Financial Restructuring in KOREA

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Preface

The period before and after the financial crisis of 1997 was an important turning point in Korea's social and economic development. It was a period marked by crisis, reform, and recovery. In overcoming the crisis, Korea did what many countries impacted by the Asian Financial Crisis could not do: implement deep and wide structural reforms. It's relatively quick economic recovery after the crisis, and the resilience of the Korean economy today, is a testament to the country's decisive response to the crisis.

In deepening the body of literature assessing the causes and effects of the financial crisis on Korea's economy, the two volume series "Theory of Economic Restructuring in Korea" offers a policymaker's in-depth analysis and first-hand account of Korea's policy response to the financial crisis in 1997. The volumes examine in great detail the role of the government and policymakers in leading the efforts to restructure the financial and corporate sector, which was at the heart of Korea's response in overcoming the crisis.

The volume helps to fill a critical knowledge gap in policymaking; how do you go from policy and reform ideas to results. More than ever, policy studies must go beyond offering textbook policy implications. They must also equip policymakers with the implementation know-how, a roadmap, to ensure policies and reforms deliver results. Indeed, good policymaking is about not only selecting and designing the right policy interventions, but also establishing a policy implementation framework, which sets clear and measurable targets, and monitors and evaluates the policy implementation process to ensure desired outcomes. In Korea's case, the government instituted policy measures such as Forward Looking Criteria, Prompt Corrective Action, and creditor-led corporate workout programs, which set clear and measureable targets, and monitored and evaluated the implementation of financial and corporate restructuring policies.

The financial crisis of 1997 had a profound impact on the country. Korea as a nation came together and worked with the international financial community to overcome the crisis. These policy and reform efforts resulted in a more sustainable and resilient economy. It also led to major legal, regulatory, and institutional reforms that helped to strengthen Korea’s financial supervision and corporate governance systems which in turn helped to deepen financial development and accelerate the internationalization of Korean corporations. Often overlooked is the voice and work of reform-minded policymakers and institutions such as KDI which advocated for a new policy direction and institutional change years before the onset of the crisis. Some of the policies and institutions that played a critical role in overcoming the crisis were being planned or in the process of being implemented before the crisis; and thus, provided a way forward once the crisis hit.

With this in mind, we hope the insights and perspectives into Korea’s response to the financial crisis offered by former Korean Deputy Prime Minister, Kwon O-kyu, contained in this two volume series, provide not only critical policy lessons but also the implementation know-how needed by Korean and international scholars and practitioners to tackle future economic and social challenges.

Joon-Kyung Kim
President of Korea Development Institute

Preface

This book can be trisected into three parts by its content. The first segment of the book looks back to the "past", offering a comprehensive review of the restructuring of the Korean financial sector that has been ongoing since 1997. The second segment of the book focuses on the "present" and what the international community as a whole has done since the 2008 global financial crisis in order to prevent a similar recurrence. The third segment of this book suggests what lessons the Korean financial industry should learn from its past experiences, and the direction it should move towards for the "future".

The section on the "past" details specific cases that illustrate the financial sector's restructuring process. Without a clear set of guidelines and little prior experience in restructuring distressed financial institutions strictly in accordance with market principles, the Korean government urgently had to deal with failing financial institutions. These difficulties made tackling each individual case a time-consuming process.

Additionally, the government undertook massive efforts to overhaul the institutional framework governing the financial sector while simultaneously handling ailing individual companies. As a result, regulations, systems, and practices associated with financial supervision and the financial market infrastructure were brought in line with international standards. Furthermore, Korea accumulated considerable restructuring expertise as well as a broad pool of restructuring experts.

Korea is considered more thorough than other countries in restructuring its financial sector thanks to a unique and potent combination of three factors, which are as follows. First, Korea had a clear sense of crisis and reached a broad consensus on the desperate need of reform. Second, the massive restructuring was firmly underpinned by Korea's solid, globally competitive industry. Third, global standards and market principles were strictly upheld in the process.

The reform drive was able to gain legitimacy and much-needed support from the public because of its strong and consistent emphasis on transparency and accountability throughout the restructuring process. Many emerging economies and international organizations consider Korea's restructuring extensive and exhaustive, leading to its status as a popular research subject among those countries. This is a clear testament to the success of Korea’s aforementioned reform.

The section on the “present” examines cross-border cooperation and actions that individual countries took in order to overcome the 2008 global financial crisis and to prevent the recurrence of such a crisis, with a focus on discussions among G20 members. The landscape of the financial market will likely be reshaped by the behavior of investment banks and the introduction of new regulations governing its behavior, as investments banks are largely believed responsible for the subprime mortgage crisis. Because of their influence, this section will also take a close look at investment banks. This discussion will include prudential regulation of financial institutions based on BASEL III, sharing the restructuring cost with the financial industry, revising the loss-compensation scheme, regulations on hedge funds and credit rating agencies, reforming international financial institutions, and harmonizing accounting standards.

The section on the “future” focuses on global expansion strategies of Korea's financial companies, revision of the Financial Investment Business and Capital Markets Act, growth strategies for Korea's investment banks, Korea's potential as a global financial hub, and strategies to make Korea into such a hub.

Korea's financial industry has great potential to become one of the key growth engines that will lead the national economy. This potential is backed by a rich surplus of funds, including public pension funds and foreign exchange reserves, diversified investment destinations such as emerging economies in Asia located in close proximity, and top-notch information technology essential to creating a strong financial infrastructure. In order to grow into a global financial hub, Korea should implement bold financial regulatory reforms, find its niche in Northeast Asia as a competitive asset management market, improve its financial infrastructure, and develop human resources.

This book will serve four purposes. First, it will review the restructuring of the financial sector following the 1997 foreign exchange crisis − an event that brought about many dramatic changes for Korea − by analyzing the individual cases of companies involved. There have been many publications that focused upon the dire circumstances that stymied the Korean economy during the crisis, but few books provide a detailed account of both how individual companies were restructured and how policies and regulations had to be revamped in spite of the mounting pressures and challenges.

Second, this book can be used as a guide for those who wish to work in the financial sector. Financial experts working at global financial institutions agree that first-hand involvement in specific cases of restructuring proved to be a valuable experience in building a successful career in the ensuing years. In this sense, the book will be a useful learning tool for aspiring restructuring experts who possess little hands-on experience, as it will walk them through each and every step of an extensive restructuring process.

Third, this book can serve as a guide for other countries wishing to learn from Korea's restructuring experiences. Many countries experience financial crises but only a few of them achieve success in reforming their institutional framework. Developing countries are particularly interested in learning from Korea’s experiences because we, more so than other advanced economies, present a better benchmark for them in terms of the restructuring principles and strategies used and the specific methods and sequencing employed.

Finally, the book suggests the next steps for Korea's financial industry down the road, based upon the lessons learned from previous experience. The book attempts to offer alternatives to an array of challenges including the revision of the Capital Markets Act, the fate of Korea Development Bank(KDB), global expansion strategies of local financial companies, and plans to make Korea into a global financial hub.

There is a myriad of other pressing issues such as rising household debt, challenges facing savings banks, privatization, and financial regulations on construction industry and real estate transactions. All of these issues call for urgent solutions, but I believe those issues are to be left in the hands of the government. As such, my focus will remain on what needs to be done for a better future of our financial industry.

The structure of the book is as follows. Chapter I is an overview of the financial sector restructuring. In the chapter, the causes of the foreign exchange crisis and how it panned out will be briefly analyzed. The chapter will also discuss the goals of the restructuring, the principles and strategies, the guiding frameworks and laws, and finally relevant organizations.

In addition, efforts will be made to give a bird's eye view of the entire restructuring, including documentation of the major milestones and outcomes. Chapter II examines the details of how banks and non-bank institutions were restructured. Detailed accounts include how the results of the management evaluation on the banking sector as a whole affected the restructuring of individual banks, and how non-bank institutions such as securities companies, merchant banks, investment banks, insurance companies and lease companies, were handled.

Chapter III discusses the reform of financial infrastructure that was initiated to facilitate restructuring. The reform brought about significant changes mainly in 8 areas: financial regulation, financial supervision, internal control of financial institutions, ownership structure and corporate governance of financial institutions, securities issuance and disclosure, accounting principles, and external audits.

Chapter IV reviews 8 individual cases: Korea First Bank, Seoul Bank, Chohung Bank, Korea Exchange Bank, Daehan Life Insurance, LG Card, Korea Investment & Daehan Investment, and Koram Bank.

Korea First Bank was the first domestic bank ever in history to be sold into foreign ownership. As the financial market steadily stabilized, Seoul Bank was able to avoid being put up for a bargain deal and instead, Hana Bank took over its control as its new owner. The deal laid the groundwork for Hana Bank to emerge as one of the four major financial holding companies in the years that followed. Chohung Bank was sold to Shinhan Bank, catapulting the merged bank into the ranks of major players. On the other hand, the sale of Korea Exchange Bank(KEB) to Lone Star Funds stirred up controversy due to a sale price far lower than its market value, and eventually turned into a political hot potato. The KEB case shows the possible perils of restructuring and has taught the financial industry a good lesson.

Daehan Life Insurance revealed the need to consider other aspects during the restructuring process, such as accountability of majority shareholders and how to determine if a bid offer is incomplete. LG Card could have triggered another major financial crisis. Ultimately, a successful restructuring was pulled off and the market still remained stable, which shows that Korea had acquired considerable restructuring knowhow by then.

All the cases listed above can be a model in their own right and showcase a full range of elements that a restructuring of a struggling financial institution can possibly involve, including the logic, procedures, negotiations, and national consensus building.

Chapter V is about macroeconomic risk management and related laws and regulations. Financial regulation has been tightened since the 2008 global financial crisis. Accordingly, financial institutions have also fortified their risk management strategies. In light of this trend, the government's approach to macroeconomic risk management detailed in this chapter is worthy of attention.

Chapter VI looks into reorganization of the global financial system and future strategies. The chapter reviews challenges and growth strategies of investment banks as the culprit of a global crisis and plans for transforming Korea into a global financial hub, as well as discussions among G20 members.

As a final note, this book is a sequel to Korea's Corporate Restructuring (3I Strategy Research Institute, 2012). The first book features an in-depth look into individual companies that underwent restructuring. In a similar vein, the book introduces ample restructuring cases of financial institutions that were at the heart of Korea's extensive restructuring drive.

As in the first book, a large part of this book is based on my lectures at

KAIST Graduate School of Finance and I am deeply indebted to the school. My colleagues and so many other people gave me invaluable support in writing this book and I am particularly grateful for their efforts in helping me obtain and check data from government organizations such as the Ministry of Strategy and Finance and the Financial Supervisory Commission. Particularly, my great thanks should be given to Jim Park for his excellent job in editing this book. Once again, I offer my sincerest thanks and enduring gratitude to all of them.

O-kyu Kwon
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CHAPTER 1

Overview of Korea's Financial Sector Restructuring

Overall, the Korean economy got better. And what mattered most was not what the IMF or the US Treasury Department did, but how Korea responded. I think President Kim Dae-jung, the hero of Korea's economic recovery and his colleagues showed how important-actually crucial- the role of a sound-minded and courageous political leader is in overcoming an economic difficulty.

"In an Uncertain World" (2002), Robert Rubin

1. Roots of the 1997 Foreign Exchange Crisis[1]

Many people point out absence of market principle and prevailing moral hazard as the fundamental causes of Korea's foreign exchange crisis. If we look at the causes in greater detail, they can be grouped into five categories: macroeconomic policy failure, ailing Corporate Korea, failing financial sector, socio-political factors, finally, vulnerabilities of the international financial system and contagious effects.[2]

1.1. Macroeconomic Policy Failure

Firstly, Korea's macroeconomic policy failed. It is generally agreed that the Korean economy was growing at a fast rate until the mid-1990s, and that its fundamentals including GDP growth, unemployment, prices, fiscal position, and exports, were all sound. However, the government maintained a foreign exchange policy that left the current account deficit accumulating over a long period of time. Consequently, foreign debt rose sharply, and particularly short-term foreign debt

1 Korea's Corporate Restructuring (Three Eye Strategy Research Institute, 2012), the first book of this series allocated a section to the same title. In this book, a summary of the same section, "Roots of the 1997 Foreign Exchange Crisis" is included to provide a background to the financial sector restructuring in Korea.

2 Lee Kyu-sung, The Foreign Exchange Crisis of Korea (2nd ed.) (2007), ParkYoungSa.

increased drastically, resulting in a foreign exchange liquidity squeeze and eventually, the foreign exchange crisis. Currency devaluation is a common thread that runs through crisis-struck Asian countries which went through a similar set of steps as follows: greater liberalization of capital markets (Korea) or increased capital inflows from yen-carry trades (Southeast Asian countries including Thailand) → large capital account surplus → sustained currency devaluation and subsequent foreign capital inflows resulting in economic growth → export competitiveness lowered by currency devaluation and widening current account deficit due to higher demand for imports → offset deficits through short-term foreign debt. The trilemma of an open economy is that it cannot juggle all of the three objectives: liberalize the capital markets, maintain an independent monetary policy, and keep its currency stable all at the same time. Korea fell into this trap of trilemma.[3]

1.2. Ailing Corporate Korea

Secondly, Corporate Korea was ailing. Soundness of the corporate sector was seriously undermined by a number of chronic maladies such as collusion between politics and business, debt-based management, the so-called "octopus-style business diversification" by chaebols, unhealthy balance sheets, outdated corporate governance, concentration of resources in chaebols, and abuse of power by owner managers. Chaebols took full advantage of the unsophisticated domestic capital markets and their sticky relations with politicians to engage in reckless business expansion. Their expansionary business ventures were supported implicitly by the government. Consequently, chaebols were able to capitalize on the majority of domestic capitals available and high-quality human resources. There was no institutionalized consumer protection back then and consumers lacked reliable information to make informed buying decisions. Therefore, chaebols were able to gain consumer confidence on the back of their positive corporate images. Foreign companies that possessed technology and capital preferred chaebols as their business partners because they assumed that chaebols were more likely to honor their commitments. However, the close ties with the government and the myth of "too big to fail" were not enough for large conglomerates to cope with every-increasing global competition. As the market environment deteriorated, a total of 17 large business groups including Hanbo and Kia collapsed in 1997 and 1998.[4]

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3 Massive inflows of foreign capital lead to market intervention aimed at stabilizing currency. Subsequently, sterilization measures including large issues of monetary stabilization bonds can be taken in order to curb excessive currency issues, causing interest rates to rise. This, in turn, attracts foreign capital, which induces currency appreciation, thereby creating a vicious cycle.

4 In 1997, twelve business groups went into bankruptcy, including Hanbo, Kia, Haitai Group, New

1.3. Failing Financial Sector

Thirdly, the financial sector was failing. Banks were believed to never fail because their business was tacitly guaranteed by the government and as a result, banks served more as an institution for the government than as a profit-seeking business. The government exercised excessive influence over banks' operations and banks practically ran their business upon instructions from the government. As these unhealthy practices continued, banks' profit base was seriously weakened, and eventually, some banks became insolvent. A serial collapse of large corporations dealt a direct blow to the financial sector. Particularly hard hit were those financial institutions that lent primarily to big businesses. Unfortunately, however, those financial institutions were not capable of managing risks. Worse yet, the financial regulatory authorities did not have the ability to turn around the market conditions or deal with the consequences of capital market liberalization. A financial crisis was looming large amid the absence of banks' risk management and inability of the financial regulators to stabilize a faltering financial market.

1.4. Socio-Political Vulnerabilities

Fourthly, there were socio-political vulnerabilities. Geo-political risks always persist on the Korean Peninsula as North and South Koreas are still technically at war. On the domestic front, the rigid labor market and increasing demands for redistribution of wealth created by economic growth, frequently triggered labor-management disputes and other social conflicts. As Korea became an increasingly democratic society, resorting to heavy-handed government control such as using police force was no longer allowed in resolving such social conflicts. Korea found itself without political leadership capable of working out conflicts and pushing forward with a reform by building a consensus and presenting a vision that could be shared by the people. In the absence of such leadership, it was hard to formulate and implement effective strategies to restore investor confidence. There were attempts, prior to the onset of the crisis, to push for a reform, but the political leadership didn't have the capacity to follow through. So the struggling financial sector was left vulnerable to external shocks, and the crisis ensued as an inevitable result.

Core, Ssangbangwool, Halla, Korea Steel, Daenong, Sammi, Hanshin E&C, Chung Gu Group, and Jinro. In 1998, 5 business groups collapsed, including Nasan, Kuk Dong E&C, Durei, Bosung, and Hwaseung.

1.5. Vulnerabilities of the International Financial System and the Contagious Effects

Finally, the Korean financial sector was adversely affected by vulnerabilities of the international financial system and fell victim to the contagious effects. With the fall of the Breton Woods system, exchange rates and interest rates became subject to sharply increased volatility. As a consequence, investors displayed a herd behavior in which they frequently changed the makeup of their assets even on small shocks. On the other hand, the IMF was not properly performing its role as a lender of last resort, and there was no consensus on how to share cost with private sector. Cross-border capital flows were quickly reversed, creating capital booms and busts across different countries, leaving many countries vulnerable to a financial crisis.[5]

2. Pre-Crisis Restructuring[6]

Prior to the 1997 crisis, financial sector restructuring in Korea was led primarily by the government. Korea had a relatively short history of economic development and the majority of industries grew under the protection and support of the government. Therefore, it is little surprising that the private sector was incapable of making their own decisions and that the financial institutions were ill-equipped to handle challenges. Inevitably, the restructuring was masterminded and orchestrated by the government. The goal of the restructuring was to bring about structural reforms in the financial industry through the granting of greater autonomy to the industry and privatization, but the outcome fell short and the financial industry failed to avert a crisis.

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5 Speculative moves involving Hong Kong dollar(massive short-selling of Hong Kong dollar in anticipation of a decline in its value) were obstructed by the counter-measures of the Chinese government(Hong Kong dollar-denominated borrowings by non-Hong Kong residents were banned and unlimited exchange of HK dollars to US dollars was allowed). Japanese banks sustained losses and withdrew their exposures to Korean banks to meet the BIS capital adequacy ratio, which left Korean banks in trouble. The withdrawals by Japanese banks amounted to approximately 10 billion dollars in the single month of November 1997. Korea's foreign exchange reserves stood at 27 billion dollars and the Bank of Korea had 10 billion dollars in reserves for foreign currency-denominated loans to overseas branches of domestic banks(the overseas branches lent the money to Korean chaebols in the form of facility investment funds to pay for the imports of overseas capital goods. Therefore, the funds were not recoverable in a short period of time. Under the circumstances, the usable reserves at the end of November fell to around 8 billion dollars. Given that American banks' rollover ratio stayed at 100% in November, the massive withdrawal of funds by the Japanese banks was critical.

6 Park Ki-jin, etc, Jeon Gae-seo & Lee Gyu-sung, Jeon Gae-seo.

2.1. Structural Reforms in the 1980s

The structural reforms in the 1980s were intended to establish market principle and enhance the competitiveness of the financial sector by strengthening autonomy, profitability and responsible management of financial institutions. To attain these goals, efforts were made as follows. First, regulations on the management of financial institutions were significantly relaxed. Specifically, controls imposed by the Ministry of Finance, the Bank of Korea, and the Various Financial Supervisory Boards upon organization, staff, budget, wage, etc of financial institutions, were removed. In addition, actions were taken to expand the business scope of financial institutions. Second, privatization of commercial banks began, led by Hanil Bank in 1981. Third, monetary supply was indirectly controlled through the reserve requirement system. Previously, aggregate monetary supply(M2) targets were set first, and supply limits were placed upon individual banks. Fourth, granting new policy loans was banned and existing policy loans were consolidated. The size of policy loans could still be increased with a ceiling for the time being, but favorable interest rates were no longer offered. All of these were steps in the right direction because the policy loans that were introduced to foster industries created the collusion between business and politics as well as international trade disputes. Nevertheless, elimination of preferential interest rates altogether was politically a tough decision.[7] Fifth, Commercial banks were encouraged to increase their capital in order to raise their competitiveness by enlarging the size of their business(the capital increases totalled 15 billion won in 1981 and 20 billion won in 1982). Sixth, the financial market was opened to foreign investors to promote healthy competition. As a result, Shinhan Bank was established in 1982, followed by KorAm Bank in 1983. In addition, banks were allowed to increase their branches (75 new branches in 1981 and 71 new branches in 1982) (vii) As a first step toward the liberalization of interest rates, interest rates were allowed to float in the short-term money markets. A large number of short-term investment finance companies and mutual savings and finance companies was created to support the

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7 Historically, financial regulation has been imposed for two main purposes. Firstly, Korea's rapid economic growth was made possible by the strong commitment and leadership of the government. For example, when a new industry needed to be developed, laws were enacted to support the development of the specific industry. In addition, the government formulated and implemented a package of fiscal, tax and financial policies to foster the industry. In this process, tight control over the financial industry became inevitable in order to promote the real economy. Secondly, regulation is necessary to ensure the stability of the financial system. As the economy develops and the government intervention in the market becomes increasingly inefficient, the economy reaches the stage in which such intervention should be minimized and the market should be left to its own devices. In this stage, competition can get severe to the point of putting the entire financial system under the threat of a collapse. At this point, the government needs to step in to make sure that the financial system remains stable and reliable.

expansion of the short-term money markets. Interest rates were liberalized gradually, starting with CPs and call rates. Still, more clean-up was necessary to reduce bad loans and with fragmented stock ownership, heads of banks were appointed by the government, indicating that responsible management practices were not yet put in place. Banks adhered to their old practices of pursuing quantitative growth, such as collateral-based lending and chaebol-focused lending, under the implicit guarantee of the government. Against this backdrop, the government explored ways to encourage voluntary restructuring among banks, resulting in the core business system in the 1990s and the deferred bankruptcy agreement in 1997.

2.2. The Core Business System in the 1990s

As the liberalization of the financial market advanced and the industry rationalization measures based on direct intervention of the government in the 1980s, lost much of the ground, a new approach was necessary in the 1990s, and financial institutions were allowed to decide how financially distressed companies should be handled. In 1991, the core business system was introduced to create incentives for corporations to focus on core businesses and ultimately to promote specialization. Under the system, 30 business groups and 76 subsidiaries were exempted from submitting a compulsory rehabilitation plan and benefited from the basket control system. However, the well-meant incentives such as relaxing the lending control and easing the limits on equity investment in the core businesses, ended up distorting the credit management system in a way that the core companies were used as a vehicle to channel funds into their parent group. Unfortunately, the incentives also failed to induce specialization in the business groups. This indicates that the financial industry was still operating under the heavy influence of the government, and that financial institutions were still incapable of restructuring themselves.

2.3. The 1997 Deferred Bankruptcy Agreement

The deferred bankruptcy agreement, which was signed on April 21, 1997, is an agreement among financial institutions designed to assist in normalizing the business operations of companies showing signs of insolvency and to efficiently resolve non-performing loans. The purpose of the agreement was to prevent financial institutions from competitively withdrawing their exposures to companies that are going through a temporary liquidity squeeze, thereby saving the otherwise healthy companies from going bankrupt. According to the agreement, the participating financial institutions should stand still and not withdraw their funds for 2 months, from companies that had more than 250 billion won in credit including payment guarantees, upon the request of the main creditor bank, which was later incorporated into the subsequent workout agreement as one of the key elements. As signs of crisis prevailed and the social morale was negatively affected by aggressive labor movements that frequently took advantage of political circumstances, the agreement was revised to require, among others conditions, that the management should hand in a statement of renouncement of all the managerial rights, and that the labor union submit a statement of agreement to possible lay-offs, if the company in question is to opt for deferred bankruptcy. Nevertheless, the agreement brought about regulatory forbearance and only postponed the exits of non-viable companies.[8]

2.4. Limits of the Pre-Crisis Restructuring Initiatives

As explained earlier, the government-led restructuring initiatives achieved only limited success in improving autonomy and efficiency of corporations and failed to significantly improve accountability, transparency and soundness in overall corporate activities. There are multiple factors that can explain why the government initiatives ended up in failure, but from the perspective of financial companies, the following factors can be pointed out. First, there was no clear understanding that a financial institution is a profit-seeking company. Second, the financial sector was liberalized while bad loans of privatized financial institutions were not resolved properly and timely. As a result, a framework for banks' responsible management was not fully in place. Third, financial institutions were still forced to look at the size of businesses, lend primarily to large conglomerates, and base their lending decisions on availability of collateral, because the credit rating system and the depositor protection scheme were either unreliable or virtually non-existent, and corporate accounting practices lacked transparency. The financial sector liberalization and the opening of the financial markets were picking up speed but the financial regulatory system was not catching up. All these factors were posing obstacles to advancing the financial industry. Under these circumstances, a restructuring drive led by

8 Analysts say that the deferred bankruptcy agreement produced little of its desired results because 92% of the companies that entered into the agreement failed to turn around their failing business and ended up being placed under court receivership or composition. In addition, critics say that around 2 months of time was wasted on average in the process and if those companies had been placed under court receivership or composition earlier instead of entering into the agreement, uncertainties could have been minimized and the psychological fatigue associated with such uncertainties could have been reduced.

financial institutions stood little chance of success. While the financial industry was struggling with its own problems, large-scale corporate bankruptcies added to the woes by seriously damaging the quality of assets held by financial institutions, calling for a massive industry-wide restructuring.

3. Goals, Principles, and Strategies of the Restructuring

3.1. The Beginning of a New Restructuring

A restructuring inevitably entails job losses and pains. The 1997 crisis was a culmination of the structural problems that had long plagued the Korean economy. In order to overcome the crisis, the economy needed to change its fundamentals including the institutional frameworks, the practices and the mind-set. There had been talks of the need for restructuring since the 1980s, and of how the restructuring was going to be carried out[9], but the underlying changes had yet to be made. There was a consensus that a reform was necessary, but the reform often lost its momentum soon after discussions began in order to find specific ways of how the reform was to be brought about, because opinions were sharply divided among the parties involved due to conflicting interests. In this sense, the 1997 crisis can be viewed as a harsh punishment that the market meted out to the Korean economy for failing to fix all those problems in time. On the flip side of the coin, however, the crisis also created the much-needed momentum to finally follow through with a long-awaited reform[10]. Immediately after the eruption of the crisis, the Korean economy suffered a long series of corporate bankruptcies and even profit-making companies experienced liquidity crunches and fell into bankruptcy. Amid growing uncertainties and worries, consumption steeply dropped and investments plunged, causing an unprecedented contraction of the economy.

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9 For example, since president Kim Young-sam declared Korea's commitment to globalization in Sydney in December 1994, presidential advisory committees that were formed to advise on a broad range of economy-wide issues including labor-management relations and financial sector issues, had discussed issues facing the Korean economy and made policy recommendations.

10 When Michel Camdessus, managing director of International Monetary Fund visited Seoul in November 1997 immediately after Korea asked for a bailout, he said the crisis was grace in disguise and his remark enraged Korean people who were suffering from job losses, bankruptcies, and other financial difficulties. However, it is hard to deny that the IMF-requested restructuring program gave a powerful impetus to the reform and enabled Korean people to accept the pains and losses associated with the restructuring and to finally bring about all the changes in various sectors of the Korean economy earlier than otherwise possible. For example, social safety nets were put in place in different areas of the society within a short period of time during the restructuring program, but if it had not been the crisis and the subsequent reforms, it would have take much longer.

Weaknesses of Korea's corporate and financial sectors including lack of transparency in accounting practices, deteriorating finances, and vulnerable governance structure, were disclosed both domestically and internationally. Foreign business partners refused to do business with Korean companies and even withdrew their investments. Consequently, the foreign exchange and financial markets were hit hard.

In spite of these circumstances, the restructuring had to go on, with the goals of stabilizing the financial markets and restoring their intermediary functions. In order to avoid a bank run and maintain order in the credit system, unlimited guarantees were provided on the principles and interests on deposits. However, these guarantees caused financially unhealthy banks to survive on borrowed high-interest funds, which in turn, further aggravated their financial position. In addition, depositors moved their money to high interest-paying financial institutions, without carefully looking into their financial health. As the finances of Korea First Bank and Seoul Bank became worse, the government invested 1.5 trillion won in the banks, respectively. But it proved to be only a stopgap measure and the banks fell back into financial distress. The government's investment only contributed to the negative view that the government was trying to protect the financial institutions in trouble, causing a delay in the restructuring process.

The restructuring framework per se was created by the agreement with IMF and IBRD. An emergency bailout plan was passed by the IMF board of governors on December 5, 1997, and the bailout funds began coming in. In March 1998, the agreement was reached with foreign banks on the rollover of foreign debts, which eased the foreign exchange liquidity crunch. Under the basic restructuring principles, financial institutions and corporations that were not deemed viable were forced to exit the market while public funds were injected into viable financial institutions with the hope of a turnaround, laying the groundwork to curb further spread of financial woes and to restore market order.

In retrospect, considerable efforts were made in the 1980s and 1990s to help the financial industry perform its intended role, but the reforms came short of making the necessary changes, eventually triggering the crisis. The reforms failed because there was no mechanism through which conflicting interests in politics, economy and society could be reconciled, and there was not enough capacity and expertise to plan and implement a successful restructuring of the financial sector.[11] Only

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11 Financial crisis continues to occur even in advanced economies with a well-developed financial industry. In the United States, deregulation of the savings and loan industry triggered massive bankruptcies and inadequate accounting regulation contributed to the LTCM and Enron crises. The subprime mortgage crisis revealed that the regulatory authority was unable to catch up with the latest trends in the financial markets. All these cases show that financial industry constantly evolves and expands into new, uncharted territories but regulators often do not have the capacity to

after the crisis wreaked havoc on the economy did the whole society begin to understand the depth of the existing problems and became alert, generating a genuine momentum for reform. The restructuring drive found additional momentum in analyzing the experiences of IMF and other countries and thus obtaining massive amounts of professional knowledge and information that Korea previously lacked, under the close guidance of experts.

3.2. Goals of the Restructuring

An accurate diagnosis of whether or not a financial institution is viable is a crucial first step in making a restructuring plan. If a financial institution was deemed non-viable or the restructuring was expected to entail excessive costs, the institution was ordered to exit while public funds were injected into viable institutions on condition of an intensive restructuring program and cost-sharing. This selective support was intended to relieve tax payers' burden and to prevent moral hazard from leading to another crisis. The government offered direct investment or financial support, when deemed necessary, to facilitate the restructuring process. The purpose of this generous support was to strengthen the intermediary role of financial institutions and thereby stabilize the financial markets as early as possible. Candidate financial institutions for management normalization were selected strictly by solvency criteria and an evaluation committee of experts reviewed the management normalization plan submitted by the institutions. After the review was completed, the financial institutions were ordered to either exit or implement the plan, following the internationally recognized standards and procedures. In addition, deposit guarantee schemes, accounting and disclosure rules, prudential regulation of foreign exchange business, loan classification and provisioning standards, and other financial rules and regulations were revised and brought in line with best global practices so as to carry out the restructuring in a fair and objective manner and to raise external confidence in the restructuring process. Further steps were taken to establish the institutional frameworks within which restructuring could be induced by market forces on a continuing basis. In other words, the restructuring was planned and carried out in a way that the old and inefficient structures and practices that had been deeply rooted in our financial system were to be eradicated.

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properly regulate the fast changing industry.

3.3. Basic Principles of the Restructuring

The Korean economy was facing two key challenges when it was struck by the crisis: The foreign exchange reserves were depleted, and the corporate and financial sectors had to be fundamentally restructured in order to eliminate the structural vulnerabilities. The Korean economy was under fast-increasing pressure. The market collapse was imminent and the ultra-tight fiscal austerity under the IMF-led reform program imposed significant constraints on the restructuring. So the following principles were adopted in order to push ahead with the restructuring under these challenging circumstances.

First, the restructuring should be carried out swiftly under the government leadership. A structural reform would take time if it was to be done, strictly following market principles, and there were concerns over uncertainties such as bank run that would likely arise in the meantime. For the same reason, purchase and assumption(P&A) rather than mergers and acquisitions(M&A) was preferred as an exit strategy for financial institutions, because it was more time-efficient.

Second, there were possibly conflicting views over which of the two sectors, corporate or financial, should be reformed first, but the chosen principle was to restructure both of the sectors simultaneously. The rationale behind the principle was that a successful corporate reform can be made possible only by healthy financial institutions, and that financial institutions can remain sound only when corporations are financially healthy. But the effects of the restructuring began to be felt in the banking sector earlier than in the corporate sector, because different factors including injection of public funds were involved in the former. Third, restructuring should consistently follow the chosen frameworks in order to minimize moral hazard and secure the support of the public. Workout was used as the basic framework for corporate restructuring while the CAMELS rating system was adopted to determine whether financial institutions were to survive or exit, closely following globally recognized standards and procedures including management normalization plan and prompt corrective action. Fourth, reforms should aim at improving the corporate and financial sectors on a fundamental and systemic level while addressing issues at hand in a timely manner. To this end, a series of measures was taken, including tightening macroeconomic management, implementing the early warning system(EWS), improving corporate governance, and introducing global accounting rules and other internationally acceptable standards. Emphasis was also placed on reforming the government sector and labor practices.

3.4. Strategies

There were five strategies for implementing the restructuring. These strategies can hopefully serve as a benchmark for other countries as well.

First, internationally recognized standards and procedures were used in the belief that doing so would help gain confidence of both domestic and foreign investors and the public support, and minimize moral hazard, thereby ensuring a smooth restructuring process. Candidate financial institutions for management normalization were selected strictly by solvency criteria and an evaluation committee of experts reviewed management normalization plan submitted by the institutions.

Second, the government generously provided direct investment or financial support when deemed necessary as a temporary assistance in the financial sector restructuring process in order to facilitate a turnaround and stabilize the financial markets at the earliest date possible. Investments were made when capital increases were needed, and impaired assets were collected and resolved by Korea Asset Management Corporation(KAMCO). When a takeover involved business transfers, mergers, liquidation, etc. and thus was expected to take a long time, P&A was used in order to save time and thus minimize potential damages to the bank's value, losses to depositors, corporate bankruptcies and other possible negative effects. Large amounts of public funds equivalent to 12% of GDP were used to cover the restructuring costs.[12] Prevention of moral hazard and support from the public is essential for a successful restructuring. For this, utmost care was taken to ensure transparency, accountability, and fair burden-sharing in each step of the restructuring process. In the same vein, when a company received government support, it was required that additional conditions such as asset reduction be imposed, and that the shareholders and the management be held fully accountable. Third, some of the non-viable banks were put up for sale to foreign buyers because learning global management practices was deemed necessary to increase compliance with international standards and global competitiveness. The decision was made, taking a cue from the Mexican case where its nationalized banks were taken over by domestic industrial capitals in 1991 and 1992. But Mexico had another financial crisis in 1995 and eventually, allowed foreign capitals to participate in takeover deals.

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12 The public funds used in the first and second rounds of restructuring amounted to 64 trillion won, equivalent to 12% of 549 trillion won in the 1999 GDP. The total amount of public funds injected by the end of 2001 reached 155.2 trillion, representing 24% of the 2001 GDP which stood at 651.4 trillion won. The amount includes 40 trillion won spent in the 3rd round of restructuring by end-2001, 23.8 trillion won in government budget allocated before public funds were available, and 29.3 trillion won in recycled funds made available with recovered public funds.

Fourth, the restructuring had to be carried out while organizations, laws, and regulations were either newly established or revised to allow the restructuring itself. Multiple changes had to take place on all fronts. On one hand, the Act on the Structural Improvement of the Financial Industry, Corporate Restructuring Promotion Act and other legal frameworks were created, and on the other hand, financial regulators were unified into the Financial Supervisory Commission (FSC) and the Financial Supervisory Service (FSS), and the roles of the organizations involved in the restructuring such as the Korea Deposit Insurance Corporation (KDIC) and Korea Asset Management Corporation (KAMCO), were expanded and strengthened. Simultaneously, institutional frameworks were laid to create the settings in which restructuring could be initiated and proceed by market forces, as well as maximize the objectivity of, and external confidence in the restructuring standards. The frameworks include the establishment of the following: loan classification and proviosioning standards, prompt corrective action, forward-looking criteria (FLC), capital adequacy ratio, risk management criteria, management evaluation system, accounting and disclosure system, prudential regulation of foreign exchange business, deposit guarantee system and mark-to-market bond valuation system Fifth, the ownership of the restructuring was clearly identified and international cooperation was strengthened. In order to garner close cooperation from the international community and restore investor confidence, the government concentrated its resources and energy on successfully working out foreign debt rollovers and negotiations with the IMF. Investor relations also remained an integral part of the communication strategies to stay open to, and connected with domestic and foreign investors. Korea actively participated in the discussions on revising the international financial architecture.

4. Relevant Organizations and Laws

4.1. Organizations

Six organizations within the government were involved in the financial sector restructuring: the Ministry of Finance and Economy, Financial Supervisory Commission, Financial Supervisory Service, Korea Deposit Insurance Corporation, Korea Asset Management Corporation, and Public Fund Oversight Committee (PFOC).

4.1.1. The Ministry of Finance and Economy (MOFE)

The Ministry of Finance and Economy is responsible for making policies on sovereign debt, financial restructuring, depositor protection, resolution of impaired assets, and international cooperation, and for managing public funds.

4.1.2. Financial Supervisory Commission (FSC)

The FSC is vested with the authority to declare financial institutions non-viable, and to coordinate and oversee the financial sector restructuring in accordance with the Act on the Structural Improvement of the Financial Industry. The launch of the FSC and the need for greater independence of the central bank had been discussed in tandem for a while prior to the crisis, and the talks began in earnest after the financial reform committee was set up in 1997 immediately before the crisis gripped the nation. However, the MOFE and the Bank of Korea (BOK) remained sharply divided over the details of how the fragmented financial regulatory frameworks were to be consolidated, and the legislation of the proposal had been delayed until after a legal foundation was laid to launch a unified financial supervisory body upon the IMF's recommendations. The Act on the Establishment of Financial Supervisory Organizations (No. 5409) was passed on December 31, 1997, paving the way for the establishment of the FSC as an independent government body under the Office of Prime Minister. Finally, the FSC was launched on April 1, 1998. The FSC consisted of a chairman who automatically assumed the status as a government official upon appointment, a vice chairman, the vice minister of the Finance and Economy as a permanent and ex officio non-permanent member, the chairman of Korea Deposit Insurance Corporation, and 3 non-permanent members (accounting, legal, and financial experts). The FSC's main responsibilities are making and revising laws and regulations on financial supervision and regulation, licensing and authorizing businesses of financial institutions, dealing with major issues regarding examination and sanctions on financial institutions, and instructing and supervising businesses of the Financial Supervisory Services (FSS). In May 1999, the Government Organization Act was revised to transfer the authority to approve and license the establishment, merger, etc. of financial institutions, and to supervise special banks, from the MOFE to the FSC.[13] The Securities and Futures Commission was formed within the FSC, with

13 Under Lee Myung-bak's administration, the Financial Supervisory Commission was reorganized into the Financial Services Commission of which mandate was expanded to include making and revising laws on financial supervision.

the mandate to manage and supervise securities and futures markets, and to deal with matters relating to corporate accounting standards. In addition, the Planning and Administration Office was set up to support the work of the FSC. The chairman of the FSC also served as the governor of the FSS. The FSC chairman also acted as the heads of the Banking Supervisory Board and the Various Financial Supervisory Boards until the fragmented frameworks of financial supervision were unified into the FSC. Given the central role that the FSC was playing in the restructuring of the financial and corporate sectors, the FSC chairman was appointed to lead the Structural Reform Planning Group, a task force that was launched later.

With the launch of the FSC as a consolidated financial regulator, Korea became one of the first countries that adopted the unified financial supervisory approach.[14] Unified financial supervision became widely recognized as a global benchmark for reforming financial supervision systems as 12 countries including the UK, Australia, Canada and 3 north European countries implemented the unified supervisory framework. Advocates of unified supervision point out as benefits, centralized management of supervisory information, regulatory consistency and continuity, greater equity, less regulatory overlaps and blind spots, and clear regulatory accountability. For example, same regulation and supervisory standards can be applied to businesses of same nature performed by different financial institutions, which keeps financial supervision consistent and simple. A brand new regulatory organization can sever all the links to the past and thus be free from political pressures exerted in an attempt to unfairly hold financial regulators responsible for the financial crisis, thus only posing stumbling blocks to the reform drive. The free-standing status also gives the new regulator greater supervisory powers, which in turn, will strengthen its status and independence.

4.1.3. Financial Supervisory Service (FSS)

The Financial Supervisory Service was established on January 2, 1999, under the Act of the Establishment of Financial Supervisory Organizations (Article 24.1) by bringing together four supervisory bodies- Banking Supervisory Board, Various Financial Supervisory Boards, Insurance Supervisory Authority, and Non-banking

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14 Many of the countries that have experienced a financial crisis are opting for a unified supervisory framework. After the global financial crisis caused by the US subprime mortgage crisis in 2008, financial regulatory reform emerged as a pressing task in many countries. Financial supervision is divided among different organizations in the UK while Indonesia chose a unified approach. As discussed at the Banking Union meetings, the EU is also leaning toward consolidated regulatory scheme.

Supervisory Authority- into a single supervisory organization. The creation of the FSS was envisioned and started as soon as the FSC was established in April 1998. The FSS establishment committee headed by the vice chairman of the FSC was composed of the vice chairman of each supervisory authority, lawyers, and professors. Under the control of the committee were a working-level committee -led by the permanent member of the FSC, and composed of the deputy vice chairman of each supervisory authority-, and task force teams in charge of coordinating and planning, organization and HR, budget and accounting, and asset management.[15] The integration plan was finalized in two phases in collaboration with an outside advisory group. The first phase that lasted from April through September 1998, focused on the organization of the integrated financial supervisory body and the overhaul of its functions. The second phase ran from September through November, 1998, during which personnel issues and post-merger management were mainly discussed. Mckinsey & Company was involved as an outside consulting service provider in both of the phases, and its final report was submitted at the end of November, 1998. Recommendations made in the report were incorporated in finalizing the articles, bylaws, and other rules and regulations governing the organizational structure of the FSS on December 18, 1998. All the positions were filled by the end of December and the FSS was finally launched on January 2, 1999.

15 The number of task force teams was increased to 7 in September 1998. Indonesia had been working on the establishment of an integrated supervisory organization, following the Korean model. With the passage of relevant laws in the fall of 2011, a unified supervisory organization was launched in January 2012 and four teams in charge of legal and organization matters, SOP, IT, and training, were set up. The chairman of the new organization took office upon parliamentary approval in June 2012 and 9 commissioners including the chairman were appointed. The new agency is scheduled to take over the financial supervisory functions from the Ministry of Finance by the end of 2012, and to integrate the remaining banking sector supervision transferred from the central bank, under its authority by the end of 2013. The new agency will be structured along the sectors of the financial industry into bureaus and the appointment of commissioners will be also based upon the specific sectors that individual commissions will represent. This sectionalized approach is not likely to create the same advantages that Korea's horizontal structure has.

<Table 1-1> Mission and Goals of the FSS

Goals

Ensuring Soundness of Financial Institutions	Establishing a Fair Market Order	Protecting Consumers
• To keep a close watch on the financial soundness of financial institutions for greater safety and stability of the financial system • To maintain consistent prudential regulation based on effective supervisory mechanisms and control systems. • To build confidence in the financial system	• To promote orderly and efficient market conduct • To ensure fair and adequate disclosure and transparency for market participants • To encourage fair competition • To uphold market principles • To develop a market for infrastructure	• To provide timely disclosure and preserve transparency for consumers • To avoid moral hazard • To educate consumers on risks • To promote fairness and equity • To mediate consumer disputes

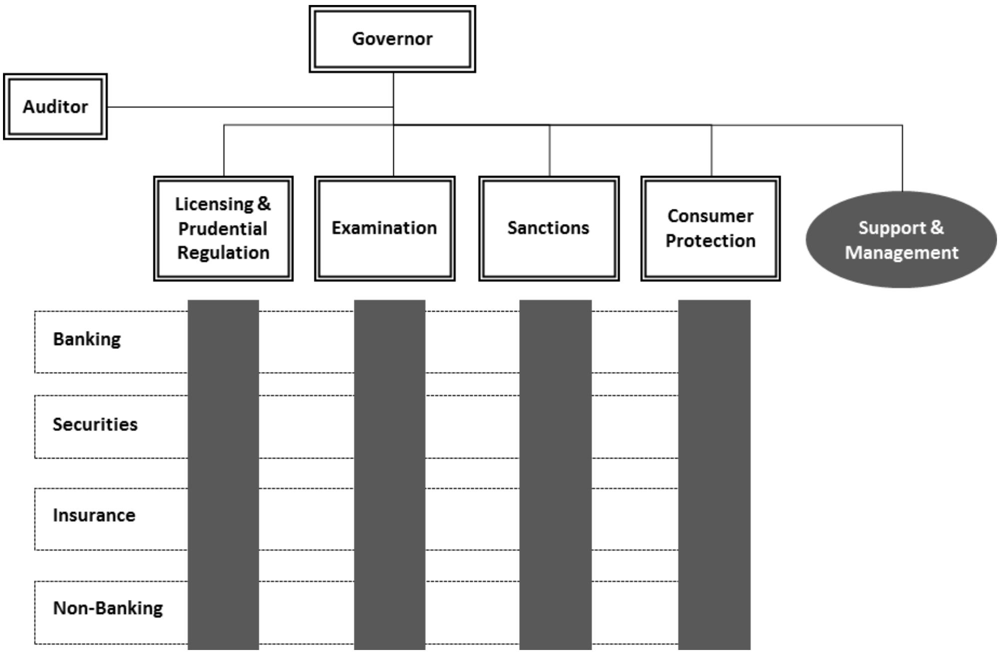
Mission

The FSS is a financial supervisory body established under the FSC, with the aim of maintaining a sound financial system and thereby promoting the national economy by ensuring the soundness of financial institutions, keeping a fair market order, and protecting the rights of financial consumers and market participants.

The four supervisory authorities that were brought under the same roof differed widely in their field of supervision, organizational culture, and supervision strategies. These differences posed considerable challenges to their consolidation. Back then, financial supervision was fragmented in most countries, except Sweden that had just launched a single supervisory body and the UK where consolidation of financial regulators was under way. So there was no good benchmark available in terms of specific methodology of how the integration was to be achieved. Major issues presented in the consolidation process were dealt with as follows: First, the mission and goals of the integrated regulator were clearly identified in the early designing stage of the integration process, and the organizational structure was optimized to accomplish the mission and the goals. Second, the unified regulator was designed in a way that enabled an organic integration rather than a merely physical combination of four distinct organizations, by conducting a comprehensive analysis of the goals and principles of financial supervision, supervisory capacity, supervision procedures and techniques, personnel systems, and information-sharing systems of the four organizations involved. Third, opinions were widely gathered throughout the integration process. Initially, only 10 people were involved in the project, but the number grew to over 50 in the final stage. They worked in partnership with Mckinsey & Company and held interviews with more than 60 experts from the financial circle and academia, for diagnostic reviews of the four organizations. On the international front, consultative talks were held with the World Bank and the IMF, and visits were made to the FSA of the UK and the financial regulator of Sweden to exchange ideas and benefit from their experiences. In the final stage, leadership workshops joined by senior executives of the four organizations, and working-level workshops were frequently held as part of the efforts to help them better understand where and how the consolidation was progressing, and to build a solid consensus. Fourth, the four organizations were blended into a matrix-type single entity. It was structured into bureaus along the main functions including licensing and supervision, examination, sanctions, and consumer protection. The bureaus were again horizontally split into smaller divisions along the supervised sectors including banking, securities, insurance, and non-banking. Fifth, what was most hotly debated in working out the organizational structure was how many bureaus would be created and how the different organizational hierarchies of the four organizations were to be coordinated and smoothly integrated into one harmonious structure. Most sensitive and thorny was how the new organization was going to mingle all the employees of the four different organizations in varying positions into a well-balanced hierarchy in a fair and equitable manner when their personnel policies and systems were disparate in every aspect including the size of payroll, promotion criteria, evaluation, and compensation. As such, there was no perfect organization plan that could make everybody happy.

The organizational hierarchy was simplified from previously 5 to 4 levels by combining the highest and second highest levels into one bracket, and the years of employment and job performance evaluation were weighted at 60% and 40%, respectively, thereby ensuring that no one saw their level adjusted down in the new organization. The salary schedule and the job positions were completely separated in a way that employees would be rewarded based more on their performance than the length of their service. Sixth, opinions were extensively collected and there were prolonged discussions in the designing and planning stages, but once the plan was finalized and agreed upon, a radical approach was chosen over a gradual approach in the following steps taken to execute the plan. The rationale behind this approach was that the faster the organizational blending and positioning of employees into the new hierarchy would be finished up, the less frictions and anxieties would be generated.

<Table 1-2> Organization of the FSS



4.1.4. Korea Deposit Insurance Corporation (KDIC)

The KDIC's major roles are as follows. First, it protects depositors by informing them of financial companies and products under its coverage, and by making deposit insurance payments in the event that payments of deposits are suspended or a financial company is bankrupt. Second, the KDIC manages the Deposit Insurance Fund(DIF) and the Deposit Insurance Fund Bond Redemption Fund. The DIF is raised through insurance premiums paid by financial companies, and contributions, while the Deposit Insurance Fund Bond Redemption Fund is raised and repaid through government contributions, special contributions by financial companies, the KDIC's recovered funds, etc. It is noteworthy that the DIF and DIF Bond Redemption Fund were separated. As part of the plans to repay public funds used to finance the restructuring, the Depositor Protection Act was revised on December 26, 2002 to allow the separation of the existing restructuring-related funds and the funds to be used for deposit insurance. Specifically, the DIF Bond Redemption

Fund was set up to take over all the assets and liabilities associated with the restructuring as of January 1, 2003, as well as other rights and obligations, and to resolve the liabilities that the DIF incurred in the process of supporting the restructuring. On the other hand, the new and separated DIF was financed by insurance premiums starting from 2003 and used exclusively to handle claims filed in 2003 and beyond. Third, the KDIC was in charge of regular risk monitoring in order to deter insurance accidents involving insured financial companies.[16] It analyzed management risks of financial companies, monitored risks in a market-friendly manner, conducted joint examinations on financial companies, and performed research. Fourth, the KDIC resolves failing financial institutions and recovers the funds injected to help faltering financial companies. Specifically, it resolves ailing companies by making insurance payments, selling them to third parties, or creating a bridge financial company. It also provides financial support for bankrupt funds, sale of shares held as equity investment, and assets it took over, and management normalization of financial companies in financial distress. In addition, it enters into MOUs with financial companies to promote management normalization, and monitors if the MOUs are faithfully executed and if the business operations are conducted accordingly. Fifth, it identifies who are responsible for financial trouble at failing institutions and holds them fully accountable in order to put responsible management practices in place. The KDIC examines troubled financial companies and insolvent corporations to clarify accountability, inspects the assets and properties of those who are involved in causing the financial trouble, and exercise the right of indemnity against those who are found responsible. This role of the KDIC is essential to ensure that restructuring gains the necessary support from the people and that the injection of public funds, a burden which eventually falls on taxpayers, be minimized.

4.1.5. Korea Asset Management Corporation (KAMCO)[17]

KAMCO purchases and resolves distressed assets from financial institutions. To

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16 This role of the KDIC required regulatory coordination among the FSS, the KDIC and the BOK. In many countries, regulators often reach a gentlemen's agreement to coordinate supervisory responsibilities among themselves, which are often overlapped. Korea also needs to increase joint supervision and examination under close cooperation between different regulators in order to reduce the burden that overlapped supervision creates upon financial institutions under the supervision of multiple regulators.

17 Originally, Korea Asset Management Corporation (KAMCO) was established in 1962 to resolve bad assets of the Korea Development Bank, and expanded the scope of its business in 1966 to dispose of impaired assets of all financial institutions. In August 1997, the relevant laws were enacted to secure its status as a restructuring institution and later in November, the new KAMCO was launched along with the establishment of the Non-performing Asset Management Fund. In April 1999, the laws were revised to allow KAMCO to act as a bad bank, and again in December, they were amended to change its Korean name as of January 2000.

carry out this role, the Non-Performing Asset Management Fund(NPA Fund) was set up. The sources of the Fund included contributions from financial institutions, funds transferred from KAMCO, government contributions, proceeds from the sale of bonds issued by the NPA Fund, borrowings from the Bank of Korea, other borrowings, profits generated from operations of the Fund.

The Fund disposed of, and retrieved all these funds in a variety of ways. For example, distressed assets were pooled into a package deal and put up for an international public tender where domestic and foreign investors were invited to participate. The Fund also issued asset-backed securities (ABS) based on cash flows that impaired assets can generate currently or in the future. When the Fund had a relatively large exposure to a particular company and the company will likely be turned around through restructuring, the Fund swapped the debt for equity, normalized its operations, and sold the company at a premium. Finally, distressed assets of the companies under the corporate restructuring agreement were collected into a corporate restructuring vehicle(CRV) for disposal. Second, KAMCO repaid public funds. It paid back the obligations as they reached maturity, out of the total principles and interests payable that amounted to 33.3 trillion won. The repayments were made via the recovery of bad assets, contributions from the Public Fund Redemption Fund, and bond refinancing. KAMCO also served as a corporate workout agency. It carried out corporate workout programs in accordance with corporate restructuring agreement, a contract of private nature among creditor financial institutions, and the Corporate Restructuring Promotion Act, a law that came in force 3 times only for a limited period of time: from August 2001 to December 2005, from August 2007 to December 2010, and from July 2011 to December 2013. It acquired non-performing assets under the workout program, engaged in spin-offs, debt-for-equity swaps and other activities to facilitate the turnaround of troubled companies, and sold companies that turned viable, thereby maximizing the recovery of public funds.

In a spin-off, operations that are profitable and competitive are separated from the distressed company and combined into a new company in order to raise the corporate value, creating a base for creditors to retrieve their loans while enabling the debtor company to continue its operations. In a debt-for-equity swap, creditors convert their loans to a company under restructuring into equity stake in the company, improve its credit rating by cleaning up its balance sheets, and realize capital gains as the share price rises. Fourth, KAMCO purchases and resolves non-performing loans(NPL). In its capacity as a perpetual restructuring agency, KAMCO acquires and disposes of bad assets from financial institutions in order to help them improve their liquidity and asset quality. Of bad assets, secured debts include real estate, certificates of credit guarantees, and certificates of beneficiary interest, and unsecured debts are other debts than secured debts and debts that still remain unpaid after all the collaterals are disposed of. Workout debts are exposures to companies under workout program, and special debts are debts of companies that are in the process of corporate reorganization or composition by a court of law. There are several buying options for these different types of debt. Distressed assets can be purchased at fixed prices. In this deal, assets are sold at fixed prices that are determined by assessments at the time of purchase, and losses or profits can be made on the purchased assets, depending on how the value of the underlying collaterals changes after the acquisition. Or assets can be acquired at prices agreed upon at the time of the purchase, and payments are made later with the proceeds from auctions and sale of the assets, which eliminates risks associated with possible declines in the value of collaterals, and guarantees profits. Fifith, KAMCO functions as a corporate clinic. It utilizes its extensive knowhow in supporting the reform efforts of companies showing signs of insolvency and companies under workout program, in various ways including asset purchase, bad banking, and consulting.

It purchases and resolves assets of corporations under workout program and companies with deteriorating finances. It also acquires and disposes of NPLs that financial institutions made to companies whose financial position is deteriorating. As a bad bank, KAMCO makes equity and other investments, provides loans, and guarantees payments. Consulting services include performing diagnostic reviews of management, proposing management normalization plans, acting as a go-between for M&As of distressed companies, and mediating the sale of assets of companies under workout program.

4.1.6. The Public Fund Oversight Committee

The committee was set up within the Ministry of Finance and Economy in February 2001, following the passage of the Special Act on the Management of Public Funds in December 2000. The committee was in charge of deliberating and coordinating all matters relating to the management of public funds. The Act was abolished in 2008 after the Lee Myung-bak administration was inaugurated, but it was re-enacted in 2009.

4.2. Relevant Laws

Various laws were enacted or revised to better cope with the crisis. The Act on the Structural Improvement of the Financial Industry, Depositor Protection Act, and the Act on Efficient Disposal of Non-performing Assets, etc. of Financial Institutions and the Act on the Establishment of Korea Asset Management Corporation (KAMCO Act) were intended to create an institutional framework for smooth restructuring, while the Special Act on the Management of Public Funds was established to ensure that public funds injected for the restructuring be managed, retrieved, and repaid in an efficient and timely manner. Legal frameworks were also newly introduced or amended in a range of areas including tax, securities trade, credit rating, accounting, external audit on stock companies, and asset securitization. Let's take a close look at each of these major legislations and revisions.

First, the Act on the Structural Improvement of the Financial Industry was originally passed as the Act on Merger and Business Conversion of Financial Institutions, but in March 1997, the latter was revised and renamed the former so that it would allow a bold and aggressive implementation of the financial sector restructuring. The Act was revised twice in April and September 1998. The Act provided a legal framework within which mergers, business conversion, reorganization, and other restructuring initiatives were to take place and proceed smoothly. Previously, a financial institution was declared insolvent once it had deposit payments suspended. Under the revised act, the rules had been eased to consider other aspects of business performance. A financial institution was classified as insolvent if it fell into one of the following categories: (i) a management evaluation finds that its liabilities are greater than its assets, (ii) a financial institution is deemed unable to conduct its regular operations, with its liabilities exceeding its assets, as a result of a large scale financial misconduct or a large sum of impaired assets, and finally (iii) a financial institution is deemed unable to make deposit payments without receiving external financial support or borrowings. The new act revised in April 1998 enabled the government to make financial contributions to an ailing financial institution, and the regulators to order its shareholders to reduce capital. In addition, exceptional cases were listed in th Commercial Law to allow a capital reduction to be approved at a board meeting instead of a general meeting of shareholders in case where a financial institution was ordered to reduce its capital. The act was changed again in September 1998 to make the procedures including the notification period for a general shareholders' meeting concerning merger, capital reduction, etc., and the disclosure period for financial statements, far simpler than under the Commercial Law and the Securities Exchange Act. Prompt Corrective Action(PCA) program which was previously applied only to banks, was expanded to securities companies, insurers, merchant banks, credit unions, and other financial institutions. The criteria for issuing a PCA became more specific and objective. Specifically, the law required that PCA program be imposed automatically in phases(recommendation, request, and order), depending on the business performance of the affected institution.

Second, the Act on Deposit Insurance Fund was legislated in December 1995 and revised in December 1997 to consolidate four deposit insurance schemes(Deposit Insurance Fund, Securities Investors' Insurance Fund, Insurance Guarantee Fund, and Credit Management Fund) into the single organization Korea Deposit Insurance Corporation (KDIC) which was launched in April 1998. KDIC assumed a bigger role in resolving failing financial institutions and financially supporting M&As of financially distressed institutions. It also gained the authority to designate potentially insolvent financial institutions and to extend support to those institutions that were otherwise highly likely to become insolvent, given their vulnerable financial position. The KDIC was allowed to issue bonds to expand the uses of the deposit insurance fund and to increase the size of the fund. A financial resolution institution(bridge financial institution) which was wholly owned by the KDIC was created to expedite the exit of failing financial institutions by taking over businesses and contracts from the troubled financial institutions.

Third, the Act on Efficient Disposal of Non-performing Assets, etc. of Financial Institutions and the Establishment of Korea Asset Management Corporation (hereinafter "KAMCO Act") was established in November 1997 to facilitate early resolution of non-performing assets and to support reform efforts of financially troubled corporations. Under the Act, KAMCO was reorganized so that it would be able to achieve the above-mentioned goals stated in the Act. As a result of the reorganization, KAMCO was entrusted with the authority to dispose of impaired assets, including recovery, collection, and sale of such assets. For this purpose, KAMCO was mandated to acquire non-performing assets and examine the finances of debtors. Additionally, the Non-Performing Asset Management Fund was set up.

These legal frameworks provided a fresh momentum for an intensive restructuring of financial institutions and subsequently, the Plan for Implementation of Financial Sector Restructuring was adopted in June 1998 at the economic policy coordination meeting. According to the plan, the first phase of restructuring was slated for completion by the end of September 1998 and further actions would be taken by October 1998 for financial institutions that were not included in the first phase. Since a simultaneous restructuring of all financial institutions could trigger a series of bank runs, leaving the already vulnerable financial markets paralyzed, banks and merchant banks were restructured first in close consultations with the IMF and IBRD. The restructuring of non-bank financial institutions including securities companies and insurers was to be carried out under the responsibility of their majority shareholders, with backup plans in place for contingencies such as insolvency that might occur even before the restructuring would begin.

Restructuring of individual companies was done in compliance with global standards and procedures, which added speed and boldness to the process and secured domestic and international support. Companies that would be ordered to exit the market were selected according to global criteria such as the BIS capital adequacy ratio(for banks and merchant banks), net capital ratio(for securities companies), and risk-based capital(RBC, for insurers). Fairness and transparency remained a top priority in reorganizing and liquidating financial institutions in accordance with internationally recognized procedures. Under these procedures, financial institutions were required to hand in a management normalization plan which went through an objective review to determine their fate. Based on the review, non-viable institutions were forced out of the market at the earliest date possible while viable institutions moved ahead with their plans.

Fourth, the Special Act on the Management of Public Funds was enacted in December 2000. The purpose of this Act was to minimize taxpayer's burden created by payment guarantees that the government extended, with a parliamentary approval, on the bonds issued by KDIC and KAMCO, because the guarantees were financed by public funds that the government raised in order to speed up the financial sector restructuring. In light of such purpose, appropriate steps were taken to closely monitor if the minimum cost principle, the burden sharing principle, and other principles were followed when decisions to inject public funds were made. The Public Fund Oversight Committee was set up within the Ministry of Finance and Economy in April 2001 to be in charge of speedy recovery and repayment of injected public funds. The committee consisted of three members from the government(the Minister of Finance and Economy, the FSC chairman, and the Minister of Budget) and five from private sector(two members appointed by the president, two nominated by the chairman of the National Assembly, and one nominated by the chief justice of the supreme court).[18] Under the committee, there was a sale review subcommittee that comprised the committee's secretary general and four experts from private sector. The committee was responsible for the entire spectrum of public funds management including making public funds management plans, setting the criteria on how the pubic fund recipients would be selected, how the funds would be used, and what follow-up measures should be taken after public funds would be injected, regularly analyzing the uses of the funds, and recovering injected public funds. As of June 2008, of the total 168.5 trillion won

18 Following the re-enactment of the Act in July 2009, the committee was headed by both the FSC chairman and a chairman elected from private sector, and also composed of the first deputy minister of planning and budget as ex-officio member, and five private sector members. Another subcommittee was set up to deliberate on injection of funds in addition to the sale review subcommittee.

provided, 91.7 trillion won or 54.4% was retrieved.[19] Other laws on tax, securities trade, credit rating, accounting, external audit on stock companies, and asset securitization, were also newly enacted or revised to support the restructuring and advance the financial market infrastructure.

5. Summary of the Restructuring

In the face of the currency crisis, the first step in the financial sector restructuring was to deal with distressed financial institutions. Emergency measures including injection of public funds were taken to restore the financial intermediary role of financial institutions, and the restructuring proceeded urgently in the order of merchant banks, banks, insurers, securities firms, and credit-specialized finance company. The first phase of restructuring which ran from November 1997 to April 1998, saw a series of nonviable companies going out of the market. In the second phase extending from April 1998 to August 2000, additional public funds were raised(50 trillion won or 64 trillion won including the amount raised during the first phase) to resolve ailing financial companies while tightening prudential regulation and expanding the market infrastructure. A sense of emergency prevailed in the first and second phases of restructuring. In the third phase which began in September 2000, there was a slight shift in the pace and the focus of the restructuring process. Additional 40 trillion won of public funds was mobilized to resolve the remainder of the troubled companies. More importantly, the institutional framework was overhauled in a way that promoted market-driven restructuring. As a result, voluntary merger and financial holding company emerged as a new focus of the restructuring.

5.1. Banking Sector Restructuring

During the first two phases of restructuring characterized by exit-centered emergency measures and clean-up of distressed assets, respectively, 26 banks in operation as of end-1997 went on one of the following three paths. First, Korea First Bank and Seoul Bank which had their assets and capital seriously impaired

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19 Additional public funds were raised and used to deal with the 2008 global financial crisis. The funds used for the 1997 foreign exchange crisis are referred to as "public funds I" while the other public funds are called "public funds II". The figures here indicate data of public funds I. According to the White Paper on Public Funds Management released in 2009, by the end of June 2008, a total of 6,398 persons were investigated, and civil and criminal lawsuits were filed against 9,633 people including those who signed as personal references, with damage claims totalling 2,778.6 billion won and provisional seizures amounting to 2,114.6 billion won.

received public funds and were sold to foreign investors, resulting in their privatization. The sale of these two banks was expected to attract foreign investments and raise external confidence. It took almost a year before U.S.-based investment fund Newbridge Capital signed an MOU to buy Korea First Bank on December 31, 1998 after it was decided that the bank would be offered for sale in international market. Another year passed before the final contract was signed on December 31, 1999. During the sale negotiations, a total of 5.1 trillion won including 4.2 trillion won in capital increase and 0.9 trillion won in purchase of distressed assets by KDIC and other government agencies, was injected into the bank after it was designated as insolvent, in order to keep its capital adequacy ratio at 10% and its operations regular.[20]

Second, 12 banks with the BIS capital adequacy ratio below 8% were asked to submit a management normalization plan which was reviewed by a management evaluation committee along with a due diligence by an accounting firm. Seven of the 12 banks that were more likely to turn around had their plans approved, on condition that they implement an intensive restructuring. Commerzbank acquired a stake in Korea Exchange Bank and joined the management while Peace Bank gave up international business. Five banks including Chohung, Commercial, Hanil, Kangwon and Chungbuk merged with other healthy banks.[21] Five banks that were assessed nonviable, including Dae Dong, Dong Nam, Dong Hwa, Kyeonggi and Chungchong were ordered to transfer their healthy assets via purchase and assumption transactions, to the five healthy banks including Kookmin, Korea Housing & Commercial, KorAm, and Hana, before they were forced out of market.

Third, thirteen banks with a capital adequacy ratio of 8% or above had their operations assessed as of end-June 1998, and based on the assessment, three banks (Jeju, Pusan, and Kyungnam) and Long-Term Credit Bank were placed under

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20 Initially, Hana Bank took over the bank(It took ten months altogether from the sale decision in February 2002, the selection of Goldman Sachs as the lead manager in April 2002, and the appointment of the preferred negotiator in August, to the conclusion of the contract in September and finally the actual merger in December. To normalize its business operations, it was declared insolvent and its capital adequacy ratio was kept at 10% with the injection of 4.5 trillion won by KDIC and other related organizations in the form of capital increase(3.3 trillion won) and acquisition of bad assets(1.2 trillion won) in September 1999. Later, a structural reform advisory contract was signed with Deutsche Bank in April 2000 and the KDIC made additional investments and contributions which amounted to 0.8 trillion won up to September 2001.

21 The management normalization plan of Korea Exchange Bank was approved as it successfully secured foreign investment by Commerzbank of Germany, but the size of its impaired assets turned out to be larger than originally estimated. Making matters worse, financial conditions at Hyundai Group deteriorated, adding considerably to the bad assets of the bank which was the major creditor of the Group. Eventually, the bank was sold to a foreign private equity fund. The case of Korea Exchange Bank taught a bitter lesson: Korea Exchange Bank wasted its time in putting itself back to normal because the effects of the foreign investment by Commerzbank was overestimated.(Lee, Hyun-jai, Shoot the Crisis, 2012) prompt corrective action programs such as management improvement measures. The evaluation criteria for management normalization plan was set in consultations with IBRD, and six accounting firms were selected to evaluate the plans according to internationally acceptable standards.[22] The criteria which was designed to determine validity and feasibility of a management normalization plan, looked at capital adequacy, asset quality, and specific plans regarding recapitalization, risky asset reduction, cost reduction, internal management improvement, and management replacement. The evaluation took a month and a half from April 30 through June 13, 1998. The evaluation used the prudential regulation standards recommended by the IMF, under which the loan classification criteria was tightened. For example, loans were classified as precautionary and substandard when they were in arrears for one month and three months, respectively.[23] At the same time, a diagnostic review of business management was performed. In the review, the bank's overall financial health, viability, and strategic positioning were examined to come up with

<Table 1-3> Major Contents of Financial Sector Restructuring

Phase	1st Phase	2nd Phase	3rd Phase
Period	Nov. 1997. 11.~Mar. 1998	April 1998~Aug 2000	Sept. 2000 and beyond
Contents	· Nonviable financial institutions were driven out of market (merchant banks, etc.) · Public funds were raised and injected (Total 22. 6 trillion won including 14 trillion won in bond issuance and other fiscal support) · Institutional changes to support restructuring (Depositor Protection Act, KAMCO Act, Banking Law, the Act on the Structural Improvement of the Financial Industry, etc.)	· Additional public funds were raised and injected(50 trillion won, 64 trillion won including the previous amount) · Prompt corrective action standards were tightened and more institutions became subject to PCA. · Additional distressed institutions were resolved. · Prudential regulation was strengthened and maximum credit to a single person was reduced. · More institutional changes(securitization, disclosure, accounting, etc.)	· More public funds were raised and injected(40 trillion won) · Financial holding company was introduced. ·More ailing institutions were resolved. · Institutional changes to facilitate restructuring(deposit guarantee limit, public funds management, responsible management, superior corporate governance)

22 Accounting firms were required to work in partnership with globally recognized foreign accounting companies in order to ensure compliance with international standards. So domestic firms formed partnerships with foreign counterparts: Samil and Coopers & Lybrand, Saedong and PriceWaterhouse, San Tong and KPMG, Ahn Geun and DTT, Ahn & Jin and Arthur & Anderson, Younghwa and Earnest Young.

