

The Financial Reform and Mutual Fund Industry in Korea

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Korean economy has developed rapidly during the last several decades. We do not believe that the economy may grow with that speed in the near future. In a sense, it is experiencing a kind of growth pain. Korean capital market is evolving and will face a major restructuring in the near future. Korea sets up a new system including the Capital Market Consolidation Act. Korea intends open new sophisticated Capital market to activate the economy. The result matches with other previous studies mentioning fund returns below the market average. Of course, the equity fund performances were better than the Treasury bond return. The results were almost the same even when we employ various fund performance evaluation measures.

Field of Research: Korean Capital Markets, Mutual Fund Industry

I. Introduction

Korean economy has grown rapidly during the last several decades. Korea's GDP has increased from just us\$2 billion in 1962 to approximately us\$800 billion in 2006. The GNI has also increased from us\$87 to over us\$18,372 in 2006. Moreover, exports climbed from us\$2 billion to us\$325 billion, and foreign exchange reserve increased from us\$166.80 million to us\$238.96 billion during the same period. The development of the Korean economy has begun with the economic development plans and industrialization in 1960's. Foreign capital played a vital role for the development process because Korea had not accumulated domestic capital to finance the development plan. In 1970's, Korea excelled the economic development performing the average annual growth rate of 9%. The pace of the economic growth continued until the Asian financial crisis in late-1990. The economy needed structural changes, however, it was not able to accomplish the structural reform before it faced the financial crisis. The Korean financial crisis was triggered by a shortage of foreign exchange reserve, though the underlying cause can be traced to a deeply-rooted structural weakness in the economy. The financial crisis followed by a series of events; excessive external debt to cover the current account deficit, the external debt relied heavily on short-term borrowings, which led to a sizeable supply-demand mismatch in the domestic foreign exchange market.

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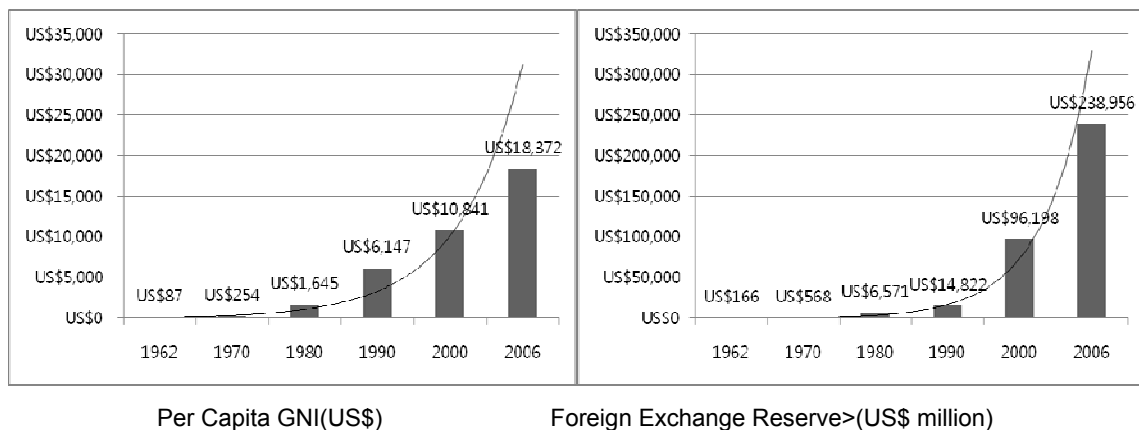
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Table 1. Key Economic Indicators

Category		1962	1970	1980	1990	2000	2006
Per Capita GNI	US\$	87	254	1,645	6,147	10,841	18,372
GDP Growth Rate	%	2.1	8.8	-2.7	9.5	8.5	5.0
Foreign Exchange Reserve	US\$ mill	166	568	6,571	14,822	96,198	238,956
Gross Savings Ratio	%	11.0	18.1	23.2	35.9	33.7	31.4

Source: Bank of Korea

Figure 1.



