Country Report
(KOREA)

Presented by

Korea Financial Investment Association

Macro-Economic Overview 2016-2017

Korea's per capita gross national income (GNI) stood at USD 27,561 in 2016, which is a 1.4% increase from the USD 27,171 posted a year ago. Real GDP growth posted 2.8% in the year.

According to statistics on annual growth in real gross domestic product (GDP) by industry, the manufacturing and construction industries experienced stronger growth, whereas growth in the service industry slowed. GDP of the construction industry enjoyed 10.5% growth with higher contribution from both residential and non-residential buildings.

As for the manufacturing industry, although transportation equipment suffered a decline, GDP increased 2.3% thanks to steeper growth from oil and coal products as well as electric and electronic devices.

GDP of the service industry advanced 2.3%, but the pace decelerated compared to the previous year. Weakened growth of the financial and insurance industries offset the stronger growth of the wholesale, retail, transportation and storage industries. The GDP of the agriculture and fishing industry fell 2.9% compared to a year ago, as worsened weather conditions such as the heat wave hurt harvests of the cultivation industry.

For final consumption expenditure, the government's share increased by 4.3% and the private sector's went down by 2.5%. The contribution of the government to the index went up thanks to boosted tax revenue, but less for the private sector as households' net interest income slumped and companies' operating profits slowed down.

Gross savings ratio in 2016 was 35.8%, up by 0.2%p compared to the last year, posting the record high after the Asian Financial Crisis.

The unemployment rate in 2016 was 3.7%, up by 0.1%p from the year before. All age groups except for those in their 40s and 50s witnessed the increased unemployment y-o-y.

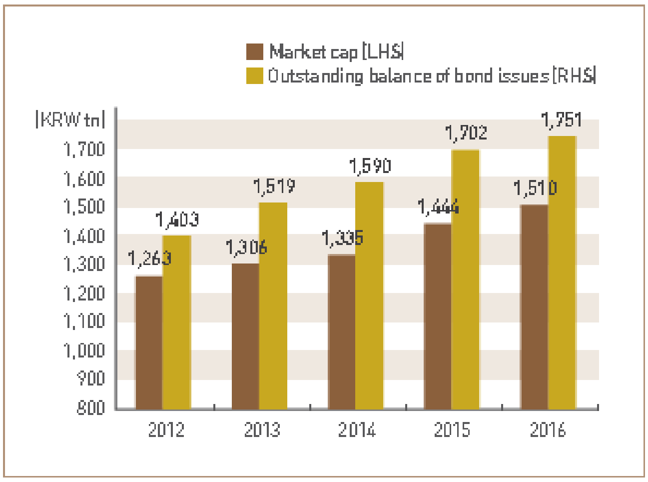
In 2017, the Korean economy is expected to improve around exports and facilities investment, thanks to the global economic recovery trend. It is also projected that the real GDP would grow by 2.9%. Exports would dramatically jump due to expanded import demand from both advanced and emerging market countries. Facilities investment is likely to improve around IT and petroleum goods-related industries. On the other hand, private consumption may become weaker and contribute less to the overall economic growth due to structural restraints such as slumping income growth rate, household debts, etc.

	2015	2016	17Q1	17Q2	17Q3
Real GDP Growth Rate	2.8	2.8	1.1	0.6	1.4
Private Consumption	2.2	2.5	0.4	1.0	0.7
Facilities Investment	4.7	-2.3	4.4	5.2	0.5
Construction Investment	6.6	10.7	6.8	0.3	1.5
Consumer Price Index	100	100.97	102.79	102.67	103.59
Unemployment rate	3.6	3.7	4.2	3.8	3.4

Capital Market Overview 2016

Korea's stock market capitalization at the end of 2016 was KRW 1,510tn, a 4.5% year-on-year increase. The outstanding balance of bond issues stood at KRW 1,751tn, up by 2.8% from the same time a year earlier. Korea's stock market capitalization to GDP ratio was 92.2%, and the bond market capitalization to GDP ratio was 106.9%, both posting a slight decline year-on-year.

