KOREA

BANKING

SUMMARY

Korea became entangled in the Asian economic crisis in late 1997 and is currently implementing broad-based reforms of its economic and financial system in cooperation with the International Monetary Fund (IMF), the World Bank, and the Asian Development Bank. These reforms include substantial liberalization of the capital markets, well beyond commitments undertaken when Korea joined the Organization for Economic Cooperation and Development in 1996. Existing restrictions on foreign investment in Korea have been largely dismantled.

As part of the economic reform program, the government has committed to a fundamental overhaul of its weak and noncompetitive financial system. The prudential regulatory framework is being strengthened. Bank and other financial institutions are now expected to operate in a more open and transparent, as well as financially sound manner. The reform process is still underway, but already a large number of merchant banks have been closed, several of Korea's largest commercial banks have effectively been taken over by the government and five commercial banks have been taken over by five more healthy banks. Nonetheless, the entire financial sector continues to face many problems, including a growing portfolio of nonperforming loans.

The entire financial sector regulatory structure has been changed. Supervisory authority over the banking, securities, and insurance sector has been consolidated into the newly created Financial Supervisory Commission (FSC), which is also in charge of financial system restructuring. The FSC is also in the process of designing improved prudential standards. The FSC reports directly to the Prime Minister and has been given a broad mandate over the operations of the financial sector.

Despite improvements, foreign banks operating in Korea continue to face competitive barriers. The major problem continues to be the requirement to consider local branch rather than parent company capital. This affects foreign banks' funding and lending operations. Restrictions on foreign exchange flows continue, though the government is now in the process of drafting a complete revision of the Foreign Exchange Law and considerable liberalization is anticipated. Foreign banks are now allowed to set up subsidiaries in Korea. Restrictions on foreign investment have been substantially liberalized and restrictions on foreign ownership of land have been completely removed. Hostile and friendly mergers and acquisitions, including of financial institutions, are now allowed.

DESCRIPTION OF THE MARKET

Structure of the Market

The banking system in Korea is in the process of a fundamental restructuring program that began in late 1997 when Korea turned to the international community for assistance. The Korean government has committed to a thorough reform of its financial system and to make that system more open and transparent. Korea has had a long tradition of government control of the financial sector, using directed credit and preferential interest rates to promote key industries. Under the conditions of the IMF program, the government is to have ceased this activity. Financial institutions are expected to replace government direction with prudent credit standards and proper risk management. As a result of past poor credit decisions, the collapse of several major corporate groups during 1997 left a number of domestic banks in very weak condition. This situation worsened following the late 1997 financial crisis as banks were faced with severe liquidity problems. Meanwhile, the level of banks' nonperforming loans continued to grow. The government is implementing, in coordination with its international donors, a full-scale reform plan designed to bring the entire financial system back to economic health and to ensure that the system operations in a market-oriented, prudential manner in the future.

Until June 1998, the domestic banking system in Korea was composed of 26 domestic commercial banks (16 nationwide banks, 10 regional banks) and four specialized banks. At the end of June 1998, the FSC ordered five weak, smaller commercial banks to be taken over by five larger commercial banks. As financial restructuring continues, additional changes are expected to take place in the number of domestic banks.

Commercial banks continue to play a significant role in Korea's banking system. Assets of the nationwide commercial banks totaled approximately 539 trillion won (US$318 billion) at the end of 1997. Banks in Korea tend to focus on short-term lending. Nationwide domestic commercial banks have traditionally been subjected to hands-on government involvement in their operations. The government continued to play a major role in the selection of bank presidents as late as 1997, though it now says this practice has ceased. The smaller regional banks are oriented more towards serving small- and medium-sized businesses in their respective provinces. Each has branches in Seoul and additional branches in their provinces. Banks have grown conservative in their lending practices in order to avoid additional damage to their own balance sheets.

The specialized banks have operated beyond their original purpose, which was to supply credit to sectors where it was insufficient. They are subject to many of the same controls as commercial banks, but have the advantage of being able to borrow directly from the government and to issue debentures. They have recently expanded into commercial banking as well and deposits represent a major source of funds. The specialized banks' assets amounted to approximately 86 trillion won (US$51 billion) at the end of 1997.

Nonbank financial institutions (NBFIs) represent a noteworthy portion of in Korea's financial system, representing by some accounts about one-third of total financial system assets. The Bank of Korea classifies the following as NBFIs: three development banks (the Korea Development Bank, the Export Import Bank of Korea, and the Korea Long-Term Credit Bank), 31 investment trust companies, 30 merchant banks (almost half have been closed by the authorities), 31 life insurance companies and more than 4,000 savings institutions. In the past, NBFIs have in general been more loosely supervised by the regulatory authorities. This is expected to change with consolidation of supervision under the FSC. The role of NBFIs in the future is unclear, as many are in financially worse shape than the commercial banks – some, particularly among the merchant banks, have already been closed and others may follow.

Regulatory Structure

The regulatory framework for the financial sector has completely changed following the economic crisis. Legislation passed by the National Assembly in December 1997 established the FSC, which reports to the Prime Minister. The legislation consolidated regulation of the entire financial system under the FSC and its regulatory arm, the Financial Supervisory Service (FSS). The FSC came into being on April 1, 1998.

