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

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I. Introduction

In Korea, the financial liberalization process which gained momentum following the 1997 financial crisis has played a prominent role in encouraging a dramatic surge of foreign capital inflows. There was a sharp increase in foreigners' capital participation in Korean financial institutions (financial sector FDI) especially between 1999 and 2001. This expansion was mainly due to the need to facilitate financial sector restructuring undertaken in the aftermath of the crisis by selling off a number of not-immediately-viable domestic banks to domestic and foreign bidders. Financial sector FDI also exhibited much stronger growth in 2004, mainly due to a surge in foreign investment in the domestic financial sector through M&As, including large-scale deals such as Citibank's acquisition (for USD 1.7 billion) of KorAm Bank, Korea's sixth largest bank. In line with this trend, foreign stock investment has also grown significantly since the Korean stock market's complete opening in July 1998, with the share of foreign stock holdings in total stock market capitalization reaching 42 per cent at the end of 2004. It is noteworthy that foreign bank entry through openings of branches (foreign bank subsidiaries have only rarely been established), which had been the most important organizational form of foreign entry until 1997, began to slow substantially from 1998, following its strong increase during the three consecutive years from 1995 to 1997.

It is well known that many emerging markets have opened their domestic banking markets to foreign competition, mostly since the second half of the 1990s. Recent studies on the effects of foreign bank penetration indicate that, while foreign bank entry can provide important potential benefits for the host county, in terms of enhancing competition and efficiency, it is not without significant risks.

The key questions that this paper focuses on addressing are threefold. First, have foreign owned banks played a role that some had originally hoped for it would play? Second, has increased foreign participation actually had any stabilizing effects on the Korean banking sector, particularly in terms of risk managements by domestic banks? Third, how does the bank regulatory and supervisory framework in the Korean banking sector need to be changed in response to the sizable foreign bank presence since the crisis?

To this end, the second section of this paper first reviews the domestic financial liberalization trends and main characteristics of financial sector FDI in Korea, particularly focusing on the post-crisis period. The third section evaluates the performances of two foreign-owned banks (Kookmin Bank and Korea First Bank) that came to have majority foreign ownership earlier than other banks, and contrast them with other domestic banks by comparing their key financial conditions. We then briefly probe the issue of whether there have been any stabilizing effects from foreign bank entry in the form of opening of branches. In addition, we carry out a more definite empirical analysis using bank panel data to determine whether domestic banks have shown any differences in risk management behavior over the post-crisis period. The fourth section then draws out the bank regulatory and supervisory implications of the Korean experience with foreign bank entry and the challenges facing supervisors. The last section provides some conclusions.

II. Financial Sector FDI in Korea

1. Recent Trends in Financial Sector FDI

From the early 1990s, the Korean government started significantly relaxing its control over the financial sector, launching a five-year financial liberalization plan in 1993[1]. Thus, the liberalization process gained momentum. Later, the November 1998 Foreign Investment Promotion Act made it possible to open up the vast majority of Korean business sectors including the financial sector to foreign investors. By offering tax and other incentives, the Act aimed at creating a more transparent and open environment. It seems apparent that such policies to bolster a liberalized investment environment have played a prominent role in provoking a dramatic surge of overall foreign direct investment (FDI) in the Korean financial sector.

Foreign stock investment, which comprises a large proportion of capital flows into Korea, has grown significantly since the outbreak of financial crisis at the end of 1997. The share of foreign stock holdings in total stock market capitalization was only 10.2 per cent in 1994, and the proportion increased gradually from then until July 1998,

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[1] It sought to achieve the following major liberalization measures: 1) Interest rate deregulation in four stages (from 1991 to July 1997). In accordance with this, all lending and borrowing rates, except demand deposit rates, were liberalized by 1997; 2) Greater managerial autonomy for banks and lower entry barriers to financial activities. This measure included allowing freedom for banks to increase their capital, to establish branches and to determine dividend payments (1994). At the same time, the measures were applicable to foreign banks attempting to open branches. The business scope of financial institutions was also enlarged by the expansion of the range of securities transactions permitted to them; 3) Foreign exchange liberalization, which involved a detailed schedule for the reform of the foreign exchange market structure (1994) and a significant relaxation of the foreign exchange concentration system (1995); 4) Capital market opening. This measure allowed foreigners to invest directly in the Korean stock markets, subject initially to ownership ceilings and to requirements that they purchase government and public bonds and equity-linked bonds issued by SMEs (1994). More importantly, foreign commercial loans were allowed without government approval, in so far as they met the guidelines established in May 1995. See Ha-Joon Chang et al. (2001).

when the Korean stock market was completely opened to foreign investors.[2] Since its complete opening, the proportion increased rapidly and reached 42 per cent at the end of 2004 (Table 1). Meanwhile, the ratio of foreign holdings of listed bonds to the total market value of listed bonds was only 0.48 per cent at the end of 2004, despite the complete opening of the domestic bond market to foreign investors in July 1998. Even though the share of foreigners' bond holdings in total bond holdings has shown a general rise (with the holdings of branches of foreign banks investing with funds borrowed from their head offices included, it reached 1.45 per cent at the end of 2003)[3], it has remained remarkably low when compared to foreigners' share of total stock market capitalization.

Table 1 Ratio of Foreign Holdings of Domestic Stocks and Bonds

End of period, %

	1994	1996	1997	1998	1999	2000	2001	2002	2003	2004
Stocks[1]	10.2	13.0	14.6	18.6	21.9	30.1	36.6	36.0	40.1	42.0
Bonds[2] (including foreign banks' domestic branches)	0.04 (0.15)	0.05 (0.43)	0.09 (2.06)	0.30 (1.49)	0.32 (1.47)	0.16 (1.03)	0.09 (1.00)	0.11 (1.55)	0.25 (1.45)	0.48 (.)

Notes: 1) Ratio of foreign stock holdings to total stock market value.

2) Ratio of foreign bond holdings to total listed bond value; figures inside parentheses represent the ratios of foreigners' bond holdings, with those of branches of foreign banks using borrowings from their head offices included. (The figures for the bond holdings of foreign bank branches also include holdings of unlisted bonds, but their scales have been trifling)

Source: Foreign Investment Trends, Financial Supervisory Service.

As seen in Table 2, financial sector FDI into Korea had increased steadily since the mid-1990s. There was, however, a particularly marked increase in financial sector FDI in 1999 mainly due to the need to facilitate the financial-sector restructuring

[2] Foreigners were allowed to invest in the Korea stock market in January 1992, for the first time, subject to ceilings of 10 per cent on each issue and 3 per cent on each investor. The ceilings were raised gradually in eight stages, and in May 1998 they were abolished completely.

[3]There is evidence that foreign bank branches tended to invest in domestic bonds when the difference between domestic foreign market interest rates increased during the first half of 2002. At that time, the difference between domestic and foreign market interest rates increased substantially from 1.63% (September 2001) to 2.92% (December 2001), and then to 2.97% (June 2002). Foreign bank branches' borrowing from their head offices also soared, from USD 9.9 billion (December 2001) to USD 15.1 billion (June 2002)). Foreign bank branches' investment in domestic government bonds showed a marked increase as well (from USD 7.6 billion (December 2001) to USD 12.9 billion (June 2002)).

undertaken in the aftermath of the 1997 financial crisis by selling off a number of not-immediately-viable domestic banks to domestic and foreign bidders. Financial sector FDI soared to USD 2.8 billion in 1999 from USD 0.64 billion in 1998 and then amounted to USD 2.2 billion in 2000 and USD 1.8 billion in 2001, vastly outpacing the average annual level of USD 0.7 billion during 1994 to 1998. In addition, financial sector FDI exhibited much stronger growth in 2004, which appears to have been closely tied to a surge in foreign investment in the domestic financial sector through M&As, mostly, including large-scale deals such as Citibank's acquisition (for USD 1.7 billion) of KorAm Bank, Korea's sixth largest bank, and GE Capital's takeover of Hyundai Capital, etc.

