Effects of Foreign Capital Entry into the Banking Industry on the Domestic Economy

Contents

I. Introduction

With the recent increase in foreign capital entry into the domestic banking industry, interest is growing regarding its effects on the domestic economy, such as on the profitability of banks and corporations. Foreign private equity funds (PEFs) entered the Korean market by acquiring troubled banks after the foreign exchange crisis. Recently, however, foreign global banks, such as Citibank, are entering in order to expand their operating network. In this process, bank assets under management by foreign capital rose from just 8.5 percent of total assets of domestic banks (including foreign bank branches) at the end of 1997 to 22.4 percent at the end of 2004. If the efficiency of domestic banks improves with foreign capital entry, it is anticipated that the positive effects on the domestic economy will be great. However, if foreign banks face an increase in credit screening costs, this very likely will have a negative effect on the domestic economy.

This study is organized as follows: reviewing the current arguments over the background and current status of recent foreign capital entry into the banking industries of emerging market countries, including Korea and its effects; theoretically analyzing the effects of foreign bank entry on the domestic economy by setting up general equilibrium models; examining the effects of foreign bank entry on the business performance of domestic banks after the foreign exchange crisis through empirical analysis; attempting to find policy tasks to alleviate the negative effects brought on by foreign capital entry based on the above analysis. The theoretical analysis examines how the entry of foreign banks affects deposit and loan interest rates, asset scale, and profitability of banks and corporate profitability. The empirical analysis estimates the effects of the growing entry of foreign banks on the efficiency, stability, profitability, asset quality, growth potential, and asset structure of domestic banks;

II. Current State of Foreign Capital Entry into the Banking Industries of Emerging Market Countries

1. Current State of Entry into Emerging Market Countries

As a growing number of companies from advanced countries entered emerging markets since the 1960s, financial institutions from advanced countries started to expand their global operating activities[1] by setting up branches to provide financial services to companies from their own countries. This is attributable to the increase in foreign direct investment (FDI) in the international trade and manufacturing sectors and continuing liberalization of the financial markets of each country and globalization of the capital markets.

From the second half of the 1990s, there was a big increase in the entry of foreign capital into the banking industries of emerging market countries mainly through the establishment of subsidiaries. The amount of foreign capital that has entered emerging market countries through cross-border bank M&A rose sharply from $6 billion between 1990 and 1996, to $50

[1] Global operating activities include the movement of funds between countries, the establishment of own-country financial institutions in other countries, and the acquisition of foreign financial institutions.

billion between 1997 and 2000. Accordingly, the share of M&A of financial institutions of emerging market countries made up of global international financial sector M&A rose from an average of 18 percent in 1990-1996 to an average of 30 percent in 1997-2000. The share of the banking industry[2] of emerging market countries made up by foreign capital in 1999 compared to 1994 rose from 1.6 percent to 6 percent in Southeast Asia, from 7.5 percent to 25 percent in Latin America, and from 8 percent to 52 percent in Eastern Europe. Foreign investment funds in the financial industry flowed significantly into emerging market countries, in particular the countries of Latin America and Eastern Europe, but relatively less to the Asian countries. During 1990-2003, M&A in the banking sector of emerging market countries came to 56 percent ($46 billion) in the South American region, 24 percent ($20 billion) in the Eastern European region, and 17 percent ($14 billion) in the Asian countries other than Japan. The recent share of foreign capital in the banking industry of each country comes to an average of 10 percent in the advanced countries (not including the UK and New Zealand), 44 percent in Latin America, 61 percent in Eastern Europe, and 15 percent in South and East Asia. (Refer to Table 1) On the other hand, from looking by country at the funds flowing into the emerging market countries, it can be seen that the proportions of funds were highest flowing from the US and Spain to Latin America, from the Western European countries to Eastern Europe, and from the US and UK to Asia. (BIS, 2004)

Table 1: <u>Share of Foreign Capital in the Banking Industries of Individual Country</u>

Region	Country	Rate	Region	Country	Rate	Region	Country	Rate
Latin America	Mexico	83	Eastern Europe	Czech. Rep.	90	Advanced Countries	New Zealand	99
	Panama	59		Hungary	89		US	46
	Chile	47		Poland	69		US	19
	Uruguay	43		Romania	47		Norway	19
	Venezuela	43		Russia	9		Switzerland	11
	Peru	42	Southeast Asia	Korea	30		Finland	6
	Bolivia	36		Malaysia	19		Japan	7
	Argentina	32		Philippines	15		Italy	6
	Brazil	30		Thailand	7		Canada	5
	Colombia	22		China	2		Germany	4

* Data: World Bank Regulation and Supervision Survey (2003)

[2] Based on the proportion of bank assets in banks where foreign ownership exceeded 50 percent of the total assets of the banking sector.

2. Current State in Korea

Before the 1997 foreign exchange crisis, foreign capital entered the domestic financial industry mainly in the form of branch establishment, but the entry of foreign bank branches contracted greatly after the foreign exchange crisis. With the liberalization of legal regulations carried out in 1994-1995[3], there was a large increase in the establishment of foreign bank branches during 1995-1997, but after the foreign exchange crisis, the entry of foreign bank branches fell by a large amount with the withdrawal from Korea of some foreign bank branches[4] following deterioration in the business environment. After the foreign exchange crisis, the large contraction in the business opportunity that followed from restructuring of large corporations, reduction in demand for loans, and the downward stabilization of domestic market interest rates led to the withdrawal of some foreign bank branches specializing in wholesale finance.

Table 2: <u>Trends in Equity Capital of Foreign Bank Branches</u>

(W10 billion, percent)

	‘94	‘95	‘96	‘97	‘98	‘99	‘00	‘01	‘02	‘03	‘04
Equity (Increase/reduction from previous year)	623 (5.8)	1,027 (64.8)	1,392 (35.6)	1,593 (14.4)	1,583 (-0.6)	1,515 (2.7)	1,555 (2.7)	1,519 (-2.3)	1,471 (-3.2)	1,447 (-1.6)	1,611 (11.3)

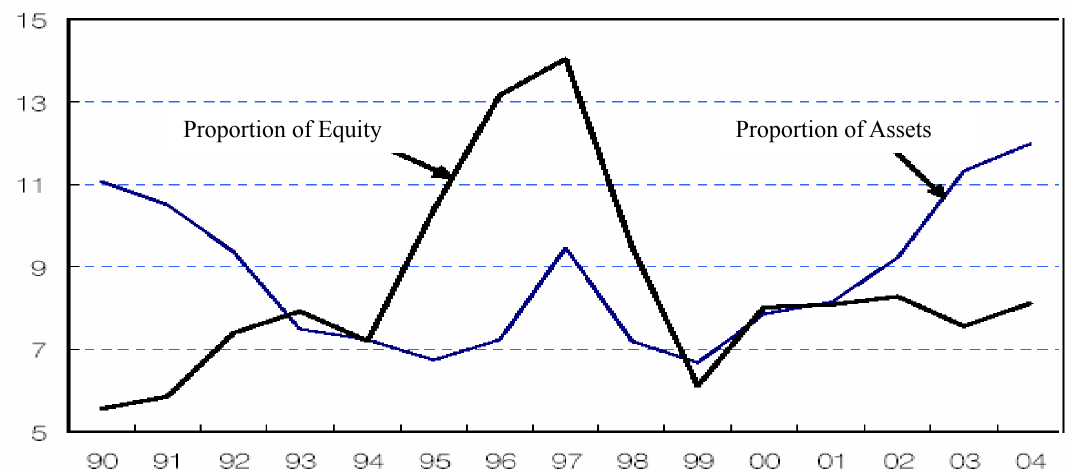
* Source: Survey Statistics Monthly, Bank of Korea

The share of the domestic banking industry taken by foreign bank branches fell greatly based on equity after the 1997 foreign exchange crisis. However, the shares have been rising based on deposit after the crisis and based on asset after 1999. This is due not only to an increase by domestic depositors in the supply of deposits placed in the branches of foreign banks that were more stable than domestic banks (flight-to-quality), but also appears to have originated with the fall in the cost of financing by foreign bank branches thanks to the low interest rates in Korea.

