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Building and Restoring Investor Confidence in the Securities Industry

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Good afternoon (morning) Ladies and Gentlemen,

It is a privilege to be here speaking at this panel discussion on building and restoring investor confidence.

The subject of restoring, building, and sustaining investor confidence is a complex, difficult and continuous process, but as we all know, the life blood of capital markets. There are no shortcuts and it can take a long time to build up. We also all know it can evaporate so quickly, as we have seen in the last three years. Today as economies and markets recover from the traumas of recent years, the financial services industry faces a huge mountain to climb to win back the respect and confidence of investors, and society in general. In our age of global investment institutions such as Goldman Sachs, JP Morgan, and the now infamous Lehman Brothers, the issue of building and rebuilding investor trust and confidence requires multilateral cooperation, with regulation at a global level, to prevent arbitrage and a repeat of the deregulatory race to the bottom that we experienced prior to the recent financial crisis. This must be accompanied by a sustained and focussed process of education of both investors and industry professionals alike.

However, while we endeavour at a global level to rebuild investor confidence and reform the global regulatory system, we must also acknowledge the different market conditions across the world – including the current success and stability of the Asian markets. Equally, we also must acknowledge that many of the challenges facing the Asia region are quite different to those of the European and American markets. As such, I would like to focus on the Asian market – and more specifically Korea – which has come out of the recent crisis in pretty good shape. I would like to explore the reasons for Korea's relative market stability in the hope that we may draw lessons from them, and then look ahead, as the pendulum of economic growth swings from the more mature Western economies, to those in the Asian region.

Critical to this issue of restoring confidence is our focus on the retail investor. We spend a great deal of time focussing at ICSA on the institutional investors, but fundamental to a successful, functioning marketplace, is the blend and confidence of both wholesale and retail investors.

Compared to the developed markets of Europe and the United States, Korea is, as I said, in remarkably good shape, with a relatively stable stock market and economic growth trending back toward its pre-crisis highs. Investor confidence is also returning to pre-crisis levels, with the shift in household asset management from deposit to investment continuing unabated.

The reason Korea was able to weather this recent period of unprecedented turmoil so well is largely thanks to its experiences with the Asian financial crisis. As I am sure you are all aware, the 1997 Asian financial crisis was essentially a foreign exchange crisis that exposed the systemic risks inherent in the Government's economic and financial policies, leading to the collapse of the Korean economy.

In particular, it was the Korean Government's drive to advance the economy by prioritizing the growth of large export-orientated conglomerates, known as chaebols, over the prudential regulation of banks and corporations, which played a key role in the unfolding of the crisis. The Korean Government instituted a policy of channelling subsidized unsecured loans and preferential treatment to certain chaebols in order to promote economic growth. This had an adverse affect on the chaebols' financial structure as they took on increasing amounts of debt in the belief the Government would not let them fail, with some accumulating debt to equity ratios in the staggering 300-400% range. Simultaneously, in return for complying with administrative guidelines on loans, the banks gained an implicit promise of unlimited insurance against insolvency, which led to inefficient screening of borrowers' credit reviews, ultimately generating riskier loans. Adding to this toxic mix was Korea's increased levels of foreign debt, which increased a dramatic 70% in the first five years after restrictions were lifted in 1985.

So while, ostensibly, these policies produced the desired results – the Korean economy grew at a highly accelerated rate of around 8% in the years leading up to the financial crisis – growth was only achieved by sacrificing the stability of the financial system.

Through the utilization of interest-rate subsidies and unsecured loans as a major instrument of development policy, the financial soundness of corporations became problematic with the development of an increasingly leveraged corporate sector and a banking sector whose financial health was solely dependent on the corporate sector. The debt equity ratios of private Korean corporations prior to the crisis stood between 3 – 4, and the debt service ratio of the Korean non-financial sector reached an enormous 53.9%.

As such, the continued rapid growth of the Korean economy had become essential for the solvency of the corporate sector – much like a corporate Ponzi scheme. Equally as important was the fact the quality of bank assets became highly dependent on the solvency of the corporate sector. So, as contagion from the foreign currency crisis, which originated with the collapse of the Thai baht, spread with the Korean won rapidly depreciating, and nervous investors and lenders withdrawing from the market, the Korean economy was revealed to be essentially insolvent.