23 In Japan, loans in arrears for 3 months and 6 months are classified as precautionary and substandard, respectively, as was in Korea previously.

its future prospects. The review also included a SWOT analysis for the bank itself and the management, and an assessment of management and operation systems such as internal control and risk management. Contingency plans were also set up to protect depositors and corporate clients, to negotiate succession of employment, and to secure alternative personnel to perform essential jobs such as IT experts in case of sabotage.

In the third phase(September 2000 and beyond), problems involving Daewoo Group with its workout program under way and Hyundai Group facing a liquidity squeeze surged to the fore, which shifted the focus of the restructuring onto restoring the soundness of the financial system through early resolution of potentially impaired assets, and onto revising institutional frameworks and creating a mechanism for ongoing restructuring in a way that could avoid asset impairment through preemptive actions. The FSC organized a management evaluation committee to review management plans presented by six banks that either failed to reach the 8% BIS capital adequacy ratio as of end-June 2002 or received public funds, and to determine whether or not they would be able to survive on their own. Public funds were injected into six banks(Hanvit, Seoul, Peace, Jeju, Gwangju, and Kyungnam) that were assessed nonviable on their own, so as to bring their capital adequacy ratio up to 10%. Hanvit Bank, Peace Bank, Gwangju Bank and Kyungnam Bank were brought together as subsidiaries under a new financial holding company, and moved ahead with steps to normalize their operations. Jeju Bank was sold to Shinhan Bank and Seoul Bank merged with Hana Bank. Kookmin Bank and Korea Housing & Commercial Bank were merged and Shinhan Financial Holding Company purchased Chohung Bank. More M&As followed and financial holding companies played a central role in these deals driven by market dynamics as illustrated in the chart below.[24]

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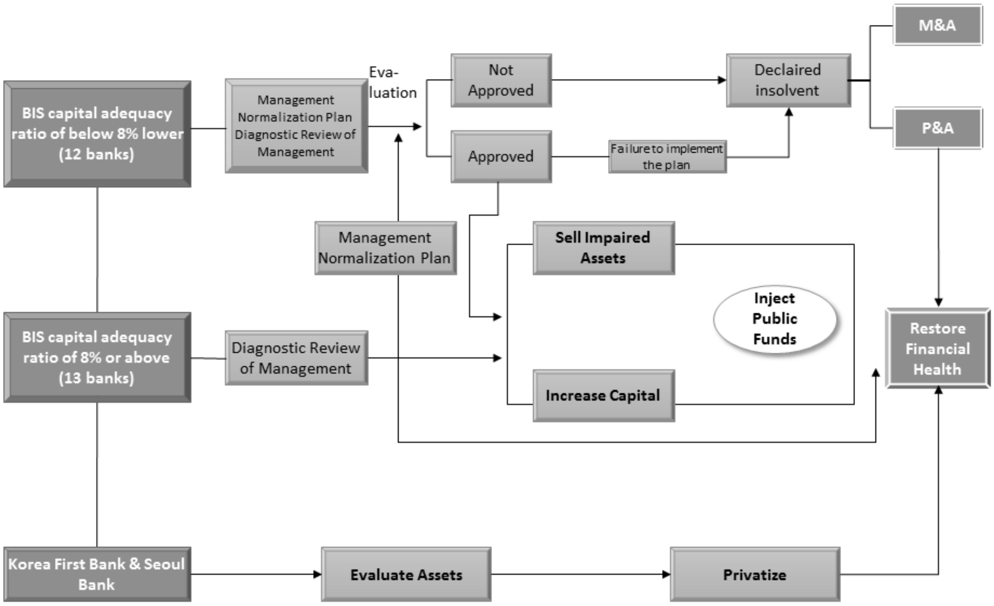
24 Banking sector restructuring in other countries was intended to serve the following three goals: (i) as an exit strategy for nonviable banks or to merge them, (ii) as strategic mergers aimed to counter deteriorating profitability, (iii) as a way to enlarge the size of business so as to better cope with globalized markets with greater competitiveness, to achieve economies of scale, and to globalize their business. Particularly, banks have been actively seeking to create synergy effects in different areas such as asset management, insurance, securities, etc., by catching up with the recent trends of mixed and diversified business, i.e, combining retail and corporate banking, and commercial and investment banking. Banks have been also actively involved in deals to expand their presence in regional areas. These types of mergers are instrumental in sharpening banks' competitive edge as they mutually complement weaknesses and save costs of building an IT network that normally entails a massive amount of money.

<Table 1-4> The Flow of Banking Sector Restructuring



<Table 1-5> M&As among Banks

Type of M&A	Acquiring Bank (Acquired Banks)
P & A (involuntary), Sale to foreign investors (June, 1998)	Shinhan Bank (+Donghwa Bank) KorAm Bank (+Kyeonggi Bank) Kookmin Bank (+Daedong Bank) Hana Bank (+Chungchong Bank) Korea Housing & Commercial Bank (+Dongnam Bank) Korea First Bank (Newbridge Capital) Korea Exchang Bank (Commerzbank)
Voluntary mergers & acquisition by foreign investors (1999~2004)	Hana Bank (+Boram Bank+Seoul Bank) Chohung Bank (+Kangwon Bank+Chungbuk Bank) Hanvit Bank (Commerical Bank+Hanil Bank) Kookmin Bank (+Long-Term Credit Bank+Korea Housing & Commercial Bank) KorAm Bank (The Carlyle Group) Korea First Bank(Standard Chartered) Korea Exchange Bank (Lone Star) Citibank (+KorAm Bank)
Financial Holding Company (2001 and beyond)	Woori Financial Holding Co. (Hanvit+Peace+Kyungnam+Gwangju) Shinhan Financial Holding Co. (Shinhan+Chohung+Jeju) Hana Financial Holding Co. Kookmin Financial Holding Co.

5.2. Others Sector Restructuring

Merchant banks saw their unsecured impaired assets growing considerably as early as the beginning of 1997, due to serial bankruptcies of large conglomerates. They borrowed short-term foreign funds to give long-term loans, but as Korea's external confidence fell and overseas funding became difficult, they faced a serious liquidity crunch. For this reason, merchant banks became the first financial institutions that were subject to restructuring. There were 30 merchant banks in operation as of the end of 1997 and all of them had their management normalization plan reviewed. According to the review, the business license of 16 unhealthy merchant banks was revoked in 1998, followed by one more bank with the license revoked and three banks merged in 1999. In January, 2000, another merchant bank had its license revoked, leaving only 9 banks eventually.

As for the restructuring of other non-bank institutions such as securities companies, insurers, and lease companies, insolvent institutions were closed down immediately while the rest of the institutions were advised to increase their capital or undertake self-rehabilitation measures under the responsibility of their majority shareholders. In June 1998, two securities companies had their license revoked after their finances deteriorated amid a liquidity shortage, and four more companies were forced out of the market in the first half of 1999. Shinsegi Investment Trust Co. and Hannam Investment Trust Co. were orded to exit the market in February 1998 and January 1999, respectively after they were faced with a liquidity crisis, following accumulated losses and sharply growing demands for redemption. Among newly established investment trust companies, four of them including Goryeo Investment Trust & Management Co. which requested that its license be revoked in order to recapitalize itself, had their license revoked after their largest shareholders went bankrupt. On the insurance side, 18 life insurers and 4 non-life insurers that were unable to honor their payment obligations as of end-March 1998, were asked to hand in a management normalization plan. A management evaluation committee reviewed their plans and accounting companies conducted due diligence on their assets and liabilities. According to the results of the due diligence and the review, 4 financially unhealthy life insurers were ordered to close down through P&A transactions in August 1998 and 2 guarantee insurance companies were merged later in November. Out of 14 life insurance companies under business normalization efforts, 6 companies that were deemed unable to execute their plan, and Korea Life Insurance whose liabilities exceeded assets according to the due diligence, were publicly auctioned off to domestic and international buyers. Lastly, 54 mutual credit finance companies and 233 credit unions left the market by the end of 1999 after their assets deteriorated amid a steep rise in the number of small and medium-sized companies falling into bankruptcy in regional areas, while the fate of lease companies was left up to their parent banks which were put in charge of the restructuring of their subsidiary lease companies. As a result of the intensive restructuring in 1998 and 1999, a total of 346 financially unhealthy financial institutions were resolved through merger, P&A transactions, liquidation and other deals by the end of December 1999, and the number was equivalent to approximately 16.5% of all financial institutions that were operating in 1997.

<Table 1-6> Financial Institutions Before and After Restructuring
(Number of Institutions)

Type/Year	End-1997(A)	Resolved Institutions(B)	End-1999(A-B)
Bank	33	10	23
Merchant Banks	30	20	10
Lease Companies	25	12	13
Securities	36	6	30
Insurers	50	5	45
Investment Trust	31	6	25
Mutual Credit Finance	231	54	177
Credit Union	1,666	233	1,433
Total	**2,102**	**346**	**1,756**

5.3. Injection of Public Funds

Public funds were injected to make deposit payments for financial institutions that were closed down during the restructuring drive, and to purchase impaired assets from financially troubled but viable institutions and replenish their capital. In an effort to minimize taxpayer's burden associated with the injection of public funds, the burden-sharing rule was strictly applied against majority shareholders and others who were found responsible for mismanagement, on the premise that the distressed financial institutions should make serious efforts to rehabilitate themselves. Public funds were raised through issuance of bonds by KDIC and KAMCO so that no direct burden would be created upon taxpayers and public finance. The government guaranteed the payment of the principle of these bonds and the bonds would be repaid partly with public finance.[25]

<Table 1-7> Uses of Public Funds (As of end-1999, in trillion won)

	NPL purchases		Capital increase (B)	Deposit payment (C)	Total(A+B+C)
	Face value of acquired assets	Cost of purchase(A)			
Banks	47.0	17.28	14.59	13.33	45.2
Non-bank institutions	8.1	3.22	3.97	11.61	18.8
Total	**55.1**	**20.5**	**18.56**	**24.94**	**64.0**

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25 The first and second phases of restructuring cost 64 trillion won including 20.5 trillion won for impaired asset purchases and 43.5 trillion won for capital increases and deposit payments. The entire amount was used up by the end of 1999. By the end of December 2001, 40 trillion won earmarked for the third phase was all injected. Of the total, equity investments(21.7 trillion won), contributions and deposit payments(14.2 trillion won), purchases of NPLs(1.8 trillion won), and other uses(0.4 trillion won) together amounted to 38.1 trillion won. Interest payments and repayments of bond principles totalled 1.9 trillion won. The entire amount of 40 trillion won was used by KDIC. The bonds issued by KDIC and KAMCO, which was approved by the National Assembly, were 104 trillion won in total including 64 trillion won in the first two phases of restructuring and 40 trillion won in the third phase. Of the 104 trillion won, 102.1 trillion won other than 1.9 trillion won used to repay the bond principles and pay interests, was funded by bond issuance. 42.8 trillion won of recovered funds was used by the end of June 2012, 19.5 trillion won from public funds(in-kind investments into banks at the beginning of the crisis, purchases of subordinated bonds, in-kind investments with government budget, borrowed funds, etc.), and 4.3 trillion won for other purposes, reaching 168.7 trillion won in total. The target amount of public funds to be repaid was set at 97 trillion won excluding 7 trillion won already paid, out of 104 trillion won including 102 trillion won used for 2002 bond issuance and 2 trillion won in borrowed funds. The repayments were made with 28 trillion won in recovered funds, 20 trillion won in special contributions by financial institutions(to be raised by imposing a 0.1% charge on the remaining deposits from 2004 to 2027), and 49 trillion won from public finance. The taxpayers' share of the total amount was 68.5 trillion won including the above mentioned 49 trillion won and 19.5 trillion won shelled out from public fund.

<Sources and Uses of Public Funds, Nov. 1997-Jun. 2012.6, in trillion won>

	Investment	Contribution	Deposit payment	Asset purchase, etc	NPL purchase	Total
Bond issuance	42.2	15.2	20.0	4.2	20.5	102.1
Recovered public funds	8.3	3.2	7.4	6.9	16.9	42.8
Funds from public sources	12.9	-	-	6.6	-	19.5
Other funds	0.03	0.2	2.9	0.1	1.1	4.3
Total	63.5	18.6	30.3	17.8	38.5	168.7

6. Results of Restructuring

Korea' financial sector restructuring is largely viewed as remarkably successful as the financial industry finally saw the light at the end of the long tunnel of the restructuring process. Korea's financial sector remained relatively robust even when the entire world was hit hard by the 2008 subprime mortage crisis of the U.S., and it also contributed significantly to the speedy recovery of the national economy. The aggressive restructuring was driven by a keen sense of crisis shared by the government and the Korean people who strongly felt that the financial sector restructuring was inevitable. In addition, Korean industry had the resilience to bounce back from external shocks, based on strong export competitiveness, because previously, it had been long exposed to international competition and sharpened its international competitive edge. The fast recovery was also made possible by voluntary participation of the Korean people in the restructuring process, such as a nationwide gold-collecting campaign, in spite of all the hardships they had to ensure before they finally came out of the long and dark tunnel of crisis. Adding to the restructuring momentum was adherence to market principles, and democratic and transparent procedures, which in turn, garnered the legitimacy of, and confidence in the restructuring from both domestic and international investors. There was a consensus for the financial sector restructuring after continued efforts, though insufficient, had been made toward financial liberalization and market opening in the 1980s and 1990s, and the consensus and the previous efforts paved the way for an aggressive restructuring in the face of the 1997 foreign exchange crisis.[26] Still, the restructuring came short of expectations because there was a prolonged delay in the privatization of financial companies that fell under the government ownership during the restructuring process and the privatized financial companies were not well-equipped to become globally competitive players.

6.1. Review of the Results

First of all, a general review of the restructuring finds that financial market indicators such as interest rates, stock prices, foreign investment, foreign currency reserves and external confidence improved markedly, and business performance

26 For example, Korea's financial liberalization efforts in the 1980s were internationally recognized. Specifically, in the early 1990s when Mexico held an international conference hosted by its Ministry of Finance in an effort to come up with strategies to usher its financial sector in liberalization smoothly ahead of its accession to NAFTA, Mexico listed Canada, Chile and Korea as success cases and it referred to Korea as a benchmark for financial market opening and liberalization.

indicators such as capital adequacy ratio, NPL ratio, productivity, and profitability became much more solid. Stock markets and other capital markets remained buoyant on the back of overflowing liquidity and sustained stability of interest rates. Interest rates stabilized at around 9% in 1999 after they skyrocketed up to 30% and foreign currency reserves were quickly replenished. Foreign currency reserves once plunged to as low as 3.9 billion dollars, but they increased to more than 80 billion dollars in 2000 when Korea repaid all of the IMF emergency bailout loans. Since then, the reserves steadily rose to over 315 billion dollars in March 2012. Korea's external confidence rebounded considerably and quickly. S&P rated Korea as low as B+ in December 1997, 10 notches down from its previous rating of AA-, but in November 1999, Korea moved up 5 notches to BBB. Moody's downgraded Korea by 6 notches from previously A1 to Ba1 in December 1997, but moved it back up 2 notches to Baa2 in December 1999. Fitch rated Korea B- in December 1997, 11 notches down from AA- and upgraded it by 7 notches to BBB in June 1999.

The structural aspects have improved as well. The financial sector came out of the massive restructuring with a much stronger capacity to absorb both external and internal shocks and as a result, the underlying infrastructure became significantly more solid. The restructuring had far-ranging effects across Korea's financial industry and brought about positive changes in all aspects of financial institutions' operations including their financial structure, corporate governance, growth potential, profitability, and risk management capacity. On a national level, foreign currency reserves sharply increased, creating a safe buffer against emergencies, and with early warning system and other crisis preventive schemes in place, Korea is now better equipped to detect risks in connection with its exposures in international financial markets. Previously lenient financial regulators adopted a strict supervisory approach under which they tightened accounting and disclosure rules, and established best practices for corporate governance and other areas. As a consequence, financial institutions' activities became more responsible and transparent. As KDIC, KAMCO, and other government agencies, accumulated experiences and expertise in restructuring, distressed financial institutions were resolved more swiftly according to market principles. Greater independence and neutrality of the central bank resulted in greater discretion and autonomy with monetary policy, which in turn helped the central bank build much knowhow on monitoring and intervening in the market amid increasing free flows of capital. The too-big-to-fail myth that was widely held in the banking sector was dispelled as market participants became well aware of risks. With all these changes and experiences, the Korean economy remained solid and successfully averted a potential financial crisis when credit card-asset backed securities weighed heavily on the financial system in 2003. Also, Korea recovered from the 2008 subprime mortgage crisis relatively faster than other leading economies. Resilience and robustness of the Korean economy was clearly manifested by the key performance indicators of the banking sector in 2003 by which the restructuring was beginning to show some tangible results. Korea was still behind the U.S. but better than Japan in terms of these indicators.

In summary, Korea's financial institutions became much more financially sound and profitable, and the financial regulators' risk management capacity greatly expanded, after the restructuring. And this is why financial institutions remained in sound financial health and was able to weather a global financial crisis caused by the US subprime mortgage debacle. Although their exposure to risk assets including subprime mortgages was relatively small, thus limiting its negative impact on their financial position, Korea's financial institutions deserve praise for their own efforts to enhance their overall competitiveness, i.e., cutting costs by taking advantage of high-quality information technology, maintaining a high capital adequacy ratio by taking their lending criteria and risk management to a new level, and lowering their NPL ratios.

<Table 1-8> Key Performance Indicators of the Banking Sector

	1997	1998	1999	2000	2001	2002	2003	U.S. (2003)	Japan (2002)
BIS capital adequacy ratio	7.5	8.2	11.8	10.6	11.7	11.3	11.2	12.74	11.25
Profitability Net profit (100 billion won)	-39.0	-190	-54.8	-42.0	-46.8	50.1	16.8	102.4 billion USD	-4.9 trillion JPY
ROA ROE	-0.50 -11.45	-2.43 -51.7	-0.83 -14.4	-0.59 -11.0	0.66 12.76	0.60 10.9	0.17 3.41	1.40 15.31	-0.06 -11.87
Productivity Per-capita net profit (100 million won)	-0.27	-1.87	-0.46	-0.43	0.58	0.58	0.22		
Asset quality Substandard and below (%)	6.0	7.6	12.9	8.0	3.4	2.3	2.6	1.19	4.56

Source: Lee Kyu-sung, Korea's Foreign Exchange Crisis(2nd ed.), Park Young Sa, 2007.

6.2. Major Achievements

First, let's look at the handling of troubled financial companies. As of the end of December 1999, 346 companies or 16.5% of all financial institutions, were resolved through merger, P&A or liquidation. As of end-August, 2002 when the initially urgent phase of restructuring ended, all of 361 companies into which public funds were injected were placed under scrutiny to clarify those who were responsible for the distress. A total of 2,920 employees including 1,376 executives were held accountable and of the those found accountable, 1,308 persons including 764 executives who were found to be involved in illegal acts or malpractices were accused of dereliction of duty.[27] In order to exercise the right of indemnity against those who were responsible for financial distress, and to obtain a provisional seizure against distressed financial companies, KDIC filed a lawsuit for damages worth 1,245.1 billion won against 3,507 persons of 327 financial institutions as of end-August 2002. KDIC also obtained financial disclosure information regarding these people and notified the obtained information to the financial institutions concerned.

In line with the financial sector restructuring, financial systems, practices in financial transactions, and supervisory frameworks were brought abreast with global trends such as accelerating liberalization of capital movements. Red-tape regulations governing financial institutions and capital markets were drastically relaxed in an effort to increase the efficiency of the financial system. Market entry regulations were eased to promote competition in the financial industry, and the related authorization and licensing procedures became more transparent with the establishment of clear guidelines for 12 financial businesses. Financial institutions were allowed to form business tie-ups in a much broader scope. Much progress was made in such areas as depositor protection, corporate disclosure system, and accounting standards. As a result, corporate activities were carried out in a more transparent way, which made it easier for market participants to monitor those activities. Prudential regulation was tightened to ensure a greater stability of the financial system and better depositor protection. Capital adequacy standards including BIS capital adequacy ratio, forward-looking criteria(FLC) and FLC-based loan loss provisioning rules, lending limits and asset management systems, and CAMELS rating system for early detection of signs of financial distress were either further strengthened or newly imposed on "all" financial institutions, as opposed to

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27 These figures compare well to the fact that not a single person was accused in the U.S. even though an enormous amount of taxpayers' money equivalent to approximately 12% of its GDP was spent on coping with the 2008 subprime mortgage crisis and subsequent repercussions.

the previously limited application to "selected" categories of institutions. Lastly, institutional frameworks were revised to develop more advanced and sophisticated capital markets.

As part of efforts to stimulate a secondary market for bonds, the role of dealers was expanded by changing the repo trading rules, the bond market infrastructure was improved, and new financial instruments such as ABS and high-yield fund were introduced. KOSDAQ grew into a direct financing market for solid small and medium-sized enterprises(SMEs) and venture start-ups, and the opening of Korea Futures Exchange(which was later consolidated into Korea Exchange) made more effective risk management tools available. Institutional changes aimed to raise transparency of capital markets include loosening the rules on rights offering and corporate bond issuance, and revising the credit rating system and corproate disclosure system.

Finally, the major contents of the restructuring are summarized in the table below.

<Table 1-9> A Brief Summary of Financial Sector Restructuring Strategies and Institutional Changes

	Financial Sector	Corporate Sector
Authorities	MOFE, FSC, FSS, KDIC, KAMCO, PFOC	MOFE, FSC, related government agencies, creditor banks & financial institutions, KAMCO
Criteria	Solvency	Viability
Principles and Procedures	- Internationally recognized procedures (evaluation committee) - Raised and injected public funds	- Workout - 5 major principles of corporate restructuring - Different approaches according to business size((1) Top 5 conglomerates: big deals, financial structure improvement agreement, (2) 6th largest and below: financial structure improvement agreement, workout led by creditor financial institutions, (3) SMEs: restructuring plans were determined and carried out independently by creditor banks), - Corporate Workout Principles(eligibility, fairness, equity, timeliness) - Basic procedures
Relevant Laws	Act on the Structural Improvement of the Financial Industry(merger, business conversion, liquidation, etc), Depositor	Corporate restructuring agreement, Corporate Restructuring Promotion Act, Corporate Reorganization Act, Integrated Bankruptcy

	Protection Act(deposit insurance, check of potential insolvency, etc.), KAMCO Act(resolution of impaired assets), Special Act on the Management of Public Funds(management of public funds), other relevant tax laws, Securities Exchange Act, credit rating-related laws, accounting-related laws, Act on External Audit of Stock Company, Asset-Backed Securitization Act, etc.	Law, tax laws, Foreign Capital Inducement Act, etc.
Infrastructure	- Financial regulatory reform(relaxed market entry regulations, internationalization and market opening, greater autonomy, wider scope of business alliances) - Improved supervisory framework(PCA, simplified licensing and authorization, tighter capital adequacy ratio requirements, FLC, more stringent loan provisioning rules, stronger prudential regulation on foreign exchange business, improved asset management system, management evaluation, depositor protection) - Internal control(risk management, lending practices reform) - Ownership and corporate governance - Invigorated capital markets(stocks, bonds, KOSDAQ, derivatives trading, on-line trading, OTC) - Primary and secondary markets(mark-to-market, credit rating system, ABS, electronic disclosure, etc.) - Compliance with international accounting standards(simplified and improved accounting rules, external audit of stock companies, etc.)	- Enhanced transparency in corporate management(combined and consolidated financial statements, external audits, compliance with international accounting standards, best practices for corporate governance, compulsory disclosure of unfair insider trading - Prohibition of cross debt guarantee - Identification of core competences - Stronger accountability of controlling shareholders and management - Tax reform to promote corporate restructuring - Revision of market exit regulations

CHAPTER 2

Sub-sector Restructuring[28]

The market is bound to fail if it is left to its own devices because it is run by self-interested human beings. So the market needs rules and judges to enforce those rules.

"The Great Game: The Emergence of Wall Street as a World Power: 1653-2000" (1999), John Steele Gordon

1. Banking Sector Restructuring

1.1. Background

As financial liberalization and market opening which began in the mid 1980s intensified in the 1990s, competition in the financial sector grew fiercer and business risks increased. The government-led restructuring produced only limited success in improving autonomy and efficiency of the financial sector, but failed to achieve tangible results in such areas as responsibility, transparency, and soundness in business operations of financial institutions. Instead of actively pursuing profitability and soundness, financial institutions remained largely complacent under the implicit protection by the financial regulators and adhered to their size-focused growth strategies, rather than systematically managing risks. NPLs quickly snowballed amid a series of large conglomerates falling into bankruptcy, and the persistently collateral-based and chaebol-dependent lending practices clearly contributed to the ballooning NPLs. In response to the fast deteriorating asset quality, banks attempted to minimize further asset impairment by implementing a highly conservative lending strategy, which exacerbated the credit squeeze, pushed companies into bankruptcy, and eventually created more NPLs, resulting in a vicious cycle. As banks which play a pivotal role in financial mediation failed to

28 Much of this chapter is derived from data and information made available by the Financial Services Commission(FSC).

function properly, the real economy sharply shrank and a sense of crisis gripped the entire economy. At this juncture, there was a growing consensus that the financial and corporate sector restructuring would hinge on the banking sector restructuring.

According to the first management evaluation of 26 banks, the capital of Korea First Bank and Seoul Bank was impaired and the government plan was to inject public funds into these two banks and bring them back to financial health while having the banks restore their capital up to the BIS capital adequacy ratio within the shortest possible period of time. Banks with their BIS capital adequacy ratio at 8% or above were also put under a management review and prompt corrective action(PCA), and other actions were imposed to improve their financial soundness.

1.2. Management Normalization: Korea First Bank and Seoul Bank

The Banking Supervisory Board issued a recommendation of management improvement on September 5, 1997 to Korea First Bank and Seoul Bank whose financial structure steeply worsened since early 1997 amid large-scale corporate bankruptcies involving Hanbo, Kia, and other business groups. Despite these actions taken, the two banks continued in a downward spiral of financial distress and finally faced bank runs when depositors of the banks became excessively anxious after the Korean government asked the IMF for a bailout package on November 21, 1997. Upon the bailout request, the IMF demanded that the two banks be shut down, but in light of the likely ripple effects that the liquidation of these two banks would have on the entire financial market, the Korean government announced a plan on December 15, 1997, to inject public funds into the banks and sell them to foreign buyers. It was an inevitable choice because otherwise, the growing anxiety and insecurity among depositors might spread across the financial industry, shaking the nation's entire financial system. Although the banks would survive, the government expressed its firm determination to push ahead with the restructuring by fixing the deadline for the overseas sale at November 15, 1998. The Banking Supervisory Board imposed a management improvement order on the two banks on December 22, 1997 and conducted due diligence on the banks in mid January 1998 in order to determine their viability. Based on the findings of the due diligence, the banks were ordered to reduce their capital in accordance with the Act on the Structural Improvement of the Financial Industry, followed by an injection of 1.5 trillion won in public funds into these banks, respectively on January 31, 1998. In addition, the Board approved the management normalization plans of the banks, aimed to renovate their business practices. Things worked out as the government planned. Korea First Bank was sold to Newbridge Capital on December 23, 1999 and Seoul Bank was acquired by Hana Bank after negotiations with HSBC fell through.[29]

1.3. Banks with BIS Capital Adequacy Ratio

1.3.1. Request for Business Normalization Plan

The government moved ahead with the restructuring of 12 banks excluding Korea First Bank and Seoul Bank, whose capital adequacy ratio fell below 8% as of end-1997. To this end, PCAs including recommending or demanding management improvement were taken against these banks on February 26, 1998, and the banks were also ordered to submit their plans by April 30, 1998 to the Banking Supervisory Board, under which they would bring their BIS capital adequacy ratio to 8% or higher by the end of June 2000.[30]

<Table 2-1> PCAs Invoked on Banks with BIS Ratios Below 8% in February 1998

PCA	Banks
Recommendation of management improvement (BIS ratios: 6~8%)	Chohung, Commerical, Hanil, Korea Exchange Chungchong, Kyeonggi
Demand for management improvement (BIS ratios: below 6%)	Donghwa, Dongnam, Daedong, Peace, Kangwon, Chungbuk

The government agreed to the terms of reference with the World Bank in order to ensure objectivity and fairness in assessing the management normalization plans submitted by the 12 banks, and internationally-recognized accounting firms were hired to evaluate the plans.[31] Six Korean accounting companies operating in partnership with international accounting firms were selected for the evaluation.

These firms conducted the assessment for a month and a half from April 30 to

29 The sale of these two banks will be discussed in detail in Chapter 3.

30 The review of PCAs and the business normalization plans is critical because the findings will be used to place the banks into 3 different categories: approved, conditionally approved, and not approved. If a plan is not approved, the bank will be ordered to exit the market.

31 International accounting companies were involved in partnerships with domestic firms in order to make sure that the assessment be carried out according to globally acceptable procedures. The joint assessment helped domestic accounting companies considerably enhance their competence and improve their reputation. It also put positive pressure on the assessed banks to bring their overall internal management systems in line with global practices. This type of ripple effect was not as obvious in other crisis-struck countries in Asia as in Korea and it lifted the Korean financial industry to a new level.

June 13, 1998 in accordance with the evaluation criteria agreed upon with the IMF and IBRD. The purpose of the assessment was to determine if the plan was feasible and realistic. They closely examined various aspects of the plan, i.e., how the banks would achieve the following: increasing the capita adequacy ratio to the required levels and raising more capital, improving asset quality, reducing risky assets and costs, upgrading internal management control, and replacing the management. Particularly, the assessment of capital adequacy ratio and asset quality used the new criteria that included prudential regulations scheduled to become applicable from 1999 as agreed with the IMF, in addition to the supervisory criteria of the Banking Supervisory Board. The rationale behind this was that the feasibility of what a plan intends to achieve in the "future" should be determined by the new criteria that includes "future" prudential regulations. Aside from the assessment of the plans, the evaluator accounting firms also performed an extensive management condition evaluation in all aspects of the banks' operations, and compared them against international best practices. The evaluation looked at capital adequacy, asset quality, risk management, credit management, soundness of internal management system, and managerial capability. The purpose of the evaluation was to assess the overall financial condition and viability of the bank, to identify the prospects including strategic positioning, to analyze strengths and weaknesses of the bank and its management, and to review internal control and risk management procedures.

<Table 2-2> Major Contents of the IMF-Recommended Prudential Regulation

• Loans in arrears for 3 months or longer are classified as substandard • Loan loss reserve ratio to be raised from 1% to 2% against loans classified as precautionary • Fixed-income trust accounts and principle-guaranteed trust accounts are risk-weighted as same as bank accounts. • Loan loss reserves against loans that are classified as substandard and below are excluded from the supplementary capital when determining the BIS capital adequacy ratio. • Securities are marked-to-market. • Reserves should be set aside for guarantees according to the FLC(This was not one of the IMF recommendations but was added to the criteria to ensure compliance with international standards).

A management evaluation committee of 12 experts including accountants, lawyers, professors and researchers was formed to conduct a final review of the banks' plans after the assessment by the accounting firms was completed.[32] In the

32 The bank management evaluation committee consisted of the following members: Yang Seung-woo, (chairman, Ahn & Jin), Lee Hyung-rae(Younghwa), Jung Jin-yeong(Kim & Chang), Cho Tae-hyeon(San Tong), Sung Min-seop(Hanvit), Lee Jae-swool(Ahn & Jin), Sohn Sang-ho(Korea Institute of Finance), Ahn Jong-gil(Myongji University), Kim Hong-ki(Samil), Lee Suk-geun(Arthur

final review that ran from June 20 to June 28, 1998, the committee determined whether or not the submitted plans were feasible and if feasible, the banks would be able to reach the 8% BIS capital adequacy ratio(or 6% if the bank decides to abandon international business) by the end of June 2000. Approval of the plan was granted, based on the judgement of these two key elements. The report on the final review was released on June 28, 1998. In the report, the committee recommended that Chohung, Commerical, Hanil, and Korea Exchange be approved with a special note, Kangwon and Chungbuk be approved on condition of additional capital increase, and Donghwa, Daedong, Dongnam, Chungchong and Kyeonggi not be approved. The FSC took the following actions on June 29, 1998, based on the committee's recommendations.

The FSC did not approve the plans of 5 banks including Donghwa, Daedong, Dongnam, Chungchong, and Kyeonggi because their liabilities were found greater than their assets as of end-March 1998 in a due diligence conducted by the Banking Supervisory Board, and they were judged unable to turn around. These banks were declared nonviable, ordered to suspend their business, and eventually resolved through P&A transactions. The shutdown of these banks broke the banks-never-fail myth and sent out a powerful message to the financial industry and the depositors that a bank can fail and be forced out of the market if it is not financially sound. Kangwon and Chungbuk were found with their liabilities in excess of assets, but upon the committee's recommendation that these banks be approved on condition of additional capital increase and merger(Kangwon), the FSC granted a conditional approval to their plans. The committee found Peace Bank not qualified for approval, but its assets(net assets amounting to 12. 3 billion won) were greater than its liabilities as of end-March 1998 in which case the bank could not be classified as "failing" under the Act on the Structural Improvement of the Financial Industry. Since the bank did not meet the legal criteria as a failing financial institution, it could not be resolved and instead, the FSC approved its plan on condition that its implementation plan should include a capital increase greater than originally planned.[33] Chohung, Commercial, Hanil, and Korea Exchange were

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Anderson Consulting), and William Hunsaker(ING Bearing Securities). A foreign member was appointed to the committee to monitor and ensure that the evaluation was conducted in a transparent manner and according to global standards(Lee Hun-jai, *ibid*).

33 Chungchong Bank was based in a province that was the strongest ground for United Liberal Democrats(ULD) and Kim Dae-jung won the presidential election on the ULD's support. Given the political context, political pressure might have been exerted upon the decision about the bank, but everything was handled strictly according to the transparent rules and international standards. As a result most of the committee's recommendations were accepted. Only Peace Bank was an exception, but as explained earlier, the bank was not be classified as a failing institution under the relevant law and thus given approval. Peace Bank was originally a workers' bank and a decision to close down the bank would have triggered a strong backlash, but fortunately, it survived on clear legal grounds.

approved with the note that their planned paid-in capital increase was heavily dependent on the future growth in their retained earnings, but the targets under their business normalization plans would be met only if their capital was to be augmented significantly by the cash inflows generated through rights offerings. Upon this recommendation, the FSC required that the banks submit an implementation plan including plans to increase the size of their proposed capital increase, as a condition of approval. The conditional approval implies that given their BIS capital adequacy ratios raging between 1% and 4%, these banks barely managed to pass the cutoff marks but in fact, were not viable on their own in their current financial conditions. The FSC demanded that 7 banks conditionally approved submit a detailed implementation plan by end-July 1998, featuring such key elements as management reshuffle and larger-scale capital increase.

<Table 2-3> Major Financial Indicators of 5 Unapproved Banks(10 billion won)

	Assets	Liabilities	Net Assets	BIS Capital Adequacy Ratio	Loans classified as precautionary or above (% of all loans)
Chungchong	3,770,1	3,941,0	-170,9	-5.97%	1,619,6(36.3%)
Kyeonggi	7,209,5	7,382,6	-123,1	-9.61%	2,862,1(49.0%)
Donghwa	9,558,3	9,769,9	-213,6	-3.72%	2,254,6(28.5%)
Dongnam	7,115,2	7,233,7	-118,5	-5.81%	1,118,4(20.9%)
Daedong	5,663,6	6,857,8	-294,2	-6.75%	1,735,2(34.1%)

Source: Lee, *ibid*

1.3.2. Resolution of Unapproved Banks

1.3.2.1. P&A

The FSC examined multiple options for resolution of the 5 unapproved banks, carefully taking into consideration the possible impact of their closure on the national economy, the estimated cost of restructuring the banks, and the additional costs that could possibly be incurred in the restructuring process. The FSC arrived at the conclusion that P&A would minimize the negative ripple effects.

The acquired bank was invited to offer their opinions and the acquiring bank's board had to approve the P&A deal before the deal was finally struck. In principle, only good assets were included in P&A transactions and assets classified substandard or below were sold to KAMCO. Of trust accounts, accounts with principal guarantee were transferable, but real fiduciary accounts were excluded.

<Table 2-4> Comparative Analysis of Resolution Methods

	Merger	Liquidation	Bridge Bank	P&A
Advantages	- Continued employment	- Simple procedures	- Continuity of business	- Minimum business hiatus - Less cost
Dis-advantages	- Time-consuming - May deteriorate financial health of the acquiring institution - Unlikely to happen on a voluntary basis	- Time-consuming - Loss of goodwill - Massive deposit payments in subrogation	- Massive deposit payments in subrogation - Possible liquidity shortage due to bank runs	- Discontinuity of employment

Some liabilities including reserves for retirement allowances were excluded from P&A transactions. The acquirers were selected from among the banks that had a BIS capital adequacy ratio of 9% or above, were highly likely to stabilize quickly after the acquisition, and were able to increase capital relatively easily through capital increase, attraction of foreign investment, and other options. The banks were matched up for a deal by taking into consideration various factors including the acquiring bank's market share, branch locations, synergy effects from the merger, and opinions of the acquiring bank. Given that Kookmin Bank and Korea Housing & Commercial Bank were striving to raise their competitive advantage in retail banking and SME lending, they were matched up with Daedong Bank and Dongnam Bank, respectively, because these banks specialized in SME lending. Deals were arranged for Shinhan Bank and KorAm Bank to take over Donghwa Bank and Kyeonggi Bank that had strong networks of branches in Seoul and Kyeonggi area. Hana Bank acquired Chungchong Bank that had the smallest number of branches among the acquired banks so that Hana Bank would be able to enlarge its size and join the ranks of leading banks at a minimum cost.

The FSC selected accounting firms to conduct an in-depth due diligence on the assets and liabilities of the banks to be acquired, from July through September 1998. On September 30, 1998, the 5 acquired banks, MOFE, FSC, and KDIC entered into an agreement under which the deficits in the assets as found in the due diligence were to be fully filled by the KDIC. The acquiring banks were granted the put-back option that allowed them to purchase sound assets and then sell to KAMCO, assets that would later become impaired if the acquired banks were not responsible for the impairment. This option was intended to prevent the acquiring banks from getting bogged down along into asset impairment as a result of the deal.

1.3.2.2. Supplementary Actions (Protection of Depositors and Corporate Clients)

In order to minimize any irregularities and inconveniences that could be caused to depositors and corporate clients during the takeover process, deposit payment, settlement, overdraft, bill discount, and other regular businesses were allowed to continue as usual. In addition, checks issued by the acquired banks were able to be cashed at the acquiring banks without any restrictions. The acquiring banks agreed to honor the commitments made by the acquired banks for their corporate clients, including lending limits, existing loan commitments, LC, and other existing payment guarantees, so as to prevent possible adverse effects upon liquidity of the corporate clients. The government also provided liquidity support and guarantees to the acquiring banks to ensure that inter-bank transactions in the call money market remained brisk. In addition, the Bank of Korea(BOK) gave extra financial support through the aggregate credit ceiling system and repo to help the acquiring banks to finance the deals. Special guarantees were provided for the client companies of the acquired banks, and exceptions were made to the lending limit on the same person or the same business group. In the same context, loans that reached maturity were rolled over and the government maintained a close watch on any attempts to withdraw loans from corporations.

The FSC led the organization of a task force that comprised MOFE, BOK, and KDIC to monitor activities in the financial market and devise strategies for prevention of liquidity crunches. The FSC had employees of the Banking Supervisory Board station at the acquired banks so that they would respond effectively and swiftly to possible sabotage attempts by the employees of the acquired banks who opposed the acquisition. The FSC also made plans to substitute the key personnel of the banks such as information technology experts in the event of a sabotage.

Succession of employment emerged as a serious issue in the acquisition process. The view held by the majority of legal experts was that an acquiring bank is not required to take over the employees of an acquired bank in a P&A deal, because unlike a comprehensive business transfer, a P&A transaction does not guarantee that the identity and nature of the acquired business would remain same. Nevertheless, the FSC requested that the acquiring banks provide job security for the employees of the acquired banks who were 4th level and below, considering that more employees would be needed to properly handle increased workload after the merger, and that unemployment was fast rising as a serious social issue.[34] The

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34 The government expected that voluntary mergers among banks would produce a different formula than 1+1=2, which was close to 1+1=1.2 in terms of employment succession because normally, deals were met with some unexpected problems including a sabotage by some of the IT technicians who suddenly disappeared and as a result, the operations at the affected bank did not get back to normal until mid-July.[35] Still, the FSC completed the resolution of the 5 banks through P&A by tackling the problems according to its plans and proceeding swiftly.

<Table 2-5> Succession of Employment (%, persons)

	Shinhan (Donghwa)	Korea Housing & Commercial (Dongnam)	Kookmin (Daedong)	KorAm (Kyeonggi)	Hana (Chungchong)	Total
Eligible employees(A)	1,837	1,661	1,740	2,265	1,447	8,950
Employed by acquiring bank(B)	364	650	519	1,017	494	3,044
Assistants to bankruptcy procedures(C)	60	60	60	60	60	300
Hired by KAMCO(D)	153	62	91	78	66	450
Total persons who stayed in employment (E=B+C+D)	577	772	670	1,155	620	3,794
Employment ratio(E/A)	31.4	46.5	38.5	51.0	42.8	42.4

1.3.3. Management Normalization of Conditionally-Approved Banks

The FSC required that 7 banks including Chohung, Commercial, Hanil, Korea Exchange, Peace, Kangwon, and Chungbuk submit a detailed implementation plan featuring radical management replacement and a larger amount of capital increase, as the condition of approval of their management normalization plans on June 29, 1998. Upon the FSC's request, the banks handed in their plans on July 29, 1998, which included how they were going to reshuffle their management, increase

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banks choose to merge due to financial difficulty and thus some layoffs is inevitable. In other words, each of the two banks involved in a merger deal would lay off 40% of its workforce, resulting in the combined workforce being 120% after the merger(Lee, *ibid*). But these acquired banks that were nonviable and on the brink of exit were clearly in a worse situation. Still, 42% of the employees were rehired by the acquiring banks, with the post-merger combined workforce reaching 1.4, which was greater than the government estimate of 1.2.

35 IT operations were suspended at all of the five banks that were forced out of business due to sabotage by employees who collectively took a leave. Even though the backup staff were put in charge of the operations, difficulties continued as the banks' employees left with the master keys or changed the PINs.

capital, attract foreign investments, reduce organization, workforce, and branches, expand profits, and deter further impairment of their assets. Commercial and Hanil announced their plan to merge after they submitted their implementation plans. The FSC formed an evaluation committee to review the plans of the 5 banks except the two banks to merge, and the review went on from August 4 to September 15, 1998 to determine if the plans were appropriate and feasible. The committee found that overall, the plans were acceptable, and required that the plans be revised or more details be added in cases where the plans were deemed inappropriate or lacking details. To effectively bind the banks to the execution of their plans, they were required to sign an MOU under which the entire management would be held accountable for failure to fully and faithfully implement the plans including all the specific details set forth in the plans. The FSS, the FSC's execution arm, monitored and reviewed the progress in carrying out the plans on a quarterly basis.

1.3.3.1. Commercial Bank and Hanil Bank

These two banks submitted their implementation plans by the deadline (July 29, 1998) after their management normalization plans were conditionally approved by the FSC on June 29, 1998, but they were not able to come up with a viable and feasible plan after all, given the dire circumstances at the height of the crisis. Under the circumstances, the banks accepted the regulator's recommendation and announced the merger plan according to which the two banks would be combined in order to grow in size and soundness, lead the domestic financial industry, and be able to compete globally.[36] On August 6, 1998, a merger committee that comprised equal numbers of members from the two banks was created and discussed details of the merger. The merger between the two banks presented a new restructuring option, paving the way for the broader financial sector to follow suit. From August 10 to 22, 1998, Younghwa and Ahn Jin conducted due diligence on the banks, respectively, and the merger ratios were determined according to the results. The banks held a board meeting where the merger was approved on August 24, 1998. According to the contract, it was a merger of equals and the merger would be final and official by the end of December, 1998.

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36 Originally, the two banks sought to attract foreign investments as a survival strategy, but it was not likely because the risk was too great from the potential foreign investors' perspective. On July 30, 1998, the chairman of the FSC called in the presidents of the two banks for a meeting where he suggested a merger as an alternative since finding foreign investors was unlikely. After the meeting, things moved ahead quickly and the banks reached an agreement to merge. The assets of the merged bank amounted to 105 trillion won, placing the bank among the world's top 100. After this deal, more banks followed suit and merged. For example, Hana and Chungchong merged, and Boram Bank also joined the trend, creating the 4th biggest holding company. Later, Chohung also consolidated Chungbuk and Kangwon under its roof(Lee, *ibid*).

The government made a commitment of financial support through injection of public funds in order to facilitate the merger and turn the merged bank into a healthy one. The Ministry of Finance and Economy published a notification on September 7, 1998 that in order for financial institutions to receive public funds, they should submit the terms of reference(TOR) to the FSC, pursuant to Articles 4 and 8 of the Act on the Structural Improvement of the Financial Industry, and its subordinate decree, the Authorization Standards and Support Measures Concerning Mergers and Acquisitions among Financial Institutions. As a follow-up measure, the FSC amended the banking supervision regulations on September 14, 1998, so that financial institutions can be ordered to increase or reduce capital if they are judged unable to maintain regular operations without external financial support after they are recommended or requested to improve their management, followed by investments of the government or KDIC in the institutions. According to the revised regulations, the FSC ordered Commercial Bank to reduce its capital from 850 billion won to 100 billion won, and Hanil Bank from 830 billion won to approximately 80 billion won, and it approved the terms of reference and their implementation plans on condition that the banks submit a detailed implementation plan for management normalization which was to be drawn in consultations with foreign consulting firms. On September 21, 1998, Commercial Bank and Hanil Bank asked KDIC for financial support totalling 5,096.4 billion won including 3,264.2 billion won for capital increase and 1,832.2 billion won for NPL purchases, and the government granted the support via KDIC and KAMCO.

At the extraordinary shareholders' meeting held at th end of September 1998, the proposed merger of Commercial and Hanil was approved(the stock conversion ratio was 9.980:1 for Commercial and 10.296:1 for Hanil). KDIC acquired new shares of the banks in exchange for its investments which the banks used to increase their capital according to Article 38-2(1) of the Depositor Protection Act, and became the controlling shareholders(94.2% stake in Commercial and 95.3% in Hanil). At the end of October 1998, the banks submitted their detailed implementation plan for management normalization. The merger was scheduled to be completed by the end of December 1998, and the new bank will be registered on January 6, 1999 as Hanvit Bank. On January 4, 1999, a general shareholders' meeting was convened to report on the merger, revise the articles of incorporation and bylaws, and appoint directors and auditors. On January 6, 2000, Commercial Bank was changed to Hanvit Bank and registered as such, and Hanil Bank was registered as dissolved, which officially completed the merger. Jin-man Kim, former head of KorAm Bank was appointed to lead the new bank, and on January 22, 1999, the chairman of the FSC, the president of the KDIC, and the chairman of Hanvit Bank signed the terms of reference which contained the essential items in 11 areas including profitability expansion, capital increase, NPL disposal, and risk management, as well as specific actions toward management normalization.

1.3.3.2. Chohung Bank, Kangwon Bank, and Chungbuk Bank

Following the FSC's conditional approval of its management normalization plan, Chohung Bank sought to attract foreign investments in accordance with its implementation plan, but the efforts ended up in failure as foreign investors' sentiment toward emerging financial markets became negative amid the eruption of the financial crises in Southeast Asia and Russia. The bank pursued a merger with Long-Term Credit Bank to no avail, as the latter announced its plan to merge with Kookmin Bank. Commercial Bank and Hanil Bank also agreed to merge, and Korea Exchange Bank was in talks with Commerzbank which was considering buying a stake in the former. So Chohung Bank was left with fewer options and making little progress. Chohung Bank was rated 4(poor performance) by the CAMELS rating standards and was requested to improve its management after the extended FSC meeting on November 27, 1998. As a follow-up to the decision, the Banking Supervisory Board placed the bank under the request for management improvement on December 1, 1998, which included management replacement, close-down of subsidiaries, capital increase, improvement of internal management systems, etc. The bank's management including the chairman resigned on November 28, 1998 before the request was placed.[37]

The only option left available to Chohung was to consolidate with Kangwon or Chungbuk that were also assessed as nonviable. Chohung stepped up its efforts toward merger which was planned to take place in phases. In the first phase, Kangwon Bank and Hyundai Merchant Bank whose management normalization plans were conditionally approved, would merge on December 17, 1998, and in the second phase, the merged bank and Chohung Bank would again be consolidated. Hyundai Group was the majority shareholder of both banks, which helped the merger proceed swiftly and smoothly. The deal was completed and the merged bank was registered on February 11, 1999. On the other hand, negotiations between Chohung and Kangwon were not making much progress because the banks were having difficulty ironing out the differences over the merger ratio. Upon securing the FSC's conditional approval, Chungbuk Bank tried to raise capital, but failed. As a result, the bank was designated as insolvent and ordered to merge with other banks on February 2, 1999. Following the FSC's order, Chohung, Kangwon, and

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37 Wi Seong-bok, chairman of Chohung Bank stepped down, but when Chohung and Chungbuk were consolidated in April 1999, he returned to the merged bank as chairman.

Chungbuk announced that they would merge together, and signed a contract on Mach 18, 1999. Chohung and Chungbuk merged first on May 4, 1999 while Kangwon remained excluded from the deal because the merger ratio was not determined yet. Subsequently, Chohung and Kangwon agreed to the merger ratio, and registration as a merged entity was finished on September 15, after the general shareholders' meeting approved the merger on August 30, 1999.[38] The government provided a total of 2,835.8 billion won in public funds, including 2,717.9 billion won for capital increases through KDIC and KAMCO and 117.9 billion won for purchases of non-performing assets in order to assist in the merger of Chohung, Kangwon, and Chungbuk. Upon completion of the merger of the three banks, the FSC and KDIC, and the majority shareholders of Chohung Bank signed the TOR for management normalization.

1.3.3.3. Korea Exchange Bank (KEB)

Under its management normalization plan conditionally approved by the FSC, Korea Exchange Bank succeeded in securing an investment of 250 million dollars(350 billion won) from Commerzbank of Germany on July 29, 1998. Commerzbank was the world's 30th largest bank with 280 billion dollars(400 trillion won) in assets, and then KEB chairman Hong Se-pyo was credited for pulling off the successful deal with his outstanding international diplomacy.[39] However, the management evaluation conducted at the end of June 1998 found that KEB's NPLs amounted to 10,792.3 billion won or 28.6% of all loans, 3 times more than the average NPLs of the 12 banks evaluated, which was 3,647.9 billion won. KEB's relatively large amount of NPLs was due to its concentration in corporate lending. As large conglomerates went bankrupt amid the financial crisis, NPLs of KEB and Korea First Bank which had relatively large corporate exposures snowballed. Since Commerzbank's investment plan was approved on a guarantee of no capital reduction, a new plan was needed for KEB. According to the previous plan for the merger of the 5 nonviable banks, Chungchung Bank was going to be

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38 In hindsight, all of the banks involved in the merger were nonviable and exit could have been an option. However, 5 banks were already ordered out of the market in June 1998, and more exits would have had devastating effects upon the market. Given the grave repercussions, the government had no choice but to merge them. The exit of Chungbuk Bank left Chungchung Province where the bank was based, without a regional bank. So the government decided to inject public funds into the banks, rather than driving the bank out of the market, and instead the headquarters of the bank would be relocated to Daejeon, the capital city of the province(Lee, *ibid*)

39 At the time, KEB handled more than 90% of foreign exchange transactions in Korea and the bank was known for its comparative advantage in corporate banking and for its superior human resources. In May 1998 when the crisis was at the peak, the bank successfully lured an investment from Commerzbank and provided a considerable boost to the Korean economy that was struggling for lack of foreign currency reserves.

left in the hands of KEB which was considered financially healthy, but the plan did not work out because Commerzbank's investment complicated the situation at KEB. After all, Hana took over Chungchung. Originally, the plan for KEB was to inject public funds on condition that its capital be reduced, the management replaced, and massive restructuring completed. However, injection of public funds was no longer an option for KEB because the government promised there would be no capital reduction in recognition of KEB's contribution to the national economy with the foreign capital the bank brought in from Commerzbank, when Korea's foreign currency reserves were depleted. Still, Commerzbank's investment of 350 billion won was too small, compared to the size of KEB's NPLs, and Commerzbank suggested that it would increase the bank's capital on condition that BOK, KEB's majority shareholder, invest more in the bank. But the government concluded that given its role as the mint, the BOK could not invest directly in KEB. So on April 21, 1999, the BOK made an investment in the Export-Import Bank of Korea, a wholly owned subsidiary of the government, which in turn, invested the same amount into KEB. Through this indirect route, the BOK provided 336 billion won to KEB. Commerzbank, on the other hand, acquired 260 billion won worth of KEB's preferred shares, the bank's management and employees bought 100 billion won worth of shares, and other ordinary shareholders, 326 billion won, which raised the bank's capital by a total of 1,022 billion won. KEB either shut down or consolidated under-performing domestic and overseas branches, laid off employees, and sold some of its subsidiaries and real estate. The bank appointed an outside director as the chairman of the board and restructured its corporate governance in a way that outside directors would be able to play a greater role. The risk management system was strengthened, and other measures were taken to bring its operations back to normal. Nevertheless, the financial distress continued to grow and eventually, KEB was sold to Lone Star Fund.[40]

1.3.3.4. Peace Bank

The FSC approved the bank's management normalization plan on June 29, 1998

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40 KEB missed out on the chance to turn around and survive on its own because the government was misled by KEB's deal with Commerzbank into promising no restructuring for KEB including no capital reduction, and failed to accurately assess the magnitude of KEB's NPLs. If the judgement of the government had not been clouded by the deal, KEB would have merged with other banks and received public funds according to the same principles applied to other banks and based on the results of the management evaluation finished in June 1998. If it had been the case, all the social controversies that have arisen surrounding the sale of KEB to Lone Star would have been avoided(Lee, *ibid*).

on condition that the bank replace the entire management, increase its capital via rights offering by 120 billion won by the end of 1998, reduce its capital, abandon international business, and stop making new loans worth 5 billion won or more. In the TOR the bank submitted to the FSC on September 15, 1998, Peace Bank pledged to raise its BIS capital adequacy ratio to 4% or above by end-March 1999, more than 6% by end-March 2000, and over 8% by the end of 2000. The bank reduced its capital from 273 billion won down to 100 billion won on October 27, 1998 while simultaneously increasing its capital by 120 billion won via rights issue. KDIC invested 220 billion won in the bank by acquiring its shares. The bank raised 80 billion won on May 18, 1999, and again 50 billion won on December 27, 1999 in rights offerings. As a result, the bank's total paid-in capital rose to 570 billion won. The management was replaced on August 21, 1998, and international business was discarded as of September 30. The headquarters was relocated on August 16, 1999, and NLPs were sold on December 23. In 2001, Peace Bank was integrated into Woori Financial Holding Company along with Hanvit Bank, Kyeongnam Bank, and Kwangju Bank.

1.3.3.5. Negotiations with Labor Union

Ahead of the planned restructuring of 9 banks including 7 banks with their plans conditionally approved in June 1998, and 2 banks to be put up for sale to foreign buyers, Korean Financial Industry Union(KFIU) threatened a general strike on September 29, 1998. The financial regulators' restructuring guidelines required a 40% reduction of workforce for each bank to be competitive, but KFIU demanded that workforce reduction be no more than 20%. Fortunately, the government and KFIU managed to strike a balance between the social cause of restructuring and practicality and meet in halfway, averting a general strike. Individual banks engaged in negotiations with their union and agreed to around 30% layoff. With the thorny issue of layoff behind, the financial market stabilized gradually.

1.4. Banks with BIS Capital Adequacy Ratio of Above 8%

In consultation with the IMF and IBRD, the government decided to hire 6 accounting firms operating in alliance with international accounting companies and have them evaluate 13 banks whose capital adequacy ratio exceeded 8%, in July and August 1998. As was with the evaluation of the banks whose capital adequacy ratio was below 8%, the evaluation used the TOR which included FLC scheduled to become applicable in 1999, and looked closely at all the aspects of the banks' operations including capital adequacy, asset quality, risk management, lending policy, internal management system, and the management. The evaluation found all of the 13 banks in excess of the required 8% BIS capital adequacy ratio as of end-June 1998, and therefore, no PCA was taken. Prior to this evaluation, Jeju Bank was rated poorly in the evaluation previously conducted by the Banking Supervisory Board(BSB) at the end of 1997, and was requested by the FSC to improve their management on April 24, 1998. Busan Bank and Kyeongnam Bank whose asset quality was assessed to be poor as of end-June 1998, were also recommended by the BSB on October 16 to improve their management. The same recommendation was issued on November 6, 1998 to Long-Term Credit Bank whose asset quality deteriorated in the same evaluation.

1.4.1. Jeju Bank

Jeju Bank had its assets seriously impaired as its payment guarantees for large conglomerates and its subsidiaries turned into loss in 1997, which adversely affected the bank's overall performance. Given the poor asset quality and poor performance of the bank, the FSC imposed a management improvement request upon the bank on April 24, 1998, and the bank submitted a management normalization plan on May 28, 1998. The BSB hired Ahn Jin, a domestic accounting firm to evaluate the plan and conduct a diagnostic review of the bank's management, and approved the plan on September 11, on condition that the bank faithfully execute the plan and bring its operations back to normal.

The bank's TOR submitted to the FSC stipulated that the bank would issue new shares to raise its capital on October 10, 1998(30 billion won in December 1998, and 65 billion won by end-March 1999), drop international business, and meet the targets for BIS capital adequacy ratio(4% or above by end-March 1999, minimum 6% by end-March 2000, and minimum 8% by end-December 2000). The bank cut its capital down to 25 billion won in November 1998, and raised a total of 95 billion won in two rights offerings(30 billion won in December 1998, and 65 billion won in March 1999). In 2000, the bank added more to its capital and strived to pull its capital adequacy ratio up to the target by expanding its net profit. The bank did its best to follow the plan and normalize its operations, but despite all these efforts, the bank was judged unable to survive on its own according to the management evaluation in 2001, and eventually, merged into Shinhan Financial Holding Company.

1.4.2. Busan Bank and Kyeongnam Bank

Following the BSB's recommendation of management improvement issued on October 16, 1998, the two banks submitted their management normalization plans on December 16, and the BSB had the accounting firm Young Hwa review the plans from December 27 1998 to January 12, 1999. Based on the results of the review, the plans were approved on condition that a follow-up implementation plan be submitted, and that the plan would include details on how the banks would increase their capital by 100 billion won by end-1999, improve their internal management systems such as reducing branches, organization and workforce, decrease NPLs, and revise the plans to improve asset quality in line with the new loan classification standard, i.e, FLC.

Accordingly, the two banks handed in their revised implementation plans that incorporated the details requested as a condition of the approval, on February 12, 1999, as well as the TOR under which the banks pledged to reach at least 8% BIS capital adequacy ratio and to respond promptly to any requests for additional capital increase. The banks faithfully and smoothly took the steps as planned toward management normalization, including raising capital, closing down or consolidating branches, laying off employees and reducing NPLs. However, Kyeongnam Bank was declared nonviable in the 2001 management evaluation and consolidated into Woori Financial Holding Company.

1.4.3. Kookmin Bank, Long-Term Credit Bank, Hana Bank, and Boram Bank

Aside from mergers among failing banks to save themselves from financial trouble, the domestic banking sector witnessed a growing trend of business alliances including merger among healthy banks in an attempt to strengthen their dominance in the domestic financial industry and compete with global players by enlarging business size and enhancing competitiveness.

Kookmin Bank and Long-Term Credit Bank announced their plan to merge, on September 11, 1998, formed a merger committee on September 17, and completed the merger by registering the merged entity on January 5, 1999. The merger was intended to maximize the synergy effects by combining the comparative advantages that the two banks had in retail banking(Kookmin) and wholesale banking (Long-Term Credit). The consolidation of two healthy banks catapulted the merged Kookmin Bank straight to the top of the industry, and the bank emerged as a dominant player.

Hana and Boram also disclosed their merger plan on September 8, 1998, to achieve economies of scale through the merger and grow the size enough to place the merged bank among major players. The government provided 300 billion won in public funds in the form of acquiring preferred shares of the new bank in order to ensure that the merged bank could keep its BIS capital adequacy ratio at a level similar to the ratio of pre-merger Hana Bank which was financially sound.

2. Non-Bank Financial Institutions

2.1. Securities Companies

2.1.1. Background

After Korea joined the OECD in November 1996, much progress was made in liberalization and globalization of the financial markets, which led to increased uncertainties in the business and operating environment for securities companies. The changing circumstances called for a more comprehensive supervision framework that could better protect investors from possible bankruptcies of securities companies and to ensure the stability of the securities industry. To this end, the financial regulators introduced the net capital rule and early warning system(EWS) in April 1997 in an effort to bring prudential regulation in line with global standards.

When these new frameworks were first introduced, the majority of securities firms had been in deficit due to accumulated losses over the previous 2 to 3 years, and their financial position was vulnerable. In order to give securities companies time to improve their financial structure and to minimize any drastic impact on their finances, the introduction of EWS was postponed for 2 years. Securities companies were struggling with two problems prior to the eruption of the financial crisis. First, operating losses continued to grow amid a sluggish stock market which translated into lower fee income and losses on valuation of products they held in their portfolio. Second, they incurred losses from guarantees on corporate bonds, a new business in which securities companies got involved after business crossover was permitted. In other words, their payment obligations from the guarantees on corporate bonds sharply increased as Hanbo, Kia, and other conglomerates fell into bankruptcies.

The securities industry was struggling with these problems, but their losses in connection with the foreign exchange crisis were relatively small because it did not engage in corporate lending. Still, there were serious imbalances between their assets and liabilities, which left securities companies highly vulnerable to external shocks. Their assets consisted mainly of securities which could be cashed only in the stock and bond markets while the majority of their liabilities was ultra-short term funds which had to be paid out at any time upon demand, such as customer deposits, short-term borrowings from financial institutions, and call money. With this financial structure, a downturn in the stock or bond market would pose double perils to the securities firms: It would drag down the value of their assets, as well as negatively affecting their liquidity. This would leave them so vulnerable and without a tool to effectively and timely respond to large-scale withdrawals of deposits or bank runs. Lack of transparency was another problem facing the securities sector. The commodity stocks and stocks that they purchased with the stock market stabilization fund were not marked-to-market. In addition, securities companies did not reflect the losses from their payment guarantees for companies that went bankrupt, properly and within an appropriate time frame. Instead, they deferred the losses over a considerably long period of time. The industry's lack of transparency had been widely known in the market, but market participants did not have any discerning tool to sort out the rotten apples from the pack. As a result, the entire industry became subject to blanket distrust by both investors and creditors, and the possibility remained that a crisis at an individual company could spread to and undermine the entire industry. And the possibility began to turn into reality in February 1997. Under these circumstances, the financial crisis that started in December 1997 left the financial market in a tight squeeze and a number of financial institutions experienced a liquidity crunch, following the suspension of business license ordered against some merchant banks and other institutions. Goryeo Securities became the first in the industry to go bankrupt on December 5, 1997, followed by Dongseo Securities on December 12, which were forced out of business.

In a bid to stabilize the financial market through speedy restructuring of financial institutions, the FSC began to impose PCA on securities companies, with a focus on managing a proper level of equity capital, on May 1, 1998. Under the principle of placing top priority on bringing the industry to stability as early as possible, majority shareholders of securities companies were put in charge of restructuring their companies, and if found unable to turn around, the companies were ordered to exit. In conjunction with the restructuring, the regulators also embarked upon institutional reforms aimed at raising the stability of the securities industry, such as keeping the entire amount of customer deposits in a separate account, effective on June 20, 1999. Previously, securities houses did not separate customer and proprietary accounts for securities trade, and instead, they paid fees for using customer deposits. The mixed accounts created profits for securities companies by benefiting them with lower funding costs(fees for using customer deposits) than if they had to find funding elsewhere. On the other hand, however, such practice put both the company and its customers at risk because massive withdrawals from customer accounts would likely cause a liquidity squeeze and the security of customer deposits could be also compromised in the event that the company went bankrupt. Separation of the two accounts made securities firms less vulnerable to possible massive withdrawals of funds by customers, as well as diminishing concerns over the safety of customers' money. After all, operations at securities companies became more stable than before.

The Securities Investor Protection Fund that was run with contributions from securities companies was abolished. Instead, KDIC took over the Fund's role in April 1998. The Fund was set up by law, but it had two major problems: First, since the Fund was not allowed to resort to other external funding than contributions from securities companies, it could not fulfill its function of paying customer deposits if the Fund ran out of money. Second, there were problems with specific ways of financing the Fund. Since KDIC replaced the Fund, offering better security over customers' money, customers' concerns lessened and it also helped the market stabilize, adding to the positive effects of the restructuring.

Since then, overall financial health improved across the industry. The industry made aggressive self-reform efforts and the stock market continued in a boom until the fourth quarter of 1998. The positive results were backed by the fact that not a single company was placed under PCA. Even though the restructuring was finished, the regulators further tightened its supervision of the industry and constantly monitored financial indicators such as net capital ratio and debt-equity ratio.

2.1.2. Nonviable Securities Companies

2.1.2.1. Goryeo and Dongseo Securities Companies

The two companies were both among the top 10 in the industry and their bankruptcy sent the entire securities industry into a shock because it was the first bankruptcy ever since the 1970s. On the surface, Goryeo Securities' bankruptcy was directly attributed to the suspension of payments on the call loans it provided to its subsidiary Goryeo Merchant Bank as the money market was fast spiraling into liquidity crunch. On a fundamental level, however, the company's financial structure made it susceptible to liquidity crisis because its liquidity remained low due to excessive investments in real estate and other fixed assets, and its reckless payment guarantees on corporate bonds reached the industry's top. So the bankruptcy was caused in large part by its mismanagement. Dongseo Securities faced a bank run because its parent group Kuk Dong Engineering and Company announced the restructuring plan under which the securities company was to be spun off from the parent group, and the spinoff was viewed by market participants as a sign of trouble at the company. However, a closer look at its financial position revealed some fundamental problems as was with Goryeo Securities. The company incurred considerable losses on its payment guarantees on corporate bonds and secretly offered a large amount of loans to a subsidiary of Kuk Dong E&C.

As the stock market contracted sharply on the back-to-back bankruptcies of these two securities companies, the regulators took swift actions to stop the spread of negative effects to the entire industry. As part of such actions, the regulators immediately moved the customer accounts and depositary marketable securities held by the two companies over to other companies, and paid customer deposits ahead of any other payments, from the Securities Investor Protection Fund. The Fund which was created in 1997 could pay a company within the limit of 1/2 of the accumulated amount, but immediately prior to the bankruptcies of the two companies, the government changed the rules so that the entire amount of the Fund could be paid in case of emergency to stabilize the financial market. The Fund was not able to cover the entire payments of customer deposits of both companies, but the securities industry reached a consensus that the trouble at the two companies should not drag the entire industry into a crisis and volunteered additional contributions into the Fund so as to make all of the payments. After customers' worries subsided thanks to the immediate transfer of the affected customer accounts and other timely follow-up actions, the regulators required the companies to submit a management improvement plan in order to assess their viability, but their financial structure improvement plans were hardly feasible and their exit was inevitable.