The Korean government led the structural reform of the economic sectors including financial, corporate and labor sectors. The government also accelerated the liberalization and globalization in trade and in capital markets. The structural reform five objectives: increased management transparency; capital structure improvements; abolition of cross-payment guarantees; selection of core sectors among various enterprises; and increased accountability of major shareholders and management.

Through the painful reform efforts, Korean economy has successfully recovered from the financial crisis. The economy turned around and it is now on the track of growth trend. However, the Korean economy also needs to solve some problems; the widening gap between strong exports and sluggish domestic demand; the increased

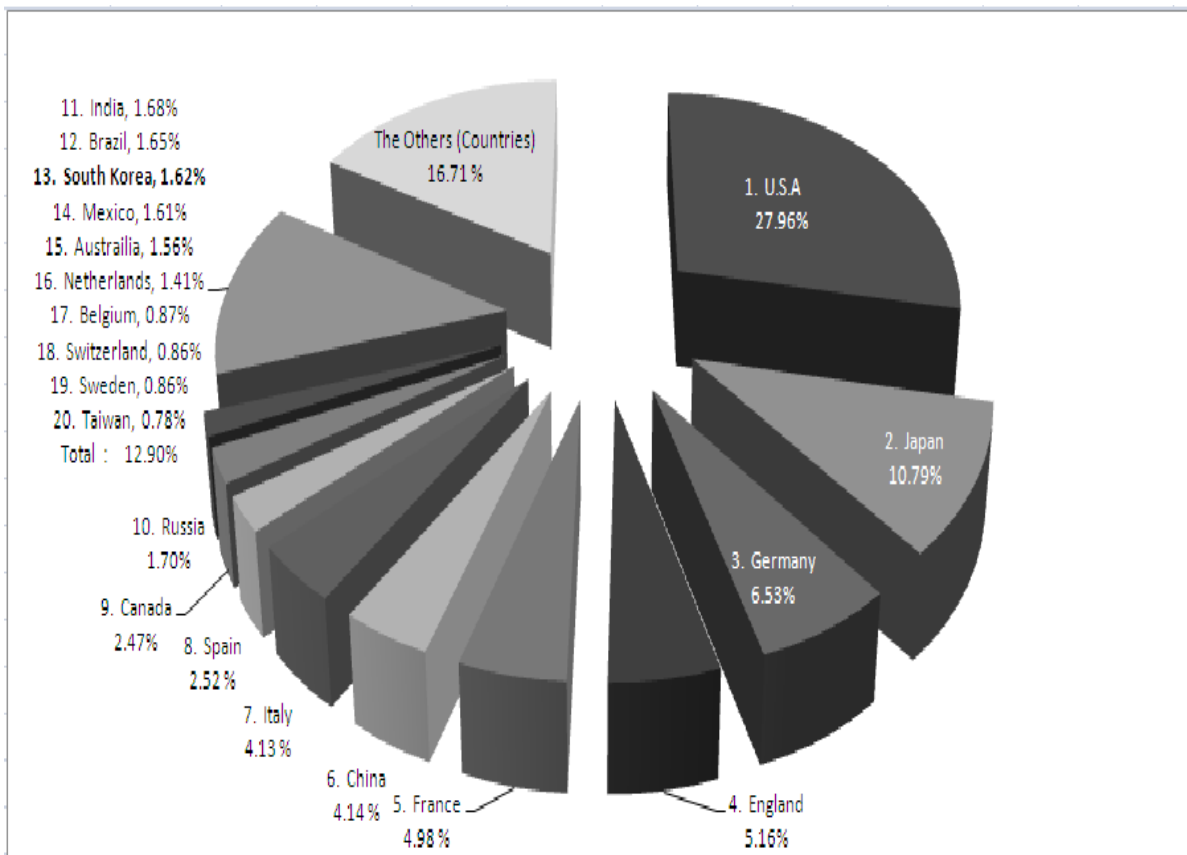
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risk in various economic sectors; the resolution of labor-management conflicts; the stabilization of real estate prices.

