Why Not Global Korean Banks?


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While the South Korean industrial firms continue to make headlines around the world as efficient producers, marketing powerhouses, and technology leaders, the service sector continues to be relatively embattled in its domestic market.

Banking in particular is an area in which Korean companies do not seem to be on the leading edge.

The magazine The Banker publishes every year a ranking of the world's 1,000 top banks. In 2006 only 13 banks from South Korea made it onto the list.

That's a far cry from Germany's 96, Spain's 46, Italy's 37, Taiwan's 17 or Brazil's 16. Even a country as tiny as Austria has more top 1,000 banks than Korea. In spite of its relatively underdeveloped financial system, China had 25 on the ranking.

The world's largest bank, Citigroup, is eight times bigger than the largest Korean bank. In many countries in Europe and the Americas banks dominate the corporate landscape or are active participants in it.

The stock market holds its breadth when they announce earnings. The very health of the economy is often measured against the fortunes of the banks because financial services account for an important share of market capitalization and GDP.

Not so in many Asian countries, especially South Korea. Banking has typically been seen by Korean policymakers and business people as an activity that supports manufacturing and agriculture, and not as a business in itself.

Historically, South Korean banks were subordinated to the role of channeling funds to dynamic industrial activities, often at the request of the government.

For over two decades, the banking system was completely state-owned. Although financial services were liberalized beginning in 1988, the banks have had trouble developing a personality of their own.

The largest Korean bank is not even within the top 50 in the world. It has become readily apparent that the relative underdevelopment of Korean banks will limit the economy's future growth.

It is important to note that the largest banks in the world are so big not because they dominate their domestic market, but rather because they have grown internationally.

> *"In the case of banking, by far the worst mistake has been to view it as a subordinate activity without the capacity of generating added value on its own."*

Some banks generate more than half of their business outside of their home country.

This essentially means that commercial, wholesale and, especially, investment banking are activities that can be undertaken in multiple markets by the same corporate entity, as long as it possesses certain advantages that enables it to compete better than local banks. Such advantages may have to do with technology, marketing or managerial skill.

The numerical weakness of South Korean banks in the global rankings is puzzling. The largest banks have a cost-to-income ratio of 53 percent, which is lower than the average for Asia and for the world as a whole, according to The Banker.

Moreover, South Korean banks have had a head start with the export-import finance business given the international competitiveness of Korean manufacturing firms.

The fact that there are major communities of overseas Koreans in Asia and in the United States should also provide some basis for the expansion of Korean banks.

Most importantly, Korean universities produce high-quality graduates versed in finance. And the country enjoys one of the highest savings rates in the world. The ingredients for a competitive banking sector are certainly present in Korea.

It seems obvious that banking could become a major source of growth for the South Korean economy.

Time to Generate Added Value

It must be kept in mind that banks generate a large number of jobs, many of which are highly qualified.

Moreover, they have the potential of contributing to the growth of other parts of the economy if they offer better and more sophisticated savings and lending products.

We have seen a bit of this effect in South Korea with the recent expansion in consumer credit, which has fueled growth induced by enhancing domestic demand.

Moreover, banks all over the world have become very sophisticated at what they do, especially in terms of information systems, treasury management, and marketing. Productivity in the sector has grown quickly as well.

In the aftermath of the 1997 crisis several well-known foreign banks and financial institutions made partial acquisitions in Korea. Some may see this as an unwelcome trend.

However, it could eventually result in a faster modernization of the domestic banking system. Further mergers could also lead to larger, even more efficient banks. Also important have been the changes in terms of the internal management of the banks.

Risk assessment techniques have improved, and the marketing of new products and services is now much more sophisticated than it used to be. It is important to make banks compete with each other.

Who owns banks does not matter as much as whether the sector's competitive structure encourages competition or not. The more competition, the more likely banks will become stronger and, hopefully, more internationally visible.

Perhaps the most important issue facing the Korean economy is to make the transition from manufacturing to services. The three other large exporters of manufactured goods — China, Japan and Germany — have also encountered many problems developing globally competitive service sectors.