Graph 1-2. Size of the Capital Market in Korea



Source : The Bank of Korea (Economic Statistics System), Korea Financial Investment Association (FreeSIS)

Put into a global context, Korea's stock market capitalization to GDP ratio (92.2%) is slightly lower than those of advanced economies, such as the US at 147.4%, UK at 130.9%, and Japan at 107%.

Household Asset Composition

Non-financial assets including real estate accounted for 62.8% of household assets in 2016, whereas the share of financial assets was 37.2%. Although the proportion of non-financial assets remains greater than that of financial assets, it should be noted that the latter is steadily rising.

Table 1-2. Household Non-Financial & Financial Assets

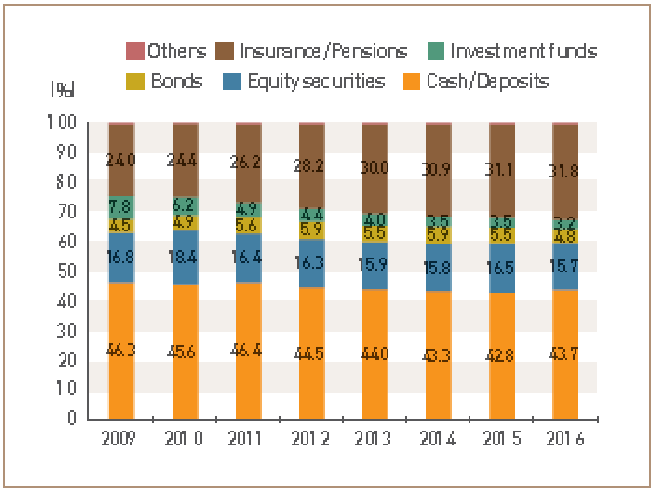
[Unit: %]

Category	2011	2012	2013	2014	2015	2016
Non-financial assets	66.7	65.7	64.8	64.1	63	62.8
Financial assets	33.3	34.3	35.2	35.9	37	37.2

Source : The Bank of Korea, National Balance Sheet

Among financial assets, cash and deposits maintained the largest share at 43.7%, but their percentage is on a downtrend. Financial investment instruments such as stocks, bonds and funds accounted for 23.7%, down by 1.8%p compared to a year ago.

Graph 1-4. Breakdown of Household Financial Assets

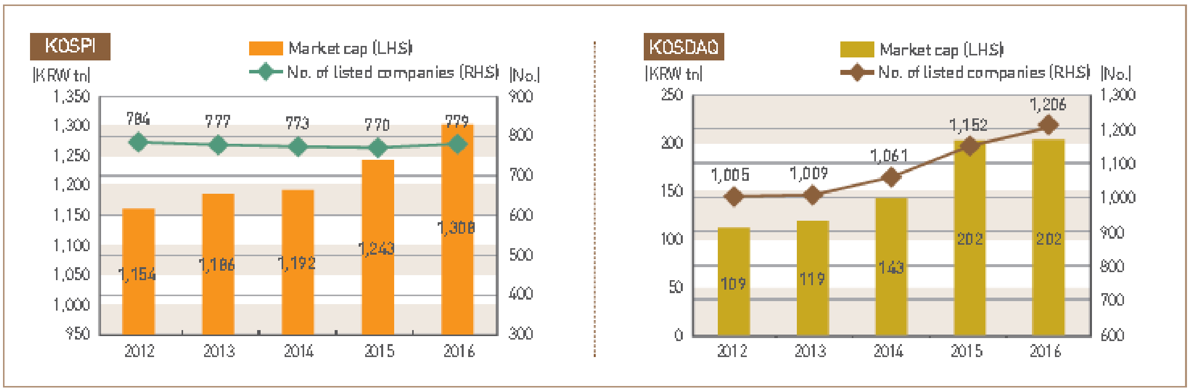


Equity Market

The KOSPI index hovered slightly above 2,000pts at the end of 2016, with the turnover declining KRW 210tn year-on-year to KRW 1,113tn.

