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Financial Reform in Korea: A Work in Progress

Speech before Korea Society

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Thank you, Chairman Gregg, for the kind introduction. I would also like to thank Korea Society for having me here today.

Distinguished guests and ladies and gentlemen,

I am pleased and honored to speak before you this afternoon. This is my first visit to the U.S. since I became the Chairman of the Financial Supervisory Commission three months ago.

I had good meetings with Chairman Donaldson of the S.E.C. and Chairman Greenspan of the Federal Reserve Board in Washington, D.C. And I am attending an international conference later this week here in New York. So this has been a very useful and productive trip so far, and I am delighted to be here and share my thoughts with you.

I am particularly pleased to have an opportunity to talk about the transformation of Korea's financial service industry and the challenges ahead right here in the City of New York, the heart of international finance.

As you may already know, the Financial Supervisory Commission was established in 1998 in the wake of the financial crisis in 1997. After taking charge of the post-crisis management for about two years, the Commission began to concentrate on its mission of ensuring the soundness of financial companies, promoting a fair and efficient financial market, and protecting consumers.

From strong balance sheets and profit-driven management to significant efficiency gains at the operational level, Korea's financial companies have made many real, positive changes in the last six years. But our reform and restructuring is still very much a work in progress. And many challenges lie ahead before Korea's financial service industry can compete with the leading global competitors. Likewise, more efforts and changes are needed for Korea to move forward as a globally competitive and attractive market.

Today, I would like to first share with you the successes we have had with our reform and restructuring. I will then discuss the tasks that lie ahead as we strive to advance Korea's financial service industry.

The financial crisis that hit Korea in 1997 was not merely due to problems in the banking sector. In fact, there was a broad consensus the crisis pointed to many structural weaknesses in the economy that had persisted over the years but had been overshadowed by Korea's high economic growth. So the initial focus of the reform drive was on correcting the structural weaknesses in the financial and corporate sectors.

With the crisis posing a potential systemic threat, the government had to allocate a substantial amount of public funds—KRW165 trillion (US$140 billion) or about 23% of Korea's GDP—to revitalize the financial system. Cleaning up the balance sheets of domestic banks was one of the top priorities for the government. And as a part of this process, a large number of non-viable financial companies were also either closed or merged with the healthier ones. Another major goal was to transform Korea's financial companies as genuinely profit-seeking entities, free from government intervention and competing on their own in the marketplace.

With respect to asset soundness, non-performing loans fell from KRW136 trillion (US$115 billion) to KRW32 trillion (US$27 billion) as of the end of June this year. And the capital base of financial institutions has also significantly improved as evidenced by the increase in bank capital adequacy ratio from about 7% at the end of 1997 to close to 12% at the end of June.

Another significant change has been the sharply improved profitability of banks. And as a result of aggressive self-restructuring measures, including a drastic downsizing of workforce and branch operations, the productivity of domestic banks more than doubled. It is also important to stress the growing scale of assets and the sophistication and diversification of financial products and services, which have helped to raise the overall quality and competitive strengths of domestic financial companies.

As the overall health of the financial sector improved, the government's role in the financial market rapidly diminished. As this happened, the policymakers stepped up their efforts to facilitate and improve market transparency through rational corporate governance and reinforced accounting and disclosure standards. Asset valuation on a realistic basis and recognizing them accordingly was another significant change. For instance, securities are marked to market and we now have strict loan classification and provisioning standards.

Trading in the equity and debt markets as well as in the money market has also significantly increased. For example, at the Korea Stock Exchange, the total market capitalization reached KRW380 trillion (US$322 billion) as of June this year. Likewise, the bond market grew sharply with active trading of government bonds.

Another major change we have witnessed in the local financial market after the financial crisis is the rapidly growing presence of foreign investors. In terms of market capitalization, the share of foreign investors is said to be more than 43% and many foreign financial service companies are expanding their business operations at a fairly rapid pace. I think it is fair to characterize these developments as a sign of foreign investors' confidence in Korea and its growth potential.

I would like to take a look back now at what has transpired since 2001—the year Korea more or less recovered from the impact of the 1997 financial crisis—and make some general observations.

Because of the emphasis on the soundness of the banking sector, the "bankcentered" restructuring led to somewhat of an imbalance between the banks and the non-banking financial institutions in terms of asset soundness and capital adequacy. Moreover, as risk-averse investors turned to bank deposits for safety, bank asset holdings began to rise.

