Financial Institutions, Markets and Infrastructure in Korea

April 2012

THE BANK OF KOREA

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CONTENTS

Part I Financial Institutions

Financial institutions serve mainly as intermediaries for savings and investment between savers and borrowers, and are commonly divided into six categories: banks, non-bank depository institutions, financial investment business entities, insurance companies, other financial institutions, and financial auxiliary institutions.

Banks

To elaborate on the financial institutions making up each category under this classification, banks are divided into commercial banks and specialized banks. Commercial banks consist of nationwide and local banks and branches of foreign banks. Special banks are financial institutions established under a special act rather than the Banking Act, and their main enterprises are banking businesses. Specialized banks include the Korea Development Bank, the Export-Import Bank of Korea, the Industrial Bank of Korea, the National Agricultural Cooperative Federation, the National Federation of Fisheries Cooperatives, and others.

Non-bank Depository Institutions

Non-bank depository institutions mainly concern themselves with taking deposits and lending, similar to banks, but are established for more limited purposes and fall under distinct regulations concerning their raising and management of funds. That is, the scope of their business activities is narrower than that of banks, payment and settlement services are either non-existent or provided in a limited manner, and the focuses of their businesses are restricted in advance in accordance with each financial institution’s unique features. Non-bank depository institutions comprise mutual savings banks, credit cooperatives including credit unions, community credit cooperatives and mutual banking entities, merchant banks and the postal savings.

Financial Investment Business Entities

Financial investment business entities include all financial institutions that primarily conduct the business of trading marketable securities in the direct financing markets. These consist of investment traders and brokers (securities and futures companies), collective investment business entities, investment advisory and discretionary investment business entities, and trust business entities.

Insurance Companies

Insurance companies are those institutions that underwrite and operate insurance against death, disease, old age, or a variety of accidents including fires. In consideration of the features of the institutions and their businesses, they are categorized into entities providing life insurance, non-life insurance, postal insurance, mutual aid, and others. Non-life insurance companies consist of property and casualty insurance companies, reinsurance companies, and guarantee insurance companies.

Other Financial Institutions

Other financial institutions include institutions mainly operating financial businesses that are difficult to classify among the financial institutions in the four aforementioned categories. They consist of financial holding companies, credit-specialized financial companies (leasing, credit card, installment financing, and new technology venture capital companies), venture capital companies (small and medium-sized enterprise establishment investment companies), securities finance companies, public financial institutions, and others.

Financial Auxiliary Institutions

Financial auxiliary institutions are those institutions that, rather than directly taking part in financial transactions, mainly provide the conditions necessary for smooth operation of the financial system. They span institutions carrying out businesses related to financial infrastructure such as the Financial Supervisory Service, the Korea Deposit Insurance Corporation, the Korea Financial Telecommunications and Clearings Institute, the Korea Securities Depository, the Korea Exchange, credit guarantee institutions including the Korea Credit Guarantee Fund and the Korea Technology Finance Corporation, credit information companies, financial brokerage companies, and others.

Financial Institutions in Korea

(as of end-December 2011)

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When examining the share of each financial cluster in the total assets of major financial institutions as of end-2010, the banking sector (including trust accounts) accounted for the largest portion with 54.8 percent, followed by insurance institutions (14.8 percent), credit cooperatives (10.5 percent), collective investment business entities (asset management companies) (9.5 percent), investment traders and brokers (securities companies) (5.5 percent), mutual savings banks (2.7 percent) and postal savings (1.6 percent).

For banks (bank accounts), their share of total assets increased temporarily owing to their recovery of soundness through restructuring and a preference by economic players for riskless assets in the wake of the 1997 Asian currency crisis. Over the long term their share has been showing a trend of decline, however, attributable for example to their low earnings ratios. Among non-bank depository institutions, the share of credit cooperatives has been experiencing steady growth, while the volume and share of assets at mutual savings banks decreased for a period following the 1997 currency crisis but rebounded due to a governmental small-loan support policy[1)]. Insurance companies' portion has shown a steady increase thanks to growing interest in preparation for the uncertain future and provisions for old age. As the capital markets recovered from the 1997 Asian currency crisis, the share of securities companies grew as well.

