Capital market overhaul

Seoul advised to seek a balance between growth, risk in fostering IBs

FSC Chairman
Kim Seok-dong

"Since the country has descended from nomads, I don't think we (Korean firms) will stay only in the Korean Peninsula. To that end (in support of the move), we need large global IBs."

"It is important to shield deposit-taking institutions from the potential excesses of investment banking, trading, and other similar activities."

Wharton School professor
Mauro F. Guillen

Analysis

By Kim Jae-kyoung

Last Tuesday, Seoul took a long-awaited, bold step toward upgrading the domestic capital market by announcing a plan to loosen regulations on the creation of homegrown investment banks (IBs), which many believe will pave the way for local securities companies to be competitive players in the global market.

The move by the Financial Services Commission (FSC), the nation's top financial regulator, came as part of its revision to the capital market law aimed at countering changes in the global financial environment following the 2008 financial crisis and bolstering the local capital market.

Under the revision, which is subject to approval by the National Assembly in October, brokerages with an equity capital of over 3 trillion won ($2.8 billion) will be allowed to become IBs. The average equity capital of the country's top five brokerages — Daewoo, Woori, Samsung, Korea and Hyundai — came to 2.7 trillion won in March, only one-thirtieth of that of Goldman Sachs Group.

On top of that, the FSC also decided to allow the establishment of an alternative trading system (ATS) in a bid to cut trading costs, increase investment options for investors and reinforce the competitiveness of the Korea Exchange. The revision also calls for tougher regulations on derivatives trading and abolition of shadow voting.

Over the past few months, FSC Chairman Kim Seok-dong has repeatedly shown his will to boost the domestic market by creating homegrown IBs, saying, "Since the country has descended from nomads, I don't think we (Korean firms) will stay only on the Korean Peninsula. To that end (in support of the move), we need large global IBs to finance (overseas major projects)."

Fostering homegrown IBs

The core of the revision unveiled last week is the government's move toward creating Goldman Sachs-style IBs and tightening controls over risky trading, including derivatives, such as futures and options.

Many global experts and analysts are in favor of the Korean regulator's ideas but they point out that it is important to put those ideas into action in a very sophisticated manner to avoid unwanted outcomes since some of the ideas are contradictory.

They claimed that it is time for local securities firms to focus more on capital market-related activities and international business than on the traditional brokerage business.

"In order for Korea's securities companies to compete with global players, local brokerages need to change its brokerage operation model, extending its portfolio in various ways, including IB, wealth management and proprietary trading," Bae Kyo-sik, Risk Management lead partner at Accenture Management Consulting, told Business Focus.

With the global financial crisis waning, for both regulators and local financial firms, the rationale and the urgency around the birth of global IBs are difficult to argue against. The domestic demand for financial services is very close to saturation. More importantly, the securities industry is behind in its global presence relative to the national economy's global status. In other words, they are capturing less than their natural share considering the opportunity potential.

> **W2.7 trillion**
> The average equity capital of Korea's top five brokerages
>
> **1/30**
> The average equity capital of Korea's top five securities firms to that of Goldman Sachs Group

"It is imperative that Korea creates its own domestic investment banking business. We are nearing the end of an era of cheap capital given the investment boom in emerging markets and a slowdown in OECD countries," McKinsey Global Institute (MGI) Director Richard Dobbs said.

"If Korea does not have a strong domestic corporate and investment banking industry, Korean companies will be disadvantaged in this world, particularly in relation to their Chinese peers. And Korea is not moving fast enough," he added.

Balance between growth, risk control

In the world of finance, there is a very popular principle: If you take more risks, you can get higher returns. However, the real lesson behind this principle is that if you take too much risk, chances are that you will get nothing in the end.

This simple phrase sends a very important message to the FSC that the regulator should maintain a delicate balance between market growth and risk controls to ensure success in its attempt to transform local brokerages into globally-competitive IBs.

In other words, if regulatory changes are too limited, it won't help local securities firms strengthen their competitive edge in the global market even if they handle IB-related activities. On other hand, if they loosen regulations too much, the market will be overexposed to risks.

"I think the most important thing to keep in mind is that if Korea (or any country) introduces regulations that are more limiting than those in other countries (like Hong Kong, the United States and Singapore), then investment banks won't do much business in Korea. But if the regulations are too lax, then Korea could be attracting risky businesses," Mauro F. Guillen, director of Lauder Institute at the Wharton School, said.

For regulators, it is important to recognize that regulatory controls should be a balance between growth and acceptable risk and not err on the side of excessive restrictions to eliminate risk from the system which will surely eliminate growth as well.

In this regard, the FSC should take a more cautious approach in controlling derivatives under the new law to ensure growth and development of the domestic capital market.