2. Korean Capital Markets

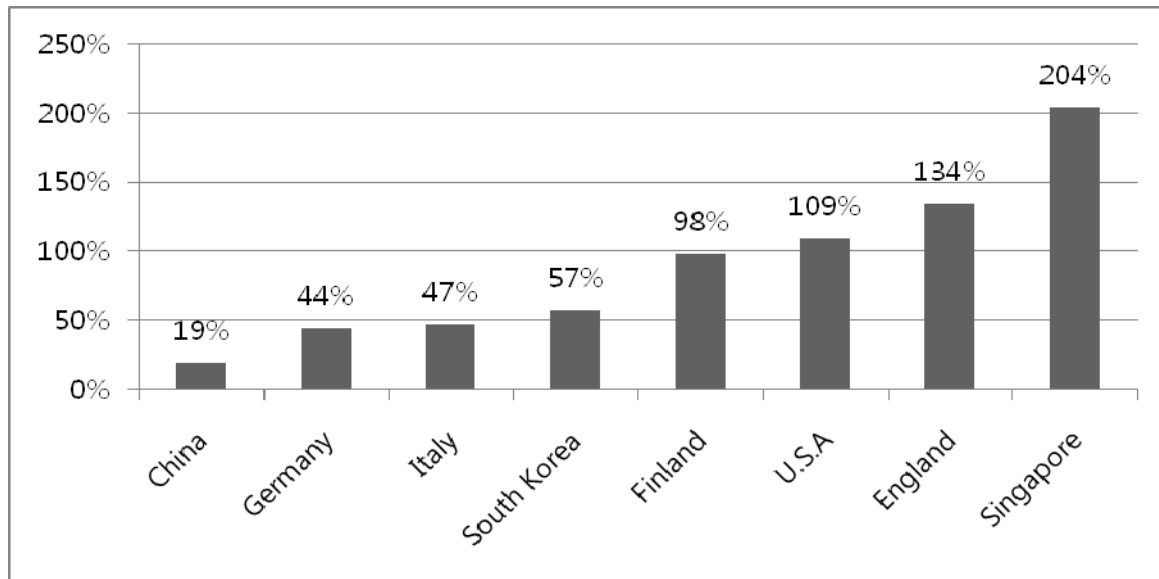
Korean capital markets and related financial services are relatively underdeveloped dimensions of the Korean economy compared with the other major economies in the world. The capital market is only about half size of the overall financial markets. Also, corporate financing through the capital market was not so active in recent several years. Korea needs to develop and restructure the capital markets.

Figure 2. Relative Size of National Economies (GDP)



Major Stock Exchanges (Market Capitalization/GDP:2004)

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Korea introduced a new law of Capital Market Consolidation Act in July 2007 to reform the legal framework of the present capital market system. The law will be activated from January 2009. Previously, different laws and regulations applied to different types of financial markets and institutions. In other words, the same financial service was subject to different regulations depending upon the institution involved. Regulatory arbitrage and/or loopholes in investor protection were in existence. Previous regulations enumerated and defined the types of securities and financial commodities legally permissible. Such enumerations were not enough for various types of investment instruments and services. Also, the rule became a hurdle for further development of financial instruments including financial derivatives. Unlike the other major economies in the world, the investment banking business in Korea was not well developed. Korea needed to strengthen the financial industry and to protect investors in the environment ever changing.

Last year, the Korean congress passed the law of capital market consolidation act (here in after referred to as the 'law'). Korea may experience a financial big bang in the capital market with the law. The law will serve to promote financial innovations and competition through the deregulations and stronger investor protection. The law intends a function-based regulatory system. Financial functions of the same nature will be governed by the same regulation, regardless of the type of financial institutions involved. The government plans to introduce a comprehensive system for financial products. The law employs a broad definition of financial investment products to accommodate the rapid development of financial products.

The law will also expand the scope of financial investment businesses. The boundaries of different financial services may disappear. At the same time, investor protection will be upgraded by introducing the advanced investor protection mechanism.

Financial Reform



Comprehensive System

- . broad definition encompassing all financial investment products.