1) Some savings banks, however, focused on external expansion and risky real estate project financing, and the depression of the real estate market in the aftermath of the global financial crisis of 2008 hurt savings bank performance. Coupled with the moral hazard of majority shareholders and management, eight savings banks including Busan Mutual Savings Bank and its affiliates were ordered to suspend operations in 2011.

Total Assets of Major Financial Institutions[1]

(as of period-ends)

Units: Billion won, %

	1995	2000	2005	2010
Banks	595,826 (62.9)	982,178 (63.4)	1,213,462 (57.8)	1,884,114 (54.8)
Bank accounts	450,061 (47.5)	887,681 (57.3)	1,100,954 (52.4)	1,716,889 (49.9)
Trust accounts	145,765 (15.4)	94,497 (6.1)	112,508 (5.4)	167,225 (4.9)
Merchant banks	45,912 (4.8)	21,273[1] (1.4)	13,237[1] (0.6)	24,242[1] (0.7)
Mutual savings banks	32,612 (3.4)	24,196 (1.6)	44,883 (2.1)	91,271 (2.7)
Credit cooperatives	75,910 (8.0)	145,065 (9.4)	220,186 (10.5)	360,863 (10.5)
Credit unions	13,217 (1.4)	20,959 (1.4)	24,757 (1.2)	48,763 (1.4)
Community credit cooperatives	20,729 (2.2)	37,061 (2.4)	53,913 (2.6)	92,101 (2.7)
Mutual banking	41,964 (4.4)	87,045 (5.6)	141,516 (6.7)	219,999 (6.4)
Postal savings	6,986 (0.7)	24,496 (1.6)	37,774 (1.8)	55,392 (1.6)
Insurance companies	86,584 (9.1)	163,562 (10.6)	308,552 (14.7)	507,482 (14.8)
Life insurance companies	69,677 (7.4)	120,730 (7.8)	239,362 (11.4)	408,495 (11.9)
Non-life insurance companies	12,711 (1.3)	28,049 (1.8)	49,100 (2.3)	98,987 (2.9)
Postal insurance	4,196 (0.4)	14,783 (1.0)	20,090 (1.0)	28,586[2] (0.8)
Investment traders and brokers (Securities companies)	27,801 (2.9)	42,033 (2.7)	62,730 (3.0)	189,384 (5.5)
Collective investment business entities[3] (Asset management companies)	75,972 (8.0)	146,717 (9.5)	198,354 (9.4)	325,279 (9.5)
Total	947,603 (100.0)	1,549,520 (100.0)	2,099,178 (100.0)	3,438,027 (100.0)

Notes: 1) Includes consolidated financial accounts of banks and securities companies. Figures in ( ) indicate the percentages in the total amounts.
2) As of end-2009.
3) Based on investment trust accounts.

Sources: Bank of Korea *Monthly Statistical Survey Bulletin*, Financial Supervisory Service *Monthly Financial Statistics Bulletin*, Korea Insurance Development Institute *Insurance Statistics Yearbook*

Part II Financial Markets

Financial markets are organized venues where economic players may raise and operate funds through transactions in financial instruments. The financial markets are divided into the direct and the indirect financing markets, depending upon whether or not the transactions are conducted through financial intermediaries.

The indirect financing markets are exchanges where funds are brokered through deposits and loans; the deposits and loans market is a good example. Financial transactions are carried out by banks, non-bank depository institutions, collective investment business entities, trust business entities, etc., that provide funds by lending money or by buying direct securities with funds raised through indirect securities such as certificates of deposit and beneficiary certificates.

Financial transactions into direct financing markets are undertaken as the fund providers purchase direct or primary securities issued by the end consumers of the funds, such as financial debentures or corporate bonds. Accordingly, the direct financing markets, which do not depend on financial intermediaries, play more active roles and are more diversified than the indirect financing markets.

In accordance with the maturities of the financial instruments involved, the direct financing markets are generally divided into the money markets and the capital markets. Additionally, they can be divided into the foreign exchange markets and the financial derivatives markets, in consideration of the features of the financial instruments concerned.