As for the KOSDAQ index, it dropped slightly by 7.5% to 631.44pts over the same period, with the turnover falling 4.5% year-on-year to KRW 835tn.

Graph 2-2. Listed Companies and Market Capitalization

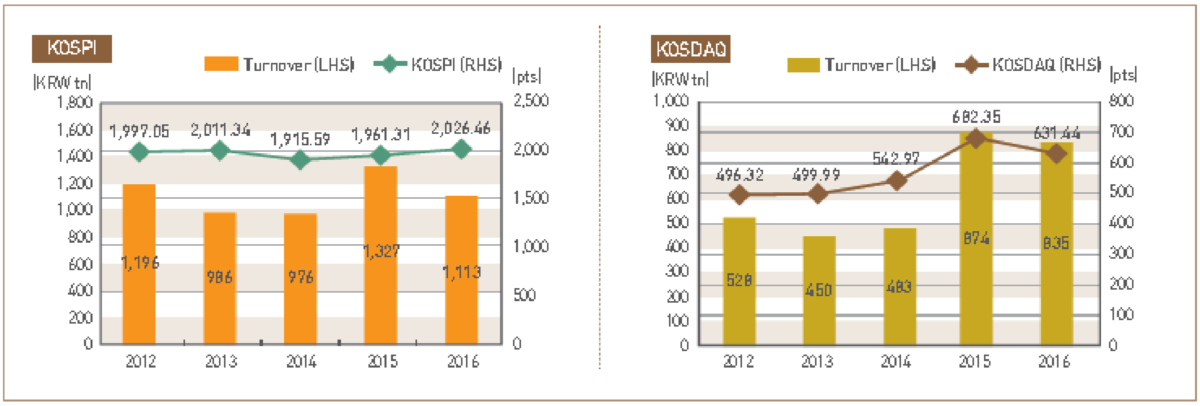


Source : Korea Exchange

In the KOSPI market, the total number of listed companies increased by 9 compared to the previous year to 779 at the end of 2016. Market capitalization recorded KRW 1,308tn, a 5.3% increase year-on-year.

Meanwhile, the KOSDAQ market had 1,206 listed companies at the end of 2016 with KRW 202tn in market capitalization. The number of listed companies increased by 54 year-on-year, while the market cap remained more or less flat. The steady growth in the number of listed companies is a testament to the fact that SMEs and venture companies are increasingly utilizing the KOSDAQ market to meet their financing needs.

