, listing suspension, and disclosure of KSDA-listed firms. In May 1997, KSDA established an independent company, the Korea Securities Dealers Association Automated Quotation (KOSDAQ), to promote the trading of stocks and bonds of small and newly established firms.

KSDA also provides training programs for its member firms in the areas of securities investment and trading. It maintains a research agency, the Ko-

<sup>3</sup>As of March 1998, 0.003 percent of the total stock trading value and 0.015 percent of its members' underwriting commissions were earmarked for KSDA. Foreign securities companies can join KSDA either as regular or special members.

rea Securities Research Institute (KSRI), which recently became independent of KSDA.<sup>4</sup>

### KOREA SECURITIES DEPOSITORY

The Capital Market Development Act of 1968 and the Public Corporation Inducement Act of 1972 encouraged a large wave of new firms to go public. The number of stocks and bonds traded in the capital market surged, and regulatory authorities became aware of the importance of having an efficient settlement and depository system. In 1974, the Korea Securities Settlement Corporation (KSSC) was established as a commercial entity to improve the accuracy and speed of the settlement system in securities transactions.

In 1994, KSSC was restructured as the Korea Securities Depository (KSD), a nonprofit public organization, to enhance its status as the sole central depository. KSD's major functions include book-entry transfer and delivery, safe depositing, agent services for receipt and payment of dividends on stocks and interest on bonds, and other clearing- and settlement-related services for both KSE and KOSDAQ. It acts as a transfer agent for the securities owners of listed firms.

KSD is also the settlement entity for KSE and KOSDAQ transactions. KSE is in charge of the clearing process while KSD takes care of settlement on a contractual basis. KSD, however, administers the whole process from clearing to settlement for KOSDAQ transactions and securities transactions among institutional investors.<sup>5</sup>

In 1995, KSD improved its settlement functions by joining the Bank of Korea Wire (BOK-Wire), the national payment system, making real-time pay-

ment possible. (Payment used to be done on a next-day basis.)

In 1996, KSD's status was again improved greatly as the revised Securities Exchange Law explicitly designated and expanded the types of securities to be deposited with KSD.<sup>6</sup> The law also widened the applicable scope of the New Issue Blanket Deposit (NIBD) system to include all new issues of securities.<sup>7</sup>

The major KSD shareholders are KSE, KOSCOM, KSDA, and securities firms. KSD has 15 departments, 2 offices, and 5 branches.

### KOREA SECURITIES FINANCE CORPORATION

The Korea Securities Finance Corporation (KSFC), established in 1955, is the only organization in the country that facilitates financing in securities transactions in the primary and secondary capital markets. Its financing ranges from margin loans and stock loans for individual and institutional investors to securities underwriting loans, working capital loans, securities collateral loans, and stock purchase loans for capital market institutions, including securities firms. It also acts as a custodian of securities in limited areas, accepts deposits from investors who plan to subscribe to initial public offerings by newly listed firms, and trades in bonds under repurchase agreements (RPs) and reverse RPs. KSFC operates 15 departments and 6 branch offices with a total staff of 318, including executive managers. Its total assets amounted to W6,426.3 billion as of end-1997 (Table A1).

### INVESTMENT TRUST COMPANIES

The first investment trust company (ITC) was established in 1974. Thereafter, for more than a decade, three ITCs with nationwide branch networks

<sup>4</sup>KSRI is one of the main research institutes closely involved in MOFE's policymaking procedures in the area of capital markets.

<sup>5</sup>In 1990, the Institutional Affirmation and Settlement (IAS) system was established to facilitate delivery, payment, and settlement of securities transactions among institutional investors. It introduced the KSD as the sole entity to coordinate the entire settlement procedure between executing securities companies and their institutional investors via KSD's account management system and SAFE (Speedy, Accurate, Faithful and Efficient Terminal), KSD-net.

<sup>6</sup>KSD internal regulations used to be applied in defining the eligibility and scope of securities to be deposited.

<sup>7</sup>The NIBD system enables issuers, at the request of investors, to register securities in KSD's name without issuing physical certificates, helping to reduce issuing costs by 95 percent and streamlining securities transaction processes. The beneficial owners of securities exercise their rights with the entry of the number of securities in the participant or client book.