In the aftermath of the IMF bailout, the Korean Government initiated radical regulatory reform, aimed at restructuring the corporate and financial system. Labour laws were liberalized, a third of all merchant banks were closed with their deposits guaranteed, and several major insolvent corporations also forced into liquidation. The bankruptcy of Daewoo was a particularly significant event for the Korean corporate sector as it marked an important shift from the previous policy of sustaining large corporations regardless of their financial viability. No longer were companies too big to fail.

And although the origin and course of the recent global turmoil are quite different from that of the 1997 crisis, there is no doubt that because Korea learned its lessons the hard way, it was able to benefit from its rebuilding and put in place the appropriate measures to deal with the crisis which emerged in 2008. Pre-emptive and comprehensive policies proved efficient for deterring the possible threats, and most importantly of all, they were applied in a flexible and transparent manner. It is vital that we learn the lessons and take action to ensure similar crises do not occur again.

So, what were the lessons learnt? **Firstly, Government action to shore up the banking sector.** At the time of the global crisis in 2008, the Government took immediate action to ensure the soundness and stability of Korean banking system. In the immediate aftermath of the Lehman bankruptcy, many banks found themselves unable to access international credit markets. Foreign lenders refused to allow Korean banks to rollover their existing loans, requiring the banks to repay in dollars, which happened in exactly the same way in 1997. In response, the Government immediately lowered its reserve base rate from 5.25% to 2.00%, supplying liquidity worth around $16.4 billion, and expanded banks' credit supply capacity by raising the Bank of Korea's aggregate credit ceiling.

The second lesson was a regulatory one. Another reason that Korea was less harshly affected by the crisis was due to the fact that the Korean financial market was more strongly regulated than those of the US and Europe. While a law aiming for wide-scale deregulation of the financial markets had recently been enacted at the time the crisis broke, it had not yet come into effect, sparing the country from potential damage. Domestic banks and corporations had significantly lower levels of leverage and were less prone to engage in the forms of risky investment that brought down institutions such as AIG. In this regard, Korea was lucky. Wide scale deregulation had not come into effect – if it had things may have been very different. A sobering lesson about the importance of regulatory balance. The right type of regulatory structure for your market, not necessarily following a worldwide trend of example to deregulate markets, irrespective of the merits for your individual marketplace.

Thirdly, the fact that Korea was able to ride out the recent financial crisis and recover so quickly, can largely be attributed to the measures taken in the post-Asian crisis period. The Korean Government and financial industry worked in partnership promoting a range of measures to ensure that there would be no repeat of the events of 1997 – measures that we can now acknowledge were largely successful – the key here is that Government and the industry must work together in an effective partnership to restore stability and confidence in the markets.

Fourth lesson: the Korean partnership of government and industry began by working on rebuilding investor confidence, recognizing that the key to developing a vital and stable capital market lies in promoting a long-term, direct investment culture where not only institutional investors, but the population at large, can tap into the markets as a means of asset or income management. Understanding that a key failure of the market lay in the nature of prudential regulation, the Government began actively working to enhance transparency laws, strengthen shareholder rights, and set in place accounting standards to prevent the misuse of funds and the levels of leverage seen in the past. The regulatory authorities were authorized to take a more active role in overseeing the capital market, and SROs such as KOFIA's predecessor, the Korea Securities Dealers Association (KSDA) were given greater power to ensure stability in the financial sector.

Fifth lesson: in order to help stabilize a volatile market heavily influenced by external factors, the industry and authorities worked to broaden the investor demand base. KSDA, KOFIA's predecessor, persuaded the Government that the Pension Fund Management Act should be amended to allow the National Pension to freely invest in equity. Since the revision of the Act at the end of 2004, the National Pension — the 4th largest pension fund in the world — has played a pivotal role in the Korean stock market. In 2005, KSDA again played a key role in introducing the Korean corporate pension plans, which are similar to the 401(K) pension plan in the US, further channelling post-retirement funds into the stock market. Pension fund reform, and the structure and nature of savings, is key to the success of any capital market.