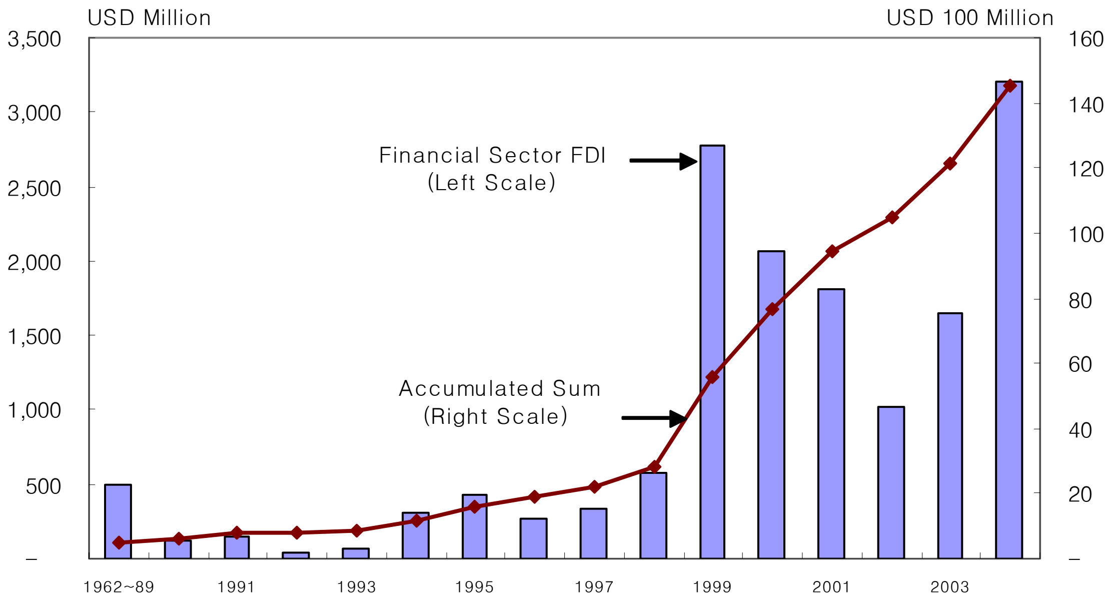
Table 2 Financial Sector FDI in Korea

USD billion

	1995	1996	1997	1998	1999	2000	'01	'02	'03	'04
FS FDI (A)	0.98	0.72	0.58	0.64	2.80	2.16	1.81	1.02	1.65	3.21
Banking & Securities	0.38	0.25	0.32	0.51	2.27	1.61	1.65	0.53	-	-
(Branches)	0.54	0.45	0.24	0.06	0.03	0.09	0.002	0.05	-	-
Insurance	0.06	0.02	0.02	0.07	0.51	0.45	0.16	0.40	-	-

Source: Foreign Investment Trends, Ministry of Commerce, Industry and Energy (MOCIE).

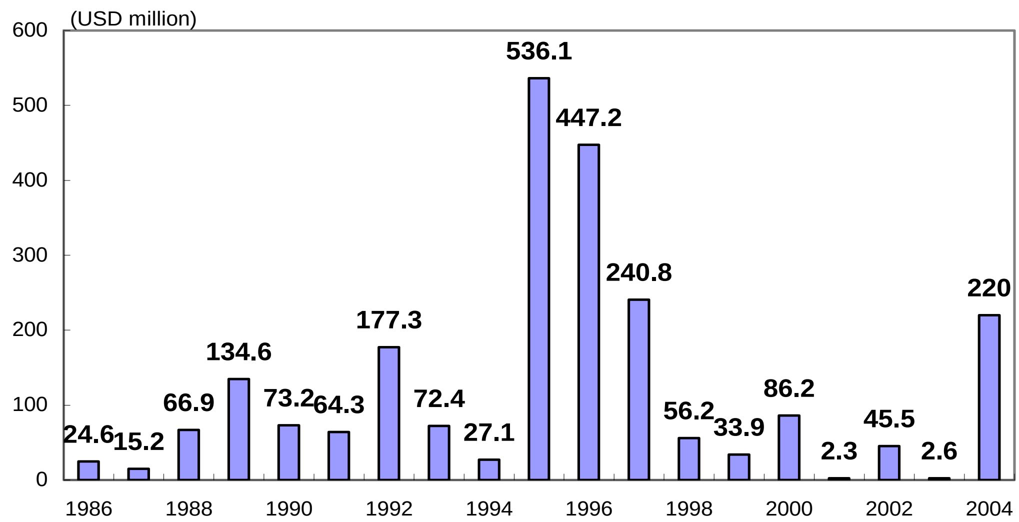
Chart 1 Financial Sector FDI in Korea



Source Foreign Investment Trends, Ministry of Commerce, Industry and Energy (MOCIE).

Financial sector FDI may be broken down into two categories: foreign entry to the banking, securities and insurance industries through green-field investment or M&As,[4] and foreign bank entry through openings of branches and representative offices (foreign bank subsidiaries[5] have only rarely been established so far). Foreign bank entry through opening of branches (and representative offices), which had been the most important organizational form of foreign entry until 1997, began to slow substantially from 1998. Chart 2 indicates that the increase in financial sector FDI due to foreign bank entry through opening of branches was relatively strong during the three consecutive years from 1995 to 1997. This was apparently driven by the above-mentioned liberalization process that significantly lowered entry barriers, for example by abolishing the Economic Needs Test (April 1994) previously mandated for foreign banks attempting to establish branches, and the requirement to establish a representative office prior to opening a branch (May 1995).

Chart 2 Increase in Financial Sector FDI due to Foreign Bank Entry through Opening of Branches



Source: Balance of Payments, the Bank of Korea.

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[4] Although disaggregated data on the mode of foreign entry to the financial sector are not available, informal data from the Ministry of Commerce, Industry and Energy reveal that around 75 per cent of foreign investment in the financial sector in 2002 was green-field investment, and the remainder M&As.

[5] It is generally observed that a branch is somewhat more efficient and lower cost for the banking organization, as it is not a separate legal entity and is operated on a fully consolidated and integrated basis. Thus, its financial helath tend to be closely tied to the health of the home office and to the state of economy in the home country. In addition, the host regulators usually rely on heavily on the home counties' regulatos for monitoring and disciplining foreign branches. Meanwhile, a subsidiary is, at least in theory, separate from its parent and subject to the same prudential regulations and the same insolvency resolution process as the host regulator applies to domestic banks. Its financial health should reflect primarily the health of the host country. See Kaufman (2004).

In particular, the fact that foreign bank entry through opening of branches resumed in 2004 seems to be associated with a rapid increase in borrowings by foreign branches mostly from their head offices, to meet their BIS capital adequacy ratios and expand their branch networks. Thirty-seven foreign banks originating from fifteen countries were operating forty-nine branches as of the end of 2004.[6]

The upshot is that foreign entry to the Korean financial sector through green-field investment and M&As seems to have largely replaced foreign bank entry through opening of branches since 1999.

2. Foreign Ownership of Domestic Banks

The increase in foreign participation in the Korean financial sector through mostly green-field investment and M&As since the crisis has led to a high degree of foreign ownership, with increasing foreign (minority) stakes in and management control of domestic banks and securities companies.

Table 3 shows that the share of foreign holdings in the equity capitals of all listed domestic banks has increased sharply since the crisis, from 16.4 per cent at the end of 1997 to 61.7 per cent as of the end of September 2004. There are seven major domestic banks - Kookmin Bank, Woori Bank, Hana Bank, Shinhan Bank, Korea Exchange Bank (KEB), Citibank Korea Inc., and Korea First Bank (KFB). Of these banks, six are now foreign owned, with foreigners holding from 48.6 per cent to 99.5 per cent of their shares as of the end of September 2004. For example, Kookmin Bank, the largest bank in Korea, was 77.2 percent foreign-owned, with the Bank of New York (ADRS) and ING Bank holding 13.9 per cent and 4.1 per cent, respectively, of its equity.

This is a remarkable increase in foreign ownership of the major domestic banks, in comparison to the pre-crisis period during which foreign ownership remained much less than 30 per cent as late as at the end of 1997. As a result, foreign participation in the control of the major domestic banks at the senior management level has increased considerably in recent years. A foreign president and five foreign executive directors now control Korea First Bank (KFB) directly, and there are twelve foreign outside directors on its board. Similarly, in the case of Korean Exchange Bank, a foreign president and two foreign executive directors are directly involved in management, and

[6] Of the forty-nine foreign branches in Korea, seven (14.3 per cent) originated in the United States, twenty (40.8 per cent) in European Countries, six (12.2 per cent) in Japan, and the remaining sixteen (32.7 per cent) in Canada, Australia and Asian countries such as China, Singapore, the Philippines, Iran and Pakistan, as of the end of 2004.