In a recent interview, Woori Investment & Securities CEO Hwang Sung-ho said that seeking to address excesses with proper regulations is right, but there is also a clear need to ensure that regulations do not constrain the broadening and deepening of financial markets, nor the utilization of a range of financial products, including derivatives.

"In order to foster the capital market, it is essential to develop the derivatives market, not only for stock index futures but also future contracts or options. It is important to let investors make their decisions to seek gains and set market prices," said Hwang.

Market experts point out that the FSC's decision to limit the birth of IBs only to securities companies is on the right track.

"(On the market reform,) the other thing I would emphasize is that it is important to shield deposit-taking institutions from the potential excesses of investment banking, trading, and other similar activities. It is important to preserve the commercial banking system," Guillen of the Wharton School said.

Opposition there

However, some analysts say that the move to create large IBs is a step in the wrong direction, citing failure cases during the 1997-1998 currency fiasco and the 2007-2008 financial crisis.

"The creation of large investment banks sounds potentially risky to me. People must have forgotten the crisis of 1998. Investment banks should be small and non-systemic," Moritz Schularick, an economics and economic history professor at the Free University of Berlin, said.

One senior partner from a global consulting firm also said on condition of anonymity, "I am not sure if you have to be a global player in corporate investment banking. Korean financial firms have avoided the worst and they have not been part of the crisis as they did not buy toxic assets."

"I've seen many second-tier banks in Europe trying to be global players in IB but they are now in deep trouble. I mean those European players recruited a lot of people from other banks and built strong trading activities, and then they failed miserably, and lost a lot of money," the New York-based consultant said. "So I think sticking to what you do well is much better than trying to expand without knowing the risks."

kjk@koreatimes.co.kr

MGI Director
Richard Dobbs

"If Korea does not have a strong domestic investment banking industry, Korean firms will be disadvantaged in this world, in particular in relation to their Chinese peers."

"I am not sure if you have to be a global player in investment banking...sticking what you do well is better than trying to expand without knowing the risks."

A New York-based
global consultant

Stock picks

BUY: CJ O Shopping

● CJ O Shopping is a cable and Internet shopping network. It has successfully launched a cable channel in Vietnam in July and its Chinese business is also prospering, said Korea Investment & Securities. Considering its growth potential, the brokerage believes the retail company is worth 350,000 won per share. Friday's closing price was 282,500 won.

It is the only major retail company in Korea that keeps growing in overseas markets, the report said. Sales volume in Korea is also expected to grow by 25 percent this year and the operating profit by around 15 percent, it said.

CJ O Shopping is a subsidiary of CJ Group. It was formerly called CJ Home Shopping but the name was changed in 2009. The "O" represents many things, such as "okay," "online," "on-air," "optimum," and "omnipresent," according to the company.

BUY: POSCO

● POSCO started the construction of an integrated steel mill in Indonesia in a joint venture with Krakatau, a local steel maker. Production will begin in 2014 and the firm hopes to reach the breakeven point before 2016.

Daewoo Securities said that the Indonesia venture is especially attractive because of a five-year corporate tax exemption, which was given because Krakatau is a government entity.

There's already a shortage of steel supply in Indonesia. Domestic producers meet only 3.7 million out of 8.5 million tons required in the country and the demand is expected to increase as the manufacturing industry starts to burgeon. Daewoo's analysts say that Indonesia's population of 230 million will provide cheap labor and facilitate the growth of the industry.

Another advantage of producing steel in Indonesia is that it is abundant with raw materials — iron ore and high-quality coal. In steel production, raw material accounts for 70 percent of the total cost, Daewoo says. About 30 to 40 percent of the ore and 100 percent of coal will be supplied from local mines.

Target price is 610,000 won. Friday's closing price was 463,000 won.

SELL: Asiana Airlines

Source: Korea Exchange

● Shares of Asiana Airlines fell by 7.8 percent since Thursday morning when one of its cargo planes crashed into the sea near Jeju Island. So there was no surprise when Korea Investment & Securities withdrew its buy recommendation on the nation's second largest airline, citing "risk management."

Asiana has 10 cargo planes, including the one lost on Thursday. Combined, the fleet made up 26 percent of the firm's revenue last year, which means that the loss of the plane could lead to around 2 or 3 percent loss in revenue.

In addition, the lost plane and cargos would cost them around 200 billion won in asset value, which amounts to 3.4 percent of its total asset. Of course, much of the damage would be covered by insurance but the real impact of the incident is still unclear. The firm only identified that there was fire in the plane's cargo section so further investigations will decide how much insurance premium it will have to pay in the future for every flight.

Compiled by Cho Jin-seo and Lee Sun-kyo