THE KOREAN BANKING INDUSTRY

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The financial environment both inside and outside of Korea has been undergoing significant changes as of late. With the breakdown of the Communist bloc and the subsequent rapid integration of the world economy, the international financial market is also being rapidly integrated. Additionally, liberalization, universalization, securitization of the financial industry have been spreading on a global scale after the 1980s. Domestically, from the start of the 1990s, the financial reform process has been broadened and accelerated to increase financial efficiency and strengthen the competitiveness of financial institutions, while the domestic financial market is also being opened at a rapid speed with Korea's admission to the OECD. All of these changes have resulted in borderless and unlimited competition among the foreign and domestic financial institutions.

History of the Korean Financial System

The framework of the modern banking system was set with the establishment of the Bank of Korea and commercial banks in the 1950s. Specialized banks were added to strengthen financial support for economic development in the 1960s. As the economy grew larger and more complex with the success of the government's series of five-year economic development plans, the government-led financial system proved to be less and less efficient. Thus from the early 1980s, a number of measures were taken for the liberalization and internationalization of the financial sector, including interest rate deregulation, the granting of greater managerial autonomy to financial institutions, the easing of restrictions on business scope and new entry, foreign exchange liberalization, and capital market opening, among others. As a result, the Korean financial system including the banking industry has undergone substantial modification during recent years in terms of its structure and function. But such reforms of the 1980s were not as effective as had been hoped because they were undertaken on a piecemeal basis without any overall vision of the financial system. From the turn of the decade, comprehensive financial reforms designed to promote the efficiency of the financial market and to strengthen the competitiveness of the domestic financial institutions were pursued more intensively with the announcement of a financial reform program for the five-year period from 1993 to 1997.

Characteristics of the Korean Banking Institutions[1]

Specialized banks: The specialized banks were established mostly during the 1960s to increase capital mobilization and to strengthen financial support for underdeveloped or strategically important sectors. They are, in principle, directed and supervised by the government and have been established to provide funds to particular sectors whose supply of funds through commercial banks was insufficient due to limited availability or low profitability. The specialized banks play a significant role in the Korean banking system as a whole. As of the end of June 1995, they held 26% of the assets, 29% of the deposits, and 34% of the loans and discounts outstanding of all deposit money banks in Korea. With the recent changes in the financial

1) *The Financial System in Korea,* The Bank of Korea, 1995

environment, however, they have expanded their business into commercial banking areas, although their share of funds allocation to their relevant sectors is still relatively high. Thus the importance of their original functions in their overall operations has declined. In accordance with this situation, some have changed their status from specialized banks to nationwide commercial banks. As of the end of June 1995, specialized banks had 1,735 domestic branches and offices, 10 overseas branches and representative offices, and 1 overseas subsidiary.

Commercial Banks : The commercial banks are banking institutions established and operated according to the provisions of the General Banking Act. They play an important role in the nation's financial markets, although their relative importance in the financial system has gradually decreased as non-bank financial institutions have expanded their areas of business. As of the end of June 1995, commercial banks accounted for 74% of the assets, 71% of the deposits, and 66% of the loans and discounts of all deposit money banks.

With the branch banking system with a nationwide or province-wide network, they have engaged to a certain extent in long-term financing in addition to the short-term banking operations traditionally associated with commercial banking. They still tend to depend heavily on borrowings from the Bank of Korea to cover persistent shortages in their own loanable funds, although the share of their total sources of funds has decreased. The ownership of any bank's stocks by a single shareholder has been restricted since 1982 to promote the managerial autonomy of banks while ensuring that the banks retain public accountability by preventing them from falling under the excessive influence of a few large shareholders. Currently, as a general rule, the ceiling on a single shareholder's ownership is limited to 4% of the total voting stock of a bank, except in the case of a joint venture or local bank.

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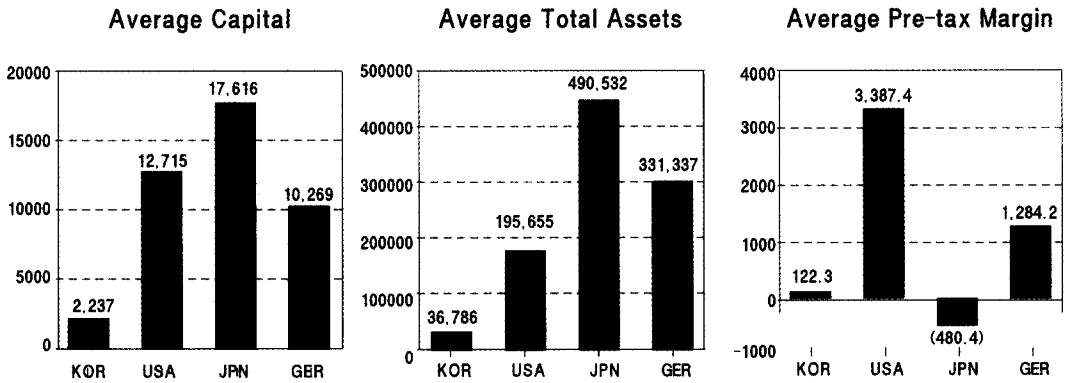
<Figure 1> The International Comparison of the Banks' Size(1995)

(per bank, US$ million)



Notes : Data are averages of each country's top 5 banks(by capital)
Source : "The Top 1000 World Banks," *The Banker*, 1996.7.