Table 3 Foreign Ownership[1)] in Major Domestic Banks

<table>
<tr><th rowspan="2">Banks</th><th colspan="2">At the end of 1997</th><th colspan="2">At the end of September 2004</th></tr>
<tr><th>Foreign Ownership</th><th>Major Shareholder</th><th>Foreign Ownership</th><th>Major Shareholder</th></tr>
<tr><td rowspan="2">Kookmin Bank</td><td>None (KHB: 41.2%)</td><td>Government: 22.4%</td><td rowspan="2">77.2%</td><td rowspan="2">Bank of New York:13.9%
ING Bank N.V. Amsterdam: 4.06%
[1 ED, 2 ODs]</td></tr>
<tr><td>None (Kookmin: 37.0%)</td><td>Government: 15.2%</td></tr>
<tr><td>Woori Bank</td><td>8.6%</td><td>Samsung Life Insurance: 6.60</td><td>11.0%</td><td>Woori Financial Group: 100 %
– Korea Deposit Insurance Corporation: 80.15%</td></tr>
<tr><td>Hana Bank[2)]</td><td>21.3%</td><td>Kyobo Insurance: 7.7%</td><td>66.0%</td><td>Angelica Investment Private, Ltd.: 9.9%
Allianz AG: 5.13%
Franklin Resource Inc.: 5.1%
[2 ODs]</td></tr>
<tr><td>Shinhan Bank[3)]</td><td>23.4%</td><td>Korean residents in Japan: 23.4%</td><td>63.0%</td><td>Shinhan Financial Group: 100%
– BNP Paribas: 4.4%</td></tr>
<tr><td>Korea Exchange Bank (KEB)</td><td>2.7%</td><td>BOK: 47.9%</td><td>71.0%</td><td>Lone-Star Fund KEB Holdings, Ltd.: 50.5%
Commerz Bank: 14.61%
Export-Import Bank of Korea: 13.87%
[President, 2 EDs, 4 ODs]</td></tr>
<tr><td>Citibank Korea Inc. [4)]</td><td>29.4%</td><td>BOA: 18.6%</td><td>99.5%</td><td>Citibank Overseas Investment Corporation (99.3%)
[3 EDs, 5 ODs]</td></tr>
<tr><td>Korea First Bank (KFB) [5)]</td><td>0.1%</td><td>Daehan Life Insurance Co. Ltd.: 4.9%</td><td>48.6%</td><td>KFB Newbridge Holdings, Ltd.: 48.5%
[President, 5 EDs, 12 ODs]</td></tr>
<tr><td>Banks Total</td><td>16.4%</td><td></td><td>61.7%</td><td></td></tr>
</table>

Notes: 1) Foreign ownership and major shareholders are based on data as of the end of 2002. The "ED" and "OD" in square brackets refer to foreign executive directors and foreign outside directors, respectively.

2) Hana Bank took over Seoul Bank in early December 2002.

3) Shinhan Financial Holding Company took over Choheung Bank in December 2003.

4) Citigroup acquired KorAm Bank in November 2004.

5) KFB was taken over by the U.S.-based Newbridge Capital in 1999 and was sold to the U.K.-based Standard Chartered Bank in February 2005.

Source: Shareholders' Information on Individual Banks.

four foreign outside directors sit on the board. Citibank Korea Inc.[7] also has participation on its board by five foreign outside directors.In the case of the Korean securities industry, foreign entry initially took the form of opening of branches from 1991, when the first branch was established, until the outbreak of the crisis. After the crisis erupted, however, a number of measures were put in place in May 1998 to open up all major aspects of the securities business, including the authorization of securities company establishment through green-field investment and abolition of the 50 per cent ceiling on the ratio of foreign investment in existing domestic securities companies. This has led to a sharp increase in the stakes held by foreign investment banks and investment funds in domestic securities companies.

Reflecting this, foreign equity participation in major domestic securities companies at the end of September 2004 was, with very few exceptions, much higher than the levels at the end of 1997 (Table 4). Overall, the share of foreign holdings in the total equity capital of listed domestic securities companies had risen from 5.2 per cent at the end of 1997 to 23.2 per cent as of the end of September 2004.

Up until the time of crisis, foreign entry into the domestic life insurance industry had mainly taken the forms of opening of branches and setting up of joint ventures, because domestic life insurance companies' shares are not listed. There was a remarkable wave of acquisitions of troubled domestic life insurance companies following the crisis.[8] Consequently, at the end of September 2004, foreign participation in the capitals of all major domestic life insurance companies, with the exception of Samsung Life Insurance, is now much larger than in the pre-crisis period. Foreign entry, meanwhile, has recently involved equity participation, rather than the opening of branches. Foreign equity participation in Samsung Fire Insurance and Hyundai Marine Insurance has increased substantially. As a result, domestic casualty life insurance companies had higher foreign market shares as a whole. In line with this, the share of foreign holdings in total equity capital of listed domestic insurance companies has risen from nearly 15.7 per cent at the end of 1997 to 51.4 per cent at the end of September 2004.

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[7] Citigroup, the world’s largest financial services company, completed its public tender for the outstanding shares of common stock of KorAm Bank Co., Ltd. in May 2004. This, together with shares acquired from an investor consortium led by the Carlyle Group and JP Morgan Corsair II, gave Citigroup an overall shareholding of 97.47 per cent in KorAm Bank. Citigroup raised its shareholding up to 99.5 per cent through another public tender offer in July 2004, before acquiring KorAm Bank in November 2004.

[8] In March 1998, Kolon-MetLife Insurance was wholly acquired by MetLife International Holdings, Inc. In March 1999, Kohab New York Life Insurance was purchased by New York Life Insurance, and in July 1999, Allianz AG acquired First Life Insurance Company.

Table 4 Foreign Ownership in Listed Domestic Non-bank Financial Institutions

%

Total Listed Securities Companies		Total Listed Insurance Companies	
End of 1997	End of Sep. 2004	End of 1997	End of Sep. 2004
5.2	23.2	15.7	51.4

Source: KIS Value, Korea Information Service, Inc.

III. Stabilizing Effects of Foreign Bank Entry on Domestic Banks

In this section, we first evaluate the performances of two foreign-owned banks (Kookmin Bank and KFB) by comparing their key financial conditions with those of other private domestic banks. It seems too early to draw any definite conclusions about the implications for the performance of banks, having recently come to have majority foreign ownership (mostly since 1999). Nevertheless, an attempt appears warranted to gain an idea, on the basis of individual bank financial statements and anecdotal evidence, as to whether they have exhibited any distinctive differences in performance from other domestic banks. We then briefly probe the issue of whether there have been any stabilizing effects from foreign bank entry in the form of opening of branches. In addition, we carry out a more definite empirical analysis using bank panel data to determine whether domestic commercial banks have shown any differences in risk management behavior over the post-crisis period.

1. The Performances of Two Foreign-Owned Banks and Other Domestic Banks

To compare the performances of foreign-owned banks with those of other domestic banks, we first choose two banks that came to have majority foreign ownership earlier than any other banks: Kookmin Bank, which has the second highest degree of foreign ownership (77.2 per cent as of the end of September 2004) among the six foreign-owned domestic banks, and Korea First Bank (KFB), which was the first to become foreign-owned in 1999, in the aftermath of the crisis, and is now run by a foreign CEO, while having foreign ownership amounting to 48.6 per cent.

Comparison of the key financial conditions of these two foreign-owned banks with those of other domestic banks suggests that they have not differed systematically in performance in the post-crisis period, and that foreign-owned banks have rather been inferior to domestic banks in the area of profits.

It is worth noting that both Kookmin Bank and KFB have been more aggressive in pursuing retail-banking expansion than other domestic banks since 2000. KFB in particular has shown a marked increase in its consumer lending-to-total lending ratio, from a mere 20.7 per cent at the end of 1997 to 69.5 per cent as of the end of 2004, well above the average consumer lending ratio (57.3 per cent) in the domestic banking sector overall.

Table 5 Consumer Lending Ratios[1] of Two Foreign-Owned Banks and Domestic Banks

%

	1997	1998	1999	2000	2001	2002	2003	2004
KFB	20.7	17.5	22.0	49.1	62.7	65.2	67.9	69.5
Kookmin Bank	66.6	61.7	56.9	58.0	63.4	63.7	65.5	68.5
Domestic Banks[2]	35.5	34.3	36.1	40.8	51.3	54.8	55.0	57.3

Note: 1) Consumer lending (excluding foreign currency loans)-to-total lending ratios Figures are based on end-of-period data.
2) Nation-wide commercial banks excluding regional banks.
Source: Financial Statistics Information System, Financial Supervisory Service (FSS).

