Domestic Financial Liberalization, Stabilizing Effects of Foreign Bank Entry, and Challenges to Bank Supervision:

The Korean Experience

Hyun E. Kim

The Bank of Korea

I. Objective

- Have foreign-owned banks played a role that some had originally hoped it would play?
- Has increased foreign participation had any stabilizing effects on the Korean banking sector?
- How does the bank regulatory and supervisory framework in the Korean banking sector need to be changed in response to the sizable foreign bank entry ?

II. Financial Sector FDI in Korea

2.1. Recent Trends in Financial Sector FDI

- Two categories of FS FDI in Korea

i) Foreign entry to the financial sector through green-field investments and M&As

ii) Foreign bank entry through opening of branches

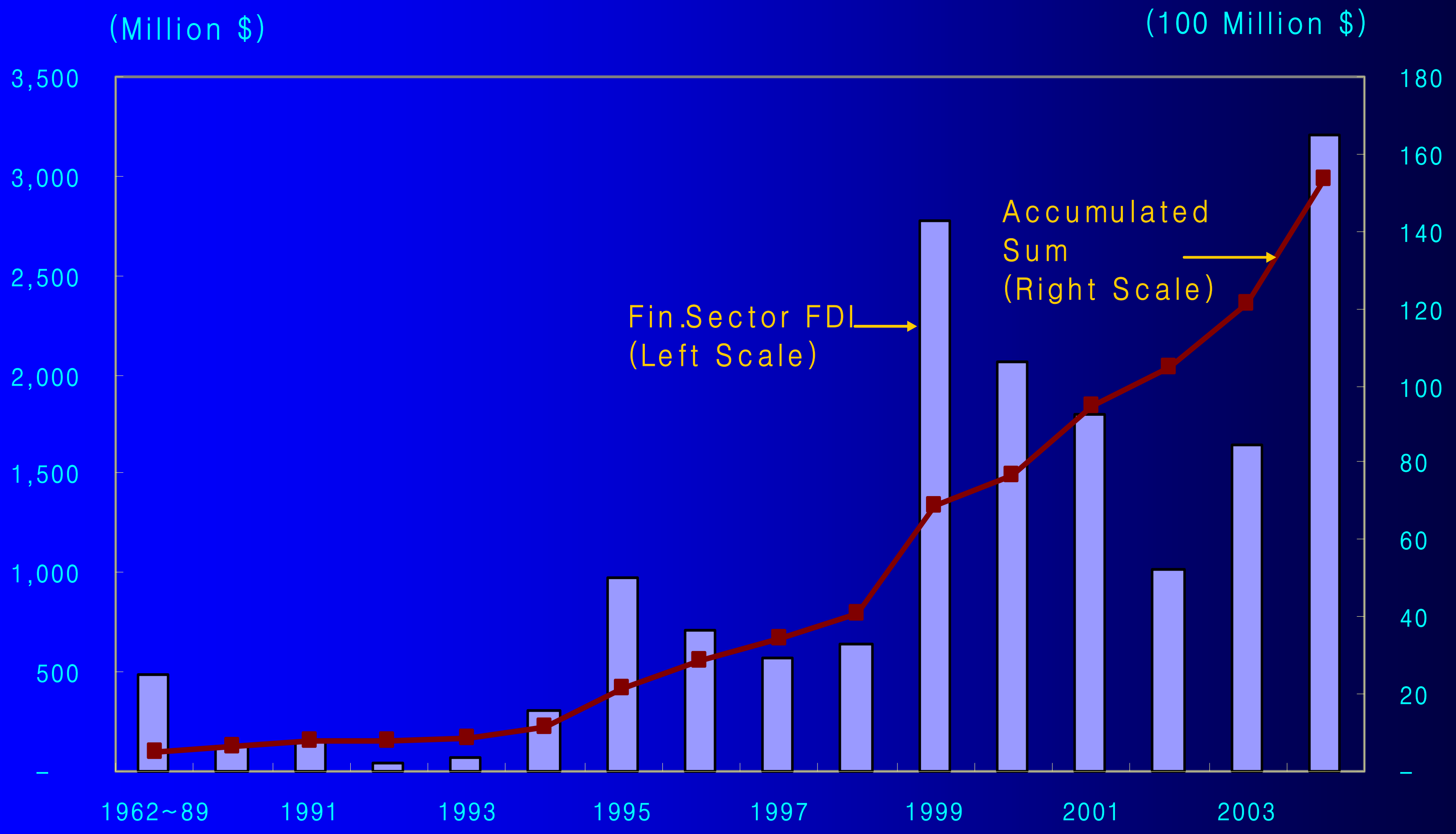
— The most important organizational form of foreign entry until 1997 (Relatively strong over 1995~1997)