<Table 2-6> Restructuring Process of Goryeo and Dongseo

	Goryeo	Dongseo
Reasons for suspension of business license	- Bankruptcy(Dec. 5, 1997)	- Bankruptcy(Dec. 12, 1997) - Business suspension was reported(Dec. 12, 1997) • Reason: company reorganization, etc.
Background to Bankruptcy	- Subsidiary Goryeo Merchant Bank had its license suspended on December 2, 1997, and consequently, 69.2 billion won it provided to the merchant bank in the form of guarantees were estimated as loss.	- The rumor spread that Dongseo provided financial support to its cash-strapped parent Kuk Dong Group, which triggered massive withdrawals, leading to the company's bankruptcy.

Contents of License Suspension(the Securities Commission)	- Business license was suspended(Dec. 5, 1997) • The scope of suspended businesses: all the activities except matters relating to return of customer depositary securities and customers' exercise of rights on those securities. • Suspended period : one month from Dec. 6, 1997	- Business license was suspended(Dec. 12, 1997) • The scope of suspended businesses: all the activities except matters relating to return of customer depositary securities and customers' exercise of rights on those securities. • Suspended period : one month from Dec. 12, 1997
Extension of License Suspension and Management Improvement Order(Securities Commission)	- Extension of suspension: 4 extensions and management improvement orders - Major contents of the final order for management improvement(March, 27, 1998)• Submission of specific measures toward management normalization and a letter of consent from the creditors to ensure the implementation of these measures • Submission of a repayment plan for 104.4 billion won drawn from the Securities Investor Protection Fund, by the end of December 1998	- Extension of suspension: 4 extensions and management improvement orders - Major contents of the final order for management improvement(March, 27, 1998) • Submission of evidential documents including a detailed management normalization plan via 3rd party acquisition and a copy of the acquisition contract. • Submission of a repayment plan for 78 billion won drawn from the Securities Investor Protection Fund, by the end of December 1998
Major Contents of Management Improvement Plans	- Debt restructuring as agreed upon by creditors - 5-year installment repayment to the Securities Investor Protection Fund	- Management improvement through 3rd party acquisition • Buyer: Horizon Holdings Ltd(US) • Price: 143 billion won • Stake to be purchased: 53 billion won (63.6%) • Acquisition of subordinated bonds: 90 billion won - Debt restructuring as agreed upon by creditors - Repayment to the Securities Investor Protection Fund by year-end
License Revocation (The FSC)	- Management improvement plan was unapproved (April 24, 1998 and May 1, 1998) and request for revocation of business license was filed. • The company failed to repay the borrowings from the Fund by the deadline. • Unable to conduct stable operations and to cope with further liquidity crunches due to creditors' refusal to provide further financial support.	- Management improvement plan was unapproved (April 24, 1998 and May 1, 1998) and request for revocation of business license was filed. • The identity of the potential buyer Horizon including its financial soundness was not fully or sufficiently known. • Horizon was not fully committed to taking over the company.
License Revoked	- June 1, 1998(The Minister of Finance and Economy)	- June 1, 1998(The Minister of Finance and Economy)

The regulators remained undecided over the viability of the two bankrupt companies and reevaluated their possibility of a turnaround by extending the business suspension as many as 4 times, but eventually, they concluded that the companies should be closed down and asked the Ministry of Finance and Economy to revoke their business license. In the process of dealing with these companies, the regulators strongly felt the need for PCA because a shutdown of a securities firm in the final stage where it was forced into bankruptcy, would inevitably and invariably impose much burden on all parties involved, including the industry, customers, and the government. This point becomes clear when the handling of Goryeo and Dongseo is compared to the way securities companies were ordered to exit the market as part of the restructuring that was carried out in the second half of 1998 and beyond.

Goryeo and Dongeo inflicted significant losses on the Fund and their creditors because they closed down after their assets fell far below their liabilities. On the other hand, Long-Term Credit Securities and Dong Bang Peregrine Securities did not cause much damage to market participants when it exited the market because the PCA system was in force and ensured that their equity capital was maintained at proper levels, which enabled the companies to liquidate themselves before they closed down. These two very different experiences suggest that companies should be regularly monitored for their capital adequacy so that exit can be ordered before their capital is depleted, rather than forcing an exit as a last resort after companies are pushed into bankruptcy. The lesson learned from the restructuring of the securities companies was that the cost of exit can be minimized only if PCAs are taken when companies are still able to make payments on their own, thereby contributing to the stability of the broader industry.

2.1.2.2. Korea Development Securities Corporation

The FSC revoked the business license of Korea Development Securities Corporation on July 25, 1998 for reasons including protection of investors and others, as the company submitted a business suspension report, following the resolution of dissolution by the board of its shareholder Korea Development Bank who wholly owned the company.

Korea Development Securities Corp. was not capable of improving its management and normalizing its operations because its capital was seriously eroded by accumulated losses and dropped down to negative 272.3 billion won amid prolonged labor-management disputes. An extraordinary shareholders meeting was convened to approve the dissolution of the company and appoint the liquidator. Subsequently, liquidation procedures began and customer accounts were transferred.

Upon completion of the procedures, the company returned its license to the Ministry of Finance and Economy on December 24, 1998, and moved ahead with the bankruptcy procedures.

<Table 2-7> Financial Summary of Korea Development Securities Corp. (billion won)

	End-March 1996	End-March 1997	End-March 1998	End-June 1998
Total assets	806.1	924.2	766.5	435.5
Total liabilities	555.4	730.0	638.8	311.6
Shareholder's equity	250.7	194.2	127.7	123.9
(Capital)	(250.0)	(250.0)	(400.0)	(400.0)
Net profit	-27.3	-56.5	-216.5	-3.8

2.1.2.3. Hannam Investment Securities Co.

The FSC revoked the license of Hannam Investment Securities and Hannam Investment Trust as both of the companies submitted their business suspension reports on August 13, 1998 after they became unable to maintain regular operations due to massive redemption requests on its beneficiary certificates. The companies faced massive demands for redemption of beneficiary certificates as subsidiaries of their majority shareholder Guhpyeong Group went bankrupt. Despite all the efforts that the companies and the group made, and all the support from the investment trust industry, investor confidence in these companies plummeted and they became unable to operate normally. Redemption requests rose back in August 1998 after they calmed down, and finally, the companies fell into insolvency, with no hope of a turnaround. Following the suspension of their license, the FSC took actions to minimize damages to beneficiaries and one of the actions was to provide financial assistance called "livelihood stabilization fund" from August 24, 1998 up to 50% of the principal(up to 70% if the principal was 5 million or less) or 100 million won. The FSC requested the prosecutor's investigation into former and current executives and majority shareholders of the companies who were found to have been involved in illegal acts or to be suspected of such acts, in the property due diligence and inspection on the companies. On August 26, 1998, Hannam Investment Trust was ordered to transfer its investment trust contracts to Hyundai Investment Trust Management Co.(formerly known as Citizen Investment Trust Management Co.) upon the latter's agreement. Hyundai Investment Trust Management completed the transfer on September 30, and resumed the redemption of beneficiary certificates on October 1.

The property due diligence revealed that Hannam Investment Securities' liabilities far exceeded its assets and Hannam Investment Trust Management was left with no business assets after it transferred all of its properties held in trust. As a result, both of the companies were deemed unable to conduct their normal business activities. The FSC requested revocation of their license to the Ministry of Finance and Economy on October 9, 1998, and the Ministry had their license cancelled on January 6, 1999 after a hearing.

2.1.3. Restructuring through PCA

2.1.3.1. Management Improvement Order

According to the PCA system that was launched on May 1, 1998, the FSC ordered that 4 companies including SK Securities, Good Morning Securities (formally known as Ssangyong Investment Securities), Long-Term Credit Securities, and Dong Bang Peregrine Securities whose net capital ratio(NCR) fell below 100%, should submit a management improvement plan which would include specific ways to increase equity capital, restrict activities that could reduce net operating assets such as acquisition of risky assets, and dispose of subsidiaries through close-down, merger or 3rd party acquisition. They were also ordered to submit a review of the plan by an accounting company, in addition to the plan itself.

Upon submission, the plans were reviewed by the Securities Companies' Management Improvement Plan Evaluation Committee and the Securities and Futures Commission. Taking into consideration the evaluation results, the FSC conditionally approved the plans of SK Securities and Good Morning Securities on September 5, 1998, and the companies were required to implement the plans by September 30, 1999. However, the plans of Long-Term Credit and Dong Bang Peregrine were not approved.

<Table 2-8> Financial Data of the 4 Securities Companies(as of end-June, 1998, %)

	SK	Good Morning	Long-Term Credit	Dong Bank Peregrine
Net Capital Ratio	-62.7	-103.6	4.8	-73.9
Debt-equity ratio	92.8	126.3	116.7	114.2

2.1.3.2. Exit of Unapproved Securities Companies

Long-Term Credit Securities were struggling to repay its debts and had to borrow funds to make the repayments, and Dong Bang Peregrine had its liabilities far in excess of its assets. The FSC designated these two companies as insolvent on October 9, 1998 pursuant to the Act on the Structural Improvement of the Financial Industry, and requested the Ministry of Finance and Economy to revoke their licenses. The Ministry held a hearing and revoked the licenses of Long-Term Credit and Dong Bang Peregrine on March 15, 1999, and April 9, 1999, respectively. The companies finally filed for bankruptcy after they went through dissolution and liquidation.

2.1.3.3. Implementation of Management Improvement Plan and Lift of the Management Improvement Order

The evaluation of the plans submitted by SK and Good Morning as of September 30, 1999, found that their operations had been brought back to normal as their financial data including NCR exceeded the criteria as required in the PCA system. The management improvement order was lifted for SK on November 12, 1999, and for Good Morning on December 10, 1999.

<Table 2-9> Financial Data after Implementation of Management Improvement Plan (End-September, 1999, %)

	Criteria	SK	Good Morning
NCR	150	193.2	272.1
Debt-equity ratio	100	114.1	128.8

2.2. Investment Trust Companies

2.2.1. Background

Under the 1995 securities industry reorganization plan, the government established the authorization and licensing criteria for investment trust business in May 1996, and induced conversion of investment advisory companies into investment trust management companies in order to dispose of the impaired assets of existing investment trust companies and resolve the oligopoly of investment trust business. In addition, the government decided to separate investment trust management business and sale of beneficiary certificates so as to ensure that properties held in trust be managed independently. Under the policy drive, 6 new investment trust management companies were created from June 1996 to the end of

December 1997, in addition to the existing 8 companies. The investment trust industry got crowded and became overly competitive as the players sharply increased in number, and the performance of investment trust companies quickly worsened and economic conditions began to deteriorate in 1997. Financial deregulation and market opening was pursued aggressively but prematurely, giving investment trust companies little time to get financially ready. Consequently, their financial position was seriously exacerbated by growing dependence on excessive borrowings and stockholding, and size-oriented, reckless expansion strategies that they adopted in the process of performing the role of institutional investor.

Particularly, the same-day redemption policy that investment trust companies was running weighed heavily on their financial position and added to their financial distress. In principle, when a customer(beneficiary) demands redemption, the company sells the corresponding securities and uses the proceeds to pay the customer. But under the same-day redemption policy, the payment had to be made in the same day so the company first paid the customer with so-called bridge calls or borrowings backed by customers' properties held in trust, before the sale of the securities was completed. So the company assumed the financial burden until the sale was completed and the money was put back into its account. Investment trust companies resorted primarily to borrowings to meet redemption demands. As the borrowings increased and the growing funding cost put pressure on their financial position, they funded the redemptions with borrowings backed by customer properties held in trust. These unorthodox practices only resulted in further asset impairment and investment trust companies lost resilience to bounce back from the crisis with their competitiveness seriously lowered by their role of institutional investor. As institutional investors, investment trust companies served as a safety net of the capital market and their activities and performance had a greater impact on the financial market than other sectors of the financial industry did. They grew increasingly dependent on government policies and its implicit support, which further eroded their competitiveness. Restructuring was inevitable to transform the debt-ridden investment trust sector and raise their competitiveness.

Priority was placed on intensive self-reform efforts toward management normalization instead of aggressive restructuring, considering that public funds could not be used to cover the losses on real fiduciary accounts, and that aggressive restructuring would likely force investment trust companies to sell large quantities of marketable securities they held, which would send the market into a shock. This approach was expected to save costs and mitigate any negative impact on the market because the market conditions were anticipated to improve amid rising interest rates and stock prices.

2.2.2. Insolvent Investment Trust Companies

2.2.2.1. Restructuring of Investment Trust Companies

Previously, investment trust companies managed properties held in trust and sold beneficiary certificates at the same time. At the time of the financial crisis, proprietary accounts of investment trust companies were in deep deficit due to redemption payments and excessive borrowings that they used to invest in securities. Under these circumstances, interest rates rose, and demands for redemption of beneficiary certificates increased due to uncertainties in the financial market, leading to liquidity shortages at investment trust companies. The government ordered the companies in a liquidity crisis to transfer their properties held in trust to other institutions and revoked their license.

· *Shinsegi Investment Trust*

Based in Kyeonggi and Kangwon areas, Shinsegi Investment Trust suffered a liquidity crisis in December 1997, following massive redemption requests immediately after the IMF-requested reform program was put in place. Eventually, the company filed for business suspension and the government ordered the suspension on December 19, 1997. The company's properties held in trust was taken over by Korea Investment Trust and its license was canceled on February 17, 1998, upon the FSC's request.

The due diligence on its properties held in trust conducted after the business suspension showed that its total losses amounted to 647.8 billion won(bridge calls). Part of the losses was made up with the funds from the sale of its proprietary assets and the rest was covered by the borrowings from the Investment Trust Stability Fund(358.6 billion won).

· *Hannam Investment Trust*

Hannam Investment Trust was based in Honam and Jeju areas and their major shareholders were businesses and enterprises operating in the regions. The company's financial position deteriorated considerably after Guhpyeong Group purchased the company in March 1998. Initially, the company engaged in both investment trust management and sale of beneficiary certificates, but new majority shareholders separated the company into two entities: investment trust management company(Hannam Investment Trust Management) and securities company(Hannam Investment Trust Securities). On May 12, 1998, the majority shareholder Guhpyeong Group announced the bankruptcy of its subsidiary and a restructuring plan, which triggered massive redemption demands. As a consequence, the company faced a liquidity crisis and finally filed for business suspension on August 13, 1998. The FSC officially suspended its business on August 14 and the Ministry of Finance and Economy revoked its license on January 6, 1999, upon the FSC's request for revocation followed by a hearing.

Hannam Investment Trust Management was ordered to transfer its trusted properties to Citizen Investment Trust(later renamed Hyundai Investment Trust). In order to cover the damages to its trusted properties found in the due diligence, the government provided a total of 2.5 trillion won to Kookmin Investment Trust after its acquisition of Hannam, including 2 trillion won via issuance of unregistered securities finance debentures and 500 billion won from the Investment Trust Stability Fund.

<Table 2-10> Financial Position at Exit: billion won)

	Total assets under management	Net profit	Shareholder's equity	Paid-in capital	Bridge Calls
Shinsegi	2,830.6	-114.5	-158.4	60.0	647.8
Hannam	2,547.1	-1.9	23.3	30.0	1,004.2

2.2.3. Restructuring of Investment Trust Management Companies

There were two categories of companies that went through restructuring: one category included companies whose parent company went bankrupt and in the other category, majority shareholders decided to have the company's license revoked. Restructuring proceeded smoothly without exerting any shock on the market in both cases.

2.2.3.1. Restructuring Due to Bankruptcy of Parent Companies

Trouble at parent companies was the primary reason behind the distress of investment trust management companies. Goryeo Investment Trust Management and Dongseo Investment Trust Management voluntarily suspended their business, following bankruptcy of their parent companies Goryeo Securities and Dongseo Securities, respectively. Goryeo Investment Trust made full payments on its properties held in trust and its license was cancelled on December 31, 1998. Dongseo Investment Trust was sold to Sejong Securities on July 12, 1999 before it fully paid individual customers who held trust accounts at the company, and it was renamed Sejong Investment Trust Management with the FSC's approval. Long-Term Credit Securities-affiliated Long-Term Credit Investment suspended its business and changed its name to Kookmin Investment Trust Management after Kookmin Bank became its new majority shareholder.

2.2.3.2. Majority Shareholder-Initiated Restructuring

As business environment further worsened with the dawn of the year 1998, largest shareholders of some companies abandoned investment trust business. Boram Investment Trust had its license revoked after Hana Bank and Boram Bank were consolidated on October 14, 1998. Top Investment Trust Management which was affiliated with Korea First Bank also had its license cancelled on November 21, 1999. Dong Bang Peregrine Investment Trust went out of business with the revocation of its license on September 2, 1998 after its parent Dong Bang Peregrine Co. failed to meet the required NCR and submitted a business license return.

Investment trust companies were restructured in a way that separated investment trust business and sale of beneficiary certificates. Citizen Investment Trust was converted into a securities company on March 1, 1997 and Citizen Investment Trust Management was created on February 23, 1998, thereby separating the two businesses as mentioned above. JoongAng Investment Trust changed itself to a securities company on April 1, 1998 and created an investment management company on September 18, 1998. The two companies were renamed Samsung Life Investment Trust Management and Samsung Investment Trust Securities. Korea First Investment Trust also transformed itself into a securities firm on January 12, 1999 and established an investment management company. Dongyang Investment Trust renamed itself Dongyang Orion Investment Trust, separated management and sales, and converted itself to Dongyang Orion Securities.

2.2.4. Institutional Changes

Institutional frameworks were revised to prevent moral hazard while investment trust companies made their own rehabilitation efforts including downsizing, layoffs, and reduction of borrowings.

2.2.4.1. Reduction of Bridge Calls

Technically, bridge calls which refer to borrowings that investment trust companies obtained based on customers' properties held in trust to finance redemptions, are not losses or impaired assets. However, companies were encouraged to repay their bridge loans because the loans could put customers' properties at risk if the companies would exit the market. As of August 11, 1999, further bridge calls were banned, and the deadline of end-March 1999 was set for the companies to bring down their outstanding bridge loans to a certain percentage of the outstanding amount as of end-June 1998. Specifically, 3 companies based in Seoul were required to meet the 70% ratio and the target ratio for 4 regional companies was 50%. The 3 Seoul-based companies were ordered to repay 50% of their bridge loans and the other 4 companies were scheduled to repay all of their exposure by the end of March 2000. The companies revised their reform plans to incorporate specific ways to reduce their bridge calls, and submit a quarterly implementation plan. To guarantee the implementation of the plans, all the management handed in a letter of commitment which was jointly signed.

2.2.4.2. Mark-to-Market(MTM)

Mark-to-Mark or MTM was introduced to eliminate inefficiencies in the secondary bond market, which were caused by information asymmetry and to promote foreign investors' participation by bringing bond valuation in compliance with international standards. Under the MTM system, loss or profit could no longer be transferred and offset between trust accounts or between trust accounts and proprietary accounts, which was possible when bonds were recorded by their book value. Furthermore, companies and fund managers became competitive and actively embraced advanced techniques because their performance data was regularly disclosed.

In the first phase of the original plan, MTM was going to be effective for all bonds included in new funds(excluding MMF) to be set up on November 15, 1998 and beyond, and the new valuation system was scheduled for full-scale application from July 1, 2000. However, the MTM introduction plan released on October 4, 1999 was revised to take a more gradual approach in light of the market conditions that remained unstable following the massive redemptions of Daewoo-related bonds. Customers' properties held in trust would be marked to market in phases while the existing bond valuation system would remain effective for the existing funds so as to minimize risks from fluctuations in interest rates. The existing funds were allowed to take more investments until the end of June 2000, within the outstanding balance of their beneficiary certificates as of end-August 1999. MTM firmly placed itself as a widely-used bond valuation system as a significant portion of Daewoo-related redemptions was invested in new, MTM-applicable funds, and customer properties in trust accounts became more sound as a result of the management normalization drive at troubled investment trust companies [41]

2.2.4.3. Changes to Disclosure Rules on Customer Properties

The new rules required disclosure of product details including nature, risks, and yield to strengthen investor protection. Investment trust(management) companies were required to publish performances of trust accounts, and provide new customers with a copy of a detailed investment guide, as well as a copy of a summary investment guide. Funds that exceeded a certain amount were subject to external audit to safeguard the security and soundness of customers' properties.

2.2.4.4. Corporate Governance and Restriction of Chaebols' Control in Investment Trust Business

One half of the board members of an investment trust company should be outside directors and an audit committee should be set up to ensure that audits can achieve the intended objectives. As an internal control device, compliance officers should be appointed to monitor risk management and compliance with regulations. In order to impose stronger limits on transactions with affiliated companies and other associated parties, maximum stock trading with affiliated companies was lowered to 7% of the trusted properties from 10%, the scope of related parties was expanded, and transactions with related parties were monitored more closely than previously.

2.2.4.5. Other Institutional Changes

Companies that sold beneficiary certificates were often parent companies of investment trust companies and had much discretion over allocation of entrustment

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41 After the onset of the 2008 subprime mortgage crisis, Ben Bernanke proposed held-to-maturity accounting standard instead of MTM when he briefed the US Congress on TARP. But the proposal was not passed due to the opposition of the Secretary of the Treasury Paulson and it was later adopted in March 2009 after Paulson stepped down. Paulson planned to clean up banks' balance sheets while keeping MTM in place, by injecting 700 billion dollars into TARP and to resolve impaired assets of the banking sector, but the plan did not work out as intended. Banks' balance sheets improved without MTM-associated pressures, the stock prices rebounded steadily, and banks were able to draw funds from the private sector(Kaletsky, Anatole, The Birth of a New Economy, 2010). The flexible approach to MTM that the Korean regulators took during the crisis was a step in the right direction because MTM can fail to serve its original purposes in a dysfunctional market.

commission. To foster the growth of the investment trust industry and further enhance compliance with global standards, regulations on entrustment commission were realigned in line with internationally acceptable standards.

Under the new rules, entrustment fee was split between management fee and sale fee, thereby reducing the possibility that sale companies could abuse their power as a parent company to structure the fee allocation in their own favor. Fees were limited at the top rather than at the bottom. The ceiling for management fee was set at 1.5% for stock-invested funds, and 1.0% for public and corporate bond-invested funds while the upside limit for sale fee was 3.0% for stock funds and 2.5% for bond funds. Depository fee was allowed to float within the limit of 0.05% so as to allow depository companies to provide better checks against management companies over management of trusted properties. To prevent massive withdrawals of funds in connection with the restructuring of Daewoo Group and stabilize the financial market, the government devised ways to create liquidity for speculative-grade bonds and dispose of the bonds, including CBO, as well as creating new products such as high-yield funds.

2.2.5. Management Normalization

Under the judgement that operations at investment trust companies should be urgently normalized to stabilize the financial market and foster the growth of a healthy capital market, public funds were injected to refill their capital and provided liquidity support with which the companies were able to finance redemptions. Simultaneously, changes to institutional frameworks were made in order to restore investor confidence. Majority shareholders invested more to increase capital and other actions were taken toward management normalization at companies whose financial position was weakened due to the damages incurred in connection with Daewoo Group. Korea Investment Trust and Daehan Investment Trust received 3 trillion won of public funds in order to calm down investors' concerns and deter a possible contagion across the whole industry. An evaluation committee was organized to assess the feasibility of the management normalization plans of investment trust companies and to deliberate their financing plans. The companies signed an MOU under which they committed themselves to implementation of the plans which was regularly monitored. The highlights of the plans included moving impaired customer properties to proprietary accounts, closing or consolidating funds in a way that increased independence and transparency of trusted properties, separating management and sale, and appointing compliance officers. Over the long term, sales units were converted into securities companies and efforts were made to recover the injected public funds as early as possible through attraction of foreign capitals, registration on KOSDAQ, sale of stakes to foreign investors, etc.

2.3. Insurance Companies

2.3.1. Background

Since the insurance market opening began in 1988, the number of life insurance companies grew from 6 to 33. Relatively less competitive new insurers competed fiercely to expand the size of `their business and consequently, business costs increased sharply, which translated into large amounts of losses. Worse yet, a chain of corporate bankruptcies since the 1997 crisis left insurers with massive NPLs. Eventually, some of the new life insurers were no longer able to carry out their businesses. The government made a bold decision to drive nonviable insurers out of business. Restructuring of the insurance sector involved public auction, P&A, nationalization, and forced merger, and followed the principles that taxpayers' burden would be minimized and majority shareholders of the insurance companies would share the losses. Executives and shareholders who caused mismanagement were strictly held accountable.

On June 20, 1998, 22 insurers including Kukje Life Insurance Co. were asked to submit a management normalization plan. Accounting firms conducted due diligence on these companies and an evaluation committee reviewed the plans carefully to determine viability. Four companies including Kukje, BYC, Taeyang and Goryeo were found nonviable and were forced out of business via P&A. Restructuring of distressed life insurers including Daehan and guarantee insurance companies began in 1999.

2.3.2. Restructuring of Troubled Life Insurers

2.3.2.1. Management Improvement and P&A of 4 Life Insurers

On June 20, 1998, the FSC ordered 18 life insurers and 4 non-life insurers that failed to meet the required RBC ratio as of end-March 1998, to submit a management normalization plan. A management evaluation committee reviewed the plans and determined the practicability and feasibility of the plans, after accounting firms conducted due diligence from June 20 to July 10, 1998. Based on the results of the evaluation and due diligence, the FSC issued management improvement actions including business suspension against the insurers on August 11, 1998.

On August 21, 1998, 4 life insurers including Kukje were ordered to enter into P&A transactions with healthy life insurers such as Samsung Life Insurance, and the KDIC provided financial support to the acquiring insurers to cover the combined deficits of 1,153.4 billion won in net assets of the distressed insurers involved in the transactions. The 4 companies had their license revoked on November 11, 1998.

<Table 2-11> Management Improvement Actions Issued in August 1998

Actions	Companies(No. of companies)
Declared nonviable/business suspended	Kukje, BYC, Taeyang, Goryeo(4)
Submission of Implementation Plan	Donga, Pacific, Kookmin, Handuk, Hankuk, Josun, Duwon(7)
Letter of Committment	Hanil, Shinhan, Hansung, Daishin, Dongyang, SK, Kumho(7) Haedong, Dongbu Fire Insurance(2)

<Table 2-12> P&A (1998)

Dissolved Insurers	Kukje	BYC	Taeyang	Goryeo
Acquiring Insurers	Samsung	Kyobo	Heungkuk	Jeil

2.3.2.2. Public Auction of 6 Failing Life Insurers

· Selection of Restructuring Candidate Companies

According to the review of progress that 14 life insurers were making toward management normalization from August to the end of December 1998, 10 companies that were making little progress after they failed to increase their capital and to secure foreign investments, were given one month(from January 18, 1999 to February 18, 1999) to implement their plans, while due diligence on their assets and liabilities began at the same time. The due diligence showed that six companies including Donga, Pacific, Kookmin, Handuk, Josun, and Duwon were unable to implement their plans and their liabilities far exceeded their assets. So these companies were put under a restructuring program starting March 1999.

<Table 2-13> Further Actions Issued Against Insurance Companies

	Companies
Submission of Implementation Plan	Donga, Pacific, Kookmin, Hankuk, Handuk, Josun, Duwon
Signing of Letter of Committment	Dongyang, Hansung, Hanil

· ***Restructuring Methods***

The 1st round of restructuring done in August 1998 used P&A while the second round adopted M&A in order to minimize financial burden and increase job security. Companies were publicly auctioned off to domestic and foreign buyers and sale procedures were adjusted in consideration of diverse situations and circumstances of individual companies as well as how negotiations on foreign investments were proceeding.

Competitive bidding was chosen to sell Kookmin Life that was in talks with New York Life, and consulting companies were hired to facilitate the sale of the rest of 5 insurers including Donga Life via public tender. To ensure transparency and fairness, key issues were deliberated and resolved by the Life Insurance Companies Restructuring Committee. The consulting companies that advised on and managed the sale ensured professionalism and efficiency in the sale process.

· ***Results of Restructuring***

First, Kookmin Life was put up for public sale. In 1999, the government selected New York Life and International Finance Corporation(IFC) as preferred negotiators for the sale of Kookmin Life. On March 25, a draft of MOU was submitted and the MOU was signed on July 29 after the parties involved ironed out differences. However, negotiations with New York Life were aborted on January 12, 2000 over differences on the value of Kookmin Life after the actuarial valuation was finished. Following the abortion of the negotiations with New York, the government signed an MOU with SK Group and completed the sale at the end of March 2000.

Next, Donga Life and 4 other life insurers were all sold in public tender. The government appointed Credit Lyonnais Securities as the lead manager in April 1999 and searched for potential buyers. After due diligences and corporate valuations were completed, investment proposals were accepted on June 30, 1999. Five interested buyers including US insurer the Hartford and Hyundai Group submitted investment proposals for 4 of the companies, but none of the buyers was interested in taking over Duwon Life.

In an effort to speed up the restructuring, restrictions were eased to allow companies affiliated with the 5 insurance companies up for sale to get involved in the sale. If interested, an affiliated company was required to purchase 2 or more of the failing insurers and the government provided financial support that matched 50% of the net asset deficit of one of the two acquired companies. This enabled affiliated companies including Hyundai Group to get involved in the public sale. The Life Insurance Company Restructuring Committee examined the investment proposals and based on the results, the government selected the preferred negotiators: The Hartford for Kookmin, the Dongyang and Rothschild consortium for Pacific, and Hyundai Group for Josun. At last, the companies were ready for sale in July 1999.

The talks with the Hartford over Donga Life failed as they could not reach an agreement on specific sale conditions and price. Instead, Kumho Group was chosen as a preferred negotiator in October 1999. In October, 1999, Yong Poong Group presented an investment proposal for Handuk Life which was struggling to find an interested buyer. Amid the ongoing negotiations with the interested buyers, the government designated the 5 insurers as insolvent according to the relevant laws in early November 1999, and took actions against the majority shareholders, executives, and employees of the 5 companies who were found responsible for the insolvency, including issuing a reprimand and filing claims for damages. In addition, all of the existing shares were cancelled without compensation, and KDIC invested 30 billion won in each of the companies to make the legally required minimum capital. So the government became the largest shareholder of these companies and took control of the sale process.

Josun(October 30, 1999), Donga(November 29), Pacific(December 9), and Handuk(December 29) agreed to the basic terms of the deal and singed an MOU with their respective buyers. Upon the agreement and MOU, due diligence and corporate valuation were carried out. According to the results, agreements were reached on sale prices and specific sale conditions. Josun entered into the final contract on January 12, 2000, Donga on February 18, and Pacific and Handuk at the end of March 2000. Duwon was finally taken over by Daehan Life via P&A on December 2, 1999 after it struggled further for a potential buyer.

As shown above, the second round of restructuring through public sale proceeded smoothly and accomplished the goal of minimizing taxpayers' burden and job insecurity. The success of the second round presented a new model for future restructuring. Hankuk, Kumho, and Dongyang to which management improvement actions were issued normalized their management earlier than expected, through capital increase by their majority shareholders and mergers, thereby contributing greatly to improving the soundness of the insurance industry.

<Table 2-14> Basic Terms of MOU on Sale of Life Insurance Companies

- M&A via stake sale - The government(KDIC) invests an amount equivalent to net asset deficit less sale price into the acquired company and sell the stake. - The buyer invests an amount equivalent to the sale price - The buyer's insurance company increases its capital via additional investment to meet the RBC ratio and then merge with the insurer up for sale. - Minimum 60% of the acquired company's employees should be taken over.

2.3.2.3. Daehan Life Insurance Company

· *Attraction of Foreign Capital*

Daehan Life Insurance Co. began its negotiations with MetLife of the U.S. in early 1998, signed a letter of intent involving 1 billion dollars on June 8, and due diligence was conducted from July 20 to August 28. The due diligence found that the company was in serious financial distress, which amounted to 3.8 trillion won in net asset deficit according to MetLife. The talks between Daehan and MetLife hit a snag due to the larger-than-expected deficit, and the two companies entered into a contract on condition that the government would make a payment guarantee on the entire amount of the deficit, on December 31, 1998. In January, 1999, MetLife asked the government to cover the full amount of the deficit as a condition of joint investment into Daehan Life.

· *Administrative Order and Public Sale*

Upon MetLife's request, the government reviewed and agreed to the magnitude of Daehan's financial trouble and conducted a property due diligence on February 18, 1999. But on February 11, 1999, an arrest warrant was issued against the individual majority shareholder Choi Soon-young, and the company was suspected of making illegal loans. Considering the company's suspected illegal activities, the property due diligence and a special inspection were carried out on February 11, earlier than originally scheduled. The results showed that the company's liabilities exceeded its assets by 2,908 billion won(20.1% of the total assets), due to 187.8 billion won embezzled by its officers and employees, 3,086.4 billion won in illegal loans to its subsidiaries, and other activities. Daehan was to be designated as a failing institution because it was found unable to normalize its operations on its own and its liabilities surpassed its assets by a large margin. But the government put the decision on hold because if designated as such, the company's value would drop as cancellations of policies would ensue, thereby possibly creating negative ripple effects across the entire insurance industry. In order to relieve the burden on taxpayers, ailing insurance companies were induced to strengthen their capital by being put up for public sale, instead of receiving public funds. Daehan Life was only likely to further deteriorate financially due to possible outflows of money via illegal activities if it had been allowed to remain in control of its own finances. In addition, the company was clearly incapable of conducting regular operations under such fragile financial conditions. Considering all these factors, the government imposed an administrative order on the company on March 23, 1999.

· ***Legal Proceedings***

After Daehan Life was offered for public sale for three times, still no buyer was found who met the selection criteria including contribution to Daehan's capital adequacy, impact on the broader insurance industry, and ability to finance the purchase. The prolonged sale process stirred up anxiety among its employees and sales agents, and concerns grew that more losses would be incurred, ultimately calling for injection of even more public funds. To allay such concerns, the government slightly shifted the gear and decided to declare Daehan as nonviable on August 6, 1999. Simultaneously, the government requested KDIC to inject public funds into the company. Under the cost-sharing principle, Daehan's shareholders were ordered to cancel all of its existing shares without compensation.

Choi Soon-young and other majority shareholders filed lawsuits(6 cases), calling for withdrawal and suspension of the above government decision on August 9, 1999. They also filed for provisional disposition, requesting a ban on resolutions by the administrators, with Seoul Civil District Court(3 cases). On August 31, 1999, the Seoul Administrative Court ruled that all the dispositions except designation of Daehan as a nonviable company were to be cancelled, citing procedural errors such as failure to properly notify the administrative dispositions and to provide opportunities for Daehan to express its opinions in writing, as well as failure to appropriately indicate the parties subject to the administrative dispositions and to ensure the delivery of the dispositions to the parties concerned. The Seoul District Court dismissed the application for provisional disposition to ban the administrators from making resolutions, stating that it was not illegal for the administrators to make resolutions on capital reduction and new rights offering because these activities were part of the administrators' public duties that they were ordered by the government authority to perform on behalf of the directors as set forth in the relevant laws and regulations.

· ***New Administrative Actions***

On September 3, 1999, the FSC cancelled its administrative actions issued on August 6, 1999. Instead, the FSC made a written notification of its planned actions and offered Daehan an opportunity to present their opinions according to the laws, ahead of taking new administrative actions. Choi and other shareholders stated that "the designation of Daehan as a nonviable institution was illegal", and asked for sufficient time to normalize its management, with the help of Panacom or new investors. On the other hand, officers and employees of Daehan presented a statement to the FSC that public funds should be provided to the company for earlier management normalization, and that Choi should stop the legal battle.

At the request of the majority shareholder Choi and other shareholders, the Life Insurance Companies Restructuring Committee reviewed the statement submitted by Choi and other related parties and found that Choi and the company were given enough time for management normalization, but there was little progress and they were unlikely to honor their commitments expressed in their statement.

So giving Daehan additional time for self-rehabilitation efforts was viewed as meaningless and the planned administrative actions including injection of public funds needed to be taken as early as possible because unless the government-led management normalization occurred in time, the sales agents would be quick to leave the company, leading to massive policy cancellations and liquidity crisis. According to the performance data that the company submitted, a liquidity crisis was imminent as a growing number of individuals and corporate clients cancelled their policies after the court ruling on August 31, 1999, and the company's insurance premium income declined, further widening the deficit. On this negative financial outlook of the company, Daehan once again was declared as nonviable on September 14, 1999, and KDIC was asked to inject public funds into the company. On the other hand, all of its existing shares were cancelled without compensation under the cost-sharing principle.

· ***New Lawsuits by Shareholders and Additional Administrative Actions***

On September 21, 1999, Choi and other shareholders filed new lawsuits with the Seoul Administrative Court to revoke the FSC's administrative actions and to determine if the actions were in violation of the Constitution(3 cases). The court dismissed all of the three cases in separate rulings on September 21, 1999 and September 30, 1999, respectively.

On September 18, 1999, Daehan's officers, employees, and sales agents released a statement calling for early injection of public funds and termination of Choi's legal battle. They also presented a petition they all collectively signed, to the Blue

House, the court, the Ministry of Finance and Economy, and other related government agencies, demanding swift actions by the government.

After Daehan failed to follow up on the administrative actions issued on September 14, 1999, the FSC suspended all the management from performing their duties and appointed the administrators on September 30, 1999. On October 1, 1999, Choi and others once again filed for cancellation of the actions and for suspension of execution to the Seoul Administrative Court, but the application for suspension of execution was dismissed on October 6.

Following the FSC's decision to increase and reduce Daehan's capital on October 1, 1999, 50 billion won of public funds equivalent to the authorized capital ceiling was injected, and all of Daehan's shares were cancelled. The Management Selection Committee was organized to appoint professional managers in an open recruiting process, and the new management was appointed on November 4, 1999. Under the new leadership, rehabilitation efforts were renewed and Daehan's NPLs and its subsidiaries were simultaneously restructured in a more efficient manner. KDIC provided 2 trillion won in public funds after it conducted a diagnostic review of Daehan's management on November 25, 1999.[42]

2.3.3. Distressed Guarantee Insurance Companies

2.3.3.1. Merger of Korea Fidelity & Surety Co. and Hankuk Fidelity & Surety Co.

Since Korea Fidelity & Surety which was dedicated exclusively to insurance guarantee was established in 1969, the guarantee insurance business had remained monopolized over 20 years until Hankuk Fidelity & Surety entered the picture in 1989, challenging the monopoly. Unhealthy, reckless competition between the two companies focused mainly on expanding the size of business and they tapped into high-risk installment plans, small loans, and guarantee insurance programs for corporate bonds. Insurance policies were undertaken without thorough review and as a result, their losses continued to build up. After all, even Korea Fidelity & Surety that previously posted recurring profits began to see its financial health under threat in 1995.

In 1997, the guarantee insurance industry was plagued with large-scale claims and steep rises in impaired assets as the economy was hit hard by the foreign exchange crisis. The combined accumulated loss in fiscal year 1997 reached 1,293.2 billion won and a liquidity crisis ensued. In February 1998, KAMCO

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42 The sale of Daehan Life Insurance will be discussed in more detail in Chapter III.

acquired the guarantee insurance companies' NPLs worth 412.1 billion won, which still was not enough to turn them around. As the restructuring of the insurance sector began in 1998, the FSC asked for the management normalization plans from the guarantee insurance companies. Due diligence was conducted from June 20 to July 10, followed by a review of the plans by the Management Normalization Evaluation Committee to determine the appropriateness and feasibility of the plans. The committee judged that the plans were inappropriate and hardly feasible. Nevertheless, if the companies were to be forced out of business without a backup system in place, it would likely cause a credit crunch and add even more uncertainties in the already fragile economy. Considering the serious potential threats to the national economy, the restructuring of the guarantee insurance companies were put off until after the financial system would regain stability. Planning the restructuring of the companies required a broader perspective because the restructuring would have a far-reaching impact on the national economy, taxpayers' money, a large number of policy holders, etc. On August 22, 1999, the two companies were asked to submit a revised management normalization plan including the merger of the two and aggressive rehabilitation measures.

The committee determined that under the revised plans submitted on September 12, 1998, self-reform efforts and the planned merger were not enough for the companies to restore financial stability. However, the committee suggested that the companies should be given an opportunity to turn themselves around along with the government's liquidity support, in light of the positive roles of guarantee insurance. So they were ordered to submit a detailed implementation plan for management normalization and the letter of commitment on September 25, 1998. KAMCO provided a total of 954.3 billion won via two NPL purchases from the two companies. On November 25, 1998, the two companies merged into the new company Seoul Guarantee Insurance.

2.3.3.2. Seoul Guarantee Insurance

Seoul Guarantee Insurance pushed for aggressive reform efforts including a 55.6% layoff by the two pre-merger companies, a 59% downsizing of the organization, a 30% pay cut, and the replacement of the entire management. Still, an assessment of its assets and liabilities as of March 31, 1999 showed that its total assets were 1,776.1 billion won and liabilities stood at 5,569.1 billion won, leaving the company in a net asset deficit of 3,793 billion won. Even with the right of indemnity worth 2,107.5 billion, the net asset deficit still amounted to 1,685.5 billion won. Unpaid insurance amount was 3,412.4 billion won and usable liquid assets were only 1,077.3 billion won. The company was practically insolvent.

Seoul Guarantee Insurance submitted to the FSS, a rationalization program including KDIC's investment, and contributions from shareholder insurance companies to cover the unpaid insurance amount and the subsequent conversion of the contributions into subordinated loans, on May 7, 1999. The evaluation committee judged that the company would be able to bring its operations back to normal within a few years with external financial support in light of the continued recovery of the domestic economy. Since it was difficult to create a guarantee market that could meet the demand of households and small and medium-sized enterprises(SMEs) within a short-term, Seoul Guarantee Insurance needed to function properly within the shortest possible time. To this end, the FSC declared the company as nonviable on June 3, 1999 and asked KDIC to invest in it. The FSC also asked KAMCO to postpone the settlement of the unpaid amount of the right of indemnity by March 31, 2001 and to settle the amount in installments from April 2001 to December 2002. The capital of Seoul Guarantee Insurance was reduced by cancelling all of the existing shares, and the FSC ordered the company to submit a detailed quarterly implementation plan and a letter of commitment that specified the consequences in case of failure to honor the commitments.

KDIC invested 1,250 billion won in the company, and shareholders including Samsung Life Insurance, and major insured persons and companies added 447 billion won which later was converted into subordinated loans.

<Table 2-15> Financial Support (Investments & Subordinated Loans, billion won)

	Private Sector				Gov't (KDIC)	Total
	Shareholder Insurance Companies	Auto Companies	Technology Finance Companies	Total		
Investment	81.9			81.9	1,250.0	1,331.9
Subordinated Loans	191.1	65.0	73.0	329.1		329.1
Renounced claims	36.0			36.0		36.0
Total	**309.0**	**65.0**	**73.0**	**447.0**	**1,250.0**	**1,697.0**

Unfortunately, the normalization efforts which were largely dependent on external financial support made an unexpected turn when Samsung Motors filed for court receivership on June 30, 1999. To make matters worse, Daewoo Group was put under a massive restructuring program on July 19, 1999 and Seoul Guarantee Insurance's turnaround now hinged on the restructuring of Daewoo Group because it had 9.5 trillion won in exposures to Daewoo. The majority of Daewoo bonds that the company guaranteed were issued before July 31, 1999 and thus was eligible for deposit guarantee. The government judged that Seoul Guarantee Insurance must survive even if it meant more injection of public funds because failure of Seoul Guarantee Insurance would likely take a huge toll on taxpayers, other financial institutions including investment trust companies that held Daewoo bonds, and the corporate bond market and other capital markets. Particularly, it was crucial to ensure payments for corporate bonds guaranteed by Seoul Guarantee Insurance in order to ease the concerns in the financial market over the fallout of Daewoo's restructuring.

Although Samsung Motors for which Seoul Guarantee guaranteed 2,100 billion won was under court receivership, the insurer was relieved of the financial burden associated with the automaker because the majority shareholder Kun-hee Lee offered his privately owned 3.5 million shares of Samsung Life Insurance to be used to offset the insurer's net asset deficit(if the shares would be worth less than 2,450 billion won, additional 0.5 million shares were to be offered). Seoul Guarantee Insurance issued ABS backed by the contributed shares, and Seoul Guarantee used the proceeds to pay for the corporate bonds that it guaranteed. In February 2000, an agreement was reached over how Daewoo bonds guaranteed by Seoul Guarantee would be handled. According to the agreement, the principal and interest of the Daewoo bonds payable by the Seoul Guarantee Insurance was finally determined at 3,400 billion won in 2000 and 2,600 billion won in 2001. KDIC phased public funds into Seoul Guarantee as needed, in order to address liquidity shortages that arose in connection with the insurer's payments for Daewoo bonds.

2.4. Merchant Banking Corporations

2.4.1. Background

Merchant banks in Korea are corporate finance-specialized institutions that deal in long-term equipment finance in addition to performing the roles of UK merchant banks and US investment banks. The Merchant Banking Act that came into effect in December 1975 provided the institutional framework for merchant banking in Korea. As Korea's international balance of payments seriously deteriorated due to the oil crises in the 1970s, a new type of financial institution was needed to serve as a new channel through which the private sector could secure a stable supply of foreign capital and to provide integrated financial services in the segmented financial market that was split between banking and securities sectors. Against this backdrop, merchant banking was newly introduced to serve these purposes. In April

1976, the first merchant bank, Korea Merchant Banking Corp. was launched and five more merchant banks were created until 1979. Until early 1990s, there were only six merchant banks. In mid 1990s, 24 investment finance companies transformed themselves into merchant banks, raising the tally to 30 at the end of 1996. However, 16 of them were shut down in 1998 after the financial crisis broke out. In 1999, Hanhwa Merchant Banking and Korea Exchange Bank merged in January, followed by consolidations of Hyundai International Merchant Bank and Kangwon Bank in January, and LG Merchant Banking and LG Securities in October. In addition, Daehan Merchant Banking was forced out of business in June, and in January 2000, Nara Merchant Banking had its business suspended due to the fallout from Daewoo Group restructuring. After all, only 9 merchant banking corporations survived and continued to operate.

<Table 2-16> Number of Merchant Banking Corps.

	At end-1985	At end-1990	At end-1995	At end-1997	At end-Jan. 2000
Existing companies	6	6	6	6	3
New companies (transformed from other business	-	-	9	24	7
Total	6	6	15	30	10

Prior to the financial crisis in 1997, merchant banking corporations engaged in a wide range of activities, including issuing, discounting, trading, brokering, underwriting, and guaranteeing commercial papers and certificates of indebtedness, operating cash management accounts(CMA), factoring, and other short-term finance businesses. In addition, they were involved in international finance, foreign exchange business, bond issuance, long-term loans, and securities trade. They maintained a relatively low ratio of impaired assets and their operations remained solid. However, they provided primarily unsecured credit and the amount of impaired assets rapidly grew in the midst of serial bankruptcies of large conglomerates that started in 1997. The profit outlook turned even more gloomy as banks and securities companies were allowed to handle commercial papers, a core and exclusive business of merchant banking corporations, in the second half of 1997. Consequently, their market share in the CP discount business nose-dived to 23.9% at the end of 1999 from 79.8% at the end of 1997. Merchant banking corporations borrowed short-term currency funds and then used them to make long-term loans to corporations and to invest in emerging market stocks. But they got pressed for foreign currency funding due to falling external confidence and their investments in emerging markets turned sour as the markets were engulfed in a financial crisis. A serious liquidity crisis stuck the merchant banking industry and restructuring followed immediately as the industry was perceived as the main culprit of the 1997 financial crisis.

2.4.2. Restructuring of Failing Merchant Banking Corporations

2.4.2.1. First and Second Business Suspensions

As a follow-up to the agreement with the IMF and "the grand plan for financial market stabilization and financial industry restructuring", the Act on the Structural Improvement of the Financial Industry was established, and according to the Act, the government ordered the first business suspension on December 2, 1997 against 9 corporations including Kyungnam Merchant Banking Corp. that were deemed incapable of running their regular businesses because their debts exceeded their properties. The suspension further weighed on the already vulnerable money market and some merchant banking corporations became unable to secure liquidity on their own. Five more corporations were ordered to suspend their business on December 10.

A bridge bank was needed temporarily to make deposit payments for the suspended companies and to deal with resolution of nonviable corporations. On December 31, 1997, Hanareum Merchant Banking Corporation was established as a wholly-owned subsidiary of the Credit Management Fund, the deposit protection agency which invested 30 billion won into the new company's capital. The major responsibilities of the new company included making deposit payments for the suspended merchant banking corporations, taking over assets and liabilities of companies to be closed down, and investing, managing, and selling the acquired assets. Licensed as a merchant banking corporation pursuant to the Merchant Banking Act, Hanareum was previously supervised by the FSC. But under the new Depositor Protection Act revised in September 1998, financial institutions that served as a resolution agency were not subject to the laws governing the establishment of individual financial institutions. So the MOFE and the KDIC took over supervision of such companies including Hanareum.

2.4.2.2. Business Normalization Plan and License Revocation

In December 1997, the government looked closely into the financial conditions of merchant banking corporations and asked all of 30 companies including suspended companies to submit a management normalization plan, with a view to sorting out nonviable companies. All of the companies handed in their plan to the MOFE on December 30, 1997, and the government set up an evaluation committee that comprised private-sector experts on December 29, 1997 in order to ensure objectivity and fairness in the evaluation.

The evaluation of the plans was carried out in two rounds. The first round of evaluation focused on determining practicability of the equity capital expansion plans to meet the BIS capital adequacy ratio. After the first round was wrapped up, the committee made the recommendation that the license should be cancelled for 10 companies including Kyungnam Merchant Banking as their capital expansion plan was not feasible. The MOFE decided to revoke their license on February 17, 1998, taking into consideration the committee's recommendation and the findings of the property due diligence. The second round of evaluation involved 20 companies that survived in the first round, and looked at 4 aspects including capital adequacy, liquidity, soundness of business plans, and compliance with laws and regulations. Specifically, the companies should meet the minimum BIS capital adequacy ratio, and be able to resolve their liquidity shortages both in won and foreign currencies, i.e., maturity mismatches between assets and liabilities. Their business plans were evaluated to determine if they ensured their long-term survival. With regards to legal compliance, the committee examined if the companies were in full compliance with laws and regulations, if they had violated any major laws or regulations, and if their planned actions to take in connection with such violations were appropriate. Following the second round of evaluation, Hansol Merchant Banking(March 16), Daegu Merchant Banking(April 1), Sang Yang Merchant Banking(April 15), and Jeil Merchant Banking(May 18) had their license cancelled. So a total of 14 companies were shut down from February to July 1998.

In August 1998, the licenses of Saehan and Hangil were additionally revoked as they were found nonviable in the face of liquidity crisis. Korea International Merchant Bank was acquired by Korea Exchange Bank, and Hyundai International Merchant Bank was taken over by Kangwon Bank in January and February 1999, respectively. Daehan's business was suspended in April 1999 after it fell into insolvency amid worsening liquidity. The license of Daehan was eventually revoked in June after a hearing. In October 1999, LG Merchant Banking was merged into its affiliated LG Securities which was authorized to conduct merchant banking for a limited period of 3 years. Faced with a liquidity crisis amid the Daewoo debacle, Nara had its business suspended in January 2000.

On the back of the expanding stock market and economic recovery that followed the reorganization, the merchant banking sector returned to profit (estimated at 279.7 billion won) in fiscal year 1999(April-December), compared to the loss of 147.2 billion won in fiscal year 1998. Although its core business of short-term financing such as CP discounting shrank in size and generated much less profit, merchant banks set aside huge amounts of loan loss reserves in 1998 and their gains in securities transactions considerably increased. Over the following years, merchant banks diversified their business portfolio into securities, fees and other profit-generating activities, away from its previous focus on asset management in response to the changing market environment.

<Table 2-17> Restructuring Timetable

	Content
Feb. 1998	Kyungnam, Kyungil, Goryeo, Samsam, Shinsegi, Shinhan, Ssangyong, Chungsol, Hangdo, Hanhwa were forced to exit the market.
Mar.	Hansol exited the market.
Apr.	Daegu and Samyang exited the market.
May	Jeil existed the market.
Jun.	Saehan and Hangil exited the market.
Jan. 1999	Korea International Merchant Bank and Korea Exchange Bank merged.
Feb.	Hyundai International Merchant Bank and Kangwon Bank merged.
Jun.	Korea International Merchant Bank exited the market.
Oct.	LG Merchant Banking and LG Securities merged.
Jan. 2000	Nara Merchant Bank had its business suspended.

2.4.3. Tightened Prudential Regulation

Prudential regulation was tightened to prevent further asset impairment at merchant banks. Under the agreement with the IMF, the same capital adequacy criteria that was used for banks also applied to merchant banks, and as a result, merchant banks were required to raise their BIS capital adequacy ratio in phases(4% by end-March 1998, 6% by end-June, and 8% by end-June 1999). Merchant banks now had to make loan loss reserves according to the new loan classification criteria that was introduced in March 1998. Application of the new criteria resulted in higher NPL ratios and merchant banks assumed considerably more financial burden because they had to set aside more reserves against possible losses. On the other hand, however, their finances got more sound. In June 2000, the even tighter forward-looking criteria(FLC) that took into consideration the borrower's ability to repay based on future cash flows was adopted, which called for additional loan loss reserves.

The government proposed revisions to the Merchant Banking Act and the Merchant Banks Supervision Regulations in April 1998, in order to encourage merchant banks to embrace sound asset management practices and improve regulatory transparency.

Key changes under the new laws included introduction of PCA, revised credit limits for single person, and new risk management criteria designed to prevent financial distress. In an effort to enhance transparency in merchant banks' business practices, the accounting rules for merchant banking were established in line with global standards.

<Table 2-18> NPLs at Merchant Banks (%, 100 million won)

	End-June 1997	End-Dec. 1997	End-March 1998	End-March 1999	End-Dec. 1999
Total loans	879,270	728,814	464,434	228,889	122,681
NPLs	15,477	32,703	22,312	28,293	16,312
NPL ratio	1.8	4.5	4.8	12.4	13.3

<Table 2-19> Actions Toward Financial Soundness at Merchant Banks

Date	Action	Detail
March 24, 1999	Established accounting rules for merchant banking	- In compliance with global standards • Effective for fiscal year 1999
March 26	Revised merchant banking supervision regulations	- PCA was introduced. • Management improvement recommendation: BIS capital adequacy ratio below 8% • Management improvement request: BIS capital adequacy ratio below 6% • Management improvement order: BIS capital adequacy ratio below 4% • Due diligence to determine viability: BIS capital adequacy ratio below 2%
April 1 (June 30)	Revised the merchant banking act and its enforcement decree	- Existing equity capital criteria was replaced by the BIS capital adequacy criteria - Credit limits were changed. • Single borrower : 25% of equity capital • Related party : 15% of equity capital • Single person: 20% of equity capital • The sum of large exposures: 5 times the equity capital

August 6	Revised merchant banking supervision regulations	- Set the scope of basic capital, supplementary capital, and deductible items - Specified the detailed lending criteria
December 24	Revised merchant banking supervision regulations	- Encouraged sound management practices and stipulated specific risk management criteria for prevention of financial distress • Risk management organization consisted of the board, a risk management committee, and risk management task force. • Basic risk management policy, internal control, and other regulations were revised and implemented according to the circumstances. - CAMELS rating system applicable to headquarters and overseas subsidiaries came into effect from fiscal year 2000. - Due diligence to determine viability: BIS capital adequacy ratio below 4%.

2.5. Leasing Companies

2.5.1. Background

The leasing industry was first launched in 1972 under the policy goal of promoting facility investment of corporations and distributing limited capitals efficiently. Since then, the industry continued to expand at a high rate while playing an important role in encouraging corporate facility investments. The industry's consistent growth is largely attributed to the continued expansion of the domestic economy and equipment investment, but other factors also contributed to the industry's expansion. Specifically, there was a chronic shortage of funds in the market, access to leasing services was made easy and simple, and the government provided generous support for the development of the leasing industry. Leasing companies functioned as an important vehicle to bring in foreign capital for Korean corporations that could not afford to obtain such capital on their own credit, and channeled the capital mainly into facility investments. They also played a part in the development of SMEs by consistently allocating a fixed portion of capital for SMEs. But many of leasing companies couldn't avoid restructuring as the economy tumbled into crisis. Since Hanbo Group went bankrupt in early 1997, large conglomerates such as Kia, Jinro, and Daenong collapsed consecutively and virtually all industries and companies, regardless of size and business type, fell victim to liquidity crunch, after the IMF agreed to a bailout program for Korea. As a result, leasing companies' losses increased exponentially. In addition, their profit base was seriously undermined by excessive competition as leasing companies strived only to enlarge their size and market share rather than seeking to improve their bottom line including ROE. Furthermore, they borrowed short-term funds to finance their mid-to long-term leases, thereby creating maturity mismatches between their leased assets and borrowings. Eventually, they faced a liquidity crunch.

Due diligence was conducted in May 1998 on 25 leasing companies that started their business prior to the 1997 financial crisis, and the results showed that net asset value was negative for 21 companies, indicating that their financial conditions were quickly deteriorating. As losses widened, further weakening the finances at leasing companies, creditors were under growing pressure. Restructuring was needed urgently to break the vicious cycle in which the longer the resolution of troubled leasing companies was delayed, the more losses were incurred. It was also necessary in order for leasing companies to restore its role of supporting corporate facility investments.

However, there were no clear legal grounds on which financially-distressed leasing companies could be forced to exit the market because the Specialized Credit Financial Business Act limited regulators' supervisory powers over leasing companies to a minimum, and PCA was not applicable to leasing companies under the Act on the Structural Improvement of the Financial Industry. Some leasing companies were left without majority shareholders after their majority shareholders which were banks were forced out of business due to financial trouble. Regional companies faced strong opposition to the restructuring from their minority shareholders, making it unlikely to pass a resolution for restructuring. Under these circumstances, the restructuring of leasing companies was left in the hands of their majority shareholders, unlike the government-led restructuring for other financial institutions. Creditors played the leading role in the restructuring of leasing companies that did not have majority shareholders. The government played a supportive role in the process by making necessary institutional changes and providing tax support to ensure that the industry-driven restructuring went smoothly.

2.5.2. Restructuring of Distressed Leasing Companies

The government took a few actions to facilitate the restructuring. First, a bridge company was created to take over, manage, and dispose of assets and liabilities from leasing companies that lost their going concern value in order to protect the interests of creditors and stabilize the financial market as early as possible. If small leasing companies file for bankruptcy or other resolution procedures when their losses are too big and thus they are unlikely to turn around, it may become hard to recover the lease assets(lease charges) which are often locked in long-term contracts, and losses to creditor financial institutions may increase. To minimize these potential losses, restructuring needed to be implemented efficiently through the setup of a bridge company. In this context, shareholders(banks) of 5 major companies with relatively large amounts of damaged assets(Seoul, Busan, Daegu, Gwangeun, JoongAng) jointly invested 20 billion won of legal capital according to the Specialized Credit Financial Business Act and created the bridge company Korea Lease Credit Co. in July 1998. In November and December, 1998, the bridge company took over assets worth approximately 3.5 trillion won from the five leasing companies, after the amount of liabilities that exceeded the assets was cancelled, making the assets and liabilities equal. The bridge company paid the principal and interest on a quarterly basis.

For a smooth restructuring, the government decided to allow leasing companies to initiate corporate workout. The decision was based on the view that a leasing company was closer to a corporation rather than to a financial institution because leasing companies did not take deposits, and were not subject to the Act on the Structural Improvement of the Financial Industry which means no imposition of PCA upon leasing companies and thus no consequences such as market exit, even if they would become financially distressed. Considering that the majority of leasing companies' largest shareholders was financial institutions, if a distressed leasing company was left unaddressed or liquidated, it might negatively affect the whole financial industry. In this sense, a bridge company was a necessary choice. Given that leasing companies still dealt with financial transactions, the corporate workout criteria was tightened as follows: First, the company applying for a workout program should be viable and the loss-sharing principle should be strictly followed. Second, the majority of creditors should agree to the workout program. Third, a high ratio of debt recovery should be guaranteed. Applications for workout were selectively granted when all these conditions were met. Under these criteria, Korea Development Leasing Corporation sought a corporate workout program and its corporate workout plan was finalized in July 1999. The Act on Restriction of Special Taxation was amended to provide tax support in a way that could assist in corporate workouts of leasing companies.

Property due diligence was conducted on all of 25 leasing companies in May 1998, and the results showed that 21 of them, except Jeil, Korea Exchange, Jeon-un, and Shinhan had negative net asset value. Based on the due diligence results, the companies were put under 3 types of restructuring: normalization led by majority shareholders, debt restructuring, and liquidation. If found nonviable due to excessive losses, the company was closed down while companies that were deemed viable were given an opportunity to bring their operations back to normal and contribute to the national economy. By the end of May 1998, Shinhan, JeilCiti and

Korea Exchange normalized their operations according to the plans made by their parent banks, including capital increases. Korea Industrial Leasing Corporation and Korea Technology Banking Corp. merged into KDB Capital in March 1999. Hanil Lease and Sangeun Lease were consolidated into Hanvit Credit Co. in January 1999.

<Table 2-20> Due Diligence Results (End-May 1998, 100 million won)

Company	Net Assets	Company	Net Assets	Company	Net Assets
Korea Industrial	-3,900	Shinbo Leasing	-420	Jeon-eun	30
Korea Development	-2,490	Seoul	-2,230	Kwang-eun	-1,040
Jeil	40	Chohung	-920	Shinhan	370
Hanil	-90	KEB	60	Daedong	-790
Kookmin	-750	KorAm	-90	Joo-eun	-300
Busan	-1,910	Kyungnam	-400	Dongnam	-880
Korea Leasing	-1,880	Kyungin	-310	Donghwa	-520
Daegu	-1,190	Sang-eun	-500		
JoongAng	-570	Central	-650	**Total**	**-21,328**

Six companies entered into debt restructuring. There were two options for debt restructuring: public corporate workout and private composition. As explained earlier, corporate workout option was allowed as an exception, only when the strict criteria was met, and only Korea Development Leasing was eligible. Korea Development finalized its corporate workout plan in July 1999, and embarked on a series of procedures including capital reduction and debt-for-equity swap. Kyungin, KorAm, Shinbo, Chohung, and Joo-eun pursued debt restructuring through private arrangements. Kyungin and Hanvit started their restructuring upon finalization of their debt restructuring plans in July and August, 1999, respectively. Shinbo agreed to a debt restructuring plan in October, and Chohung and Joo-eun also reached a debt-restructuring agreement in November, 1999.

If losses were too large or majority shareholders did not exist, the companies were shut down in order to prevent the negative effects from spreading to the broader industry. Those companies were either taken over by the bridge company or sold to a third party. Five companies with excessively large amounts of losses and Korea Industrial transferred their assets and liabilities to the bridge company. The five companies's combined assets were 3,594.6 billion won and the liabilities amounted to 4,491.7 billion won at the time of the transfer that took place at the end of September 1998. The liabilities exceeded the assets by 897.1 billion won, which was written off. Approximately 80% of the employees remained in the job after the restructuring, achieving a high rate of employment stability. Korea Industrial pushed ahead with private composition and corporate workout, but failed to work out an agreement among creditors. In December 1999, its assets and liabilities were transferred to the bridge company. The restructuring of companies without majority shareholders was led by the plenary creditors' council that comprised all of creditors and the creditors' steering committee that consisted of key creditors. Various options were tried, such as asset transfer to the bridge company, sale to a third party, and debt restructuring. As mentioned earlier, Kyunggi opted for debt restructuring and the rest of the 4 companies were put up for sale to a third party. Donghwa and Central were sold to Youngnam Merchant Banking, and Daedong and Dongnam were acquired by Kyungin. Jeon-un sought to normalize its operations via capital increase and debt restructuring, but could not reach an agreement, eventually filing for bankruptcy at the end of December 1999. The first round of restructuring was brought to an end with 23 of the total 25 leasing companies either brought back to life or restructured through debt restructuring or liquidation.

<Table 2-21> Restructuring Results

		Companies	Note
Normalization	Company-driven restructuring	KEB, JeilCiti, Shinhan	
	Merger	Korea Industrial+Korea Technology Banking→KDB Capital Hanil+Sang-eun→Hanvit Credit	
Debt restructuring	Corporate workout	Korea Development	
	Private composition	Kyungin, KorArm, Shinbo, Chohung, Joo-eun	
Liquidation	Transfer to bridge company	Seoul, Busan, Daegu, Gwang-eun, JoongAng, Industrial	
	Sale to 3rd party	Donghwa, Central. Daedong, Dongnam	
	Bankruptcy	Jeon-eun	Sale to 3rd party after filing for bankruptcy

2.6. Mutual Credit Finance Companies and Credit Unions

2.6.1. Background

Mutual credit finance companies and credit unions faced serious problems as their profit base was eroded by reduced assets, funding difficulties, and rising NPLs. As a result, their financial position was greatly undermined in the rapidly changing financial environment characterized by serial corporate bankruptcies, declining real estate value, and intensifying competition, after the economy was struck by the financial crisis in 1997. In response to the growing concerns over the industry, PCA was introduced for mutual credit finance companies, and management guidance system was adopted for credit unions in 1998. In addition, loan loss provisioning and other prudential regulations were further strengthened. Hanareum Mutual Credit Finance(bridge company) was set up to facilitate the restructuring by helping viable companies reorganize themselves back to normal and by inducing market exits for nonviable companies.

2.6.2. Restructuring of Ailing Mutual Credit Finance Companies

Majority shareholders were placed in charge of restructuring through PCA-based recapitalization, voluntary merger, or other management improvement schemes. Nonviable companies were sold to a 3rd party in public tender and companies that found no interested buyer were taken over by the bridge company and subsequently liquidated.

In June 1998, BIS capital adequacy ratio-based PCA system was introduced, laying the institutional framework for stronger prudential regulation. Given that mutual credit finance companies were regionally based and did not handle international business, the PCA standards were adjusted down to below 4% for management improvement recommendation, below 2% for management improvement request, and below 1% for management improvement order.

In September 1998, Hanareum Credit Finance was established as a bridge company invested by KDIC according to the Depositor Protection Law, with the purpose of efficiently resolving ailing mutual credit finance companies and protecting their clients. Hanareum took over assets from 33 companies and successfully recovered much of the assets by the end of December 1999, as well as making deposit payments on behalf of KDIC. Buyers of nonviable companies were selected through public competitive bidding, and all of the assets and liabilities were transferred to the buyers. At the same time, KDIC made long-term loans at low interest rates to the acquiring institutions in order to help them normalize their operations as early as possible. In 1998 and 1999, a total of 10 companies were sold to 3rd parties and the majority of them was purchased by mutual credit finance companies operating in neighboring regions. Distressed companies that were operating in the same region were encouraged to merge so that the expanded size of business could boost the momentum for their management improvement drive. Subsidiaries of banks were merged into their parent banks. Of the 12 companies that were restructured through merger by the end of 1999, 7 of them were integrated into their parent banks and only 4 chose to merge for the purpose of expanding their size of business.

<Table 2-22> Types of Restructuring (End-February 2000)

Revocation of License (transfer to bridge company)	Merger	Sale to 3rd party	Total
(Seoul)Gisan· Geumjung· Daehan·Sungwon, (Busan)Dong-a· Wooyang· Ajoo· Shinsegi· Hankuk, (Incheon)Shinil, (Daegu)Kyeongbuk· Shinyang· Open, (Daejeon)Central· Daehwa· Kukin· Ssangin·Daejeon, (Gwangju)Ilshin· Bumin· Honam· Hwashin, (Kyeonggi)New Kyeonggi· Wooshin· Kyeong-il· Daeshaeing, (Chungnam)Chungnam·Chochiwon, (Chungbuk)Daecheong, (Kyeongbuk)Donghwa· Kyeongil· Samwon· Yeongju· Kyeongju·Youngcheon, (Jeonbuk)Yoonam, (Jeonnam) Olive, (Kangwon)Wonju, (Kyeonggi)Woojeong	(Daegu)Youngnam Kookmin+Daegu Kookmin, (Seoul)Shinyoung+Jeil, (Chungnam)Seosan+Chungil, (Jeju)Jeju+Jae-eun, (Chungnam)Daecheon +Chung-eun, Daegu Kookmin+Busan Kookmin+Jeonnam Kookmin+Kookmin Bank, (Daejeon)Hanil Central+Hanvit Bank, (Seoul) Joo-eun Youngdong+Korea Housing & Commercial Bank, (Gwangju)Gwang-eun +Gwangju Bank, (Chungbuk)Seoul+Chungju+Jincheon Sangchang, (Seoul)Bukuk+Hansol, (Seoul)Dong-a (Seoul)Hana	(Kyeonggi)Hanbo, (Kyeongbuk Kyeongju)Osung, (Chungnam)Dongbo·Onyang·Seosasn, (Kyeonggi)Shinan, (Busan)New Busan·Donghwa, (Daegu)Daehan, (Kyeongnam)Hanil, (Busan)Shindonghwa	
39	17	11	67

2.6.3. Restructuring of Credit Unions

Credit unions were encouraged to improve their management through the management guidance system launched in April 1998 and voluntary mergers, and nonviable unions were resolved according to the bankruptcy procedures. Credit unions that could possibly fail were induced to merge with healthy credit unions in the neighboring areas and National Credit Union Federation of Korea acted as a go-between. By the end of 1999, 59 credit unions chose to merge with others.