The two foreign-owned banks have also engaged in similar deposit-based funding as other domestic banks. Table 6 shows that Kookmin Bank and KFB maintained 70.7 per cent and 65.9 per cent of demand deposits to total assets, respectively, as of the end of

Table 6 Funding and Liquid Assets of Two Foreign-Owned Banks[1]

%

	Deposits/total assets[2]					Liquid assets/total assets[3]				
	1997	2001	2002	2003	2004	1997	2001	2002	2003	2004
Korea First Bank	57.1	66.4	72.2 (11.3)	68.9 (9.6)	65.9 (9.3)	17.1	11.3	9.6	10.2	6.2
Kookmin Bank	-	73.4	71.8 (10.9)	71.8 (11.4)	70.7 (11.9)	-	5.4	3.1	3.8	3.2
Domestic Banks[4]	61.0	69.8	69.0 (10.0)	68.3 (10.0)	65.6 (10.0)	18.8	8.1	6.7	7.1	6.0

Notes: 1) Figures are based on end-of-period data.
2) Deposit includes deposits in both local currency (Won) and foreign currency
3) Liquid assets consist of cash and checks, due from the BOK or other banks, foreign currency and bills and drafts bought.
4) Nation-wide commercial banks excluding regional banks.
5) The demand deposit to total deposit ratios are reported in parentheses.
Source: Financial Statistics Information System, Financial Supervisory Service (FSS).

2004, slightly higher than the average ratio (65.6 per cent) of demand deposits of all domestic banks. In addition, there were no compellingly obvious differences in the ratios of demand deposits to total deposits between these two foreign-owned banks and other domestic banks in the post-crisis period. However, it seems apparent that there were substantial differences in liquid asset ratios between these two foreign-owned banks. Kookmin Bank showed much lower liquid asset ratios relative to the average ratios of all domestic banks, while Korea First Bank maintained higher ones.

Data on bank profits in Table 7 reveal that Korea First Bank (KFB) in particular showed a lower ROA and ROE in 2002 than the averages of all domestic banks. The ROA and ROE of KFB over the fourth quarter of 2001 through the fourth quarter of 2002 stood at just 0.4 per cent and 6.3 per cent, respectively, while the equivalent ratios for all domestic banks remained at 0.6 per cent and 11.0 per cent. Moreover, the profits of both Kookmin Bank and KFB dropped slightly in 2003, mainly due to their higher loan loss provisioning than their domestic counterparts.

Table 7 ROA and ROE of Two Foreign-owned Banks and Domestic Banks

%

	ROA				ROE			
	1997	2001	2002	2003	1997	2001	2002	2003
Korea First Bank	1.1	0.9	0.4	△0.04	26.8	15.2	6.3	△0.82
Kookmin Bank	1.0	0.8	0.8	△0.34	18.0	12.6	13.0	△6.28
Domestic Banks[1)]	△0.5	0.8	0.6	0.1	△10.8	16.3	11.0	1.99

Note: 1) Nation-wide commercial banks excluding regional banks.
Source: Financial Statistics Information System, Financial Supervisory Service (FSS).

There is also the issue of whether increased foreign participation has contributed to any operational differences between foreign-owned and other domestic banks. Although institutional corporate governance reform has been pursued, including requiring outside directors and audit committees, an evaluation by the Financial Supervisory Service (FSS) reveals no significant operational differences between foreign-owned and other domestic banks.

It has been argued that foreign bank entry makes it possible to improve the quality, pricing and availability of financial services in the domestic financial market, by facilitating the application of more modern banking skills and technology (Levine, 1996). However, as noted earlier, KFB has shown a tendency to concentrate on retail-oriented lending, rather than providing enhanced financial services and pursuing portfolio diversification through the use of advanced banking technology and skilled banking personnel. It seems very likely that KFB has not satisfactorily played the role that some had originally hoped it would play. Kookmin Bank has also not been by any means outstanding in this regard.

2. Stabilizing Effects of Foreign Bank Entry through Opening of Branches

Table 8 shows that while the deposit-to-asset ratio for foreign bank branches has declined somewhat, their proportions in total assets of both borrowings from their head offices (Due to Head Office and Branches) and their derivatives instrument liabilities and accounts payable increased in both 2002 and 2003. Note that their borrowings (mostly short-term) from their head offices and branches[9] in 2003 (23.7 per cent of total assets), which outpaced their deposit-taking (15.5 per cent), tended to play the role as their most important funding sources, together with derivatives instrument liabilities and accounts payable (31.7 per cent).

In particular, it seems clear that foreign bank branches served as “safe havens” for domestic depositors at the height of the 1997 financial crisis. In 1998, domestic depositors displayed a tendency to shift their funds away from investment finance companies and small banks toward large banks, especially foreign banks such as Citibank and HSBC that were perceived as sounder than the local banks, which were mostly laden with bad loans. This “flight-to-quality” phenomenon may be confirmed by the increase in 1998 in deposits at foreign bank branches, as opposed to the situation with domestic banks.[10] In their operations of assets, however, foreign bank branches exhibited stronger investment securities growth in the years from 2001 through 2003, with their securities to total asset ratios exhibiting high levels ranging from 26 to 32 per cent. This reflected an increase in their investments in Monetary Stabilization Bonds (central bank obligations) and government bonds, due to their need

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[9] Such a sharp increase in borrowings from the head offices and branches was due to the branches’ need for short-term funds denominated in foreign currency to engage in currency swaps with domestic insurance companies.

[10] Overall deposit amounts of domestic banks and foreign bank branches are as follows:

unit : USD billon

	1996	1997	1998	1999	2000	2001	2002
Domestic commercial banks:	326.4	353.7	251.4	298.2	337.1	266.7	288.6
	(16.9)	(8.4)	(-28.9)	(18.6)	(13.0)	(-20.9)	(8.2)
Foreign bank branches:	3.8	3.8	3.9	5.2	7.1	8.8	10.0
	(-2.2)	(-1.1)	(4.2)	(31.7)	(37.8)	(22.6)	(13.6)

* Annual growth rates of deposits in parentheses

Table 8 Assets & Liabilities of Foreign Bank Branches

%

		All Foreign Branches 2001	All Foreign Branches 2002	All Foreign Branches 2003
Liabilities	Deposits [1]	22.4	18.1	15.5
	Call Money	17.3	13.8	15.0
	Due to Head Office & Branches	25.8	32.2	23.7
	Derivatives Instrument Liabilities & Accounts Payable	20.6	22.7	31.7
Assets	Securities	26.9	31.7	26.2
	Loans[2]	20.9	23.8	21.0
	Bills Bought in Foreign Currency	7.1	5.2	5.0
	Derivatives Instrument Assets & Accounts Receivable	19.2	21.0	31.3

Notes: 1) CDs included.
2) Inter-bank loans in foreign currency are included.
Source: Banking Statistics, Financial Supervisory Service (FSS).

to hedge foreign exchange and interest rate risk resulting from their increased currency swaps with domestic insurance companies and enlargements of their country limits on securities investment.

Foreign bank branches showed relative weakness in profits through 2002, as is revealed by the fact that both their ROAs and their ROEs fell sharply in 2002, to levels much lower than those of domestic banks. This was because their non-interest income, for example their gains on foreign currency and derivatives trading, was reduced, mainly due to strengthened competition among foreign bank branches and the improved creditworthiness of domestic banks (Table 9). However, foreign banks maintained higher shares of liquid assets than domestic banks through 2003. This reflected their relatively larger investments in liquid and lower-risk assets such as MSBs and government bonds. They also maintained consistently lower non-performing loan ratios and higher risk-based capital ratios than domestic banks, although domestic banks have also shown improvements in those indicators over the past three years. These findings provide some support for the view that the overall financial conditions and performances of foreign bank branches tend to be stronger than those of domestic banks. In addition, it seems likely that greater foreign bank participation has contributed to increased banking competition, as evidenced by the reduced non-interest income from trading of foreign currency and derivatives, and thereby to reduced profits.