**Table A1: Financial Structure of Korea Securities Financing Corporation, as of end-1997 (W billion)**

<b>Assets</b>		<b>Debt and Equity</b>	
Cash and due from banks	63.6	Deposits	555.9
Securities	31.2	Bills issued	4,413.1
Loans	6,006.5	Borrowings	1,100.5
Fixed assets	8.5	Others	103.4
Others	316.5	Total debt	6,172.9
<b>Total assets</b>	<b>6,426.3</b>	Total equity	253.3
		<b>Total debt and equity</b>	<b>6,426.3</b>

Source: Bank of Korea, 1998.

operated in the market. In 1990, five more companies were given ITC licenses, but their businesses were restricted to certain regions of the country.<sup>8</sup> The total assets of ITCs by end-1997 amounted to W102.6 trillion. The share of the ITC industry in the financial market's total assets increased from 5.6 percent in 1987 to 7 percent in 1997.

Securities investment trusts are similar to the UK's contractual-type unit trusts. ITCs, as fund management companies, sell their products in the form of beneficiary certificates directly to customers through their branches. The certificates are mostly closed-end with fixed maturity, although open-end trust funds are also available. An investment trust contract is concluded between an ITC and a trustee company that acts as a custodian and bookkeeper and must be a bank authorized for trust business. The beneficiaries are the recipients of profits from the trust, distributed in cash. ITCs also provide trust-type securities savings that are almost identical to demand deposit savings of banks since there is no restriction on withdrawal.

The trust funds that an ITC can set up are of two types: stock funds and bond funds. Stock funds are heavily weighted with stocks, but have an upper limit on the proportion of stock investments. Bond funds are heavily weighted with bonds and are prohibited from investing in stocks. However, additional issues and redemptions are allowed for bond funds. In the 1990s, almost 80 percent of the

funds have been bond funds as stock price movements and the performance of stock funds have disappointed investors.

ITCs must invest trust funds primarily in listed securities. They are prohibited from using the funds to make loans, except call loans.<sup>9</sup> Regardless of type, some funds are invested in call loans and time deposits to meet investors' redemption requests. For risk diversification, MOFE prohibits ITCs from investing more than 10 percent of a trust fund in one stock, acquiring more than 20 percent of a firm's stocks, or acquiring securities held by its subsidiaries or affiliates. In 1996, MOFE abolished the entry barrier into the ITC industry by allowing other financial institutions, including securities companies, to establish investment trust management companies (ITMCs). ITMCs specialize in the management of trust funds and do not sell funds. Recently, they were allowed to manage stock funds as well as bond funds.

### SECURITIES COMPANIES

As of March 1998, 34 securities firms had registered with MOFE, including three joint ventures between domestic and foreign securities firms. The three major business lines of securities companies are brokerage, dealing, and underwriting. MOFE applies different minimum capital requirements depending on the securities company's scope of business. There is not

<sup>8</sup>Later on, six merchant banks were also permitted to manage trust funds that may only invest in bonds.

<sup>9</sup>To protect investors, ITCs are prohibited from using trust funds as call loans to their own accounts. However, they easily circumvent the regulation by using other financial institutions as a bridge.

**Table A2: Assets of Financial Institutions**

Financial Institutions	Assets (W billion)					Percent of Total				
	1987	1991	1993	1995	1997	1987	1991	1993	1995	1997
Money banks	110,482.6	220,388.9	275,689.9	379,517.1	573,695.5	56.0	45.6	38.8	38.0	39.4
Development institutions	20,277.6	43,162.7	51,853.6	70,544.2	149,078.9	10.3	8.9	7.3	7.1	10.3
Merchant banks	2,865.8	6,952.3	33,114.1	45,908.0	77,647.9	1.5	1.4	4.7	4.6	5.3
Investment trust companies	11,048.0	34,128.5	59,091.1	75,972.0	102,555.6	5.6	7.0	8.3	7.6	7.0
Korea Securities Finance Corp.	555.4	3,984.4	5,167.5	8,344.5	6,426.3	0.3	0.8	0.7	0.8	0.4
Savings institutions <sup>a</sup>	37,889.7	121,660.3	213,651.5	327,579.5	428,096.6	19.2	25.1	30.1	32.7	29.4
Life insurance companies	11,647.1	36,656.2	48,790.9	66,972.1	92,534.0	5.9	7.6	6.9	6.7	6.3
Securities companies	2,399.4	16,866.5	22,376.9	25,048.1	27,380.0	1.2	3.5	3.2	2.5	1.9
<b>Total assets</b>	<b>197,165.6</b>	<b>483,799.8</b>	<b>709,735.5</b>	<b>999,885.5</b>	<b>1,457,414.8</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>

<sup>a</sup> Savings institutions include mutual credits, mutual savings and finance companies, credit unions, credit cooperatives, trust accounts of banks, postal savings, and postal life insurance. Source: Bank of Korea, 1994–1998.