3 The economic needs test system, which was a screening condition applied when foreign banks established offices and branches, was abolished (April 1994), and the prerequisite condition of having to set up an office in Korea before being able to set up a branch was removed (May 1995).

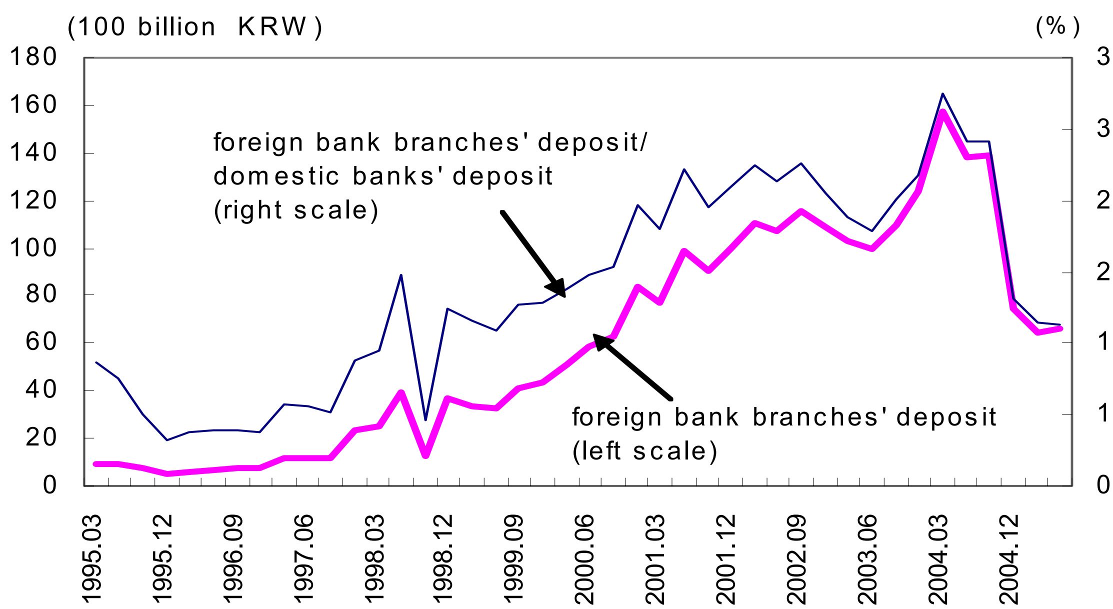
4 Dokkai, Mitsubishi Trust, Sakura, Daiwa, Bankers Trust, Nations, Canada Royal, Pariba banks, etc.

Figure 1. **Changes and Trends in the Proportion of Foreign Bank Branches to Commercial Domestic Banks**



* Data: Survey Statistics Monthly, Bank of Korea

Figure 2. **Changes in Foreign Bank Branches' Deposit**



As foreign capital rapidly expanded their entry into the Korean market through acquisition of domestic banks after the 1997 foreign exchange crisis, the share of foreign capital in the domestic banking industry increased accordingly, by a large margin. After the foreign exchange crisis and until 2003, private equity funds (PEFs), such as Newbridge Capital and Lone Star, entered through acquisition of the management control of financially-troubled banks in the process of restructuring the domestic financial industry, but recently there has been an increase in the entry of large foreign banks, such as CitiBank and SCB. Newbridge Capital acquired the management control of Korea First Bank (1999), Carlisle of Hanmi Bank (2000), and Lone Star of Korea Exchange Bank (2003). Citibank reacquired Hanmi Bank (February 2004), which had been acquired by Carlisle, and SCB reacquired Korea First Bank (January 2005), which had been acquired by Newbridge Capital. Just as seen in the examples mentioned above, direct investment[5] by foreign capital in the domestic banking industry through M&A increased rapidly, so the share of foreign banks in the domestic banking industry rose significantly. The proportion of the assets of foreign banks (Korea Exchange Bank, Korea First Bank, Citibank and foreign bank branches) in which foreign equity exercises management control to the total assets of domestic banks (including commercial and special banks and foreign bank branches) rose by a large margin from 8.5 percent at the end of 1997 to 22.4 percent at the end of 2004 (foreign bank branches: 8.7 percent). Furthermore, as direct investment by foreign capital in the domestic banking industry, as well as foreign portfolio investment, rose greatly after the foreign exchange crisis, foreigners' equity ratio soared rapidly in the domestic banking industry. In the domestic banking industry (based on commercial banks), foreigners' equity ratio (based on market prices) increased rapidly from 16.4 percent at the end of 1997 to 50.2 percent at the end of 2003 and 59.2 percent as of the end of September 2004. The percentage of ownership by foreigners in companies listed on the stock exchange (based on the number of shares, with a total average of 21.8 percent) are, in order of industry, banking industry (47.9 percent), insurance industry (35.8 percent), telecommunications industry (34.6 percent) as of the end of September 2004. Therefore, foreign investment in the banking sector is relatively high compared with other domestic industries.

Comparing the degree of foreign capital entry into the banking industry with other countries, foreign capital entry into Korea is higher than in the advanced countries and countries of East Asia and is lower than in the countries of Latin America and Eastern Europe. Looking at the share of foreign capital in the banking industry based on total assets[6], Korea is at 55.7 percent (at the end of September 2004) and the advanced countries and countries of East Asia were generally less than 20 percent (not including the UK and New Zealand), the Latin American countries were in the range of 30-80 percent and the Eastern European countries were 50-90 percent (at the end of 2003).

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[5] After the foreign exchange crisis, foreign capital entered the domestic financial sector through Greenfield Investment in the investment trust industry and life insurance industry, but not in the banking industry.

[6] Based on the proportion of assets held by banks with at least 50 percent foreign ownership of total assets in the banking sector.

