

10 Years of the FSCMA: Changes in Korea's Capital Markets and Financial Investment Services Industry

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The Korean securities industry has undergone many changes since the Financial Investment Services and Capital Markets Act came into force in February 2009. The average shareholders' equity of top 5 firms more than doubled from less than KRW 2.3 trillion in 2008 to over KRW 5.3 trillion in 2018. The proportion of brokerage revenue in the securities industry's total revenues declined from 60% to about 40% over the same period. Furthermore, the increased proportions of proprietary trading and investment banking businesses resulted in more diversified revenue structure for securities companies. Meantime, it is difficult to say that the capital markets played a bigger role in corporate financing, except for several years shortly after the financial crises. That seems to be a reflection of a steady drop in demand for external funds in the real (corporate) sector, and SMEs' reliance on bank loans as a source of external financing, caused by the lack of access to the capital markets. To invigorate the real sector, it is necessary to strive for greater access of SMEs and startups to the capital markets. This is the role of a risk capital supplier that the capital markets and the financial investment services industry should take on.

* All opinions expressed in this paper represent the author's personal views and thus should not be interpreted as Korea Capital Market Institute's official position.

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The Financial Investment Services and Capital Markets Act (FSCMA) was approved by the National Assembly in July 2007 and entered into force on February 4, 2009 after going through the preparatory period of 18 months. February 2019 marks 10 years since the implementation of the FSCMA. According to the government's briefing material on the proposed FSCMA at that time,¹⁾ background and rationale for its enactment were capital markets' much weaker intermediary role than banks', underdevelopment of the financial investment services industry, and problems in the legal and institutional frameworks for the capital markets. In other words, the legislation was based on the view that the domestic capital markets' lackluster financial intermediation role was due mainly to the underdeveloped financial investment services industry, and the underdevelopment of the industry stemmed from problems facing the relevant legal and institutional frameworks. Accordingly, the core purposes of the FSCMA enactment were to provide the foundation for the development of the financial investment services industry by addressing legal and institutional issues, and then, by fostering the development of the financial investment services industry, to strengthen the role of the capital markets.

The briefing material also considered the emergence of financial investment services companies capable of competing with investment banks in advanced countries as the development of the financial investment services industry, and outlined the expected benefits of the FSCMA on the industry, including much broader business scope of financial investment services firms, synergy creation through multiple business activities, designing and offering of diverse financial instruments, and economies of scale achieved through business growth in size. At this juncture, 10 years since the FSCMA implementation, this article examines whether the FSCMA has brought the expected benefits to the financial investment services industry, more specifically, the securities industry by looking at changes in the shareholders' equity and revenue structure of securities companies, and changes in the proportion of capital markets in the corporate finance market. Finally, it provides implications for future directions.

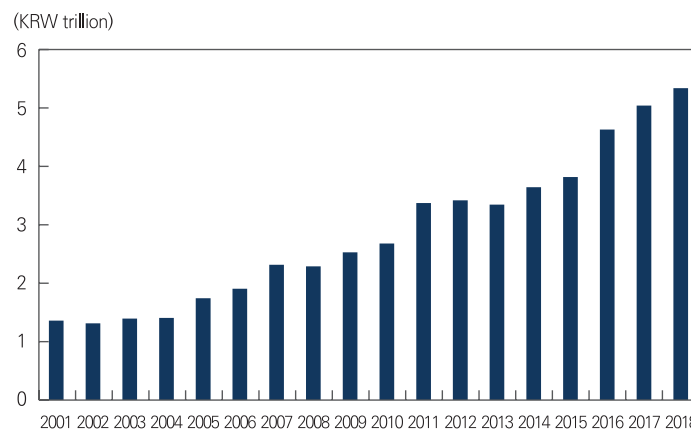
Securities companies' size growth and revenue diversification

First of all, I look at changes in domestic securities companies in terms of size and revenue structure. Although there are different measures to determine the size of a securities company, the FSCMA focuses on an increase in the shareholders' equity held by securities companies

1) Ministry of Finance and Economy, 2006, A briefing on the Proposed Financial Investment Services and Capital Markets Act.

based on the belief that sufficient equity capital is necessary for them to move away from the existing revenue structure heavily dependent on brokerage revenue, gain competitive advantages in investment banking and proprietary trading, and raise the proportions of revenues from those businesses.