Table 9 Major Indicators of Bank Performance

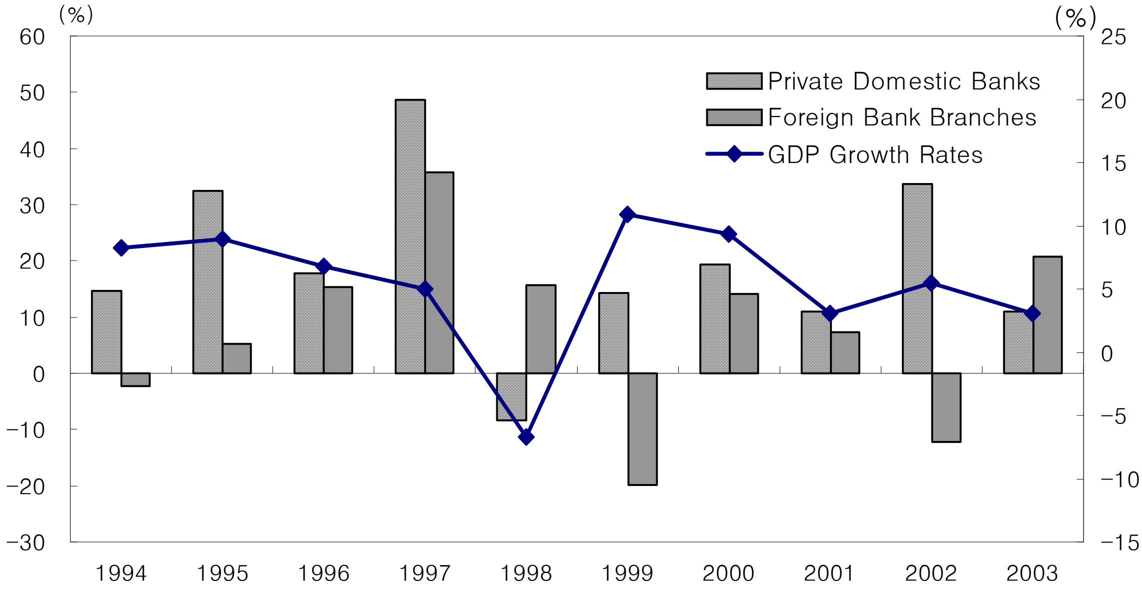
%

	Foreign Bank Branches				Domestic Banks			
	2000	2001	2002	2003[3)]	2000	2001	2002	2003[3)]
ROA[1)]	1.58	1.06	0.50	0.57	△0.54	0.80	0.56	0.1
ROE[1)]	18.14	13.27	7.59	8.01	△0.81	16.30	10.95	1.99
Liquidity Ratio[2)]	114.0	129.6	136.08	125.55	113.9	100.6	111.0	109.51
NPL Ratio	1.03	1.11	0.56	0.76	6.6	2.9	2.0	2.19
BIS Capital Ratio	26.82	27.62	19.88	24.85[3)]	10.53	10.81	10.52	10.7[3)]

Notes: 1) Both ROEs and ROAs are ratios over the relevant periods.
2) Liquidity ratio refers to the proportion to total liquid liabilities of liquid assets.
3) Figures are based on data as of the end of September 2003.
Source: Banking Statistics, Financial Supervisory Service (FSS).

A key issue to be examined is whether movements in foreign banks' lending have been more closely tied to economic conditions than those at domestic banks. Chart 3, which compares real GDP growth rates with the loan growth rates of foreign bank branches and domestic banks, indicates that foreign bank branches did not "cut and run" when faced with the severe economic slowdown in 1998 following the financial crisis, despite the fact that domestic banks did cut off credit lines to their customers. However, foreign bank branches tended to cut back substantially on lending when the economic recovery was already under way in 1999, in sharp contrast to the behavior of domestic banks. This result suggests that the lending pattern of foreign bank branches over the post-crisis period in particular tended to be counter-cyclical, with that of domestic banks being more or less pro-cyclical. It is nevertheless by no means clear that foreign bank branches played a role in mitigating the pro-cyclical pattern of lending by domestic banks and contributed somewhat thereby to the Korean economy's withstanding of the severe post-crisis slowdown, in the sense that the scale of lending by foreign bank branches in fact remains very small relative to that of domestic banks (Table 10).

Chart 3 <u>Comparison of Real GDP Growth Rates and Loan Growth Rates of Foreign Bank Branches and Domestic Banks</u>



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

Table 10 <u>Total Lending of Foreign Bank Branches and Domestic Banks</u>

USD billion, %

	1997	1998	1999	2000	2001	2002	2003	2004
Domestic Banks[1)]	201.5	126.2	169.2	212.4	206.7	285.0	332.0	354.8
Foreign Bank Branches	8.8	7.0	6.6	7.9 (3.6)	7.4 (3.4)	6.7 (2.3)	8.5 (2.6)	6.5 (1.8)

Note: 1) Nine nation-wide commercial banks excluding regional banks.
2) Ratios of total lending of foreign bank branches to that of all private domestic banks reported in parentheses.

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

There has also been concern about the question of whether foreign bank branches show a tendency of "cherry picking" the most creditworthy domestic firms and individuals. One plausible reason that foreign banks tend to shy away from lending to less creditworthy customers may be that most banks with an international presence are large. For large foreign banks, "organizational diseconomies" may make it difficult for them to provide relationship lending services to small businesses at the same as they are providing transaction lending services and wholesale capital market services to their larger clients (Berger-Udell, 1995, Berger-Klapper-Udel, 2001). From the findings of one of the most recent FSS audits, it seems apparent that most foreign bank branches in Korea tend to concentrate on wholesale banking such as trade finance and project finance, and on private banking such as the custody business and providing cash management services (CMS), as well as on trading foreign exchange, bonds and derivative products. Citibank and HSCB, in particular, have also tended to undertake retail-banking activities. These foreign banks, however, have been targeting the more creditworthy domestic customers, while focusing especially on more stringent loan enforcement than domestic banks by utilizing advanced credit risk evaluation methods. Under these conditions, it appears not totally implausible to conclude that domestic banks have been led to deal with less creditworthy (more risky) customers such as SMEs[11] and to thus increase the overall riskiness of their portfolios. Consistent with the claim of foreign banks' cherry-picking strategy, HSBC, one of the leading foreign banks currently operating in Korea, exhibited a markedly low overdue mortgage loan ratio of 0.28 per cent as of the end of 2002, compared to the equivalent ratio of 2.0 per cent recorded at Kookmin Bank.[12] The reason why HSBC had such a low overdue loan ratio may be traced back to several factors. First, it was able to enter the mortgage loan market earlier than Kookmin Bank and thus preempt the more creditworthy customers, while offering mortgage loans at the lowest lending rate. Second, it showed more defensive behavior in its offering of mortgage loans (primarily long-term) – keeping its loan-to-value ratio at no more than 60 per cent over the two years of 2001 and 2002, even when major domestic banks including Kookmin Bank raised theirs to 70 to 80 per cent.

Overall, even though foreign banks have tended to mitigate the pro-cyclical pattern of lending by domestic banks, the overall scale of their lending remained very small relative to that of domestic banks. They also have sought to cherry pick the most creditworthy customers. However, foreign bank branches served as "safe haven" for domestic depositors at the height of the 1997 financial crisis. Thus, it appears not implausible to conclude that a greater foreign bank presence contributed to some extent to a more stable domestic banking system.

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[11] This result may have arisen in part from the fact that the mandatory ratio for lending to SMEs has since February 1999 been set lower for foreign bank branches, at 35 per cent, than the equivalent ratios for commercial and regional banks, which are 45 per cent and 60 per cent, respectively.

[12] HSBC also showed a low overdue consumer loan ratio of 0.85 per cent as of the end of 2003, compared to the equivalent ratio of 2.35 per cent at Kookmin Bank.

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

This chapter turns to the question of whether foreign bank entry during the most recent years has had any significant effects on risk management at domestic banks. To address this question, we estimated the following regression equation using bank panel annual data for the period from 1999 to 2003.

$$RMP_{i,t} = \beta_0 + \beta_1 DS_{i,t-1} FB_{t-1} + \gamma DB_{i,t-1} + \epsilon_{i,t}$$

The subscript i represents the individual domestic commercial banks existing in each year t, and t covers 1999 through 2003. $RMP_{i,t}$ is a measure to proxy for the overall risk management performance of bank i in a given year t and is derived from the weighted average of data[13] used for measuring bank i's credit risk management performance ($CRMP_{i,t}$), its market risk management performance ($MRMP_{i,t}$) and its liquidity risk management performance ($LRMP_{i,t}$).[14] The weights are given in accordance with the Korean Financial Supervisory Service (FSS)'s rule for evaluating banks in terms of their risk management performances. $DS_{i,t}$ refers to the size of bank i in a given year t, and FB_t refers to foreign banks' local market penetration, mostly through green-field investment and M&As. Here, three major domestic banks (KEB, KFB, and Citibank Korea, Inc.) are selected as foreign banks because each bank has been under the control of a foreign president. We have selected the ratio of foreign banks' assets to those of all domestic banks (fourteen commercial banks) to proxy for FB_t. The coefficient of $DS_{i,t} \cdot FB_t$ is expected to have a positive value, as larger banks are more likely to tighten their risk management in response to increased foreign bank entry to the domestic market.[15] $DB_{i,t}$ denotes a vector of control variables other than $DS_{i,t} \cdot FB_t$ that might affect domestic banks' risk management performance. The control

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[13] The data is all standardized on a scale of 0 to 1.