Table 3: Equity Shares Held by Foreign Capital in Domestic Banks (as of the end of September 2004)

Bank	Asset ratio	Foreigners' Equity ratio	Proportion of foreigners on the board of directors	Majority Shareholders and Their Equity Ratio
Kookmin Bank	16.87	77.36	15.00	ING Bank 4.06
Woori Bank	9.90	10.93	0.00	Deposit Insurance Corporation 80.15
Hana Bank	7.48	66.59	5.71	Angelica Investments 9.89
Shinhan Bank	6.65	62.98	0.00	BNP Pariba 4.39
Korea Exchange Bank	5.99	71.88	36.84	Lone Star 50.53
Choheung Bank	5.70	62.98	0.00	BNP Pariba 4.39
Korea First Bank	3.99	48.56	65.52	Newbridge 48.56
Citibank	3.79	99.33	42.11	Citibank 99.33
Daegu Bank	1.64	56.54	0.00	Samsung Life 7.36
Busan Bank	1.56	59.05	0.00	Lotte Jegwa 14.11
Cheonbuk Bank	0.41	11.56	0.00	Samyangsa Co., Ltd 11.82
Cheju Bank	0.17	39.35	0.00	Shinhan Financial Holding Company 62.42
Kwangju Bank	0.84	10.93	0.00	Deposit Insurance Corporation 80.15
Gyeongnam Bank	1.04	10.93	0.00	Deposit Insurance Corporation 80.15
Subtotal of commercial banks	66.02	59.74		
Korea Development Bank	8.10	0.00	0.00	Government 100 percent
Ex-Im Bank of Korea	10.2	0.00	0.00	Government 52.3 percent
Industrial Bank of Korea	6.70	15.53	0.00	Government 57.7 percent
National Agricultural Cooperative Federation	11.13	–	0.00	–
National Federation of Fisheries Cooperatives	1.02	–	0.00	–
Subtotal of special banks	27.97	3.72		
Subtotal of foreign bank branches*	6.01	100.00	–	–
Total of banks	100	46.72		

Note: Banks marked with * above are banks in which foreigners hold management control.

III. The Background of Foreign Capital Entry into the Banking Industry

1. Smooth Supply of Foreign Capital into Host Countries and the Need to Make the Financial System More Advanced

In order to secure a stable supply of the long-term funds required for economic development from the 1960s, host countries, such as emerging market countries, encouraged the establishment of branches and subsidiaries[7] of foreign financial institutions. It is

[7] Comparison between branches and subsidiaries: Parent financial institutions are responsible for the losses of their subsidiaries up to the amount of their equity participation but have unlimited responsibility for the losses of branches. Also, the profits of branches belong entirely to the parent financial institution but those of subsidiaries belong to the parent institution in proportion to its share of equity participation. On this point, it is more difficult for a subsidiary than a branch to receive financing from the parent institution, but

difficult to secure large amounts of funds through loans. It is also difficult to secure a stable supply of long-term funds through cross-board borrowing from foreign financial institutions due to the asymmetry of information between foreign financial institutions and domestic financial institutions or companies. On the other hand, if the host country secures funds through government guarantees, it could bring about both positive and negative effects; it would lead to a fall in credit risk or a more financial burden to the government as non-performing loans increase due to the moral hazard among domestic borrowers. Foreign financial institutions' entry in the form of branch or subsidiary can give an opportunity to expand financing for domestic borrowers since that makes it relatively easier for foreign financial institutions to analyze the domestic financial market and borrowers, eventually alleviating information asymmetry between foreign financial institutions and domestic borrowers. Like these, lending through branches or subsidiaries makes it easy to analyze the economic conditions of the target country and to secure top-rated borrowers. Therefore, even when there is a financial crisis in a target country, loans are not greatly reduced, but there is a tendency that direct foreign loans shrink by a large amount. (Clarke, Cull, Peria, Sanchez (2003))

Since the late 1990s, emerging market countries have encouraged foreign banks to enter their markets in the form of subsidiaries, in a respond to the growing need to advance their financial systems by enhancing the efficiency of their banking industries. Generally, foreign banks can contribute to enhancing the efficiency of the host countries' banking industries, by utilizing superior financial and management techniques after establishing subsidiaries through the acquisition of banks in the host country.[8] With the occurrence of financial crises in the early 1990s in Latin America, the entry of foreign equity increased rapidly in the process of increasing the capital of troubled financial institutions at the same time that efficiency and safety in the banking system were built up. In Latin America, in particular, because the governments were not able to support capital increase for financially-troubled banks in their countries due to their huge fiscal deficits, they permitted foreign capital to enter their domestic markets. After the collapse of communism in Eastern Europe, in the process of quickly privatizing the banking industry in order to apply for EU membership, a growing number of Western European banks equipped with advanced bank management techniques entered Eastern Europe from the mid-1990s. After the Asian countries were hit by the 1997 financial crisis, they permitted the promotion of business through foreign banks in order to build up efficiency in the banking industry. In the Asian countries, based on relatively healthy government finances, the government asset management companies were put in charge of dealing with the bad loans of banks and so rather than increasing equity in financially-troubled banks, foreign bank subsidiaries were attracted mainly in order to build up efficiency in the banking industry.

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subsidiaries are more advantageous than branches in the case of retail finance in that varied financial services can be provided.

[8] If a foreign bank acquires a financially-troubled bank that has a nationwide operating network within the host country, it can contribute to building up overall efficiency in the banking industry of the host country through building up efficiency of the host country bank that was acquired. On the other hand, foreign bank branches mainly enter the host country by being newly established rather than through acquisition and so the business scale is small. Therefore, the effects of improving efficiency in the banking industry of the host country are limited.

2. Expansion of the Income Creation Base by Financial Institutions

With the fall in profitability of foreign financial institutions from the 1980s with intensifying competition among financial institutions in their home countries, there was a rapid increase in the promotion of business into emerging market countries in order to expand the profit creation base. From the 1960s through 1980s, foreign financial institutions carried out overseas expansion mainly in order to provide financial services to companies from their home country that were located overseas (following the customers). From the 1980s, competition among financial institutions within the advanced countries became more severe due to full-scale financial liberalization.[9] By the 1990s, financial institutions from the advanced countries were creating opportunities to achieve higher profitability based on superior financial techniques and new financial products at the same time that they were entering the emerging market countries in order to increase stability through diversification of their profit base (diversified investments). In particular, from the second half of the 1990s, foreign banks expanded their promotion of business through subsidiaries in order to create profit in the retail financial sector with a background of technological progress in the financial sector and liberalization in the target countries. As electronic finance and credit scoring became easier with developments in the technological level, it became possible to supply loans smoothly to small customers, too. With the fall in the costs of financing through small deposits, it became easier to achieve economies of scale in the retail finance sector. (Clarke, Cull, Peria, Sanchez (2003)) In order to overcome the disadvantage of being late movers in the target countries, most foreign banks promoted business through acquisition of existing target country banks rather than establishing new subsidiaries.

3. Examples in Korea

Before the foreign exchange crisis in Korea, most efforts were made to attract foreign capital, but after the foreign exchange crisis, foreign capital entry into the domestic banking industry was encouraged in order to improve efficiency in the banking industry through restructuring. Foreign capital entered in order to create profits by making use of their comparative advantage, such as advanced financial techniques and by improving bank value through restructuring of domestic banks. During the pre-crisis period, government policymakers had relaxed the regulations on foreign bank branches, recognizing the growing need to attract foreign capital due to the expanding current account deficit. Foreign financial institutions entered the Korean market, by setting up branches in order to make use of advanced financial techniques and achieve higher profits in retail finance, derivative financial products and foreign exchange transactions.