* Foreign bank subsidiaries : only rarely established so far (Citibank's takeover of KorAm Bank, in Nov.2004)

- A sharp increase in foreigners' capital participation through green-field and M&As between 1999 and 2001
  - Rapid progress in domestic financial liberalization
  - The need to facilitate financial sector restructuring (privatization) undertaken following the crisis by soliciting foreign investors

- Financial sector FDI:
  - USD 0.7 billion (1994~98) → Soared to USD 2.80 billion in 1999 → USD 2.2 billion in 2000… begin to drop after 2001 → Resumed to USD 3.21 billion in 2004 (large-scale deals such as Citibank's acquisition of KorAm Bank)

Financial Sector FDI



2.2. Foreign Ownership of Domestic Banks

- High degree of foreign ownership
  - Of seven major domestic banks, six are foreign owned
  - A remarkable increase in foreigner's holdings in the total equity capital of all listed **domestic banks** : **16.4** % at the end of 1997 → **61.7**% by Sept. 2004
    - Foreigner's holdings in the total equity capital of all listed domestic **securities companies**: **5.2** % at the end of 1997 → **23.2** % by Sept 2004

III. Stabilizing Effects of Foreign Bank Entry on Domestic Banks

3.1. The Performance of Two Foreign-Owned Banks and Domestic Banks

* Two major banks (Kookmin Bank, Korea First Bank) are selected as foreign-owned banks

- These two foreign-owned banks :
  Not differed systematically in performance since 2001, and have been inferior to the domestic banks in the area of profitability

– **Retail-banking expansion:** More aggressive than other domestic banks since 2001

Consumer Lending-to-Total Lending Ratio(%)

	2001	2002	2003
KB	63.4	63.7	65.5
KFB	62.7	65.2	67.9
DB	51.3	54.8	55.0

– **Profits:** Showing lower ROA & ROE than domestic banks in 2002 & 2003

* The profits of both KB & KFB dropped slightly in 2003 due to their high loan loss provisioning

ROA and ROE (%)

	2001	2002	2003
KB	0.8	0.8	-0.34
	(12.6)	(13.0)	(-0.82)
KFB	0.9	0.4	-0.04
	(15.2)	(6.3)	(-6.28)
DB	0.8	0.6	0.1
	(16.3)	(11.0)	(1.99)

(ROE in parenthesis, DB: Domestic Banks)

– **Role in improving the quality and availability of financial services in the domestic financial market:**

Concentrating on retail-oriented lending, rather than providing enhanced financial service and pursuing portfolio diversification

➔ **Very likely that the two foreign-owned banks have not played satisfactorily the role that some had originally hoped they would play**

3.2 Stabilizing Effects of Foreign Bank Entry through Opening of Branches

* Thirty-seven foreign banks originating from fifteen countries are currently operating **forty-nine branches**

- **A “Safe haven” for domestic depositors:**

  — In 1998 following the crisis, deposits shifted away from investment finance companies and small banks to large banks (“flight-to-quality”), especially foreign banks perceived to be sounder than local banks