Money Markets

The money markets are those markets where financial instruments that expire within one year are commonly transacted in order to maintain the balance of the supply of and the demand for short-term funds. The money markets in Korea embrace the call market, as well as a wide range of other financial markets including those for commercial paper (CP), certificates of deposit (CDs), repurchase agreements (RPs), monetary stabilization bonds (MSBs) and cover bills (CBs).

Capital Markets

The capital markets are those where the means to raise long-term funds, such as stocks and bonds, are issued and transacted. These are usually categorized into the stock market and the bond market. The secondary stock market is further divided into the marketable securities market and the KOSDAQ, where listed stocks are traded, and the Free Board for unlisted stocks. The bond market is where long-term bonds with maturities of one year or more are issued and traded. The secondary bond market is divided into the face-to-face market (marketable securities market) where listed bonds are traded, and the off-board market where all bonds including unlisted bonds can be transacted. The capital markets include the newly emerging asset-backed securities market, which is seen as a means for companies and financial institutions to mobilize funds. This market is where asset-backed securities (ABSs), issued based on illiquid assets such as properties, accounts receivable and mortgage-backed securities, are traded.

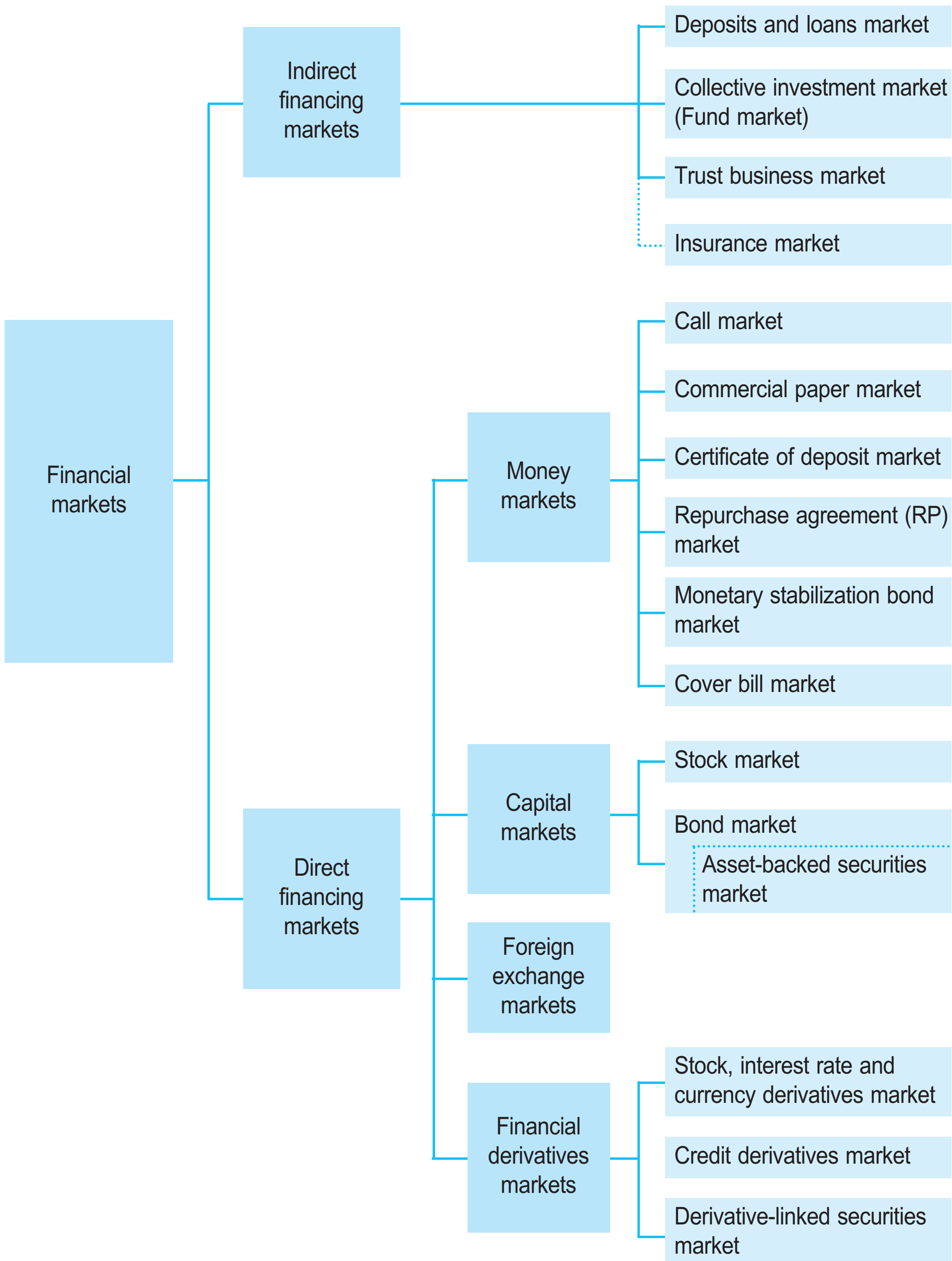
Foreign Exchange Market

The foreign exchange market is the place where the regular or continuous trading of foreign currencies occurs between foreign currency purchasers and suppliers. The foreign exchange market is divided between the customer market, where foreign currency is traded between general consumers and foreign exchange banks, and the inter-bank market, where foreign currency is transferred between foreign exchange banks. However, the foreign exchange market most commonly refers to the inter-bank market, as this is where the basic exchange rate is determined.

Financial Derivatives Market

The financial derivatives market is the place where financial derivatives designed to reduce the risk of changes in the value of underlying assets can be traded. The financial derivatives market in Korea consists of the market for stock, interest rate and currency derivatives, together with the credit derivatives market and the derivative-linked securities market.

Structure of Financial Markets in Korea



The size of the financial markets in Korea has increased continuously, thanks to economic growth, improvements in the mobilization and management of funds by economic players, the fostering of the capital market and the open door policy, and the infrastructure restoration following the 1997 Asian currency crisis. As of end-2010, the total volume of the financial markets in Korea, including the short-term financial and capital markets, amounted to 2,616 trillion won — up 15 times from 174 trillion won in 1990. The ratio of the financial markets to GDP in Korea rose from 0.91 in 1990 to 2.23 at the end of 2010.