[9] The full-scale promotion of financial liberalization from the 1980s originated from the recognition that fund supply had not taken place efficiently in the real sector due to the growing tendency of financial institutions to avoid excessive risks, even though they had greatly built up stability in the financial sector following the rapid strengthening of regulations in the financial industry in the aftermath of the Great Depression of 1929. (Allen and Oura (2004))

On the other hand, during the post-crisis period, regulations on the acquisition of domestic banks by foreign capital were relaxed in order to increase capital for financially-troubled banks and improve efficiency in the banking industry. As for the foreign private equity funds (Newbridge Capital, Lonestar, etc.), they entered the Korean market in order to achieve profits by selling the acquired domestic banks within a short period of time after improving the value of the acquired banks through restructuring. As for the foreign global banks (Citibank and SCB, etc.),[10] the profit base of their branch operation in Korea was undermined as the competitiveness of domestic banks was strengthened increasingly in wholesale finance, derivative financial products and foreign exchange transactions. On the other hand, however, foreign global banks had competitiveness advantage in the retail finance sector such as private banking(PB)[11] and in raising funds with their high credit standings. Against this backdrop, they focused on acquiring domestic banks, rather than setting up branches as a way to expand their entry into the Korean market.[12]

IV. Current Arguments over the Effects of Foreign Capital Entry on the Domestic Banking Industry

A. Effects on the Efficiency of the Domestic Banking Industry

Generally, when foreign global banks enter the domestic banking industry, intensifying competition with domestic banks, domestic banks respond by reducing operating costs and cutting interest margins (cutting loan interest and raising deposit interest) in order to secure their market share, so it is expected that efficiency will increase in the domestic banking industry. Because foreign global banks have a comparative cost advantage, such as through relatively low financing costs and the utilization of advanced financial and management techniques, domestic banks make efforts to improve their cost efficiency by reducing operating costs in order to compete with foreign banks. As interest margins for domestic banks shrink while they are competing with foreign banks, the scale of bank deposits and loans expands and at the same time, connected lending[13] tends to fall. Thus, the efficiency of credit allocation may improve. On the other hand, the efforts of domestic banks to cut operating costs and reduce interest margins do not necessarily work to increase their profitability in the short term.

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[10] Foreign branches actually recorded losses in derivative financial product transactions in 2002 and 2003.

[11] Recently in Korea, with the increased polarization, the number of high-amount asset holders is increasing greatly. Moreover, the rapid aging of the population raises the need to provide an integrated financial planning service to ordinary people, to help them lead a more stable lifestyle.

[12] In the case of foreign capital entry in the form of branches, setting up an additional branch requires at least KRW3 billion. However, given the fact that at least KRW100 billion is needed for domestic commercial banks to set up an additional branch, it is more profitable for foreign banks to acquire domestic banks when entering the retail finance business.

[13] In general, advanced country banks utilize advanced screening techniques and apply loan interest rates that reflect credit risk and tend not to handle connected lending at low interest rates that runs counter to market principles. These practices begin to take root gradually in domestic banks in emerging market countries as well. .

If advanced global banks enter the domestic banking industry, introducing new advanced financial techniques and financial products (hedge mechanisms, off-floor derivative products, etc.), domestic banks make efforts to improve their financial service quality by developing new financial products, thereby contributing to strengthening the financial intermediary function and developing financial markets. In particular, as the quality of financial services improves through mutual competition in such businesses as customer asset management (private banking), financing and derivative/securities businesses and risk-hedging business in which foreign banks have a comparative advantage, the development of the domestic financial markets is expected to be promoted.

On the other hand, with the increase in mergers and acquisitions between banks in the process of entry by foreign banks into the domestic banking industry, the market concentration of the domestic banking industry can increase, but this does not necessarily reduce competition between banks.(Claessens, Demirgüç-Kunt and Huizinga (2001)) Usually, even if market concentration in the banking industry is high, the barriers to entry are low so that the more market entry by new competitors such as banks or non-banks is made possible (competitive market structure), the more competition between existing banks can be strengthened.

B. Effects on the Stability of the Domestic Financial System

The entry by foreign global banks into the domestic banking industry promotes the soundness and stability of the domestic banking industry by introducing advanced risk management techniques such as off-floor derivative products, by expanding the write-off of bad debts in order to reduce non-performing assets of target domestic banks, through active and conservative loan operations such as strict credit evaluation. If the domestic economic conditions deteriorate significantly, due to the occurrence of a foreign exchange/financial crisis, depositors tend to withdraw their deposits in small banks or those showing signs of insolvency and deposit their funds in large foreign banks that are judged to be healthier ("flight-to-quality").[14] In this case, foreign banks can act as a "safe haven" to prevent a bank run, thereby contributing to the stability of the domestic financial system.

[14] Right after the foreign exchange crisis of Dec. 1997 in Korea, domestic depositors withdrew their deposits from non-bank financial institutions and small insolvent banks and then deposited those funds in large domestic banks and the branches of foreign banks.

Changes in Financial Institutions' Deposits after the Financial Crisis

(100 bil KRW)

	1997.09	1997.10	1997.11	1997.12	1998.01	1998.02	1998.03
Kookmin Bank[1)]	223.1	221.3	223.6	231.3	236.3	246.2	243.9
Small insolvent banks[2)]	112.1	116.8	114.1	111.0	106.3	114.3	114.3
Non-banks [3)]	146.1	148.9	151.7	157.2	153.3	152.3	152.9
Foreign bank branches	9.4	9.9	11.2	15.1	15.7	15.5	15.7

1) The Kookmin Bank has been the largest bank in Korea since 1995.
2) Donghwa, Dongnam, Daedong, Chungcheong, Kyungki were acquired by the other banks or forced out the market by 1998.7.
3) Non-bank financial institutions include Merchant Banking Corporations, Mutual Credits, Community Credit Cooperatives, Credit Unions, Mutual Savings Banks

If a foreign exchange or financial crisis hits the domestic economy, worsening the economic recession and causing credit crunch (financial distress), unlike domestic banks, foreign banks continue to loan based on their adequate capital and capability to urgently mobilize funds from their parent banks, thereby contributing to improving the stability of the domestic financial market and reducing the pro-cyclical pattern of easing and tightening of lending.[15] In general, foreign financial institutions consider the domestic political risk level (country risk)[16] comprehensively, in accordance with changes in policy that cannot be predicted, such as capital controls or appropriation of foreign capital, when deciding whether or not to withdraw invested capital from a host country. However, recently, foreign financial institutions are very cautious of losing reputation, i.e. reputation cost incurred by withdrawal of capital. Unlike in the past, they tend to continue to leave capital in the host country, although its economic situation deteriorates severely.