Functional Regulation

- . Financial investment products categorized by their economic nature.
- . Financial investment services categorized by their economic nature.



Capital Market Consolidation Act



Business Scope Expansion

- . Remove boundaries among different financial investment services.

Advanced Investor Protection

- . Investor protection to global standards.

2.1. Comprehensive System

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Previously, the securities and derivatives were strictly enumerated in the relevant laws. Financial investment companies may only deal with legally enumerated financial investment products and only to which investor protection are applied. The enumerated items include government bonds, municipal bonds, special bonds, corporate bonds, stocks, investment certificates, beneficiary certificates, MBS, ELW and ELS. Also, financial derivatives were confined to those underlying securities including securities, currencies, commodities and credit risk.

The new comprehensive system employs a broad definition encompassing all financial investment products. The new system allows financial investment companies to design and deal with all financial investment products. It also provides comprehensive investor protection in all financial products.

The new comprehensive system introduces new definitions of investment contract securities and securitized derivatives. The investment contract securities are defined as investments made in common public business with the expectation of profit generation. The securitized derivatives are defined as rights under the contract for the purpose of gaining profits or avoiding losses, which are closely tied to the fluctuations of the underlying asset prices.

2.2. Functional regulation

The law is expected to shift from the current institutional regulations to the functional regulation. The financial services of different institutions including securities firms, asset management companies, futures trading companies, real estate investment firms, ship investment management companies and trust companies will be reorganized as per the actual functions of trading, arranging, asset management, discretionary investment advisory services, and asset custodian management irrespective of the financial institutions and companies. The financial investment services are classified according to the economic nature of the services. They are categorized into six functions: trading, arranging, asset management, discretionary and non-discretionary investment advisory services, and asset custodian management. Also, the financial investment products are categorized according to their economic nature.

The law distinguishes the financial products, which entails a possibility of loss and/or gain, from non-financial products such as bank deposits. Financial investment products are divided, based on the degree of risk, into securities and derivatives. Securities are classified as the general financial products and derivatives are classified as the risky financial products. Derivatives are further divided into exchange-traded derivatives and Over-The-Counter (OTC) derivatives.

Investors are classified into professional and non-professional investors according to their risk hedging capacities. The risk hedging capacities will be evaluated by their accumulated expertise in the pertinent area and the fund size under their management. Professional investors include financial institutions, large corporations, government agencies, international organizations and individuals who meet certain requirements regarding transaction experiences. Non-professional investors are

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other individuals and corporations not belonging to the category of professional investors. Several areas of regulation revision need to be noticed.

- ① The entry regulations are revised according to the risks associated with specific financial functions. The measure of risks will be assessed by taking into consideration such factors as the degree of risk exposure, the prospective investor's risk hedging ability, capital requirements, underlying risk associated with financial products.
- ② The prudential regulations are revised. The same prudential regulations will be applied to all financial investment companies. The regulations to be applied include capital adequacy ratio, transactions with majority shareholders, corporate disclosure and sound management guidelines.
- ③ The same business activities with the same financial functions are subject to the same regulation. The general provisions will be applicable to all areas of investment services. Individual provisions will consider the unique nature of each service.
- ④ The regulations related to the investment companies with tangible entities will be consolidated by function. The regulations stipulating foreign investment companies will be streamlined, including the clarification on the cross-border capital supply.

2.3. Business Scope Expansion

The business scope expansion will remove the boundaries among different financial investment services. Previously, financial investment services were divided into securities services, futures services, asset management, trust and discretionary and non-discretionary investment advisory services. The business areas were separated and not allowed to be crossed. The new system allows firms to do business crossing over the six financial investment services. The six financial services include trading, arranging, asset management, discretionary and non-discretionary investment advisory services, and asset custodian management. With the new system, the conflict of interests needs to be controlled properly. The new brokerage system may allow firms to expand sales networks, thus help to offer various channels of access to financial investment products. The broker may invite investors and undertake brokerage between investors and financial investment firms.