Financial Market Trends in Korea

(as of period-ends)

Unit: Billion won

	1990	2000	2005	2010
Money markets	44,335	138,757	201,938	259,946
Capital markets[1)]	130,137	641,741	1,446,128	2,356,213
Financial markets	174,472	780,498	1,648,066	2,616,158
GDP	191,383	603,236	865,241	1,172,803
Financial markets/GDP	0.91	1.29	1.90	2.23

Note: 1) The volume of the bond market included in the total amount of the capital market in 1990 was based on the balance of public bonds going on the Korea Exchange.

Sources: Bank of Korea, the Korea Exchange

Part III Financial Infrastructure

Financial infrastructure indicates the legal system or institutions that support and oversee the financial institutions and markets in order to ensure smooth financial transactions. It comprises the central banking system, the payment and settlement system, the financial supervisory system, the deposit insurance system, and more.

Central Bank

The central banking system includes the central bank, its organization, decision-making system and sphere of business. As the lender of last resort with the right to issue banknotes and coins, the central bank performs the function of determining policy rate, imposing reserve requirements on the deposits of banks and, if necessary, supplies financial institutions with needed funds. These functions contribute to price stabilization, as well as stabilization of the financial system. The Bank of Korea, founded on June 12, 1950, serves as Korea's central bank.

Payment and Settlement System

The payment and settlement system performs the function of settling credits and debts established through real economic and financial transactions. It consists of means of payment, participant institutions and the settlement system. Means of payment include cash and non-cash instruments such as bills, checks and credit cards. The participant institutions comprise those financial institutions that provide non-cash instruments of payment, such as banks, the post office and credit card companies; clearing houses, which offset debts between financial institutions and include the Korea Financial Telecommunications and Clearings Institute; and the Bank of Korea, which finalizes payment and settlement by transferring funds between the current accounts of financial institutions. The settlement system is divided into the net and the gross settlement systems, depending upon the settlement method, as well as the retail payment system and the large value payment system, depending upon the features of the transactions concerned. In general, owing to the natures of the transactions concerned, the retail payment system is operated by the net settlement system and the large value payment system is managed according to the gross settlement system. In Korea, the gross settlement system for large value payments is conducted through BOK-Wire+, operated by the Bank of Korea. The net settlement system for retail payment is conducted through the bill clearing system, the GIRO system, the bank information network and others, managed by the Korea Financial Telecommunications and Clearings Institute.