Meanwhile, foreign global banks tend to supply credit only to top-ranked customers ('cherry picking') when handling retail and wholesale finance in the domestic market. When this 'cherry picking' practice becomes the norm among foreign banks, the ratio of domestic banks' loan to customers with relatively low credit ratings, such as small to medium-sized companies, increases. In this case, total loans to the SME sector may decrease as foreign banks have reduced loans to SMEs but domestic banks can not make new loans to all of those SMEs whose loan applications were rejected by foreign banks. Therefore, the possibility that the financial soundness of domestic banks would deteriorate cannot be excluded. Consequently, domestic banks which have lost high credit customers will face difficulties to increase loans to SMEs as they have to consider their asset soundness. In particular, foreign banks tend to reduce their loan supply to small and medium-sized companies, for which the process of screening and managing loans is very costly due to a lack of information about the domestic economic situation and practices. This is attributable to the tendency to reduce loan supply to SMEs (organizational diseconomies (Berge-Udell, 1996)) since they prefer standardized loan screening using financial statements in order to reduce costs. Indeed, the larger foreign global banks are, the more corporate loan screening costs rise. Furthermore, their management costs also rise due to their increasingly complex business structures as they began to provide global financial services.

Foreign banks tend to place importance on short-term profitability since their business performance is evaluated on the basis of shareholder profits. Therefore, they would have a

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[15] When the domestic economy has stagnated in this way, domestic banks usually show a pro-cyclical response, such as collecting or reducing loans. In contrast, however, foreign banks show a counter-cyclical response, continuing their loan services in the host country. In this regard, foreign banks contribute to mitigating the severity of the economic recession which is deepened by the pro-cyclical lending of domestic banks.

[16] In Argentina, for instance, the prolonged economic recession, combined with the failure of government policies, after the 1998 foreign exchange crisis caused by the sharp devaluation of the peso, dampened investor confidence, which led to a bank run. In an effort to resolve the difficulties, the Argentine government took drastic measures, freezing deposit payouts by all domestic banks, including foreign banks, and instituting capital controls. Due to the unprecedented indiscriminate measure by the Argentine government, which was imposed on all banks equally regardless of their different financial conditions, financially-sound foreign banks were unduly subjected to a huge loss and investor confidence in them was undermined. As a result, foreign banks which had acted as "safe haven" withdrew their capital from the country, recognizing that the nation's risk level rose.

lukewarm attitude if they conclude that their public service function to achieve the stability of the domestic financial market runs counter to the bank's profits. In addition, from the perspective of foreign banks, private profits achieved by fulfilling the public service function of banks in the domestic economy, partially go to society and they are less than private costs. Therefore, foreign banks have little incentive to serve the public service function. If parent banks change their operation and risk management strategies of subsidiaries in the process of entering the domestic banking industry, causing a restraint on business activities of their subsidiaries or a sever financial distress, this would bring about a huge ripple effect, which quickly spills over to the domestic economy as a whole without regard to the actual conditions of the domestic financial market, undermining the stability of the domestic financial system. In particular, the more parent banks are concentrated in a small number of advanced countries with close correlation, the higher the possibility that the domestic financial markets will be exposed to changes in the economic and financial conditions of the home countries of foreign banks.

C. Effect on Domestic Financial Supervision and Regulation

Foreign banks, in many cases, decide to de-list[17] themselves from the domestic stock exchange In the process of their entry into the domestic market. To market participants, this means less information on foreign banks, which is needed to monitor and evaluate their business performance and risk levels. Under these circumstances, market discipline can be weakened, which causes great difficulties in supervising and regulating banks. Once foreign banks de-list themselves from the domestic stock exchange, they do not have any obligation of constant public disclosure of their business performance. As a result, stock analysts have difficulties in conducting business analysis of those banks for lack of information on the banks concerned and thus, their business performance and business strategies can not be reflected in their stock prices. Therefore, market discipline in the stock market can be weakened because it becomes much more difficult to monitor and evaluate the business performance and signs of insolvency of the banks concerned.

Meanwhile, foreign banks usually introduce more elaborate and innovative financial products and techniques when entering the domestic banking industry. In response, supervisory authorities that have an obligation to supervise foreign financial institutions doing business in the domestic market would have incentive to produce and specialize in relevant knowledge. Furthermore, supervisory authorities tend to strengthen their supervision of whether foreign banks set up and operate internal risk management systems appropriately.

[17] For instance, Citibank went through a two-step process in May and July 2004 to acquire 99.5 percent of Hanmi Bank's shares through public subscription and then decided to do a final acquisition in November 2004. When it was launched as Citibank Korea, Inc., it de-listed its stocks from the domestic stock exchange. Korea First Bank followed suit, deciding to de-list in April, this year. According to the current Securities Exchange Act of Korea, if the majority stockholder of a listed company owns 80 percent or more of the total share of the company concerned, the company may be de-listed from the stock exchange.

<Table 4>

Current Arguments over the Effect of Foreign Bank Entry on Efficiency, Stability and Financial Supervision in the Domestic Banking Industry (Summary)

Main Points of Arguments	Efficiency of the Domestic Banking Industry	
	Positive Effects	**Negative Effects**
1. Efforts by domestic banks to reduce costs amid intensifying competition	X	
2. Improving the efficiency of credit allocation as connected lending decreases	X	
3. Introducing and spreading new advanced financial techniques and financial products(spillover)	X	
4. An increase in market concentration		Δ
	Stability of the Domestic Financial System	
	Positive Effects	**Negative Effects**
5. Role of safe haven that prevents a bank run	X	
6. Tendency to place importance on reputation costs associated with the withdrawal of invested capital in host countries (“cut and run”) in case of a financial crisis	X	
7. Role of alleviating the pro-cyclicality of domestic credit	X	
8. Tendency to place importance on top-ranked customers (“cherry picking”)		X
9. Lack of interest in the public service function of banks		X
10. Limitations on the operating activities of foreign banks doing business in the domestic market due to changes in strategies by their parent banks		X
	Domestic Financial Supervision and Regulations	
	Positive Effects	**Negative Effects**
11. undermining market discipline due to foreign banks’ de-listing from the domestic stock exchange		X

Note: 1) The Δ symbol indicates the cases that do not necessarily bring about negative effects, such as weakening competition.

V. Empirical Analysis of the Effects of Foreign Bank Entry on the Business Activities of Domestic Banks

In this section, empirical analysis is carried out to examine how the management indices of domestic banks have changed in terms of stability, efficiency, profitability, asset soundness and asset structure following the intensified competition between banks caused by the expanded domestic entry of foreign banks after the foreign exchange crisis.

1. Changes in the Management Indices of Domestic Banks Following the Rapid Increase in Foreign Bank Entry

Comparing changes in the major management indices of foreign banks[18] and domestic banks after the rapid increase in foreign bank entry from the end of 2000,[19] the cost efficiency and profitability of domestic banks improved greatly compared with foreign banks, but stability and asset soundness improved slightly.[20] The total costs/total assets and operating costs/total assets ratios of domestic banks fell by a lot more than those of foreign banks did in 2000-2004, and ROA of domestic banks increased by more than that of foreign banks. Reflecting this, the cost efficiency and profitability of domestic banks are shown to have increased by a lot more than foreign banks.