Troubled credit unions were encouraged to restore their financial stability on their own under the management guidance, but when found unlikely to survive, they took the bankruptcy procedures. Given the nature as a union, there were limits to what their self-restructuring efforts could achieve, and the majority of the unions were forced to exit after management guidance was provided. A total of 105 unions went bankrupt by the end of 1999.

<Table 2-23> Summary of Restructuring Results (End-February, 2000)

License revocation	Bankrupt	Dissolved	Merger	Total
2	122	76	61	261

CHAPTER 3

Market Infrastructure Reform

Credit makes soldiers go to battles without pay, and an army march. It is an invincible fortress and a license for money lending business. It quickly fills the Treasury and banks with enough money upon demand.

"The Complete English Tradesman" (1725), Daniel Defoe

Market infrastructure reform was conducted in 8 areas: financial regulation, financial supervisory system, internal control system of financial institutions, ownership and corporate governance of financial institutions, vitalization of capital markets, securities issuance and disclosure rules, globalization of accounting standards, and external audit rules. Unless a reform of market infrastructure is accompanied, it is impossible to create a sound financial market or nurture sound financial institutions even if public funds are injected and thus the balance sheets of financial institutions are made to look better for a while. In this sense, renovating the infrastructure provides an important setting for the entire financial sector restructuring.

1. Financial Regulatory Reform

Financial regulatory reform was attempted in the 1980s and 1990s, but did not bear fruit. The failure of the reform was attributed mainly to the absence of a mechanism through which conflicts of interests could be resolved. When the financial crisis struck the Korean economy, the existing systems all collapsed almost simultaneously, which was fueled by the intensifying market liberalization and opening ushered in by a series of triggering events such as accelerating globalization, the launch of WTO, Korea's accession into OECD, financial liberalization and liberalization of capital movements. There was a consensus across all social classes on the need for a reform, which allowed a massive overhaul of the financial industry that had relied heavily on government protection and control, as well as implementing a bold financial regulatory reform aimed at enhancing the competitiveness of the industry.

With the Framework Act on Administrative Regulation taking effect in March 1998, the sunset clause, regulation cost evaluation and other elements were introduced, taking OMB of the U.S. as a benchmark, and the regulatory reform committee was launched. Regulatory impact assessment was also introduced and performed as a regular practice, and a regulation deliberation committee was set up within the Ministry of Finance and Economy. The committee was mandated to abolish all the regulations that were imposed without a clear legal basis, under the goal of eliminating 50% of the existing regulations. The basic principles of the financial regulatory reform are as follows: First, the preemptive regulatory approach including authorization, licensing, and approval was replaced by much-relaxed report or registration systems. Second, indirect regulatory approach including the use of BIS capital adequacy standards was adopted for prudential regulation of financial institutions. Third, direct regulation and regulatory overlaps were either removed or revised accordingly, and regulation standards that were susceptible to discretionary interpretations because of the ambiguity in the wording such as "when deemed necessary", were made objective, specific, and transparent so as to minimize the room for discretionary interpretation. Finally, public disclosure system was actively utilized as a tool to enhance consumer protection so that consumers would be better informed and have more choices, and related regulations were significantly eased.

1.1. Relaxation of Market Entry Regulations

- Investment consulting companies and investment advisory companies were now allowed to simply register, instead of getting licensed, to start their business.
- The scope of business alliances and other types of business crossover was expanded across banking, securities and insurance.
- The minimum capital required to set up a securities management company was lowered to 10 billion won from previously 30 billion won, and to 500 million won from 1 billion won for an investment consulting company.
- Regulations on authorizing or approving M&As, business transfer, and business shutdown of financial institutions were simplified. These activities were permitted when minimum requirements such as depositor protection measures were met.
- The licensing guidelines for financial businesses were revised to make the licensing procedures more transparent.

1.2. Internationalization and Market Opening

- Aggregate foreign investment ceiling and single person investment ceiling were removed for almost all corporations except public corporations, and the restrictions on investable securities were also abolished.
- Foreign securities businesses were no longer required to obtain a license when they wanted to open an office in Korea to collect and provide market data, and to perform other similar activities.
- Foreigners were allowed to trade securities on the KOSDAQ Market in addition to the main bourse Korea Stock Exchange, and to obtain credit including loans in connection with their investments in securities.
- Foreigners were no longer required to acquire 50% or more of the shares in public tender when they intended to purchase 25% or more of the total voting shares. The removal of this restriction paved the way for foreign investors to gain ownership of domestic financial institutions through M&As.

1.3. Greater Autonomy for Financial Institutions

- Fit-and-proper rules for executives of financial institutions were made less strict, the qualifications verification procedures were abolished, and restrictions on executives and employees concurrently holding multiple positions at subsidiaries were eased.
- Opening of new branches, relocation of branches, and opening of overseas branches were no longer subject to license or approval. Instead, only ex-post facto notification or report was required.
- Reports and notifications on such regulated activities as asset management by investment trust companies and other management companies, and on qualifications for executives, that financial institutions were required to submit to the FSC, were either eliminated or simplified.

1.4. Corporate Funding and Financial Management

- Restrictions on capital increase were all lifted and the corporate bond issuance ceiling was raised.
- All of the restrictions on overseas securities issuance and uses of overseas raised funds were removed.
- Corporate bonds and special bonds were no longer subject to the pre-issuance planning aimed to control the amounts of issuance.
- Foreign securities trade was no longer subject to brokerage fee ceilings which

were determined as a percentage of the trading amount.

- Previously, a uniform 10% subscription deposit was imposed on subscribers of stocks of companies that went public on Korea Stock Exchange or the KOSDAQ Market, but it was liberalized.
- Pre-issuance notification and approval was abolished for financial bonds and early redemption was allowed.
- Companies going public were allowed more discretion in determining the price of their common stock.
- Underwriters of publicly offered stocks for listing were no longer required to make a market.

2. The Financial Supervisory Framework

2.1. Prompt Corrective Action(PCA)

First, prompt corrective action(PCA) was introduced. Under the PCA system, the regulator automatically issues an action to either normalize the problem financial institution or force it out of business when the institution's managerial status is such that the conditions for the action are met. PCA helps minimize the social cost associated with failure or bankruptcy of a financial institution, maintain the stability of financial institutions, and raise their competitiveness by providing incentives for financial institutions to preemptively address financial problems through timely recapitalization and other measures. Previously, the criteria for taking supervisory actions was not clearly defined, and the regulator imposed such actions at its discretion in light of the financial market conditions. So the new PCA system was far more effective and transparent because it was an automated system that was activated when the pre-set conditions are met. In January 1997, the Act on the Structural Improvement of the Financial Industry was revised to provide a legal framework for PCA. According to the Act on the Establishment, etc. of Financial Supervisory Organizations enacted in December 1997 and the Act on the Structural Improvement of the Financial Industry revised in January 1998, the FSC took over from the MOFE, the authority to determine the PCA enforcement criteria and all the related details. The managerial soundness regulations that were previously fragmented along different financial industries were integrated into the PCA system in the first half of 1998. The specific criteria for imposition of PCA was adjusted for different sub-sectors in the first half of 1999, and the PCA system was newly introduced for futures companies. PCA was issued based mainly on BIS capital adequacy ratio for depository institutions including banks, merchant banks and mutual credit finance companies, on net capital ratio(NRC) for securities companies, and on risk-based capital(RBC) for insurance companies.

<Table 3-1> Criteria for PCA Issuance

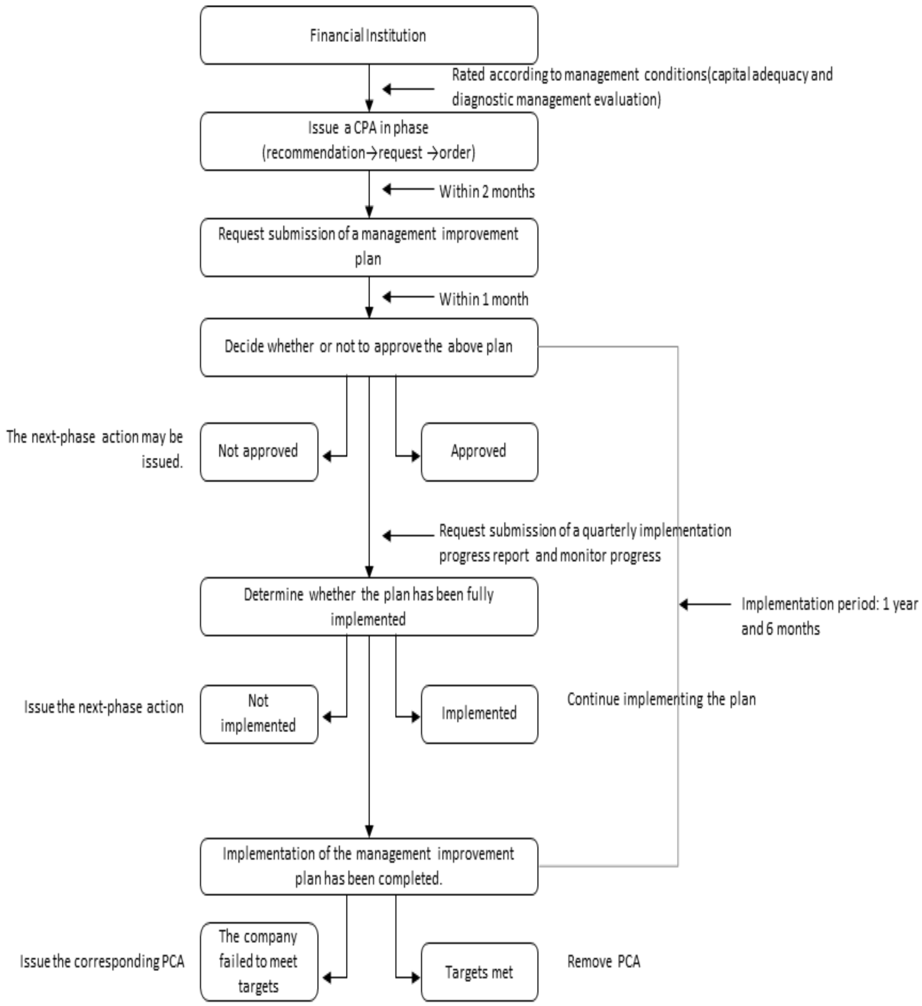
	Criteria	Adequately capitalized	Undercapitalized Financial Institutions		
			1st phase (management improvement recommendation)	2nd phase (management improvement request)	3rd phase (management improvement order)
Banks	BIS capital adequacy ratio	8% or more	Less than 8% 6% or more	Less than 6% 2% or more	Less than 2% or declared insolvent
Merchant Banks	BIS capital adequacy ratio	8% or more	Less than 8% 6% or more	Less than 6% 2% or more	Less than 2% or declared insolvent
Securities & futures companies	NCR	150% or more	150% or more less than 150%	Less than 120% 100% or more	Less than 100% or declared insolvent
Insurers	RBC	100% or more	Less than 100% 50% or more	Less than 50% 0% or more	Less than 0% or declared insolvent
Mutual credit finance companies	RBC	4% or more	Less than 4% 2% or more	Less than 2% 1% or more	Less than 1% or declared insolvent

In the first phase of improvement management recommendation, the regulator recommends the problem financial institution to change its workforce and organization, to reduce costs, to limit new investments, to dispose of non-performing assets, and to recapitalize. In the second phase, the company in trouble is requested to shut down branches, to sell subsidiaries, to suspend part of its business, and to make a business transfer plan. Finally, the third phase involves measures for management improvement, cancellation of shares, business transfer, merger, business suspension, transfer of contracts, etc.

2.2. The Business Licensing System

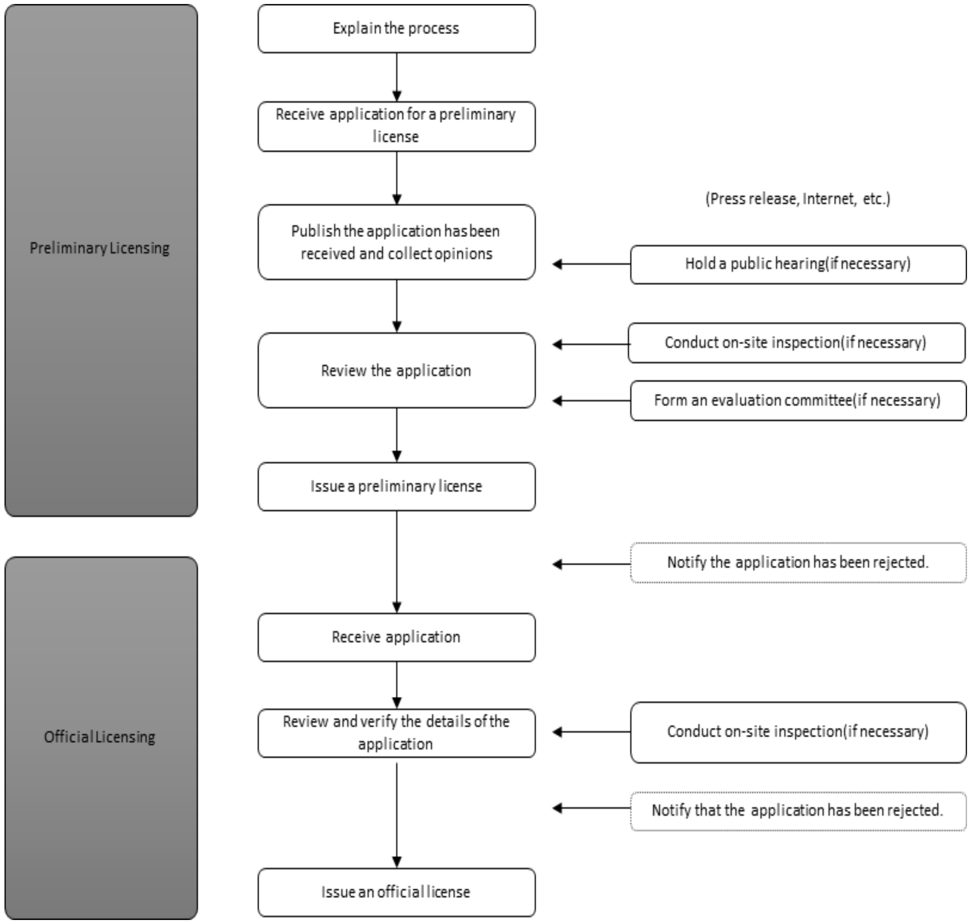
Licensing regulations that were fragmented in different laws governing individual financial businesses, enforcement decrees, enforcement rules, notifications issued by the Minister of Finance and Economy, and supervision regulations were consolidated

<Table 3-2> A Flow Chart of How PCA Works



into single bodies of regulations for each individual financial business. Other standards and criteria than laws were loosened while ensuring equity and balance across different industries. In order to ensure fairness and transparency in licensing, the licensing procedures were standardized, modeled on OCC of the U.S., and regulators in other advanced countries. Licensing processes were divided into two major phases: preliminary license and official license. The licensing guidelines were applicable to establishment of a new financial institution, merger, business conversion,

<Table 3-3> A Flow Chart for Licensing Procedures



business transfer, dissolution or shutdown of a business, business crossover, etc. Licensing criteria was revised in a way that increased equity across different industries. For example, when a non-financial company intends to invest in securities, mutual credit finance, merchant banking, credit card business or insurance business, the company's equity capital should be at least 4 times as much as the target investment and its debt-equity ratio should be 200% or more. This requirement applied to all industries. In order to reduce the social cost associated with failure of financial institutions, and to hold majority shareholders more strictly accountable for causing damages to their company, licensing guidelines for individual financial industries were amended in December 1999 in a way that restricted the majority shareholders of a problem institution from starting or investing in a new financial business and prevented the other financial companies owned by the majority shareholders from expanding their business. If the majority shareholders responsible for mismanagement bore part of the financial losses, such restrictions could be eased. The licensing system was markedly changed to be brought in line with global practices and structured to minimize the room for regulatory discretion including economic need test. The new licensing system lowered market entry barriers and made merger and other activities easier, thereby leading to greater transparency and lower license premium.[43]

2.3. Promotion of Business Alliances

Changes were made to promote business alliances between financial institutions. Regulations were established in January 2000 to allow financial institutions to entrust non-core businesses to other companies in order to create the effects of business crossover through business alliance and to achieve greater transparency, while keeping the business boundaries clearly set. For example, banks could open securities accounts by forming an alliance with securities companies, and sell insurance products on behalf of insurance companies under the partnership with insurance companies.[44] On the international front, the U.S. abolished the Glass-Steagall Act (1933) and created the Financial Services Modernization Act(1999) under which commercial banks were permitted to engage in investment

43 In addition, the thick rule book(the comprehensive and complete compilation in English and Korean, of laws, decrees, rules, ordinances, notices, precedents, etc) is necessary. the fit-and-proper rule should be followed more strictly, and accountability of majority shareholders should be further strengthened.

44 Further progress was made in this area of business alliance. For examples, bancassurance was introduced and securities companies were allowed to make payments and settlements. Bancassurance was welcomed by banks but opposed by insurers. In the first phase of introduction(August 2003), banks were allowed to sell savings-type insurance products including pension insurance and education insurance, followed by a type of the guarantee insurance policies under which the premiums paid are not recoverable in the second phase in April 2005. In the third phase, banks were permitted to sell another guarantee-type insurance product that repays the part of all of the premiums at the expiration of the policy in October 2006. Auto insurance and whole-life insurance products were scheduled to be added to the list in April 2008, but the relevant law was not passed by the National Assembly due to the strong resistance from 300,000 insurance agents. The second change was opposed by banks. It is widely practiced in most leading countries, and savings banks, agricultural and fisheries cooperatives, post office were already allowed to perform such activities. In addition, securities companies were also indirectly making payments and settlement in connection with banks. The key issue was if securities companies would be allowed to get directly involved in the settlement and payment network. There were arguments against the proposition because it would practically enable chaebols such as Samsung that owned securities companies to engage in banking business, and the Bank of Korea also objected to the plan, calling for its authority to conduct joint inspection on securities companies which were not under its supervision, but eventually, the proposition was passed into law in 2008.

banking by setting up a holding company or a subsidiary. The 2008 subprime mortgage crisis somewhat slowed down the trend, but the scope of business crossover or alliance continued to expand and prudential regulation also got tightened accordingly. Europe has been traditionally strong in universal banking and the U.K. witnessed the so-called Wimbledon effect, referring to big British banks taken over by foreign investors, following the Big Bang in 1986. For example, Morgan Grenfell was taken over by Deutsche Bank in 1989, SG Warburg was acquired by UBS in 1995, and Schroders PLC was bought by Citi Group in 2000. After all, these alliances helped London become globally competitive and rise as one of the global financial hubs, as well as contributing to job creation and creating added value.

2.4. Better Depositor Protection

The depositor protection scheme was designed to protect small account holders who lacked information on the performance of financial institutions and thus remained vulnerable to any financial trouble at those institutions. The ultimate goal was to safeguard the stability of the financial system. On the other hand, only a small fraction of large deposit accounts held by institutional investors who were relatively well informed was protected under the scheme in order to hold institutional investors responsible for their own exposures. Korea introduced the depositor protection system under the Depositor Protection Act established in 1995. Under the system, the majority of small-amount depositors had priority in receiving protection but the protection did not cover the entire deposit amount because depositors should also be held responsible for choosing to deposit their money at an unhealthy institution. Each depositor could have maximum 20 million covered by the deposit guarantee per financial institution and the ceiling was 50 million won per insurer. The government switched to a blanket guarantee system which was scheduled to be in effect temporarily until the end of 2000. The switch was intended to minimize the impact of the financial sector restructuring that had been going on since the financial crisis erupted in December 1997 and to keep the financial system stable. As financial institutions and their clients both displayed moral hazard, the government decided that consumers should be able to develop a discerning eye to sort out healthy institutions. To this end, the Enforcement Decree of the Depositor Protection Act was revised in July 1998 to maintain the full guarantee including the principal and interest accrued, only until the end of 2000 for the accounts that were created before July 31, 1998, and to set the guarantee limit of 20 million won per depositor including the principal and interest for the accounts that were opened after July 1, 1998. In 2001, the blanket guarantee system was replaced with a partial guarantee system and the guarantee ceiling was lowered to 50 million won per person including the principal and interest. RPs issued by banks and securities firms on July 25 1998 and after, and guarantee insurance polices purchased on August 1, 1998 and after were excluded from the protection. The switch to a partial deposit guarantee system forced depositors to choose healthier financial institutions and prevented moral hazard among depositors and financial institutions, thereby facilitating a market-driven financial sector restructuring.

2.5. Disclosure Rules

Disclosure is a tool to promote sound management of individual financial institutions and to ensure the stability and efficiency of the financial system via market disciplines by keeping creditors, depositors, shareholders, and other market participants accurately and timely informed of financial conditions of financial institutions, in light of their social functions and public nature. Under the liberalized and open financial environment, corporate disclosure can maximize the market discipline effects and thus effectively complement the regulator's prudential regulation. Disclosure system was launched before 1996 and remained segmented along the 3 major sectors of banking, securities and insurance, but the details such as content, disclosure frequency and specific methods were far behind global standards. Financial institutions were not fully aware of the system and had not provided clients, shareholders, creditors, and other interested parties with sufficient information about management conditions and risks. As a consequence, market discipline did not properly function when the crisis broke out in 1997, increasing uncertainties in the financial system. In October 1998, supervisory regulations for individual financial industries were revamped and the disclosure rules were also overhauled to be in line with international accounting standards(No. 30).

Specifically, the previously segmented disclosure rules were consolidated into the Disclosure Rules for Financial Business, and individual associations of different financial industries were asked to adopt the rules and oversee the implementation. Merchant banks, credit unions, mutual credit finance companies, credit-specialized finance companies and domestic branches of foreign banks were added to the list of institutions subject to the disclosure rules. Regular disclosure was increased to 2 times per year(4 times for banks) from previously only once a year. Major financial data should be disclosed regularly, but any major changes that may affect performance or financial position should be disclosed as such changes arise. Content to be disclosed was also expanded in scope to be in line with practices in advanced economies, and disclosed data was made available also at branches for financial consumers to access, as well as on the Internet. New disciplinary actions were introduced for incomplete or false disclosure. If disclosed data was false or omitted intentionally, the company should revise or correct the data and disclose it again. In addition, disclosed financial statements were subject to external audit. All these changes to disclosure rules considerably strengthened market discipline.

2.6. Capital Adequacy Requirements

Capital adequacy is critical in maintaining the stability of the financial system because it is a key measure of solvency and financial soundness of financial institutions. Advanced countries have long adhered to the 8% capital adequacy ratio set by the Bank for International Settlement or BIS as the minimum adequacy level to indicate the financial soundness of banks. Banks were required to keep their BIS capital adequacy ratio at 8% or above from 1995, but the rule did not apply to merchant banks, mutual credit finance companies and other non-bank financial institutions. After the 1997 crisis, merchant banks were required to follow the same BIS capital adequacy requirement in April 1998 as part of the efforts to encourage them to keep their finances sound through capital restoration. Mutual credit finance companies had to maintain their BIS capital adequacy ratio at 5% or higher, effective from December 1998. Amid growing uncertainties in their business environment, an integrated financial regulatory approach was needed to improve financial soundness of securities companies, and the prudential regulation criteria for securities firms was set in March 1997. Under the criteria, securities companies were obligated to keep their net capital ratio at 150% or above so that the amount of liquid assets that can be cashed immediately should remain at least 1.5 times more than the combined sum of liabilities and potential losses that may be incurred in the future. This way, liquidity shortages or management instability that may arise from steep losses can be avoided. After the life insurance market was opened in the late 1980s, concerns over possible insolvency of new life insurance companies that were relatively less competitive emerged as a pressing issue. To address this issue, the regulations were revised in March 1991 to require that the total assets of an insurer should exceed the total liabilities by a certain amount as of the end of each business year. According to the new prudential regulation revised in June 1994, insurance companies were required to keep their capital account, not the total assets, including capital, retained earnings, and reserves for dividend payments to policy holders, greater than their liabilities by a certain margin. However, it was pointed out that uniform application of the margin to companies with varying sizes of assets and capitals only hindered accurate assessment of financial soundness. In June 1998, the fixed margin was replaced by proportional regulation. In May 1999, the details of the proportional regulation were changed to follow the EU approach according to the agreement with the IMF, thereby improving compliance with global standards.

The Basel Committee classifies banks' capital into Tier 1 and Tier 2, based on the capacity to absorb potential losses(short-term subordinated bonds that cover market risk are sometimes classified in Tier 3), and the committee allows regulators to exercise some discretion in classifying certain types of financial assets in consideration of differences in the accounting and legal systems among countries. Tier 1 capital is composed of core capital that consists primarily of common stock and retained earnings. Tier 2 capital represents supplementary capital which is considered second most safe after Tier 1 capital, and it includes undisclosed reserves, revaluation reserves, loan loss reserves, hybrid bonds, and subordinated debt. Hybrid bond is a security that combines the elements of both debt and equity and can be categorized into Tier 2 or Tier 1, depending on the degree of contribution into capital. In Korea, the concept of hybrid is defined in a narrow scope, with certain conditions to be met, and it is considered as part of Tier 1 capital. Depending on the stability of the capital such as possibility of deferred interest payment, convertibility into common or preferred stock, and maturity, Tier 2 capital is again divided into two levels: upper and lower. The Basel Committee argued for the need of stronger supervision of banks' risks including the minimum capital requirements, and launched a new BIS accord, also known as Basel II in June 2004, extending and superseding Basel I of 1988 which the committee believed failed to effectively deal with increasingly sophisticated transactions structured to avoid regulatory capital including ABS. Korea planned to adopt Basel II in January 2009, but postponed the introduction until January 2010, considering the fallout of the 2008 global financial crisis,

<Table 3-4> Comparison of Basel I and Basel II

Pillar	Basel I	Basel II
Minimum capital requirements	Credit risk	Concurrent use of standardized requirements and Internal Models Approach(IMA)
	Market risk	Same
	-	Operational risk added
Supervisory review(new)	-	Capital should be more than the minimum requirement of 8%
Market disciple(new)	-	Enhanced reporting requirements: specific components of capital and risk assessment processes

The Basel committee published a partially revised Basel II proposal on July 13, 2009. The proposed accord featured stronger regulation of banks' capital and a broader scope of disclosure on asset management. Under the new accord, exposures to re-securitized assets were more risk-weighted, and banks were required to reserve more into their capital under Stressed VaR, a measure of market risk tailored to stressed market conditions, as the market conditions get worse. The committee worked out new standards such as capital buffer, a capital conservation for stressed market conditions, higher-quality capital, and minimum leverage ratios. These new standards were combined into Basel III [45]

2.7. Asset Quality Classification and Loan Loss Provisioning Rules

Asset quality classification criteria and loan loss provisioning rules were improved. Previous asset quality classification criteria for banks and merchant banks were not clearly defined and banks had too much leeway in classifying their assets. Loan loss provisioning standards were arbitrarily determined by the regulators at their discretion during each accounting period. The regulatory arbitrage hindered fair and accurate assessment of financial position and performance of financial institutions. In order to get rid of this regulatory arbitrage, the loan classification and loan loss provisioning criteria for banks were revised and tightened in July 1998. From December 1998 to March 1999, accounting rules and asset quality classification standards were also upgraded to achieve greater transparency. Under the new asset quality classification rules, loans in arrears between 1 months and 3 months are classified as "precautionary", as opposed to 3 and 6 months previously, and "substandard loans" are loans in arrears for 3 months or longer, instead of 6 months or longer. The loan loss reserve rates were adjusted upwards: 2% from 1% for precautionary loans(current rates range between 7% and 19%), and banks were required to set aside reserves for guarantees for loans that were substandard or below. Non-bank financial institutions were also made subject to similar asset quality classification criteria, which were either revised from the criteria for banks or newly introduced. Furthermore, the forward-looking criteria and new loan loss provisioning rules were adopted in September 1999 and implemented from December 1999. The new FLC which is widely used in advanced countries looks at the borrower's future ability to repay rather than the past performances. The previous 3-category asset quality classification system for securities companies was switched to a 5-category system in March 1999 that classified assets as normal(currently "pass"), precautionary(currently "special attention"), substandard,

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45 Details will be discussed in Chapter VI.

doubtful, and estimated loss. The reserve-setting rules were brought in line with those for other industries. In May 1999, a legal foundation was laid to establish asset quality classification and loan loss provisioning standards for investment trust companies. In March 1999, asset quality classification standards were introduced for insurance companies and began to be implemented in April 1999. Similar standards were implemented for mutual credit finance companies, credit unions, and specialized credit finance companies in December 1998.

<Table 3-5> Current Loan Classification and Loan Loss Provisioning Standards

	Details	Loan Loss Reserve Rate		
		Corporate Loan	Household Loan	Credit Card Loan
Normal	- The borrower is capable of repaying the loan, considering the managerial conditions, financial conditions and future cash flows, and the loan is deemed fully recoverable.	0.85% or more*	1% or more	1.5% or more
Precautionary	- Considering managerial conditions, financial conditions, and future cash flows, there is no immediate risk of loss, but there are potential risk factors that may undermine the borrower's repayment ability. - Loans in arrears for one month or more but less than 3 months	7% or more	10% or more	15% or more
Substandard	- Considering managerial conditions, financial conditions, and future cash flows, there is a considerable risk of loss because the risks that may undermine the borrower's repayment ability have materialized. - The estimated recoverable portion of the loans in arrears for 3 months or longer - The estimated recoverable portion of the loans to the borrower that presents a serious risk of loss because the borrower has been officially declared insolvent, or is under liquidation or bankruptcy procedures, or is closed down. - The estimated recoverable portion of the loans classified as "doubtful" or "estimated loss"	20% or more	20% or more	20% or more

Doubtful	- The amount in excess of the estimated recoverable portion of the loan to the borrower whose repayment ability has materially deteriorated, considering managerial conditions, financial conditions, and future cash flows. - The amount in excess of the estimated recoverable portion of the loan to the borrower who has been in arrears for 3 months or more but less than 12 months	50% or more	55% or more	60% or more
Estimated loss	- The amount in excess of the loan that is certainly unrecoverable and should be written off as loss, because the borrower's repayment ability has seriously deteriorated, considering the managerial conditions, financial conditions, and future cash flows. - The amount in excess of the estimated recoverable portion of the loan to the borrower who has been in arrears for 12 months or more. - The amount in excess of the estimated recoverable portion of the loan to the borrower who has a serious risk of default because the borrower has been officially declared insolvent, or is under liquidation or bankruptcy procedures, or is closed down.	100%	100%	100%

Note: * For normal loans to construction, wholesale and retail business, hotel and other accomodations business, restaurants, real estate and rent business, 0.9% or more should be set aside.

Source: the FSS, the Regulations on Supervision of Banking Business

2.8. Prudential Regulation of Foreign Exchange Business

The financial supervisors tightened prudential regulation of foreign exchange business. Prior to the financial crisis, foreign exchange transactions were subject to strict control under the Foreign Exchange Control Act, and as a result, foreigners concentrated their exposures on lending to financial institutions and large conglomerates, rather than directly investing in domestic companies. As large corporations collapsed in a series of bankruptcies that started in early 1997 and

Korea's external confidence took a steep fall, foreign capitals flew out of the country in massive quantities, leaving local financial institutions and companies in acute foreign currency shortages and eventually leading to the foreign exchange crisis. In a bid to attract foreign investment which is a stable channel for foreign currency inflows, foreign exchange regulations were either abolished or eased. In September 1998, the previous Foreign Exchange Control Act that was designed to regulate foreign currency holding and transactions was revised and renamed the Foreign Exchange Transactions Act designed to support the liberalization of foreign exchange transactions and to facilitate cross-border foreign exchange transactions.[46] The licensing system for foreign exchange business was changed to a registration system. The supervisory authority was split between the Ministry of Finance and Economy which was in charge of overall supervision including registration of foreign exchange business, and the FSC/FSS which were responsible for supervising and examining day-to-day activities of foreign exchange-handling institutions. Against this background, the FSC established and implemented the Regulations on Supervision of Foreign Exchange Business in tandem with the enforcement of the Foreign Exchange Transactions Act on April 1, 1999, with the aim of minimizing the potential adverse effects of the foreign exchange liberalization and strengthening prudential regulation of financial institutions that conduct foreign exchange transactions. Specifically, banks and merchant banks were required to manage their foreign exchange risks by taking offsetting foreign exchange positions, and to manage their liquidity risks by meeting the foreign currency liquidity ratio, maintaining a certain level of maturity gap[47] between short-term foreign-currency assets and liabilities, and managing the sources of long-term foreign currency borrowings. Furthermore, foreign exchange business-handling institutions were required to set and stick to the internal standards for identifying and managing various risks such as country risk, and if the standards were deemed inappropriate, they could be requested to revise the standards. As for foreign currency liquidity ratio for 3 months or less and maturity mismatch between short-term assets and liabilities, the same criteria used for

46 After the foreign exchange crisis, Korea was at a crossroads: whether it would further liberalize foreign exchange transactions or tighten the regulation. Korea chose to accelerate liberalization and tighten prudential regulation. As a result, daily average volume of foreign exchange transactions expanded to 43.8 billion dollars in 2010, from 3.6 billion dollars in 1998. On the other hand, Malaysia, Indonesia and other crisis-struck countries took the other path and imposed stronger regulation on foreign exchange trade. Indonesia's daily trading volume was 3.5 billion dollars in 1998 and still stood at 3.4 billion dollars in 2010. As liberalization expands, direct market intervention becomes less effective while vocal intervention and policy-based approach become inevitable.

47 Less than 3 months, less than 1 month, less than 7 days, etc. Different requirements for spot, futures, and combined positions. Buying and selling positions that exceed the set ratios are regulated.

merchant banks applied to other foreign exchange business-handling institutions. They were also required to set their own risk management standards and an independent risk management unit should be set up to manage risks. According to the foreign exchange position regulations for banks and merchant banks, 3-month or less foreign exchange liquidity ratio should remain at 70% or more. With regard to maturity mismatch, assets should remain in excess of liabilities when the time to maturity is 7 days or less, and the asset deficit ratio should stay at 10% or less when the time to maturity is one month or less. Foreign exchange transactions were classified into tree types: spot exchange position, futures exchange position or combined position. Based on combined positions, excess buying or selling ratio was set at 50% or less for banks and merchant banks, and 20% or less for securities and insurance in order to limit foreign exchange exposures and minimize market-disturbing factors.

2.9. Regulations on Credit Extension and Asset Management System

Regulations on credit extension and asset management were tightened. One of the reasons behind the crisis was that large corporations depended heavily on borrowings from financial institutions for reckless and overlapped investments which failed and led to serial corporate bankruptcies. As a result, financial conditions of the lending financial institutions became unhealthy. To curb the lopsided lending practices, lending limits on special borrowers such as single person, single business group, and majority shareholders were imposed prior to the crisis, but the limits were applicable only in a narrow scope that included only loans and payment guarantees and they were not in line with global standards. Equity capital was also defined narrowly, as the sum of capital as indicated on the balance sheet, reserves, and other retained earnings. Such definition was not compatible with the BIS capital adequacy standards and was not in compliance with international standards. The banking laws and regulations were amended in February 1999 so that concentration of lending was relieved and potential financial deterioration of lenders could be prevented. In addition, chaebols' debt-equity ratios were reduced by 200%. In November 1998, asset management ceiling was placed for investment trust companies, and merchant banks became subject to similar credit extension and asset management limits that applied to banks, in February 1999.

<Table 3-6> Credit Limits for Banks

	Previous	New	Effective Date
Definition	- Equity capital: the sum of capital, reserves, other retained earnings, etc. - No definition for credit extension	Equity capital: the sum of basic capital and supplementary capital as defined under the BIS criteria Credit extension: loans, payment guarantees, purchases of securities(for the purpose of providing financial support), transactions involving credit risks	April 1, 1999
Credit limit on single borrower	An extension of credit(loan + won-denominated payment guarantees) exceeding 45% of the bank's equity capital to a single business group is banned.	An extension of credit exceeding 25% of the bank's equity capital to a single person, or a single corporation, or others who share the same credit risk(single borrower) is banned.	January 1, 2000
Credit limit on single person	A loan exceeding 15% of the bank's equity capital or a payment guarantee exceeding 30% of the bank's equity capital cannot be provided.	Credit exceeding 20% of the bank's equity capital cannot be extended to a single person.	January 1, 2000
Limit on the sum of large credits	The sum of large credits(individual credits extended to single individual, corporation or single business group that exceed 15% of the bank's equity capital) cannot be larger than 5 times the bank's equity capital.	The sum of large credits(credits extended to single individuals, corporations, or single borrowers that exceed 10% of the bank's equity capital) cannot be larger than 5 times the bank's equity capital.	January 1, 2000
Credit to majority sharehold ers	Credit to majority shareholders should be 45% of the bank's equity capital or less and cannot exceed whichever is smaller: the amount calculated by the ratio set in the presidential decree or the amount equivalent to the investment ratio.	Credit to majority shareholders should be 25% of the bank's equity capital or less and cannot exceed whichever is smaller among the amounts calculated by the ratios set in the presidential degrees.	2000.1.1
Credit to subsidiaries	Banks cannot extend loans or other types of credit that exceed the limits set by the FSC, to subsidiaries.	Banks cannot extend credit that exceed the limits set by the FSC, to subsidiaries.	1999.4.1

<Table 3-7> Limits on Management of Trust Assets for Investment Trust Companies

CPs issued by a single corporation	1% or less of the daily average amount of the total trust assets in the immediately preceding month
CPs issued by a single business group	5% or less of the daily average amount of the total trust assets in the immediately preceding month
Corporate bonds issued by a single business group	15% or less of the total corporate bonds held in trust in the immediately preceding month
Securities of sale company and specially-related parties	10% or less of each category of trust assets

<Table 3-8> Credit Extension Limits for Merchant Banks

Credit limit on related parties	lowered to 15% or less of equity capital from previously 50% or less
Credit limit on single borrower	lowered from 100% or less to 25% or less
Credit limit on single person	lowered from 50% or less to 20% or less
Limit on sum of large credits	not greater than 5 times the equity capital

2.10. CAMEL

CAMEL[48] was introduced and actively implemented. CAMEL rating system is a supervisory rating system to classify overall conditions of financial institutions and identify their weaknesses by assigning key performance ratings based on financial

48 CAMEL is a term made of 4 initials that represent the components of the rating system: Capital adequacy, Asset quality, Management capability, Earnings, and Liquidity. CAMEL was developed in 1978 and has been used by US federal banking supervisors including the FRB and FDIC. The official name of the system is the Uniform Financial Institutions Rating System and it was introduced to provide a standardized set of criteria to assess financial conditions of financial institutions. BIS capital adequacy ratio is a ratio of equity capital to risky assets while CAMEL evaluates the financial soundness and operational efficiency of a bank by using non-quantitative indicators such as management capability, as well as various quantitative data including BIS capital adequacy ratio. For example, non-quantitative components that are considered when assessing capital adequacy, include the management's ability to monitor and control risks, capacity for capital increase, and feasibility of policies pursued by the management, in addition to BIS ratios and other quantitative indicators. Management capability includes overall financial conditions, ability to ensure sound operations and compliance with laws and regulations, and progress in corporate governance improvement, etc. With "sensitivity to market risk" added, it is also called CAMELS.

statements, business reports, and other data, and by analyzing the results. The results are also incorporated into a broader evaluation of financial institutions to foster their responsibility management. The CAMEL rating system was adopted for banks, and key quantitative indicators were analyzed to identify and discuss issues. The rating system was implemented partially for securities and insurance companies and it was not applied at all to other financial institutions. In 1998, the CAMEL rating system began to apply to all financial institutions including merchant banks, securities firms, and insurers, and the ratings assigned were incorporated into the PCA system, as part of the imposition criteria. The implementation of the CAMEL rating system allowed the regulators to monitor overall conditions of financial institutions on an ongoing basis, to detect weaknesses early, and to take timely supervisory actions. Used in conjunction with PCA, CAMEL also contributed to improving overall soundness of financial institutions.

<Table 3-9> Adoption of the CAMEL rating system

Merchant banks	Introduced in April, 1998, preparatory work in 1999, and officially implemented in 2000.
Securities & investment trust companies	Introduced on December 29, 1998
Insurers	Preparatory work in 1999 and officially implemented in January 2000
Mutual credit finance companies	Implemented from the first fiscal year(July 1, 2000) that followed after January 1, 2000
Credit unions	Implemented in 2000

2.11. Improved Transparency in Asset Management System

Previously, proprietary accounts and trust accounts of banks were not separated, and this created some problems. There were possible conflicts of interests between the two accounts because assets were moved and shuffled around to offset or disguise losses at either of the two accounts by doing so. Clients also misunderstood that trust accounts that paid dividends based on performance were same as bank deposits that guaranteed the repayment of the principal, distorting the rules of trust business. To fix the problems, transfer of impaired assets between the two accounts was prohibited, and dividends were paid out strictly based on performance of trust accounts. In November 1998, regulations on trust period and trust fee were removed, allowing banks much discretion and autonomy in operating trust accounts, and soundness of trust assets was improved by ensuring that allowance for bond valuation should be reflected in determining trust dividend rates. Marking-to-market was adopted for products that were launched on November 15, 1999 and after, and in January 1999, offering of development trust accounts that guaranteed the repayment of principal and interest was banned to ensure that banks' trust accounts pay dividends strictly based on performance. Banks that concurrently operated trust accounts were required to put in place a system on January 1, 2000, that could prevent conflicts of interests between their proprietary and trust accounts in such aspects as organization management, fund management, and information sharing. In addition, asset quality classification standards for real estate investment trusts(REITs) were adopted in December 1999, and the specific rules for making allowance according to the standards were also set.

2.12. Securities Investment Company

A securities investment company, which is a type of securities investment trust, publicly raises money from investors to set up a fund that invests primarily in securities until the maturity date, and pays the earnings to the investors. It is a company-type investment trust in the sense that a fund itself is a company and it is commonly known as mutual fund. A securities investment company is a paper company and therefore, the fund is managed by an asset management company. Investors become shareholders of the company and receive earnings that are determined when the company is dissolved. In September 1998, the Securities Investment Company Act and the Enforcement Degree came into effect, followed by the enactment of the enforcement rules and regulations on supervision of securities investment companies in November 1998. Following the completion of the institutional groundwork, 4 company-type funds were created with the funds raised for corporate restructuring. Seoul Debt Restructuring Fund and Han River Restructuring Fund were created and registered with the FSC on October 23, 1998, followed by Arirang Restructuring Fund and Mukunghwa Restructuring Fund on November 7. These funds signed contracts with foreign asset management companies to launch asset management business. More investment companies were set up. Eleven were registered with the FSC as securities investment companies by the end of 1998, and 78 funds were registered as such by the end of 1999. Initially, the FSC approved only closed-type investment trusts that banned redemption until the company's dissolution, but open-type investment trusts were also introduced under the new enforcement decree revised on August 5, 2000.

2.13. Asset Management Companies

Asset management company is a stock company that is established according to the Securities Investment Company Act and registered with the FSC. An asset management company is entrusted by a securities investment company with the management of the latter's fund. Its purpose is to invest the entrusted fund in securities and distribute earnings to shareholders of client securities investment companies. Asset management companies provide investors with more choices for securities investment and help increase compliance with international standards in investment trust business. Additionally, they also promote advancement of capital markets by broadening the pool of institutional investors. A total of 28 companies were registered with the FSC by the end of December 1999 and they can be categorized into 3 types. First, some companies concurrently engage both in contract-based investment trust business and asset management for securities investment companies. They are investment trust management companies and there are 18 of them in this category. Second, they can conduct both investment advisory services and asset management for securities investment companies. Six companies fall into this category: Mirae Asset Management & Investment Advisory, SEI Asset Korea Investment Advisory & Asset Management, World Asset Investment Advisory, Dime Investment, Midas Asset Management, and My Asset Management. The third type deals only in asset management for securities investment companies and there are 4 companies in this category including Regent Asset Management, Yuri Asset Management, Global Asset Management, and KTB Asset Management. There are certain registration requirements that asset management companies should meet: it should be a stock company with a paid-in capital of 7 billion won or more and at least 5 professional asset managers.

2.14. Corporate Pension System

Employee retirement plan is legally required in Korea, but since corporations are responsible for managing the plan, sometimes employees could not receive the retirement benefits if their company went bankrupt. And the plan did not include pension payment as was the case in advanced countries. In December 1996, the Labor Standards Act was revised to introduce the employee pension system, paving the way for corporate pension plan. Following the serial corporate bankruptcies triggered by the economic crisis, there was a steep rise in the number of disputes over retirement benefits. In response to the growing disputes, the government took 2 years to work out the details and finally allowed insurance companies to sell retirement insurance products(retirement trust) in March 1999. The type of retirement insurance that was initially approved by the government had limitations: it was a pension-type insurance(lump sump payment for banks and investment trust companies), that offered defined benefit, and policy holders had to pay the entire amount of premiums. In March 2000, banks completely separated proprietary accounts and trust accounts and put in place a structure that prevented conflicts of interests between the two accounts in terms of managing the organizations and funds, and sharing information. The special retained earnings system that was newly introduced provided solid guarantee of the principal. Given the changes, banks were also allowed to sell retirement plans, and investment trust companies followed suit in 2005. The Employee Retirement Benefit Security Act that was enacted on December 1, 2005 enabled policy holders to choose between lump sum payment of retirement benefits and pension plan, as well as between defined contribution and defined benefit. Employees were required to contribute a certain amount into the plan and the portability of the new system ensured that the retirement plan be transferred to the new company when an employee found employment at another company[49], and a business hiring 5 employees or more was legally required to offer an employee retirement plan from 2010.

3. Internal Control System of Financial Institutions

3.1. Supervision of Risk Management

First of all, risk management practices were supervised more strictly than before. Financial institutions continued to expand their presence in overseas markets since the deregulation began in the 1980s. Particularly, merchant banks took aggressive approaches, making inroads into Hong Kong and other international markets. They financed their purchases of long-term assets with short-term borrowings and as financial markets became increasingly volatile, there was a growing need for them to effectively manage risks stemming from the increasing volatility. In the 1990s, merchant banks incurred massive losses from their derivatives trading, and exposures to Thailand, Indonesia, Russia, and other markets through investments in

49 The pension system should consist of 3 pillars: public pension, corporate pension, and personal pension. Public pension should replace 40% of the pre-retirement income and it includes national pension plan, and special employment pension plans such as government employees, teachers and military servicemen and women. Corporate pension plan should have a 30% income replacement ratio and there are two types: internal reserve and external reserve. In case of external reserve, there are again two choices: retirement lump sum and retirement insurance. Personal pension plan should replace 3-% of pre-retirement income. Recently, there have been talks about Pillar Zero, referring to the basic livelihood pension plan that is funded by taxes.

junk bonds, the regulators designed a new supervisory approach with a strong focus on risk management in August 1998. First, sensitivity to market risk was added to the previously 5-category CAMEL ratings system for banks. The new CAMELS ratings system looked at changes in interest rate, exchange rate, and stock prices, in addition to the existing factors. Application of CAMELS expanded to the entire financial sector, and modeled on the BIS risk management guidelines[50], financial institutions were asked to come up with a comprehensive risk management system in July 1999, that specified a setup of an independent risk management organization, risk management policy for their subsidiaries, responsibility of the board and the management for risk management, etc. In June 1999, accounting rules for derivatives transactions were brought in line with global standards, and in January 2000, best practices for derivatives transactions were created. The best practices covered a range of aspects including internal control, risk management criteria, regulation of unhealthy dealings in derivatives, reporting standards for material information relating to derivatives transactions.

50 There are 5 major risks for financial institutions: credit risk, market risk, operational risk, interest rate risk, and liquidity risk. The first three risks are subject to the BIS minimum capital adequacy requirements. Other risks include system risk, settlement risk, country risk, strategic risk, reputation risk, and legal risk. For banks, the 5 major risks are expected to be weighted in the same order, and for securities companies, market risk and operational risk can be weighted most while interest rate risk and credit risk can be viewed most significant for insurers because their assets are generally managed for the long term. System risk refers to cases where the financial system faces unexpected uncertainties due to shocks that originate from inside or outside of the system. The shocks go through the two phases of accumulation and spread. Spread takes places via two routes. The first route is exposure. For example, if mutual exposure increases in derivatives trading, the possibility of evolving to a system risk becomes greater. The second route is information asymmetry. Subprime mortgage crisis was exacerbated by this information asymmetry. In other words, the two parties to a transaction did not know what kind of exposure the other party had and there was a growing mistrust between the parties involved in the transaction, which created a system risk. Three components of a financial system are financial institutions, financial market, and financial infrastructure. System risk associated with financial institutions include serial failures of financial institutions, liquidity depletion including liquidity squeeze, and asset inflation caused by excessive credit supply, and subsequent collapse of the asset market. System risk related to financial market occurs when increased cross-border movements of capital in the foreign exchange market can cause contagious effects, or price bubbles form and collapse in a real estate market, or herd behavior creates risks as credit card loans and mid-term loans increase in the loan market. Finally, infrastructure-related system risk occurs when the payment and settlement system gets paralyzed due to bank runs.

<Table 3-10> 5 Major Risks for Financial Institutions

(1) Credit risk: refers to potential loss when the counter-party to a transaction defaults and includes rises in spread due to deteriorated credit. Basel II suggests that credit risk should be managed as below.

	Treatment	Make-up	Follow-up
Expected loss	Cost	Reserve	Reflected in future interest rate
Unexpected loss	Risk	Equity capital	Reflected in capital

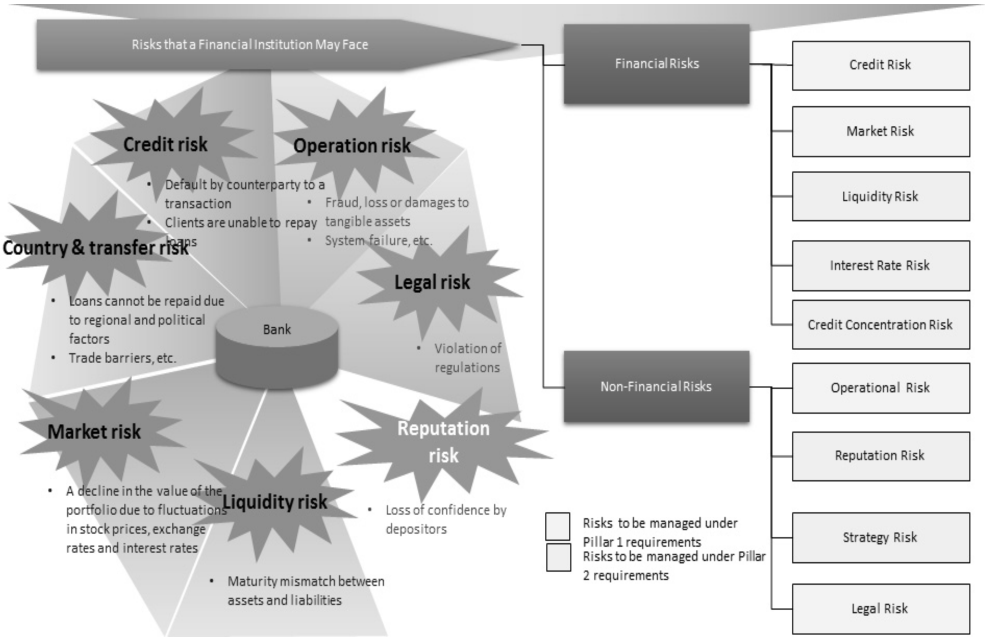
(2) Market risk: refers to potential loss that may be incurred if stock prices, interest rates, exchange rates, and other factors change in the unexpected direction. In other words, it is a risk from changes in the market prices of financial assets such as stocks, bonds, foreign currency holdings, and derivatives, and commodities such as gold and crude oil. For example, if assets and liabilities are denominated in the same foreign currency and equally liquid, the degree of the foreign exchange risk can be determined by the positions. A long position(buy position, assets greater than liabilities) will lose if the foreign currency gets devalued, and a short position(sell position, liabilities greater than assets) will lose if the foreign currency is appreciated.

(3) Operational risk: refers to potential loss that may occur due to inappropriate internal processes, personnel and systems, or external incidents. Specific examples include illegal behavior of insiders and outsiders, problems with workplace safety, transaction practices involving customers and products such as misselling, natural disasters, and technology glitches. The 1995 Barings scandal was caused by enormous losses in a derivative transaction carried out by Leeson at its Singapore branch. The key reason behind this tragedy was that one individual could take an excessive exposure because the one individual was in control of both the front and the back office operations. Even a small coffee shop hires two cashiers so that they can keep each other in check and none of them can steal any cash. But Barings put one particular individual in charge of so much of the branch's operations so that he could keep the losses hidden for a long time. The Barings case represents a typical case of operational risk that derived from the combination of misbehavior of an individual and ineffective internal control.

(4) Interest rate risk: a financial institution makes profit by borrowing funds(liabilities) and managing the funds(assets). Inevitably, there are mismatches in maturity between assets and liabilities. As a result, the value of assets and liabilities changes according to the changing interest rate, and the institution's profit is also linked to the changes. The S&L crisis of the U.S. in the 1980s was triggered by the materialized interest rate risk as the savings and loan associations made long-term mortgage loans with short-term borrowings. They borrowed loans with one-year maturity at an annual rate of 4%, and made 6% loans with 3-year maturity, leaving them with a 2% margin. However, they had to refinance their borrowings a year later when the funding cost went up higher, leading to losses. The FRB raised the interest rate up to 6% and the S&L associations had to borrow funds at a rate far above 10% and incurred huge losses. They switched to floating rates for their loans, thereby transferring the risk from changing funding costs to their clients. Subsequently, there was a shift to floating-rate mortgage loan in the market.

(5) Liquidity risk: when there is a mismatch in the funding process and management schedule, unexpected outflows of funds can leave the institution in a shortage of liquidity, and the institution may be forced to default, resort to high interest-rate funds, or sell their assets at lower prices than otherwise they would. In 2003, Korean credit card companies experienced a serious liquidity crisis because they offered credit card loans and cash advance services without proper credit evaluation, resulting in a rapid growth in arrears and eventually large losses. In addition, they issued excessive amounts of credit card bonds and could no longer issue new bonds to finance the roll-over of the existing bonds, leading to a liquidity crunch.

<Table 3-11> Risks for Financial Institutions[51]



3.2. Innovative Lending Practices

Korean financial institutions were using outdated loan review techniques and not implementing appropriate post-loan monitoring because they had long been under the government intervention and relied on collateral-based lending. Not surprisingly, when they were hit by the financial crisis, they were not able to cope with it. A lending practices innovation team was set up within the government in order to enhance the role of loan review and encourage banks to improve their lending practices. To this end, extensive changes were made to the credit management system. A credit rating system was introduced in 1999, along with the establishment of the loan reviewers' council that evaluated loan applications and made lending decisions, and the loan review committee. In 2001, the changes applied to non-bank institutions.

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51 *Source*: the Bank of Korea.

<Table 3-12> Key Changes in the Lending Practices(December, 1999)

Task	Details
Loan inquiries handled based on marketing concepts	- Loan inquiries are dealt with by specialists, and details of the inquiry are kept in the record and reflected in the credit policy(implemented by all of 23 banks)
Credit rating system	- A more sophisticated and advanced credit rating system is adopted by 19 banks to replace the existing corporate evaluation system.
Less reliance on collateral	- Credit loans are treated differently according to the credit ratings assigned by the new credit rating system(18 banks)
Greater access to information on borrowers' debt obligations	- Borrowers are required to submit documents that list their debt obligations and subject to sanctions for submission of false or incomplete information(all banks).
Greater transparency in credit approval process	- The loan reviewers' council was set up, and all the records including reviewers' comments on the results of their review and credit approval decisions are kept(17 banks).
Stricter loan review	- Second loan review by corporate analysts(23 banks) - Credit ratings are revised according to the results of regular or irregular loan monitoring and corrective actions are taken, based on the monitoring results(23 banks).
Early warning system	- Companies showing signs of financial distress are detected and monitored by designated managers to keep a closer watch on those companies. - Early warming system was adopted(14 banks).
Centralized branch organization	- The hub & spoke system was introduced. Under the system, branches specialize in either credit extension or deposit-taking (16 banks).
Credit specialists	- Create a pool of credit specialists. - Performance evaluation, reward and disciplinary systems for credit specialists who are responsible for loan review and corporate analysis were improved(5 banks).
Credit information system	- Industry and corporate information is complied into a database. An integrated electronic credit information system including credit line was developed(9banks).

4. Ownership and Corporate Governance Structure

4.1. Ownership Structure

Under the Banking Act revised in January 1998, banks were allowed to recapitalize themselves and introduce advanced financial techniques by attracting foreign investments. In addition, foreign financial institutions were allowed to hold shares of Korean banks beyond the single-person shareholding limits(4% in commercial banks and 15% in regional banks). Foreign institutions could now acquire as much stake in domestic banks as they wished to, as long as they met certain conditions such as international confidence, and they notified the acquisition to the FSC or obtained the FSC's approval. Korean nationals were allowed to acquire banks' shares in the same procedures within the stakes reported or approved for foreign financial institutions, if conditions including financial position were me t.[52] Majority shareholders exercise control over the selection of the management at Korea Exchange Bank(KEB), Citibank, and Korea First Bank, and the rest of the executives are appointed according to the procedures set by law, at general shareholders' meetings where key shareholders play the role of anchor and induce a consensus. Government-owned banks appoint the management according to the legal procedures including the president nomination committee, but the government virtually exercises full authority over the selection process.[53]

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52 This brought about considerable changes to the ownership structure of domestic banks. As of end-June 2007, Citi had a 15.93% stake in Kookmin Bank, Euro-Pacific Growth Fund 5.46%, ING 4.06%, and National Pension Fund Corp. 3.45%. Shinhan Bank was wholly owned by Shinhan Financial Holding Company which was 9.06% owned by BNP Paribas, and 5.86% by KDIC. Woori Bank was also 100% owned by Woori Financial Holding Company which was 72.97% owned by KDIC. Hana Financial Holding Company owned 100% of Hana Bank shares, but Angelica Investment held a 9.62% stake in Hana Financial Holding and GS Dejakoo had 8.94%. Lone Star owned 51.02% of Korea Exchange Bank shares, Citi Bank was 99.94% owned by Citi Group, and Korea First Bank was wholly owned by Standard Chartered. The government had a 100% stake in KDB. IBK was 51.% owned by the government, 12.5% by KDB, and 3.2% by the Export-Import Bank of Korea.

53 It is noteworthy to give an overview of the separation fo banking and commerce at this juncture. The Financial Holding Company Act revised in December 2009 eased regulation of industrial capital's shareholding in bank holding companies and raised the shareholding limit to 9% from previously 4%. It remains controversial if the logic behind the deregulation and promotion of competition intended for other industries can be applied straight to the financial industry without making any adjustments. Given that chaebols are in control of non-bank institutions, there is only so much that the Act can achieve and it is only the separation of "banks" and commerce, instead of separation of the entire financial sector and commerce. If a non-financial corporation owns up to 9% stake in a bank without exercising managerial control or getting involved in decision-making process, it merely increases stock investments in the company's portfolio, which is not desirable. In other words, an industrial capital has no reason to own such a significant stake in a bank if it is not to influence the bank's management. After all, the ultimate goal of such stock ownership is managerial control and industrial capital's control of banks may bring undesirable consequences. Banks can benefit from the management expertise and experiences of large conglomerates which may bring in scarce domestic capital into the banking sector. But there are some serious considerations to be made in this matter. First, fundamentally, there is intrinsic instability in banking, which derives from the fact that banks use clients' deposits to make money. Second, the controlling shareholders of the conglomerates will likely exercise domineering power over the banks they own. Third, banks do not need to turn to chaebols for capital because there is an oversupply of domestic capital. Fourth, even if deregulation can make banks more competitive, increased competitiveness does not necessarily translate into financial soundness. As a way to increase banks' competitiveness, business crossover through a financial holding company structure can be allowed, but the link between industrial capital and bank should remain loose, given unique characteristics of banking sector that entail system risk. Financial institutions can become stronger as they compete among themselves, but competition always entails losers, and failure of a financial institution can create serious economic and social repercussions. Corporations in their nature seek profit and therefore, may disregard risk management. In this sense, financial markets need to be managed

4.2. Corporate Governance[54]

Actions were taken to improve corporate governance, which in turn was expected to raise operational efficiency and competitiveness of banks. To promote responsibility management at financial institutions, regulations were changed in January 1997 such that half of the board members should be outside directors whose role is to provide checks and balances against the management, that all of the outside directors should form a nomination committee that can nominate the candidates for president and auditor, with approval of two thirds of the members present at the meeting. In February 1999, decision-making and execution were separated within the board, and the board's role of providing checks and balances against the management was further expanded. Outside directors increased in number and power within the board. The board was given greater decision-making authority by setting up various committees under it, such as the board operation committee, risk management committee, and management advancement compensation committee. For greater transparency, the enforcement decree of the Securities Exchange Act was revised in May 1999 to ban officers and employees who were employed by affiliated companies within 2 years, from being appointed as permanent auditors, and other rules on permanent auditors were changed.

From December 1999, all listed companies were required to appoint as many outside directors as they comprise 1/4 of the board, and to set up an outside director nomination committee. Furthermore, listed companies with total assets worth more than 2 trillion won should appoint 3 or more outside directors and the number of outside directors should be at least half of the board. The Securities Exchange Act was amended to ensure that outside directors remain impartial. Under the revised Act, largest shareholders and specially-related persons, key shareholders, and persons who were employed by affiliated companies within 2 years were disqualified as outside director candidates so as to ensure that outside directors can remain independent and perform the role of watchdog. In January 2000, listed companies were obligated to set up an audit committee and appoint compliance officers. The audit committee operates under the board and consist of 3 or more directors. At least 2/3 of the committee members should be outside directors who are not related to the controlling shareholders or the management of the company to ensure that audits can be conducted independently. Other non-bank financial institutions were required to ensure that half of their board is comprised of outside directors, to create an audit committee, and to appoint compliance officers under

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from a national perspective, rather than from an individual corporate perspective.

54 Corporate governance of financial companies came back in focus, following the scandals involving Shinhan Bank and Kookmin Bank. See Chapter VI for more.

the related laws revised in December 1999. Minority shareholders were given greater managerial participation. In order to facilitate minority shareholders' participation in managerial decision-making process, the requirements for derivative suits brought by shareholders of list companies or KOSDAQ-registered companies were eased, and other measures were adopted to empower minority shareholders. Companies were allowed to introduce cumulative voting with amendments to their articles of incorporations in order to prevent majority shareholders from appointing all of the directors. Written ballot system was also permitted to make it easier for shareholders to excercise their rights.

5. Vitalization of Capital Markets

5.1. Secondary Market for Bonds

Steps were taken to vitalize the secondary market for bonds because the market provides a stable venue for companies to obtain long-term funds and help them lower funding costs. In addition, they can also reduce the portion of indirect financing via banks, as well as contributing to stability of the financial system. Following the foreign exchange crisis, the bond market was opened, benchmark interest rates were developed, and the marking-to-market(MTM) system and the simultaneous settlement system were launched. In August 1999, RP trading rules were changed and the value of collateral could be better managed through the use of standardized contract, custody of collateral bonds, and daily settlement. In September 1999, short sale was partially permitted with the introduction of bond lending and borrowing. Specifically, settlement could be postponed until T+1 day or 2 days, instead of daily or same-day settlement so that short sale was made possible even during the time from transaction to the actual settlement. Companies that specialize in brokering between dealers were created as part of efforts to foster inter-dealer brokers.

5.2. Bond Market Infrastructure

Bond market infrastructure was augmented. Bond valuation criteria should be published via disclosure. Benchmark yields by grade and maturity should be published so that yield curves for all bonds can be computed and used for marking-to-market. Credit was now rated on a rolling basis and the ratings were valid for 3 months, instead of 6 months. False or inappropriate credit rating was subject to stricter regulation and sanctions. For example, default rates by grade and disciplinary standards for credit rating agencies that issue false or inappropriate ratings were published. Settlement systems of Korea Securities Depository and the Bank of Korea were integrated for more efficient settlement, and a plan was under way for simultaneous exchange between bonds and payments for settlement of OTC transactions.

5.3. High-Yield Bond Market

In October 1999, high-yield funds and funds that invest primarily in CBOs backed by below-investment grade bonds were developed as these two types of instrument facilitate funding for corporations rated below BBB and provide investors with opportunities to gain high returns.

5.4. KOSDAQ Market

In May 1999, registration requirements for large companies were loosened, and accounting rules were changed to allow up to 50% of the annual income of the current year to be recognized as cost. In December 1999, KOSDAQ registration and exit rules were revised, reporting standards were strengthened, and unfair trading was more strictly monitored. All these efforts added up to a phenomenal growth of the KOSDAQ Market.

5.5. Opening of Korea Futures Exchange

The Futures Exchange Act was established in December 1995 for the launch of Korea Futures Exchange, and 4 products were listed in April 1999, followed by treasury bond futures in September 1999. Some raised doubts if futures trading would be possible in Korea, but the plan for the opening of a futures market was supported by the analysis that gambling and horse racing which were booming in Korea could be a viable indicator of success potential for a futures market. It took 7 months and one week before the futures trading volume reached one million contracts, posting a much faster rate than Singapore that took 21 months, and Taiwan that achieved the volume in 13 months. KOSPI 200 futures contract was listed on CME and remains the world's most actively traded futures contract.

5.6. Listing Regulations and Globalization of Stock Markets

In November 1999, foreign companies were allowed to list their stocks on Korea Exchange(KRX). Five foreign companies were listed on KRX by 2008, and KRX assisted in the opening of the stock exchanges in Vietnam and Cambodia as a 50:50 joint venture. KRX devised more effective ways to regulate cyber stock markets, and launched an OTC brokerage system for non-registered, and non-listed stocks.

6. Issuance and Disclosure Regulations

6.1. Securities Issuance

Regulations on rights issues and corporate bond issuance were eased. In February 1998, financial management regulations for listed companies were revised to abolish the requirements and ceilings for rights issues. In June 1998, regulations on securities underwriting business were amended to lift the issue size control and the restrictions imposed according to the use of the proceeds. In addition, issuers and underwriters were allowed to determine the conditions for corporate bond issuance. In June 1998, overseas securities issuance regulations were eliminated, and instead, companies were allowed to issue bonds in overseas markets on their own credit ratings. Limits on the use of the proceeds from overseas bond issuance were also removed.

Demand forecasting system was improved. In May 1999, the regulations on securities underwriting business were amended to expand the application of the demand forecasting system to the KOSDAQ Market. In December 1999, the standard demand forecasting model was developed and contributed to the optimization of IPO pricing and investor protection.