Financial Supervisory System

The financial supervisory system aims to protect the properties of finance customers and promote financial transactions by ensuring that institutions conduct financial intermediation fairly, as well as by fostering sound management. For this purpose, financial supervisory institutions perform the function of approving the establishment of financial institutions, drafting regulations to be followed by financial institutions in conducting their business, and overseeing regulatory compliance. Korea applies an integrated financial supervisory system, in which the Financial Services Commission (FSC) and the Financial Supervisory Service (FSS) supervise nearly all financial institutions. The FSC deliberates on and determines important matters concerning financial supervision, including financial supervisory policies and the licensing of financial institutions, while the FSS implements the decisions of the FSC and examines and supervises financial institutions. In addition, the Bank of Korea and the Korea Deposit Insurance Corporation partially serve supervisory roles with limited functions of financial oversight, such as requesting inspections and conducting joint examinations with the FSS.

Deposit Insurance System

The deposit insurance system is a type of insurance system through which, when a financial institution is unable to pay the principal or interest it owes due to unsuccessful managements, a deposit insurance institution remits a portion or all of the principal and interest in the place of that financial institution. The deposit insurance system serves as a financial safety net, protecting small-scale depositors from the reckless management of financial institutions and preventing bank runs. The deposit insurance system in Korea was organized in 1996 with establishment of the Korea Deposit Insurance Corporation. Currently, bank deposits and selected financial instruments from securities and insurance companies are protected by the system. Thrift institutions such as credit unions, community credit cooperatives, agricultural cooperatives, fisheries cooperatives and forestry cooperatives support proprietary deposit protection systems, as they aim at mutual aid among cooperative members. Postal savings and insurance are not covered by the Korea Deposit Insurance Corporation, because payment in these systems is guaranteed by the government in accordance with the related legislation.

Part IV Recent Changes in the Korean Financial System

1. Promoting Financial Reform for Overcoming 1997 Crises and Financial Advancement

Since the 1990s, Korea had been carrying out a variety of measures designed to develop its financial system, but before fully accomplishing financial liberalization and greater openness it was forced to suffer through the currency crisis of late 1997. This occurred because financial liberalization and openness were being promoted in the absence of appropriate financial infrastructure, and excessive competition between financial institutions led to a reckless inflow of capital and excessive lending. The management of financial institutions as a result eroded, and the financial reforms conducted from 1998 were focused on enhancement of the financial infrastructure in order to speed up the restoration of sound management at financial institutions and simultaneously bring about the positive effects of financial liberalization and openness.

Firstly, insolvent financial institutions were resolved through methods such as liquidation or mergers and acquisitions, based upon judgments as to their viability. As a result, the number of banks fell from 33 in late 1997 to 19 in June 2005. The number of merchant banks, meanwhile, which had once been almost 30, was reduced to just two at that point, with most of them having been liquidated due to poor management. This was also the fate of many financial institutions targeting the lower income brackets, such as mutual savings banks. Through this process of financial institution resolution, the government raised and then injected public funds worth around 160 trillion won and took a leading role in determining the survivability of financial institutions and selling insolvent ones.

At the same time, the government worked actively to enhance the financial infrastructure in order to allow the ongoing efforts for financial liberalization and openness to produce the expected results. Regarding greater financial openness, measures to liberalize foreign currency exchange were enforced in December 1997, by transitioning from a managed floating to a free floating exchange rate system and through the all-out deregulation of overseas remittances. Meanwhile, the limits on foreign investment in stocks were lifted in May 1998.

In addition, an easing of regulations was carried out through expansion of the scope of services able to be offered by financial institutions, together with liberalization of interest rates. To reinforce the competitiveness of financial institutions and permit more diverse financial services, regulations on the services they were allowed to provide were relaxed considerably. In 2000, the Financial Holding Company Act was enacted. Banks were authorized to sell beneficiary certificates in September 1998, and in August 2003 bancassurance, or the Bank Insurance Model, was introduced. In January 2004, the Indirect Investment Asset Management Business Act was enacted, promoting the sale of indirect investment securities and expanding asset management by indirect investment agencies. There occurred a simultaneous easing of the criteria for establishing financial institutions such as insurance companies and securities firms, and of the regulations on asset management and branches. In December 2004, by abolishing restrictions on demand deposit interest rates, implementation of the Four-step Interest Rate Liberalization Plan begun in 1991 was finally completed.