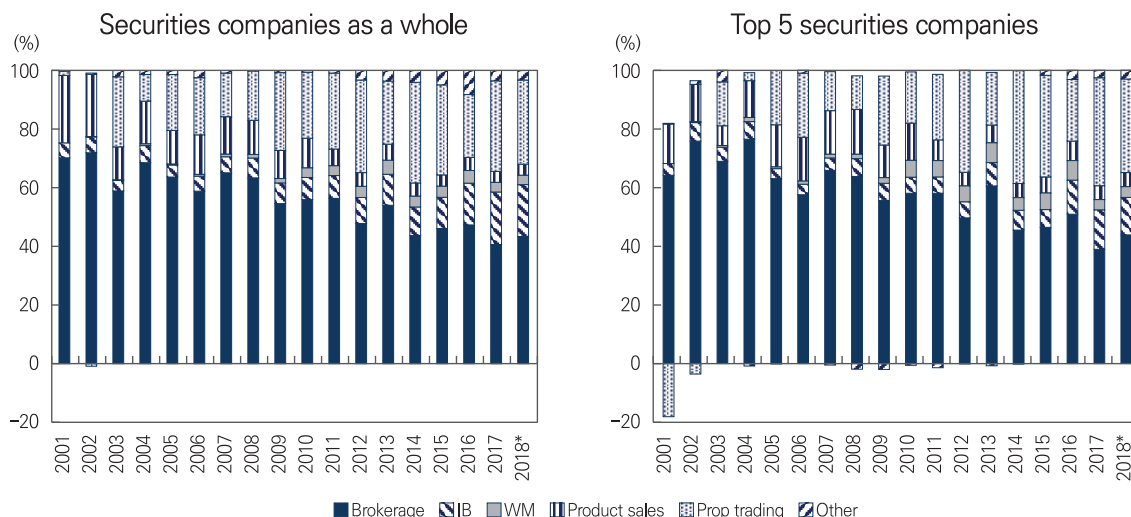
Figure 1. Changes in the shareholders' equity of top 5 securities companies



Note: 1) Average shareholders' equity of top 5 securities companies for each year
 2) The 2018 numbers are based on data at the end of the third quarter of 2018.
 Source: Annual reports of each of securities companies

Figure 1 shows trends in the average shareholders' equity of five biggest securities companies in Korea from 2001 to 2018. For the sample period, the average shareholders' equity of top 5 firms has increased steadily. In 2008, shortly before the FSCMA implementation, their equity was less than KRW 2.3 trillion on average but rose more than twice to over KRW 5.3 trillion at the end of the third quarter of 2018. For the period from 2001 to 2008 prior to the enforcement of the FSCMA, the average shareholders' equity increased at a CAGR of 7.7%. For the period from 2009 to 2018 after the FSCMA implementation, it grew at a CAGR of 8.7%. That suggests that top-tier securities companies have expanded their shareholders' equity at a faster pace since the FSCMA entered into force. Of course, it is impossible to say that the FSCMA was the one and only reason for the equity growth. However, the FSCMA is meaningful and important in that the FSCMA, together with a series of institutional arrangements (e.g., a scheme to nurture mega investment banks, and net capital rules) aimed at promoting the equity increase of securities companies, incentivized securities companies to expand their equity. Indeed, the FSCMA brought about significant changes.

Figure 2. Changes in the revenue structure of securities companies



Note: The 2018 numbers are based on data for the first three quarters of 2018.

Source: Annual reports of each of securities companies

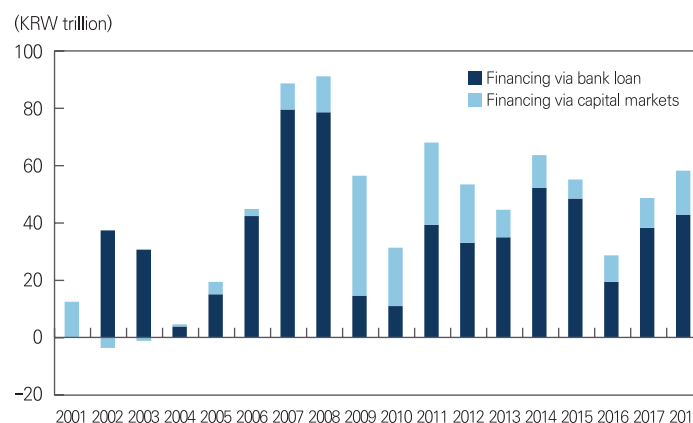
Figure 2 illustrates marked changes in the revenue structure of domestic securities companies from 2001 to 2018. The most notable change is a continued decline in brokerage business as a proportion of total revenues. Brokerage business accounted for over 60% of the industry’s net revenue before the FSCMA implementation. But this proportion continued to drop to about 40% in 2018. Yet, it is hard to say that the decline was in full swing following the FSCMA enforcement in 2009. Figure 2 displays a steady decrease in the brokerage proportion over the sample period. This is attributed primarily to continued deterioration in brokerage profitability spurred by falling commission rates amid intense competition. Meanwhile, proprietary trading business exhibited the largest growth. Proprietary trading as a proportion of the industry’s net revenue reached a maximum of 24% (in 2003) for the period 2001-2008 and increased to 22% to 34% for the period 2009-2018. Moreover, investment banking (IB) as a proportion of the industry’s net revenue showed a marked increase. Not only that, IB revenue in absolute terms more than tripled from KRW 600 billion in 2008 to KRW 2.249 trillion in 2017. Considering that the FSCMA was expected to induce securities companies to shed their over-reliance on the brokerage business and diversify the revenue structure, and especially to encourage them to grow the IB business that acts as an intermediary between investors and companies, its expected benefits appear to have occurred to some extent. The FSCMA implementation made it easier for securities companies to offset the decline of profitability in the brokerage business by the growth in the IB and proprietary trading businesses.