Sixth lesson: in the area of investor protection, the authorities and the industry **placed a great deal of emphasis on individual/retail investor education**, recognizing its role in protecting investors and restoring investor confidence. In 2005, the Korea Council for Investor Education (KCIE) was established to implement systematic and efficient education programs that can reach the widest range of people. The council consists of seven organizations, including KOFIA, the Financial Services Commission (FSC), the Financial Supervisory Service (FSS), with KOFIA serving as the Secretariat and Chair. Again teamwork to ensure effective implementation of a key component of the restoring confidence in markets.

To ensure local accessibility, KCIE has a nationwide network of regional councils in eight major cities. The investor education initiatives for individual investors led by KCIE and KOFIA are conducted in three major areas.

Firstly, we work to develop a wide range of education content designed to meet the diverse needs of investors arising from the rapidly changing financial environment, and provide comprehensive online education services through internet-based lectures and a more traditional classroom environment. Secondly, we provide tailor-made education services customized for each age or professional group. Thirdly, we work to extend our education reach to not only target current investors, but also the financially disadvantaged and social minorities.

In addition to these measures, KOFIA, and its predecessor KSDA, embarked on a variety of public relations activities to restore investor confidence in coordination with the industry, media, and government authorities. To inform the public of the merits of long-term, indirect investment, KOFIA worked with the media to run numerous campaigns and promotional advertising. The "Buy 10 Shares", "Saving through Stock Investment", and "Create Long-Term, Indirect Investment Culture" campaigns are just a few examples of our efforts to educate retail investors of the benefits of long-term, indirect investment activities.

The seventh lesson was one of absolute clarity around regulatory responsibility. The recently enacted Financial Investment Services and Capital Markets Act (FSCMA) marked the natural evolution of this combined government-industry effort to enhance and strengthen the capital market. Strongly supported by KOFIA and the industry, FSCMA aimed to strike a careful balance between the need for strong, prudential regulatory oversight by the authorities, whilst also promoting the flexibility and competitiveness of self-regulation. With FSCMA, transparency, including accounting standards and shareholders rights, was advanced to match the developed economies, while the Korean market itself was liberalized to allow a greater range of products and services, with the provision they comply with investor protection measures. There was also a critical effort to ensure clarity of responsibility under the new Act between the Financial Services Commission (FSC), the Financial Supervisory Service (FSS) and KOFIA, the self-regulatory body. I do believe that there is a huge requirement for absolute clarity in the marketplace, as to who has responsibility for what, from a regulatory standpoint. Responsibility and accountability are key.

With its emphasis on protection rules such as the selling and marketing rules and institutional measures such as the Derivatives Review Committee, FSCMA served to open up and liberalize the Korean capital market, whilst ensuring that investors are kept safe from unsuitable or overly complicated financial products which could cause them undue financial harm.

In my detailing some of the key lessons learnt from the Asian crisis – which have clearly helped the Korean market this time – none of this is to say that the Korean market has been 100% successful in its reforms, or that issues of investor trust and confidence do not still linger. They do, and are issues that must be addressed. An example, one which has been ongoing for an unacceptable length of time, is what Forbes referred to as the Korean discount – "the amount by which investors undervalue Korean stocks." This discount occurs due to ongoing perceptions of an unlevel playing field in the market, due to corruption, and its effects have been estimated to reduce the value of the KOSPI index by up to 5%. Such acts of corruption, like the recent Busan Savings Bank scandal, where executives and major shareholders allegedly misused bank funds to the tune of over 4 billion USD, without the knowledge of the regulatory authorities, only serve to heighten investor mistrust and reduce confidence in the authorities policing the markets.

However, despite these mishaps, I feel it is safe to say that the Korean market is currently a story of great success – particularly in light of the last 3 years. And I feel that there are many lessons which the developed markets can learn from Korea’s experience over the past 15 or so years.

By providing such a comprehensive investor education model, one which has a broad reach across all levels of society, the populace gained confidence in, and an understanding of, the various products they are investing in. By enforcing market rules more fairly, consumers are able to feel that their interests, and not just the interests of the large investment banks and brokerage houses, are being tended too. The symbolism of allowing the Daewoo Group, at the time the third largest chaebol in the country, to fail, cannot be overstated. By sending a clear message that chaebols would no longer receive special treatment, or be rescued from their own mismanagement, the Government signalled its intension to regulate corporations more effectively, thereby increasing investor confidence. In just 10 years, Korea went from being a country that required the IMF’s assistance, to a relatively stable market that was able to not only ride out the economic storm relatively well, but is already returning to pre-crisis levels of growth.