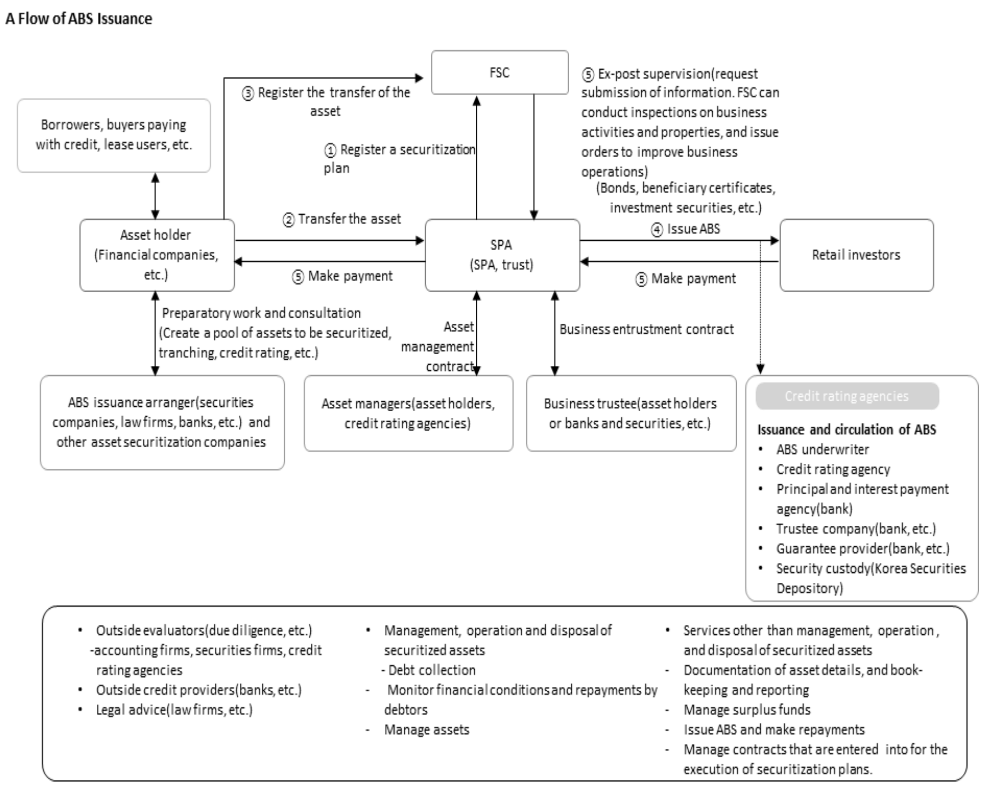
6.2. Corporate Disclosure System

Under the new disclosure system, simplified merger procedures were adopted in December 1999. For example, the board instead of a general shareholders' meeting, was authorized to approve a merger when all of the shareholders of the merged company agreed to the merger or the surviving company already owned 90% or more of the stake in the merged company. In December 1999, Companies were allowed to repurchase their own stocks in a public transaction to provide a tool for them to defend themselves against hostile M&A attempts. In June 1999, the stock repurchase ceiling was abolished. With the launch of the electronic disclosure system, listed companies were required to publish 3 types of reports on the Internet including business report, semi-annual report, and audit report. In April 2000, all reports and documents subject to disclosure were required to be published electronically.

6.3. Asset Securitization

Asset-backed securities is a funding option to issue securities by separating securities from their underlying assets. For the introduction of ABS, the relevant laws were enacted. ABS has two key characteristics. First, it is a non-recourse instrument. In other words, even if the separated underlying assets are not sufficient to cover the principal and interest payments, no claims to payment can be made to the original owner of the underlying asset. Such claims can be made only to the special purpose entity(SPE). Second, the cash flows generated from the pool of the underlying assets are paid out to the senior tranche first, and then the mezzanine tranche, and finally the equity tranche under the credit-tranching structure. Losses are shared in the reverse order. The tranching structure enables the senior portion of the ABS to be rated higher than the rest of the underlying asset.

<Table 3-13> The Basic Structure of ABS



ABS can be divided into CLO, CBO, MBS, and CARD(CLO and CBO are collectively called CDO), depending on the underlying asset. By type, there are ABS bond, ABSCP, and ABS beneficiary certificates. Finally, synthetic securitization combines CDO and CDS. For example, CLO is backed by loans. If it is backed by NPLs, the cash flow that can be obtained from sale of collaterals and debt collection can be the underlying asset, because the principal and interest payments are not paid in time or at all. CBO are divided into P-CBO(primary market) and S-CBO(secondary market). Securities companies and other financial institutions take over the entire amount of bonds issued by a company that normally cannot issue bonds due to its low credit rating, transfer all of them to an SPV that securitizes them into P-CBO through credit enhancement.

For example, Korea Technology Credit Guarantee Fund(KIBO) can provide a guarantee, which brings the bonds rated B or below up to an investment-grade for securitization. On the other hand, financial institutions can sell their bonds that dropped to below-investment grades to an SPC which then securitizes them into S-CBO. CARD(Certificate of Amortizing Revolving Debts) is an ABS backed by current credit card loans and credit card loans that are expected to occur up to a certain point in future's time. It can be relatively easily restructured into another investment instrument because credit card loans have short-term maturities. In other words, if the credit card loans are repaid, it will generate cash flow, and the cash flow is split into the investors' share(only the interest-paying part of the CARD) and the share of the underlying asset holder(this part of CARD can be used to purchase new credit card loans which can be added to the underlying asset).

ABS has the following effects. First, it improves the financial condition of the underlying asset holder. Financial institutions can sell risky assets for cash which can be used to raise their BIS capital adequacy ratio. Corporations can raise funds without increasing their debt ratio. Second, ABS lowers the funding cost. Even asset holders with low credit ratings can still use their high-quality assets for ABS issuance. Even the high-quality assets cannot be securitized if the companies have to be the issuer. Third, ABS offers investors a safer investment option with credit enhancements attached to ABS.[55]

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55 From the perspective of a financial institution, ABS can be used as a useful tool to raise BIS capital adequacy ratio without actual capital expansion by employing all sorts of techniques and reconstructing its balance sheet. Financial institutions can securitize their assets and secure cash while on the other hand, they also acquire subordinated ABS(held as investments). The old BIS standards assigned uniform weight to securities held as investment, regardless of whether they were senior or subordinated. So ABS only took advantage of this loophole. In other words, the risky assets declined on the balance sheet, but the actual risk for the financial institution acquiring ABS remains the same. Basel II introduced various risk assessment techniques and assigned different risk weights, but excessive discretion was granted in connection with risk assessment, which eventually caused a global financial crisis triggered by the subprime mortgage crisis.

7. Accounting Standards

7.1. Accounting Standards by Types of Business

In recognition of the urgent need for ensuring transparency in the financial conditions of financial institutions in order to deter recurrence of financial crisis, the corporate accounting standards were revised and the accounting standards classified by types of business were established. The previous accounting standards for the financial sector were geared toward making accounting information compatible with supervisory purposes, rather than informing general investors. Under the old standards, cross-business comparability and consistency were compromised, which was one of the reasons that accounting information on financial institutions lost credibility. To address this problem, major actions were taken. First, corporate accounting standards were brought in line with global standards. Second, accounting information was made comparable across different businesses. Third, the new standards reflected unique characteristics of individual businesses. Fourth, the standards provided better convenience to both producers and users of accounting information. Based on these four principles, the accounting standards for banking, securities, and insurance were created on December 12, 1998, the simplified accounting standards for investment trust business were established on March 24, 1999, and the standards for mutual credit finance business on June 23, 1999. Major changes included improving accounting techniques for securities, making provisioning for payment guarantees mandatory, and tightening the rules on disclosure of notes. Accounts and information that were difficult for general users of financial information to understand due to complicated nature of financial transactions, were made simpler and more comprehensible, and harmonized. Changes were made to improve accounting methods to treat securities trading margin, insurance policy reserve mechanism, acquisition cost of new long-term insurance contracts, and business expenses of life insurance companies.

7.2. Rules for Combined Financial Statements

The Act on External Audit of Stock Companies was revised twice in January and February 1998 to require that top 30 business conglomerates as defined under the Monopoly Regulation and Fair Trade Act should produce combined financial statements and have the statements audited by external auditors, starting in the fiscal year that began in 1999, and to make external audit of the combined statements mandatory. In October 1998, the simplified standards for combined financial statements of corporate conglomerates were established to offer comprehensive accounting information of an entire business group under the de facto control of same person, thereby raising transparency and confidence in the business operations. The standards applied to top 30 business conglomerates designated by the Fair Trade Commission in the current year and the immediately preceding year. If one consolidated financial statement within a business conglomerate accounts for 80/100 of the total combined assets of the affiliated companies, there is practically little difference between the combined financial statement and the consolidated financial statement, and therefore, the conglomerate was not required to report a combined statement. A combined financial statement should include all domestic affiliated companies and all forms of overseas affiliated companies that are part of the business conglomerate as of the date the statement is produced, only excluding small-scale affiliated companies. The company to prepare a combined financial statement should be selected, taking into consideration the auditors of the affiliated companies to be in the statement, the closing month, and total asset sizes of individual companies. Business conglomerates can select their affiliated companies to include in the statement, and the statement should be produced as of the closing date of the company that produces the statement.

7.3. Accounting Standards for Leases

In April 1998, the Securities and Futures Commission created the accounting standards for leases based on the previous standards. In July 1998, these standards were completely overhauled to be brought more in line with the global accounting standards, and to treat leases according to their economic substance. The new standards increased its scope of application and the lease classification criteria was changed. Under the new standards, operating leases were amortized over the economic life of the lease, and the rules on deferred treatment of foreign exchange translation losses or gains from operating leases were deleted. Accounting rules on treatment of cancelled financial lease contracts were made more specific, and improvements were made to the methods to value financial lease assets and liabilities of lessee(user). Finally, new accounting standards for sales-type leases were established.

7.4. Rules for Consolidated Financial Statements

The standardized rules for consolidated financial statement were revised with a view to provide accurate and timely accounting information on economic entities to capital market participants and thus improve transparency in corporate activities. The revision was made in tandem with the amendments to the Enforcement Decree of the Act on the External Audit of Stock Companies. Under the new rules, the economic entity concept was used instead of the parent company concept, and the entire amount of unrealized gains or losses arising from inside trading among affiliated companies in the consolidated financial statement were removed in order to comply with global standards more closely. The scope of companies to be in the statement is determined not only by shareholding ratio but also by effective control. Purchase method and pooling of interests method were introduced to ensure consistency with the accounting standards for corporate acquisitions, mergers, etc. established in March 1999.

7.5. Accounting Standards for Corporate Acquisitions, Mergers, etc.

Previous accounting standards for merger did not accurately reflect economic substance that business combination transactions such as corporate acquisition and merger, thus possibly distorting financial information. To address this problem, the accounting standards for corporate acquisitions, mergers, etc. were created in March 1999 so that economic substance could be better reflected in the balance sheet. The new rules applied in a broader scope so that all forms of business combinations including not only mergers under the Commercial Law, but also corporate acquisition and business transfer. Either purchase method or pooling of interests method was used to fit the nature of the transaction. In case of a merger between the parent company and a subordinated company, the book value should be transferred onto the consolidated financial statement, and rules on notes to disclosure were tightened for business combinations.

7.6. Quarterly and Semi-Annual Financial Statements

In April 1998, the Securities and Futures Commission established the quarterly financial statement standards, based on the existing quarterly financial statement standards. In December 1998, quarterly financial statement was introduced under the revised corporate accounting standards and the Securities Exchange Act, and the semi-annual financial statement standards were renamed "the quarterly & semi-annual financial statement standards.

The new standards deleted the matters on deferred assets and asset revaluation in line with the corporate accounting standards, and made revisions to valuation using the equity method, corporate tax expenses, accounting change and changes in accounting estimate, and disclosure of notes. With the adoption of quarterly financial statement, a quarterly report is due first in 3 months and again 9 months from the beginning date of the business year, and quarterly reports are prepared according to the same rules applicable to semi-annual reports.

8. External Audit

8.1. Eligibility to Audit Financial Institutions

In December 1998, the criteria for accounting firms eligible to au아t financial institutions was established. In order to enhance reliability of financial institutions' accounting information, banks and merchant banks with total assets worth 800 billion won or more should be audited only by accounting companies that signed an audit quality control contract with a foreign accounting firm that the Securities and Futures Commission(SFC) determined were globally recognized. The criteria was incorporated into the Act on the External Audit of Stock Companies in March 1999.

8.2. Preparation of Combined Financial Statements

For seamless implementation of the combined financial statement system, the Act on the External Audit of Stock Companies specified the documents that should be submitted if affiliated companies were to be excluded from the combined financial statement or a business conglomerate wanted to have the combined statement waived, as well as the criteria for selecting the company to prepare the statement and specific selection process. In addition, the Act also provided the reporting format for changes to the affiliated companies to be combined. Pursuant to the Act, the SFC identified the business conglomerates that should prepare the combined financial statement for fiscal year 1999, the conglomerates exempted from preparing the statement, and the companies responsible for preparing the statement, and notified the conglomerates accordingly in May 1999.

8.3. Audit Review System

In the wake of the financial crisis, much stress was placed upon greater transparency of accounting information. In response to this increased concern over the quality of accounting information, the Act on Appointment of Inspections, etc., the Regulations on Audit Review, and the Act on the Operation of Specialized Review Organization, etc. were consolidated into the Act on the External Audit of Stock Companies in March 1999, which was revised in November. The revised Act expanded the scope of audit and called for imposition of stricter actions based on the audit results in order to promote accurate accounting and fair audit. Under the new Act, special audits could be planned and performed to zero in on particular accounts, types of business or business groups. A legal basis was newly created to conduct special audits on audit reports for companies designated as problem financial institutions for the recent 3 business years. Companies that frequently change their accounting practices are selected with priority for a general audit review. Stronger actions were taken against companies according to the results of audit reviews. If a company or an affiliated company refuses to present information or to be investigated without valid reasons, the company should be reported or notified to the police, in addition to administrative actions taken against the company. Rules on aggravated punishment for auditors and certified public accountants were made tougher, and the FSC introduced a new rule under which accounting firms that have committed an audit failure can be banned from being appointed as auditor for up to 2 years. A legal ground was created to hold CEOs of accounting firms who signed their audit reports accountable and take actions against them. The new Act imposed much stricter actions against accounting fraud and inappropriate audits. When it is deemed necessary to determine if a company should pay a penalty based on the results of an audit review, a request for an investigation can be presented to the governor of the FSS.

CHAPTER 4

A Closer Look at the Restructuring: Cases

Regardless of whether it is important or not, or how much efforts you made toward it, you should always have well-forged multiple alternatives ready in your mind.

"Siegmund Warburg, from High Financier: The Lives and Time of Siegmund Warburg" (2010), Niall Fergurson

This chapter reviews 8 cases of the financial sector restructuring: Korea First Bank, Seoul Bank, Chohung Bank, Korea Exchange Bank(KEB), Daehan Life Insurance, LG ard, Korea Investment Trust & Daehan Investment Trust, KorArm Bank. Korea First Bank was the first bank in history that was sold to a foreign investor, while Seoul Bank was able to avoid being sold at a bargain price as the market stabilized, and instead was taken over by Hana Bank. With the acquisition of Seoul Bank, Hana Bank was able to emerge as one of the 4 major financial holding companies. Chohung Bank was purchased by Shinhan Bank, laying the foundation for the latter to rise as a mega bank. KEB, on the other hand, became the center of controversy which eventually evolved into a political scandal after it was sold to Lone Star at a price far below its fair value. The sale of KEB offered many lessons for future restructuring. The case of Daehan Life Insurance revealed a wider range of issues that should be considered in the process of restructuring distressed financial institutions, such as accountability of majority shareholders and the scope of incompleteness or inappropriateness of a tender offer. LG Card was poised to develop into a large-scale financial crisis, but with accumulated restructuring expertise and experiences, a successful restructuring was pulled off while keeping the market stable. KorAm Bank was sold to a strategic investor and became the cradle of professional managers who later led many of domestic financial institutions. KorAm's case suggests how the domestic financial sector can benefit from international competition. All of these cases present unique models for restructuring of problem financial institutions, and provide food for thought on a myriad of issues involved in the financial sector restructuring, including the logic, procedures, negotiations, and national consensus.

1. Korea First Bank

As mentioned earlier, Korea First Bank marked the first case in history where a domestic bank fell under foreign ownership. The case of Korea First Bank offers the following implications. First, the bank was sold to a foreign PEF. It implied that the Korean market was not capable of handling failed financial institutions, and the government could not afford to liquidate or inject public funds into the bank. Since there was no strategic investor showing interest in the acquisition of the bank, the government was forced to resort to the only option of selling the bank to a PEF. Later, Standard Chartered took over the bank in a strategic alliance, which after all, met the originally intended goals of overseas sale: learning advanced management techniques and bringing more competition into the domestic banking sector. A total of 17.63 trillion won in public funds was spent on handling a troubled financial institution whose assets amounted to 48 trillion won, and as of the end of 2011, 12.64 trillion won was recovered, leaving some 5 trillion won in loss. Given that sale to a foreign investor was inevitable to prevent bank runs and safeguard the market stability, the loss is considered moderate, compared to the possible consequences of other alternatives such as liquidation. Second, it presented an effective model for sale of a distressed bank. In other words, distressed assets and part of liabilities were separated from the troubled bank and subsequently removed from the balance sheet. Then, the government provided financial support to cover the loss to transform it into a clean bank and sold it. On the reverse side, this restructuring model can be also used when Korean capitals take over financially distressed foreign banks. Third, two important lessons were learned in the sale negotiations. First, fair valuation of assets was not possible because the market was not functioning properly so assets were sold at a blanket discount and with a put-back option, making a breakthrough in the sale which otherwise would have faced an impasse. This illustrates how important it is to remain creative and open to new approaches to resolve deadlocks in negotiations. Second, the government put itself in a position to benefit from the upside potential of the bank when the bank turned around, by investing public funds into the bank. To this end, the government retained as much stake in the bank as possible(49%), and secured preemptive right(11% of the government's stake). Fourth, the entire sale process was thoroughly reviewed and evaluated by the strict set of criteria at the time of sale in order to preclude potential criticism that is often raised against the sale of a bank when the bank makes a turnaround and returns to profit. Specifically, the government filed a request for audit with the Board of Audit and Inspection so that all of the sale process was revised by a credible national agency and all of the details were kept in the record, and individuals involved in the sale would not be implicated in any trouble later. This critical step can certainly prove to be beneficial in other cases.

1.1. Background

Under the LOI signed with IMF on December 3, 1997, Korea First Bank(KFB) and Seoul Bank were required to submit a recapitalization plan to meet the BIS capital adequacy ratio, within 2 months. If the plan was to be approved, the ratio had to be met within 4 months and if the ratio was not met by the deadline, the banks were to be closed down. However, the plan was changed to sell them to foreign buyers under the 3rd LOI signed on December 24, 1997, and the reasons are as follows.

On December 5, 1997, the IMF board passed the bailout package totalling 58.35 billion dollars: 21 billion dollars from the IMF, 10 billion dollars from the World Bank, 4 billion dollars from ADB, and 23.35 billion dollars in second-tier aid provided by 13 countries). However, bank runs continued, and foreign exchange market, stock markets and bond markets still remained volatile. The persistent instability indicated the wide-held view that the financial aid was not enough amid the ongoing financial crisis that swept much of Asia. So the IMF Plus negotiations got under way for early withdrawal of the IMF bailout fund, and on December 25, 1997, an agreement was reached for early use of 10 billion dollars. In order to work out solutions to fundamentally resolve the foreign exchange shortage, the negotiations were initiated in New York on December 29, 1997 to roll over Korea's short-term external debt.

Under these circumstances, Korea First Bank incurred large amounts of losses due to the collapse of its client corporations including Hanbo and Kia, and additional loan loss reserves that had to be made according to the international accounting standards and the new asset quality classification standards. As of the end of 1997, the loss amounted to 1,615.1 billion won and the estimated BIS capital adequacy ratios fell to -2.7% for KFB and 0.97% for Seoul Bank. A management improvement order was issued on December 22, 1997, and the banks' management was forced to resign on December 24, 1997. As mentioned earlier, the

3rd LOI signed on December 24, 1997 changed the original plan for the banks and an agreement was made to inject public funds into the banks and sell them to foreign buyers. Considering that KFB had 4.9 million retail clients and 77,000 corporate clients, there was a serious threat of bank runs spreading to the broader sector and it was expected that the sale conditions would be better if they would be sold when still in operations rather than after they would be bankrupt. Based on the judgement, the Monetary Policy Committee ordered a capital reduction on January 15, 1998 and requested the government and KDIC for investments. On January 30, 1998, the government ordered the two banks to reduce their 820 billion won capital down to the minimum legal capital of 100 billion won, respectively(the reduction ratio: 8.2:1). Instead, the government made an investment in kind worth 1.5 trillion won in total which was split equally between the two banks, and the same amount was invested by KDIC. It took 2 years until the banks were privatized and then sold to Newbridge Capital. They were later sold to Standard Chartered, and it took another 5 months. The international competitive bidding was held in December 2004 and the banks were finally sold in April 2005.

<Table 4-1> Milestones in KFB Sale

Detail	Date
IMF bailout loan was officially requested by MOFE	Nov. 21, 1997
MOFE and IMF signed the LOI for restructuring loan and agreed on privatization of KFB	1st: Dec. 3, 1997 3rd: Dec. 24, 1997
The government decided to privatize KFB via public sale of KDIC's stake in the bank (the KFB Privatization Committee under MOFE)	Mar. 1998
Morgan Stanley was selected as the lead manager.	May. 19, 1998
The FSC and Newbridge Capital signed the MOU on the sale of KFB.	Dec. 31, 1998
The FSC and Newbridge Capital signed the TOI on the sale of KFB.	Sept. 17, 1999
KDIC and Newbridge Capital signed the contract to sell KFB.	Dec. 23, 1999
Newbridge and Standard Chartered signed the stock sale contract, and notified KDIC of the intention to exercise the drag along right.	Jan. 10. 2005
KDIC, the government, Newbridge and Standard Charter signed a contract to sell the stakes held by KDIC and the government.	Mar. 16, 2005
Shares were transferred and the payments were received.	Apr. 15, 2005

1.2. KFB Sale Process

1.2.1. Planning

The sale of KFB was part of the LOI (Letter of Intent) that the government and the IMF signed. Customarily, the recipient government and the IMF work out the details of an LOI, but in actuality, the IMF provides a loan in the form of an LO I.[56]

Under the LOI, first, internationally recognized advisors would be selected by March 31, 1998 to set up the banks' privatization plan. Second, an invitation would be sent out to internationally recognized investment banks by March 31, 1998, along with proposals for due diligence and external audits by internationally recognized accounting firms. Third, the deadline for the privatization was set for November 15, 1998. The government organized the privatization committee on February 7, 1998, and established the sale plan in March 1998. The committee was made up by the director general of the Financial Policy Office of MOFE(chairman), director of the treasury division of MOFE, managing director of KDIC, vice chairman of the Banking Supervisory Board, and vice chairman of Korea Institute of Finance. Under the plan, the government and KDIC would sell the combined stake equivalent to 50% +1 share that the potential buyer would need to ensure the control of the banks. Simultaneously, efforts were made to raise sovereign credit rating and to optimize the conditions for smooth sale by planning long-term growth of the banks and sending effective signals to the global financial markets. Consortiums that consisted of domestic and foreign buyers were granted priority in the negotiations.

The FSC selected a group of sale managers on May 19, 1998. Morgan Stanley was hired as the lead manager, Coopers & Lybrand as the accounting advisor, and the domestic law firm Bae, Kim & Lee, and White & Case of the U.S. as the legal advisors.

1.2.2. Selection of Preferred Negotiator and Sale Negotiations

Morgan Stanley approached 49 financial institutions and sent out an invitation

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56 The ownership of the IMF program is crucial and the LOI commits the recipient government to taking full responsibility of faithfully executing the loan program. The only collateral for all IMF loans including stand-by loans is the commitment to honoring the obligations as agreed upon in the LOI. In case of financial support, the IMF supplies hard currencies such as dollar that can be used for international trade, in exchange of the currency of the recipient country. The supply of dollars by the IMF is called purchase, and the repayment of the dollars by the recipient country is called repurchase.

with details on the planned sale of the banks to potential buyers to meet the sale deadline of November 15, 1998. But the results were disappointing. there were only 3 interested buyers including HSBC, Citibank, and the Newbridge Capital consortium. According to the sale prospectus drawn up by Morgan Stanley, new shares issued by the banks would be offered for sale, and the government would cover 80% of the depreciation loss for bad debts that would occur in the 3 years after the acquisition, within the limit of 3.3 trillion won. KDIC would issue bonds to cover the loss and the government would guarantee the principal and interest. The book value of the banks' shares would be guaranteed, and there would be a guarantee of minimum profit. The timing of the sale would be determined by the government and the profit beyond the book value would be reverted to the government.

Despite all these efforts, the banks failed to find a new owner and the sale deadline was extended to January 1999. Finally, HSBC and Newbridge Capital Consortium expressed their interest in buying the banks[57], and the consortium made a better offer. Since strategic alliance was a key component that the government sought in the banks' sale to foreign investors, the government checked with HSBC if it was willing to accept the same conditions offered by the consortium, but it declined. The FSC focused the sale negotiations on maximizing the amount of premium and minimizing the put-back option attached to the assets to sell[58], and signed the MOU on December 31, 1998. The MOU includes the followings: First, impaired assets and some liabilities would be separated from the banks and transferred to a bad bank, and the government would cover the loss stemming from the separated assets, thus cleaning up the balance sheets of the banks. Second, the government built a cost-recovery scheme in the deal by holding a 49% stake in the banks after the sale, and by securing subscription right to 11% of its shares. By doing so, the government would be able to share the profit and recover much of the investment if the banks would turn around and increase in value.

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57 HSBC was the first to express interest and suggested that the government would take only 20% stake, but the government demanded 40%. Since the government already invested 1.5 trillion won in the banks, it was important to create a structure in which the government would share the upside potential of the banks. Negotiations continued, but HSBC did not budge an inch from the final offer of 27.5%. When the negotiations with HSBC were stalling, Newbridge Capital Consortium stepped in and offered a 49% stake for the government on December 11, 1998, and fresh negotiations started with the consortium(Lee, *ibid*).

58 The signing of the MOU helped raise external confidence in the Korean economy. As a result, Moody's moved Korea up to Baa3 from Ba1 and Korea reached an investment grade back for the first time since it was brought down to a speculative investment grade after the onset of the foreign exchange crisis.

1.2.3. Sale Conditions

Negotiations with the consortium moved on, based on the MOU and much time passed before the terms of investment(TOI) that contained detailed sale conditions was finally signed on September 17, 1999. The final contract was signed on December 23, 1999, a year after the MOU was signed. The TOI, a legally-binding contract included details of stake sale, the scope of initial asset separation, and valuation method for the remainder of the assets(supplementary to MTM). The definitive agreement set forth detailed sale conditions based on the TOI, including the official date of sale completion which was set for the end of 1999, sale procedures and methods, debt rescheduling and credit protection, the scope of assets to be separated from the banks, and procedures and method of post-sale support.

<Table 4-2> Comparison of Offers by HSBC and Newbridge Capital Consortium

	HSBC	Newbridge Capital Consortium
Ownership	80(acquirer):20(government)	51(acquirer):49(government)
Total sale price*	80% of the banks' net value	51% of the banks' net value
Premium	200 million dollars (initial restructuring cost deducted)	- Subscription right to 10.5% of the government stake - Subscription right to be exercised 5 years after the sale - The price: stock price plus an annul 10% compound interest rate applied to the price of shares acquired by the consortium.
Sale of the stake	- The buyer can exercise the call option on the government's stake - When: after 3 years - Price: the net asset value at the time of exercise	- Sell the stake at market price(the government can sell the stake in the same amount and under the same conditions if the buyer sells its stake.
Put option on impaired assets	Unlimited in the first one year	Unlimited in the first one year, and allowed up to the cap in the second year.

Note: * If the value of net assets needed for the good banks to restore a proper BIS capital adequacy ratio is estimated at 1.2 trillion won or 1.0 billion dollars, the prices would be 960 billion won and 612 billion won, respectively.

Originally, under the MOU, the deadline was May 2, 1999, but the sale took almost a year because the parties could not narrow the gap in the valuation of the assets. The consortium demanded valuation of assets at market price, but the government could not accept the demand because market price-based valuation would likely cause some problems. First, the market price was only 20~30% of the book value, which meant more losses that the government should cover. Second, if corporate loans were to be valued by market price, a large portion of the assets would be classified as impaired, which would deal a detrimental impact on external confidence in the affected companies. Third, bonds would be marked to market immediately, as also demanded by the IMF, the bond market would be thrown into a chaos and the investment trust fund market which was worth 300 trillion won would likely be paralyzed. Fourth, the restructuring of Daewoo Group was still in limbo and KFB's exposure to the group as the main creditor, made valuation of its assets complicated.[59] Given the circumstances, the government stalled the negotiations, and thoroughly analyzed the details of the TOI. The government returned to the negotiations with an alternative in June 1999, and reached an agreement by offering a blanket discount on the assets instead of MTM, and a 2-year put back option. There was a tug of war over the discount rate(10% vs. 3%) and the government issued the ultimatum of 3% on July 20, 1999, which the consortium accepted, finalizing the TOI.[60] The government filed a request for audit with the Board of Audit and Inspection and had all of the terms and conditions reviewed by the Board, because a different set of standards might be used in a future audit to assess the terms of the deal later when the bank would turn around and return to profit.

The sale contract had three parts: First, the Acquisition Agreement set the matters on the stake sale up to the closing of the deal. The agreement was signed by KDIC, KFB New Bridge Holdings Limited[61], KFB, and the Resolution & Finance Corporation. Second, the Assistance Agreement which was entered into by KDIC, KFB, and the Resolution & Finance Corporation stipulated the matters relating to the Corporation's support after the closing of the deal. Third, the Shareholders' Agreement was signed by KDIC, MOFE, KFB, and KFB Newbridge Holdings Limited to specify the matters regarding the exercise of the voting rights and sale of the shares.

1.2.3.1 Acquisition Agreement

First, the assets that were not acquired by Newbridge were removed from the banks' balance sheets and KFB's assets and liabilities were matched. Assets not

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59 Lee, *ibid*.

60 KEB is a case in point. In order to prevent potential controversies surrounding the sale, that may occur in the future, an audit by the Board is useful because it will check all the potential issues and settle them once and for all(Lee, *ibid*).

61 A wholly-owned subsidiary of Newbridge Capital set up to invest in KFB acquired included subsidiaries to be spun off, overseas branches, stocks, and NPLs. KFB's capital was reduced to 908,584 million won so that Newbridge's 50.99% stake in KFB was matched with 500 billion won invested by Newbridge. If the capital needed to meet the 3% equity capital ratio or the 10% BIS capital adequacy ratio was greater than the ultimately reduced capital, KFB's capital was reduced to match the former. KDIC sold its KFB shares equivalent to 50.99% of the total KFB shares to KFB Newbridge Holdings Ltd. for 500 billion won. KDIC acquired the warrant to buy 11% of the government's shares(5% of the total KFB shares) at the time the contract ended.

What the deal meant was that Newbridge acquired a 51% stake in KFB, and in return, paid the amount equivalent to 51% of the net asset value of the bank that was needed to bring the bank's BIS capital adequacy ratio back to the required level, while the government sold the new shares, thereby recovering the cost equivalent to the proceeds from the sale of the new shares. The warrant or subscription right was meant to be the premium which was equivalent to 11% of the government's shares or 5% of the total KFB shares. The warrant can be exercised after 3 years and the stock price at the time of acquisition plus the annual 10% interest rate, which allowed the government to benefit from the upside potential.

1.2.3.2. Assistance Agreement

KDIC provided an intial loan loss reserve of 3.5% for KFB's remaining loans which were transferred to the Resolution & Finance Corp. KDIC continued to provide support for KFB's loan loss reserves and was allowed to choose one of the three options for financing the loan loss reserve for the remaining loans: paying the reserve, purchasing the loans, or adjudication.

The assistance agreement was intended to cope with assets that would be impaired after they were acquired by Newbridge. All of the impaired assets could be transferred to the Resolution & Finance Corp. in the first year after the acquisition, and the transfer would be allowed within a limit from the second year on. Transfer of impaired assets followed the rules agreed upon by both parties.

1.2.3.3. Shareholders' Agreement

KDIC transferred its voting right to Newbridge so that the latter could solely exercise the voting right. KDIC still kept its voting right with regards to disposal of all of KFB's assets, KFB's filing for bankruptcy or dissolution, capital reduction, new rights issues, and dismissal of directors or auditors either appointed or approved by the KDIC. Newbridge had the authority to appoint directors and auditors while KDIC could appoint 3 of the outside directors including one auditor. The agreement was meant to give Newbridge maximum autonomy in managing the bank.

Sale of KFB shares was banned entirely for the first year, and from the second year on, the shares could be sold upon the other party's approval. If KDIC would sell its KFB shares, Newbridge had the right of first refusal. If Newbridge would sell 30% or more of its stake, KDIC would be forced to sell its stake at the same price and same terms(DAR). If Newbridge would sell less than 30% of its shares, KDIC was allowed to sell its shares at the same price and same terms(Tag Along Right). The drag along right(DAR) was intended to assure that the buyer would have a solid control of KFB in case Newbridge was to sell the controlling stake, while the tag along right(TAR) was granted in order to enable KDIC to join the deal and reap the profit in case Newbridge wanted to sell its shares but to retain its managerial control. KDIC was also allowed to list its shares if Newbridge would list its shares(piggy back).

Any sale of the shares should be, in principle, based on market price, and the shares could not be disposed of without the government's approval, for the first two years. The government secured the right to sell its shares in the market on the same terms and conditions that would apply to Newbridge's shares. The contract would be terminated if Newbridge's stake would fall below 15% or when it would be 10 years after the closing of the deal. The agreement was designed to ensure that rights and obligations were balanced out and that the parties to the deal shared both risks and opportunities linked to the upside and downside.

1.2.4. Closing

KDIC scheduled the completion of sale for December 31, 1999 and finished everything including the required capital reduction and financial support by December 30, 1999(The transaction was finalized on December 30, because December 31 was a holiday). To bring KFB's capital down to 980.6 billion won, the amount agreed upon in the contract, shares worth 1,976.3 billion won were cancelled without payment and 418.2 billion won was reduced by payment in cash. The government cancelled its shares worth 63.1 billion won without payment and 1,418.2 billion won with payment. The government took over KFB's assets worth 3,527.5 billion won which were not acquired by Newbridge, and provided 38 billion won for a special reserve. The government transferred 50.99% of KFB"s total issued stock or 99,999,956 shares to Newbridge, and received 500 billion won for the shares on January 20, 2000.

<Table 4-3> Changes in Shareholding after Sale to Newbridge (100 million won, %)

	Before capital reduction		After capital reduction		Immediately after sale	
	Amount	Shareholding Ratio	Amount	Shareholding Ratio	Amount	Shareholding Ratio
Gov't	1,360	3.0	304	3.1	304	3.1
KDIC	43,447	97.0	9,502	96.9	4,502	45.9
KFB NH	-	-	-	-	5,000	51.0
Total capital	44,807	100.0	9.806	100.00	9,806	100.00

1.3. Post-Sale Management

1.3.1. Purchase of Bonds with Warrant(January 31, 2000)

In the TOI, KDIC secured the rights to subscribe to new shares equivalent to 5% of KFB's total shares as of the date the bank's sale was completed, which was incorporated into the definitive agreement. So KDIC and Newbridge signed a contract on January 21, 2000 under which KDCI bought 91.1 billion won worth of bonds with warrant issued by KFB.

1.3.2. Post-Sale Settlement (August 21, 2000)

Under the sale contract, the closing date was December 31, 1999, but the closing date was brought forward to September 30, 1999 when the definitive agreement was signed on December 23, 1999 because KFB's financial statements could not be prepared as of December 31. The accounting companies hired by Newbridge and KDIC conducted due diligence and compared KFB's financial statements as of end-September 1999 and the end of 1999, to settle the discrepancies on August 21, 2000. Since KFB incurred operating loss in the 3 months(from the end of September to the end of December), KDIC paid 168.4 billion won to offset the decrease in KFB's net asset and 81.5 billion won for additionally separated assets on August 21, 2000.

1.3.3. Put-Back Option

The put-back option in the sale contract included acquisition of NPLs, support for loan loss reserves, a guarantee of credit yield, a guarantee of the principal and interest on straight bonds, purchase of substitute payment guarantees, acquisition of equity swapped for debt and convertible bonds, and indemnification and compensation.

<Table 4-4> Summary of KF's Put-Back Option

	Content
Acquisition of NPLs	Acquire NPLs as they occur
Guarantee of credit yield	Guarantee certain yields on credit to Daewoo Group and other companies under workout or private composition.
Support for loan loss reserves	Provide financial assistance to cover loan loss reserves for NPLs
Guarantee for straight bonds	Guarantee payment of principal and interest on straight bonds
Purchase of substitute payment guarantees	KDIC will make the payment if there is a claim for a substitute payment.
Acquisition of equity-swapped for debt and CBs	Acquire equity and convertible bonds associated with debt restructuring
Indemnification & compensation	Compensate for lawsuits and taxes associated with business operations that were conducted prior to the sale(end of 1999)

If KFB filed a claim for compensation, KDIC reviewed the claim including the reason and amount, based on the advice from its legal advisor and due diligence by its accounting firm, and determined whether or the compensation would be made or how much the compensation would be. According to these procedures, KDIC provided approximately 5.2 trillion won in public funds until December 2005(518.5 billion won in contribution and 4,707.8 billion won in asset acquisition).

1.4. Sale of KFB to Standard Chartered Bank(SCB)

Newbridge Capital which was a financier embarked on a divestment process to recover its investment once the bank turned around. In December 2004, Newbridge offered its stake for sale in a competitive bidding and HSBC of Hong Kong and Standard Chartered Bank(SCB) presented a bidding proposal. Newbridge and SCB signed the share purchase agreement on January 10, 2005, involving a sale of 100% KFB stake. Newbridge asked the government and KDIC to join the deal by exercising its drag along right, and also to enter into the accession agreement. As explained earlier, the drag along right oblige KDIC to sell its shares on the same terms and conditions that Newbridge does in case the latter decides to sell 30% or more of its KFB stake. The accession agreement bound the government and KDIC to sell their stakes according to the terms and conditions in the share purchase agreement that Newbridge and SCB signed, and as a result, the government and KDIC also acquired the seller position and a party to the share purchase agreement.

The sale review subcommittee and the Public Fund Oversight Committee meeting were convened on March 4, and March 7, 2005, respectively to approve the sale of KFB shares held by the government and KDIC. On March 16, 2005, the accession agreement was signed by the government, KDIC, Newbridge, and SCB. The deal was closed on April 15, 2005, upon receipt of the payment and stock transfer. KDIC received a total of 1,648.7 billion won(16,511 won per share) for 48.49%(99,853,167 shares) of KFB's total shares it sold, plus the interest. The interest was calculated by applying the 3-month LIBOR of the business day(January 7, 2005) immediately preceding the closing date(January 10), for a period of time from the date the contract was signed to the closing date.

<Table 4-5> Proceeds from the Sale of KFB

	Total	Newbridge	KDIC	Govt'
No. of shares (Shareholding ratio)	205,922,640 (100%)	99,999,956 (48.56%)	99,853,167 (48.49%)	6,069,517 (2.95%)
Price (won)	3,400,000,000,000	1,651,104,756,621	1,648,681,115,394	100,214,127,985

KDIC entered into a currency swap on the proceeds of the sale on April 15, 2005 in consideration of the impact of the massive inflow of funds in the Korean currency into the domestic market, and the amount of US dollars that was needed in the second half of 2005. So part of the proceeds was received in won(938,485,872,015 won) and the rest in US dollars(710,195,243,379 won or approximately 690 million dollars) The demand for US dollars at the time was 1.8 billion dollars in total, with the exchange bonds issued by KEPCO reaching maturity on October 11, 2005, and the OPERA Bonds[62] on December 12, 2005. KDIC entered into a swap with KDB for 699,743,838 dollars, and reaped 8.5 billion won in a gain on foreign exchange, based on the exchange rates on the repayment dates for KEPCO's exchange bonds and OPERA bonds(October 11, 2005 and December 12, 2005).

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62 OPERA or Out Performance Equity Redeemable in Any Asset is a bond backed by stocks of two or more companies and it allows the buyer to exchange the bond for any of the stocks after a lapse of a certain period of time. The government issued OPERA bonds backed by one public corporation and one bank, to facilitate privatization of public corporations. Calls for redemption in dollar were expected because the stock prices were set high.

<Table 4-6> KDIC's Swap Transaction

		KDIC's payment obligations	KDB's payment obligations
Repayment of KEPCO's EBs	April 15, 2005	USD 137,104,338	KRW 140,120,633,273
	Oct. 11, 2005	KRW 140,230,316,743	USD 137,104,338
Repayment of OPERA Bonds	Apr. 15, 2005	USD 562,639,500	KRW 575,017,569,000
	Dec. 12, 2005	KRW 575,298,888,750	USD 562,639,500

1.5. Major Issues Raised about KFB's Sale

1.5.1. Fire-Sale Price

In spite of the audit by the Board of Audit and Inspection that reviewed and approved the details of the deal, questions about the sale price were raised. The major accusation was that the sale price even including the premium was far from enough to cover the public funds already injected, and the 100% put-back option left the government's obligations lingering on for an extended period of time. But the fair price of the bank would have been still 500 billion won, regardless of the buyer[63]. As mentioned earlier, a due diligence was conducted and the assets not to be take over by Newbridge were separated from the consolidated financial statement. Then, KFB's assets and liabilities were matched, and the capital was reduced to 980,584 million won so that 500 billion won that Newbridge invested in KFB would match 50.99% of KFB shares. Subsequently, KDIC sold a stake in KFB that was equivalent to 50.99% of the total KFB shares to Newbridge. Valuation of a company based on its net asset value would bring the same result, regardless of the buyer. Only the value of the premium can be different and thus raise the price beyond the net asset value. However, raising the premium was not an option because the sale of the bank to a foreign buyer was widely publicized and there was little hope to find a new potential buyer. The premium was the right to buy KFB's new shares equivalent to 11% of the government's stake, and KDIC secured 5% of the total issued shares(9,805,840) which it sold in 2005 for 96.9 billion won.

The put-back option was viewed as a less costly alternative because resolving and compensating for 100% of impaired assets before the sale would likely impose

63 On May 23, 2003, the price was 6,749 won per share, and the total price of the new shares was 66.2 billion won. The sale price was 16,626 won per share and it comes to 96.9 billion won[1,626-6,749)×No. of shares(9,805,840)] a greater financial burden than dealing with asset impairment that might occur for a fixed period of time in future. With a 100% put-back option, the bank should determine the loss from its exposure to a corporate client and compensate for the loss immediately, which will likely have a significant impact on the corporation, In addition, the bank will likely exhibit greater moral hazard. Therefore, both parties need to work out the standards to resolve problem companies and adhere strictly to the standards when determining and compensating for losses. In this sense, a moderate put-back option is essential in this type of sale transaction.

Particularly since there was no more interested buyer, if sale to a foreign buyer had failed, other alternatives such as bankruptcy or merger with another domestic bank would have been pursued, which would have cost more by lowering external confidence, making substitute payments on deposits, bankruptcies of client corporations, etc. Given the circumstances, there was no alternative.

The local media(Chosun Ilbo, January 6, 1999) took the view that the government was forced to accept the unfavorable conditions because it failed to meet the deadline of November 15, 1998 as agreed upon with IMF while foreign media reported that the sale would mark a watershed in Korea's economic reform and accelerate the reform down the road(South China Morning Post, January 18, 1999).

According to the 2011 White Paper on Public Fund Management,(as of end-June 2011) the total public funds injected into KFB was 17.6 trillion won and 12.64 trillion won was recovered[64], with approximately 5 trillion won not recovered, achieving a 71.7% recovery rate. This rate stands similar to the overall public fund recovery rate of around 70%. The total public funds used was 168.6 trillion won and 101.6 trillion won was recovered, which represents a 60% recovery rate, and it is estimated to be around 70% if additional 15 to 20 trillion won to be recovered is added. If rounded up to trillion won, the recovery rates are both around 70%. It is not such a bad result if the recovery rate is 71.7%, with 5 trillion won unrecovered when a bank with 48 trillion won assets was saved.

1.5.2. "Eat and Flee"

Since Newbridge as a financial investor seeks only short-term profits and does not possess experiences in managing a financial company, sale to Newbridge could

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64 KDIC invested 5.0 trillion won, contributed 1.14 trillion won, and acquired assets worth 7.95 trillion won in connection with the put-back option. KAMCO purchased assets worth 2.77 trillion won, and the government contributed 0.75 trillion won. The total was 17.64 trillion won. The recovered amount of 12.64 trillion won included 9.17 trillion won by KDIC, 3.33 trillion won by KAMCO, and 0.14 trillion won by the government.

not achieve the intended goals of bringing in advanced financial techniques and thereby providing a momentum for the domestic financial industry to advance. Instead, it would only enriches the pockets of a foreign, speculative fund.

Opponents of the critics argue as follows. Newbridge Capital is a joint venture set up by two leading US investment firms, Texas Pacific Group and Richard C Blum & Associate. It invests 10 billion dollars as majority shareholders in more than 40 companies, and turned Bank of America and American Savings Bank around to profit after it acquired them in the 1980s.

Newbridge has been making joint investments in partnership with GE Capital, Merrill Lynch and other leading financial companies, and successfully brought KFB back to normal by having a team of high-caliber global financiers take over KFB's management.

In hind sight, acquiring a financial company through a PEF is one of regular investment banking activities. The Korean financial market back then was not capable of coping with problem financial institutions, and liquidation nor injection of public funds was a viable option. In reality, sale to Newbridge was the logical conclusion and attained the original goal of strategic alliance since KFB was sold to Standard Chartered Bank after it made a turnaround.

2. Seoul Bank

Unlike KFB which found the new owner Newbridge, Seoul Bank remained under the government ownership until early 2002 after negotiations with HSBC failed. As the financial market began to stabilize after the sale of KFB and the successful conclusion of the negotiations to roll over foreign debts in New York, the government judged that the market was ready to deal with the consequences even if the talks with HSBC did not bear fruit. Since privatization was part of the agreement with the IMF, Seoul Bank was sold to Hana Bank in a relatively short period of time, which was around 10 months after the resale process began in 2002. Key points in the sale of Seoul Bank are as below.

First, the sale took the form of a merger, and the shares of the new bank were offered as the payment for the deal. The possibility of benefiting from the upside potential was maximized by securing a guarantee of minimum recovery amount and minimizing indemnification. Unlike in the case of Korea First Bank where the put-back option was minimized and 7.95 trillion won of public funds was used to acquire assets in connection with the put-back option, no public fund was involved in the acquisition of Seoul Bank's assets under the put-back option.

From the buyer's perspective, the acquisition had a minimum impact on its liquidity because it paid for the purchase with the new bank's shares instead of cash. Second, Seoul Bank's assets were bigger than those of Hana Bank, but the merged bank was named Hana Bank, which raised some issues associated with a reverse merger. The key issue was corporate tax. In order to get tax benefits including deferred depreciation of corporate tax, Seoul Bank that posted a operating loss should be the acquiring entity. As Hana Bank became the dominant entity, the issue of corporate tax arose. MOFE made the authoritative interpretation that only when the transaction involved parties in a special relationship and was intended to avoid taxes, it would be a reverse merger.

The tax issue was resolved smoothly by successfully arguing that KDIC and Hana Bank were not in a special relationship because KDIC received only preferred shares of the new Hana Bank. Third, Seoul Bank did not fall victim to a fire-sale deal. As the financial market returned to stability, the government took time in raising the efficiency in Seoul Bank's internal operations before it sold the bank to Hana Bank, a domestic strategic investor, instead of rushing to sell the bank to a foreign investor. Selling a bank when the market turns around, can generate considerably large profits, and it is in the national interest to give such an opportunity to a domestic buyer rather than to a foreign buyer. A total of 9.1 trillion won of public funds was provided to Seoul Bank, and 6.44 trillion won or 70.7% was recovered as of the end of 2011. The recovered amounts of public funds were similar for KFB and Seoul Bank, but the domestic buyer Hana Bank reaped the gains from the increased corporate value after the bank's turnaround, instead of a foreign capital taking the fruit away.

2.1. Background

As their financial positions quickly weakened amid back-to-back collapses of large conglomerates such as Hanbo and Kia, KFB and Seoul Bank received a management improvement recommendation issued by the financial regulator on September 5, 1997, but their finances continued to worsen. After the government asked the IMF for a bailout loan on November 21, 1997, depositors were consumed with growing concerns, causing bank runs at the banks. The IMF requested that the two banks be closed down. However, liquidation of the banks was expected to deal a severe blow to the financial market, and the government announced a plan on December 15, 1997, under which public funds would be injected into the banks to stabilize their operations and the banks would be sold to a foreign buyer. The government had no other option because it had to stop the growing concerns among depositors from spreading to the entire financial industry. The Banking Supervisory Board imposed a management improvement request upon KFB and Seoul Bank on December 22, 1997, and due diligence was conducted on the banks in mid-January 1998 in order to assess their financial conditions. Based on the results of the due diligence, and according to the Act on the Structural Improvement of the Financial Industry, KFB and Seoul Bank had their capital reduced, and received 1 trillion won and 500 billion won, respectively on January 31, 1998. The Banking Supervisory Board approved the management normalization plans submitted by the banks. The supply of public funds calmed down worried depositors, thereby deterring a further spread of uneasiness. The government concentrated its efforts on bringing the banks back to normal before it put the banks up for sale to foreign buyers. The government pressed ahead with its plan and sold KFB to Newbridge Capital on December 23, 1999, but negotiations with HSBC on the sale of Seoul Bank fell through. It took 10 months before Seoul Bank was finally sold to Hana Bank in December 2002, after the government established a new plan for the bank's sale in February 2002.

<Table 4-7> A Brief Timeline of the Sale of Seoul Bank

Content	Date
The Public Fund Oversight Committee(PFOC) decided to put Seoul Bank up for a public sale to domestic and foreign buyers.	Feb. 8, 2002
The Seoul Bank Sale Subcommittee selected Goldman Sachs and Samsung Securities as lead managers.	May 9, 2002
Teaser letter was sent out to 32 domestic and international financial institutions.	May 31, 2002
Information memorandum was sent out to 16 institutions at home and abroad.	Jun. 11, 2002
The subcommittee short-listed 3 potential buyers.	Jun. 29, 2002
Final bids were received from 2 potential buyers.	Jul. 31, 2002
PFOC selected Hana Bank as the preferred negotiator.	Aug. 19, 2002
PFOC passed a resolution on the merger	Sept. 13, 2002
The definitive agreement was signed.	Sept. 27, 2002
Seoul Bank cancelled 50% of its shares without payment.	Nov. 26, 2002
Hana Bank's acquisition of the new bank's shares	Dec. 2, 2002

2.2. Sale of Seoul Bank

2.2.1. The Sale Plan

On February 8, 2002, PFOC passed a resolution for the sale of KDIC's shares in banks, and pushed ahead with the plan to sell KDIC's stake in Seoul Bank(around 50%) to potential buyers who had expressed interest in the bank thus far, as well as looking for a healthy bank that would be interested in merging with Seoul Bank.

From April 12 to May 9, 2002, the government appointed Goldman Sachs and Samsung Securities as the lead managers, Shin & Kim as the legal advisor, and Samil as the accounting advisor, contacted potential buyers, and received preliminary bids. On May 31, 2002, the lead managers sent out the teaser letter to 32 institutions around the world, and the information memorandum to 16 institutions at home and abroad on June 11, 2002, on condition that they signed the confidentiality agreement.

<Table 4-8> The List of Recipient Institutions of Information Memorandum

	Institution
Korea(6)	Hana Bank, Chohung Bank, KEB, Dongwon Securities, Dongbu Group, Newbridge & KFB
The U.S. & Canada(1)	JPM Partners
Asia-Pacific(1)	DBS Bank
Europe(1)	Standard Chartered Bank
PEF(6)	Rasa Global Capital Management, Lonestar, HPI, Gilbert Global Equity, Warburg Pincus, Citi Corp Investment, Lombard

On June 27, 2002, preliminary bids were received from 8 domestic and international institutions, and all of the 8 bidders (Hana Bank, Chohung Bank, KEB, JP Morgan Partners, Lone Star, Warburg Pincus, HPI, and Rasa Global Capital Management) wanted to bid independently. On June 29, 2002, the sale subcommittee under the PFOC came up with a short list that included Lone Star, Hana Bank, and JP Morgan Partners, and the 3 short-listed potential buyers conducted a due diligence from July 3 to July 24, 2002. On July 31, 2002, Lone Star and Hana Bank submitted their investment proposals which are summarized in the table below.

The subcommittee reviewed the final proposals of the two interested buyers, and recommended Hana Bank as the final candidate buyer on August 5, 2002.

<Table 4-9> Summary of the Investment Proposals

	Lone Star Fund	Hana Bank
Price	850 billion won (6,958 won per share)	Merger ratio1) Seoul 2.1 : Hana 1 · Estimate by Hana: 8,186~9,005 won per share (→ 1.0~1.1 trillion won)
Payment Method	Cash[2]	Shares of the merged bank
Transaction	○ Acquire 100% stake[3] ○ To hold at least 51% during the 2-year lock-up period.	Merger(Seoul Bank to be the surviving bank)
Other conditions	○ Reasonable reduction in branches and layoff ○ KDIC compensates for the loss that is greater than 1% of the acquisition price for the first 3 years in case there is a violation of the representations and warranties clause(the total compensation limit is up to the acquisition price) ○ If the government does not fulfill its guarantee obligation(90%) on the loan to Russia by September 7, 2002, KDIC will take over the obligation within 30 days after the definitive agreement is signed. ○ All contracts and agreements including MOUs with KDIC should be terminated before the signing of the definitive agreement.	○ Layoff and reduction in branches under the MOU with KDIC prior to the merger(519 employees, 14 branches) ○ KDIC will compensate for losses associated with the lawsuit against KEB on distribution of collaterals pledged by Dong Ah Construction, and losses incurred in a lawsuit involving 10 billion won or more per case(no compensation limit) ○ The merger committee will consist of 4 members from Hana and 2 members from Seoul, and resolutions will be passed with approval of the majority. ○ KDIC will entrust its voting rights to the board, except on matters subject to a special resolution by a general shareholders' meeting. ○ All contracts and agreements with KDIC including MOU will be terminated immediately after the general shareholders' meeting approve the merger.

Notes: 1) KDIC will become the largest shareholder with 29.9%(5.82 million shares) after the merger.
2) Lone Star will pay 10% of the acquisition price 6 months after the definitive agreement is signed, in case of any post-sale losses that may be uncovered
3) Lone Star verbally expressed its intention to acquire only 70% in response to the government's concern about the upside potential.

However, on August 6, 2002, the PFOC postponed the selection of the final candidate, citing inadequacy in the sale conditions, after it accepted the evaluation report from the subcommittee. On August 7, 2002, Lone Start submitted a new proposal where some conditions were revised, citing that the July 31 proposal needed some clarification. Hana Bank also presented a revised proposal on August 13, 2002. On August 14, 2002, KDIC had the lead managers ask Lone Star and

Hana Bank to present any further clarifications if any by 12 pm, August 15, 2002. The final proposals submitted on August 15 offered additional incentives for the buyer.

<Table 4-10> Major Revisions to the Proposals by Lone Star and Hana Bank

	Lone Star	Hana Bank
Price	900 billion won(raised by 50 billion won)	Merger ratio: Seoul 2.1 : Hana 1(1.1 trillion won)
Revisions	- If Seoul Bank reaches 75%(0.87 trillion won) or more of its accumulated net profit target during 2003-2005, Lone Star will pay KDIC 1/2 of the amount in excess of the target within the limit of 350 billion won, one month after the books get closed at the general shareholders' meeting(April 2006).	- Hana Bank guarantees that KDIC can sell its shares in the surviving bank for at least 1.1 trillion won within a year and a half after the date the merger is completed. - The surviving bank will manage the sale of KDIC's shares according to the agreement with KDIC. - If the surviving bank cannot arrange for the sale of the shares within a year and a half, the surviving bank can offer cash or convertible securities(bonds or preferred shares).

On August 19, 2002, the PFOC chose Hana Bank as the final negotiator and Lone Star as the next in line, and requested KDIC to finalize the negotiations on details with Hana Bank as early as possible, report the outcome to the PFOC for a resolution, and proceed to enter into the definitive agreement.

<Table 4-11> Key Points of the PFOC's Guidelines on Negotiations for the Definitive Agreement(August 19, 2002)

- The agreement should include a legal device to guarantee the payment of the minimum amount(1.1 trillion won) offered by Hana Bank within a year and a half from the completion of the merger. - Details of the transaction including the price and indemnification methods should be worked out in the government's favor, in light of corporate tax benefits and other factors.

In evaluating the proposals, the PFOC looked at the price, layoff plans, how the two potential buyers would be able to enhance the value of Seoul Bank, and how they would help the domestic financial industry grow, among other things, and it found that Hana Bank's proposal offered superior conditions.

Specifically, Lone Star offered 0.9 trillion won in cash for Seoul Bank while Hana Bank planned to pay for the deal with the shares in the merged bank, with a guarantee of minimum 1.1 trillion won. Hana's offer was 0.2 trillion won more than what Lone Star was willing to pay. The government also could benefit from the upside potential, i.e., make additional profits from potential rises in the stock price after the merger, which could help maximize the recovery of public funds.

Second, Hana Bank was more likely to create synergy effects as it had a proven record of successfully merging with Boram Bank and Chongchung Bank, as well as its managerial capacity. In addition, Hana's takeover of Seoul Bank was expected to further consolidate the domestic banking sector where too many players were competing. On the other hand, Lone Star as a fund that specializes in taking over impaired assets, did not present itself favorably as a strategic investor. With no experiences in managing a bank, Lone Star was unlikely to produce any tangible results in the short term. In other aspects such as layoff and branch reduction plans, and indemnification, both proposals were rated similarly as they all had a combination of strengths and weaknesses.

Overall, Hana Bank offered better conditions and thus became the preferred negotiator.

2.2.2. Negotiations

Negotiations went on from August 20 to September 12, 2002. KDIC proceeded with the negotiations to work out details for the definitive agreement while simultaneously conducting a due diligence on Hana Bank from August 22 to September 4. KDIC followed the PFOC's guidelines and led the negotiations so that the price and other conditions could be changed in its favor.

On September 13, 2002, KDIC reported the outcomes of the negotiations to the PFOC which adopted the following resolutions.[65]

<Table 4-12> Resolutions by the PFOC (September 13, 2002)

■ The PFOC selected Hana Bank as the definitive buyer. ■ The price and other conditions will be the same as what was reported as the results of the negotiations at the 30th PFOC meeting(except matters relating to the sale of KDIC's shares after the merger). - The PFOC grants KDIC full discretion in handling all the matters necessary for the conclusion of the definitive agreement, except key conditions of the agreement. ■ KDIC will make a separate plan to sell its shares in the merged bank, and the sale will be subject to the review of the sale subcommittee and a resolution by the PFOC. ■ Whether the definitive agreement is concluded or not, KDIC will ensure that Seoul Bank implements its self-reform plan under the MOU that KDIC and Seoul Ban signed.

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65 Generally, the government or KDIC pulls entirely out of the deal once the payment is made for the deal. But in this case, KDIC was paid with shares in the merged bank and became the largest shareholder in the bank so the PFOC set the guidelines for the negotiations.

On September 23, 2002, the sale subcommittee reviewed the plan for privatization of Seoul Bank and sale of KDIC's shares in the bank submitted by KDIC, following the PFOC's resolutions on September 23, 2002, and agreed to the terms and conditions of the definitive agreement, officially concluding the merger.

2.2.3. Conclusion of the Definitive Agreement and Closing

On September 27, 2002, the two parties entered into the definitive agreement as follows.

The merger ratio is 2(Seoul): 1(Hana), and Seoul Bank will be the surviving entity. KDIC will receive shares of the merged bank for payment, with the guarantee that it will be paid at least 1.15 trillion won for the shares in 18 months from December 2, 2002 when it disposes of the shares. KDIC can appoint one outside director(to the Audit Committee) and transfers all of its voting rights to the board of the merged bank, except on special resolutions by a general shareholders' meeting and appointment of one outside director. KDIC secured the guarantee that it will be paid at least 1.15 trillion won for its shares when it disposes of them after 18 months from the date the merged bank is registered. KDIC and Hana Bank will work out the details on how KDIC's shares will be disposed of, and finalize the details before the general shareholders' meeting will be convened to approve the merger, so that the final details cab be added to the definitive agreement. If the BIS capital adequacy ratio falls below 8.5% due to share buy-backs, KDIC will acquire the redeemable preferred shares within the set limit. If KDIC arranges for itself to sell its shares, which will changes the largest and second largest shareholders in the merged bank, the bank will have the right of first refusal.

A general shareholders' meeting was held to approve the merger on November 14, 2002, and the capital of Seoul Bank was reduced by half without payment. The registration of the new bank was completed on December 2, 2002, and acquired 61,080,000 shares in the new bank on the same day.

2.3. Post-Merger Management

Public funds that were injected into Seoul Bank were recovered by selling the shares in the new bank. Under the terms of the sale contract, 30% of KDIC's shares(9.3% of Hana Bank shares or 18.32 million shares0 were sold in two transactions on December 23, 2002 and March 3, 2003, retrieving 345 billion won. The remaining 70% stake(21.6% of Hana Bank's shares or 427.6 million shares) was sold for 1,071 billion won in a bloc sale on April 14, 2004. With the disposal of the entire stake held by KDIC, Seoul Bank was privatized earlier than scheduled, and KDIC recovered a total of 1,416 billion won, 314.9 billion won more than the minimum amount of 1,150 billion won that Hana Bank guaranteed.

<Table 4-13> Sales of Hana Bank's shares hed by KDIC

Date	Ratio(%)	No. of shares (10,000 shares)	% of all Hana's shares	Price per share (won)	Amount (billion won)
Dec. 23, 2002	10	611	3.1	18,830	1,15
Mar. 3, 2003	20	1,222	6.2	18,830	2,30
Apr. 14, 2004	70	4,276	21.6	25,050	1,071
Total	100	6,108	30.9		1,416

2.4. Major Issues

In 2007, tax issues were brought to the force as corporate tax was due in connection with the merger. Whether the depreciation of corporate tax could be deferred or not depended on which of the two banks was the surviving entity after the merger. Logically, Seoul Bank that posted a net loss should be the surviving entity so that the corporate income could be depreciated over years, but the new bank was named Hana Bank to retain its brand value. So the tax authority had to levy taxes on the new bank. The tax authority imposed 1.7 trillion won including a fine for defaulting on taxes over the previous 5 years, and Hana Bank raised an objection. The tax authority referred the issue to the Ministry of Finance and Economy for authoritative interpretation. According to the MOFE's interpretation, “when a transaction between parties in a special relationship is intended to avoid taxes, it can be a reverse merger,” and since KDIC held 35% of Hana Bank's preferred shares, they were considered as specially-related parties. Following the MOFE's interpretation, Hana Bank filed a request for a review of the legality of the taxation, and the tax authority held a committee meeting including civilian members from private sector to review the legality of taxation. The committee ruled that the transaction between KDIC and Hana Bank did not constitute a transaction between specially-related parties because preferred shares did not have voting rights. Instead, the committee concluded that the merger was part of a restructuring. The minutes of the PFOC meeting that passed the resolution of the merger indicated that the government took corporate tax exemption for granted because the minutes recorded that the PFOC asked KDIC to work out a most favorable price, in consideration of corporate tax exemption.

The tax issue could have evolved into a major political controversy if handled inappropriately. Still, it was resolved smoothly without causing any trouble to any of the government officials involved in the deal or parties to the deal because initially, all of the government authorities including the tax authority and MOFE ruled in favor of taxation and subsequently, the tax exemption was found valid in a review by the committee that had civilians as its members.

3. Chohung Bank

The sale of Chohung Bank offers the following lessons. First, the government worked out multiple devices to take advantage of the upside potential. For example, cash, shares of the buyer, and an earn-out arrangement were combined. A guarantee of a minimum value was added in the agreement, and the buyer's shares that were received as part of the payment consisted of both redeemable preferred shares and convertible redeemable preferred shares, thus creating a structure in which the government as the seller could gain additionally from the transaction. Second, the merger with Shinhan Financial Holding Company brought two positive effects: any profits from a turnaround were retained within the country, as opposed to a sale to a foreign buyer which would likely entail outflows of profits. The merger of Shinhan and Chohung created a mega bank with economies of scale. Third, the managements of the two banks remained sharply divided and in conflict in the process of combining the two banks physically and organically, which could have been better handled. The chairman and the president of the holding company, and the president of Shinhan Bank all resigned simultaneously amid a power struggle for the succeeding leadership of the new bank. If the regulators predicted the problem early on and handled it better, the unfortunate simultaneous resignation that damaged the corporate value could have been avoided. If a succession plan had been clearly required in advance like it is now in the CAMELS ratings system, the succession would have been done smoothly according to a transparent set of procedures, and the dishonorable resignation of the 3 leaders would have been avoided.

3.1. Background

At the end of 1999, Chohung acquired Chungbuk Bank and Kangwon Bank and returned to normal with the injection of public funds. Two years later on August 6, 2002, the PFOC decided to sell the government's stake in the bank. It took about one year before all the payments for the shares sold were received, and the sale process proceeded according to the plan without a glitch. The table below shows the major milestones in the timeline of the sale.

<Table 4-14> Timeline of Chohung Bank Sale

Content	Date
The PFOC decided on a public sale of Chohung Bank to domestic or foreign buyers.	Aug. 6, 2002
Morgan Stanley and Samsung Securities were selected as the lead managers.	Sept. 23, 2002
The teaser letter was sent out to 47 potential buyers at home and abroad.	Oct. 2, 2002
The information memorandum was sent out to 15 domestic and foreign institutions.	Oct. 11, 2002
The sale subcommittee short-listed 4 interested buyers.	Oct. 25, 2002
The final bids were received from 2 interested buyers.	Dec. 2, 2002
The PFOC selected Shinhan Financial Holding Company as the preferred negotiator.	Jan. 23, 2003
The PFOC selected Shinhan as the definitive buyer.	Jun. 19, 2003
KDIC approved the sale contract.	Jul. 9, 2003
The definitive agreement was signed.	Jul. 9, 2003
The shares were transferred and the payment was received.	Aug. 18~19, 2003

3.2. The Sale Process

3.2.1. Selection of Preferred Negotiator

On August 6, 2002, the PFOC decided to sell Chohung Bank to a strategic investor while simultaneously seeking to sell it to a domestic institutional investor in an OTC transaction in case it would fail to find a strategic investor to buy the bank. A strategic investor means an investor who buys the stake in the bank for the purpose of a strategic business alliance or business expansion, rather than seeking a return on the investment. On September 3 to 23, 2002, KDIC selected Morgan Stanley and Samsung Securities as the lead managers, Shin & Kim as the legal advisor, and Deloitte An Jin as the accounting advisor. On October 2, 2002, the lead managers contacted 88 potential buyers around the world, sent out the teaser letter to 47 of them, followed by the information memorandum sent out to

15 domestic and foreign potential buyers on October 11, 2002, on condition that they signed the confidentiality agreement.

<Table 4-15> The Recipients of Information Memorandum

	Institutions
Korea	Shinhan Financial Holding Co., Dongwon Securities, Samsung Life Insurance (3)
The U.S. & Canada	JPM Partners, AIG Investment Corp (2)
Asia-Pacific	Shinsei Bank , Fubon (2)
Europe	ABN Amro (1)
PEF	HPI, PAMA, Cerberus, Gilbert Global Equity, Newbridge Capital, Warburg Pincus, Lombard (7)

On October 23, 2002, preliminary bids were accepted from 8 institutions. Shinsei Bank, Cerberus, ABN Amro, Fubon, Newbridge Capital, AIG Investment Corp, and HPI tendered individually and only Shinhan Financial Holding Company formed a consortium.

On October 25, 2002, the sale subcommittee short-listed Cerberus, Shinhan, Shinsei Bank, and ABN-Amro Capital. The four short-listed potential buyers conducted due diligence on Chohung Bank from October 25 to November 30, 2002, but the due diligence was obstructed by the labor union and some of the information was not available for the due diligence.

On December 2, 2002, two bidders submitted an investment proposal. Cerberus and Shinsei Bank made a joint bid and KFB joined the consortium led by Shinhan Financial Holding Company.