In terms of bank loans, the largest component of bank assets, domestic banks began to compete aggressively with each other to expand lending to households and small and medium-sized companies. This occurred as demand from large businesses fell rapidly. The rising debt burden on consumers and SMEs then began to dampen consumption and investment, diminishing the efficacy of macroeconomic policies aimed at stimulating growth.

To be sure, the likelihood of distressed consumer and SME loans posing a systemic risk is low. But despite the improvement that Korea's financial companies have made with respect to their internal controls and risk management, there is still much room for improvement in these areas. Indeed, I believe prudent lending still very much remains a major task.

Although the overall risks in the financial system have sharply declined, the flow of investment funds has been less than consistent and remains concentrated in short-term instruments like money market funds and bank deposits with maturity of less than one year. The short-term nature of investment funds these days is evident from the supply and demand picture. On the supply side, we continue to see investor preference for safety in the equity and debt markets. And on the demand side, we see sluggish business investment creating a slack in the demand for long-term capital.

With investment capital flowing in and out of short-term investments, there is a potential for increasing volatility of asset prices, diminishing efficacy of monetary policies, and slow economic growth. So this is an issue that the policymakers are paying attention to.

Actions are needed on several fronts to deal with this issue. One is to continue focusing on raising market transparency and investor confidence. Another is for more businesses to look boldly to the future and invest. As for the need for more aggressive business investment, it is of course up to the companies themselves to find the most productive uses for their capital. For their part, the policymakers are working hard to provide clear policy goals for the market and contribute to an environment favorable to investors.

Looking ahead, the regulators recognize the importance of taking a steady and firm course to deal with the issues I mentioned earlier and working closely together with everyone involved in the process.

I would first note that, as I mentioned earlier, our reform and restructuring is a work in progress, and we very much remain committed to our reform and restructuring agenda throughout our financial system.

I think it’s also important to note that, unlike in the past, we are now faced with challenges that have much less to do with structural weaknesses. Going forward, one key challenge will be to enhance the competitiveness and profitability of financial companies at the individual firm level.

That is, what matters is not a reform package handed out by the government but rational competition for profit in the marketplace. Under this principle, the policymakers will continue to work on implementing more effective regulations so as to eliminate obstacles that dampen competition and other market dynamics. I believe doing so will also encourage financial companies to maximize their own resources and compete rather than looking to the government or the regulators for help, especially in times of distress.

More effective prudential regulation and supervision will also be needed to identify and preempt potential risks that can arise from intensifying competition, universal banking, and financial conglomerates.

I would also note that we embrace market-friendly approaches in our regulation and supervision as we are doing with financial institutions to prepare for the New Basel Accord to ensure a smooth transition to the new capital regime.

We are also looking to put into place more measures to stimulate capital flow, particularly through the long-term corporate bond market. In order to deepen the capital market, we are working on new initiatives to promote institutional investors like investment trust companies and pension funds so that they can grow in quality as well as in quantity.

I would also like to make a couple of remarks on the prospect for Korea's asset management services industry.

Late last year, the government announced a new strategic initiative to position Korea as the financial hub for Northeast Asia with asset management services leading the way. In emphasizing asset management services, the government noted the positive effect that strong asset management service providers have on the industry as a whole and the expected demand growth for asset management services from large public pension funds and new retirement funds. When factors such as Korea's aging population, a trend toward low interest rates, and deregulation are taken into account, the prospect for asset management services to lead Korea's financial services industry is brighter than ever before.

Distinguished guests, and ladies and gentlemen,

Korea overcame the 1997 financial crisis with its uniquely dynamic determination and strength. Our overriding goal has been to restore and ensure the soundness of the financial institutions and the stability of the financial system. Our success is real, and there is more to come.

Our work is ongoing, and we will not back away from doing what is necessary to transform Korea a truly dynamic and vibrant global marketplace.

The blueprint the government laid out to turn Korea into Northeast Asian financial hub with asset management services leading the way is a key part of that effort. And we remain deeply committed to establishing a supervisory system that meets the highest global standards for prudential regulation and supervision.

I believe that, with a world-class infrastructure, a large pool of well-educated and technically competent workforce, and information technologies second to none, we will realize the goals we set for ourselves. This is the very message I would like to leave you with.

Your continuing interest in our work is important to our success, and I would very much like to ask you to stay engaged in Korea to help us take yet another giant stride forward for a brighter future because the best of Korea is in fact yet to come.

Thank you.