Graph 2-1. Stock Market Trend



Source : Korea Exchange

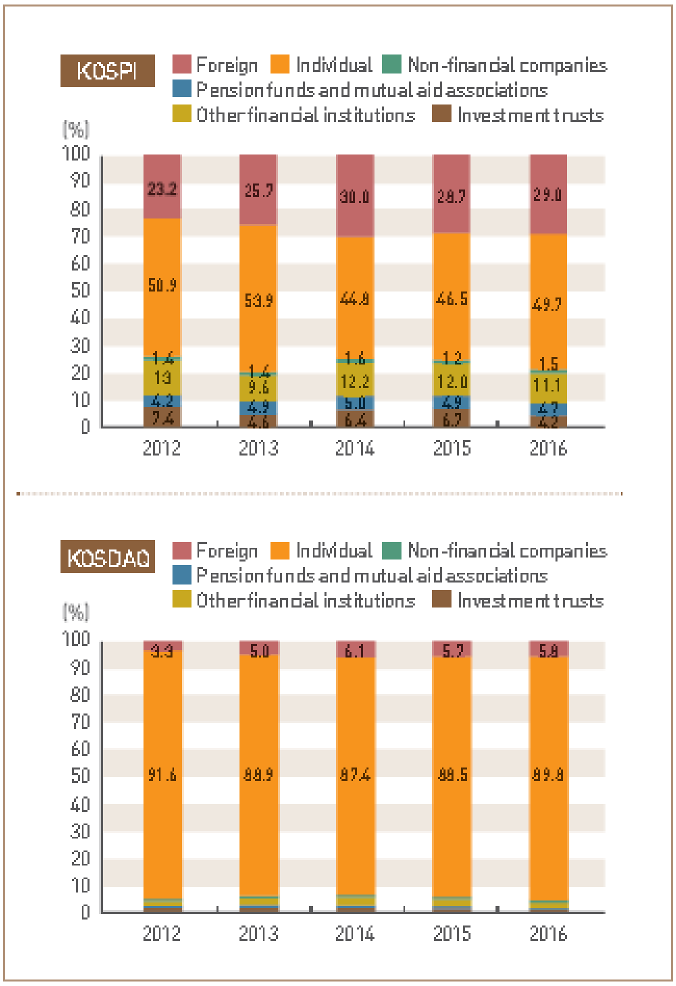
A look at the turnover shows that individual investors made up the largest portion of the Korean stock market followed by foreign investors and institutional investors.

Individual investors accounted for 49.7% of the total turnover in the KOSPI market in 2016, while foreigners took up 29%. Institutional investors, including investment trusts, pension funds and mutual aid associations, assumed 19.9%.

The higher share of foreign investors since 2014 contributed to a more balanced market. However, the percentage of individual investors rose again in 2016.

As for the KOSDAQ market, it is still dominated by individual investors who make up approximately 90% of the total turnover. The share of foreign investors and institutional investors went down compared to 2015 and is at a marginal level in 2016.

Graph 2-3. Stock Market Breakdown by Investor Type

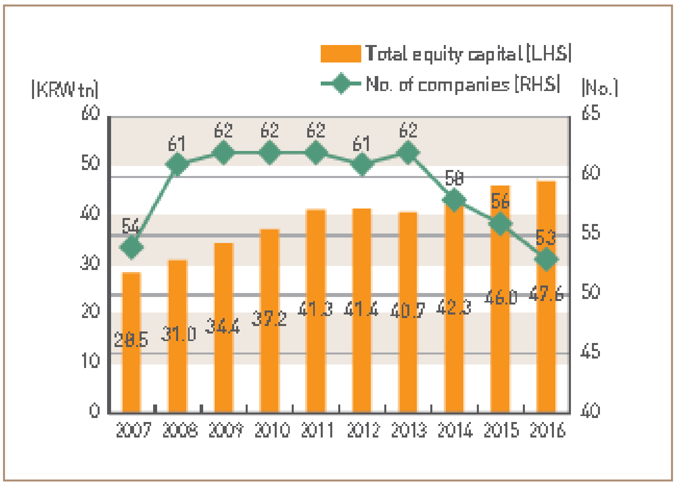


Source : Korea Exchange

There were a total of 53 securities companies in Korea at the end of 2016, a drop by 3 compared to a year earlier. The number of securities firms peaked in 2013 at 62, but then dropped by 9 over the next three years.

This was due to the corporate restructuring and reorganization of securities companies following a prolonged market recession. Four securities firms closed down their businesses due to mounting losses.