From December 11 to 26, 2002, the PFOC held 4 sale committee meetings to evaluate the proposals and select the preferred negotiator. In the first meeting on December 11, 2002, the committee reviewed the proposed plan on the selection of the preferred negotiator, and was briefed on the progress in the privatization of Chohung Bank and the proposals of the two consortiums. The second meeting on December 17, 2002 focused mainly on a review of the analytic information compiled by the advisors in connection with the selection of the preferred negotiator. The information package prepared by the advisors included ①additional briefing on the final proposals of the two consortiums, ② an analysis of the dilution effects on the stock value, of the issuance of new shares by Shinhan Financial Holding Company, ③ an analysis of the expected synergy effects from the merger of Shinhan and Chohung, ④ the expected effects on the growth of the domestic banking industry, and matters relating to the merger, ⑤ possible uses of the deficits carried over, and the effects of the fixed assets' revaluation on the net asset value, and ⑥ a comparative analysis of the terms and conditions of the two deals: Shinhan's offer for Chohung vs. Hana Bank's offer for Seoul Bank. The third meeting was held on December 23, 2002 and the discussions centered around the valuation of Chohung Bank and projections. Specifically, the meeting discussed ① additional analysis of Shinhan's offer, ② the results of Chohung's valuation by different methods, ③ Chohung Bank's earnings forecasts made by Chohung Bank itself and the advisors, ④ a post-merger market share forecast and an analysis of sensitivity to synergy value, and ⑤ an analysis of the value of the conversion option for convertible preferred shares. The fourth meeting held on December 26, 2002 discussed the results of the deliberation on the final winning bidder and decided to recommend the consortium led by Shinhan Financial Holding Company for the preferred negotiator to the PFOC.

<Table 4-16> Comparison of the Two Consortium Bids

	Cerberus	Shinhan
Stake to be purchased	51% of the total issued shares	80.04% of the total issued shares (the entire stake held by KDIC)
Payment & Price	○ To pay entirely in cash * Up to 5,000 won per share - On condition of compensation for additional losses that may be uncovered after the final due diligence (Details on how the compensation was going to be made was not provided)	○ For 51%: cash payment(6,150 won per share) - The price can be adjusted within the 10% range after the final due diligence. ○ For 49% : to be paid for with the shares of Shinhan Financial Holding Company (Common shares: 25%, redeemable convertible preferred shares: 24%) * Exchange ratio: Chohung 1 : Shinhan 0.3428 ○ The cash payment ratio and the ratio of preferred shares can be increased.
Major terms & conditions	○ Requested that additional losses that may be uncovered after the exclusive final due diligence should be compensated for. ○ No specific mention of representations and warranties.	○ KDIC should compensate for losses in the following cases. - Common violations of the representations and warranties, worth 5 billion won or more - Losses on loans sold to KAMCO, redemptions on ABS, bonds issued by the Russian government, principal-guaranteed beneficiary certificates(including those sold by Chohung Investment Trust) 1) - The compensation limit is up to the acquisition price, and it will be valid for the first 3 years after the acquisition(one year after the ruling in case of lawsuits and 5 years for tax and environmental issues).

Note (1) : Shinhan verbally expressed its intention that it might exclude KAMCO-related loans and Russian bonds.

On January 23, 2003, the PFOC selected Shinhan as the preferred negotiator and set the guidelines on the negotiations. The guidelines were intended to maximize the recovery of public funds by revising the terms and conditions of the deal in favor of the government, the seller, to work out ways to ensure the negotiations would be conducted on a fair and equal footing, to have a third party other than the managers carry out a valuation(intrinsic value and acquisition value) and use the valuation in determining the final price, and to report the results of the negotiations upon completion to the PFOC, before entering into the definitive agreement.

On February 18, 2003, Shinhan Accounting Corp.(not at all related to Shinhan Financial Holding Company) was hired as the third valuator in order to increase fairness and transparency in the sale process, and An Jin and Samjong as the consultative companies. Shinhan Accounting Corp. conducted the valuation form February 26 to April 25, 2003 and the sale subcommittee reviewed the valuation results on June 9, 2003.

3.2.2. Negotiations and the Definitive Agreement

Under the PFOC's guidelines, KDIC carried out negotiations with Shinhan from April 2 to June 14, 2003. The discussions on the price began on April 29 and KDIC worked out changes to the terms and conditions of the transaction in its favor. On June 19, 2003, the PFOC was briefed on the outcome of the negotiations and decided that Shinhan would be the definitive buyer. The deal was fine-tuned in further negotiations from June 20 to July 6, 2003.

<Table 4-17> Summary of the PFOC's Decisions(June19, 2003)

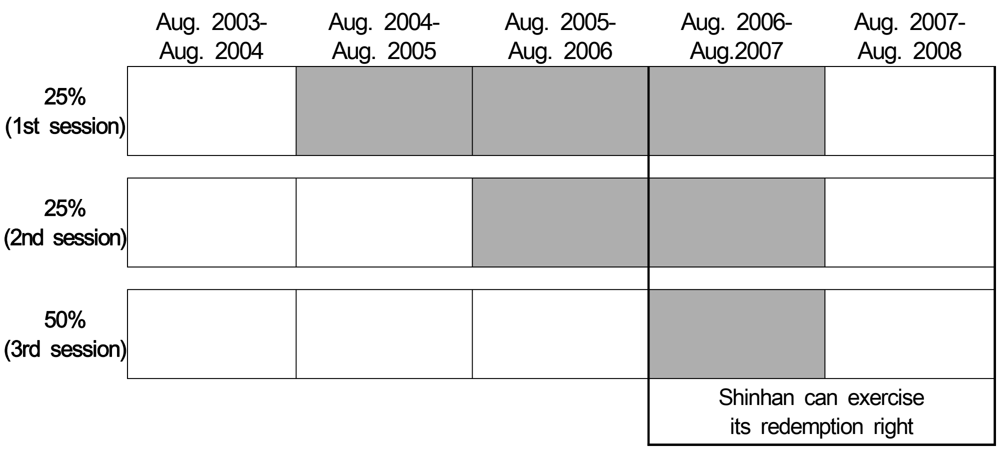
☐ KDIC will sell its Chohung Bank shares on the terms and conditions agreed upon in the negotiations with Shinhan as reported to the PFOC. ○ With one revision to the earn-out arrangement: Shinhan will pay KDIC 20% of the amount exceeding 1.8 trillion won in net profit for 3 years(2004 to 2006). ☐ Shinhan will be responsible for setting up a post-merger management plan including employment by negotiating and settling issues with related parites, and KDIC will report the results to the PFOC after everything is settled. ○ KDIC will have full discretion in negotiating details of the deal and entering into the definitive agreement with Shinhan, on behalf of the PFOC.

According to the definitive agreement, 543,570,144 common shares(80.4% of the total issued shares) of Chohung Bank held by KDIC are sold for up to 3,370.1 billion won(subject to change according to the post-merger compensation), based on the valuation the preferred shares of Shinhan Financial Holding Company. Cash payment for KDIC's 51% shares will be 1,718.8 billion won and 900 billion won of the amount will be paid first before the closing date. The remaining 818.8 billion won will be paid 2 years from the closing date and be offset by indemnifications that may arise, in which case KDIC will be entitled to an annual 4.3% rate on the remaining amount to receive. In the share exchange transaction which enables KDIC to potentially gain additional profit in the future, KDIC will receive 91,304,564 shares for its 49% stake in Chohung Bank. The exchange ratio will be one common share of Chohung for 0.3428 preferred shares of Shinhan, with the redemption price of 18,086 won per share. The preferred shares of Shinhan that KDIC will receive includes 44,720,603 redeemable convertible preferred shares(24% of KDIC's stake) and 46,583,961 redeemable preferred shares(25% of KDIC's stake). The details on the structure and redemption of the preferred shares will be stipulated in the investment agreement. The acquisition of the preferred shares means that KDIC the seller has the potential for additional profits. In other words, there is an upside potential for capital gains when preferred shares are converted into common shares. In fact, KDIC sold the common shares converted from the preferred shares in a bloc transaction on April 11, 2006 for 46,600 won per shares, gaining a profit of 28,514 won per share, compared to the redemption price of 18,086 won. Another device that KDIC included in the deal to secure a source of additional profits is the earn-out arrangement under which KDIC can get 20% of the amount exceeding 1.8 trillion won in Chohung's accumulated net profit for the 3 years from 2004 to 2006. In order to supervise the earn-out arrangement, KDIC can appoint one outside director into the board of Chohung Bank until the end of fiscal year 2006.

The closing date will be September 30, 2003 and Shinhan can pay in cash and with its preferred shares. KDIC will convene a general meeting of Chohung's shareholders after it receives Shinhan's preferred shares, and will guarantee Shinhan's managerial control by allowing Shinhan to nominate all of the directors to the board. KDIC will compensate for particular assets after the merger and the assets eligible for compensation will be limited to credit to top 10 problem companies(Hynix, SK Global, Hyundai Merchant Marine, Kumho Industrial, Tiger Pools Korea, Yong Pyong Resort, Hankook Synthetic Textile Co., Incheon Oil Refinery, and Hyundai Corp. and including KAMCO-related assets), and credit card assets. KDIC will set the criteria for indemnification and compensate for only the amount that exceeds the criteria. The compensation ceiling will be 652 billion won which will be split into 385 billion won for credit card assets and 267 billion won for credit to the problem companies including KAMCO, and the two amounts can be traded within the limit of 10% of the total ceiling. The compensation obligation will be effective for 2 years after the closing date(one year for credit card assets except refinancing loans, and it will be made in cash, with an annual 4.3% rate applicable on the remaining amount payable to KDIC. For other claims for post-merger compensation that amount to more than 100 million won per case, if the sum of all claims is more than 15 billion won, only the amount in excess of 15 billion won will be paid. For claims worth 100 million won or less per case, the entire sum of the claims will be paid if the sum exceeds 20 billion won.

The major contents of the investment agreement are as follows First, the redeemable convertible preferred shares(RCPS) that will be issued to KDIC will be 44,720,603 shares and the ratio will be one Chohung common share to 0.3428 preferred share. The issuing price or redeemable price will be 18,086 won per share, with a dividend of 365 won per share(2.02% dividend rate). The shares will be junior to bonds and other preferred shares in redemption and dividend payment and senior to common shares. The conversion and redemption schedule is as below.

<Table 4-18> Conversion and Redemption Schedule for Shinhan's RCPS



KDIC can exercise its conversion right in the gray-colored periods( ) while Shinhan can redeem the shares only in the 4th and 5th years. In the 5th year, Shinhan must redeem the shares and pay KDIC 808.8 billion won. If the profit available for dividend is not enough to cover the redemption, the redemption can be postponed until sufficient profit can be made. KDIC will exercise its conversion right on its common shares in Shinhan Financial Holding Company as early as possible. If KDIC retains all of the shares, its shareholding ratio will rise to 3.38% in August 2004, 6.54% in August 2005, and 12.28% in August 2006. If KDIC's stake exceeds 4% after the conversion, it can nominate one outside director.

<Table 4-19> KDIC's Shareholding Ratio upon Conversion

	Aug. 2004	Aug. 2005	Aug. 2006
No. of common shares	11,180,151	22,360,302	44,720,603
Ratio	3.38%	6.54%	12.28%

The redemption schedule for Shinhan's redeemable preferred shares is as below.

<Table 4-20> Redemption Schedule for Shinhan's Redeemable Preferred Shares(shares, billion won)

	Aug. 2006	Aug. 2007	Aug. 2008	Aug. 2009	Aug. 2010	Total
No. of shares to redeem	9,316,792	9,316,792	9,316,792	9,316,792	9,316,793	46,583,961
Amount	168.5	168.5	168.5	168.5	168.5	842.5

Shinhan was guaranteed the right of first refusal in case KDIC intended to sell its Shinhan shares. Shinhan secured the right to buy all of KDIC's RCPS or the RCPS-converted common shares, with a 30-day exercise period. If Shinhan would not exercise the right of first refusal, KDIC would be free to sell the shares on the terms and conditions agreed upon with Shinhan in the next 90 days.

<Table 4-21> Transfer Restrictions in the Investment Agreement

○ KDIC cannot sell 25%(11,180,151 shares) or more of its RCPS to a single buyer, without a prior consent of Shinhan. ○ KDIC cannot transfer its RCPS to a single buyer who holds 4% or more common shares of Shinhan. * Not applicable to converted common shares

As for the redeemable preferred shares, the following conditions will apply. The redemption price will be 18,086 won per share(based on 6,200 won per Chohung's share), and the redemption period will be 7 years. From the end of the third year, equal amounts will be paid each year, and 168.5 billion won will be paid each year. The dividend rate will be 4.04% per year, and if there is no profit available for dividend, the payment will be made in the accumulated amount in the year that generates enough profit for dividend payment.

If the redeemable preferred shares are converted, KDIC's shareholding ratio will be at least 4%. So KDIC will exercise its voting rights on matters that should be decided by a special resolution or approved at a general shareholders' meeting, matters on dividend, and nomination of KDIC-recommended outside director.

Redeemable preferred shares do not carry voting right, but if KDIC does not receive dividend due to insufficient profit, KDIC will be allowed to exercise a voting right on the preferred shares as if they were common shares.

The agreement requires Shinhan to exert its utmost efforts to ensure that the preferred shares will be redeemed within the set time frame. Shinhan cannot pay more than 750 won per share in dividend on common shares in the years the net profit falls below 800 billion won so that profit available for dividend on preferred shares can be secured. KDIC cannot transfer 25% or more of its RCPS to a single buyer so as to protect Shinhan's managerial control.

3.2.3. Closing

The deal was closed on August 18-19, 2003. The stock acquirer was Shinhan Financial Holding Company and the stake sold was 80.04% which was all of the shares held by KDIC. The payment was in cash. Of the total cash payment of 1,718.8 billion won, 900 billion won was paid on August 19, 2003, and the remaining 818.8 billion won was to be paid later after the post-merger compensation would be subtracted from the amount, within the limit of 652.2 billion won. The payment for the preferred shares was split into 808.8 billion won for Shinhan's 44,720,603 RCPS and 842.5 billion won for 46,583,961 RPS. The redemption price for RCPS was set for 18,086 won per share and the dividend for 365 won per share. The redeemable preferred shares would be converted at the price of 18,086 won per share and the dividend was determined at 730 won per share. The payment details are summarized in the table below.

<Table 4-22> The Payment Structure for Chohung Bank Sale

☐ **Total price : 3,370.1 billion won**

○ **Cash : 1,718.8 billion won**

- **900.0 billion won** : paid on the closing date(Aug. 19, 2003)
- **818.8 billion won** : to be paid after the post-merger compensation is made within the limit of 652.2 billion won

○ **Preferred shares : 1,651.3 billion won**

- **Shinhan's RPS: 808.8 billion won**(44,720,603 shares)
  - * Redemption price: 18,086 won per share, the dividend: 365 won
  - * Conversion Schedule

	Conversion Period	Note
1st(25%)	From Aug. 2004	To be sold in April 2006 after conversion
2nd(25%)	From Aug. 2005	
3rd(50%)	From Aug. 2006	If not converted, Shinhan can redeem the shares from Aug. 2006 to Aug. 2008.

- **Shinhan's RPS* : 842.5 billion won**(46,583,961shares)
  * Redemption price: 18,086 won per share, the dividend: 730 won per share
  * Redemption Schedule

	Redemption Period	Note
1st(20%)	Aug. 2004~Aug. 2006	Shinhan Financial Holding Co. should redeem the shares with the profit available for dividend during the set periods.
2nd(20%)	Aug. 2005~Aug 2007	
3rd(20%)	Aug. 2006~Aug 2008	
4th(20%)	Aug. 2007~Aug. 2009	
5th(20%)	Aug. 2008~Aug. 2010	

3.3. Major Issues

3.3.1. Shinhan did not have the cash to buy Chohung Bank

Shinhan agreed to pay 51% of the total price in cash. Of the total cash payment, 900 billion won was raised via issuance of preferred shares, and the rest of the cash payment was scheduled to be made after 2 years. The remaining 49% of the price was paid with redeemable preferred shares and redeemable convertible preferred shares. This payment structure raised the question if Shinhan actually had enough cash to take over Chohung. However, the cash payment was as much as 1.7 trillion won which was such a large amount that could not be channeled within a short period of time. If the amount of cash was to be raised in the market, the issuing conditions would be very unfavorable. Given these conditions, the two parties agreed to a delayed payment that was customarily used in a large-scale stake sale, with part of the payment to be made with shares. This payment structure is not unusual in other M&A deals, and ultimately, Shinhan had to redeem the preferred shares under the payment structure.

3.3.2. Controversy Over Price

Shinhan agreed to pay a total of 3.4 trillion won or 6,200 won per share for Chohung Bank. Given the price, Chohung was sold on a 84% premium over the book value which was 3,375 won per share as of end-2002, and on a 56% premium over the closing price of 3,980 won per share on July 9, 2003. In addition, the government ensured that it could gain further if Chohung Bank would make profits and if Shinhan's stock price would rise in the future. It is a much better deal than originally offered by Shinhan. In the first bid, Shinhan offered only 5,500 won per share and the final price of 6,200 won is around 700 won per share or 370 billion won more than the first-offered price. In the first bid, Shinhan offered a total of 3 trillion won or 5,520 won per share. And for KDIC's 51%

stake it offered 6,150 won per share(may be lowered within the 10% limit, after the final due diligence, and the remaining 49% shares would be exchanged at the ratio of 1 Chohung share for 0.3428 Shinhan share(based on market price).

KDIC renegotiated the price and raised the final price to 3.37 trillion won or 6,200 won per share. Shinhan agreed to pay 6,200 won per share in cash for the 51% shares, and the 49% would be paid for with shares with the same exchange ratio of 1 Chohung to 0.3428 Shinhan, but with the guarantee of 6,200 won per share. Analysts agreed that the price was not below the fair value, and the merger would likely produce positive synergy effects.

3.3.3. 3rd Party Evaluator and the Evaluation Results

On January 23, 2003, the PFOC selected Shinhan as the preferred negotiator and at the same time, asked KDIC to hire a third party evaluator to assess the value of Chohung Bank so as to come up with a fair price and to preclude any potential controversy over the price. The PFOC also asked KDIC to maximize the use of the evaluation results in determining the price. KDIC formed the 3rd party evaluator selection committee and accepted the bids for review. As a result, Shinhan Accounting Corp.(not related at all to Shinhan Financial Group) was selected. In addition, Chohung's external auditor An Jin and Shinhan's external auditor Samjong got involved as consultative institutions. The selection committee was composed of five members including 3 outside experts, one Chohung director and one KDIC director.

The evaluation results were fully respected and put to maximum use. The results of the due diligence and valuation by Shinhan Accounting Corp. were used in every aspect. The price negotiations were largely based on the model, hypothesis, estimate and evaluation of Shinhan's valuation. by Shinhan. Based on the due diligence by Shinhan Accounting Corp. KDIC decided to compensate for post- merger losses beyond Shinhan's estimate, up to 652.2 billion won. Instead, the price was adjusted up to 6,200 won per share, also according to the valuation by Shinhan.

The price Shinhan Financial Holding Co. initially offered in the December 2, 2002 investment proposal was 5,520 won, and the advisors came up with the prices that ranged from 4,800 won to 6,400 won at the sale subcommittee meeting on December 26, 2002. The third party evaluator Shinhan suggested the price be between 5,929 won and 6,967 won in the stock valuation report dated April 25, 2003. Shinhan Accounting determined that the net worth of Chohung was 2,387 won, which was lower than 2,980 won estimated by the advisors, but the intrinsic value was estimated between 5,929 won and 6,967 won, which was higher than what the advisors provided.

Based on the profit forecast by Shinhan Accounting, KDIC added the earn-out arrangement under which it would receive 20% of the amount in excess of 1.8 trillion won in net profit during the 3 years from 2004 to 2006, because the excess profit can be attributed to the synergy effects of the merger.

3.3.4. The Agreement between KDIC, Shinhan Financial Holding Co. and Chohung Bank's Labor Union

When the PFOC decided on the preferred negotiator on January 23, 2003, it passed a resolution that ensured objectivity and fairness in the process of integrating the two banks on an equal footing in such areas as workforce coordination and branch rationalization.

The PFOC further crystalized this resolution when the PFOC adopted the resolution to sell Chohung Bank to Shinhan on June 19, 2003. According to the resolution, Shinhan was allowed to negotiate with related parties on the post-merger management plan including succession of employment, and KDIC was required to report the results to the PFOC after the fact. On June 22, 2003, KDIC, Shinhan Financial Holding and the labor union of Chohung Bank reached an agreement to this end. Under the agreement, KDIC was responsible for ensuring a smooth sale as the shareholder and the seller. Upon completion of the sale, KDIC would be no longer a shareholder and thus agreed to steer clear of labor-management issues. Instead, the labor union and the management would resolve issues through negotiations and consultations. The details of the agreement were reported to the PFOC and approved as reported on November 18, 2003.

There were media reports about a possible meeting between the president elect and the leadership of Chohung Bank's union, but eventually, the deal was struck according to the plan, without any significant changes to the plan such as a takeover by the union as the union demanded.

3.3.5. Payment with RPS and the Impact on Recovery of Public Funds

KDIC received RCPS convertible to common shares, as part of the payment(3.4 trillion won) for the sale of Chohung Bank. The receipt of RCPS guaranteed the minimum amount(18,086 won per share) and offered the possibility of additional gains from rising stock prices, depending on Shinhan's performance. If all of the payment is made in cash, the payment will be made immediately, but the opportunity for synergy effects and additional gains from stock price increases will be lost. KDIC received shares instead of cash, but the minimum price was guaranteed while future profits were to be shared, with the option of converting the

RCPS to common shares.

Of the RCPS, 22 million shares that were converted into common shares in November 2005 were sold in a block sale in April 2006 at the closing price of 46,600 won per share without a discount, creating 28,514 won of additional profit per share or 2.6 times more than the guaranteed price. So the stock exchange deal served both of the originally intended purposes: sharing the upside potential from the rising share price and maximizing the recovery of the public funds.

<Table 4-23> Financial Support for Chohung Bank and Estimated Amount to Be Recovered(unit: trillion won)

Public Funds Injected (A)	Recovered amount(B)			Estimated amount to be recovered(C)			Sum of recovered amounts (D=B+C)	Amount in excess of the injected amount(D-A)
	Recovered cash amount	Proceeds from April 2006 sale	Subtotal	Redeemable preferred shares*	Remaining RCPS	Subtotal		
2.7	1.3	1.0	2.3	0.8	1.0	1.8	4.1	1.4

Note: * Based on the assumed price of 46,600 won, the block sale price(scheduled for conversion into common shares in August 2006)

3.3.6. Controversy on Bank 1 Strategy

According to Bank 1 strategy, when two companies merge, they keep their corporate personality and their own business operations as they integrate physically and organically in phases. It was discussed as a topic for a class at Harvard business school. The strategy ran counter to the argument that the physical integration should be completed swiftly first and then the organic or chemical integration such as CI should be pursued. Bank 1 was discarded at an extraordinary general shareholders' meeting and the management behind it stepped down.

What is regrettable about this incident is that if there was no clear succession plan in connection with the consecutive appointment of the chairman, the financial regulator should have ensured that the company was rated unfavorably in the CAMELS rating system and it also should have tightened the supervision to make sure that the succession plan was strictly followed. If the CAMELS rating system had been revised after this incident, the chairman, the president of the holding company, and the bank's president would have not stepped down simultaneously in December 2010 in connection with the succession to the chairman, causing serious damages to the corporate value.[66]

3.4. Most-Merger Management

The sale was completed by selling Shinhan's shares offered as part of the payment in a block sale. The shares were disposed of in two session of block sale in April 2006 and February 2007. The block sales were summarized in the tables below.

<Table 4-24> The 1st Block Sale

Content	Date
Acquired common shares by exercising the conversion right on RCPS	Nov. 28, 2005
The PFOC decided to sell Shinhan's shares	Dec. 30, 2005
The sale subcommittee decided on selecting the managers for the sale of Shinhan's shares.	Feb. 7, 2006
The managers were selected(UBS & Korea Investment & Securities)	Feb. 24, 2006
The PFOC decided on details on the sale of the shares	Mar. 15, 2006
The shares were sold in a block sale.	Apr. 11, 2006
The shares were transferred and the payment was received.	Apr. 13, 2006

<Table 4-25> The 2nd Block Sale

Content	Date
Acquired common shares via conversion of RCPS	Aug. 21, 2006
The PFOC decided on the sale of Shinhan's shares and selection of managers	Dec. 22, 2006
Citigroup and Samsung Securities were selected as managers.	Jan. 25, 2007
The PFOC decided on details of the sale.	Feb. 9, 2007
The shares were sold in a block sale.	Feb. 23, 2007
The shares were transferred and the payment was received.	Feb. 27, 2007

The first block sale went as follows. First on November 28, 2005, the share price doubled the conversion price(18,086 won per share) guaranteed by Shinhan, and a total of 22.36 million shares or 6.22% of RCPS were converted into common shares. On December 30, 2005, the PFOC decided to sell the shares, and planned to sell all of the common shares held by KDIC(22 million shares) within

66 The succession plan requirement was incorporated into the CAMELS rating system belatedly when the Regulations on the Banking Supervision were revised in August 2012.

the first quarter of 2006. Shinhan Financial Holding Co. renounced its right of first refusal and the two parties agreed to the following. KDIC agreed to sell 10-20% of the converted common shares in a boc sale, and the rest of the shares would be sold to the investor(s) designated by Shinhan in a block sale at the same price.

On March 15, 2006, the PFOC determined the details of the sale plan such how, when, and how many of the shares would be sold, and what the minimum price would be. Under the sale plan, KDIC swiftly set the internal guidelines, and decided to execute the sale when the demand was high enough according to the consultations with the managers. On April 10, 2006, KDIC determined that there was sufficient demand for the shares, confirmed the closing price of the day which was 46,600 won per share, and had the managers receive the orders from institutional investors from home and abroad, and assign the shares after the market was closed. Before the opening of the market on April 11, the managers completed the block sale by entering KDIC's sell order and the buy orders from investors into the block sale trading system of Korea Exchange. On April 13, KDIC recovered 1,038.9 billion won in total by selling its 6.22% stake or 22,360,302 shares for 46,600 won per share(with 0% discount from the closing price of the previous day). Retail investors bought a total of 10% or 2,236,030 shares and the friendly investors designated by Shinhan purchased the remaining 90% (20,124,272 shares).

The second block sale took place in February 2007. As the price went above Shinha's guaranteed price, KDIC converted the remainder of 22.36 million RCPS(5.86%) into common shares on August 21, 2006. On December 22, 2006, the PFOC decided to sell all of KDIC's 22 million common shares within the first quarter of 2006, and dispose of the shares subject to the right of first refusal in the same way as the first block sale in consultations with Shinhan. In other words, 10% would be sold in a block sale, and the rest of 90% to the investors designated by Shinhan. On February 9, 2007, the PFOC determined the details of the sale conditions including the deadline which was within the first quarter of 2007, the minimum discount rate, and the minimum sale price. Since making a timely decision was crucial for a successful sale, KDIC swiftly set the internal guidelines including the price and other details, and had the managers report the market conditions on a daily basis in order to find an optimal time for the sale. The composite stock index reached a record high on February 22, 2007, and Shinhan's share also rose to a new high, closing at 57,500 won per share on the same day. In light of the market trend, KDIC decided to sell the shares, and the managers carried out the block sale before the market opened on February 23. KDIC's 5.10% (19,446,312 shares) was sold for 57,500 won(0% discount from the previous day's closing price), garnering 1,114.8 billion won. Retail investors took over 10%(2,236,030 shares), the Shinhan-designated investors 77%(17,210,282 shares), and 13%(2,913,989 shares) remained unsold because Shinhan failed to designate the investors to buy those shares. Of the 2.7 trillion won of public funds injected into Chohung Bank, 1.3 trillion won was retrieved in cash, and 2.5 trillion won was recovered in the two block sales, totaling 3.8 trillion won in the recovered amount. With the sale of the remaining RPS and common shares, approximately 4.4 trillion won was expected to be recovered, which was much more than the public funds used on the bank.

<Table 4-26> Public Funds Injected into Chohung Bank and Recovered Amounts (trillion won)

Public funds injected (A)	Recovered (B)				Estimated recovery in 2008 and after			Total recovered amount (D=B+C)	Amount in excess of the injected amount (D-A)
	Cash	Proceeds from sale of common shares	RPS	Subtotal	RPS	Remaining common shares	Subtotal		
2.7	1.3	2.2	0.3	3.8	0.5	0.1	0.6	**4.4**	**1.7**

KDIC sold 90% of the shares to Shinhan-designated investors in the block sales because it was part of the agreement when it sold Chohung Bank in August 2003, i.e., if KDIC would convert its RCPS into common shares and sell them, Shinhan would get the right of first refusal and if Shinhan would not exercise the right, KDIC would sell the shares to the investors designated by Shinhan. If Shinhan exercises its right of first refusal, the sale may entail multiple problems and risks such as the objectivity and fairness of the price that KDIC offers Shinhan in advance, difficulty in timing the sale, and changes in the share price during the 30-day exercise period. So KDIC suggested that Shinhan would renounce its right and instead, KDIC would sell 10% in a block sale and the rest to the investors that Shinhan would choose, at the closing price of the previous day. The PFOC passed the resolution on the sale including this suggestion, and KDIC sold 90% to Shinhan-designated strategic investors while limiting the offer on the market to 10% at the previous day's closing price with a zero discount thereby maximizing the price.

4. Korea Exchange Bank(KEB)

The investment that KEB secured from Commerzbank clouded KEB's genuine need for financial support, and the bank was eventually sold to a foreign buyer. Korea was in dire need of foreign capital in the wake of the financial crisis and the timely attraction of foreign investment by KEB was viewed as a huge success, but the size of the capital was not enough for turning the bank around on their own. KEB needed to reduce its capital in order to receive public funds it desperately needed to survive and normalize its operations before it could be offered for sale. But the foreign investment came with the guarantee of no capital reduction and there was no way for KEB to get the financial support from the government. There was only one option left for the bank: finding a new owner outside of the country. The bank was sold to the financial investor Lone Star because there was no other interested buyer and the sale to the fund raised so many questions to ponder upon. Issues surrounding the sale to Lone Star included eligibility of Lone Star as the buyer of KEB, and violation of the single-person shareholding limit, which developed into a political scandal. Eventually, the Board of Audit and Inspection and the prosecution got involved and launched investigations into the deal. The media raised concerns that the conduct of public duties by government employees would be seriously obstructed and negatively affected by such investigations and accusations in future dealings. The Lone Star scandal offered the following lessons. First, foreign capital is not the answer to turning a financial institution around. Foreign ownership in domestic financial institutions can promote healthy competition in the industry, bring in advanced financial techniques, and create other benefits, but once the problem institution turns around, there is a potential outflow of national wealth, and as was witnessed in East Europe, if the domestic financial sector is dominated by foreign capitals, capitals tend to move across borders frequently, limiting the effects of the financial and macroeconomic policies. Second, the governance in making policy decisions should be considered in selling domestic companies to foreign buyers. If there had been clear responsibility and transparency in who made the decisions and how the decisions were made, not so many people involved in the deal would have suffered in the investigations by the Board of Audit and Inspection and by the prosecution. Third, the deal triggered a political scandal and wasted so much of national resources. There should have been a system to prevent such complications and waste of energy and resources. For example, in the case of Korea First Bank, the financial regulator volunteered to ask for an audit by the Board of Audit and Inspection immediately after the sale was closed so that any potential issues could be reviewed by the current standards rather than by the future standards. This prevented any problems that could arise from using a different set of criteria later when the problem company turns around. This type of precaution was not used for KEB, and the media pointed out that excessive investigations into policy decisions after the decisions were already implemented, would have a negative influence upon the conduct of public duties by government officials.

4.1. Overview

Conditionally approved in the management evaluation on June 29, 1998, KEB secured an investment of 250 million dollars(350 billion won) from Commerzbank of German on July 29, 1998. But the due diligence a month later revealed 10.8 trillion won in loss and Commerzbank's investment of 350 billion won fell far short of what KEB needed to replenish its seriously eroded capital. Additional capital increase was inevitable and upon Commerzbank's suggestion, KEB's capital was raised by 1,022 billion won including 260 billion won for preferred shares issued to Commerzbank, 336 billion won invested by the Bank of Korea through the Export-Import Bank of Korea(Korea EXIM Bank), 326 billion won by individual shareholders, and 100 billion won by the majority shareholders. The capital increase was accompanied by an intensive restructuring. The financial conditions at KEB continued to worsen and another attempt was made to further raise capital, but failed due to unfavorable circumstances in the domestic and overseas stock capital markets. Both public offering and overseas issuance of hybrid bonds worth 200 million dollars did not fell apart. Instead, KEB sought to find foreign investors who would bring in much-needed capital for restoring its financial soundness.

KEB's financial position required a urgent, large-scale capital augmentation. At the end of June 2003, KEB posted a loss of 146.6 billion won, and its BIS capital adequacy ratio was 9.5%. The FSS expected the ratio to drop to 6% at the end of the year in light of the massive potential losses from its exposures to Hynix and other Hyundai-affiliated companies, and NPLs held by its credit card subsidiary. The magnitude of the loss placed KEB somewhere between a management improvement recommendation and a management improvement request. On August 12, 2003, the FSS and KEB signed the agreement to improve the bank's key performance indicators, which included a capital increase. But the exiting majority shareholders including Commerzbank did not have the intention of investing any more money in the bank. So a large-scale foreign investment was the only option in order to ease the worries among financial market participants without injecting any further public funds. Commerzbank requested the government to guarantee that there would be no capital reduction, when it invested in KEB, and the government granted the request because foreign capital was urgently needed at the time. As a result, there was no way that the government could provide public funds to the bank.

Against this backdrop, KEB desperately strived to find foreign investors before its potential losses would materialize and in June 2003, it finally accepted a proposal from Lone Star in which Lone Star would make its investment decision after a due diligence. The FSC allowed Lone Star to acquire and hold more shares than the single-person shareholding limit of 10% set in the Article 15 of the Banking Act on September 26, 2003. Lone Star acquired 325,851,715 shares or 51.00% of the bank's shares worth 1.38 trillion won. Lone Star was also granted the call option it could exercise to Commerzbank and Korea EXIM Bank, in which case its stake would increase up to 65.23%.

<Table 4-27> KEB Shares Acquired by Lone Star

	New Shares	Existing Shares	Subtotal	Call option on existing shares**	Total
No. of shares	268,750,000	57,101,715*	325,851,715	90,898,285	416,750,000
Shareholding ratio	42.06%	8.94%	51.00%	14.23%	65.23%

Note: * acquired from Korea EXIM Bank(30,865,792 shares) and Commerzbank(26,235,923 shares)
** Lone Star can buy the shares from Korea EXIM Bank(49,134,208 shares) and from Commerzbank(41,764,077 shares) within 3 years.

<Table 4-28> Lone Star's Investments in KEB

	No. of shares	Price per share(won)	Amount (unit: 100 million won)
Acquisition of new shares	268,750,000	4,000	10,750
Acquisition of existing shares	57,101,715	5,400	3,084
Total	325,851,715	4,245	13,834

Lone Star is a private equity fund based in Hamilton, Bermuda, that invests primarily in impaired assets. It established the first fund to take over bad assets that were impaired as a result of the US savings and loan crisis in the late 1980s. It has offices in London, Tokyo, Seoul, Taipei, Beijing, Dallas, Dublin, Berline and other cities around the world. Since 1995, Lone Star has been investing more than

18 billion dollars through its subsidiaries around the world, and Lone Star Fund IV that was first set up in 2001 reached 4.25 billion dollars. Key investors include public pensino funds, college funds, international organizations, bank holding companies, trust companies and insurance companies. It invests mainly in debt, real estate, and financially distressed companies. Lone Star invested more than 10 trillion won in total(based on book value) and acquired Hanvit Credit Co.(Star Lease) and Kuk Dong E&C. It also set up a restructuring company and an asset management company jointly with KDB, KAMCO, and Korean banks.

4.2. KEB-Lone Star Negotiations: Outcomes and Evaluation

The results of the negotiations between KEB and Lone Star are summarized as follows. Lone Star acquired a 51% stake in KEB for 1,383.4 billion won or 1.15 billion dollars. New shares were 4,000 won per share and existing shares were sold for 5,400 won per share. Commerzbank and Korea EXIM Bank that participated in the capital increase previously gained 400 won per share above its acquisition cost of 5,000 won per share. The changes in the shareholding ratios as a result are shown in the table below.

<Table 4-29> Majority Shareholders' Shareholding Ratios (%)

	Before Lone Star Investment	After Lone Star Investment	If the call option is fully exercised
Lone Star	-	51.00	65.23
Commerzbank	32.55	14.75	8.21
Korea EXIM Bank	32.50	14.00	6.31
The Bank of Korea	10.67	6.18	6.18

The call option also included in the agreement was exercisable on the remaining preferred shares, i.e., 42 million shares held by Commerzbank, and 49 million shares held by Korea EXIM Bank, within 3 years. The exercise price was whichever was greater between the price increased 4.5% each year from 5,400 won and the price obtained by dividing by half the sum of 4,250(the average of the prices of the acquired new and existing shares) and the market price at the time of exercise(the average of the closing prices for the preceding 10 days). The call option was intended to guarantee a price equal to or higher than the price for the shares already sold(the price of the existing shares sold + the interest rate on treasury bonds), and to benefit from potential rises in the stock price in the future. With the call option, Lone Star was allowed to increase its stake up to 65.23%.

Under the agreement, Lone Star could appoint 2/3 of the board members so that it had the control over management, and Korea EXIM Bank and Commerzbank still remained the key shareholders. Lone Star, Commerzbank, and Korea EXIM Bank were all banned from selling their shares for the next 2 years(October 31, 2003 to October 31, 2005). DAR and TAR were included in the agreement as well. The drag-along right allowed Lone Star to ask the other shareholders join in selling their shares while Korea EXIM Bank and other shareholders had the right to sell their shares on the same terms and conditions that Lone Star would sell its shares. Claims for indemnity could be made within 18 months after the closing date as was customary in such transactions. Neither party could disclose the details of the agreement without a prior written permission from the other party.

Lone Star's involvement in KEB offers some implications. First, Korea's external confidence improved by successfully attracting foreign investment. Prior to Lone Star's investment, Allianz Life Insurance brought in 780 million dollars, and Commerzbank invested 740 million dollars in KEB. LG Card obtained 680 million dollars from its foreign investors, Korea First Bank 440 million dollars, and Kookmin Bank 420 million dollars. But Lone Star came with the largest amount which was 1.15 million dollars. Second, the much-needed foreign capital served as a stepping stone for KEB to transform itself into a clean bank. If KEB had failed to obtain the investment and the potential losses had materialized, its BIS capital adequacy ratio was feared to fall below 6% at the end of 2003, and the bank would have posted a loss of 0.8 trillion won.

Given that KEB's capital was seriously eroded and reached the lending limit, the securities investment ceiling, and other ceilings affected by the capital position. As a result, KEB was struggling to carry out its operations. In this sense, the inflow of capital from Lone Star provided much boost. Third, the sale price was generally considered fair or above the fair price, considering its net asset value and the prices in other transactions involving domestic banks. Particularly, Korea EXIM Bank and Commerzbank realized a gain of 400 won per share from the sale of their shares in KEB which they purchased at 5,000 won per share. Furthermore,

<Table 4-30> Comparative Review of Prices in KEB Sale

□ When compared to Chohung Bank sold around the same time(August 2003) ○ PBR(sale price/net asset value) - PBR for KEB was 2.44, higher than Chohung's 2.34**(estimated by Samil-PWC) * KEB: 4,250 won/1,735 won ** Chohung : 5,600 won/2,385 won ○ The payment for KEB was made entirely in cash while only 51% of the payment for Chohung was in cash and the remaining 49% with preferred shares.

they stood to gain more if the stock price was to rise as the bank's operations would improve.

4.3. Justification for Lone Star's Above-Limit Share Acquisition

To hold shares of a bank above the 10% limit for single person under the Article 15 of the Banking Act, the FSC's approval should be obtained. The FSC grants its approval when the requirements set forth in Article 5(marked with asterisk) of the Enforcement Decree to the Banking Act are met, or when there are special reasons such as for the purpose of resolving a problem financial institution under Article 8 of the Enforcement Decree. Since KEB was not declared as a distressed institution, the FSC's approval remained a controversy after Lone Star acquired KEB. The government, however, judged that KEB's financial conditions were bad enough to be considered as a distressed company and it fell into one of the special reasons such as for resolving a problem institution under Article 8. The judgement was based on the following. First, given the financial conditions at KEB, a large-scale capital expansion was urgently needed. KEB recorded 146.6 billion won in loss and its BIS capital adequacy ratio was 9.5% at the end of June 2003. In addition, large amounts of potential losses were looming due to its exposures to Hynix and other Hyundai subsidiaries, and growing losses at KEB Card. Second, KEB's BIS capital adequacy ratio was estimated to drop to 6% at the end of 2003 according to the examination by the FSS, and KEB and the FSS signed an agreement to improve the bank's key performance indicators on August 12, 2003. Third, Commerzbank, Korea EXIM Bank, and other shareholders were not intent on participating in the capital increase planned in the aforementioned agreement. Fourth, the existing public funds were set aside for other purposes so there were no extra funds available that could be provided to KEB. The government had to either get a parliamentary approval to raise additional public funds or find a foreign investor who was willing to make a large investment in KEB if it were to relieve worries that prevailed in the financial market without further injection of public funds. Obtaining a parliamentary approval would not only take time but cause KEB's unhealthy financial conditions to be disclosed, leading to a steep fall in its corporate value. So foreign investment was the only option left. With the capital brought in by Lone Star, KEB's BIS ratio rose to 9.3% at the end of December 2003. Otherwise, the ratio would have plunged to around 4%, in which case a PCA would have been imposed.

4.4. Investigations by the Board of Audit & Inspection and the Prosecution

On March 3, 2006, the National Assembly asked the Board of Audit and Inspection to perform an audit on Lone Star's takeover of KEB.[67] The audit was requested, based on the suspicion that the government inflated KEB's losses when there was no objective evidence and sold the bank illegally to Lone Star. The Board conducted an audit and announced the final results on March 12, 2007. Following the audit, the Board asked the FSC to take proper remedial actions on its approval for Lone Star to acquire KEB shares beyond the legal limit in 2003, and requested Korea EXIM Bank to file a damage claim against KEB's management and others who were responsible for causing the sale price to go down. In March 2007, the Board changed how the eligibility of Lone Star as the majority shareholder was reviewed and verbally ordered the financial regulators to investigate Lone Star's overseas operations. In response to this order, the FSC submitted an answer to the Board that it would reconsider whether or not to cancel its approval for Lone Star's acquisition of KEB shares after the court's final ruling. Korea EXIM Bank notified the Board that it would decided if it would take a legal action against KEB's management and others involved in the sale, taking into consideration the court ruling once the ruling would be made.[68] The prosecution's investigation and the subsequent trial proceeded as follows.[69] On March 7, 2006, the Financial Committee of the National Assembly brought an accusation on suspicions surrounding KEB's sale to Lone Star to the prosecution.[70] The prosecution's investigation involved three difference elements: (i) Lone Star's takeover of KEB itself was investigated. (ii), the investigation looked into the alleged stock price manipulation in connection with KEB's acquisition of KEB Card as a separate element of the case. (iii) also as a separate component of the investigation, Hyundai WIA was investigated for allegedly lobbying for a debt write-off.

(i) With regard to Lone Star's takeover of KEB, the investigation looked into

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67 The audit was proposed by the legislator Ra Kyungwon in December 2005 and passed by the Standing Committee of the National Assembly.

68 The Board's judgement proved to be wrong later as the court rules that the government officials involved were not guilty.

69 Some argued that the prosecution brought other elements into the case because the case was not sustainable by itself and the chance of winning the case was uncertain. In other words, the prosecution was pressured to find someone guilty of something as the growing media attention brought the case in the spotlight.

70 The accusation was made in October 2005 upon the representative initiative by the legislator Choi Kyung-hwan. The ruling party was able to stop the accusation, but they did not out of a rather naive assumption that they might as well just go ahead with the accusation if they could.

the following to prove breach of trust. First, can KEB be classified as a potentially problem institution based on its BIS ratio, and did Lone Star meet the eligibility criteria as KEB's majority shareholder? Second, the sale procedures were reviewed for any possible problems. The BIS ratio and the eligibility as the majority shareholder should be viewed in light of the economic circumstances at the time and the regulators should be fully responsible for any wrong doings in this respect. In principle, only strategic investors(if foreigner, the investor should engage in a financial business), not financial investors, can acquire a bank's shares in excess of the single-person shareholding limit set in the Banking Act, but if the acquisition is for the purpose of resolution of a problem financial institution and for other special reasons listed in the Act, it is exceptionally permitted. The regulators maintained the position that the sale to Lone Star was inevitable because with no additional capital injection from its major shareholders, KEB was very likely to be declared as a problem institution even though it was not at the time and if declared so, a bank run would ensue and more public funds would be needed, and the entire financial market would be negatively affected. But the prosecution and the Board did not agree on the possibility of KEB's designation as a distressed bank. After all, the forecast of KEB's BIS capital adequacy ratio was at the center of the issue. Looking back, the financial regulators were in the best position to measure the scale of KEB's impaired assets which was at the heart of the issue, and therefore, it was inappropriate for another institution to depend on an outsider's opinion to make a judgement on the regulator's decision which was made based on its assessment of the bank's risky exposures, and the court reflected this view in its ruling that stated "if the regulators approved the sale following the internal procedures and based on its professional conviction that the sale was necessary in order to resolve the financial problems facing the bank, it is only a matter of policy choice and policy decision and the regulators cannot be held responsible for breach of trust".[71]

Second, the procedural question was if sufficient efforts were made in looking for potential buyers in every step of the sale process, particularly in sending out the teaser letter and the information memorandum. Generally, when the company

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71 In the so-called KEB sale scandal, the prosecution indicted a former director general of the MOFE, former KEB CEO and others involved for breaching their duties and taking bribes on December 7, 2006, but the court began the hearing on January 15, 2007 and found them not guilty in the first trial in November 2008, and made the same ruling in the appeals trial on December 29, 2009. If there is a possibility that issues can be raised after the sale, extra caution should be taken to ensure transparency and accountability as was in the case of the sale of Korea First Bank and a request for an audit can be filed with the Board of Audit and Inspection so that the sale can be reviewed and confirmed as legal in every aspect according to the criteria at the time. If the same steps had been taken for KEB, the government officials involved in the sale would not have been entangled in such lawsuits.

up for sale is not yet declared as a problem institution, the search for potential buyers is conducted in secrecy so that the company can be sold at a better price. In this context, there could have been some limit to what could be done to find potential buyers.[72]

(ii) The investigation on the alleged manipulation of KEB Card's stock price centered on the suspicion that KEB mentioned a possible capital reduction for KEB Card at the press conference on November 21, 2003 where it announced its plan to merge with KEB Card, which brought down the stock price in its favor. In fact, KEB's board approved the merger with KEB Card without capital reduction for KEB Card on November 28, 2003. The court found KEB guilty in the first trial(February 1, 2008), but the decision was overruled and the bank was proven not guilty in the second rial(June 24, 2008). But the Supreme Court returned the case to the high court on March 10, 2011 because it viewed the accused as guilty, and the Seoul High Court ruled that KEB was guilty(on October 6, 2011, former Lone Star Korea CEO Yoo Hoi-won was sentenced to 3 years in prison, Lone Star was ordered to pay a fine of 25 billion won and KEB was proven not guilty)[73]

(iii) The third element of the investigation concerned Hyunai Motor and its affiliated company WIA[74]. WIA was placed under a workout program in the wake of the financial crisis and a large amount of debt was cancelled to turn the company around. Subsequently, a restructuring company took over WIA and then Hyundai Motor acquired WIA. The problem was that the former CEO of An Gun Accounting Corp. offered a bribe to government officials and others in order to get the debt write-off approved. The court hearing found the KDB and KAMCO directors guilty in connection with the bribery, but the government official(director general of the MOFE) was proven not guilty because the CEO's allegation that he provided a bribe to the official was not convincing.

The media viewed the investigations by the Board of Audit and Inspection and the prosecution as follows. Excessive investigations into policy decisions may have a negative impact on how government officials and policy makers perform their duties. The investigations were stretched beyond the KEB sale to look into the stock price manipulation and Hyundai Motor's lobbying, but all of the allegations

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72 But if the seller had certain potential buyers in mind in order to sign a dual contract that guaranteed large sums of bonus payments including the golden parachute for the existing management, it may constitute a breach of trust crime.

73 As Lone Star was convicted, questions about its eligibility as the majority shareholder of a financial institution were raised anew, and the FSC ordered Lone Star to sell its stake. Eventually, KEB was sold to Hana Bank and Lone Star left.

74 WIA was originally a Kia Motor's subsidiary that manufactured transmissions and machine tools and became affiliated with Hyundai Motor after the auto maker took over Kia. KDB and KAMCO acquired stakes in WIA and normally, in a corporate restructuring program, they write off debt and improve the financial position to transform the company into a healthy one for sale.

involving the government official proved not guilty. Concerns were raised over the so-called Byeon Yang-ho syndrome referring to the tendency that government officials will likely try to keep themselves from harm rather than pressing ahead with their professional conviction when making policy decisions. In addition, critics argued that the Board, the prosecution and the National Assembly all played a part in politicizing the issue as the "eat and flee" case(Lone Star reaped a profit that was 2.2 times more than its investment in just about two years).[75]

<Table 4-31> Media Reports on the KEB Sale Scandal

<JoongAng Daily(Internet, December 30, 2009 by Won-bae Kim and Sung-woo Park> Yang-ho Byeon(55), former director general of the Ministry of Finance and Economy(MOFE), who was indicted in connection with the sale of KEB to Lone Star was proven innocent in the appeals trial. The Seoul High Court also made the same ruling on the 20th against Byeon who was charged with allegedly conspiring with the US private equity fund Lone Star for the sale of KEB to the fund at a fire-sale price(breach of trust under the Act on the Aggravated Punishment, etc. of Specific Economic Crimes). The court ruled that "if a government official breached his duties and caused harm to the national interest by letting a third party gain profit, he is guilty of breach of trust, but if he acted on his professional conviction and following the internal decision-making process in order to deal with a problem financial institution, it is only a policy choice and decision and he cannot be held accountable for breach of trust. The scandal had a profound impact on government officials and the financial circle. After Byeon was arrested, government officials adopted the attitude that "it is best to avoid making big decisions that can hold you responsible later". As Byeon was found innocent in the appeals trial, the case was practically brought to an end. The Supreme Court does not sort out facts but makes a judgement over if the legal principles were properly followed. The ruling put a stop to the attempts to hold government policies against the legal criteria. Byeon's lawyer said, "Eventually, justice will prevail". Even though Byeon was proven innocent, the case left a permanent mark on the mind-set of government officials and the financial circle. Government officials tried to stay out of issues that required big decisions for fear of possible punitive consequences if something went wrong. The attitude was dubbed "Byeong Yang-ho syndrome. Speaking on anonymity, a government official said, "We watched what happened to Byeon due to his involvement in the KEB sale, and no government official is willing to make sensitive decisions that may cause controversy later". The financial circle takes the ruling as denial of the negative public sentiment against the sale. During the Roh administration, politicians and civic groups stirred up controversy over the KEB sale, on the back of the negative public sentiment, and finally, the Board of Audit and Inspection and the prosecution launched investigations. In October 2004, Kyung-hwan Choi, the current Minister of Knowledge Economy and former legislator of the Grand National Party raised suspicions over the

75 The media pointed out that when Koomin Bank took over BII of Indonesia for 83.5 billion won and sold the bank for 375 billion won 4 years after the acquisition, leaving Kookmin with a profit of 291.5 billion won, but no one talked about the eat and flee issue and it presents a contrast to what Lone Star was accused of. Worse yet, KEB sale to Lone Star evolved into a political scandal, thereby wasting so much time and energy. Later, any political offense against NDF transactions was intentionally blocked to prevent national resources from being wasted and this type of attitude could have been useful in the case of KEB sale as well.

sale, and the party organized the Lone Star fact-finding task force. Ki-taek Hong, professor of economics at Chung Ang University said, "the price can be different, depending on how the financial statements are analyzed and it seems like the Board and the prosecution jumped into a hasty conclusion that it was a fire-sale price". He also added, "the scandal struck a serious blow to Korea's external confidence and had a negative impact on our financial industry".

Critics also say that normal investments and transactions involving foreign investors should not be subject to the so-called eat and flee controversy. Since Korean companies and funds invest considerably in overseas markets, the eat and flee accusation does not make sense. In fact, Kookmin Bank took over BII of Indonesia for 83.5 billion won in 2003 and sold its stake last year for 375 billion won, reaping 291.5 billion won in profit, but there was no eat and flee controversy over Kookmin's sale.

The court ruling is expected to speed up the sale of KEB as the legal obstacle to the deal was removed. John Grayken, chairman of Lone Star announced in last October that Lone Star would sell its 50.02% stake in KEB within six months to 1 year. Currently, KB Financial Holding Co., Hana Financial Holding Co., KDB Financial Holding Co., and NH Bank are interested in acquiring KEB.

4.5. Lone Star's Sale of KEB

Lone Star made a few attempts to sell KEB and leave, but the attempts were thwarted by the prosecution's investigations and trials. Finally, Lone Star was able to sell the bank in January 2012.

4.5.1. The First Attempt: Kookmin Bank

On May 19, 2006, Kookmin Bank and Lone Star signed the definitive agreement. Under the agreement, Kookmin was to pay 6.33 trillion won for Lone Star's 64.% shares in KEB or 15,200 won per share. On May 23, 2006, Kookmin Bank requested the FSC's approval for its shareholding in KEB beyond the limit. On November 23, 2006, Lone Star terminated the agreement with Kookmin as the investigations were launched by the BAI and the prosecution after the closing date of September 16 and as a result, the approvals from the FSC and the Fair Trade Commission would not likely be obtained for the time being.

4.5.2. The Second Attempt: HSBC

Lone Star's second attempt to sell KEB was with HSBC and they signed an agreement on September 3, 2007. HSBC agreed to pay 18,415 won per share or a total of 6.05 trillion won for Lone Star's 51% stake in KEB. On September 27, 2007, HSBC requested a review of competition restrictiveness by the Fair Trade Commission, and asked the FSC to approve its shareholding beyond the limit on December 17, 2007. On December 20, 2007, the FSC notified to HSBC that the review would be on hold because the review should take into consideration the final court rulings when the trail would be finished, as well as the legal requirements. On March 5, 2008, the Fair Trade Commission approved HSBC's takeover of KEB. On April 29, 2008, HSBC extended the contract to July 31, 2008, but ultimately terminated the contract in September 2008 due to the time constraints and uncertainties over the court proceedings.

4.5.3. The Third Attempt: Hana Financial Holding Co.

In March 2010, Lone Star released its plan to resume its attempts to sell KEB, and continued the under-the-table work to work out the terms and conditions with Hana Financial Holding Co. and other interested buyers. On November 16, 2010, Hana announced it was seeking to buy KEB. However, the Supreme Court found Lone Star guilty of manipulating the price of KEB Card shares and returned the case to Seoul High Court on March 10, 2011, causing concerns over the planned sale of KEB to Hana. On March 14, 2011, KEB labor union and civic groups filed a claim for 148.6 billion won in damage against Lone Star in connection with the stock price manipulation, and more problems that could bring KEB's value down. On July 8, 2011, Hana and Lone Star agreed to extend the contract for six months.

On October 6, 2011, Seoul High Court sentence former Lone Star Korea CEO Yoo to 3 years in prison for manipulating KEB's stock price. The FSC issued a preliminary warning that it would order Lone Star to fulfill its eligibility as the majority shareholder. Lone Star failed to meet the eligibility criteria and the FSC notified to Lone Star in advance on October 31, 2011, that it would order the sale of Lone's Star's 41.02% shares in KEB in excess of the limit. On November 18, 2011, Lone Star was ordered to sell the shares unconditionally. The order was based upon the Enforcement Decree of the Banking Act that Lone Star is allowed to hold shares in a bank beyond the limit as long as it has not been punished for violating any of the relevant financial laws. The FSC approved Lone Star's additional shareholding based on this condition when it acquired KEB for 2,154.9 billion won in August 2003. Lone Star was convicted in October 20011 of KEB Card stock price rigging in 2003 after it decided not to appeal. With this conviction, Lone Star was disqualified from owning a bank and ordered to sell its 41.02%, leaving it with only the 10% stake in KEB. But the FSC did not specify details of how the stake could be sold and Lone Star was free to sell it anyway it wanted.[76]

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76 Civic groups argued that Lone Star accused of adopting the eat and flee strategy should be ordered as a punitive action to sell its KEB shares on the market so as to minimize the management premium it could get, but the FSC explained it did not impose any conditions on how Lone Star

At long last, the FSC approved Hana's application to integrate KEB as its subsidiary on January 27, 2012. With KEB joining the fleet, Hana Financial Holding Company emerged as the 3rd largest banking group with the total assets reaching 316 trillion won, after Woori Financial Holding Co. with 332 trillion won and KB Financial Holding Company with 329 trillion won. Hana paid 3,915.6 billion won in total for the KEB stake and 391.6 billion won in taxes. Lone Star's profit from the sale was more than 2.2 times what it paid two year ago excluding the dividend payments it received in the years, by buying the stake for 1,164.8 billion won and selling it for 3,915.6 billion won.

5. Korea Life Insurance

Korea Life Insurance which was originally part of Shindongah Group was declared insolvent in 1999 after its majority shareholder was arrested for illegal lending and its liabilities exceeded its assets. The insurer received as much as 3.55 trillion won in public funds. As the company steadily stabilized its operations, the government sold its stake and privatized it. The following lessons were learned in the process. First, there was the question of the shareholder eligibility of the buyer Hanwha consortium. Hanwha Group was not able to bear its share of responsibility as the largest shareholder in the process of resolving the financial distress of Hanwha Merchant Bank and Chungchong Bank, and the group was ordered to leave the financial industry. Later it re-entered the market after it took some financial responsibility. This case raised the question of where the line should be drawn in defining the responsibility of a majority shareholder. Second, the agreement was sent before the International Commercial Arbitration & Conciliation Board to have its validity determined as Macquarie, a member of the consortium turned out to be merely a financial investor, not a strategic investor. With a dual contract, Macquarie made null and void the requirement of

could sell the shares because it was not stipulated in the law. "Unconditional sale of the stake" implied that Lone Star was not subject to any restrictions in executing the contract on the sale of KEB shares with Hana. Civic groups criticized that Hana included the premium in its offer price and Lone Star would eventually take the premium away. Civic groups also raised an issue with the FSC for classifying Lone Star as a non-industrial capital as opposed to non-financial company or industrial capital. If classified as an industrial capital, Lone Star had to sell the rest of the shares except the allowed 4% stake, and civic groups maintained that it should have been determined as an industrial capital and thus subject to a punitive sale order. The FSC said the decision was made, taking into consideration advice and opinions from legal experts who said that what Lone Star had done so far as a shareholder did not warrant such a drastic action. The FSC added that the judgement on whether Lone Star was a non-financial company or not did not necessarily have to be preceded by a disposition order for failure to meet the shareholder eligibility.

having to be a strategic investor in the notice of public tender. It shows that due efforts should be made to confirm if the bidders have met all of the qualifications and requirements. Third, there was the question of fair price. As the economy expanded, the price continued to be raised, which made it tricky to find a balance between the necessary privatization and maximum recovery of public funds.

5.1. Summary

The sale of Korea Life was completed in one year and 8 months after the PFOC decided to sell the company. Since the market was stabilized, the sale followed the typical procedures, and the organizations involved in the sale including the sale subcommittee, the PFOC, and the FSC were able to pay full attention to details and proceed with the sale smoothly.

<Table 4-32> Timeline of Korea Life Insurance's Sale

Content	Date
The PFOC decided to sell Korea Life Insurance.	March 20, 2001
The sale subcommittee selected Merrill Lynch & KEB as the managers	May 30, 2001
Kick-off Meeting	June 5, 2001
The PFOC reported a sale plan with details(In principle, it would sell at least 51% of its stake to domestic or foreign insurance companies, or a consortium that included an insurance company.	August 7, 2001
The managers conducted due diligence and corporate valuation.	June-August 2001
The teaser letter was sent out to 64 domestic and foreign potential buyers.	August 31, 2001
Information memorandum was sent out to 10 of the potential buyers.	September 10-27, 2001
Letters of intent were received from Met Life and Hanwha consortium.	October 8, 2001
The interested buyers conducted due diligence.	Oct. 29-Nov. 30, 2001
Met Life and Hanwha consortium made their final bids.	December 14, 2001
The two final bidders submitted their revised final bids.	January 11, 2002
KDIC inquired on the investor eligibility criteria with the FSC.	March 13, 2002
Hanwha consortium submitted the final bid.	March 15, 2002
Met Life notified its intention to withdraw the bid.	March 20, 2002
The subcommittee reviewed Hanwha's final bid.	April-June 2002
The FSC responded to the inquiry on the investor eligibility.	June 21, 2002
The PFOC selected Hanwha consortium as the preferred negotiator.	June 27, 2002
The PFOC and Hanwha negotiated details of the sale.	July-September 2002
The FSC offered a revised response on the investor eligibility.	September 18, 2002
The PFOC decided to sell Korea to Hanwha.	September 23, 2002
The KDIC committee passed the resolution to sign the definitive agreement with Hanwha.	October 9, 2002
The definitive agreement was signed with Hanwha.	October 28, 2002
The shares were transferred and the payment was received.	December 12, 2002

5.2. Negotiations

On March 20, 2001, the PFOC decided to put Korea up for a public tender, and to simultaneously normalize the insurer's management via investment of public funds, in order to retrieve the public funds already invested in Korea Life and increase the efficiency of the sale process. The sale subcommittee was put in charge of reviewing the details of the sale plan such as the terms and conditions, and the committee would report the restuls to the PFOC. Only consortiums that included insurers were eligible to bid. No put-back option was attached to the deal, which indicated the economy was rebouncing and that only fair price would be acceptable and the seller would not bear excessive burden.[77]

<Table 4-33> The Summary of the Basic Sale Plan for Korea Life Insurance

· **The stake up for sale** : minimum 51%
· **Sale of Shindongah Fire & Marine Insurance** : to be sold in a separate transaction
· **Sale of 63 Building(now officially known as Hanwha City)** : Flexible and open to accommodate demands of investors
· **Investor Eligibility** : Domestic and foreign insurers, or consortiums including insurers
· **Key terms and conditions** : The parties to the negotiations work out details, but no put-back option to be offered.

The task force for the sale of Korea Life was formed as follows. In March 2001, KDIC set a task force dedicated to the sale of Korea Life and in the same month, the sale support team was created within Korea Life. In May 2001, Merrill Lynch and KEB consortium was appointed to manage the sale, Bae, Kim & Lee and Skadden Arps were hired as the legal advisor. Samil Accounting Corp was the accounting advisor and Tillinghast-Towers Perrin was contracted as the actuary. The selection of these advisors was reported to the subcommittee. The managers sent out the teaser letter to 64 potential buyers around the world including insurers, investment banks, financial investors and bancasurance companies on August 31, 2001, followed by the information memorandum(IM) sent out to 10 of the potential buyers who expressed their interest from September 10 to 27, 2001, on condition that they signed the confidentiality agreement.

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77 By defining the eligibility as a consortium that includes one or more insurers, it could be interpreted that the insurer(s) can join the consortium as a limited partner, instead of a general partner. This ambiguity opened the door for Macquarie to join Hanwha consortium as a financial partner. In this sense, more clarity was needed.

<Table 4-34> List of Teaser Letter and IM Recipients

	Teaser	IM
Korea	13	Hanwha Group, Shinhan Bank(2)
North America	19	Met Life, GE Capital, Morgan Stanley Real Estate, Lone Star Fund(4)
Asia	6	-
Europe	18	Fortis, Winterthur(2)
Africa	1	-
Other financial investors	7	Capital Z, Newbridge(2)
Total	64	10

On October 8, 2001, MetLife and Hanwha consortium turned in their LOIs and carried out due diligence from October 29 to November 30, 2001 by stationing in the Data Room[78]. The two bidders collected and analyzed the data provided by the sale support team of Korea Life and conducted interviews with Korea Life's working-level employees in order to determine the scope of Korea Life's assets and liabilities, and the corporate value. The advisors of the seller and the potential buyers are listed in the table below.

<Table 4-35> Advisors of the Seller and the Bidders

	MetLife	Hanwha	KDIC
Managers	CSFB	-	Merrill Lynch & KEB
Legal	Kim & Chang	Gwang Jang, Sejong	Kim, Bae, &, Lee, Skadden Arps
Accounting	An Gun	An Jin	Samil
Acutuary	M&R	M&R	Tillinghast

The bidders asked that the due diligence should be as of the end of September 2001 instead of the end of March so that the most recent performance data could be included. The change was to the advantage of the seller as well because the economy was bouncing back and the net asset value was also likely to rise.

On December 14, 2001, the investment proposals were received from MetLife and Hanwha consortium. MetLife's proposal contained the OldCo-NewCo separation which is a form of extreme put-back option intended to cut all the potential losses

78 On the opening day of the data rooms, Korea Life's management held a briefing session to give the bidders an overview of the company. Hanwha set up the data room on the 16th floor of the Shindongah Fire's headquarters and MetLife on the 46th floor of 63 Building owned by Korea Life. The rooms were open from 9 am to 9 pm on week days and from 9 am to 6 pm on Saturdays.

entirely out of the deal in the first place. The two proposals are compared in the table below.

<Table 4-36> The Investment Proposals by MetLife and Hanwha Consortium

	MetLife	Hanwha Consortium
Estimated corporate value	· △825 billion won	· 701.3 billion won
Transaction type	· OldCo-NewCo	· Takeover of all assets and liabilities including 63 Building and Singdonah Fire & Marine Insurance.
Acquisition of shares	· 9.9% of OldCo · 67% of NewCo	· 51%
Amount	· 669 billion won	· 357.8 billion won
Key terms & conditions	· Pure operating assets including new contracts and sales force to be transferred to NewCo. · Met Life has no obligation to invest additional funds into OldCo.	· A 3-year grace period to meet the required RBC. · Put/call option to be exercised if KDIC violates the terms of the contract. · Stake-proportional investments in case of additional losses

On December 26, 2001, KDIC announced its plan to receive new bids. MetLife proposed an unacceptable transaction method and Hanwha's bid price was too low and some of the terms were problematic. So the two bidders were asked to fix the problems and offer new bids. On January 11, 2002, the two bidders submitted their revised bids. MetLife changed the transaction method to a closed block, but the price and other terms including elimination of business risks remained unchanged. A closed block is set to keep contracts and certain assets excluded from the application of the accounting standards and the computation of the risk-based capital although the buyer takes over the entire company, and these contracts and assets will be managed separately from new businesses. Like the OldCo-NewCo method, it is intended to acquire only pure operating assets. Hanwha suggested that it might revise the price up if it would secure an exclusive right of first negotiation, and offered better conditions regarding additional capital injection, the makeup of the board, and escrow account, but the price was still low. From January to March 2002, KDIC carried out negotiations with the two potential buyers, based upon the new proposals. The two proposals displayed vast discrepancies in the transaction method and other conditions, which made it difficult for KDIC to choose one over the other. In addition, having two potential buyers in the negotiations would likely give KDIC more bargaining power by making the deal more competitive. MetLife and KDIC failed to iron out the differences over the transaction method, and MetLife finally withdrew from the negotiations. On the other hand, Hanwha submitted its final proposal that offered a better deal including a higher price on March 15, 2002.

<Table 4-37> Changes in Hanwha's Proposals

	1st Proposal (Dec. 14, 2001)	2nd Proposal (Jan. 11, 2002)	3r~5th Proposal1) (Mar. 13-15, 2002)
Grace period for RBC	3 years	3 year	Deleted
Additional capital injection	according to the stake owned	KDIC has no obligation to inject further capital	Same as left
Board makeup	No director to be appointed by KDIC	KDIC can appoint 2 outside directors	Same as left
Escrow Account	91.3 billion won of the price	55.5 billion won of the price	Same as left
Funding capacity	No guarantee	A guarantee added	Same as left
The total acquisition price	701.3 billion won	701.3 billion won	900~1,100 billion2)

Notes: 1) The 3rd~5th proposals had no changes in the conditions.
2) 900 billion won in the 3rd proposal,, 1,050 billion won in the 4th, and 1,050~1,100 billion won in the 5th.
* Escrow Account: to be used to pay for indemnity.

