FINANCIAL HOLDING COMPANY REFORMS AND POLICY SUGGESTIONS

Department of Financial Market Analysis

Introduction of financial holding companies

Through expansion of size and diversification of Korea's financial institutions, the competitiveness of the domestic financial industry will be bolstered. Larger size will allow financial holding companies to resolve the difficulties in harmonization within the organization, and help affiliates maintain professionalism. The formation of financial holding companies is unlikely to erode the profits of company affiliates, and it will prevent the problems of one affiliate from spreading to other affiliates.

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Stipulations of financial holding company bill

Financial holding companies must hold at least 50% of their subsidiaries' shares (30% for listed subsidiaries), and act purely as holding companies, taking care of management and auxiliary tasks.

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An individual can only own 4% of a bank holding company. This restriction holds only for companies specializing in finance, and non-bank holding companies are not subject to ownership restrictions. Financial holding companies are allowed to hold only 50% of an affiliate's shares, or 30% if the affiliate is listed on the stock market. While the formation of intermediate holding companies are allowed, a holding company must own 100% of its intermediate company's shares to prevent excessive expansion.

To avoid conflict between financial holding companies and small shareholders, a special procedure has been created that lets the holding company own 100% of its affiliate's shares. A share transfer system allows a financial company to trade all of its stocks for the stocks of a newly formed financial holding company, letting the financial company completely affiliate with the holding company. In addition, a share exchange system allows the shares of existing financial holding companies to be exchanged for all of the shares of a financial company. Also, a system of three-way merger has been introduced that lets a financial holding company merge with an affiliate and a third company. All three of these systems can be enacted through a special resolution at shareholders' meetings.

Financial holding companies are subject to several money raising and operation restrictions.

Financial holding companies are subject to several money raising and operation restrictions. The debt ratio of the holding company is restricted to 100% of capital. The holding company may invest in securities with its surplus capital, but can only hold 5% of another company's securities. Only financial holding companies that are controlled by bank holding companies and financial companies may own the shares of non-financial companies. In this case, the financial holding company's voting rights are limited.

Measures to prevent double taxation have been created and conditions for listing on the stock market have been loosened. To prevent double taxation on dividends that financial holding companies receive from their affiliates and the dividends received by the holding company's shareholders, tax deductions for shareholder dividends will be appended to the tax laws. To allow financial holding companies to raise capital easily, they will be permitted to list themselves on the stock market as soon as they are formed.

Evaluation of the system

The main problems of the financial holding company system are its ownership limitations and strict regulations on debt ratios.

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Basically, financial holding companies are being used as a means of financial restructuring. The main priority of introducing financial holding companies was to improve the competitiveness of the banking sector, and for entry into the non-banking sector, the existing "subsidiary" or "business holding company" systems are adequate.

The distinction between banks and non-bank holding companies may become a hinderance to one of the main objectives of financial holding companies, which is industry diversification. Therefore, this separation may actually be a step backward from global trends such as diversification, and decrease competitiveness, while slowing the process of mergers between firms in different industries.

Loss of the double leverage effect[1] has been caused by the restriction of financial holding company debt ratios to 100% and the 100% ceiling on subsidiary contributions. Currently, the US and other advanced countries have recognized that such a double leverage effect exists for financial holding companies, However, the Korean government argues that the 100% restriction is needed to curb holding companies from excessive expansion and to maintain financial stability.

Under the current tax system, regular financial companies transforming into financial holding companies may actually face more taxation. So there is the need for a connected tax payment system, and analysts concur that such a system is unavoidable in the long run. However, the government is currently skeptical about the system because it may bring lower tax revenues and may be abused by large corporations as a means to avoid taxes.

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Individual ownership of bank financial holding companies is limited to 4%. Created with the intent of blocking industrial capital from controlling the financial sector, the 4% restriction has side effects such as making it difficult for the financial holding companies to procure capital and lowering management accountability. In addition, Koreans may be receiving unfair discrimination under the restriction, which does not apply to foreigners. Therefore, although many analysts predicted that the financial holding company law would greatly relieve regulations on ownership, the government has kept the individual ownership limit at 4% and has delayed discussion of the issue to the next revision of banking laws.

Improving the system

The laws for financial holding companies, which are currently classified into bank and non-bank holding companies, should be gradually reformed in the mid to long term. In the short term, while the banking sector's ownership requirements and the existing division of bank and non-bank holding companies are maintained, the system's effectiveness should be increased by loosening ownership limitations or debt ratio ceilings.

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In the mid to long term, barriers between bank and non-bank holding companies

1) The double leverage effect occurs when both the holding company and a subsidiary use loans or other external capital as leverage to raise the profitability of internal capital.

should be lowered, ownership limitations for companies specializing in finance should be further relaxed, and loosening of ownership limitations to help the disaffiliation of financial companies that originated from non-financial conglomerates should be considered.

Regulations should have real effects rather than arbitrarily relying on debt ratios or affiliate ownership ratios.

In introducing financial holding companies, one should first consider the practical effects. Regulations should have real effects rather than arbitrarily relying on debt ratios or affiliate ownership ratios. Korean financial holding companies should keep pace with world trends such as the increasing size and diversification of banks to maintain competitiveness. Financial holding companies will not fulfill their original intent if they are merely used as a tool for financial restructuring. In the long term, to prepare for the unification of offline and online business and the combination of finance and industry, policymakers should explore a holding company in which the two sectors are combined. In addition, financial holding companies should be allowed relatively free organization to help improve management and boost efficiency.

The minimum share ownership ratio on a holding company's establishment should be loosened to 20% for listed firms and 40% for unlisted firms.

The present 50% mandatory ownership ratio of holding companies for subsidiaries (30% for listed subsidiaries) will be a considerable burden on financial institutions. Banks, securities firms, and insurance firms have a very large capital base and a high dispersion of share ownership, which will make it very difficult for holding companies to meet this requirement. Therefore, the minimum share ownership ratio on a holding company's establishment should be loosened to 20% for listed firms and 40% for unlisted firms, and a two year period should be allowed during which the holding company can raise its ownership to meet the requirement.

To stimulate the formation of financial holding companies, a connected taxation system is needed. 18 OECD countries have adopted a connected taxation system, and a recent survey by the Korea Chamber of Commerce and Industry showed that 73.7% of respondents desired such a system. In as far as the system can be a strong incentive for financial firms to transform into financial holding companies, policymakers should examine a connected taxation system in a favorable light.

To prevent an affiliate's problems from spreading to other affiliates, barriers between affiliates should be erected. However, these barriers should not be so great that they dampen the synergy between affiliates. VIP