To prevent flawed management at financial institutions from reappearing, regulations regarding sound financial institution management were tightened. After the Prompt Corrective Action (PCA) System was imposed on banks, merchant banks and securities companies in April 1998, the system was gradually expanded to cover insurance companies (June 1998), mutual savings banks (December 1999) and credit unions (December 2003). Following reinforcement of the criteria for classifying the assets of financial institutions based upon their levels of soundness in July 1998, a minimum period of three months of overdue payment replaced the previous six months as the criterion for non-performing assets. In January 2000, the Forward Looking Criteria (FLC) System, a system for classifying assets according to their levels of soundness taking into account the future repayment capacities of borrowers, was introduced to banks. It was later also applied to merchant banks (June 2000) and to insurance companies (September 2000).

Next, as a part of the drive to increase management transparency and ensure a more responsible management system, the accounting and disclosure systems at financial institutions were reinforced. In November 1998, the reliability of accounting systems was elevated by a shift of the methods for evaluating securities owned by financial institutions to a fair-value basis, and the disclosure period for accounting information and management reports on banks, securities and insurance companies was reduced from one half-year to one quarter (January 2000). The same was later done for asset management companies (January 2004). In January 2005, a securities-related group litigation system was introduced as a measure facilitating relief against damages caused by the falsification of disclosure documents, use of insider information or market manipulation.

Furthermore, in order to encourage the emergence of sound financial capital and promote responsible management at financial institutions, efforts to improve the ownership and governance structures of financial institutions were undertaken. In April 2002, the Banking Act and the Financial Holding Company Act were revised, to ease restrictions on the ownership of financial institutions through changes such as a raise in the percentage limit of individual possession of a bank's or bank holding company's voting stock from four to ten percent. In 1999, to prohibit major shareholders from exercising undue influence, stricter regulations on the trading and granting of credit to major shareholders were imposed. The criteria for a financial institution becoming a major investor and its minimum capital requirements were also specified. In January 2000, to improve the existing external audit system, an obligation was imposed on banks and merchant banks, as well as at securities firms, insurance companies and asset management firms of minimum sizes or larger, to introduce board systems centered on outside directors and install audit committees.

Meanwhile, in the capital markets, the opening of the Korea Futures Exchange took place in April 1999, and of the Free Board (the Third Market) for trading over-the-counter stocks outside the Korea Stock Exchange and the KOSDAQ (Korea Securities Dealers Automated Quotation) market in March 2000. In addition, the Electronic Communication Network (ECN) was inaugurated in December 2001, enabling transactions in 250 types of stocks traded on the KOSPI and KOSDAQ exchanges after the closure of those two standard markets. In January 2005, the Korea Stock Exchange, KOSDAQ and the Korea Futures Exchange were united into the Korea Stock and Futures Exchange, which was renamed the Korea Exchange (KRX) in February 2009. Furthermore, a succession of systems designed to facilitate the raising of funds through direct financing were introduced: the Asset-backed Securities (ABS) System (September 1998), the Corporation-type Investment Beneficiary Certificate System (December 1998), and the Mortgage Loan System (April 1999).

2. Reorganization of Regulations on the Capital Markets and Financial Investment Sector

After the currency crisis the government pushed steadily ahead with financial opening, financial regulatory easing and improvement of the financial infrastructure, together with financial structural adjustment, and as a result reaped outcomes including financial market stability, heightened external credibility, and a system for ensuring financial institution management soundness. On this basis, from the mid-2000s it developed efforts to financial system improvement, to promote the financial industry as a growth industry capable of creating high value-added and high quality employment.