But it should note that Figure 2 reveals little differentiation in the revenue structure among securities companies of different sizes. The revenue structure of securities companies as a whole was hardly different from that of top 5 securities companies. This remained unchanged even after the FSCMA came into effect.

Strengthening the role of the capital markets as a fund-raising intermediary

In this section, I examine changes in the proportion of the capital markets in the overall financial market with a particular focus on fund-raising intermediation for corporations. Figure 3 depicts changes in the proportions of two financing sources, i.e., banks (indirect finance) and capital markets (direct finance) in total corporate financing.²⁾ Until 2008, funding via banks (bank loans) continued to exceed 80% of the funds raised by corporations. The proportion of bank loans was reversed immediately after the global financial crisis. Later, this proportion rose to approximately 70% again.³⁾ Corporate funding via the capital markets also dwindled from 2009 onwards, but remained above the pre-2008 levels. To sum up, bank loans still represented the large portion of corporate financing although the capital markets played a bigger role as a source of financing for companies, following the FSCMA implementation.

Figure 3. Trends in the size and proportions of corporate funding sources



Note: 1) Financing via bank loan = year-end corporate loans outstanding – prior year-end corporate loans outstanding
 2) Financing via capital markets = net corporate bond issues + stock issues
 3) The figure above does not include net commercial paper issuance.
 Source: The Bank of Korea’s press release on Financial Market Trends

2) The amount of financing via bank loan in year t is computed by subtracting the amount of corporate loans outstanding at the end of year t-1 from the amount of corporate loans outstanding at the end of year t. The amount of financing via capital markets is calculated by combining the net issue amount of corporate bonds with the issue amount of stocks each year.
 3) The sharp contraction in bank loans in 2001 and 2009 was attributable to bank deleveraging during the Asian financial crisis and the global financial crisis, respectively.

However, that does not mean insignificant capital market development over the sample period. It is necessary to take a look at the phenomenon by linking it with the real economy, i.e., the corporate sector. Korean companies raised 98% of funds from internal sources. For large companies in particular, their internal funds already exceeded the investment needs long ago.⁴⁾ In other words, the demand for external finance among large corporations has not increased. In these circumstances, small-and medium-sized enterprises (SMEs) seeking external funds had to rely on bank loans owing to the lack of access to the capital markets, which is reflected in Figure 3.

Conclusion

In 2006 when the enactment of the FSCMA was under intense discussion, I mentioned that the FSCMA enactment would meet one of necessary conditions for the development of the capital markets and the financial investment services industry in Korea.⁵⁾ This means that it would be impossible to develop the financial investment services industry without the FSCMA, but at the same time the development of the industry would not be ensured by the FSCMA only. The increased shareholders' equity and changed revenue structure of securities companies as described above are the results produced by a combination of the new institutional foundation laid by the FSCMA, one of necessary conditions for the industry development, and the securities industry's efforts.

As explained earlier, the drop in corporate demand for external funds is one of the reasons behind no marked rise in the proportion of capital market funding in the overall corporate funding. This affected the IB revenue of securities companies. In fact, despite the considerable growth in the revenue and proportion of the IB business, such growth fell short of earlier expectations as compared to the cases of global investment banks. It is very important to build a virtuous cycle of vibrant real economy, more corporate investment and growing demand for external funds. The creation of the virtuous cycle necessitates efforts to enhance the capital market access of SMEs and startups in need of external funding. This is the role of a risk capital supplier that the capital markets and the financial investment services industry should take on.

4) Cho Sung Hoon, 2018, Corporate Investment and Financing: Trends and Implications, Capital Market Focus Opinion 2018-21, Korea Capital Market Institute.

5) Cho Sung Hoon, 2006, The Financial Investment Services and Capital Markets Act and Challenges for the Korean Financial Investment Services Industry, Journal of Securities, Winter 2006 Issue 17-30, Korea Securities Dealers Association.