The law would expand the Collective-Investment-Scheme (CIS) to the extent permissible under the Korean civil or commercial codes for the purpose of promoting indirect investment. The current CIS includes investment trust company limited and limited partnership of private offering. The new scheme will expand further to include investment trust, company limited, limited partnership of private offering, private limited company, limited partnership of public offering, silent partnership and general partnership. The new law defines investment vehicles comprehensively, thus, will increase the scope of CIS-managed assets which were previously enumerated for legal permission. The new scheme allows funds to manage assets with full discretion in order to enhance the autonomy of asset management industry and satisfy the needs of investors. The new scheme will initiate the introduction of mixed asset

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funds. The new law allows financial investment firms to offer services freely in foreign currency and permit foreign currency denominated capital transactions on their own accounts unless it breaches the current foreign exchange transaction law.

2.4. Advanced Investor Protection

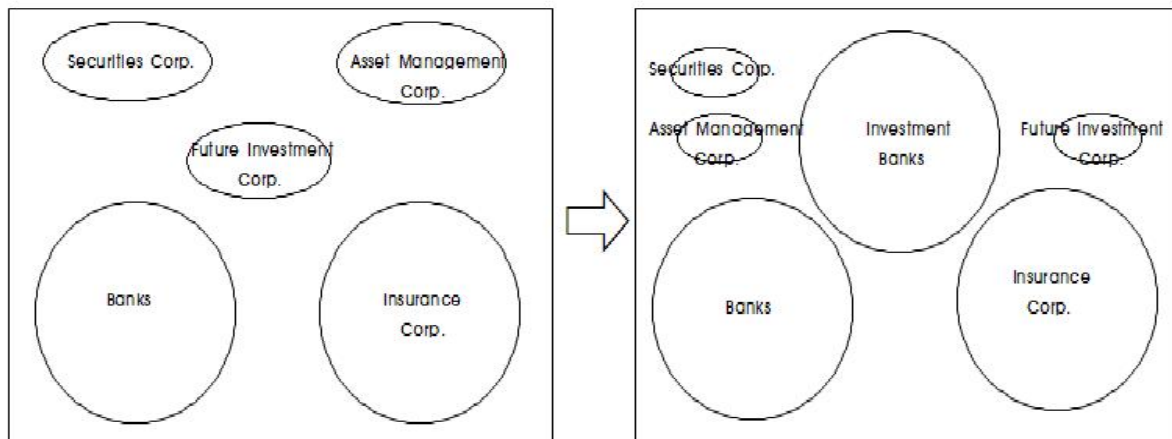
The scope of investor protection will be expanded. The law is carefully designed to eliminate loopholes in investor protection. The law introduces and upgrades investor protection to global standards. The financial investment companies will be held liable in the event of noncompliance with the provided guidance. Investment will be solicited according to investor profile based on the principle of suitability. This applies to non-professional investors who are relatively disadvantaged in handling the risks. Unsolicited calls for investment marketing may infringe on privacy. Therefore, investment solicitation through real-time methods like visiting or phone calling will be permitted only when investors want and authorize it.

2.5. Changes Expected

Korea expects the appearances of investment banks with global competitiveness. The current financial firms may face a series of convergence and consolidation. The reform of the financial industry will be facilitated by alleviating previous restrictions. Diversified financial products may appear in the financial market for competition. The new types of financial products in addition to the conventional securities may facilitate corporate financing tools and channels. Diversified financial products may provide better opportunity to the investors for the wealth management. The new law is expected to promote the mergers and acquisition to increase the economies of scale. Korea may see bigger banks and bigger financial investment firms.

Figure 3. <Big Investment Banks>

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3. Mutual Fund Industry in Korea

Korean fund industry has developed since 1970's. The industry has become a major financial investment route since 2000's. Korea has only ten major asset management companies dealing more than 10 trillion won (about 100 billion us\$).