On January 1, 1999, the four existing regulatory bodies covering banking, securities, insurance, and nonbank financial institutions are scheduled to be fully integrated into the FSS. The legislation creating the FSC in theory allows it considerable autonomy in its decision-making and regulatory authority. The FSC is taking the lead in financial system reform and is also designing prudential standards to guide the regulatory authorities under its jurisdiction. The Bank of Korea and the Ministry of Finance and the Economy continue to play important roles in the formulation and administration of monetary and credit policy.

U.S. PRESENCE IN THE MARKET

Fifty-three foreign banks from 16 different countries have a total of 69 branches in Korea. Most have tended to specialize in wholesale banking. Total assets of foreign banks amounted to 46 trillion won (US$27 billion) at the end of 1997, or about 8.5 percent of total assets held by deposit money banks (commercial nationwide domestic banks, and foreign banks). Foreign banks also operate 24 representative offices.

The 12 U.S. banks operating in Korea have a total of 23 branches. Total assets are approximately 11.3 trillion won (US$6.7 billion), or approximately 2 percent of total assets of deposit money banks. One U.S. bank has a representative office in Korea. Another U.S. bank also has a non-controlling interest in KorAm bank, a joint venture with Korean investors. U. S. banks also have interests in

nonbank subsidiaries or affiliates which include a leasing company, merchant banks, and a credit card company.

TREATMENT OF U.S. FINANCIAL INSTITUTIONS

In its early economic development, Korea needed foreign exchange for its export-led economy and to support its companies in their overseas activities. As a key source of foreign exchange, foreign banks were given relatively favorable treatment compared to domestic banks in some areas. As Korea began to register current account surpluses in the mid-1980s, these preferences were eliminated and other aspects of Korean banking regulation and policy which favored domestic banks impacted on foreign banks' ability to lend in local currency and hence to serve their customers' needs. While some of the restrictions on foreign banks have been removed or reduced, foreign banks still have a smaller presence in the Korean market than they did prior to the 1980s.

A major impediment inhibiting the ability of foreign banks to compete in Korea is the Korean government's continuing use of local branch capital as the benchmark for determining a variety of funding and lending limits. Korea requires foreign branches to be separately capitalized and other regulations are based on local branch capital. For example, a foreign bank's prudential lending limits are based on its branch capital as opposed to its total capital, which will undoubtedly be much higher. While the Korean government has argued that this treatment is necessary for prudential regulatory reasons, it differs from that in the United States and most other industrialized countries which base prudential limits on the worldwide capital of a foreign branch's parent bank. Although domestic banks are also subject to limits based on the size of capital, the "capital" employed in their case is the entire bank's capital.

One area of bank operations which is affected by using branch rather than parent firm's capital as the benchmark are the single customer loan limits. The single customer loan limits further constrain bank lending practices because of government-imposed limits on loans to companies in the largest business groups and policy-based lending requirements to small-and medium-sized enterprises. Domestic banks also face the same restrictions but have the kind of broader branch coverage and local lending expertise to undertake this lending on a more prudent basis. The Korean government believes that the single customer loan limit (45 percent of a bank's equity) is necessary for prudential reasons and is discussing with the IMF lowering the limit to 25 percent. The branch capital limits also affect foreign bank activity in the forward foreign exchange market through overbought/oversold limits.

While foreign exchange regulations have been liberalized over the past four years and the government is now undertaking a full-scale revision of the Foreign Exchange Law, tight controls on the introduction of new financial instruments, an area where foreign banks would be particularly competitive, remain in place. Previous restrictions on foreign capital inflows have been removed.

Foreign banks are also disadvantaged in access to local currency funding. The use of swap lines has been a major source of local currency funding for foreign banks and earlier efforts by the government to limit the use of swap lines were major issues in financial policy talks between Korea and the U.S. in the early 1990s. As a result of the economic crisis, the Korean government has increased swap lines in order to generate needed foreign exchange. In July 1998, position limits were abolished for foreign exchange swap lines. However, the Korean government has not committed to maintaining this less restrictive stance once the crisis is over. The interbank money market remains underdeveloped. It is dominated by Korean banks and foreign banks do not consider it a reliable source of funding, especially during periods of tight market liquidity.

Effective March 1998, foreign banks are allowed to set up subsidiaries in Korea. Effective June 26, 1998, the government removed all restrictions on land ownership by foreigners. Foreign financial institutions are now allowed to participate in non-hostile and hostile mergers and acquisitions of domestic financial institutions. In the aftermath of the economic crisis, the Korean government has been encouraging increased foreign investment in the financial sector.

The United States and Korea began negotiations in July 1998 on a bilateral investment treaty (BIT). The BIT may contain reciprocal commitments with respect to national treatment and most favored nation treatment on and after establishment in financial services. Negotiations continue between the two governments, with a third round of talks scheduled for mid-November 1998.

As part of an overall financial sector program agreed upon with the IMF, Korea has gone considerably beyond its GATS commitments in the banking sector. The Korean government has agreed to bind all financial market opening commitments made in the OECD accession process in the WTO, a step it was unwilling to take during the WTO financial services talks. Restrictions on foreign bank subsidiaries were removed. Foreign banks are now allowed to acquire Korean banks and restrictions on land ownership have been removed.

Exchange Rate Used:

1997 end-of-period	1,695 Won/US$