Firstly, in August 2007, six existing laws addressing the capital markets, including the Securities and Exchange Act, the Indirect Investment Asset Management Business Act and the Trust Business Act, were bundled into the

Financial Investment Services and Capital Markets Act (enforced in February 2009; hereafter "the Capital Markets Act"). By encouraging financial innovation and competition through the reorganization of regulations on the capital markets and financial investment enterprises, as well as expanding the direct financing market through measures such as the cultivation of large-scale investment banks and revitalization of the capital markets, this newly unified Act aimed to create a foundation fostering harmony within the existing system of indirect financing centered around banks.

Businesses operated by financial investment houses were sorted into six categories — investment trading, investment brokerage, collective investment, trust, discretionary investment, and investment advisory — and individual entities became required to either receive selective approvals or be registered in one or several of these categories in order to operate financial investment businesses. In this regard, categorized businesses considered highly likely to have conflicts of interest with each other were prohibited from sharing information on transactions, prevented from having the some executives working at more than one of them, and allowed only limited collective access to one another's offices. Furthermore, financial investment businesses with more than 2 trillion won in inherent assets and over 6 trillion won in investments were required to appoint non-executive directors and install auditing committees. The Act defines financial investment products as all financial instruments that entail the possibility of generating losses from their original amounts, based upon the all-inclusive concept. Financial investment products were classified into securities, listed derivatives and over-the-counter (OTC) derivatives. Securities were then further divided into debt securities, equity securities, beneficiary certificates, securities depository receipts, investment contract securities and derivatives-linked securities (DLS).

This expansion and systemic reorganization of the capital markets since the mid-2000s has led to a remarkable growth in new securities-related institutions. From

2005 to 2010, 39 collective investment businesses and eleven financial investment dealers (stock companies) were created. Notably, as of end-2010 the number of collective investment businesses stood at 80, a 2.6-fold increase from the 31 that existed at the time of the 1997 currency crisis.

Moreover, the development of capital markets and the efforts of financial institutions to diversify their businesses influenced an expansion of newly-established financial holding companies. From 2001, financial holding companies began to be created centered around banks. The KDB Financial Group (bank holding company) was re-founded in October 2009, by converting the Korea Development Bank (KDB) from a specialized bank to a company limited by shares. This meant that the KDB was now in principle subject to the Banking Act, and also that its range of services could be expanded to the scope of a commercial bank, allowing it a basis for competing with commercial banks. As of end-December 2011, there were nine bank holding companies and three non-bank holding companies in operation in Korea, making twelve financial holding companies in total.

Meanwhile, after the 1997 currency crisis, a considerable decline in the number of banking facilities providing small-scale loans to the underprivileged for living expenses, through the liquidation of insolvent financial institutions and processes of mergers and acquisitions of banks, caused an increase in the lending business. In response, the government worked to repair the related systems in an effort to protect the underprivileged having poor credit histories from usurious interest rates and illegal dealings with unregistered private and institutional money lenders. In 2007, to protect financial consumers from unregistered money lenders, the government reenacted the Interest Limitation Act, which had been abrogated in 1998. Plans to invigorate microfinance services, which can increase the financial access of the underprivileged, were also actively carried out.

Changes in Numbers of Financial Institutions[1]

(as of period-ends)

	1997	1998~2004			2005~2010			2010
		Newly Established	Merger[2]	Exit[3]	Newly Established	Merger[2]	Exit[3]	
Financial holding companies	-	3	-	-	6	-	-	9
Banks	33	-	9	5	-	1	-	18
Mutual savings banks	231	13	28	103	7	1	14	105
Credit unions	1,666	9	107	502	5	39	70	962
Merchant banks	30	1	7	22	-	1	-	1
Securities companies[4]	36	19	4	8	11	4	-	50
Collective investment business entities[4]	31	24	2	6	39	6	-	80
Life insurance companies[5]	31	4	5	9	1	-	-	22
Non-life insurance companies	14	4	1	2	2	1	-	16
Total	2,072	77	163	657	71	53	84	1,263

Notes: 1) Excludes branches of foreign financial institutions.
2) Numbers of financial institutions ceasing to exist following mergers.
3) Includes revocations (and applications for revocations) of licenses, bankruptcies and liquidations.
4) Financial investment business entities under the Capital Markets Act.
5) Excludes Postal Insurance.

Source: Financial Supervisory Service

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