Table 2: No. of Mutual Fund Companies and Fund Size

year	No. of companies			No. of funds	fund size (billion won)
	domestic	foreign	total		
1985	9	-	9	128	5,804
1990	14	-	14	363	23,369
1995	14	-	14	1,943	64,590
2000	37	3	40	8,246	138,295
2001	37	5	42	6,890	155,036
2002	36	8	44	5,864	174,174
2003	37	8	45	9,107	145,037
2004	36	11	47	6,540	186,991
2005	34	12	46	7,380	204,333
2006	35	14	49	8,269	234,606

Source: Asset Management Association (www.amak.or.kr/Disclosure)

Literature on mutual fund performances

Most of the previous studies on mutual fund performance, report that mutual funds

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perform below the average 'buy and hold' (Jensen (1968), Malkiel (1995), Gruber (1996), Wermers (2000)) investment strategy. The results mean that the performance of a specific fund may not be better than a random selection in the general market. The performances of mutual funds may be even worse when we take into account the transaction costs. Of course, there exist funds perform better than the average. If it is possible that we can recognize the funds beforehand, we may select the funds of outperformance.

Results and Conclusions

We used data from zero-in fund evaluation Corp. to analyze Korean equity funds from the period of 2001~2006. We included every existing equity funds of the period to eliminate the survival error problem. The equity funds also include index funds. The funds included are shown on the table below. Total number of funds included is 3,776.

Table 3: Korean Equity Funds

		pre-2001	2001	2002	2003	2004	2005	2006	Total
	Growth Style	1,039	180	104	102	96	140	124	1,785
	Stable Growth Style	308	132	55	29	30	55	36	645
	Stable Style	267	212	231	115	76	87	143	1,131
	Kosdaq	93	6	4	0	0	2	0	105
	Index Style	20	18	21	11	6	5	29	110
Total		1,727	548	415	257	208	289	332	3,776

The table below shows general performance of the equity funds. Average fund return during the period was 17.0% compared with the equity market of 20.3%. The result matches with other previous studies mentioning fund returns below the market average. Of course, the equity fund performances were better than the Treasury bond return.

Table 4: Fund Performances

구분	2001	2002	2003	2004	2005	2006	총합계 (%)
Funds	28.6	-0.2	26.0	4.7	42.0	2.5	17.0
KOSPI	37.5	-9.5	29.2	10.5	54.0	4.1	20.3
Bond Treasury	5.9	5.1	4.8	3.3	5.1	4.9	4.9

We looked at the fund performances by style. During the period, the average returns of KOSPI and Treasury bond were 20.3% and 4.9% respectively. As

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mentioned before, the overall average of total equity funds was 17.0%, which is below the KOSPI. If we look at funds by style, Index funds were on top of other equity funds. Growth funds, stable growth funds follow the next.

Table 5: Average Rate of Return (2001 ~ 2006)

	Growth Style	Stable Growth Style	Stable Style	Kosdaq	Index Style	Total (Funds)	KOSPI	treasury bond
Rate of Return	21.1	13.4	8.2	13.7	22.1	17.0	20.3	4.9

We looked at various measures of fund performances including Sharpe ratio, information ratio, Treynor index, CAPM alpha, and 3-factor alpha. In Korea, index funds were on top of other fund styles in their performance during the period. Growth funds follow the next.

Table 6: Performance Measures by Style

	Sharpe ratio	Information ratio	Treynor Index	CAPM α	3factor α
Growth Style	0.2005	0.0410	0.0145	0.0039*	0.0041*
Stable Growth Style	0.1697	-0.0905	0.0131	0.0016	0.0014
Stable Style	0.0916	-0.1069	0.0126	0.0007	0.0006
Kosdaq	0.0891	-0.0607	0.0055	-0.0025	0.0003
Index Style	0.2144	0.0508	0.0140	0.0038*	0.0035*

*s are significant at 5% level.

4. Conclusion

Korean economy has developed rapidly during the last several decades. We do not believe that the economy may grow with that speed in the near future. In a sense, it is experiencing a kind of growth pain. Korean capital market is evolving and will face a major restructuring in the near future. Korea sets up a new system including the Capital Market Consolidation Act. Korea intends open new sophisticated Capital market to activate the economy. The result matches with other previous studies

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