As of the end of June 1995, Korea's commercial banking system consisted of 15 nationwide commercial banks, 10 local banks and 71 branches of 52 foreign banks. At that time, the shares of the total deposits of commercial banks were 82% for nationwide commercial banks, 17% for local banks, and 1% for foreign banks while the shares in commercial banks' total loans and discounts were 79% for nationwide commercial banks, 17% for local banks, and 4% for foreign banks.

"Compared to Korean banks, the average asset size of the Japanese banks is 12 times as large, while that of the U.S. banks is 5 times."

Weak Competitiveness of the Commercial Banks

During the 30-year economic development process, the financial industry has generally been regarded as the means of financing manufacturing investments to support the nation's economic development. Thus, greater consideration has been placed on the industrial policy rather than the growth and the efficiency of the financial industry itself, which legitimated the intervention of the government in the financial industry with protective and regulatory measures. This made the financial market flooded with various types of small financial institutions through the regulation of entry and business areas, forcing them to take over a large scale of insolvent credits as a policy loan. In addition, the regulated financial institutions have been able to strengthen their monopolistic status gained through government intervention, which has resulted in a easy-going, loose management. As a result, the domestic financial market has greatly been distorted and the competitiveness of the domestic financial institutions has been weakened severely, although they have made rapid progress in terms of quantitative growth.

Compared with foreign developed banks, domestic commercial banks will be in a disadvantageous position in managing assets and funding after opening the domestic financial market because they are much inferior to the foreign developed ones in terms of the size of their assets and capital. Compared to Korean banks, the average asset size of the Japanese banks is 12 times as large, while that of the U.S. banks is 5 times. In addition, the profitability indicators of the domes-

<Table 1> Some Performance Indicators of the Domestic Banks(1995)

(million won, %)

	Productivity(Per capita)			Profitability		Stability
	total assets	total revenue	total net profit	ROA	ROE	capital asset ratio
nationwide banks	2,016	218.5	7.5	0.28	3.91	9.0
local banks	1,571	177.5	9.6	0.56	5.63	11.4
commercial banks	1,850	202.1	8.3	0.32	4.19	9.3

Source : *Statistics of Bank Management*, The Office of Bank Supervision, 1996 tic commercial banks have continuously decreased, although the productivity indicators have steadily increased from 1990 to 1995 due to the efforts to improve productivity by expanding their economic size and rationalizing their management. In particular, the ROE (Return On Equity) for domestic banks was 4.19% at the end of 1995, which was much lower than 7.0% for the foreign developed ones.

Market Opening and Restructuring

Foreign banks have already made good progress in advancing into the Korean financial market since first being allowed to open branches in 1967. As of the end of June 1995, 52 foreign banks had a business presence in Korea including 11 American, 14 Japanese, 3 British and 6 French banks. In all, there were 71 foreign bank branches and 23 foreign bank representative offices. This number will grow at an accelerated rate from 1997 to 1998 with Korea's admission to the OECD. In 1997, foreign banks will be allowed to become shareholders of the domestic banks and in 1998, they can establish their local juridical person. Once the bank industry is opened, the competition will be very fierce between the domestic and foreign banks, which will affect the restructuring process of the domestic financial industry.

By way of precaution against market opening and unlimited competition with the developed foreign financial institutions, comprehensive restructuring of the financial industry has been gradually implemented from 1993 onward to provide a finance environment in which domestic financial institutions may make progress by themselves as a independent industry and strengthen their competitiveness. Its main direction can be summarized as follows; to increase the managerial autonomy of the financial institutions, to adjust their business areas on the main axes of banking, securities and insurance, and to promote upsizing through M&As and specialization. But the present phase can hardly be expected to enhance noticeably the competitiveness of the domestic financial institutions, because it is based on the present framework of the financial industry, and too gradual to catch up with the global trends. The developed countries have already completed the structural adjustment of their own financial industries to lead their financial institutions to M&As for upsizing or specialization, and their phase of integration of the business areas is entering into "universal banking," pursuing the perfect removal of barriers among banking, securities and insurance. Therefore, it will be inevitable to broaden the scope and accelerate the speed of restructuring of the domestic financial industry in order to survive the unlimited competition after opening the financial market.

Conclusion

During the process of the economic development, the banking industry successfully accomplished its role of supporting the growth of the real sector. Now, though, it has recently become one of the main factors lowering the growth potential of the Korean economy under the rapidly-changing financial environment. The recent changes in the environment can be not only a threat but also an opportunity to develop the domestic financial market and strengthen the competitiveness of domestic financial institutions. Only earnest and thorough preparation will allow the domestic financial industry to support efficiently the real sector and develop itself as a independent promising industry in the 21st century. VIP

(Bum-Koo Kim)

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