On the other hand, the fall in the total costs/total assets ratio was much more than the rise in ROA, net profit/total assets, of domestic banks during the same period. In the light of this fact, the reduction in costs through a fall in financing costs[21] appears to have contributed greatly to the improved profitability of domestic banks. Compared with foreign banks in 2000-2004, the delinquent credit/total credit and non-performing credit/total credit ratios of domestic banks fell by a small amount compared to those for foreign banks. And the margin of increase in the domestic banks' BIS capital ratios was small as compared with foreign banks' ratios. Reflecting this fact, the improvement in stability and asset soundness of domestic banks appears to have been lacking compared with foreign banks. Meanwhile, the fact that foreign banks had higher safe securities[22]/total securities and household loans/total loans ratios and a lower small to medium-sized company loans/total loans ratio than domestic banks shows that foreign banks tended to prefer safe assets.

[18] Foreign banks include Korea First Bank, Korea Exchange Bank, and KorAm Bank, where foreigners have actual management control.

[19] Comparison from after the end of 2000 was done in consideration of the exercising by Korea First Bank of KRW 3.3 trillion (12.3 percent of total assets) of large-scale put-back options in 2000 that greatly improved profitability.

[20] Even when comparing the major management indices as of the end of 2004, the cost efficiency and profitability of domestic banks was higher than for foreign banks, but the BIS capital ratio and asset soundness were lower.

[21] During this period, the deposit bank weighted average receiving interest rate (based on newly handled amounts) fell by a large amount as follows: 7.01 percent (2000) → 5.43 percent (2001) → 4.73 percent (2002) → 4.15 percent (2003) → 3.75 percent (2004).

[22] Safe securities are government debt and unification bonds.

Table 4: Comparison of the Major Management Indices of Foreign and Domestic Banks

			2000(A)	2001	2002	2003	2004(B)	B-A
Relative Proportion of Foreign Banks[1)]			10.1	9.47	10.89	20.57	21.45	5.93
Cost Efficiency	Total costs / Total assets	Domestic	12.59	8.67	7.84	7.72	8.33	-4.26
		Foreign	10.68	10.40	8.29	7.98	9.84	-0.84
	Operating costs / Total assets	Domestic	11.33	7.93	7.36	7.30	8.06	-3.27
		Foreign	10.33	10.01	7.85	7.54	9.43	-0.90
Profitability	ROA	Domestic	-0.95	0.44	0.60	0.42	0.88	1.83
		Foreign	-0.37	0.66	0.41	-0.09	0.54	0.91
Stability	BIS capital ratio	Domestic	10.61	10.67	10.91	10.75	11.21	0.60
		Foreign	10.42	11.80	11.07	10.88	11.54	1.12
Asset Soundness	Delinquent credit / Total credit	Domestic	8.94	3.08	2.27	2.40	1.93	-7.02
		Foreign	8.96	5.36	2.10	1.93	1.57	-7.39
	Nonperforming credit / Total credit	Domestic	6.49	2.44	1.81	1.94	1.73	-4.76
		Foreign	7.56	4.68	1.93	1.49	1.23	-6.33
Asset Structure	Corporate loans / Total loans	Domestic	67.92	59.90	56.05	56.55	55.94	-11.98
		Foreign	59.67	52.63	47.05	45.96	41.62	-18.05
	SME loans / Total loans	Domestic	55.05	52.41	50.54	52.92	51.15	-3.90
		Foreign	40.18	32.19	36.90	37.42	34.55	-5.63
	Household loans / Total loans	Domestic	27.21	36.71	41.43	40.86	39.38	12.17
		Foreign	32.81	44.26	50.73	52.22	56.57	23.76
	Safe securities / Total securities	Domestic	45.32	49.46	47.11	47.41	–	2.09[1)]
		Foreign	56.83	55.31	57.88	60.87	–	4.04[1)]

Note: 1) Deducts the ratio as of the end of 2000 from the ratio as of the end of 2003.
Source: "Bank Supervisory DB" Financial Supervisory Service

2. Responses of Domestic Banks to the Expanded Entry of Foreign Banks

With the expanded domestic entry of foreign banks, competition between banks to attract large deposits from a deposit standpoint and competition to expand loans to top-grade borrowers from a credit standpoint look to be intensifying. According to the sensitive reactions to bank stability in connection with large non-guaranteed deposits, the increasing entry of foreign banks that are more stable than domestic banks has caused intensified competition between banks to attract these large deposits. From a credit standpoint, domestic banks appear to compete intensely with foreign banks in loans to households and firms with high credit ratings and in foreign currency loans where foreign banks enjoy a relatively high comparative advantage through the utilization of advanced loan screening techniques and the ability of financing with low costs. As it is difficult for foreign banks to expand loans to small and medium-sized companies and to non-rich people due to a lack of information, it is anticipated that competition in these areas will not be severe. In particular, as large domestic banks tend to have high proportions of large deposits in their total deposits and high proportions of credits to borrowers with high credit ratings to their total credit[23], they can be exposed to more intensified competition with foreign banks. On the other hand, small to medium-sized domestic banks with high proportions of small credit loans and loans to small to medium-sized companies do not appear to be much exposed to competition with foreign banks.

With increased entry of foreign banks, the larger the domestic bank, the more it appears to compete with the foreign banks and build up higher efficiency and stability. Large domestic banks, which have a high proportion of large deposits that are sensitive to bank stability, try to strengthen risk management and build up stability in order to attract large deposits. Also, large domestic banks, which have a high proportion of credit to borrowers with high credit ratings originally, shall see an increase in transactions with borrowers having low credit ratings while losing customers with high credit ratings due to the entry of foreign banks that prefer credit to customers with high credit ratings. This result raises the necessity for large domestic banks to strengthen stability. Also, large domestic banks respond to the intensified competition by building up cost efficiency through various reductions in costs, such as interest costs and personnel costs, and try to increase profit efficiency by expanding their profit base. On the other hand, if domestic banks expand their investments to build up profitability in a long time period in responds to the entry of foreign banks, they may see deteriorations of cost efficiency in a short-term. (Lensink and Hermes (2004))[24]

[23] Normally, large banks prefer standardized loan screening techniques that utilize financial statements due to their high agency costs, so the proportion of top-rated borrowers from large banks is relatively high and the proportion of small to medium-sized company loans is low. (Strahan and Weston (1996))

[24] In countries with a low level of economic development, not only is the quality of personal capital in the financial sector lower than in advanced countries but financial techniques and systems are outdated, so a lot of investment expenses are spent to build up bank profitability by hiring expert personnel and improve computer systems in order to respond to the entry of foreign banks.