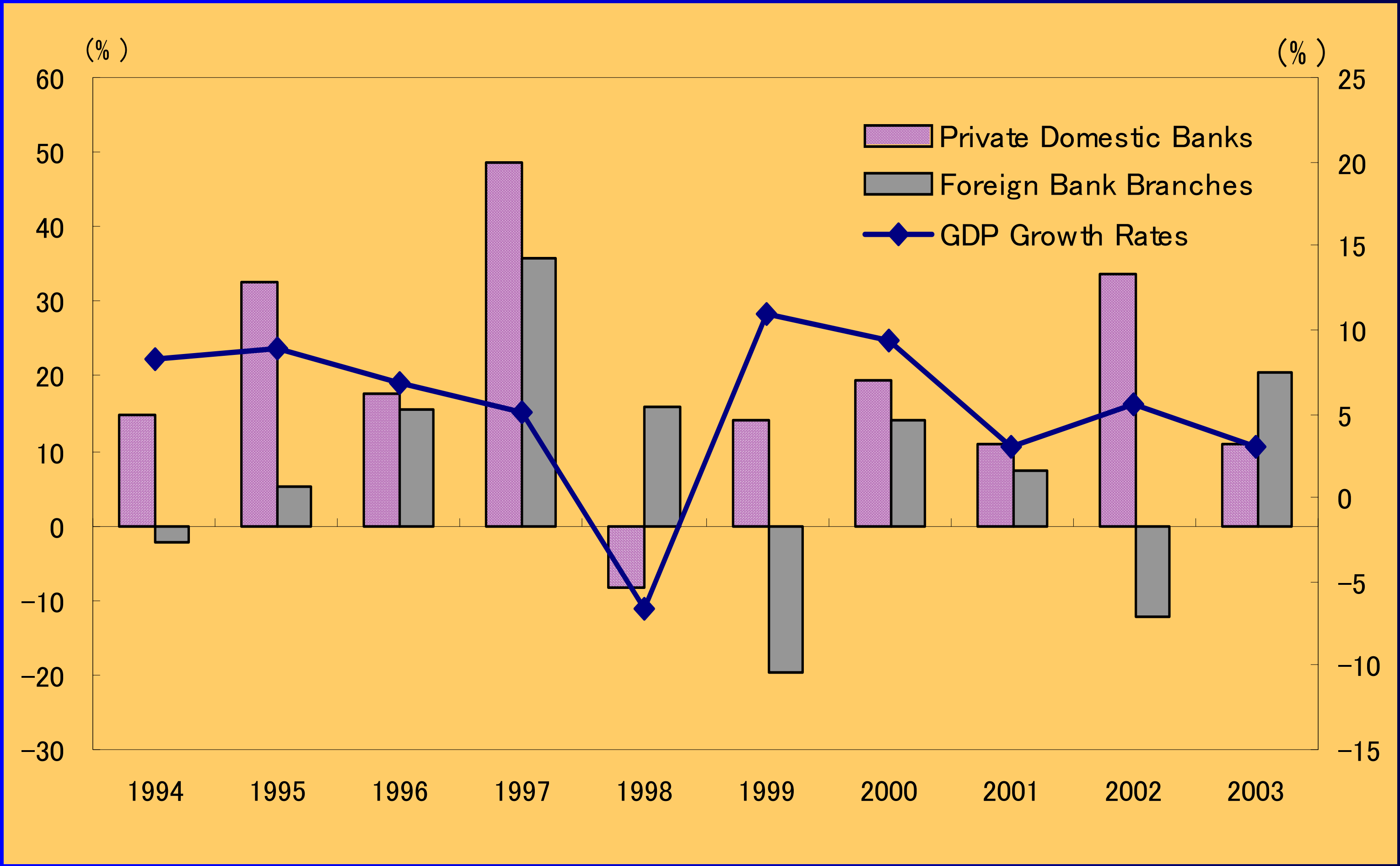
Counter-cyclical lending pattern

– Foreign bank branches did not "cut and run" when faced with the severe economic slowdown in 1998 following the crisis, while domestic banks cut off credit lines

– Foreign bank branches' lending over the post-crisis period tended to be counter-cyclical, with that of domestic banks being more or less pro-cyclical

⇒ But not wholly clear as to whether foreign bank branches had a role in mitigating the pro-cyclical pattern of lending by domestic banks (branches' overall lending were small)

Comparison of Real GDP Growth Rates and Loan Growth Rates of Foreign Bank Branches and Domestic Banks



Source: Banking Statistics, Financial Supervisory Service (FSS).