Graph 2-5. No. of Securities Companies and Equity Capital



Source : Financial Supervisory Service, Monthly Financial Statistics Bulletin

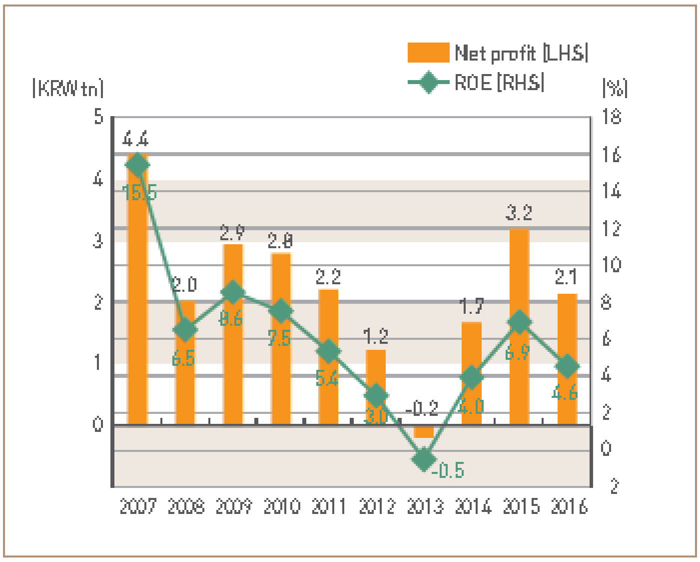
Five were strategically merged with other companies to secure long-term growth engines. One went bankrupt, but one set up new operations. Interestingly, while the overall number of securities companies fell, their equity capital which displays the size of a securities company, continued to grow. Equity capital of securities firms totaled KRW 47.6tn at the end of 2016, an average increase of KRW 0.9tn per company.

This demonstrates the trend of securities companies growing in size through strategic M&As and secondary offering backed by the Korean government's policy to foster large-scale full service investment banks.

Securities companies recorded KRW 2.1tn in net profit in 2016, shedding 33.9% compared to the KRW 3.2tn posted a year ago. Their net profit had been on a growth track thanks to positive factors including an improved operating environment after posting KRW 0.2tn net loss in 2013.

However, net profit moved once again to a downward trajectory last year as brokerage commissions decreased on lower turnover. ROE was also hurt by lower net profit, registering 4.6% in 2016, a 2.3%p decline compared to the year before.

Graph 2-6. Securities Companies' Net Profit and ROE



Source : Financial Supervisory Service, Monthly Financial Statistics Bulletin

In 2016, securities companies suffered declines for most of their major profit sources. Commission profits were scaled down by 5.5% year-on-year to KRW 7.5tn, while profits from proprietary trading slipped 40.9% over the same period to KRW 2.5tn.

Brokerage commission profits, which account for the largest proportion of total commission profits (49.6%), retreated 19% year-on-year to KRW 3.7tn in 2016 due to a decline in the turnover. The second largest source of commission profits was investment banking services, including securities underwriting and advisory services, and M&A business activities.

While these commission profits jumped 6.1% year-on-year to KRW 1.3tn, income from asset management services, such as fund distribution, investment advisory services, discretionary investment services and investment trust services recorded KRW 0.8tn. Although brokerage commissions still make up the largest portion of the commission income structure, contribution from IB services also increased year-on-year.

The proprietary trading profit of securities firms dropped in 2016, as the interest rate reversed to an uptrend, which led to the KRW 1.2tn decline year-on-year in their net balance for the disposal and valuation of bonds.

Table 2-1. Profit Structure of Securities Companies

[Units: KRW tn, %]

Category		2015 (A)	2016 (B)	Change (B-A)	Growth rate (%)
Commission profits		7.9	**7.5**	△0.4	△5.5
	Brokerage	4.6	**3.7**	△0.9	△19.0
	IB services	1.2	**1.3**	0.1	6.10
	Asset management services	0.9	**0.8**	△0.1	△11.0
Proprietary trading profits		4.2	**2.5**	△1.7	△40.9
	Stocks	0.5	**0.3**	△0.2	△41.5
	Bonds	5.2	**4**	△1.2	△23.6
	Derivatives	△1.6	**△1.8**	△0.2	-

Source : Financial Supervisory Service, Financial Statistics Information System (Press release)

Bond Market

Bond issuance was scaled down by KRW 93.8tn year-on-year to KRW 580.5tn in 2016 as higher bond interest rates and larger volatility prompted issuers and institutional investors to put off their issuance and investment plans. The issuance amount of Korea Treasury Bonds (KTB) dropped 15.3% year-on-year to KRW 138.2tn, while that of Monetary Stabilization Bonds (MSB) decreased 14.3% to KRW 161.1tn over the same period.