[14] Here, market risks comprise interest rate risk, asset price risk and foreign exchange risk. A bank's asset-liability maturity gap (Σ((assets with *i* maturity - liabilities with *i* maturity)/total assets)) has been used as a measure to proxy for its performance in managing interest rate risk. The average of the ratio of the bank's stock holdings to total assets and the ratio of its long-term bond holdings to total assets is used as a measure to proxy for its asset price risk management performance. We have selected the ratio of foreign assets to foreign liabilities to proxy for the bank's liquidity risk management performance. We have selected the BIS capital adequacy requirements as a measure to proxy for the bank's credit risk management performance.

[15] For an example of the use of a time series variable multiplied by a cross section variable as an independent variable, refer to Cetorelli and Strahan (2004).

variables considered comprise micro factors that involve the following bank characteristics of local banks: return on assets (ROA), number of outside directors (NOD), scale of bank assets (BAS), ratio of the differences between non-interest earnings and interest earnings to total assets (NINT), and ratio of safe asset holdings to total assets (SAH). In particular, one-year-lagged independent variables are used to avoid the endogeneity problem.

The results are shown in Tables 11 and 12. In the overall risk and credit risk (RMP and CRMP) equations ([1] and [2]), DS·FB, the primary interest of this analysis, has significantly positive coefficients. This result confirms that foreign bank penetration through green-field investment and M&As over the most recent years has led domestic banks to focus on overall risk management, especially credit risk management. However, the coefficient estimates of DS·FB in the market risk and liquidity risk (MRMP or LRMP) equations ([3] and [4]) are not significant. This may be interpreted as meaning that domestic banks' management of market and liquidity risks appears not to be dependent on foreign bank penetration to the local banking sector in an important way. In particular, the BAS (scale of bank assets) and NINT (difference between interest and non-interest earnings) variables in the RMP and CRMP equations have significant negative coefficients. These results indicate that the local banks having higher levels of assets or more diversified sources of earnings tend to place less emphasis on their risk management, notably credit risk management. Additionally, the estimated coefficients of the numbers of outside directors (NOD) in the RMP and CRMP equations turn out to be significantly positive. This suggests that the local banks having more outside directors are more likely to be concerned about their risk managements, as these banks are expected to have better governance structures.

Overall, it seems most likely that foreign bank penetration to the domestic banking sector during the most recent years has contributed to enhancing risk management, notably credit risk management, on the part of domestic banks. But there is no evidence that the foreign bank presence has significantly affected market and liquidity risk management by domestic banks. One plausible explanation for this result may be that domestic banks have been led to focus more on credit risk management than market and liquidity risk management, in attempting to meet their BIS capital adequacy ratio requirements.

Effects of Foreign Bank Entry on Risk Management at Domestic Banks (1999~2003)

Table 11

< Fixed Effect Model >

Independent variables / Dependent variables	DS·FB	BAS	NINT	NOD	ROA	SAH	$\bar{R}^2$
[1] RMP	5.872 (2.49)**	-1.409 (0.50)***	-2.108 (0.81)**	0.504 (0.28)*	-0.819 (1.26)	-0.269 (0.61)	0.50
[2] CRMP	6.853 (3.16)**	-1.695 (0.64)**	-1.974 (1.04)*	0.697 (0.36)**	-1.117 (1.60)	-0.091 (0.78)	0.45
[3] MRMP	3.855 (2.70)	-0.794 (0.54)	-3.151 (0.89)***	0.273 (0.30)	-0.910 (1.37)	-0.837 (0.66)	0.71
[4] LRMP	3.037 (5.10)	-0.640 (1.03)	-0.964 (1.68)	-0.381 (0.58)	1.455 (2.58)	-0.382 (1.25)	0.61

Notes: Figures in parentheses are standard errors, and the superscript *, ** and *** indicate significance levels of 10%, 5%, and 1%, respectively.

Table 12

< Random Effect Model>

Independent variables / Dependent variables	Const.	DS·FB	BAS	NINT	NOD	ROA	SAH	$\bar{R}^2$
[1] RMP	0.545 (0.18)***	3.396 (1.77)*	-0.765 (0.30)**	-1.990 (0.72)***	0.565 (0.24)**	-0.278 (1.09)	0.293 (0.41)	0.64
[2] CRMP	0.428 (0.22)*	3.671 (2.20)*	-0.876 (0.38)**	-1.810 (0.92)**	0.781 (0.31)**	-0.437 (1.36)	0.570 0.48	0.61
[3] MRMP	0.810 (0.15)***	2.620 (1.72)	-0.438 (0.24)*	-3.068 (0.78)***	0.268 (0.26)	-0.707 (1.16)	-0.303 (0.43)	0.80
[4] LRMP	0.777 (0.19)***	0.800 (2.82)	-0.255 (0.34)	-1.140 (1.43)	-0.714 (0.47)	2.940 (2.07)	-0.410 (0.64)	0.72

Notes: Figures in parentheses are standard errors, and the superscript *, ** and *** indicate significance levels of 10%, 5%, and 1%, respectively.

IV. Challenges to Domestic Bank Regulation and Supervision

1. Regulation and Supervision Related to Foreign Entry to the Domestic Financial Sector

(Operational Funds of Foreign Bank Branches)

The operational funds of foreign bank branches are classified as either Capital A funds or Capital B funds. Capital A funds are recognized as the equity capital of a foreign bank attempting to open branches in Korea. Thus, they may be categorized as financial sector FDI associated with foreign bank entry. Capital A funds include local currency denominated funds that foreign bank branches must hold through their parent's sales of funds denominated in foreign currency to the Bank of Korea, together with funds transferred from the retained earnings carried forward of incumbent branches for an expansion of the branch network. Each foreign bank branch needs to hold at least KRW 3 billion (equivalent to USD 2.5 million) in Capital A funds.

Capital B funds represent the sum of the long-term loans[16] that foreign bank branches borrow from their parent banks (or other branches abroad) and operate domestically, plus the local currency-denominated funds that they hold through sales of funds denominated in foreign currency to the BOK under repurchase agreements. Since Capital B funds typically comprise long-term borrowings, they are counted as supplementary capital of foreign bank branches. Another reason for allowing holding of Capital B funds as supplementary capital involves preventing foreign branches from limiting their scopes of operation due to relatively low levels of Capital A funds. However, foreign bank branches are not permitted to hold Capital B funds exceeding 200 per cent of their total capital, mostly due to concerns about the potential effects of over-leverage on their soundness.

(Ceilings on Foreigner Equity Holdings)

In accordance with the November 1998 Foreign Investment Promotion Act, the Korean government took major steps to reduce entry barriers to the financial sector. It lifted the four-percent limit on the equity of a domestic financial institution that a foreign entity participating in the financial sector and seeking to do business in the

[16] The Governor of the FSS may deduct long-term loans from Capital B funds if such funds have not been operated in Korea.

Korean financial sector, such as the banking, securities or insurance sector, could hold.[17] In this instance, the foreign entity's total assets and business volume must be recognized as adequate compared to the average level of the relevant business sector. Furthermore, its financial status must be maintained adequately when evaluated with respect to its BIS capital adequacy ratio (8 per cent) and its credit ratings by international credit rating agencies. A foreign entity participating in the financial sector may hold up to 10 per cent of the total equity of a domestic financial institution by simply filing a report of this to the Financial Supervisory Commission (FSC).

However, upon obtaining approval from the FSC, a foreign entity participating in the financial sector and seeking to purchase a financial institution or to establish branches (subsidiaries) in Korea may hold as much as 25 per cent of the total equity of a domestic financial institution. Subsequently, approvals to hold up to 33 per cent and 100 per cent level can be granted step by step.

It is noteworthy that Korean nationals are allowed to hold the equities of domestic financial institutions by following the same procedures as foreign entities, and are limited in their maximum permitted holdings of a domestic financial institution's equity to the maximum limit approved by the FSC for a foreign entity or reported by a foreign entity.