- **"Cherry picking" strategy**
  - Most foreign bank branches sought to "cherry pick" creditworthy customers ⇒ domestic banks has been led to deal with less creditworthy customers such as SMEs and to thus increase the overall riskiness of their portfolios
  - HSBC has been targeting the creditworthy domestic customers
    ⇒ had a low overdue mortgage loan ratio (0.28% at year-end 2002, vs. 2.0% at Kookmin Bank) mainly because it was able to preempt creditworthy customers at lowest lending rate

$\Rightarrow$ Overall, a greater foreign bank presence contributed to some extent to a more stable domestic banking system

3.3. The Effect of Foreign Bank Entry on Risk Management at Domestic Banks

- Aims to determine whether foreign bank entry during the most recent years had any significant effects on risk management at domestic banks

Empirical Specification:

A regression equation using bank panel data

$$RMP_{i,t} = a + \gamma DS_{i,t-1} FB_{i,t-1} + \delta CV_{i,t-1} + \xi_{i,t}$$

where t covers from 1999 to 2003 (4 years),

- RMP is a measure to proxy for the overall risk management performance of a local bank i in a given year t,
- **DS ·FB** implies that larger banks are more likely to tighten their risk management in response to increased foreign bank entry to the domestic market
- CV denotes a vector of the control variables that might affect the local banks' risk management performance (bank characteristics)

- Empirical Results
  - Foreign bank penetration to the domestic banking sector during the most recent years did contribute to enhancing overall risk management, notably credit risk management, on the part of domestic banks

  - There is no evidence that foreign bank presence has significantly affected market and liquidity risk management by domestic banks

  ⇒ Domestic banks have been led to focus on credit risk management in attempts to meet their BIS capital adequacy ratio requirements, and have paid less attention to market and liquidity risk management,

IV. Challenges to Domestic Bank Regulation and Supervision

4.1. Major prudential supervision to promote the soundness of financial institution following the crisis

- Korean Supervisory Authority (FSS) turned away from its past focus on business operation and price regulation to prudential regulation to manage financial institutions' risk exposures

– Strengthen the BIS capital ratio requirement
⇒ 8 per cent rule adopted in 1998, and the method for calculating the ratio was changed to meet international standards in January 1999

– Introduce a prompt corrective action (April 1998), and forward-looking criteria for evaluating the levels of credit risks(December 1999)

4.2. Major Challenges Faced with the Korean Supervisors by Opening Domestic Banking Sector to Foreign Competition

- **De-listing** from the Korean stock exchange of Citibank Korea, Inc.* may weaken market discipline
  - Disappearance of market information may render market participants' monitoring and assessments of the bank's performance and risk profile more difficult

* Citibank had raised its shareholding percentage to 99.5 per cent before taking over KorAm Bank in December 2004 (de-listed if majority shareholders own more than 80 %)

– FSS is expected to take some measures aiming to encourage and require disclosure of information on de-listed banks

- **Losing control of several foreign-owned banks** not amenable to following the regulator's guidelines (a moral suasion)

  – The regulator encouraged several foreign banks to provide low-cost loans to re-capitalize the troubled card company (LG card) ⇒ They didn't follow the authority's guidelines

– The supervisor decided to restrict the number of a bank's foreign board members to less than one half of them, and to introduce a residency requirement for them

- Arising of significant resistance to foreign investors such as PEFs concentrating on short-term investment in domestic banking sector
  – Korea First Bank, whose majority owner is Newbridge Capital, was sold earlier this year to Standard Chartered (substantial capital gains from resale of KEB)

– A consensus reached on this issue is that the government should seek to attract long-term strategic buyers such as globally competitive banks conducive to a more efficient and stable domestic banking system

• Strengthen economic needs test for foreign bidders

– Furthermore launched locally-funded PEFs aiming to compete with foreign investors(December 2004)

<The end>