**Table A3: Revenue Sources of Securities Firms**

Year	Amount (W billion)					Percent of Total				
	Brokerage Commission	Underwriting Fee	Financial Revenue	Gains on Securities Trading	Total	Brokerage Commission	Underwriting Fee	Financial Revenue	Gains on Securities Trading	Total
1989	675.4	148.4	447.2	597.5	1,868.5	36.2	7.9	23.9	32.0	100.0
1991	379.1	599.7	775.7	191.6	1,946.1	19.5	30.8	39.9	9.8	100.0
1993	941.8	310.6	1,020.7	562.7	2,835.8	33.1	11.0	36.0	19.9	100.0
1995	1,844.8	259.2	853.4	1,376.2	4,333.6	42.6	6.0	19.7	31.7	100.0
1997	1,377.7	759.0	1,021.5	675.3	3,833.5	35.9	19.8	26.7	17.6	100.0

Source: Securities Supervisory Board, 1998.

much difference among management strategies of securities companies. Regardless of their size or competitive advantage, the firms are engaged in all three main business lines. No firm specializing in brokerage, for example, has been established despite the lower minimum capital requirement to acquire a brokerage license. With MOFE's approval, a securities company may engage in activities complementary to its main business, including credit extension to investors, securities savings, operation of the Bond Management Fund (a trust fund), payment guaranty for corporate bonds, and RP and reverse RP transactions.

However, based on the financial reform plan announced in late 1997, financial institutions, including commercial banks, will soon be able to carry out securities businesses in-house, except brokerage, which is the core business of securities companies.<sup>10</sup> The reform plan is part of the restructuring program to strengthen the financial industry.

Securities firms have grown steadily in number and size with the growth of the capital market. However, their financial performance has been disappointing despite Government protection of existing firms through entry barriers and diverse supportive regulatory measures.<sup>11</sup> The securities industry's share in the total assets of financial institutions peaked in 1991 at 3.5 percent but decreased to 1.9 percent as of end-1997 (Table A2).

The average return on equity was only 1.36 percent for those belonging to the top 30 chaebol, and 2.74 percent for the others in 1991–1996. Although

<sup>10</sup>The authorities allow securities business on the condition that financial institutions other than securities companies merge either with securities companies or among themselves. Unfortunately, no restructuring in the form of mergers and acquisitions has happened as of March 1998.

<sup>11</sup>Recognizing the public externality of a financial institution, the Government generally provides direct or indirect subsidies, including funding at lower-than-market rates, higher priority in capital raising, etc.

**Table A4: Nonperforming Loan and Net Operating Capital Ratios of Securities Companies, as of January 1998**

Securities Company	Nonperforming Loan Ratio (%)	Net Operating Capital Ratio (%)
Boo Kook	4.1	158.3
Boram	8.7	117.9
Cho Hung	7.2	190.6
Coryo	41.3	na
Daewoo	9.4	171.0
Daishin	8.3	129.4
Daeyu	14.7	256.4
Dong-Ah	5.3	131.0
Dongbang Peregrin	70.7	92.4
Dongbu	1.8	75.9
Dongsuh	24.9	na
Dongwon	19.3	311.1
Han Jin	35.0	29.3
Hanil	18.9	219.9
Hannuri Salomon	1.5	170.5
Hanwha	0.3	84.2
Hanyang	33.7	185.8
Hyundai	15.2	(64.8)
Keon Seol	0	721.9
Korea Development Bank	47.6	(32.0)
Korea Exchange Bank Smith Barney	0	306.5
Korea First Bank	42.4	312.8
Korea Long-Term Credit Bank	12.5	82.2
Kyobo	3.6	80.7
LG	20.7	150.0
Samsung	3.1	185.0
Seoul	34.5	79.6
Shin Heung	2.5	774.4
Shinhan	14.7	273.6
Shinyoung	0.6	646.1
SK	48.6	(216.9)
Ssangyong	9.3	54.2
Tong Yang	19.4	141.7
Yuhwa	48.8	1,181.5

na = not available.  
Source: Financial Supervisory Commission.

tentative, the results for fiscal year 1997 are much gloomier as losses totalling over W1 trillion had been realized for all securities firms.<sup>12</sup> Only five securities firms recorded positive net profit while 26 firms reg-

<sup>12</sup>About \$714 million at W1,400 to \$1.

istered net losses, resulting in a serious drop in their capital bases. The huge losses of securities firms in 1997 forced two of them to stop operations. More securities firms are in line for financial failure unless swift structural changes, including increased capital bases, are implemented.