Furthermore, the Korean market, through its balance of regulation and liberalization, has set in place a series of measures to prevent the abuse of investor trust. Stringent know your customer and misspelling prevention rules, as well as measures to ensure the pertinent aspects of financial products such as the risk, etc are explained to investors, all serve to increase investor confidence on a day-to-day basis.

The individual or retail investor must be protected. As important, we constantly have to put ourselves in the role of an individual investor who is trying to make sense of what is going on in the economic and financial life of his, or her, country as well as regionally and globally. In this regard, I would like to highlight the importance of investor education in restoring and maintaining confidence in the markets and the financial services industry. It is in my view as fundamentally important as regulatory reform. We must demystify, we must explain the industry, and its function, in simple understandable terms. We must not confuse and overly complicate to justify our fees and services, although clearly some of the products and services are indeed complex.

Although Korea and other Asian markets weathered the last financial crisis reasonably well, across the world we all constantly have to deal with building the confidence and skills of new individual investors, as well as maintaining the confidence of existing ones, and protecting them.

We must learn from each other, what works in different markets and regions, may be appropriate to use elsewhere in the world. Of course that was why ICSA founded back in 2005, IFIE, the International Forum for Investor Education, which focuses on financial and individual investor education best practices, standards, information sharing and capacity building across the globe. KOFIA then took the leadership to organise AFIE, the Asian Forum for Investor Education, to share information and best practices in financial and investor education in a regional forum across Asia. In 2010, a second global region, MENA-IFIE, was organized and IFIE anticipates global regional organization efforts to continue, particularly in Latin America, and hopefully, Europe.

I am proud to say, I was the founding Chairman of the IFIE, which was launched out of ICSA some 5 years ago. Indeed there are a number of the founding members of IFIE represented in this room. And I am pleased to note that KOFIA CEO Hwang is the newly elected Chair of IFIE.

In the last five years, IFIE has had three successful global investor education conferences in partnership with IOSCO, the last in Cairo Egypt hosted by IFIE member and MENA-IFIE Chair EFSA. I am pleased to note that KOFIA will host the 2012 Global Investor Education Conference in Seoul, in May 2012, immediately following the IOSCO Annual Conference. Much has been achieved but so much more can, and must, be achieved to help ensure a better understanding of financial markets across the world by the retail investor. In my view, the industry must be much more rigorous in the training of industry personnel, and we must redouble our efforts to ensure the training of the regulatory community as well. It may not be fashionable, or liked, because of the time and cost involved, but I believe continuing education for these groups to be absolutely vital.

In the wake of the Asian crisis, Korea went through a period of soul searching and underwent regulatory and structural reforms to ensure that the conditions that led to the crisis could never be repeated. However, we have yet to see such measures from the US and Europe. While there has been a degree of reform, it has not been nearly enough to address issues such as “too big to fail”, leaving in place a system beset by moral hazard. Furthermore, we have not seen nearly enough signs of regret or humility from those whose actions led us into this crisis – indeed the reaction from many of the leading US and European institutions has been of defiant hostility in the face of criticism from the government and the general public – a public whose pensions and assets these firms expect to be entrusted with.

For while every significant market downturn will result in a decline in investor confidence, and each crisis may be different, we have to accept that this crisis was a crisis of our own making, and that investors' lack of trust and faith in the market is the direct result of those actions. We will need to find ways in a global context to demonstrate to investors that the financial service providers are constraining themselves, and acknowledge their past misdeeds, and that we are trying to learn lessons from other crises and other markets across the world, so that we can build markets in which investors can be confident, well equipped, and vitally protected where it is needed.

We are entering a period of history when the pendulum of world growth is swinging to Asia for the foreseeable future, and the capital markets must play their part in helping sustain and nurture that growth. Lessons must be learnt from our experiences of the past, and acted upon, not merely forgotten as one generation passes on to the next.