<Table 4-38> Changes in the Prices Proposed by Hanwha Consortium(billion won)

	1st Proposal (Dec. 14, 2001)	2nd (Jan.11, 2002)	3rd (Mar.13, 2002)	4th (Mar.14, 2002)	5th (Mar.15, 2002)
Price	701.3	701.3	900	1,050	1,050~1,100

From April to June 2002, the subcommittee reviewed Hanwha's investment proposal. After it reported the progress in the sale led by KDIC and the details of Hanwha's final proposal on March 19, 2002, the sale subcommittee held 10 meetings until June 18, 2002 where it collected the opinions from related persons and experts, and evaluated the buyer's eligibility and the proposed price. The committee reported the results to the PFOC on June 27, 2002. The committee concluded that there were some issues to be resolved in Hanwha's proposal, but it implied that the PFOC could approve the deal if it deemed such decision appropriate in light of the broader economy.

<Table 4-39> Results of the Subcommittee's Review[79]

○ Hanwha consortium is not qualified to take over Korea Life and its proposal does not maximize the recovery of public funds, but the authority to make the final decision rests with the PFOC.

Upon the request of the subcommittee, the managers moved back the base date of the due diligence from the end of September 2001 to the end of March 2002 so that the recently improved performance could be included, and Korea Life's value was re-calculated accordingly. Initially, the managers valued Korea Lifeat 1,241 billion won(as of end-September 2001, 15% discount rate), but the revised value(as of end-March 2003, 15% discount rate) was estimated to be between 1,225 and 1,615 billion won.

On June 27, 2002, the PFOC decided to grant Hanwha the preferred negotiator status and set the preconditions for KDIC to incorporate in the following negotiations.[80]

<Table 4-40> The Preconditions for Negotiations with the Preferred Negotiator

◇ **Buyer eligibility** : A fire wall to be set up and Hanwha's capital to be expanded. · Korea Life is banned from providing new financial support to Hanwha-affiliated companies for the 3 years after acquisition. · KDIC has the right to appoint auditor and a certain number of directors. · Hanwha Group should bring its debt-equity ratio down to 200% or below by the end of 2005. ※ If any of the above conditions is violated, KDIC can exercise a call option on the shares it sold, which should be specified in the agreement. ◇ **Price** : The price should be determined, based on the valuation by the managers as of the end of March 2002, and the management premium.

On June 28, 2002, the negotiations began. KDIC and the managers played a leading role in the negotiations. The parties to the negotiations gradually worked out differences in a series of negotiations(held consecutively on June 28, July 5, July 8, and July 9) and small-scale meetings. On September 22, 2002, Hanwha proposed 1,615 billion won as the final price. The price meant the total corporate value of Korea Life, and Hanwha wanted to buy a 51% stake and an option for another 16% stake.

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79 The committee stated that Hanhwa was not qualified to take over Korea Life but it did not specify the reasons. It is not clear in the committee's conclusion that Korea Life should be sold to a strategic partner, and the subcommittee did not mention it specifically in its evaluation report. In other words, the committee put the final decision in the hands of the PFOC, and therefore, the original intention to sell Korea Life to a strategic investor did not materialize.

80 The preconditions above show that the PFOC's role has been greatly expanded in substance.

<Table 4-41> Hanwha's Final Proposal

Price	Stake to buy	Payment method
· 1,615 billion won (for 100% stake) - 2,275 won per share	51% + Option 16%	· 823.6 billion won to be paid in two installments. → Upon acquisition: 411.8 billion won → In 2 years: 411.8 billion won ※ If the option is exercised: 258.4 billion won -Exercise period : 5 years or when the company is listed.

<Table 4-42> Changes in Hanwha's Proposed Prices (billion won)

<Before it became the preferred negotiator>

	1st (Dec.14 2001)	2nd (Jan.11, 2002)	3rd (Mar. 13, 2002)	4th (Mar. 14, 2002)	5th (Mar. 15, 2002)
Price	701.3	701.3	900.0	1,050.0	1,050.0~1,100.0

<After it became the preferred negotiator>

	6th ('02.7.5)	7th ('02.7.8)	8th ('02.7.13)	9th ('02.8.5)	10th ('02.8.29)	Final ('02.9.22)
Price	1,100.0	1,220.0	1,300.0	1,420.0	1,520.0	**1,615.0**

Hanwha accepted the preconditions that the PFOC suggested. Under the preconditions, Hanwha had to reduce its debt-equity ratio to 200% or below within 3 years and was banned from providing new financial support to affiliated companies. In addition, KDIC was granted the call option to exercise if Hanwha would violate any of these preconditions. The price was fixed so that it would not change after the sale, by removing from the agreement, the put-back option and a partial payment to be made after the closing. Hanwha was banned from engaging in any activities that might dilute the value of the government-held shares in Korea Life, and it was required to cooperate sincerely if KDIC would want to list Korea Life. The agreement was revised not to require that KDIC should compensate for post-sale losses that might be incurred in connection with the tax issues involving Chairman Soon-young Choi. As a result, KDIC added approximately 150 billion won to the value of Korea Life. On September 23, 2002, the PFOC finally decided to sell Korea Life to Hanwha consortium.

On September 23, 2002, the 32nd PFOC meeting was held to approve the sale of Korea Life to Hanwha consortium, and KDIC was given full discretion in negotiating other details than the major terms and conditions toward the conclusion

<Table 4-43> The PFOC's Resolutions

◇ KDIC's 51% stake in Korea Life will be sold to Hanwha consortium. ◇ The terms and conditions including the price will follow the final negotiation results that KDIC reported to the PFOC at the 32nd meeting. ◇ The PFOC leaves other details of the definitive agreement than the key terms and conditions to the discretion of KDIC.

of the definitive agreement. KDIC reported the proposed definitive agreement to the operating committee on October 9, 2002 and signed the agreement with Hanwha consortium on December 28, 2002.

5.3. Major Contents of the Definitive Agreement

The major components and contents of the definitive agreement are summarized in the table below.

<Table 4-44> The Components of the Definitive Agreement

	Content
Parties	· KDIC, Hanwha Group*, Orix Co, Macquarie Life
Key content	· Shareholders Agreement · StockPurchase Agreement
Signing date	· October 28, 2002

Note: * Hanwha Securities, Hanwha Petrochemical, Hanwha General Chemical, Hanwha Distribution, Hanwha Land Development

Hanwha agreed to provide no additional financial support from Korea Life to Hanwha-affiliated companies for 3 years after the signing of the definitive agreement, to lower its debt-equity ratio to 200% or below by the end of 2005, and to keep the ratio at 230% or below at all times until 2005. KDIC was allowed to exercise a call option if Hanwha failed to honor any of these commitments. With 30% or more stake, KDIC was allowed to appoint 3 outside directors and one inside director(auditor), and to veto major management decisions made by the board. The lock-up period during which the acquired shares could not be sold was 5 years for Hanwha and 2 years for Orix and Macquarie, respectively. If Korea Life would need to meet the required RBC ratio, Hanwha Group was obligated to invest additional capital and meet the ratio while KDIC had no obligation to make additional investments. As a collateral to guarantee the installment payments, a right of pledge was established on the shares sold equivalent to 130% of the unpaid amount(411.8 billion won). The put-back option was removed. The put-back option was intended to cover the potential losses that might be caused by the tax issues associated with chairman Choi as raised by the buyer, tax issues concerning real estate used for non-business purposes, and assets that would get impaired after the sale. Indemnity was minimized and remained in effect until the end of June 2004. Indemnity would remain valid for an unlimited period of time on the ownership of the sold shares, and until the end of the extinctive prescription on tax issues.

On December 12, 2002, the sale was completed with the receipt of the payment and the transfer of the shares. After the sale, KDIC's stake was 49%(34,790 shares), which would drop to 33% if the call option would be exercised.

<Table 4-45> Sale of Korea Life's Shares

Stock value	Stake sold	Recovered amount(sale proceeds)
1,615 billion won (for 100% stake) - 2,275 won per share	51% + Option 16%1)	823.6 billion won paid in two installments2) · Dec. 12, 2002: 411.8 billion won · Dec. 13, 2004 : 411.8 billion won ※ If the option is exercised: 258.4 billion won · Exercise period : within 5 years after the singing of the definitive agreement

Note: 1) If Korea Life is listed within five years. The option can be exercised within the limit of the stake held by KDIC after Korea Life is listed.
2) A right of pledge can be established on the sold shares equivalent to 130% of the unpaid amount.

The public funds were provided to Korea Life as shown in the table below.[81]

<Table 4-46> Public Funds Injected into Korea Life (billion won)

Date	Oct. 1, 1999	Nov. 25, 1999	Sept. 6, 2001	Total
Amount (equity investment)	50.0	2000.0	1500.0	3,550.0
Reason for support	Complete capital reduction to zero	To cover the net asset deficit for management normalization	To cover the net asset deficit for management normalization and subsequent sale	

81 The total amount of public funds invested in Korea Life was 3.55 trillion won and 1,082 billion won was recovered from the sale of a 67% stake including the call option, to Hanwha. In March 2010, KDIC sold 13% of its 33% stake in Korea Life at 8,200 won per share when Korea Life went public, and recovered additional 540 billion won. The remaining stake is 20% and the stock price should be at least 20,000 won per share in order to recover the entire amount of public funds injected into Korea Life(3.55 trillion won-1,082 billion won-540 billion won = approximately 1.9 trillion won). Korea Life's stock price was 7,250 won per share as of September 13, 2012.

5.4. Post-Sale Management

As part of the post-sale management, the government reviewed if the terms and conditions attached to the sale were faithfully followed. According to the weekly contract(5.2.c), the KDIC conducted an onsite inspection to check if Hanwha was complying with the agreement: if Korea Life provided any new financial support to Hanwha-affiliated companies, met the debt-equity ratio, and implementing the special resolutions by the board. The on-site inspection was carried out twice a year as of the book-closing days in March and September, and 5 times in total until 2006(September 2003, July 2004, November, 2004, July 2005 and January 2006). The inspections found that there was no violation of the agreement.

Indemnification[82] remained in effect until the end of June 2004. Indemnification was unlimited for matters relating to the ownership of the sold shares while indemnification in connection with tax issues was provided until the extinctive prescription ended. If the compensation amount for damages due to violations of the representations and warranties and defects in the documents, exceeded 30 billion won, it was paid within the cap of 1,615 billion won or the total value of Korea Life determined in the agreement. In other words, the seller is not responsible for any loss unless the loss is more than 30 billion won.

5.5. Major Issues

5.5.1. International Arbitration

On March 20, 2001, the PFOC decided to sell Korea Life Insurance after it invested public funds into the company, the successful candidate buyers should be insurance companies at home and abroad or consortiums that had insurance companies as a member of the consortium(August 7, 2001). Hanwha consortium led by Hanwha Group invited the Australian life insurer Macquarie to join the consortium to meet the buyer eligibility and acquired KDIC's 51% stake in Korea Life on December 12, 2002. After the Hanwha director who was leading the

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82 Indemnification is an obligation by a party to provide compensation for any particular loss suffered by another party, and it is a type of warranty liability. It is intended to cover potential losses that may arise in the future, which are not specified in the contract, by setting specific conditions that need to be met for compensation. Post-transaction compensation for contingent liabilities such as damages inflicted as a result of a pending lawsuit is an example of indemnification. Representations and warranties is also a part of indemnification in the sense that they guarantee that the statements by a party that are difficult for the other party to verify are true. On the other hand, a put-back option holds the seller responsible for assets that are impaired after the takeover. An unexpected lawsuit can be an example. The option oblige the seller to pay for the decline in the corporate value as a result of the lawsuit.

takeover was investigated by the prosecution[83], the court ruled that Hanwha and Macquarie had a dual contract for the bidding. Hanwha figured that having a globally recognized life insurance company in the consortium was a key to a successful bid and tried to get such a company involved in the consortium. However, it failed and signed a dual contract with Macquarie for its participation in the consortium. This arrangement runs counter to what the government was looking for in a successful bidder and constitutes a violation of the eligibility requirements. Macquarie simply let Hanwha use its name to form the consortium, with the ulterior motive of gaining an outsourcing contract to manage related assets, rather than participating in Korea Life's management, which makes Macquarie simply a financial investor and not meet the PFOC's investor eligibility criteria. With the dual contract with Macquarie, Hanwha formed a consortium that included an insurance company and became the sole bidder who was seemingly qualified, thereby limiting the entry of other potential investors who failed to form a consortium with an insurer, to the competition. The prosecution indicted Hanwha in February 2005, but Hanwha was found not guilty both in the first and second trials. The Supreme Court declared Hanwha innocent in June 2006.

KDIC became aware of this problem when the court made its first ruling on July 1, 2005, and suggested on May 29, 2006 to the PFOC that the matter should be brought before the International Commercial Arbitration and Conciliation Board for mediation. KDIC notified Hanwha of its intention to cancel and make the agreement null and void on July 4, 2006, took steps to have Hanwha return the sold shares, on July 28, and filed an application with the Board for mediation on the same day. Following KDIC's application, Hanwha also sent in an application to have KDIC fulfill its obligations regarding the call option on July 28, 2006. The panel was formed, the TOR was prepared, and other steps were taken, including discovery, submission of documents and a hearing session. On August 1, 2008, the final verdict was reached[84]. All the facts were established in favor of KDIC, but the court ruled that the act of deception by Hanwha was not so material that the agreement had to be made null and void. Upon the ruling, Hanwha exercised its call option on a fully legal ground and increased its stake from 51% to 67%, eventually listing the shares of Korea Life.

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83 The prosecution's investigation was initiated by questions raised at the National Assembly, and findings of the investigation into Hanwha Group.

84 Typical mediation process is as follows: submission of application and answers→ organization of a panel → confirmation of TOR → discovery → presentation of documents → hearing and cross-questions → presentation of additional documents → ruling.

5.5.2. Buyer Eligibility

The PFOC asked the FSC for an official opinion on the eligibility of Hanwha as Korea Life's buyer, and the FSC offered the response that Hanwha was qualified to take over Korea Life, based on its review of the relevant regulations and previous cases. Based on the FSC's response, KDIC approved the sale of Korea Life to Hanwha. In its response to KDIC on the buyer eligibility, the FSC stated that the major investor eligibility criteria was applicable to the establishment of a new insurance company and not to a takeover of an existing insurer. According to the Enforcement Decree of the Insurance Business Act(major investor eligibility, newly established in June 2000), a company that has been designated as a financially distressed company or a majority shareholder of a financial institution of which business license or registration or approval has been revoked, or a specially-related person of such institution, cannot become a major investor of an insurance company. The Decree lists exceptions to the restrictions, that includes a person who was proven not responsible for financial distress in a court ruling or a person/company that assumes financial responsibility for financial distress, or others who meet the criteria set by the FSC. The FSC's stance was that the eligibility criteria had never applied when insurance companies changed majority shareholders, ever since the Decree was amended in June 2000.[85]

KDIC arrived at the conclusion that Hanwha took its responsibility as the largest shareholder for the financial trouble at Hanwha Merchant Bank and Chungcheong Bank by taking over bonds issued by Korea Securities Finance Corp.[86] The accounting fraud that Hanwha previously committed posed a potential obstacle to its entry into the financial industry, but the financial regulators maintained that since a FSC's penalty[87] had been already imposed upon Hanwha, it was not fair to disqualify Hanwha as the buyer due to the fraud.

Legal changes were made to ensure that the fit-and-proper rule should be followed in reviewing and determining the qualifications of major investors.

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85 It is clearly wrong. It was corrected when the Insurance Business Act was revised on August 29, 2003 to introduce the fit-and-proper rule and to require a buyer of an existing insurance company to meet the same requirements that apply to the setup of a new insurance company and obtain a prior approval from the FSC.

86 Hanwha purchased 130 billion won worth of bonds issued by Korea Securities Finance Corp. in connection with the financial distress of Hanwha Merchant Bank while the FSC decided at the plenary meeting held on April 27, 2001 that Hanwha was not responsible for the financial trouble of Chungcheong Bank.

87 Hanwha Corp. was banned from issuing securities for 3 months for an accounting fraud that amounted to 331 billion won, Hanwha Petrochemical was prohibited from issuing securities for 6 months and it was requested to dismiss the directors involved in the fraud in connection with an accounting fraud involving 121.4 billion won, and finally, Hanwha Distribution was also banned from issuing securities for 6 months and requested to dismiss the directors involved.

Nevertheless, additional actions seem to be required to hold Hanwha responsible for the financial distress at Hanwha Merchant Bank and the accounting fraud.

5.5.3. Questions about the Price

The final price for the 51% stake was 823.6 billion won, which doubled from the price that Hanwha offered in its first investment proposal in December 2001. In the first investment proposal, Hanwha valued Korea Life at 700 billion won, and Hanwha's valuation was between 1.05 and 1.1 trillion won when it was selected as the preferred negotiator. Merrill Lynch, one of the managers judged that the final price offered by Hanwha was the highest among over 60 potential buyers that it contacted around the world. In other words, the price was the highest possible price that could be reached when Korea Life was valued at 1.2 to 1.6 trillion won with a 15% discount rate applied, based on the forecast of an annual net profit of 700 to 800 billion won for the 4 to 5 years following the takeover. In a contrast, MetLife that also expressed an interest in Korea Life estimated the value of Korea Life as negative.

<Table 4-47> Korea Life's Earnings Forecast by the Managers(billion won)

	FY2002 (Mar. 2003)	FY2003 (Mar. 2004)	FY2004 (Mar. 2005)	FY2005 (Mar. 2006)	FY2006 (Mar. 2007)
Estimated net profit(A)	711.0	739.0	774.0	818.0	622.0
Actual net profit(B)	979.4	615.0	536.6	Total	
				2131.0	
Difference(B-A)	268.4	-124.0	-37.4	Total	
				-93.0	

Korea Life's net profit for the fiscal year 2001 was 868.4 billion won, but it was priced only at 1,615 billion won for sale because its net assets were in the negative and large sums of capital would be needed to meet the RBC. Therefore, the net profit could be translated directly into the corporate value. It can be summarized as below.

Corporate value = Net asset + Value of total contracts - Cost for RBC
(1,615 billion won) (-378 bln won) (2,979 bln won) (986 bln won)

Korea Life was valued at 2,979 billion won, by converting the net profits into the present value with a 15% discount rate, on the assumption that there was no net asset deficit and its RBC was met.

<Table 4-48> A Forecast of Korea Life's After-Tax Net Profits(billion won)

	FY2002 (Mar.2003)	FY2003 (Mar. 2004)	FY2004 (Mar. 2005)	FY2005 (Mar. 2006)	FY2006 (Mar. 2007)
After-tax net profit(A)	711.0	739.0	774.0	818.0	622.0

The net asset based on the market price as of the end of March 2002 was determined to be -378 billion won as shown in the table below.

<Table 4-49> Computation of Korea Life's Net Asset(billion won)

Net asset on B/S	Adjustments for real estate	Other accounting adjustments	Net asset based on market price
553.0	△871.0	△60.0	△378.0

The RBC ratio should be fully met in order to carry out insurance business and it was estimated that 986 billion won was needed to meet the required RBC ratio. The amount of 986 billion won consisted of 657 billion won to be set aside for existing contracts and 329 billion won to be provisioned for new contracts. [88]

5.5.4. The Minimum Cost Principle

The article 13 of the Special Act on the Management of Public Funds(the Minimum Cost Principle) stipulated that KDIC should provide public funds in the way that minimize the cost and maximize the effect. But KDIC's investments into Korea Life were made(2.05 trillion won on October 1 and November 25, 1999) upon the request by the FSC before the Act was established on December 20, 2000 and thus the minimum cost principle was not applicable. When the public funds were provided, the FSC requested that 50 billion won excluding the paid-in capital of 30 billion won out of the 80 billion authorized capital was urgently provided, given the circumstances of the financial market at the time. The amount was estimated to be sufficient for early normalization of Korea Life's operations in the diagnostic evaluation of its management conditions.

The additional investment in Korea Life (1.5 trillion won on September 6, 2001) was decided by the approval of the National Assembly prior to the enactment of the Special Act on the Management of Public Funds as the FSC and the PFOC

88 The 5-year period set in this case presents a valuation model for other companies in the future and indicates that setting a proper period of time is an important consideration.

decided to normalize Korea Life's management through financial support and find a new owner at the same time.[89] So additional funds were provided to Korea Life for early management normalization while it was put up for sale to buyers at home and abroad(The PFOC's resolution on the sale of Korea Life Insurance on March 20, 2001). The additional injection of public funds was aimed at recovering the already injected public funds at the earliest possible time and expediting the sale. Since Korea Life was going to be sold, other resolution options such as liquidation and transfer of contracts. than equity investment was not considered, and it was firmly decided that Korea Life was to be sold after the additional investment.

5.5.5. Post-Sale Management

Major checkpoints were Hanwha Group's debt-equity ratio(to e kept at 230% or below and to be below 200% by the end of 2005), no new financial support from Korea Life for Hanwha Group, compliance with these two conditions, violation of which would result in the exercise of the call option, KDIC's appointment of 3 outside directors and 1 inside director(auditor) if KDIC held more than a 30% stake, KDIC's veto power on major resolutions by the board, and the ban on sale of Hanwha's acquired shares in Korea Life for a set period of time

A review was conducted to check if all of the above-listed conditions were faithfully met and there was no violation. Hanwha's debt-equity ratio was 206.5% at end-2002, 194.6% at end-2003, and 179.2% at end-2004 according to data released by the Fair Trade Commission. If the gains on valuation of investments using the equity method of accounting, are excluded, the ratio was 208% at end-2003 and 202.6% at end-2004. There was no new financial support that Korea Life provided to Hanwha Group. The credit balance of 25 billion won as of December 31, 2005 that Korea Life had to Hanwha-affiliated companies, out of the total credit of 81 billion won that was extended prior to the sale, was rolled over, which cannot be viewed as new financial support according to the legal advisor Kim, Bae, & Lee. The ban of new financial support to Hanwha-affiliated companies for 3 years after the sale was included as one of the conditions that the PFOC imposed when it selected Korea Life as the preferred negotiator on June 27, 2002. The ban was intended to prevent Korea Life from getting entangled again into financial distress, by prohibiting acts of financial support such as lending to Hanwha Group, as the industrial capital Hanwha Group took over the financial institution Korea Life. Although Hanwha became a shareholder of Korea Life and

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89 It was included in the "Second Phase Financial Sector Restructuring Plan that the FSC announced on September 24, 2000.

the two companies formed a special relationship, the rollover of the existing loans is in line with the normal business practices and does not cause any loss to Korea Life. It does not create any special benefits for Hanwha, either. Rather, it may be viewed as a reverse discrimination against Hanwha if the rollover is considered as a new financial support and thus banned. The legal advisor Kim, Bae, & Lee determined that the rollover was not a new financial support which was banned in the definitive agreement. Based on the interpretation of the definitive agreement and the legal advice, KDIC reached a conclusion that rolling over the loans made to Hanwha prior to the signing of the agreement did not breach the ban on new financial support.

After Korea Life(including Shindonah Fire & Marine Insurance and 63 Building) was taken over by Hanwha Group(October 28, 2002), Korea Life purchased golf membership and condominiums which totalled 16.5 billion won directly from Hanwha Land Development, instead of buying them on the membership exchange.

<Table 4-50> Membership Purchases from Hanwha Land Development (unit: 100 million won)

	Korea Life	Shindongah Fire	63 City	Total
Golf membership	51.60	9.60	9.60	70.8
Condominium membership	56.14	33.80	3.75	93.69
Total	107.74	43.4	13.35	164.49

Note: Korea Life(including Shindongah Fire and 63 Building) purchased the golf and condominium memberships for the purpose of supporting sales activities and improving employee benefits.

KDIC asked its legal advisor to review if these purchases constituted new financial supports(vii) transactions that may cause losses due to a potential default by the other party under Article 5.2(b) of the Shareholders Agreement). The legal advisor presented the opinion that they fell under the category of transactions in commodities and services and therefore did not constitute new financial supports.

<Table 4-51> The Summary of Legal Reviews

○ The ban on new financial support in the agreement is intended to restrict transactions that extend credit including loans so it is not to be interpreted as restricting transactions in commodities and services. - It is reasonable to consider memberships as part of "commodities and services" and thus the ban is not applicable.

Since the memberships were sold at the same price that were offered to other regular members, the purchases may not be viewed as special deals. However, if the price was intentionally set higher than a fair price in the first place, thus leaving the supply in excess of the demand by regular members, the memberships unsold and subsequently purchased by its affiliated companies could be considered as offering special benefits to the seller. Since the affiliated companies paid excessive prices for the memberships, generating the effects of helping the selling company, the directors who made the purchase decisions can be held accountable for breach of trust.

5.5.6. Additional Investments in Korea Life

In April 2001, 1.5 trillion won of public funds was additionally invested into Korea Life. In connection with this additional investment, two controversial questions were raised: if the earings were intentionally forecast to be lower than they should(6.5 billion won in net profit forecast for FY 2001 vs. 868.4 billion won in actual net profit) and if the actual profit of 868.4 billion won was incorporated in the sale price of Korea Life. (i) The earnings forecast was made available for reference purposes to assess the effects of public funds injection into Korea Life. The forecast was made by Korea Life in consultation with Boston Consulting Group in February 2001 before it signed an MOU with KDIC. When the earnings were forecast in February 2001, Korea Life was expected to post a large net loss for the fiscal year 2000(April 2000~March 2001), and the company actually sustained a net loss of 298.9 billion won. In addition, the domestic economy and the financial market were in an extremely unstable condition, which warranted a conservative forecast. In the same year, the life insurance industry launched whole-life insurance products and embarked on aggressive marketing campaigns, but the sales outlook remained uncertain, adding uncertainty to the earning forecast.

So KDIC concluded that the earnings were forecast, on purpose, to be lower than they should. The additional public funds investment into Korea Life was

<Table 4-52> PRe-Tax Net Profits of To 3 Life Insurers(billion won)

	FY1999	FY2000	FY2001*	FY2002
Korea Life	-814.4	-298.9	868.4	979.4
Company "S"	4444	363.0	895.9	1387.0
Company "K"	66.8	-374.0	186.6	507.6

Note: Both of the other companies S and K also registered a net profit that was markedly higher than in the previous fiscal year 2000.

already in the FSC's Second-Phase Financial Sector Restructuring Plan(September 24, 2000) and the PFOC's resolution on the Sale of Korea Life passed on March 20, 2001. So the earnings forecast was not altered to benefit a particular company. In fact, the final decision to choose the preferred negotiator was made a year later in June 2002. More public funds were deemed as needed in order to simultaneously carry on with the management normalization and the sale process, which was ultimately anticipated to expedite the recovery of the already injected public funds and to raise the efficiency in the sale process. (ii) The actual net profit of 868.4 billion won in the fiscal year 2001 was reflected in determining the corporate value of Korea Life(as of March 2002). The sale price of 1,615 billion won reached the upside limit(1.2~1.6 trillion won, a 15% discount rate) of the valuation made by the sale managers based on the assumption that Korea Life would continue to make 700 to 800 billion won in net profit for the 4 to 5 years after the sale.

6. LG Card

The case of LG Card brought into the spotlight such issues as the principle-based restructuring, shareholder accountability, and the role of the government. (i) Solvency should be the sole factor that determines whether a troubled financial company should stay or leave the market. LG Card was the biggest credit card company with 14 million members and the government aggressively sought to revive the company based on the judgement that it would be able to turn around once the liquidity crisis would be over. (ii) The company's major shareholders shared the burden through capital increases and others, and took due responsibility. The total financial support for LG Card amounted to 9.35 trillion won. Creditor financial institutions provided 4.15 trillion won and the major shareholders invested 5.2 trillion won. The contributing financial institutions offset their losses with the proceeds from the sale while the shareholders withdrew from the financial business. (iii) As for the role of the government, the government was forced to take the lead and actively ask for industry-wide cooperation because the system risk was involved. This type of leadership by the government cannot be viewed as the heavy-handed control over the financial industry. Rather, it should be considered as moral suasion. Despite the aggressive persuasive efforts by the government, some creditor institutions refused to lend a helping hand and the financial burden of making additional investments was shared by the rest of the creditors. However, the wheel of fortune turned in favor of those who helped in a bad time as LG

Card pulled off a successful turnaround. As LG Card returned to normal and began to generate profits, government-owned financial institutions that invested in the credit card company instead of the creditors that refused to help garnered massive profits. It clearly illustrated how the entire economy and individual creditor financial institutions can benefit from responding to moral suasion.

6.1. Background to the November 2003 Liquidity Crisis

The liquidity crisis was bulging across the credit card industry in 2003. The crisis was attributed to a combination of three major factors: excessive liquidity in the market, the herd behavior among credit card companies and the regulators' failure to properly supervise. Specifically, credit card companies were obsessed with improving their short-term performance and issued credit cards to individuals on the street without properly assessing their credit and all of the credit card companies jumped on the bandwagon. Card companies issued credit card-backed bonds in order to provide credit to their card users and all of the bonds were sold quickly in the market amid overflowing liquidity. In the plan announced on April 3, 2003 to resolve the liquidity crisis facing the industry, the government decided that the shareholders, mostly large conglomerates and banks, should be responsible for recapitalizing their credit card companies, rather than injecting public funds. Credit card companies owned by large corporations such as LG, Samsung, Lotte(acquired by Dong Yang), and Hyundai(acquired by Diner Club), and those affiliated with banks such as KB, KEB, Shinhan, Woori, and BC Card raised their capital under the responsibility of their shareholders. KB and KEB were merged with their parent banks. Card companies made self-reform efforts under the April 3 government plan and replenished their capital by 3.85 trillion won via rights issues worth 2.04 trillion won and bond issues worth 1.85 trillion won. Consequently, a growing volume of credit card asset-backed bonds was issued and circulated in the market from May 2005 and the market began to stabilize.

In February 2004, however, credit delinquents began to grow in number and posed a problem. The number of credit delinquents peaked at 3.97 million in May

<Table 4-53> Issuance and Circulation of Credit Card Asset-Backed Bonds

	Mar. 2006	May	July	September	October
· Issuance(unit: 100 million won)	2,450	7,720	18,463	6,730	2,030
·Distribution rate(%, as of the end of the month)	7.00	7.53	7.32	6.49	6.90
· Default rate on credit card assets(%)	9.6	11.7	11.4	12.3	-

2004. The credit ratings of other credit delinquents ranged from 8 to 10 while credit card users who were rated higher at 5 to 7 turned delinquent. These credit card delinquents had their loans called in by their banks after they took out loans backed by real estates amid rising real estate prices which later dropped, or they often fell into arrears with multiple loan payments as they repeatedly resorted to another credit card loan to pay their existing credit card debt.[90] Under these tough circumstances, delinquent rates continued to rise amid lackluster economic recovery, debt recollection rates slowed down due to moral hazard, and the combined losses accumulated to 4.1 trillion won in the first nine months of the year. As a result, LG Card and KEB Card were unable to normalize their management without additional capital increases and other aggressive self-reform efforts. When the April 3 plan was released, the whole credit card industry lost confidence and credit card asset-backed securities were entirely shunned by market participants, regardless of their credit standing, but this time, the problem was limited to only some individual companies as the confidence in the industry improved as a result of the restructuring efforts that were made in the mean time. LG Card's liquidity problem worsened after its major shareholder Warburg Pincus sold its stake in the company in October 2003. On the other hand, Samsung and other card companies had sufficient liquidity and the possibility of a liquidity crunch at those companies remained low.

<Table 4-54> Liquidity Status at Individual Card Companies (unit: 100 million won, as of end-October)

	Liquidity	2003 (reaching maturity)			Q1 2004	After Q1 2004	Total
			November	December			
LG	**17,000**	**35,944**	**21,261**	**14,683**	**39,095**	**149,192**	**224,231**
KEB	**3,000**	**7,793**	**4,771**	**3,022**	**10,357**	**33,120**	**51,270**
Samsung	32,000	9,731	6,446	3,285	21,675	151,467	182,873
Woori	7,500	3,666	1,617	2,049	8,326	39,603	51,595
Hyundai	6,500	1,424	400	1,024	5,929	17,274	24,627
Shinhan	4,671	1,856	1,172	684	3,029	1,195	6,084
Lotte	413	100	0	100	1,129	1,267	2,496

90 Banks offered revolving loans to small-amount delinquents. Multiple-loan delinquents were handled collectively by the banks involved and the focus was placed on preventing moral hazard by granting hair cuts if they agreed to a 8-year repayment schedule with Credit Counseling and Recovery Service.

6.2. Problems and Responses

6.2.1. Implications of LG Card's Bankruptcy for Korea's Economy

Since credit card companies form the basic infrastructure of the economy by functioning as a key settlement system, their bankruptcy can cause serious social problems. If around 14 million LG card users are forced not to use their cards, complaints will likely be filed en mess around the nation. For example, payments for transportation fees and gasoline via credit cards will be stopped, card holders will lose their accumulated points, and shops will refuse to accept the credit card. As LG Card stopped cash advances, there was a possibility of a steep rise in the number of debtors with multiple loans who reached their credit limit after they had long depended on revolving loans.[91] Furthermore, LG Card's client stores(2.84 million stores as of the end of October 2003) will incur unexpected losses as they will not receive payments(for 3 to 7 days' sales), and stores may also refuse to take other credit cards for fear of potential losses, thereby throwing the credit card payment system into a crisis. Eventually, retail finance will be adversely affected and the economic recovery will get further prolonged, weighing on the entire economy. Bankruptcy of LG Card whose assets reached 26.3 trillion won was likely to leave the financial market in a shock. Investment trust companies holding LG Card-issued bonds will face massive redemption requests. Investment trust companies held 3.5 trillion won worth of LG Card bonds and if market participants' worries spread to other card companies, a series of massive redemption requests was very likely, resulting in corporate funding difficulties, sky-rocketing interest rates amid large-scale sell-offs of bonds and stocks held by investment trust companies, and plummeting stock prices.

Other card companies were also at the risk of facing a financial distress as consumers refused to use credit cards, decreasing revenues for card companies, and the growing moral hazard led to lower debt collection rates. Some even raised the possibility that the entire financial sector might be dragged into the crisis as the woes at the credit card industry could spread to banks and other financial institutions.[92]

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91 For example, multiple card holders(850,0000 persons) who took cash advances from LG Card also took 4.2 trillion won in cash advances from other credit card companies.

92 The total amount of LG Card bonds held by financial institutions reached 17.9 billion won(including 4.0 trillion won held by National Pension Fund).

6.2.2 Restructuring Options for LG Card

The government recognized the gravity of the situation facing LG Card and sought ways to cope with the problem in a way that could bring the market and the economy back to stability. The government became aware that the trouble at LG Card was not limited merely to the individual company, but might undermine the backbone of the hard-built credit-based society and put enormous stress on the national economy, particularly the real economy and the financial market. Given the profound negative impact of LG Card's possible bankruptcy on the financial market, the broader economy, and the society, the government considered and discussed various ways to turn the company around. PCA by the Act on the Structural Improvement of the Financial Industry was not available option. LG Card's adjusted capital adequacy ratio was above 8% as of the end of September 2003 and therefore was not subject to PCA. The company could not be put into court receivership according to the Company Reorganization Act because if put into court receivership, the company's trade receivables will be frozen and the company will become unable to operate normally, which will cause inconvenience to small member stores. Suspension of business can trigger early redemption requests on its ABS, which in turn will likely worsen its financial position. If the ABS get impaired, the confidence in the bond market may be compromised, eventually spreading the uncertainty to the entire financial market and the financial industry. Worse yet, if the company is put under court receivership, it will take a long time until the matter is completely resolved, adding to the uncertainty. The joint management by the creditors under the Corporate Restructuring Promotion Act was not possible because ABS, trade receivables and others to which the Act was not applicable accounted for 58% of the total credit of 12 trillion won, making it hard for the creditors to jointly manage the company and normalize its operations. Even if the creditors agree to a joint management scheme(with approval from creditors that hold 3/4 of the credit eligible for the joint management under the Act), other credits not eligible need to be rolled over through separate negotiations with individual creditors. After all, private composition-type joint management by the creditors or a workout program was chosen. The government persuaded the creditors into reaching an agreement with LG Group, LG Card's parent company, stressing that the workout program could minimize the negative impact and speed up the restructuring process.

However, what was most important was to make an accurate judgement on if it was a matter of liquidity or solvency that LG Card was struggling with. If it is fundamentally a solvency issue, a series of steps should be taken to scale down the problem and eventually the company should be shut down while the focus should remain on market stabilization. But if it is a temporary liquidity problem, bold actions are required to provide liquidity and help the company survive. The government reached the judgement that the company was viable and able to return to financial health once the crisis would be over.

6.3. Negotiations between Creditors and LG Group

6.3.1. The First Agreement(November 23, 2003)

Creditors and LG Group worked out 4 agreements on the restructuring of LG Card. The second agreement ended in failure in December 2003 and only three of the agreements were concluded. In the first agreement reached on November 23, 2003, the creditors agreed to provide 2 trillion won(annual 7.5% interest rate) by the end of March 2004 and roll over credit card asset-backed securities issued by LG Card for every 3 months. LG Card and its major shareholders agreed to increase the capital by a total of 1 trillion won(300 billion won by the end of December 2003 and 700 billion won by the end of March 2004), and to pledge collaterals(shares of LG Card and LG Securities held by LG Group chairman Bon-boo Koo and its affiliated companies) to guarantee the repayment of the 2 trillion won loaned by the creditors. If management normalization would be impossible due to recurrence of a liquidity crisis and other reasons, the LG Card shares pledged as collateral would be cancelled and LG Group would have to give up the other collaterals. Creditors would swap the 2.0 trillion won debt for equity and take the responsibility as the largest shareholder for normalization of LG Card.

6.3.2. Further Restructuring Measures (December 2003)

Even after the creditors provided 2 trillion won under the agreement that the creditors and LG Group concluded on November 23, 2003, market participants grew even more concerned about LG Card and the company faced serious funding difficulties. In light of the unfavorable circumstances, another liquidity crisis was expected to strike LG Card at the end of December 2003 or at the beginning of January 2004. Unlike the first restructuring package on November 23, 2003, the second restructuring program was based on changing the company's owner. As part of management normalization measures, 2 trillion won was added to the company's capital and one trillion won was provided to support liquidity. For the capital increase, new investors contributed one trillion won to the capital and the creditor banks converted one trillion won of the previously provided liquidity support into equity. Liquidity support consisted of 0.8~one trillion won by LG-affiliated companies (via acquisition of credit card asset-backed securities) and one trillion won by new investors.

New investors were found primarily among deposit-taking domestic banks through simplified procedures and if no new investor was found, KDB agreed to get involved. New investors were offered incentives including the transfer of LG Card shares held by LG Group at a low price and the management right over LG Investment Securities. The second restructuring plan was slated to be announced immediately after LG Card's general shareholders' meeting on December 16, 2003, but it did get to be released because no new investor wanted to put money into the company after the due diligence by KPMG found on December 18, 2003 that the company's capital was impaired by 3.2 trillion won, which was larger than estimated. LG Group presented a letter of commitment confirming that the group would transfer its shares in LG Card and discard the financial business, following the principles of shareholder responsibility.

6.3.3. The Second Agreement(January 7, 2004)

On January 7, 2004, the creditors led by KDB and LG Group agreed to joint management of LG Card by the creditors. The creditors and LG Group agreed to split the 3.2 trillion won of impaired capital(as of end-October 2003, the due diligence by Samjeong KPMG), and the creditors provided 3.65 trillion won including a 2 trillion won debt-for-equity swap(1.52 trillion won by banks and 0.48 trillion won by insurance companies)[93] and 1.65 trillion won of liquidity support provided by banks that was converted into equity.

For its share of burden, LG Group agreed to reduce major shareholders' equity(24%) by a ratio of 44:1 and additionally provide up to 1.725 trillion won to support the management normalization of LG Card. The additional financial support included 0.8 trillion won in liquidity support by LG Group(0.5 trillion won by acquisition of subordinated convertible bonds and 0.3 trillion won in liquidity support), 0.35 trillion won from the sale of LG Investment Securities, 0.2 trillion won in donation to LG Card, and u to 0.375 trillion won in additional liquidity support.

6.3.4. The 3rd Agreement(December 31, 2004)

LG Card's capital was further eroded by operating losses in 2004. For capital

93 The participating banks were KDB, Kookmin, Nonghyup, Woori, Shinhan, Chohung, IBK, KEB, Hana, and KorAm(10 banks) and there were 6 insurance companies including Kyobo Life, Korea Life, Samsung Life, Dongbu Fire, Samsung Fire & Marine, and LG Fire.

expansion, the creditors agreed to provide 500 billion won and LG Group committed an equal amount of equity investment.

6.4. The Role of the Government

The government and the financial regulators formulated a plan for management normalization at LG Card and played the role of coordinator and mediator for the 16 major creditor financial institutions in order to prevent system risks. While striving to best accommodate the demands of private financial institutions, the government aggressively persuaded them into providing financial support to LG Card by helping them become aware of possible ripple effects of LG Card's bankruptcy upon the economy. Whether this role of the government is excessive control over the financial industry or moral suasion depends on the presence of system risk. If the government asks financial institutions to cooperate when there is a potential system risk, it is moral suasion that the government must exercise. It is frequently witnessed in advanced countries that the government serves as the coordinator and mediator for financial institutions in order to stabilize the financial market. For example, the US government got actively involved in coping with the financial crisis faced by the Long Term Capital Management in 1998 and the UK government also played a leading role in helping out small banks at the brink of bankruptcy, following the closure of the Bank of Credit and Commerce International in 1991, thereby successfully averting system risks.

However, it took longer for the government to work out a management normalization plan for LG Card because the private sector was fully respected for its own choices in the process of informing and persuading the private-sector participants. This attitude is clearly in contrast to the heavy-handed government control over finance prior to the 1997 foreign exchange crisis when the government used mostly instructions and orders to keep the market stable. After the agreement was reached on the plan, the government stepped aside and persuaded government-invested or affiliated financial institutions such as National Pension Fund into roll over bonds issued by LG Card. The financial system is designed by the government and run by private financial institutions. So how the government gets involved in dealing with system risks and how much burden the government bears depends on private financial institutions' capacity to cope with system instability or risks. Ever since the foreign exchange crisis, the private sector had built much experience and expertise in responding to system risks in the process of restructuring, and thus it was able to play a central role in resolving the credit card debacle in 2003. It was a long and winding road to the agreement by creditors and some creditors refused to participate, leaving the rest of creditors with the burden of making additional equity investments than they otherwise had to. When LG Card returned to profit, KDB and KAMCO that took over the financial burden of the creditors that did not join the rescue program for LG Card enjoyed reaping massive profits, teaching the lesson that cooperating for the sake of the entire economy will eventually prove to beneficial to individual companies.

<Table 4-55> The Summary of LG Card's Management Normalization Process

Date	Milestones	Detail
Nov. 2003	Liquidity crisis erupted at LG Card	
Nov. 17, 2003	Creditor banks(8) convened a meeting	- First liquidity support of 2 trillion won provided(287.8 billion won by KDB) - Rollover of existing debt and revolving lending limit
Nov. 21	LG Group chairman Bon-moo Koo submitted a letter of commitment.	- LG Group invested one trillion won into LG Card's capital. - Major shareholders and specially-related persons offered their shares in LG Corp, LG Investment Securities and LG Card as collateral.
Nov. 24	KDB provided the first liquidity support.	- 287.8 billion won(total 2 trillion won by 8 banks)
Dec. 6	Economic ministers' meeting was convened.	- The government actively supported creditors' efforts to maximize the effects. * Rollover of LG Card bonds, etc.
Dec. 16	Creditors' meeting(8 banks)	- LG Card was put up for sale: only 8 banks were exclusively invited to offer bids(deadline: Dec. 23, 2003) - Early management normalization efforts were made, led by participating banks - LG Group agreed to provide additional liquidity support(800 billion won) in return for the transfer of LG Corp.'s shares pledged as collateral.
	Chairman Bon-moo Koo presented a letter of commitment.	- LG provided 800 billion won in liquidity support and discarded financial business. - Upon completion of liquidity support and the sale of LG Card, LG Group would be no longer be obligated to invest into LG Card's capital and LG Corp.'s shares would be returned.
Dec. 19	The FSC determined responses to LG Card's potential financial squeezes	- The plan to deal with the bonds payment of which were not deferred(2.55 trillion won), out of the triggered ABS. - Call loans, etc.
Dec. 22	Released the due diligence report	- KPMG's due diligence: net asset value was -3,240.2 billion won
Dec. 23	The negotiations with 8 banks to sell LG Card failed.	- The deadline for submission of LOIs was extended. * from Dec. 23, 2003 → Dec. 26, 2003
Dec. 30	The attempted sale of LG Card officially failed.	

Dec. 30	Creditors(banks, insurers, securities, investment trust companies, National Pension Fund) agreed to roll over LG Card's debt.	- Rollover by one year of debt including corporate bonds, CPs and ABS that reached maturity in 2004. * The debt rollover was led by the FSS.
Jan. 2, 2004	16 creditors held a meeting. (the 1st meeting in 2004)	- 10 banks, 3 life insurers and 3 non-life insurers - Creditors agreed to jointly manage LG Card for early management normalization
Jan. 2004	2nd liquidity support	- 9 banks provided 1.59 trillion won(to be swapped for equity in July)
Jan. 15, 2004	A management support team was dispatched.	- Initially 10 members and later increased to 6
Feb. 6	15 creditors held a meeting (3rd in 2004)	- KEB was not present at the meeting and KorAm Bank refused to accept part of the agreement. The details of liquidity support and investment amount were partially revised.

6.5. The Sale of LG Card

LG Card turned around in 2005, with its net profit reaching more than one trillion won. After Hae-choon Park who successfully resolved Seoul Guarantee Insurance was appointed as the president in 2006, LG Card was sold to Shinhan Bank for 5.182.7 billion won. So the creditors recovered the combined 4.15 trillion won. Shinhan, after the acquisition of LG Card, emerged as the industry leader with a 15.7% market share and the number of its card users dropping to 9.6 million from 14 million, followed by Samsung with 13.9%, Kookmin with 15.0% and BC with 32.2%. Creditors and major shareholders shared the cost as shown in the table below.

<Table 4-56> LG Card's Restructuring Cost Split between Creditors and Shareholders

	1st Agreement	2nd Agreement	3rd Agreement	Total
Creditors	2 trillion won in new debt	3.65 trillion won of debt-for-equity swap	0.5 trillion won	6.15 trillion won(4.15 trillion won given 2 trillion won of collateral returned to shareholders
Shareholders	1 trillion won for capital increase, 2 trillion won in collateral	Capital reduction, 1.7 trillion won	0.5 trillion won	5.2 trillion won
Subtotal	5 trillion won	5.35 trillion won	1 trillion won	9.35 trillion won

7. Korea Investment Trust & Daehan Investment Trust Securities

What is noteworthy in the sale of Korea Investment Trust and Daehan Investment Trust is (i) the two companies of the same nature were sold simultaneously, (ii) details of indemnity were determined prior to the negotiations, and (iii) a relatively small amount of public funds was recovered because the two companies incurred large-scale losses in the process of playing the role of institutional investor to stabilize the credit system.

7.1. Overview

The major milestones in the sale of the two companies which took a year and a half from the decision to sell them to the closing, were listed in the table below.

<Table 4-57> A Brief Chronology of the Sale of Korea Investment Trust and Daehan Investment Trust

Major Content	Korea Investment	Daehan Investment
The PFOC decided on the sale of Korea Investment and Daehan Investment(public sale to domestic and foreign buyers)	Nov.7, 2003	
The sale subcommittee hired Morgan Stanley as the manager	Dec. 23, 2003	
Kick-off meeting	Jan. 12, 2004	
Teaser letter was sent out to 104 potential buyers at home and abroad.	Jan. 20~Feb. 11, 2004	
Information memorandum was sent out to 36 potential buyers.	March 8~April 12, 2004	
The subcommittee short-listed 7 candidate buyers.	April 19, 2004	
Final bids were received(6 potential buyers)	July 1, 2004	
Preferred negotiators were chosen(Dongwon Financial Holding Co. for Korea Investment Trust and PCA consortium for Daehan Investment Trust	July 14, 2004	
Announced the end of negotiations with PCA consortium	-	Aug. 16, 2004
Began negotiations with Hana Bank consortium	-	Aug. 24, 2004
The PFOC decided to sign the agreement and to inject public funds.	Feb. 18, 2005	April 29, 2005
KDIC committee adopted the resolution to sign the agreement.	Feb. 21, 2005	April 29, 2005
The definitive agreements were signed with Dongwon Financial Holding Co and Hana Bank.	Feb. 22, 2005	May 2, 2005
The FSC asked KDIC to invest.	Mar. 21, 2005	May 16, 2005
The KDIC committee decided to invest and sell its stakes.	Mar. 23, 2005	May 25, 2005
Financial support(1st closing)(1,398 billion won for Korea Investment Trust and 1,104.3 billion won for Daehan Investment Trust.)	Mar. 30, 2005	May 30 2005
Stake sale(2nd closing) (546.2 billion won for Korea Investment Trust and 475.0 billion won for Daehan Investment Trust)	Mar. 31, 2005	May 31, 2005

7.2. The Sale Process

On November 7, 2003, the PFOC decided to sell Korea Investment Trust and Daehan Investment Trust. The committee decided that two companies would be put up for public sale to domestic and foreign buyers(including the transfer of assets and liabilities), in light of the minimum cost principle, the ripple effects on the national economy, and the synergy effects that could be achieved in connection with the securities sector restructuring. The sale subcommittee was in charge of reviewing details including the price, procedures and methods, and reported the review results to the PFOC.

<Table 4-58> The Subcommittee's Reports on the Sale of Korea & Daehan Investment Trust Companies

· Selection of managers(December 23, 2003) · A plan to reduce the amount of public funds through prior resolution of key assets(April 12, 2004) · The short-list of candidate buyers(April 19, 2004) · The criteria and time for public funds injection, the sale of the entire stake(May 24, 2004) · The selection of the preferred negotiator and the simultaneous sale of the two companies(July 7, 2004), etc.

The Working Group was formed between November 2003 and January 2004, and the Group consisted of the task force team for the sale of the two companies set up within KDIC in November 2003 and the sale support teams established within Korea Investment and Daehan Investment. Morgan Stanley was appointed as the manager, Kim, Bae, & Lee and Dorsey & Whitney as the legal advisors, and An Jin Accounting as the accounting advisor The manager contacted 141 potential buyers around the world from January 20 to February 11, 2004. Information Memorandum(IM) was sent out to 36 of those potential buyers on condition of signing the confidentiality agreement from March 8 to April 12, 2004.

Separate preliminary bids for the two companies were received from 10 interested buyers on April 12, 2004. Woori Financial Holding Co., Dongwon Financial Holding Co., Mirae Asset, PCA, AIG, Carlyle, Newbridge, and UBS submitted bids independently while Kookmin & JPMC, and Hana Bank & GSCP made consortium bids. After a review, the subcommittee short-listed 7 candidates on April 19, 2004, including Woori Financial Holding, Dongwon Financial Holding, PCA, AIG, Carlyle, Kookmin & JPMC consortium, and Hana Bank & GSCP consortium. The committee reviewed the preliminary bids on the following criteria: ① valuation and payment method(55%), ② contribution to the growth of Korea & Daehan Investment Trust Companies and the investment trust industry(30%), and

③ the likelihood of entering into the definitive agreement(15%). The short-listed bidders conducted due diligence from April 26 to June 25, 2004. The candidates were divided into two groups and carried out the due diligence on each of the two companies, consecutively.

<Table 4-59> The List of IM Recipients

	Recipient Institutions
Korea	Kookmin Bank, Hana Bank, Woori Financial Holding Co., Dongwon Financial Holding Co., Seoul Securities, Mirae Asset, Hawha Securities, Dongbu Group, Hyosung(9)
U.S. & Canada	AIG, MetLife (2)
Asia-Pacific	HSBC, Orix (2)
Europe	ABN Amro, ING, PCA (3)
PEF	Ankar Fund, Carlyle Group, Capital Int'l, CVC International, Gilbert Global, Goldman Sachs PEG, H&Q, Investor AB, JF Asset Management, JP Morgan CP, JP Morgan CorsairⅡ, Lehman Brothers High-yield Opportunities Fund, New Bridge, Olympus Capital, Only Asset, PAMA, Standard Charterd PE, Temasek, UBS Capital, Warburg Pincus (20)

<Table 4-60> Advisors for Short-Listed Candidates

Candidate	Manager	Accounting	Legal
Carlyle	CSFB	Young Hwa	Yulchon
AIG	Citi Group	Young Hwa	Evergreen SidleyAustin
Hana·GS	Goldman Sachs	Samil	Kim & Chang
Kookmin·JPMC	JPMorgan & ING	Samjeong(Korea Investment), Samil(Daehan)	Kim & Chang
Dongwon Financial Holding Co.	Samil	Samjeong	Kim & Chang
Woori Financial Holding	-	Samil	Sejong
PCA	Lazard & Seoul Securities	Samjeong	Sejong

As shown in the table above, same advisors were hired by multiple candidates which raised the conflict of interest issue. So the firewall was set up and the employees of the advisors involved in the due diligence were banned from making phone calls, having face-to-face meetings or meals with one another or among themselves.

Candidates had the option of submitting investment proposals for only one of the two companies or both of them and proposals were received from 6 candidates on July 1, 2004 as below.

<Table 4-61> 6 Candidates that Submitted Investment Proposals

	Candidate
Korea Investment & Daehan Investment	Dongwon Financial Holding①, Woori Financial Holding①, Hana Bank(AFH*) consortium②, PCA(Olympus, Seoul Securities) consortium③
Only Korea Investment	Carlyle
Only Daehan Investment	AIG(Carlyle, Hyosung) consortium

Note: * AFH joined Hana Bank consortium instead of GSCP, a member of the original consortium.
** Numbers indicate which of the two companies the candidates are more interested in acquiring: ① Korea Investment Trust ② Daehan Investment Trust ③ No preference was indicated

On July 14, 2004, the PFOC selected Dongwon Financial Holding and PCA consortium as the preferred negotiators.

<Table 4-62> Preferred Bidders and Reserve Bidders

	Korea Investment	Daehan Investment
Preferred bidders	Dongwon Financial Holding	PCA(Olympus, Seoul Securities) consortium
Reserve bidders	Carlyle	Hana Bank(AFH) consortium

The PFOC's criteria for a successful bidder was set in the basic framework of maximizing the recovery of public funds and creating synergy effects for the securities sector restructuring. The subcommittee performed a preliminary review according to the following criteria: ① valuation and payment method(60%), ② contribution to the growth of Korea & Daehan Investment Trust Companies and the investment trust industry(20%), and ③ the indemnity (15%), and ④ the likelihood of entering into the definitive agreement(5%). Subsequently, the PFOC reviewed the bids and made the final decision(July 14, 2004). Particularly noteworthy is that individual criterion was weighted differently than in the review of the preliminary bids. Specifically, the price and indemnity were weighted higher while the industrial policy considerations and the likelihood of a definitive agreement were weighted lower, which is reasonable.

Finally, the negotiations started on July 26, 2004. The preferred negotiators Dongwon Financial Holding Co. and PCA consortium were granted a 45-day exclusive negotiation period. PCA consortium withdrew its bid on August 16, 2004. The consortium did not offer specific reasons for the withdrawal and instead simply cited "internal and external facts" as the reason for the withdrawal. So the KDIC initiated the negotiations with the reserve bidder Hana Bank consortium for the sale of Daehan Investment Trust Securities on August 24, 2004. The PFOC examined the key conditions for the agreement with Dongwon Financial Holding on October 29, 2004 and the results are summarized in the table below.

<Table 4-63> The PFOC's Review of Key Conditions for the Sale of Korea Investment Trust

◇ Price : 546.2 billion won(paid entirely in cash, all of the stake) ◇ Key Conditions · Book-value funds and market-priced funds: indemnity for the portion for which the company is found responsible according to the court ruling. · Problem assets : KDIC to take them over at the closing · Revisions to the collective agreement : The agreement was revised to stipulate that KDIC would do its best to ensure that the PFOC makes necessary changes to the pre-conditions for the closing that it agreed on with Dongwon before the closing.

The agreement should not be written in a way that clarifies the responsibility of 3rd parties including the union and the government, and the matters involving 3rd parties should be worded with such phrases as "they shall do their best".

7.3. Major Contents of the Sale Agreements

7.3.1. The Stock Purchase Agreement for Korea Investment Trust

Under the agreement signed on February 22, 2005, KDIC agreed to sell all of the stake it would acquire in exchange of its investment into Korea Investment Trust and the price was 546.2 billion won which the buyer agreed to pay in cash. The buyer was Dongwon Financial Holding Co. and public funds were to be provided at the closing in the form of investment and asset purchases to cover the losses and meet the financial ratios. The KDIC and the MOFE agreed to cancel all of their shares(86.6% and 12.15%, respectively). Following international practices for indemnity policy, the parties agreed that indemnity would be provided in connection with representations, warranties, and covenants for up to 2 years. Compensation was to be made mainly for problem assets included in market-priced funds, book-value funds under the old terms and conditions, subordinated CBOs in CBO funds, and accounting treatment of business transfers.

7.3.2. The Stock Purchase Agreement for Daehan Investment Trust

Under the stock purchase agreement that was signed on May 2, 2005, KDIC agreed to sell all of its stake in Daehan that it would acquire in exchange of its investment, for 475 billion won which the buyer agreed to pay in cash. The buyer was Hana Bank and the other members of the consortium including AFH(a subsidiary of Temasek) and its affiliated companies were allowed to get involved in the acquisition. KDIC agreed to provide public funds at the closing in the form of investment and asset purchases to cover the losses and meet the financial ratios. Following international practices for indemnity policy, the parties agreed that indemnity would be provided in connection with representations, warranties, and covenants for up to 2 years. Compensation was to be made mainly for subordinated CBOs in CBO funds, losses from trust-type savings account, problem assets in market-priced funds, and accounting treatment of separation of trust management business.

<Table 4-64> The Summary of the Sale Agreements

	Korea Investment	Daehan Investment
Price	546.2 billion won	475.0 billion won
CBO Funds	· In case of lawsuits regarding subordinated CBOs, the compensation will be provided for the losses for which the court rules the company is responsible.	· Losses from incomplete repayments will be compensated for. - In case of lawsuits regarding subordinated CBOs, the compensation will be provided for the losses for which the court rules the company is responsible.
Problem assets in market-priced funds	· In case of lawsuits regarding certain problem assets , the compensation will be provided for the losses for which the court rules the company is responsible.	· In case of lawsuits regarding certain problem assets , the compensation will be provided for the losses for which the court rules the company is responsible.
Problem assets in book-value funds	· In case of lawsuits regarding certain problem assets , the compensation will be provided for the losses for which the court rules the company is responsible.	· Problem assets will be disposed of by the company prior to the sale.
Trust-type savings account	· Losses on reverse margin will be compensated for.	· Losses on reverse margin will be compensated for.
Revisions to the collective agreement	· KDIC will make reasonable efforts to revise the collective agreement.	· KDIC will make reasonable efforts to revise the collective agreement.
General indemnity	· Cap : 70% · Basket : 1%(less than 1% to be deductible) · Per-Claim : 50 million won · Period : 2 years	· Cap : 70% · Basket : 1%(less than 1% to be deductible) · Per-Claim : 50 million won · Period : 2 years
Lock-up period	· Sale or transfer will be restricted for 3 years(mergers with affiliated companies are unconditionally allowed and the minority stakes can be sold after one year from the closing.	· Sale or transfer will be restricted for 3 years(mergers with affiliated companies are unconditionally allowed and the minority stakes can be sold after one year from the closing.

General indemnity in the table above refers to what the seller is responsible for or an exemption of the buyer from loss. Cap is the upper limit of the amount that the seller is responsible for as a ratio of the sale price. Basket means what is covered in indemnity and per-claim is the maximum amount per claim. It means that the buyer will be responsible for small amounts and the seller will be responsible for up to 50 million won per claim.

7.4. Injection of Public Funds and Sale of KDIC's Stakes

The public funds provided at the first closing and the sale of KDIC's stakes at the second closing are summarized in the tables below.

<Table 4-65> Public Funds Provided at the First Closing(billion won)

		Korea Investment(A) (Mar. 30, 2005)	Daehan Investment(B) (May 30, 2005)	Total(A+B)
Investment	To raise NCR to 150%	864.9	400.3	1,265.2
Asset purchase	Impaired assets and non-liquid assets of the two companies	483.1	654.0	1,137.1
Contribution	Kept in an escrow account for the post-sale true-up	500	500	100.0
Total		1,398.0	1,104.3	2,502.3

<Table 4-66> Details of the Stake Sale(2nd Closing)

	Korea Investment	Daehan Investment
Date of sale	March 31, 2005	May 31, 2005
Buyer	Dongwon Financial Holding (currently known as Korea Investment Holdings Co.)	Hana Bank
Stake	100%	100%
Price	546.2	475.0

<Table 4-67> Financial Support for Korea & Daehan Investments Trust Companies(unit: 100 million won) and Recovered Amount

	Korea Investment(A)	Daehan(B)	Total(A+B)
MOFE(Dec. 28, 1999)	6,000	3,000	9,000
KDIC(Jun. 10, 2000)*	43,000	25,000	68,000
Subtotal(a)	49,000	28,000	77,000
Investment	8,649	4,003	12,652
Asset purchases	4,831	6,540	11,371
Contribution(escrow account)	500	500	1,000
Amount provided for this sale(b)	13,980	11,043	25,023
Total(c=a+b)	62,980	39,043	102,023
Proceeds from sale of stakes(d)	5,462	4,750	10,212
Proceeds from asset sales(e)**	-	-	-
Total recovered amount(f=d+e)	5,462	4,750	10,212
Net amount provided(g=c-f)**	57,518	34,293	91,811

Note: * Includes the payments(1.9 trillion won) for the stakes in KDB and IBK that were acquired in December 2000.
** Non-liquid assets and other assets purchased from the two companies are going to be disposed of when the market conditions are deemed best for the disposal, which will add to the recovered amount of the public funds. In this case, the recovered amount and the net amount provided may change.

7.5. Post-Sale Management

7.5.1. Settlement

First, there is a true-up for the investment. For the sale of the companies, the amount of public funds to be injected into the companies was preliminarily determined based on the estimated closing balance sheet. After the sale, the closing balance sheet was fixed and the actual amount of public funds that was needed was determined. The difference between the two amounts in the two balance sheets was settled as shown in the two tables follow.

<Table 4-68> True-Up Process

Flow	Korea Investment	Daehan Investment
The companies submitted the closing B/S to KDIC.	Jun. 14, 2005	Jul. 28, 2005
Statements of objections were presented.	Aug. 18, 2005	Aug. 26, 2005
Negotiations began and true-up experts were hired.	Oct. 31, 2005	Oct. 10, 2005
Final statements were submitted to true-up experts.	Nov. 14, 2005	-*
True-up experts notified the final outcome.	Dec. 21, 2005	-*
The final agreement was reached.	-	Jan. 10, 2006
Settled through escrow account	Dec. 28, 2005	Jan. 17, 2006

Note: * Hana Bank refused to hire true-up experts and therefore, the differences were worked out in bilateral negotiations.

<Table 4-69> True-Up Results(million won)

Item	Amount		Note
	Korea	Daehan	
Estimated B/S when public funds are injected(ⓐ).	438,355	412,800	The basis for the NAV to be reached in the stock purchase agreement
The closing B/S prepared by the companies (ⓑ)	431,782	409,476	
Difference (ⓒ=ⓐ-ⓑ)	6,573	3,324	The amount of public funds that the buyers estimated was needed.
Amount disputed by KDIC	15,445	1,307	Excluding deferred corporate income tax on deficit carried forward.
Amount acknowledged by KDIC (ⓓ)	6,712	804	
Additional amount to be injected (ⓔ=ⓒ-ⓓ)	(139)	2,520	1.39 million won in the escrow account was retrieved.
Interest accrued (ⓕ)	(3)	55	
The final amount to be injected additionally (ⓖ=ⓔ+ⓕ)	(142)	2,575	

7.5.2. Indemnification and Legal Proceedings

The seller agreed to indemnify the buyers for losses incurred in lawsuits, for which the companies were found responsible, for a fixed period of time[94] after the

94 General indemnity is in effect for 2 years(3 years for funds), and special indemnity remains effective for 3 to 7 years(5 years for tax issues and 3 years for reverse margin on trust-type sale. It was agreed that the seller would manage the proceeds from the cases won in connection with establishing accountability for mismanagement, decide whether or not to accept lawsuits or to appeal to a higher court when one or both of the companies were a party to the case, in order to recollect the reserves made by the companies prior to the sale.

<Table 4-70> Indemnification Payments and :the Recovered Amount
(as of end-December 2005, million won)

	Korea	Daehan	Total
Payments(ⓐ)	1,711	249	1,960
Recovered amount(ⓑ)	344	2,479	2,823
Net recovered amount(ⓑ-ⓐ)	-1,365	2,230	863

As part of the subordinated CBO and SPC management, a dividend was paid on the surplus assets of Korea Investment's SPC, and the dividend was received through Resolution & Finance Corporation(SPC). Subordinated CBOs issued by Daehan Investment were redeemed earlier than scheduled. The CBOs held by funds were all redeemed by 2007.[95]

7.6. Major Issues

7.6.1. Reasons for Additional Injection of Public Funds

Korea Investment and Daehan Investment strived to normalize its operations after they received the combined 7.7 trillion won(4.9 trillion won for Korea Investment and 2.8 trillion won for Daehan) in 1999 and 2000, but the companies fell into even deeper financial distress amid the sluggish stock market and the worsening business environment. The PFOC decided that the two companies were unlikely to achieve management normalization within a short period of time and that they would be put up for a public sale to domestic and foreign buyers in order to stabilize the financial market amid the delayed management normalization at the companies while minimizing the injection of public funds(November 7, 2003). KDIC invested 1,398 billion won into Korea Investment on March 30, 2005

savings accounts)

95 The redemption was made within 20% of the outstanding amount held by funds in 2005 and 2006 and all of the outstanding amount was redeemed in 2007. The subordinated CBOs that were redeemed in 2006 amounted to approximately 48.9 billion won.

and 1,104.3 billion won into Daehan on May 30, 2005 to improve their financial soundness and take over impaired assets.

<Table 4-71> Injection of Public Funds into Korea & Daehan Investments for Sale (unit: 100 million won)

Types of Investment & Uses		Korea(A)	Daehan(B)	Total(A+B)
Investment	To meet the NCR(150%), etc.	8,649	4,003	12,652
Asset purchase	Impaired assets and non-liquid assets from the companies	4,831	6,540	11,371
Contribution	Deposited in an escrow account for the true-up after sale.	500	500	1,000
Total		13,980	11,043	25,023

7.6.2. Use of the Redemption Fund

According to the Depositor Protection Act that was revised at the end of 2002, the Deposit Insurance Fund Bond Redemption Fund(referred as "the Redemption Fund" hereinafter) was used to resolve problem financial companies that fell into financial distress on and before December 31, 2002 and the Deposit Insurance Fund(DIF) was set up to handle new problem companies. The FSC designated the two companies as insolvent on December 10, 1999 and their liabilities continued to

<Table 4-72> Legal Clauses on the Redemption Fund

Depositor Protection Act(Act No. 6807, Dec. 26, 2002)
Article 4(Uses of the Redemption Fund) <Subparagraphs 5 or 7 of Article 26-2 (3) and subparagraph 2 of the same article shall apply to the following(Amended on December 31, 2003)>
1. Insurance contingencies that occurred on and before December 31, 2002.
2. <u>If a company was determined or recognized as an insolvent financial institution by the FSC on or before December 31, 2002.</u> (excluding new financial assistance provided according to Article 38 after the Corporation(KDIC) provided financial assistance to the insolvent financial institution and therefore, the reasons for determination or recognition rendered under the provisions of Article 2-5 or Article 2-5(2).