Corporate bond issuance also fell 12.1% year-on-year to KRW 72.5tn due to factors including the restructuring of vulnerable industries and higher interest rates.

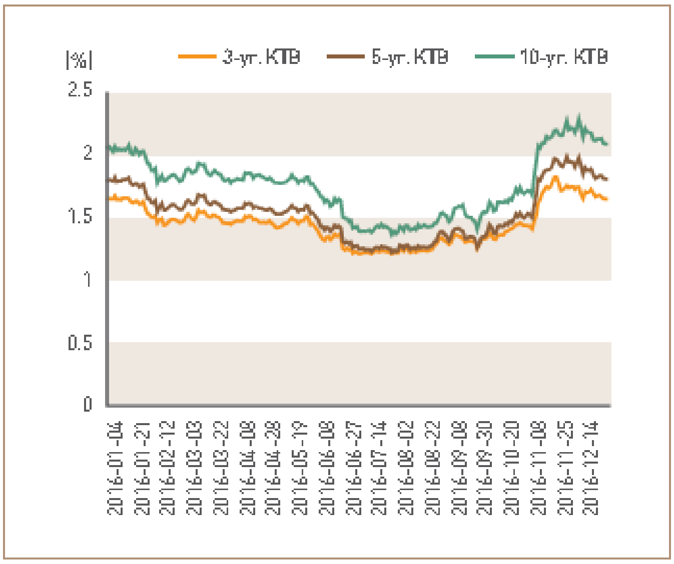
Table 3-1. Bond Issuance by Type

[Units: KRW tn, %]

Category		2014	2015	2016	Year-on-year	Share (%)
Government bonds	Issuance amount	146.6	163.1	138.2	-24.9	23.8
	Balance	493.3	544.8	581.4	36.6	33.2
Municipal bonds	Issuance amount	4.3	5.8	3.6	-2.2	0.6
	Balance	19.4	21.5	21.3	-0.2	1.2
Special bonds	Issuance amount	67.4	91.4	61.8	-29.6	10.6
	Balance	354.1	334.2	336.6	2.4	19.2
Monetary stabilization bonds	Issuance amount	189.9	188.0	161.1	-26.9	27.8
	Balance	178	180.9	168.4	-12.5	9.6
Financial bonds	Issuance amount	115	143.4	143.3	-0.1	24.7
	Balance	278.4	351.6	374.3	22.7	21.4
Corporate bonds	Issuance amount	78.9	82.5	72.5	-10.0	12.5
	Balance	266.9	270.3	269.0	-1.3	15.4
Total	Issuance amount	602.1	674.3	580.5	-93.8	100.0
	Balance	1,590.0	1,703.6	1,750.9	47.4	

Bond interest rates displayed a downtrend in the first half of 2016 as investor preference for safe assets increased after the Bank of Korea cut its key interest rate to 1.25% from 1.50% on June 9 and the UK announced its plan to leave the EU. The interest rate for the 3-year KTB hit a historic low of 1.203% on July 6.