3. Setting of Estimation Equations

In order to evaluate empirically the effects on domestic banks in terms of their stability, efficiency, profitability, asset soundness, growth and asset structure following the intensified competition between banks caused by the entry of foreign banks, estimation is carried out using panel data of commercial banks between 1999 and 2004.[25] As indices to represent changes in the stability, cost efficiency, profit margin efficiency, asset soundness, growth and asset structure of banks, the following were used, respectively: BIS capital ratio, total costs/total assets ratio, ROA, non-performing credit/total credit ratio, current period assets/previous period assets ratio, loans to small and medium-sized companies/company loans ratio and large company loans/total loans ratio. Considering that the degree of exposure to competition increases the bigger a domestic bank is if the entry of foreign banks increases, the cross product term of domestic bank size times foreign bank asset proportion[26] is used as an explanatory variable.[27] In order to control the fact that the degree of risk management by domestic banks differs depending on other factors, the number of outside directors, size of bank assets and non-interest net income ratio ((non-interest income - interest income)/total assets) are used as explanatory variables. Furthermore, in order to alleviate the endogeneity problem occurring when dependent variables have an effect on the explanatory variables, the bank specific explanatory variables are taken with one-year lag with the dependent variables. To control macroeconomic shocks, the rates of changes in GDP and CPI, and Government Bond yield rate are included in the explanatory variables. The estimation equation that reflects these points is set as follows and the empirical analysis was performed using the random effect model.

$$\begin{aligned} Y_{i,t} = {} & \alpha + (\beta_0 + \beta_1 DS_{i,t-1}) FB_{t-1} + \Sigma_{j=1}^{n} \beta_2^j \, DB_{i,t-1}^j \\ & + \gamma_1 GDPR_t + \gamma_2 CPIR_t + \gamma_3 INTR_t + \varepsilon_{i,t} \end{aligned}$$

$Y_{i,t}$: Dependent variable representing the management indices of domestic banks;
$DS_{i,t}$: Variable representing the size of domestic banks (deposits in domestic banks);
$FB_{i,t}$: Variable representing the degree of foreign bank entry (proportion of foreign bank assets to total bank assets);
$DB^j_{,i,t}$: jth variable representing the domestic bank characteristics.
$GDPR_t$: GDP growth rate, $CPIR_t$: rate of change in CPI, $INTR_t$: 1-year Government Bond yield rate

[25] The estimation period was set to be from 1999, when the proportion of foreign banks increased rapidly, and the reason special banks were not included is because the management practices in special banks are different than commercial banks.

[26] The foreign bank assets/total bank assets ratio was used to reflect the degree of entry by foreign banks and foreign banks included Korea First Bank in 1999, Korea First Bank and Hanmi Bank in 2000-2002, and Korea First Bank, Hanmi Bank and Korea Exchange Bank from 2003.

[27] For a case of using the product of cross product terms as an explanatory variable in panel analysis, refer to Cetorelli and Gambera (2001).

4. Results of Empirical Analysis

The estimation results show that the expanded entry of foreign banks increased the proportion of loans by large domestic banks to small to medium-sized companies and had a positive effect on stability, but did not have a great effect on cost efficiency and asset soundness. (Refer to <Table 5>) When the rations of small to medium-sized company loans to total company loans and those of large company loans to total loans of domestic banks are used as dependent variables, the estimators of β_1 have a significant positive value and negative value, respectively. This reflects that after the entry of foreign banks large domestic banks saw a reduction in loans to sectors with high credit ratings and an expansion of loans to the small and medium-sized company sector having relatively low credit ratings. One can find that small banks have not affected greatly by foreign bank entry as the estimators of β_0 do not have significant values. The fact that loans by large domestic banks in sectors with low credit ratings expanded appears to be caused the fact that foreign banks prefer safe assets and their costs of making loans to small to medium-sized companies increased.

When using total expenses/total assets and operating expenses/total assets ratios of domestic banks as dependent variables, reflecting the fact that the coefficients of DS*FB have significant positive values, foreign bank entry did not contributed to improvement of cost efficiency of large domestic banks.[28] This result can be originated from the fact that as large domestic banks were expanding investments to improve profitability in response to increasing competition.

In the estimation using the BIS capital ratio of domestic banks as dependent variables, the DS*FB coefficients showed a significant positive value, and this result implies that entry of foreign banks contributed to the building up of stability by large domestic banks. This originated from the fact that as foreign banks which have high stability enter into the market large domestic banks have to increase their stability in order not to loose their customers who are keen on safety of deposits. These results also imply that competition between banks has been intensified since foreign bank entry. Claessens and Laeven (2004) found that foreign bank entry intensifies the competition among banks in emerging economies.

When using the nonperforming credit/total credit and delinquent credit/total credit ratios of domestic banks as dependent variables, the DS*FB coefficients were not significant, which shows that the entry of foreign banks did not improve the asset soundness of domestic banks. This appears to be the origin of the result that while large domestic banks expanded their trading with customers having relatively low credit ratings due to the entry of foreign banks that tend to prefer top-rated borrowers, on the other hand, the credit management of domestic banks was also strengthened.

Reflecting the fact that the DS*FB coefficients were not significant when using the current period assets/previous period assets ratio of domestic banks as dependent variables, this shows that the entry of foreign banks did not function as a factor in reducing the growth of

[28] That the cost efficiency of domestic banks improved in <Table 4> is seen to have originated, not from the effects of the entry of foreign banks but rather, from efforts to reduce bank costs due to a fall in financing costs, privatization of banks and strengthened market principles in the banking industry caused by the trend toward stability at a lower level of market interest rates.

large domestic banks. This appears to originate from the response of large domestic banks to the entry of foreign banks to make extra efforts not to loose market share.

The result that the estimators of FB do not have significant values implies that small domestic banks are not affected by foreign bank entry greatly.

Table 5: Estimation Results (1999-2004)

Dependent variables	Independent variables	FB β_0	DS · FB β_1	ASSET β_2^1	NINT β_2^2	No. of OD β_2^3	GDPR γ_1	CPIR γ_2	INTR γ_3	$\bar{R}^2$
Stability	BIS capital ratio	-0.016	1.63	-2.90	-10.58	3.78	0.01	0.15	- 0.072	0.62
		(0.034)	(0.48)***	(1.00)***	(4.94)**	(1.65)**	(0.15)	(0.24)	(0.15)	
Profitability	ROA	0.07	1.08	-4.74	-4.06	-1.72	0.36	1.02	-0.06	0.39
		(0.11)	(0.91)	(2.10)**	(8.97)	(3.06)	(0.52)	(0.84)	(0.54)	
Cost efficiency	Total expenses / Total assets	-0.26	4.09	-1.72	2.42	-2.69	-1.37	-3.27	0.69	0.58
		(0.37)	(1.76)**	(2.61)	(18.98)	(6.13)	(1.73)	(2.79)	(1.81)	
	Operating expenses / Total assets	-0.20	3.40	-1.80	1.97	-0.82	-1.19	-2.84	0.49	0.61
		(0.29)	(1.35)**	(1.63)	(14.72)	(4.67)	(1.36)	(2.20)	(1.43)	
Asset soundness	Nonperforming credit / Total credit	-0.00	0.00	0.01	-0.17	-0.07	-0.01	-0.03	0.00	0.69
		(0.00)	(0.01)	(0.02)	(0.14)	(0.04)	(0.01)	(0.02)	(0.01)	
	Delinquent credit / Total credit	-0.00	0.00	0.03	-0.14	-0.06	-0.01	-0.04	0.00	0.79
		(0.00)	(0.01)	(0.02)	(0.14)	(0.04)	(0.02)	(0.03)	(0.02)	
Growth	Current period assets / Previous period assets	-0.00	0.01	-0.41	-0.56	-0.10	0.00	0.02	0.00	0.24
		(0.00)	(0.07)	(0.18)**	(0.76)	(0.26)	(0.01)	(0.02)	(0.01)	
Asset structure	SME loans / Company loans	0.00	0.12	-0.18	0.54	-0.01	0.03	0.06	-0.03	0.90
		(0.00)	(0.02)***	(0.05)***	(0.30)*	(0.10)	(0.03)	(0.04)	(0.03)	
	Large company loans / Total loans	-0.00	-0.05	0.09	-0.63	0.00	-0.02	-0.04	0.02	0.87
		(0.00)	(0.01)***	(0.03)***	(0.20)***	(0.06)	(0.02)	(0.03)	(0.02)	

Notes: The values inside parenthesis represent standard deviation and the above marks *, ** and *** represent statistical significance at significance levels of 10 percent, 5 percent, and 1 percent, respectively.