Gone are the days when people considered that a large proportion of the service sector was a natural monopoly and that it could not participate in foreign trade or investment.

Technological change, deregulation, privatization, and liberalization have enhanced the global nature of telecommunications, electricity, water, gas distribution, and banking. South Korea seems to be facing similar difficulties.

In the case of banking, by far the worst mistake has been to view it as a subordinate activity without the capacity of generating added value on its own.

Asia in general is clearly falling behind other parts of the world in this respect, a trend that stands in stark contrast with the awesome power of its manufacturing firms. The time has come to reverse the situation.

Capital Market Act Catalyst for Growth of Financial Market

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The recent financial market shock from China was huge and the aftershock is still being observed around the globe.

The global financial market shake up following the Asian sell off may continue for some time. This incident shows that our globe is a big, networked community and no single market can stand in isolation from the rest of the world.

Some analysts view the China shock as a sign of a long-awaited correction. Some are even predicting that global equity markets will experience an extended decline in share prices.

Such over-valuation may be common in Asian markets such as Vietnam and India, among others. During the past couple of years, the stock markets in these countries have been extremely hot.

At the same time, these countries have experienced dramatic increases in domestic savings, most of which have been used to buy U.S. Treasury securities. The excess savings of Asian countries have been thus supporting domestic consumption in the United States.

The global imbalance has another ramification. Private equity investors mainly from the U.S. market have gathered funds from the United States to invest in equity securities in these Asian nations.

Asian savers earned about a 4 percent to 5 percent rate of return, while private equity investors make an annual expected return of about 25 percent. The premium of roughly 20 percent is the profit that goes into the pocket of U.S. private equity investors such as Blackstone, Carlyle Group, KKR and Lone Star, among others.

Of course, some of the 20 percent premium is the premium for the risk involved in investing in these risky securities. However, the size of the premium is too large to be justified as risk premium only.

The premium is rather a reflection of the reward given to professional private equity investors who have better risk management technology, a better governance structure, and a better legal and regulatory infrastructure than most Asian investors.

I would like to call them arbitragers as they earn 20 percent more than Asian investors on equities originating in Asia simply because of this.

Lately, Asian regulators and policy makers have come to realize that much of the premium could be earned by Asian investors if the market infrastructure in their markets is further developed to achieve better investor protection, better risk management, and better corporate governance practices.

One of the examples is the proposed legislation of the "Capital Market and Investment Services Act," commonly known as the Capital Market Consolidation Act.

Ther are major thrusts in this proposed legislation. First, any financial product, which meets basic economic properties specified in the Act, is recognized as an investment product.

More specifically, an investment product is a financial product with a risk of principal loss. A derivative is a product that is subject to the risk of losing more than the principal amount of investment.

The Act will no longer list all the securities and derivatives. The so-called "negative list" method replaces the old "positive list," method of defining an investment product.

Under the proposed law, financial products that carry no risk of principal loss, e.g., bank deposits and life insurance products are not investment products. But everything else is and subject to the proposed law.

This change implies that there will be an astronomical increase in new kinds of investment products. Moreover, financial derivatives can be written not only on financial asset prices but also on any quantifiable indices such as weather and pollution.

This sets the stage for financial innovation that helps develop creative derivatives and complex financial instruments.

Secondly, the new law allows various investment services and products to be provided by a single firm, called a "financial investment company." This company can handle under one roof such investment services as investment banking, brokerage deals, collective investment, investment advice and wealth management.

A firewall between any two or more investment services is still required to limit adverse consequences of potential conflicts of interest.

A securities firm will, under the new law, be able to achieve synergy by becoming a one-stop financial shopping center to attract customers who want multiple financial services from a single provider.

Scope economies through cross selling financial services will also be possible by sharing customer credit information.

The proposed law will help financial investment companies to increase their profitability and size to become globally competitive investment banks (IBs).

Thirdly, the regulatory framework will be changed from institutional regulation to functional regulation.

This will eliminate regulatory gaps and lapses when regulating the same function offered by different types of institutions. Regulatory uncertainty for investment services companies will also decline.

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