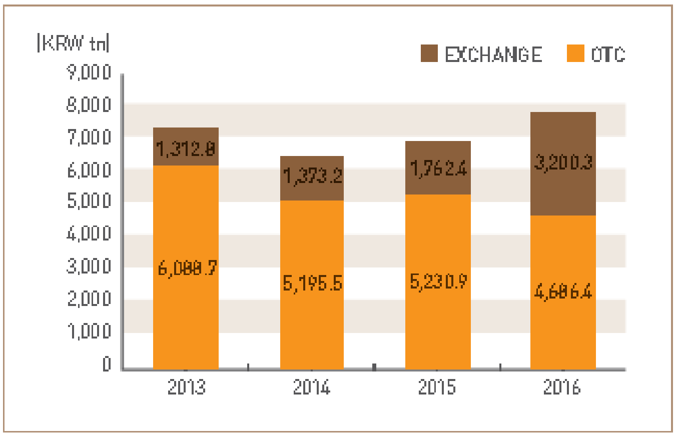
Graph 3-1. 2016 Bond Interest Rate



Since October, the bond interest rate reversed to an uptrend as the possibility of a key interest rate reduction lessened due to concerns over domestic household debt and stronger inflationary expectations driven by improved US economic indicators.

Bond trading based on volume slightly stalled in 2014 for both the OTC market and the exchange market. However, trading volume began to grow from 2015, and particularly in 2016, it increased 12.8% year-on-year to KRW 7,886.7tn due to Korea's key interest rate cut and the US Fed's rate hike implemented in December.

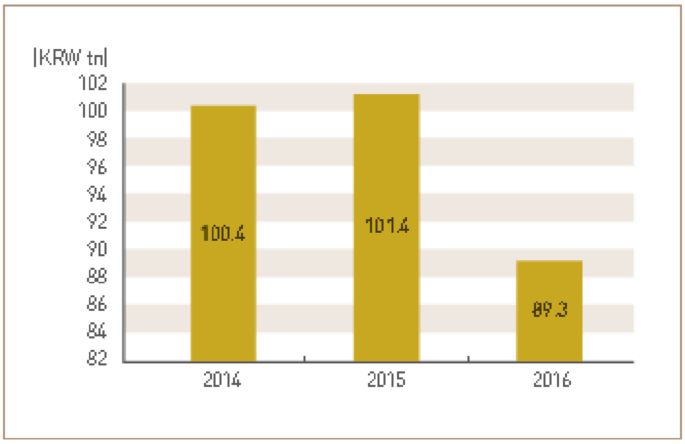
Graph 3-2. Annual OTC and Exchange Trading Volume



Source : Korea Financial Investment Association, Korea Exchange

The OTC market made up around 80% of the total bond trading volume, but this figure dropped significantly to 59.4% in 2016.

Graph 3-5. Korean Bonds Held by Foreign Investors



Source : Financial Supervisory Service, "Foreign Investors' Securities Trading Trend" (Press release)

As part of its reform plan to expand foreign currency liquidity, the Korean government began granting tax exemptions to foreigners in 2009 on interest income and capital gains for KTB and MSB investments.

Although this tax exemption was repealed in 2011, net foreign buying of Korean bonds continued due to prospects for a stronger Korean won and the efforts of each countries' central banks to diversify foreign currency investment assets. At the end of 2016, the outstanding balance of foreign-held domestic bonds stood at around KRW 89.3tn, an 11.9% decline from the previous year

Regulatory Developments

2016

1. **Implementing the Individual Savings Account (ISA)**

   ✓ KOFIA further promoted the ISA scheme adopted in March 2016 by introducing online sales of discretionary ISAs, ISA account transfer service, and an ISA comparative disclosure system. To this end, KOFIA launched advertisement campaigns with securities companies throughout the year to enhance the public interest in ISAs and attract subscribers.

2. **Introducing the Independent Financial Advisor (IFA)**

   ✓ KOFIA played an essential role in the introduction of IFAs, which aim to provide objective and professional financial advice. Additionally, KOFIA undertook its follow-up measures for the successful operation of IFAs, such as setting up guidelines for best practices and investment recommendations.

3. **Expanding Market Distribution Channel, etc.**

   ✓ KOFIA contributed to expanding fund distribution channels by supporting credit card companies to enter the online fund distribution business. Also, the association led the efforts to improve fund distribution policies, such as enhancing customer identification programs and allowing non-face-to-face opening of accounts.