2. Major Prudential Supervision to Promote Financial Institution Soundness Following the Crisis

The rapid process of financial liberalization, and the desperate need to re-capitalize devastated financial institutions with private sector funding in the aftermath of the 1997 financial crisis, presented a marked opportunity for well-capitalized, internationally-diversified global investors and banks to become an important source of new capital in the domestic financial sector. On the other hand, this expanded participation of foreign investors has increased domestic financial institutions' risk exposures and led to large unanticipated swings in foreign capital flows. In response to these increasing risks, the Korean supervisory authority (the Financial Supervision Service) has turned away from its past focus on business operation and price regulation and begun to focus on prudential regulation to manage financial institution risk. The BIS capital ratio requirements have been tightened, the asset soundness classification criteria strengthened to meet international standards, and prompt corrective action

[17] Individual private foreign investors are still limited to a maximum investment of four per cent of the equity of a single financial institution.

introduced into the regular system for supervising financial institutions.

To facilitate the efficient supervision and regulation of financial institutions, prudential supervision has been tightened. In accordance with its agreement with the IMF in December 1997, the Korean government strengthened the BIS capital ratio requirements to promote the soundness of financial institutions.[18] In 1998, financial institutions with BIS capital ratios lower than 8 per cent were required to improve their financial structures. In January 1999, the method for calculating this capital ratio was changed to meet international standards (loan loss provisions for nonperforming assets are now deducted from tier 2 capital, for example, and securities held by financial institutions are evaluated at market value).

In December 1999, forward-looking criteria were introduced for evaluating the levels of credit risk to which financial institutions could expose themselves in managing their assets. The move was intended to enhance institutions' soundness by helping prevent their loans from turning sour. In addition to the details of borrowers' past financial transactions—the only concern of previous asset classification practices—forward-looking criteria also consider their future debt repayment capacities. Accordingly, financial institutions now evaluate their asset holdings in three areas—the borrower's debt repayment capacity, degree of solvency, and compliance with the payment schedule—and classify asset soundness in each area according to five grades: normal, precautionary, substandard, doubtful and estimated loss. The lowest of the three grades given for each asset becomes that asset's final soundness level. The requirements for loan loss provisions have also been tightened based on these classifications. Financial institutions must set aside 0.5 per cent of their normal assets, 2 per cent of their precautionary assets, 20 per cent of their substandard assets, 50 per cent of their doubtful assets and 100 per cent of their estimated loss assets as provisions against loan loss.

In addition, they must maintain their own independent credit review systems, in order to enhance the accuracy and objectivity of their classifications of asset soundness and their accumulations of loan loss provisions. In April 1998, the Korean government enacted the Financial Industry Restructuring Act and introduced a prompt corrective action system, aiming to preclude supervisory forbearance by requiring undercapitalized banks to be subject to mandatory sanctions (prompt corrective actions) and thereby prevent their insolvency. The prompt corrective action system bolsters safety and soundness of the financial system by facilitating both the market exits of insolvent

[18] In December 1997 the Korean government agreed with the IMF to make it mandatory for Korean banks to achieve minimum 8 per cent capital ratios, in accordance with the BIS's Core Principles for Effective Banking Supervision.

financial institutions and the restoration of normal management at financial institutions showing signs of unsoundness (Table 3). Before introduction of the system, the Korean supervisory authorities (the Financial Supervisory Service) used a management improvement guidance system to supervise financial institutions. That system was ineffective, because decisions about whether on not to take corrective actions on troubled banks were largely up to the discretion of supervisors and the actions they could take excluded such powerful options as canceling business permits and ordering management changes. Under the prompt corrective action system, action is now automatically triggered under clear and objective criteria relevant to management conditions at financial institutions, limiting the discretion afforded supervisors in dealing with problem banks. The criteria used are the BIS ratios and the CAMELS[19] evaluation system results for banks and merchant banking corporations, the net operating capital ratios for securities firms, and the solvency margin ratios for insurance companies. As recommended by the BIS and the IMF, the scope of the prompt corrective action framework embraces almost all financial institutions.

3. Challenges to Domestic Bank Regulation and Supervision

While many studies have recently elaborated the benefits of opening the domestic banking sectors to foreign competition, mostly focusing on the two primary areas of concern, efficiency and financial stability, and almost all with respect to emerging market economies, relatively less has been devoted to dealing with its costs.[20] There is little doubt that increasing the presence of foreign global banks can enhance competition and efficiency in a previously closed financial market of the host country. This appears particularly the case in Korea, in that a recent empirical study confirms foreign bank entry by opening of branches to have contributed to greater cost efficiency on the part of domestic banks, presumably by putting competitive pressure on the domestic banks to

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[19] CAMELS evaluates capital adequacy, asset quality, management soundness, earnings and profitability, liquidity, and sensitivity to market risk. This system was introduced in Korea in October 1996, with the aim of ensuring objective and reasonable assessment of financial institutions' management conditions. Under this system, financial institutions are evaluated in a comprehensive and unified method, in areas such as their management capabilities, observance of legal regulations and financial conditions. Initially, banks were evaluated on the five main components of their financial positions: capital adequacy, asset quality, management, earnings and profitability, and liquidity. Later, sensitivity to market risk was added, in reflection of the importance of risk management. For foreign bank branches, in contrast, the ROCA ratings method is used, which evaluates the four components of risk management, operational controls, compliance and asset quality. See Hyun E. Kim (2003)

[20] For an explanation on this point, see the BIS CGFS WG report on 'FDI in the Financial Sector of Emerging Market Economies' (2004), Peek and Rosengren (2000), Claessen et al. (2000, 2001), Clark, Cull, Peria and Sanchez (2001), and Focarelli and Pozzolo (2002), among others.

cut down on their operating expenditures.[21] While there are many advantages to allowing foreign banks to enter domestic banking markets, arguments against foreign bank entry from a bank supervisory standpoint in particular have remained limited.

(De-listing of Foreign Subsidiaries on the Local Exchange)

One of the key questions that have important implications for bank supervision in a time of globally active banks with significant stakes in the Korean domestic banking sector concerns the loss of information if the foreign parent decides to de-list its subsidiary from the local exchange. This issue has received, and is continuing to receive great attention at the Korean supervisory authority since Citibank, the world's largest investment bank, took over KorAm Bank, the sixth largest bank in Korea, in November 2004. At the time, Citibank had raised its shareholding percentage to 99.5 per cent through public tender offers made in both May and July 2004, before acquiring KorAm Bank, and had been able to de-list from the stock exchange. This was feasible in accordance with the Korean Securities Exchange Act requiring that the Korean Stock Exchange de-list a listed entity whose majority shareholders own more than 80 per cent of its outstanding shares.

As a result of the de-listing of Citibank Korea, Inc., equity market signals and disclosure statements are no longer available and, even more importantly, judgments by bank analysts who examine its financial information and disseminate their assessments, disappear in the local market.[22] Thus, it is most likely that the de-listing of Citibank Korea, Inc. from the Korean exchange may weaken market discipline because the disappearance of market information may render monitoring and assessments of its performance and risk profile by market participants more difficult.

In response to the decision of Citibank Korea, Inc. to de-list on the Korea exchange, the Korean supervisory authority (FSS), in collaboration with domestic financial institutions, is attempting to resolve the associated problems by requiring publication of information on de-listed banks such as Citibank Korea, Inc. It is expected that the supervisory authority will take some measures aiming to encourage and require disclosures of information on de-listed banks, including their non-performing loan (NPL) ratios and the delinquency ratios of many different layers of their borrowers.

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[21] Hyun E. Kim and B.Y. Lee (2003) carried out an empirical analysis using bank panel data to identify the efficiency effects of foreign bank entry by opening of branches on domestic banks in terms of costs and profits over the period from 1987 to 2000. They found no evidence, however, that foreign bank entry through the opening of branches has improved local banks' profitability.

[22] See the BIS CGFS WG report on 'Financial Sector FDI' (2004).