VI. Conclusion and Policy Tasks

Considering that the recent entry of foreign capital is disproportionately concentrated in the domestic banking industry and that the domestic entry by foreign private equity funds doesn't contribute to improving the cost efficiency of domestic banks, in future bank privatization, domestic financial capital should be encouraged to participate actively at the same time that it would be desirable, when selling to foreign capital, to strengthen the suitability screening of large shareholders while attracting sound banks rather than foreign private equity funds. In order to raise domestic financial capital that can acquire banks owned by the government, it is necessary to relax regulations that restrict private equity funds (PEF) from becoming large.[29] On the other hand, if sound foreign banks enter and pursue stable management with high cost efficiency and long-term time horizons, it appears that domestic banks will also increase efficiency in order to strengthen their competitiveness.

Furthermore, reflecting the fact that foreign banks entering the domestic market recently normally prefer top-rated customers due to the high screening costs related to loans to small to medium-sized companies and the resulting reduction of loans to small to medium-sized companies, it is necessary to provide encouragement so that loans are not reduced to small to medium-sized companies with high growth potential through introduction of a credit guarantee system between small to medium-sized companies, a system of general management support for small to medium-sized companies, increased utilization of information held by public agencies, strengthening the function of credit rating institutions and activating corporate bond market for small to medium-sized companies. If a system of credit guarantees between small to medium-sized companies is introduced, small to medium-sized companies in the same business or having a trading relationship with each other can participate through mutual guarantees, which raises the possibility that the participating group will be composed of top-rated small to medium-sized companies and bank loans to these groups can be expanded. Companies having trading relationships with certain small to medium-sized companies or companies belonging to the same business sector have information to be used to evaluate the future profitability and growth of the respective small to medium-sized companies more precisely, so if small to medium-sized companies having trading relationships or belonging to the same business sector participate in the mutual guarantees, the possibility is high that top-rated small to medium-sized company groups will be formed. Authorities may consider an incentive skim for banks to introduce and operate general management support programs such as consulting on investment, marketing, financial situation analysis and forecasting work, for small to medium-sized companies with high growth potential. Authorities can also consider a plan for banks to actively utilize the overall financial situation information of lenders (asset holding situation such as real estate, income and tax payment results, etc.) that are built into the administrative computerized network of the administrative department in order to reduce screening costs of banks for

[29] A minimum investment limit for individuals and companies (W2 billion and W5 billion, respectively) in a fund, a maximum number of investors in each fund (less than 30 people), etc.

small to medium-sized companies and self-employed companies.[30] If the current small to medium-sized company credit rating work of the Credit Guarantee Fund and Technology Credit Guarantee Fund were managed overall and focused on Korea Enterprise Data[31], which is a credit information company specializing in small to medium-sized companies that was launched in March 2005, the correctness of the credit rating information could be improved further, so it is expected that loans to top-rated small to medium-sized companies would be expanded more. If the function of credit rating institutions is strengthened, small and medium-sized companies will be able to issue corporate bonds with cheaper prices.

Considering that there is a trend to strengthen stability through the active disposal of weak assets in general following the foreign bank entry, if domestic banks show relatively weak efforts to improve stability and their competitiveness to take in deposits weakens, this is expected to have negative effects, such as loss of profitability and rises in loan interest rates, so it is necessary to encourage overseas expansion through branches and subsidiaries and diversify the revenue base while expanding businesses of customer asset management (private banking). At the beginning, financial services were expanded in order to be able to support the business activities of the Korean citizens located in the host countries, but with the formation of a global network and activation of risk management and advanced screening techniques, if a certain degree of competitiveness is achieved, banks look for strategies to gradually expand their operating base to customers in the respective location centered around private banking and wholesale and retail finance.[32]

As shown in the recent acquisition of Hanmi Bank by Citibank, with the domestic entry of foreign banks, there is a high possibility that this will reduce stability of the domestic financial system due to difficulties in finding out early the signs of insolvency due to weakening of market discipline in the respective bank if the bank is de-listed. At the time of strengthening the obligation for public reporting by a de-listed foreign bank, it is also necessary to provide plans for stricter monitoring by investors through the issuance of subordinated debt. In order to strengthen market discipline regarding a de-listed bank, it is necessary to provide encouragement to the bank to issue subordinated debt in the domestic market at the same time that the continuous public reporting of major management matters is made obligatory even after de-listing of the respective bank. The supervisory authorities can make the reporting of materials related to major management matters obligatory through the current Banking Business Supervisory Regulations (Article 38) for de-listed foreign banks.[33] If foreign de-listed banks (subsidiaries) issue subordinated debt[34] domestically, the

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[30] Some information related to debtors is currently provided only to the Asset Management Corporation using the administrative computer network, but it is predicted that loan screening costs could be greatly reduced if banks could also utilize this under the agreement of the debtor.

[31] Centered on the Credit Guarantee Fund, this was set up with equity investments by 11 agencies, including the Technology Credit Guarantee Fund, Small to Medium-Sized Enterprise Promotion Corporation, Bank Alliance, Enterprise Bank, Industrial Bank, Kookmin Bank, Shinhan Bank, Woori Bank, Hana Bank, and Foreign Exchange Bank.

[32] In this case, from a global business cycle perspective, the more a bank expands to countries with a low correlation of business activity with Korea, the more advantageous this is for the expanding bank in alleviating revenue fluctuations.

[33] If a foreign bank de-lists from the domestic securities market, there is no obligation to report or publicly announce major management matters in the Securities Trading Laws (Article 2 – Public Reporting Obligations), but according to the Banking Industry Supervisory Regulations there is an obligation to

monitoring function of domestic investors in the respective bank is strengthened, and pre-emptive supervision[35] by the supervisory authorities becomes possible.

continuously report business reports, such as financial statements.

[34] The supervisory function of investors for evaluating bank risk is increased in banks that have issued subordinated debt with low repayment priority in bankruptcy, so it is possible for market discipline, such as efforts for voluntary risk management, to be strengthened. For example, subordinated debt investors react sensitively to an increase in risk of the bank and demand a high premium or reduce the amount of subordinated debt purchased based on this, so they are motivated to try to achieve voluntary risk management, such as self-control of activities to pursue too much risk.

[35] Considering that the outlook of investors for growth, profitability, and safety in the respective bank is ordinarily reflected in the price of subordinated debt for banks issuing subordinated debt, the supervisory authorities are able to preemptively supervise based on the subordinated debt price.

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