4. **Introducing Tax-Exempt Overseas Funds**

   ✓ KOFIA supported member companies to launch tax-exempt overseas funds which help invigorate overseas investments and efficiently manage portfolios.

   ✓ The Enforcement Decree of the Restriction of Special Taxation Act, enacted in February 2016, permits special investment accounts that offer tax exemption for trading and exchange gains or losses, including foreign gains or losses, on overseas-listed equities incorporated in an overseas equity fund.

   ✓ The exemption is in effect for a maximum of ten years and applies to accounts opened between February 29, 2016 and December 31, 2017. This is anticipated to promote investment in overseas equity funds which have experienced a drop in recent years.

5. **Fostering Big Investment Banks**

   ✓ KOFIA contributed to improving regulations for nurturing big investment banks. Brokerage houses with a capital base of more than 4 trillion won (USD 3.5 billion) are allowed to issue promissory notes beginning in 2017. Additionally, brokerage houses with a capital base of more than 8 trillion won can operate Investment Management Accounts (IMAs) where their clients' assets are held and managed.

- ✓ KOFIA supports them to be able to involve in not only OTC block deal matching services but also real estate collateral trusts which were previously allowed only for banks, so as to offer a wide range of corporate finance services.

<u>2017</u>

1. **Nurturing Ecosystem for Innovative Ventures and Startups**

- ✓ It was noted that compared to major economies such as U.S. and China, Korea, despite of its sizable economy, lacked the volume of venture investment and risk capitals. Thus, the FSC has put forward a measure to nurture the ecosystem needed for fostering ventures and startups.

- ✓ Innovative Venture Fund will be formed with about KRW 10 trillion of capital commitments within next three years in order to expand the supply of risk capital.

- ✓ Public FIs such as Korea Technology Credit Guarantee Fund together with private sectors will additionally provide capital up to KRW 20 trillion to those already invested by the Innovative Venture Fund.

- ✓ Stock option at the venture companies will be tax-exempted.(up to KRW 20 million of stock option execution profit)

- ✓ Startups will be able to raise capital through crowdfunding more than previously set amount of KRW 7,000 million annually. The exact amount limit hasn't been decided yet.

- ✓ Market dedicated for SMEs such as KONEX and K-OTC Pro has already been in place, but not been very active yet.

  i. In KONEX market, companies will be allowed to have public offering without registration statement up to KRW 2 billion (previously 1 billion).

  ii. In case of K-OTC Pro system, which was launched in the middle of this year, it has been operating within the boundary of current regulatory system thereby only engaged in stock trading. With the new measure coming up, the FSC will expand the type of investment vehicles allowed to trade on the K-OTC Pro and also provide exemption on certain disclosure and registration requirements.

2. Implementing Financial Regulation Testbed

- ✓ In order to swiftly test the viability of innovative financial services without heavy regulatory burdens, the FSC has adopted Financial Regulation Testbed in the form of No Action Letter, Consigned Test, and Authorized Agent Status.
- ✓ No Action Letter : If there is a regulatory uncertainty in regards to which existing regulation a new financial service should comply with, no action letter can serve as a solution in that the letter could grant a permission for a new financial service to be operated.

3. Reinforcing Investor Protection in Regards to Sales of High-Risk Derivatives Linked Securities Such as ELS

- ✓ Starting from 2018, financial institutions have to tape-record the whole sales process of high risk financial products such as derivatives linked securities when selling these products to risk-averse investors or senior investors aged more than 70 years.

4. Reinforcing Self-Regulation in Regards to Price Target in the Analyst Reports

- ✓ From September 2017, analysts have to disclose the difference between a stock's price target and the actual price in the future in their research analysis report. For example, if an analyst gave a stock a one-year price target on January 1st 2017, he/she has to declare in his/her report, which would be published on January 1st 2018, a difference between the prices from 2017 to 2018, converted into a percentage. This is to improve market practice of analysts, who had been conventionally setting the price target too high, and to enhance credibility of the market research reports