(Possibility of Loss of Control over Foreign-Owned Banks)

An often-voiced concern recently is that the regulatory authority may have a diminished ability to engage in moral suasion or undertake enforcement of bank regulations when dealing with foreign international banks more focused on expected financial returns and profits and less sensitive to domestic goals promulgated by the regulator.[23] For example, the Korean regulatory authority attempted to follow a policy of forbearance in around early 2004, allowing the insolvent LG card company, the largest one in Korea, to continue operating, and encouraged several foreign-owned banks (Kookmin Bank, KEB, etc.) to provide low-cost loans to re-capitalize the troubled company. However, the regulator's ability to engage in moral suasion was greatly lessened and it ended up losing control of these foreign-owned banks, which were not amenable to following the authority's guidelines. There was some anti-foreign bank sentiment at that time, believing that a sizable foreign bank presence could make it harder for the financial sector to play its public roles that sometimes require taking actions counter to its own private interests.

With more than 60 per cent of the domestic banking system under foreign control, it has become increasingly important to make a number of supervisory innovations to enhance the bank supervisors' ability to affect the motivations and intentions of foreign-owned bank management. In line with this, the FSS decided in February 2005 to restrict the number of a bank's foreign board members, including foreign outside directors, to less than one half of them, and to introduce a residency requirement for them, in a bid to prevent foreigners unfamiliar with business practices and ethics in banking from becoming executives in Korea. This plan is about to come into effect, as a bipartisan group of twenty lawmakers has submitted a proposal for revision of the Korean banking law to the National Assembly.[24]

(Investment Horizons of Foreign Investors)

There has also been growing concern about the role of the investment horizons of foreign investors. One view, emphasizing the need for long-term investment, argues that some international investors such as private equity funds, which have shown tendencies

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[23] See Peek and Rosengren (2000).

[24] If the proposal is not passed in the National Assembly, the supervisor might apply the fit and proper test mandatory to bank directors under the current banking law to ensure that foreign-owned banks in Korea gradually reduce the numbers of their foreign directors.

to engage in short-term investment in troubled domestic financial institutions, driven by a motivation to maximize market value in the short term, could undermine the financial stability of the Korean financial system. However, it seems important not to underestimate some positive roles that such investors have played, by cleaning up the balance sheets of the acquired institutions and driving their progress in risk management.

Recently, significant resistance to foreign investors concentrating on short-term investment in the Korean banking sector has arisen. This appears closely tied to the behaviors of the foreign ownerships of two Korean banks. Korea First Bank, the nation's eighth largest lender was sold earlier this year by Newbridge Capital, a U.S. investment fund, to Standard Chartered. It is well known that Newbridge Capital made substantial capital gains from its resale of KEB at that time, when compared with its initial takeover value in 1999. Korean Exchange Bank, meanwhile, the nation's fifth largest lender and currently majority-owned by the Dallas-based fund Loan Star, is expected to be sold off this year in a case similar to that of KFB.

From this perspective, a general consensus reached on this issue is that where soliciting foreign bidders is the only option, the government should seek to attract long-term strategic buyers, such as efficient, globally competitive banks, rather than foreign private equity funds, as this may be conducive to a more efficient, and stable domestic banking system. To this end, it has been recommended that the supervisors strengthen the economic needs test for foreign bidders. Furthermore, with the December 6, 2004 launch of locally-funded private equity funds (PEFs) aiming to compete with foreign investors, the largest state-controlled bank, Woori Bank, could possibly be sold off to a local PEF, rather than foreign investors.

V. Concluding Remarks

This paper focused on the implications of the increased foreign participation in the Korean banking sector during the post-crisis period for stabilizing effects on domestic banks, particularly in terms of their risk management, and for bank supervision. A number of major findings can be summarized as follows.

First**,** there has been a sharp increase in foreigners' capital participation through green-field investment and M&As in Korean financial institutions (financial sector FDI), especially between 1999 and 2001. This may be closely tied to the rapid progress in domestic financial liberalization in Korea and to the need to facilitate financial sector restructuring undertaken in the aftermath of the crisis. Furthermore, financial sector FDI resumed much stronger growth in 2004, mainly due to several large-scale deals such as Citibank's acquisition (for USD 1.7 billion) of KorAm Bank, Korea's sixth largest bank. It is noteworthy that foreign bank entry through openings of branches (foreign bank subsidiaries have only rarely been established), which had been the most important organizational mode of foreign entry before the crisis, has shown only meager post-crisis growth.

Increased foreign participation in the Korean financial sector has led to a high degree of foreign ownership at domestic banks and securities companies. The share of foreign holdings in the equity capitals of all listed domestic banks has increased sharply since the crisis, from 16.4 per cent at the end of 1997 to 61.7 per cent as of the end of September 2004. There has also been a significant increase in the share of foreign holdings in the total equity capital of listed domestic securities companies, with the ratio rising from mere 5.2 per cent at the end of 1997 to 23.2 per cent through September 2004. In line with this trend, foreign stock investment has grown substantially since the Korean stock market's complete opening in July 1998, with the share of foreign stock holdings in total stock market capitalization increasing from 14.6 per cent at the end of 1997 to 42 per cent at year-end 2004.

Second, comparing the key financial indicators of two foreign-owned banks (Kookmin Bank and Korea First Bank (KFB)) with those of other domestic banks reveals that they have not differed systematically in performance in the post-crisis period, and that the foreign owned banks have rather been inferior to domestic banks in the area of profits-- for 2002 and 2003, in particular. These two foreign-owned banks have been more aggressive in pursuing retail banking expansion since 2000, rather than providing enhanced financial services or pursuing portfolio diversification through the use of advanced banking services. It also appears that they have shown no significant operational differences in terms of corporate governance, compared to other domestic banks.

Third, it seems clear that foreign bank branches served as "safe havens" for domestic depositors at the height of the 1997 financial crisis. In 1998, domestic depositors displayed a tendency to shift their funds away from investment finance companies and small banks toward large banks, especially foreign banks such as Citibank and HSBC that were perceived as sounder than the local banks.

Foreign bank branches did not "cut and run" when faced with the severe economic slowdown in 1998 following the financial crisis, despite the fact that domestic banks did cut off credit lines to their customers. It seem obvious that the lending pattern of foreign bank branches over the post-crisis period in particular tended to be counter-cyclical, with that of domestic banks being more or less pro-cyclical. It is nevertheless by no means clear that foreign bank branches played a role in mitigating the pro-cyclical pattern of lending by domestic banks, because the overall scale of lending by foreign bank branches in fact remained very small relative to that of domestic banks.

Most foreign bank branches, however, have been targeting the most creditworthy domestic customers. Thus, domestic banks have been led to deal with less creditworthy customers such as SMEs, and to increase the overall riskiness of their portfolios. Overall, it appears that the greater foreign bank presence has served to some extent as a stabilizing influence on the domestic banking sector.

Fourth, empirical analysis to address the question of whether foreign bank penetration into the domestic banking sector during the most recent years has had any significant effects on risk management at domestic banks reveals that it has contributed to enhancing risk management, notably credit risk management, on the part of domestic banks. However, there is no evidence that foreign bank entry has significantly affected market and liquidity risk management by local banks. This result may reflect the fact that domestic banks have been led to focus on credit risk management in attempts to satisfy their BIS capital adequacy ratio requirements, and have thus paid relatively less attention to market and liquidity risk management.

Finally, while it is the case that foreign banks and investors have played a catalytic role in enhancing competition and efficiency and served as a stabilizing influence to some extent in the Korean banking sector, their presence has not been without costs, particularly in terms of bank regulation and supervision. A first concern is that the de-listing from the Koran stock exchange of Citibank Korea may weaken market discipline, as the disappearance of market information may render market participants' monitoring and assessments of the bank's performance and risk profile more difficult. Citibank took over KorAm Bank and raised its shareholding percentage to 99.5 per cent. In response to this problem, the supervisory authority is expected to take some measures aiming to encourage and require disclosures of information on de-listed banks. A second concern is that the regulator's ability to engage in moral suasion has weakened recently, so ended up losing control of several foreign-owned banks which were not amenable to following the authority's guidelines. At that time, there were some arguments against a sizable foreign bank presence in the sense that foreign banks could make it harder for the financial sector to play its public role that sometimes requires the taking of actions counter to their own private interests. The FSS, thus, 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, in a bid to strengthen its ability to affect the intentions of foreign-owned bank management. A third concern is that the arising of significant resistance to foreign investors such as private equity funds concentrating on short-term investment, in the Korean banking sector. A consensus thus reached on the issue is that where soliciting foreign bidders is the only option, the government should seek to attract long-term strategic buyers such as globally competitive banks, rather than foreign private equity funds. In December 2004, moreover, the Korean government launched locally-funded private equity funds (PEFs), aiming to compete with foreign investors. A recommendation has also been made that the supervisors should strengthen the economic needs test for foreign bidders.

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