Article 26-3 (Establishment, etc. of Fund for Redemption of Deposit Insurance Fund Bonds
① ~ ② (omitted)
③ The redemption fund shall be used for the following:
1. (omitted)
2. Insurance money, payments to depositors under Article 35-2, and <u>support money and incidental expenses for the resolution, etc. of insolvent financial institutions under Article 36-5 (3) or 38;</u>
3. ~ 4. (omitted)

④ (Omitted) [This Article Newly Inserted by Act No. 6807, Dec. 26, 2002] exceed their assets even after the injection of public funds, with a deferred PCA, the PFOC decided to use the Redemption Fund to help the companies in November 2003. Upon the PFOC's decision, KDIC used the Redemption Fund for the companies pursuant to Article 4-2 of the Supplementary Provisions of the Depositor Protection Act.[96]

7.6.3. Reasons for Low Recovery of Public Funds

The reason that the recovery ratio of the public funds injected into the two companies was relatively low is that the majority of the funds was used to prevent the collapse of the financial system and to stabilize the market. In other words, the losses were expanded in the process of the two companies performing the role of institutional investor that they were asked to play in order to stabilize the financial market. Such examples include the stock market stimulus package(December 12, 1989), Korea Investment's takeover of Shinsegi Investment in 1997, and the loss shared in the process of Daewoo Group's restructuring in 1999. In the U.S., additional financial assistance was provided in cases where losses were sustained as a result of the support measures for financial institutions following the subprime mortgage and the expansion of loans by financial institutions under the measures. In a similar vein, the recovery of the funds invested into the two companies was inevitably low because the main purpose of the injection of public funds into the two companies was to stabilize the financial market. The unrecovered funds can be viewed as the unavoidable cost that should be paid in the process of market stabilization for which ultimately the government should bear the responsibility. After all, only one trillion won of the total 2.5 trillion won invested into the companies was recovered. The PFOC decided on November 7, 2003 to sell the companies in a public auction to domestic and foreign bidders in the judgement that it could achieve the two objectives of minimizing the injection of public funds and stabilizing the financial market. KDIC searched for new owners of the two companies, and signed the contracts with Dongwon Financial Holding for Korea Investment and Hana Bank for Daehan. KDIC sold the two companies after it spent a total of 2,502.3 billion won(1,398.0 billion won for Korea Investment and 1,104.3 billion won for Daehan) on meeting the financial soundness ratios and acquiring impaired assets. Of the total, 1.4 trillion won(914.9 billion won for Korea Investment, and 450.3 billion won for Daehan) was used to cover the net asset

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96 Daehan Investment's assets exceeded liabilities(by 232.3 billion won) temporarily when the book was closed as of the end of March 2004 but it was due to the extraordinary profit of 362 billion won from wining the lawsuit against Nara Merchant Bank. The company's capital was impaired when the potential losses associated with book-value funds and CBO funds were factored in.

deficits[97], and to raise their financial ratios up to the required level for a financially sound company, and 1.1 trillion won(483.1 billion won for Korea Investment and 654.0 billion won for Daehan) was spent on purchasing the assets of the two companies that the buyers refused to take over or over which the buyers and sellers failed to work out the differences in the valuation. The public funds invested into the two companies did not only bring them back to normal but also had the effects of restoring investor confidence by getting rid of past losses and creating synergy effects for the securities sector restructuring. For this reason, the funds should be considered as the cost that was needed to pay for market stabilization.[98]

<Table 4-73> Uses of Public Funds and Recovered Amounts

(Korea & Daehan Investments(as of end-May 2005, unit: 100 million won)

Uses		Korea(A) (Mar. 30, 2005)	Daehan(B) (May 30, 2005)	Total(A+B)
Investment	To meet a 150% NCR.	8,649	4,003	12,652
Asset purchases	To acquire impaired assets and non-liquid assets from the companies	4,831	6,540	11,371
Contribution	Deposited in an escrow account for the true-up after sale.	500	500	1,000
Total(C)		13,980	11,043	25,023
Sale price	All of the stakes(100%)	5,462	4,750	10,212
Disposal of acquired assets*	Recovered through disposal of acquired assets, by the Resolution & Finance Corp.	-	-	-
Total(D)		5,462	4,750	10,212
Net injected amount(C-D)		8,518	6,293	14,811

Note: Non-liquid assets and other assets purchased from the two companies are going to be disposed of when the market conditions are deemed best for the disposal, which will add to the recovered amount of the public funds. In this case, the recovered amount and the net amount provided may change.

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97 The net asset value was -476.6 billion won for Korea Investment and -37.5 billion won for Daehan, respectively at the time of sale.

98 The PFOC compared and analyzed the costs of different options including liquidation, P&A and management normalization on a stand-alone basis, as the delay in the management normalization of the companies posed threats to the stability of the financial market. The cost to the national economy in case of liquidation was estimated at 5.8 trillion won. So the PFOC decided on November 7, 2003 to sell the companies in an international open competitive bidding in consideration of the minimum cost principle, the ripple effects to the national economy, and the synergy effects for the restructuring of the securities sector.

7.6.4. Controversy Over Sale Price

KDIC put the two companies up for sale in an international open competitive bidding and allowed 7 groups of bidders selected by the sale subcommittee to conduct due diligence on the companies. The bidder offered their prices based on the due diligence and taking into consideration both internal and external factors including the stock market conditions and the performance of the assets under the two companies' management. KDIC negotiated with the highest bidder and reached the sale agreement after the deliberation by the PFOC. Given the process, the sale price for the two companies was a fair market price that was determined by the buyers through competition.

<Table 4-74> Sale Prices for 3 Investment Trust Companies(unit: 100 million won)

Items	Korea	Daehan	Hyundai
NAV(ⓐ)	4,384	4,128	4,096
Sale price(ⓑ)	5,462	4,750	4,444
PBR(ⓑ÷ⓐ)	1.24	1.15	1.08

7.6.5. The Gap between the Valuation by Managers and the Actual Sale Price

The PFOC selected Dongwon Financial Holding Co. and PCA consortium as the preferred negotiators on the view that even though the bidding prices were lower than the intrinsic values of the companies that the managers came up with, the prices were still in the range of the relative value and the prices offered by the bidders based on the due diligence in a competitive open bidding were considered as reasonable market prices. The intrinsic value determined by the managers was relatively higher because the valuation was based on a rather liberal sales forecast from the seller's perspective who was inclined to raise the price. The final prices

<Table 4-75> Final Bid Prices for Korea Investment & Daehan Investment (unit: 100 million won)

Company	Dongwon Financial Holding	Hana Bank consortium	Bidder A	Bidder B	Bidder C	Bidder D	Average
Korea	5,412	3,900	5,000	4,540	5,400	-	4,850
Daehan	4,012	3,500	4,500	3,800	-	3,650	3,892

offered by the 5 groups of bidders ranged from 390 billion to 541.2 billion won for Korea Investment, and 350 billion to 450 billion won for Daehan, and it is only reasonable to consider the highest bid as the market price.

On the balance sheets as of December 2004, Daehan looks better than Korea Investment, but when Daehan's potential losses are taken into consideration, the opposite is true. For example, The net asset deficit of the SPC that issued subordinated CBOs was approximately 550 billion won for Daehan while Korea Investment had no deficit. The sale prices for the two companies(546.2 billion won and 475.0 billion won for Daehan) were different due to the following reasons. The net asset value of Korea 438.4 billion won and it was 412.8 billion won for Daehan, which leaves a difference of 25.6 billion won. Korea Investment was able to retain the funds raised from the subordinated CBOs for up to 10 years while Daehan was scheduled to redeem the CBOs within 2007. Daehan had a relatively larger number of senior employees in its workforce hierarchy, which entailed greater labor costs, and non-quantitative components of Korea Investment's collective agreement were generally more favorable to the company than those of Daehan. The average bid price of Korea Investment was approximately 100 billion won more than that of Daehan.

<Table 4-76> Factors that Determined the Sale Prices for Korea & Daehan Investments(unit: 100 million won)

Company	Sale price	Quantitative factors			Non-quantitative factors
		NAV	Effects of CBO	Labor cost	
Korea	5,462	4,384	232	705	-
Daehan	4,750	4,128	-	791	Restructuring costs
Difference	712(a+b+c+d)	256(a)	232(b)	86(c)	138(d)

7.6.6. Tax Effects of the Merger

KDIC asked the buyers to pay higher prices, given the tax-saving effects from the deficits carried over as a result of the merger. However, the buyers refused to raise the prices, arguing that the tax effects were already incorporated into the prices and it was not in line with customary M&A practices. KDIC further negotiated the tax effects and other major issues in a package deal and struck an agreement in which the sale price was raised. Eventually, the tax effects from the deficits carried over were considered as one of the factors that determined the sale prices of the two companies. For additional information on the negotiations on

Korea Investment's deficit carried over, Dongwon Financial Holding offered 541.2 billion won in its final bid(selected as the preferred bidder on July 14, 2004). KDIC continued to insist on the tax effects while Dongwon demanded a price cut, citing the unrevised collective agreement, and Korea Investment's NAV and real estate value that declined since the end of December 2003. In the price negotiations that continued from August 30 to October 22, 2004, KDIC strongly asked Dongwon to raise the price to 590 billion won, based on the effects of the deficit carried over from the merger, and as mentioned earlier, Dongwon refused to raise the prices, arguing that the tax effects were already incorporated into the prices and it was not in line with widely accepted M&A practices. Morgan Stanley, the manager of the sale offered the view that the effects of the merger should be the synergy effects of the acquirer which could be varied depending on the strategy used in the merger, including the consolidation of the headquarters and branches, and the setup of IT systems, etc., and negative effects from pay raises and compensation packages should also be considered. Morgan Stanley concluded that insisting further on the price increase on the ground of tax effects was not likely to achieve the intended goal. Following the advice from the manager, KDIC reached an agreement, after blanket negotiations, on the sale price of 546.2 billion won and other major terms and conditions of the sale on October 27, 2004. Under the agreement, the two parties agreed to raise the price to 546.2 billion won from 541.2 billion won initially offered in Dongwon's final bid and instead to cancel out all of the differences.

7.6.7. Asset Purchases and Pricing

KDIC provided the public funds into Korea Investment and Daehan Investment in the form of investment which was used to take over impaired assets from the companies and to meet the financial ratios to the levels of a financially healthy company. KDIC acquired impaired assets that the buyers refused to take over or that were not taken over due to differences in valuation, at their book value that the two companies recorded. Even if KDIC had acquired the assets at other prices than the book value, it would have made no difference in the amount of the public funds injected because the price was to be incorporated into the companies' balance sheets as profit or loss.

<Table 4-77> Major Asset Purchases from Korea Investment and Daehan Investment(unit: billion won)

	Korea Investment (Mar. 30, 2005)	Daehan Investment (May 30, 2005)	Total
Stocks	241.6 (71 stocks including Hynix shares worth 222.3 billion won)	220.6 (65 stocks including Samsung Life shares worth 126.0)	462.2
Bonds	241.5 (74 different bonds including Hyundai E&C worth 85.5 billion won)	4334 (77 different bonds including subordinated CBOs worth 259.6 billion won)	674.9
Total	483.1	654.0	1,137.1

<Table 4-78> Details of Asset Purchases(as of end-March 2005 for Korea Investment and as of end-May 2005 for Daehan Investment)

<table>
<tr><td rowspan="6">Deducted items</td><td colspan="2">These assets are assets that are not related to sales* and if the companies hold them in their portfolios, the public funds equivalent to the value of the assets should be injected so that the Resolution and Finance Corp. purchased and disposed of the assets, thereby reducing the net amount of public funds to be injected.
* 616.7 billion won in total including 340 billion won for Korea Investment and 276.7 billion won for Daehan.</td></tr>
<tr><td>Samsung Life shares
(126 billion won for Daehan)</td><td>· Acquired as the payment of the debt owed by Samsung Motors.
(approximately 225,000 shares(1.13%). The book value is 560,000 won per share)
· Seoul Guarantee Insurance is looking for a foreign buyer on behalf of the creditors.</td></tr>
<tr><td>Hynix shares
(222.3 billion won for Korea and 80.2 billion won for Daehan)</td><td>· Shares acquired in a debt-for-equity swap and the sale is restricted until the end of 2006.
· To be transferred to the Resolution & Finance Corp. for sale.</td></tr>
<tr><td>Other non-listed shares
(11.9 billion won for Korea and 4.3 billion won for Daehan)</td><td>· Pre-KOSDAQ stocks
Korea Investment : CMK, Digital Imation, etc.
Daehan Investment : Renault Samsung Motors, EONEX, etc.</td></tr>
<tr><td>Bonds guaranteed by Seoul Guarantee Insurance
(71.8 billion won for Korea and 30.1 billion won for Daehan)</td><td>· Seoul Guarantee Insurance-guaranteed, ill-liquid corporate bonds issued by financially-weak companies such as Ssangyong Cement</td></tr>
<tr><td>CPs issued by Seoul Guarantee Insurance
(31.8 billion won for Korea and 24.3 billion won for Daehan)</td><td>· Long-term CPs(8 to 40 years in maturity) issued by Seoul Guarantee Insurance as a payment for the corporate bonds it guaranteed.
These CPs are virtually not marketable.</td></tr>
</table>

Non-deductible items	These are assets that are included in the computation of risk amount and they are not marketable*. The buyers are unlikely to take them over and the risk amount is high. The Resolution & Finance Corp. took them over and disposed of them to reduce the net amount of funds to be injected. * 520.4 billion won in total including 143.1 billion won for Korea Investment and 377.3 billion won for Daehan.	
	Unsold certificates of beneficiary (112.2 billion won for Korea and 315.2 billion won for Daehan)	· Taken over by the companies due to difficulty in securitizing them when repurchased. The bulk of the underlying assets is impaired. Korea Investment: Hyundai E&C, CPs of Seoul Guarantee Insurance, etc. Daehan: subordinated CBOs, Hyundai E&C, CPs of Seoul Guarantee Insurance, etc.
	Exposures to credit card and capital companies (10.0 billion won for Korea Investment and 44.3 billion won for Daehan)	· The debt issued by credit card and capital companies was ill-liquid due to the liquidity crisis of LG Card. Korea Investment : LG Card asset-backed securities(10.0 billion won) Daehan Investment : LG Card asset-backed securities(21.0 billion won), exposures to Samsung Card and BC Card(23.3 billion won)
	Subordinated CBOs(Korea Investment - * , 17.8 billion won for Daehan)	· Subordinated bonds issued by the SPC set up to repurchase Daewoo-related bonds. The liquidity of these bonds is extremely low. * The 1st securitization of Korea Investment's assets (Jan. 4 and 5) : 1,000 won per each
Total		1,137.1 billion won (483.1 billion won for Korea Investment and 654.0 billion won for Daehan)

7.6.8. Reasons for Compensation for TTSA-Related Losses

Trust-type savings accounts(TTSA), unlike other general trust accounts, provides a fixed interest rate. The past administrations allowed investment trust companies to sell this type of product to help ease their liquidity shortages, but the there was no longer a legal ground for the sale of these accounts when the two companies were up for sale.[99] In the past, Korea Invetment and Daehan Investment used the funds raised from TTSAs to acquire assets that became impaired in the process of restoring the soundness of the trust assets in 2000, and as a result, the majority of

99 Under the Act on the Promotion of Catpial Markets and the Trust Business Act(enacted in December 1776), the government allowed securities investment trust companies to sell trust-type savings accounts. Korea Investment and Daehan Investment were allowed to sell TTSAs only for a limited period of time until December 2000 set by the Act on Structural Improvement of the Financial Industry, after they converted into securities companies in June 2000. But they failed to obtain a license for running multiple businesses under the Securities and Exchange Act and there was no legal ground for them to sell TTSAs. The related provisions were deleted in the Indirect Investment Asset Management Business Act(January 2004) that replaced the existing Securities Investment Trust Business Act.

the assets held in TTSAs were loans and non-liquid assets in the companies' proprietary accounts, and the companies did not have enough funds to repay deposits received from customers.

KDIC injected public funds into the two companies that were converted to Korea Investment Trust Securities("Korea Investment" hereinafter) and Daehan Investment Trust Securities("Daehan Investment hereinafter"), in June 2000, and ordered them to reduce their TTSA business in phases under the MOU on management normalization that it signed with the companies. Despite the gradual scale-down efforts, the gap between the committed interest rate(fixed) and the yield(floating) on TTSAs persisted and the reverse margin continued to increase. In response, KDIC planned to terminate the TTSA business for both of the companies while looking for their new owners. However, if TTSAs are all terminated simultaneously, the companies selling the accounts will face liquidity problems as they try to fund the repayments of the deposits received from customers, and the amount of public funds injection will likely increase initially. In addition, customers lured by TTSA into the companies can leave the companies en mass, undermining the foundations of their business and ultimately the value of the companies in the sale. For these reasons, KDIC decided to gradually reduce the TTSA business so as to keep the initial injection of public funds at a minimum and raise the value of the companies for sale. Considering the maturities of TTSAs that ranged from 3 to 12 months, a grace period of one year from the closing date was granted, and the companies were banned from extending the maturity of, and renewing the TTSA existing accounts or creating new TTSA accounts.

<Table 4-79> TTSAs (2003-2005)(unit: 100 million won)

Companies	At end-Dec. 2003	At end-Dec. 2004	At end-Dec. 2005
Korea Investment Trust Securities	31,903	27,036	2,556
Daehan Investment Trust Securities	30,000	25,947	3,151
Tongyang Merchant Bank	4,932	5,251	235

7.6.9. A Comparative Review of Different Options

In resolving an insolvent financial company, liquidating or letting the company go bankrupt minimizes the direct cost of public funds if only the direct cost is considered. However, the basic policy followed in the Special Act on Management of Pubic Funds and other laws is to base the injection decision on the impact of liquidation or bankruptcy of a financial institution on the national economy.

Regarding the handling of Korea Investment and Daehan Investment, the PFOC adopted the following resolutions on November 7, 2003: ① the management at the companies will be normalized by additional investment of public funds, ② the companies will be put up for public sale to domestic and international bidders, ③ P&A The sale will include P&A, and ④ multiple options including liquidation will be reviewed and compared, and the decision on the method will be made in consideration of the minimum cost principle, the effects on the national economy, and synergy effects on the securities sector restructuring.

Liquidation of the companies was expected to blow a major blow to the investor confidence in trust companies in general and to trigger massive redemption requests. Massive amounts of trust assets including stocks and bonds put up for sale by the companies were likely to pulling the stock prices down and cause interest rates to soar, sending the shock waves through the entire financial market and dragging other smaller-scale securities and investment trust & management companies into the financial mire. The 2,500 officers and employees of the two companies would be put at the risk of losing job and other losses to the national economy were considered as the fallouts from the liquidation or bankruptcy.

One of the possible side effects of management normalization by the companies is that if only one of the two companies is sold and the other seeks management normalization with financial assistance from the government, market participants may perceive that the unsold company is not sold because it is not marketable enough, which can have a negative impact on the performance of the company and hurt the corporate value. The sale decision on hold may cause moral hazard among the company's officers and employees and cause additional financial problems, eventually requiring more public funds.

<Table 4-80> A Cost Analysis of Different Resolution Options(as reported to the PFOC on November 7, 2003, unit: trillion won)

	Investment by government only	International sale	P&A	Liquidation
Initial injection of public funds(A)	4.00	4.00	1.70	-
Recovered amount*(B)	α	1.40	0.34	-
Net injected amount (C=A-B)	4.00-α	2.60	1.36	-
Cost to the national economy(D) · Financial cost(short term) ·Beneficiaries of trust assets	 - -	 - -	 1.57 -	 5.70 1.24
Total cost(C+D)	**4.00-α**	**2.60**	**2.93**	**6.94**

Note: The recovered amounts from the sale are assumed to be 0.7 trillion won for the two companies, respectively.

8. KorAm Bank

A few things are worthy of mention in Citigroup's acquisition of KorAm Bank. First, the acquisition of a domestic financial company by a foreign strategic investor promoted competition in the domestic financial sector and provided opportunities to learn advanced financial techniques. Many of Citibank Korea managers were hired as CEOs of domestic financial institutions later, which attests to the fact that Citigroup's takeover played a part in taking the management practices at domestic financial institutions to a new level. Second, Citigroup paid the uniform price to major shareholders and minority shareholders by requiring that it acquired 80% or more of all shares through a public purchase on the stock market, unlike regular M&A transactions where the buyer offers a higher price to the major shareholders. In order for this type of deal to work, the buyer's price should be higher than the market price, and it is noteworthy that Citigroup employed its regular strategy of securing the corporate control by de-listing the stock after the takeover.

8.1. Background

KorAm Bank was the first joint bank set up in 1986 by Korea-America Finance Company and the Bank of America. The financial investor Carlyle consortium became the largest shareholder in 2000 and the bank was put up for sale as the lock-up period expired. KorAm Bank had the upper hand in the M&A negotiations because its financial position was solid, the bank had an outstanding risk management capability for credit to small and medium-sized companies, and as a middle-ranked player, it had a unique place in the competitive banking sector hierarchy.

First, the bank's assets were very sound and the bank was adequately capitalized. As of the end of June 2003, the bank's ratio of assets classified as precautionary or below, the ratio of assets classified as substandard or below, coverage ratio, and the Tier-1 capital ratio were estimated at 3.1%, 1.9%, 88.7%, and 7.2%, respectively.

<Table 4-81> Financial Ratios of Major Banks

	KorAm	Kookmin	Shinhan	Chohung	Woori	Hana
Total credit(billion won)	28,838	136,518	49,272	48,887	84,829	56,073
Precautionary and below(bln won)	902	12,781	2,047	4,180	5,092	2,858
Substandard and below(bln won)	541	5,940	1,254	2,157	2,495	1,535
Loan loss reserves(bln won)	480	3,529	935	1,813	2,181	1,176
Precautionary and below(%)	3.1	9.4	4.2	8.6	6.0	5.1
Substandard and below(%)	1.9	4.4	2.6	4.4	2.9	2.7
Provisioning/substandard and below(%)	88.7	59.4	74.5	84.1	87.4	76.6
BIS (%)	12.1	10.3	10.1	9.2	11.5	10.3
Tier-1 ratio (%)	7.2	6.7	6.3	4.9	6.9	5.5

Second, KorAm Bank possessed a particularly strong risk management ability for credit to SMEs because it had accumulated cash flow-focused credit management techniques with the help of Bank of America from the bank's inception. The bank's credit to SMEs made up 37% of all credit and 48% of the credit was credit loans. But the loans to SMEs that were substandard or below were only 0.55%, which was much lower than 1.88% for all assets classified as such. This clearly shows that KorAm Bank's risk management capability for credit to SMEs is superior.

Third, Kookmin, Shinhan, Woori, and Hana rose as the 4 mega banks as a result of M&As among the major players, benefiting from economies of scale, when over-banking was a growing problem, while mid-sized banks such as KEB, Korea First Bank, KorAm and regional banks were placed further at a disadvantage. Smaller-sized banks were losing ground amid intensifying competition and achieving economies of scale through merger emerged as a pressing task for those banks in order to stay competitive. Against this backdrop, KorAm Bank with superior asset quality and solid capital adequacy became an attractive target for M&A. The 3-year lock-up period for the KorAm shares held by Carlyle ended on November 15, 2002 and Carlyle began to look for buyers to sell the shares. On the list of potential buyers Carlyle contacted were Kookmin, HSBC, Citibank, Standard Chartered, GE Capital, ABN Amro, and Temasek Holdings. GE Capital and Temasek were found disqualified to acquire a commercial bank, leaving out Kookmin Bank as well that made a joint bid with Temasek. The list narrowed down to the two bidders, Citibank and Standard Chartered, and in February 2003, Citibank took over KorAm Bank and Standard Chartered later acquired Korea First Bank.

Temasek and Kookmin Bank made a joint bid but both of them left the competition because Temasek was disqualified. It is inappropriate to classify Temasek as an industrial capital based on its investment portfolio rather than its ownership structure(similarly, the same criteria was used to determine whether National Pension Fund was an industrial capital or not and it is also problematic.), and it was a step in the right direction to change the criteria in the process of increasing equity investment by industrial capital. Specifically, a fund is not considered an industrial capital when it is a general partner and a limited partner with industrial capital making up 15% or less is classified as a financial capital, under the revised criteria.

Citigroup needed KorAm Bank as part of its strategy to expand its presence in the Asian market that had a high growth potential, and the group was seeking to establish a full line-up of retail finance through aggressive localization. Founded in 1812, Citigroup boasts a history that goes back around 200 years. At the time of acquisition, the group had 1.2 trillion dollars in assets, 104.1 billion dollars in capital, and 120 million customers. With a global network of 3,400 branches in over 100 countries, Citigroup was a leader of globalization.

<Table 4-82> Key Financial Indicators of Citigroup(unit: billion dollars)

	2001	2002	2003
Total assets	1,051	1,097	1,264
Total capital	88.4	92.9	104.1
Revenues	67.4	71.3	77.4
Net profit	14.1	15.3	17.9
ROE (%)	19.7%	18.6%	19.8%
Market capitalization	259.9	180.9	250.3
Other	- Over 3,000 branches including 2,600 branches in the U.S. and 253,000 employees in more than 100 countries around the world.		

Citibank Korea was launched in 1967 as a 100% Citigroup-invested branch. In 2003, it had 12 branches and 1,000 employees, and was particularly strong in retail finance such as asset management including private banking and credit card business. This presents a contrast to branches or subsidiaries of other foreign banks operating in Korea, that focused on corporate banking. Among foreign banks, Citibank and HSBC have successfully cemented their positions in retail banking in Korea. Citibank is recognized for its contribution to the growth of the domestic financial industry in the sense that many of former Citibank Korea executives became CEOs of domestic financial institutions later, thanks to the advanced manager training programs that they received at Citibank Korea. Citigroup is known for implementing flexible strategies in different markets in varying stages of development. For example, Citibank took over Travelers and Smith Barney to strengthen its insurance and investment banking, and concentrated on retail banking in emerging markets with a growth potential for retail banking while it acquired banks that were strong in corporate finance in markets where retail banking was not mature yet or corporate finance was relatively strong.

<Table 4-83> Citigroup's Expansion in Emerging Markets

Year	Acquired banks	Market share
1999	Financiero Atlas(Chile)	No. 2 in retail finance
2000	Bank Hadlowy(Poland)	No. 1 in corporate finance
	Financial Associates Capital(Japan)	No. 5 in retail finance
2001	Banamex(Mexico)	No. 1 in retail finance
2003	Shanghai Pudong Development Bank(acquired 4.62% stake in the bank for a strategic alliance for credit card business)(China)	No. 9 in retail finance
2004	KorAm Bank(Korea)	No. 5 in asset size

Previously, even though Asia was a strategically important area that generated around 10% of the entire revenue for Citibank, its business in the region was limited only to retail finance such as credit card business. In Japan, Citibank had more than 20 branches in 2003, launched the nation's first 24 hours/day ATM, and was the first bank that opened on Saturdays. These innovative efforts significantly raised the consumer awareness of Citibank in Japan. In Taiwan, Citibank grew as one of the five major players in credit card business and individual lending with only 10 branches. It successfully established itself as a major household lender in Hong Kong after it first set its foot in the market. Citibank secured a notable market share in the credit card business with only a small number of branches in countries like the Philippines, Malaysia and India. Citibank's acquisition of KorAm Bank is expected to make its retail finance line-up full and to be the touchstone of Citibank's expansion strategy in Asia. Japan remains a risky market due to potential financial distress that may occur any time and it is too costly to acquire Japanese banks. Citibank stays ready to increase its presence in China but for now its presence is limited to strategic alliance and its focus remains on lending and credit card business until it is certain that the market is stable enough to take more bold steps. On the other hand, Korea is a relatively stable market with a solid growth potential in retail finance and a steadily growing demand for integrated asset management services. So Korea where Citibank is seeking to expand its retail finance can serve as a critical stepping stone for Citibank to build a full line-up in retail finance so as to better compete in the Asian market.

<Table 4-84> Major Milestones in Citibank's Acquisition of KorAm Bank

Date	Content
Feb. 23, 2004	Citibank announced its plan to take over KorAm Bank
Feb. 23	KorAm Bank's board approves the singing of the tender agreement
After Feb. 23	Citibank N.A. requested the FSC's approval for holding shares in a bank beyond the limit for same-person.
April 26	The FSC granted the above request.
May 5	Citibank N.A. purcahsed the 36.6% stake from Carlylie in global depository receipt(GDR)
May 7	Citibank N.A. made a tender offer for KorAm Bank shares(60.9%)
May 10	Citibank N.A. signed the MOU on business transfer from its branches.
June 1	Yeong-gu Ha of KorAm Bank was appointed as the CEO of the merged bank.
June 11	KorAm Bank passed the resolution to request delisting of its shares.
July 7	Trading in shares of KorAm Bank was stopped.
July 9	A general shareholders' meeting was convened to approve and request the delisting of KorAm Bank shares.
July 13	KorAm Bank shares were delisted.
July 14, 2004 - Jan. 13, 2005	Procedures for protection of minority shareholders were taken
August 36	A request was made to the FSC for a preliminary approval for business transfer from Citibank branches.
October 29	The FSC approved the above request.
November 1	Citibank Korea was launched.

8.2. Major Characteristics of the Acquisition

There are three unique aspects to Citibank's acquisition of KorAm Bank. First, the transaction was a transfer of management right between two foreign investors(from Carlyle to Citigroup) and the buyer was a strategic investor, not a financial investor. Newbridge Capital(1999), Carlyle Fund(2000), and Lone Star

(2003) that took over Korea First, KorAm Bank, and KEB, respectively were non-bank U.S. PEFs and got involved in the acquired banks' management as the majority shareholders. These PEFs are financial investors whose sole objective is to take over financially-troubled companies, raise the value of the companies through restructuring, and sell them for profit.

But Citigroup which is the largest financial group in the world is a strategic investor and is directly involved in managing the acquired bank in the Korean market, encouraging healthy competition in the domestic financial market.

Second, the tender offer amounted to more than 3 trillion won which is the largest amount of cash payment for a takeover of a domestic company by a foreign capital.

Third, Citigroup paid the same price for the shares it acquired both to major and minor shareholders, unlike other M&A transactions where major shareholders are normally offered a higher price. In addition, Citigroup left the deal in the hands of minority shareholders by presenting the condition for the conclusion of the deal, that it should acquire at least 80% of KorAm shares including the 36.6% stake transferred from the Carlyle Group, in a public tender.

8.3. Specific Takeover Procedures

Under the tender agreement that Citibank and KorAm signed on February 23, 2004, the takeover transaction will be concluded only when Citigroup acquires at least 80% of all KorAm shares including the 36.6% stake it purchased from Carlyle. If the stake falls below 80%, the tender offer will be withdrawn and the deal will fall apart. The price per share which was 15,5000 won represents a 6.7% premium over the average closing price of KorAm stock on the Korean Stock Exchange for the previous 30 trading days and a 17.2% premium over the average closing price for the previous six months. Even if other pricing methods are used to determine the acquisition price, such as discounted cash flow method, free cash flow method, and discounted abnormal earnings model, they all arrive at a price very similar to the actual acquisition price. Citigroup paid 15,500 won per share for the Carlyle' 36.6% stake and offered the same price for the rest of the shares to acquire in a tender offer where it will increase its total stake up to at least 80%. If this condition is not met, the deal may be cancelled in which case KorAm Bank should paid 80 million dollars or around 93.4 billion won in a termination fee.

<Table 4-85> A Summary of the Tender Offer by Citigroup

Stake to be acquired	- Approximately 43.85% of all registered common stock of KorAm Bank, excluding the 36.6%(74,226,857 shares) held by the Carlyle consortium from the total 80% target stake to acquire.
Price per share	- 15,500 won
Conditions	- If the shares offered for sale by shareholders in the tender offer exceed the Citigroup's target, the group will acquire all of the shares beyond the target. - If the target is not met, none of the shares offered for sale by shareholders in the tender offer will be acquired.
Period	- The tender offer will be published within 5 days after the regulatory approvals are obtained and be closed within 45 days.

Citigroup made the tender offer on May 7, 2004 and purchased 60.9% which increased its total stake to 97.5% including the 36.6% stake taken over from the Carlyle consortium. Later, KorAm Bank took over Citibank's 15 branches in Korea for 833 billion won, completing the merger. Only Seoul branch remained in operation for the maximum 3 years that followed for post-merger management including derivatives transactions. Citibank Korea was officially launched on November 1, 2004.

<Table 4-86> The Results of the Tender Offer by Citigroup for KorAm Bank

1. Shares traded in the tender offer
   A. Target number of shares to be acquired : 88,226,555 shares
   B. Number of shares offered for sale by shareholders : 123,709,576 shares
   C. Number of shares acquired : 123,709,576 shares
2. Price
   - Total amount : 1,917,498,428,000 won
   - Price per share : 15,500 won
3. Payment (the date of the board's resolution) : May 7, 2004

8.4. Major Issues

First, the brand and the name of the new bank were two of the hotly discussed issues. Among the candidates were KorAm Bank, Citibank, Citi-KorAm Bank, and KorAm-Citibank. Eventually, the merged bank was named Citibank Korea Inc., and Citibank was chosen as the brand. Some argued that KorAm Bank should be retained as the brand in order to relieve the possible negative sentiment toward the expansion of a large foreign capital into the domestic banking sector and to facilitate corporate banking activities. However, Citibank was adopted as the brand of the new bank, considering that Citibank is largely perceived as an advanced financial institution in Korea. The decision was also affected by the fact that in a survey of major Asian companies by Far Eastern Economic Review, a financial news magazine published in Hong Kong, Citibank or Citigroup was rated No.1 brand for the previous 10 years.

Second, labor issues have always been controversial in every M&A case in Korea and the success of a deal often hinges upon how these touchy issues are resolved. As in other cases, Citigroup faced many challenges including a strike as disputes with the union arose in many areas such as wage, working conditions, benefits and corporate cultures. After all, Citigroup and the union worked out these differences and reached an agreement. The two parties agreed to discuss a wage increase after the collective wage agreement for the entire financial industry would be reached, and Citigroup promised not to put at a disadvantage those who participated in the strike and not to press any civil or criminal charges against them. Therefore, labor issues did not present any major obstacle to the merger.

<Table 4-87> A Summary of the Labor-Management Agreement

-The number of employees classified into the category where their job is solely restricted to the teller position will be reduced by 30% each year in 2004 and 2005, and the category itself will be abolished entirely by the end of 2006. -Fixed salary increase schedule: fully applicable to Level 4 or below from August 1, 2004 and to become applicable to Level 3 except the vice branch manager and team heads by the end of 2005. -A consolation package equivalent to 400% of the basic salary will be paid. -130 employees will be promoted in the second half of the year. -There will be no forced restructuring against the wishes of the employees, including forced retirement or dismissals, and employees will be placed in proper positions in consideration of their geographical ties, academic background, career path, aptitude, and their individual wishes. -The principle of no wage for no labor will be applied for the 10 business days during which the employees did not work due to the strike. -The official business language will be Korean even after the Seoul branch of Citibank will be integrated.

CHAPTER 5

Macroeconomic Policy Coordination and Macro Risk Management

Credit expansion is not triggered by a series of accidents, but it is rather a result of the systematic efforts of financial market participants over hundreds of years to reduce transaction cost and the cost of holding liquidity or cash at the same time.

"Manias, Panics and Crashes: A History of Financial Crisis" (2006), Charles P. Kindleberger

1. Macroeconomic Policy Coordination

1.1. Macroeconomic Policy and Macro Risks

Macroeconomic policy deals with the management of macro variables in order to meet macroeconomic objectives. Microeconomic policy concerns labor market, financial market, agriculture, energy, government, and public corporations. On the other hand, macroeconomic policy aims to achieve macroeconomic goals of economic growth, employment, international balance of payments, and prices, by managing such policy variables as interest rate, exchange rate, and government spending. As was shown in many cases of financial crisis, private financial institutions should also make due efforts toward macro risk management and for this, they should closely monitor, and assess the impact of the macroeconomic policies of the government.[100] For the government's part, it is important to keep the channel of communication open at all times so that the intentions of the policy makers are accurately understood by the private sector. In addition, ensuring responsibility and transparency in the decision-making process is also an equally important task for the government.

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100 For example, domestic financial institutions did not have a BOK watcher prior to the financial crisis in 1997, but now most of them have a BOK watcher within their organization and respond sensitively to changes in the government policies on interest rates and foreign exchange rates.

Macro risks are classified into 3 categories, depending on where the risk is originated: system, economy, and financial crisis. Traditionally, the government is viewed as responsible for managing these risks, but the private sector is also becoming increasingly capable of actively responding to such risks as they feel the need to manage risks on their own.

The fundamental goal of macroeconomic policy lies in keeping the economy in an expansionary phase over a long term. In other words, it is important to keep the economy on its potential growth path by minimizing the fluctuations of the economy. It is not desirable to leave the depth of volatility increasing and the adjustment cost should be minimized by ensuring that resources are efficiently distributed. For example, when the economic downturn continues and companies fall into bankruptcies, physical production capacity of companies will likely be lost as facilities may be closed down and skilled workers may leave their workplace. When the economy turns around and enters an expansionary phase, the growth momentum can be lost or delayed due to lack of the physical production capacity lost or damaged during the previous downturn. From the distribution perspective, the low-income class is the first to suffer in an economic downturn and the last to benefits from an economic upturn.

An accurate diagnosis of the economic condition is one of the most important factors that should be considered in managing macroeconomic policies. Macroeconomic policies are often subject to the risk of being implemented pro-cyclically rather than counter-cyclically due to various types of time lags such as the time lag from collecting statistical data to formulating and implementing policies. Therefore, it is becoming increasingly important to use coincident indicators to assess the current economic condition in a timely manner and to establish the EWS to perceive and identify risks at an early stage. Particularly, the financial sector needs to be equipped with a system to determine market risks and detect signs of an economic crisis. If a diagnosis warrants a new combination of macroeconomic variables, the timing and the scale of re-balancing of key variables should be determined. Since different organizations determine different variables, close cooperation among related policy makers is essential. For example, in Korea, interest rates are decided by the Monetary Policy Committee, foreign exchange rates are determined by the government, and the government spending is jointly decided by the government and the National Assembly. So the risk remains that actions may not be taken in a timely manner or distorted in the process.[101] With

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101 The tension between the government and the central bank exists in any country. The monetary policy authorities are now very independent in most of Europe as many of European countries have been integrated into the EU. But the central banks were hardly independent in major countries such as France and the U.K. prior to the integration. Normally, a government is inclined regards to interest rate policy it is critical to for policy makers to communicate closely with the market so that the their intentions are accurately understood by the market and market participants make adjustments efficiently according to changes in the policies.

Responsible and transparent macroeconomic policies are very important for foreign exchange rate policies. For example, critics point out that government interventions in foreign exchange rates caused significant financial burdens on the government in the past but their effects were limited. Given the past experiences, decisions should be made in a responsible and transparent manner.

1.2. Timely Diagnosis of the Economic Condition

1.2.1. Coincident Indicators

Coincident indicators that are used for the purpose of making a timely diagnosis of the economic condition should be made available at least twice a month and compiled within 5 days after they are published. The indicators should include industrial production, domestic consumption, domestic investment, and overseas demands. Industrial output data is also used to infer investment trends because investment data is generally not solid.

The Korean government uses the coincident indicators listed in the table belo w.[102] Retail sales, domestic transactions paid for with credit cards and gasoline sales are indicators of consumer spending. Sales at department stores represent spending by high-income households while sales at discount stores indicate spending by low-income households. Domestic automobile sales data is a measure of both consumption and investment because car is a durable good and a corporate investment good. Industrial electricity consumption is directly related to industrial output. The indicators should be reviewed each month for any particularities of the month in light of monthly fluctuations and quarterly trends.

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to seek employment and growth as priorities for political reasons and therefore, it often raises interest rates later than it should in a phase of economic recovery. Article 2 of the Bank of Korea Act clearly prescribes that the goal of monetary policy is price stabilization, and that the members of the monetary policy committee and the governor of the Bank of Korea should serve for a fixed term so as to ensure the bank's independence.

102 Export data is not included in the table because the data is tallied on a daily basis and

<Table 5-1> Coincident Indicators (August 2008)

1. Retail sales

☐ Sales from August 1~15: sales at department stores rose 5.9% from the same month a year ago while sales at discount stores fell 0.5%.

(Compared to the same month a year ago,%)	2008						2007		2008	
	3	4	5	6	7	**8**	Year-on-year	4/4	1/4	**2/4**
Department stores	6.7	6.5	11.3	11.2	5.9	**5.7**	3.0	2.9	2.4	**9.6**
Discount stores	2.8	0.1	4.9	△1.9	2.1	**△0.5**	0.6	△4.4	6.4	**1.1**

2. Purchases with credit card

☐ Maintained a double-digit growth from August 1~15(18.2%)

	2008					2007		2008	
	4	5	6	7	**8**	Year-on-year	4/4	1/4	**2/4**
Amount approved (trillion won)	24.7	25.3	24.2	26.4	**11.4**	254.8	70.2	71.4	**74.2**
Compared to the same month a year ago (%)	19.4	20.0	18.8	22.9	**18.2**	15.3	18.3	21.7	**19.4**

3. Gasoline sales(August 1~15)

☐ Gasoline sales rose 9.7% as the price hike slowed down(24.0%→16.2%).

(Compared to the same month and the same quarter a year ago, %)	2008					2007		2008	
	4	5	6	7	**8**	Year-on-year	4/4	1/4	**2/4**
Gales sales	6.5	0.0	△4.6	△5.1	**9.7**	4.2	0.8	△0.2	**0.6**
Gasoline price	12.8	17.3	22.9	24.0	**16.2**	2.4	12.3	16.6	**17.7**

4. Domestic automobile sales(August 1~15)

☐ Domestic sales of domestically produced automobiles(No. of cars) **increased 2.6%** from the same month a year ago.

	2008					2007		2008	
	4	5	6	**7**	**8**	Year-on-year	4/4	1/4	**2/4**
No. of cars sold (10,000 cars)	11.1	10.8	9.8	**10.7**	**2.9**	121.9	32.4	30.2	**31.7**
Compared to the same month a year ago	11.4	.3.	△7.5	**5.1**	**26.6**	4.7	△0.4	3.8	**2.2**

5. Industrial electricity sales

☐ Sales of electricity used for industrial production **rose 8.1%** from the same month a year ago.

	2008				2007		2008	
	4	5	6	7	Year-on-year	4/4	1/4	**2/4**
Sales(GWn)	16,964	16,985	17,048	17,726	194,936	50,478	51,280	**50,998**
Compared to the same month a year ago	6.2	4.7	4.8	8.1	6.5	9.3	8.7	**5.2**

1.2.2. Early Warning System(EWS)

The early warning system(EWS) refers to a comprehensive risk management system designed to preemptively detect signs of an economic crisis and to take timely actions against it. The system was established in September 2004, following the decision by the Economic Policy Coordination Council(presided over by the president) on January 30, 2004 and it was launched in January 2005. The system consists of 9 sub-categories including finance, raw materials, real estate, and labor that were added in addition to the external conditions that was included in 1999 after the eruption of the foreign exchange crisis. A measuring model was created to predict risks for each individual sub-category and an assessment of the current situation is made based on the early warning index computed using the model.

<Table 5-2> EWS Categories and Responsible Government Agencies

Major Categories(5)	Sub-categories(9)	Government agencies
External	External	Ministry of Strategy and Finance
Finance	Financial Market	The FSC & the FSS
	Financial Industry	
Raw Materials	Oil	Ministry of Knowledge Economy
	Other Raw Materials	
Real Estate	Housing	Ministry of Land, Infrastructure and Transportation
	Land	
Labor	Employment	Ministry of Labor
	Labor-Management Relations	

Setting the thresholds is very important. The risk level should be sensitively determined and fine-tuned, taking into consideration circumstances that actually caused problems or were highly likely to cause problems in the past. However, since the judgements are made based on the past data, the question remains if the judgements will be valid for a future situation, which is a typical shortcoming of a metric model.

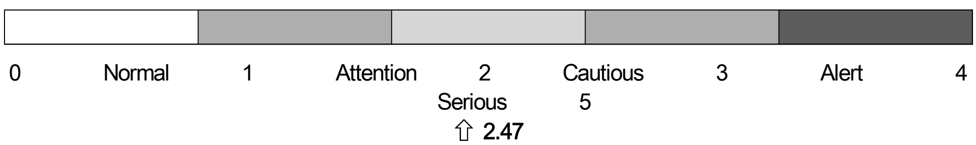
A total of 30 variables were selected in 5 categories including stocks, real economy and bonds that have a strong cause and effect relationship with financial crisis and that can serve as strong leading indicators of a financial crisis.

<Table 5-3> The Flow of Early Warning Index Computation

① **Collect raw data on individual variables**   ⇩   ② **Convert data**(eliminate noises such as seasonality) and **standardize the data(**averaging/standard deviation)   ⇩   ③ Find the **simple average** of the standardized data for 5 individual categories(composite index)   ⇩   ④ **Recalculate the composite index** to adjust the index into 5 stages(0~5)

Finally, how the risk level is labeled and determined is important. There are 5 levels that indicate the degree of risk: from 0 to 1 is labeled "normal", 2 to 3 "cautious", 3 to 4 "alert", and 4 to 5 "serious". As of the end of July 2008, the early warning index stood at 2.47 or "cautious".

<Table 5-4> Risk Classification Continuum



The EWS has 5 categories and 9 sub-categories.

First, the external category is composed of a total of 21 variables that have a cause-and-effect relationship with foreign exchange crisis and that are indicative of such crisis, including the real economy, trade, finance and foreign exchange data. These variables have been intuitively selected based on past experiences. A specific number is pre-set for each variable and when the number reaches a threshold, it is considered a sign of risk. For example, if the monthly export growth rate falls below a certain level, it is viewed as a sign. The pre-assigned weighted values of individual variables showing signs of risk are compiled to determine the EWS index(the composite risk level), and if the index breaks out of a certain range, it is programmed to indicate that there is a high risk of a foreign exchange crisis.

<Table 5-5> Variables for External Risk Assessment

21 Variables	Content
Real Economy(4)	Shipment and inventory indices, industrial production, dishonored bill rate, consolidated fiscal balance/GDP ratio
Current Account(6)	Terms of trade volatility, current account/industrial production index ratio, export concentration index, volatility of real foreign exchange rates, export growth, revaluation and devaluation pressures for real effective exchange rates from competitor countries.
Finance(5)	Composite stock index, changes in domestic credit/IPI ratio, surplus capital demand index, changes in real domestic interest rates , instability of monetary aggregates multiplier
Foreign Exchange(6)	Changes in foreign currency reserves, total external liabilities/exports, short-term foreign debt/foreign currency reserves, banks' foreign currency-denominated debt/asset ratio, contagious effect index, capital account/GDP ratio. capital balance/GDP ratio

Second, there are 30 variables in 5 areas of the finance category, including stocks, real economy, and bonds that are closely related to, and indicative of a financial crisis. The pre-assigned weighted values of individual variables showing signs of risk are compiled to determine the EWS index(the composite risk level), and if the index breaks out of a certain range, it is programmed to indicate that there is a risk of a financial crisis, which is classified into 5 stages: normal, attention, cautious, alert, and serious.

<Table 5-6> Variables Indicative of Financial Market Risk

30 Variables	Content
① Funds and monetary conditions(3)	M2 growth rate, bank lending growth, Fund flows: M2 at banks/M2 at investment trust companies
② Stock(4)	Net foreign purchase, dividend yield, turnover ratio, customer deposits
③ Macroeconomy(6)	inventory/shipment ratio, unemployment rate, BSI, exchange rates for Korean won, foreign currency reserve, imports
④ Overseas(7)	S&P 500, credit spread, LIBOR, NIKKEI, exchange rates for yen, international oil prices, spread between international and domestic interest rates
⑤ Constituents of instability index(10)	Month to month changes in KOSPI, KOSPI trading volume, KOSDAQ trade volume, standard deviation of KOSPI, standard deviation of KOSDAQ, standard deviation of KOSPI trading volume, mid-month standard deviation of KOSPI trading volume, corporate bond yields, term spread, credit spread, treasury bond yields, dishonored bill rate

There are 24 variables in the financial industry category and these variables are monitored daily to keep a close watch on soundness, liquidity and other aspects of individual financial companies in 6 sectors. The potential risk that is assessed for individual companies based on the daily monitoring is classified into 5 stages. A separate EWS index is computed for non-bank financial institutions that mainly low-income families use. Mutual savings banks are risk-weighted according to the grade assigned by the classification of financial companies to calculate the potential risk index for the non-bank financial institutions.

<Table 5-7> Variables for Risk Assessment of Financial Companies

Companies(24 variables)	Content
Banks(6)	Aggregate default rate, short-term loan ratio, number of days when the amount of new loans decreased, rate of loss from securities valuation, rate of reduction in won-denominated deposits received, call rate spread
Insurance(4)	delinquency rate, insurance money payout ratio(against premium revenues), initial premium growth rate, funds balance ratio
Securities(3)	Changes in accounts receivable from securities transactions, risk on derivatives, liquidity ratio
Asset management(2)	Number of days with falling assets under management and the reduction rate, difference between book value and market price of MMFs.
Credit card & hire-purchase finance companies(4)	Usable liquidity, rollover ratio for corporate bonds and CPs, corporate bond/CP issuance spread, regular payment ratio
Mutual saving banks(5)	changes in credit loans made, reduction rate for deposits received, short-term borrowings ratio, ratio of loans in arrears, rate of loss from securities valuation

Third, the oil market segment comprises 21 variables that are closely related to, or highly indicative of an oil crisis such as price changes, demand and supply, and international financial market trends. Individual variables are weighted in a way that can best reflect a possible crisis, and the variables are compiled to come up with the EWS index. If the index breaks out of the pre-sent range, it indicates that there is a risk of an oil crisis.

<Table 5-8> Variables Indicative of Oil Market Risk

21 variables	Content
Dubai oil price(3)	Real oil price impact index Month-on-month change in the real oil price impact index 3-month change in the above index
Crude oil supply(7)	4 month average of month-on-month growth in U.S. crude oil inventories U.S. crude oil inventories Month-on-month growth of OPEC oil production 4-month average of month-on-month growth of OPEC oil production The reciprocal of OPEC's surplus production capacity Month-on-month growth in OPEC's surplus production capacity OPEC's surplus production capacity
Demand for crude oil(3)	Month-on-month growth in U.S. industrial production index Month-on-month growth in global petroleum demand Global petroleum demand/1000
International financial market(8)	Month-on-month change in the real effective exchange rate for US dollar Month-on-month change in the US Dow Jones Industrial Average Index U.S. short-term interest rates Month-on-month change in U.S. short-term interest rates
	U.S. long-term interest rates Month-on-month change in U.S. long-term interest rates Month-on-month change in NYMEX trading volume NYMEX net futures positions/ 1000

Fourth, other raw materials include variables such as real economy, trade, and finance that have a strong cause-and-effect relationship with prices of other raw materials(11 items in 4 segments)[103]. Only prices are monitored for 5 items including gold, natural rubber, silk cocoons, raw leather, and pulp. If individual variables reach certain thresholds, it is considered as a sign of risk. Variables showing signs of risks are weighted by the signal/noise ratio and the EWS indices are computed for the 4 segments which are added up with the import-weighted values applied to arrive at the final index. If the index breaks out of the pre-set range, it is considered as an indicator of a possible crisis.

103 The 4 segments and 11 items are non-ferrous metals(aluminum, electrolytic copper, nickel), steel materials(scrap metals, slab, billet), petrochemical materials(naphtha, propane, para xylene), and textile materials(raw cotton, ethylene glycol)

<Table 5-9> Variables in the Other Raw Materials Segment

4 segments	Content
Non-ferrous metals(7)	① U.S. industrial production index, ② GDP gap of China, ③non-ferrous metals inventories, ④ changes in the prices of non-ferrous metals futures, ⑤ changes in international oil prices, ⑥ U.S. short-term interest rates, ⑦ volatility of dollar/euro exchange rate
Steel(7)	① prices of bituminous coal for fuel, ② import prices of Japanese ores, ③ prices of international crude oil futures, ④ won/dollar and yen/dollar exchange rates, ⑤ U.S. GDP growth rate, ⑥ China's GDP growth rate, ⑦ changes in steel production in Asia
Petrochemical materials(7)	① China's GDP growth rate, ② volatility of dollar/euro exchange rate, ③ NYMEX crude oil futures prices, ④ U.S. short-term interest rates, ⑤ U.S. crude oil inventories, ⑥ OPEC's surplus production of crude oil, ⑦ net futures buying by NYMEX investors
Textile materials(5)	① China's GDP growth rate, ② U.S. GDP growth rate, ③ prices of international crude oil futures, ④ raw cotton futures prices, ⑤volatility of dollar/euro exchange rate

Fifth, a real estate market crisis is defined as a condition in which housing prices or land prices change dramatically,[104] compared to the same month a year ago. Regional EWS indices are published for different regions to monitor risks in the housing market(Gangnam area and capital area), and the land market(capital area and Chungcheong area). Variables that have a high cause-and-effect relationship with a crisis of the real estate market were listed(18 for housing and 14 for land). If individual variables reach the pre-set thresholds, it is considered as a sign of risk. The EWS index is obtained by simply adding up all the signs of risk. The risk for real estate market is classified into 5 stages. Further analysis is performed on variables that are not quantifiable or for which data is not enough for time series. At the end of each month, the EWS monitoring committee meets to determine the stage of risk, based on the EWS analysis and opinions collected from experts.

104 Dramatic changes are defined as below in expansionary and contraction phases.

Month-on-month change	Expansionary	Contraction
Housing market	Max > 1.5% (2.0% for regional areas)	Min < -1.0 (-1.0% for regional areas)
Land market	Max > 1.0% (1.5% for regional areas)	Min < -0.5% (-1.0% for regional areas)

<Table 5-10> Variables Indicative of Real Estate Market Risk

	Major Variables	Additional Variables
Housing Market	Liquidity at financial institutions, composite stock price index, composite leading indicators(CLI), customers deposits, 3-year treasury bond rates, banks' loan-deposit ratio, listed builders' stock price index, number of apartment units built, industrial production index, consumer price index, amount of large construction contracts, number of apartment-application deposit accounts	Home mortgage loans, construction BSI, consumer expectation index, number of housing-related news articles, number of unsold apartment units.
Land Market	Liquidity at financial institutions, composit stock price index, composite leading indicators, 3-year treasury bond rates, banks' loan-deposit ratio, consumer price index, average wage of all industries, number of land lots traded nationwide, area of land traded for residential purposes	Home mortgage loans, construction BSI, consumer price index, number of housing-related news articles, transactions of land for construction of apartments in the capital area

Sixth, the labor market variables are mainly concerned with employment rate. There are 8 key variables in 5 segments including leading, coincident, and lagging indicators, employment, and labor mobility. A model that forecasts the employment rate in 8 months is built and a future employment rate can be predicted at a present time, using the 8 variables. If the employment rate is at average or higher, it is a normal condition and if the rate falls 1.5 times the standard deviation, it is viewed as a sign of risk. The reciprocal of the employment rate forecast in 8 months is the EWS index and the thresholds are set accordingly. If the index reaches a certain point, it is interpreted as a sign of a crisis in the labor market.

<Table 5-11> Variables Indicative of Labor Market Risk

Segments(9 variables)	Content
Composite leading indicators(1)	Ratio of jobs offered to job seekers
Composite coincident indicators(1)	Index of manufacturing capacity utilization ratio
Composite lagging indicators(1)	Household consumption & expenditures
Employment(4)	Employment rate, employment rates for persons in their 40s, labor force participation rate for persons in their 30s and 40s.
Labor mobility(1)	Turnover rate

Seventh, labor-management tensions that affect external confidence, the domestic economy, and society are monitored to assess the risk in labor-management relations. A model is created to predict the labor-management tension(number of unworked days per 10,000 wage workers) 6 months from a present time. The tension is quantified into an EWS index and if the index exceeds a pre-set threshold, it is considered as a sign of risk and if it breaks out of a certain range, it should be interpreted as a sign that there is a high risk of a labor-management relations crisis.

<Table 5-12> Variables Indicative of Labor-Management Risk

Segments(10 variables)	Content
Labor-management relations by industry(3)	No. of labor disputes in manufacturing, transportation, and services
Labor-management relations by region(3)	No. of labor disputes in other areas than Seoul, Gyeongnam, and other areas
Labor-management relations issues(3)	No. of labor disputes caused by wage, collective agreement, restructuring and other issues except collective wage bargaining
Yearly trends(1)	Yearly trends of rising or falling labor-management tensions

1.3. Monitoring of Risks in the Financial Sector

The following shows how risks in the financial sector were monitored as of March 2007. What is noteworthy is that the aggregate index method used in the past was found inadequate in detecting risks early enough, leaving insufficient time to cope with a fast-evolving crisis properly. With this index method, a risk in one area can be offset by stability in another area and as a result, a potential crisis may not be perceived. It is convenient because all the risks are combined and represented in a single index. However, it is important to qualitatively assess risks because risks in individual areas can certainly spread rapidly to other areas. For example, the composite index was stable even though there were more than 3 items marked with cautious, alert , or serious in March 2005, in which case the possibility of a crisis continued to increase and actions needed to be taken urgently.[105]

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105 Actions were taken at the end of August(August 31 Plan), which was 5 months later. The risk monitoring report for April 2009 shows that the impact of the global financial crisis continued to grow over time since August 2008 when more than 3 items were marked in red(warning sign), and even though the composite index of the financial market stress test was rated stable, some of the individual instability factors considerably rose and therefore, the government implemented

For March 2005, the results of the risk monitoring were as shown in Table V-13, and the results were analyzed as follows, considering that a crisis is generally triggered when displacement of key variables occurs amid a prolonged state of excessive liquidity and increasing herd behavior.

First, liquidity expansion pressure remains but it is expected to steadily decrease. Underlying factors that cause liquidity to increase still persist as financial institutions expand their lending mainly to SMEs and short-term foreign borrowings continue to rise. However, home mortgage loans are growing at a slower pace, the current account deficit is declining, and foreign investments are rising, which will put downward pressure on liquidity and overall, liquidity will follow the downward path.

Second, the herd behavior among debtors and loan applicants slowed down but in some areas, it was further intensified. Sentiment largely stabilized in the real estate market and in connection with home mortgage loans, but the overheated demand for studios apartments in Songdo reveals a lingering sense of instability among market participants. Investors became increasingly aware of risks associated with overseas stock investments following the severe fluctuations of the Chinese stock markets at the end of February and began to diversify their investment portfolios into Japan and other advanced economies. On the other hand, Kookmin Bank and Shinhan Bank that were previously less aggressive in enlarging the size of their assets are showing signs of joining the competition by lending more to SMEs. In addition, domestic companies continued to sell forward exchange contracts on blind expectations that Korean won would appreciate. Third, the possibility remains that key variables may be displaced, but it is less likely than in the previous month. As the economy is forecast to rebound gradually, led by domestic consumption, the ability of households and SMEs to repay their debts is anticipated to increase and the rise of mortgage rates is slowing down. Though they remain structurally vulnerable to asset impairment, non-bank institutions lending mainly to low-income households are witnessing their financial health steadily improving, and external variables are returning to normal at a fast rate after the exchange rate and other variables fluctuated due to worries over international financial markets at the beginning of the month.

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active market stabilization measures with a focus on foreign exchange market and capital markets.

<Table 5-13> The Results of Financial Sector Risk Monitoring

		Jul. 2006	Aug.	Sept.	Oct.	Nov.	De.	Jan. 2007	Feb.	Mar.
1. Liquidity	M2 growth rate (from same month a year ago, %)	7.7	7.5	9.0	10.1	11.1	11.4	11.3	11.5	mid 11%
	Short-term deposit ratio (from same month a year ago, %)	1.4	△0.5	0.5	4.3	5.2	7.1	8.1	8.8	7.0
2. Real Estate (Seoul)	Sale prices of apartments (from previous month,%)	0.3	0.3	0.6	2.2	6.2	3.7	1.8	0.3	0.2
	Lease for apartment (from previous month,%)	0.2	0.4	1.2	1.7	1.7	0.6	0.7	0.4	0.6
3. Mortgage loans	Change in banking sector (from previous month,%)	1.2	0.6	1.2	1.4	2.0	1.4	0.4	0.2	0.0
	Delinquency rate(%)	1.0	1.0	0.8	0.9	0.7	0.6	0.7	0.7	0.6
4. Loans to SMEs	Change in banking sector (from previous month,%)	0.8	0.9	2.2	1.5	2.2	0.5	1.0	1.7	2.3
	Dishonored bill rate(%)	0.10	0.12	0.13	0.18	0.14	0.12	0.10	0.10	0.07
5. External	Short-term foreign borrowings (from previous month, 100 million dollars)	26.5	51.3	41.9	△1.9	△4.0	23.3	28.4	27.9	-
	Yen/dollar exchange rate average (from previous month,%)	0.9	0.1	1.1	1.4	△1.3	△0.1	2.7	0.2	△2.8

Normal   Attention   Cautious   Alert   Serious

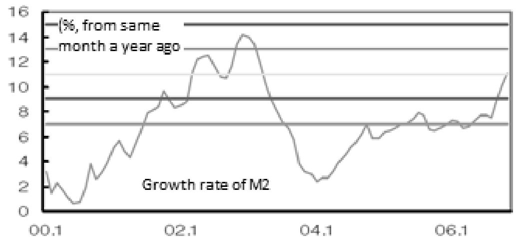
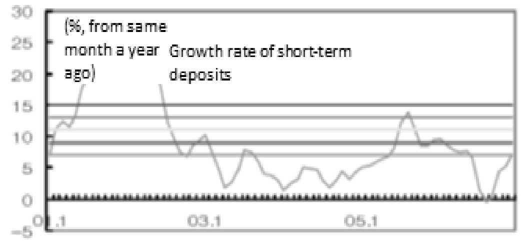
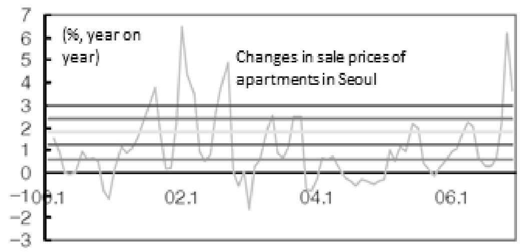
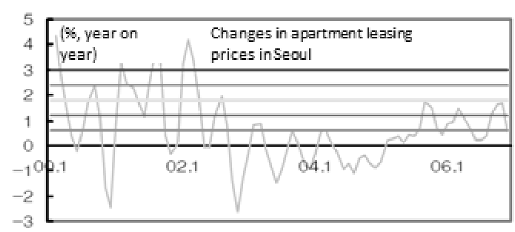
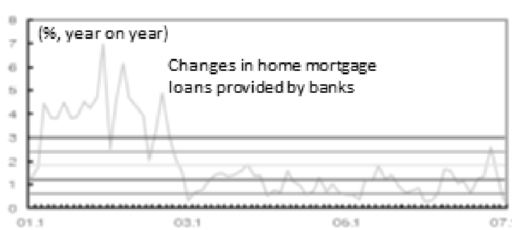
The following is the checklist for risk monitoring and the quantitative criteria.[106]

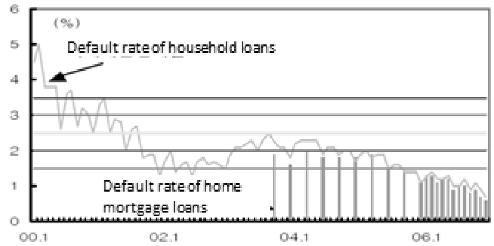
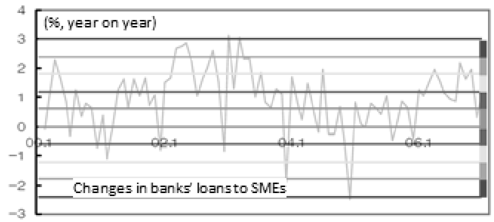
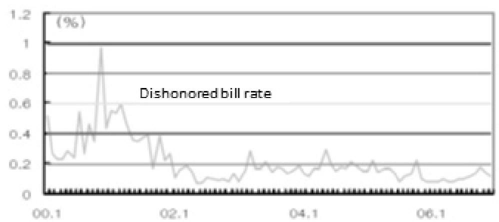
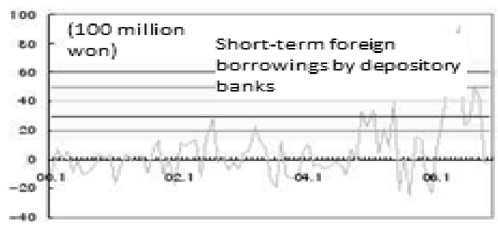
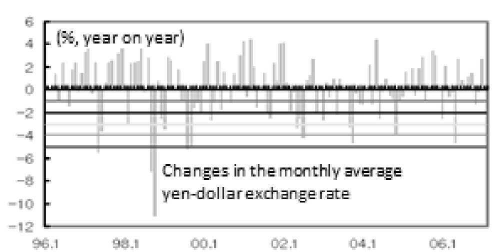
106 The quantitative analysis uses the five key variables while the rest of the indicators(supplementary, coincident, and referential) are used for the qualitative analysis.

<Table 5-14> Risk Indicators

	Key Indicators (for quantitative analysis)	Supplementary Indicators	Coincident Indicators	Referential Indicators
1. Liquidity	- M2 - Short-term deposits	- Reserve base - M1 - Lf - Short-term deposit(ratio)	- Loans from depository banks(weekly)	-
2. Real estate	- Sale prices of apartments in Seoul - Lease for apartments in Seoul	- Prices by area and type of housing - Units traded - Unsold apartments	- Sale prices & lease of apartments in Seoul - No. of reported home sales(weekly)	- Lease & sale prices - Rate of return on major assets - Sale prices of new apartments(monthly) - Short-term deposits
3. Home mortgage loans	- Changes in the banking sector - Delinquency rate	- Changes in the non-banking sector - Mortgage rates	- Changes in the banking sector(daily) - Interest rates(weekly) - Approved, new, and repaid amounts(daily)	- Balance approved by banks - Housing prices - Home mortgage rates & CD rate spread - Financial institutions' lending practices
4. Loans to SMEs	- Changes in the banking sector - Dishonored bill rate	- Delinquency rates for banks - Changes in the non-banking sector - Changes in individual lenders and delinquency rates	- Dishonored bill rates in Seoul(daily) - Guarantee payments by Korea Credit Guarantee Fun(daily)	- Corporate bond spread - BSI on SMEs' funding conditions - Financial institutions' lending practices
5. External	- Short-term foreign borrowings by depository banks(BOP) - Yen/dollar exchange rate	- Net selling of forward exchange positions by corporations - Foreign-currency loans - Basic balance - Overseas real estate & foreign funds - Short-term foreign loans by Japan	- Exchange rates(daily) - Foreign exchange stabilization bond spread(daily) - CDS premium(daily) - U.S. & Japan's interest rates(daily) - Yen forward positions on CME(weekly)	- Shipbuilding orders received(quarterly) - External EWS - Foreign currency liquidity at banks - Fiscal and trade balances(U.S. & Japan)
6. Stock markets	-	- Stock indices - Stock funds - Foreign net buying	- Stock indices(daily) - Changes in stock funds(daily) - Foreign net buying(daily)	- Composite leading(coincident) indicators - DOW Index - WTI
7. Non-banking sector	-	- Financial sector EWS - Credit card delinquency rates - PF loans by savings banks and default rates	- Distribution yield of credit card ABS(daily) - Credit sales(5 days) - Cash advances(5 days)	- Household loans - Financial debt delinquents

<Table 5-15> Quantitative Criteria for Risk Indicators

Area		Criteria	Results
Liquidity	M2 growth rate (from same month a year ago)	·Normal : 7% or below ·Attention: 9% or below ·Cautious : 11% or below ·Alert : 13% or below ·Serious : more than 13%	
	Short-term deposits rate (from same month a year ago)	·Normal : 7% or below ·Attention: 9% or below ·Cautious : 11% or below ·Alert : 13% or below ·Serious : more than 13%	
Real estate	Growth rate of apartment sale prices in Seoul (from previous month)	·Normal: 0.6% or below ·Attention : 1.2% or below ·Cautious: 1.8% or below ·Alert : 2.4% or below ·Serious : more than 2.4%	
	Growth rate of apartment leases in Seoul (from previous month)	·Normal : 0.6% or below ·Attention : 1.2% or below ·Cautious : 1.8% or below ·Alert : 2.4% or below ·Serious : more than 2.4%	
Home mortgage loans	Growth rate in the banking sector (from previous month)	·Normal : 0.6% or below ·Attention : 1.2% or below ·Cautious: 1.8% or below ·Alert : 2.4% or below ·Serious : more than 2.4%	

Area		Criteria	Results
Home mortgage loans	Delinquency rates in the banking sector	・Normal : 1.5% or below ・Attention : 2.0% or below ・Cautious : 2.5% or below ・Alert : 3.0% or below ・Serious : more than 3.0%	
Loans to SMEs	Changes in banks' loans to SMEs (from previous month)	・Normal: 0~0.6% or below ・Attention : -0.6% ~1.2% ・Cautious : -1.2%~-1.8% ・Alert: -1.8%~2.4% ・Serious : below -1.8%, more than 2.4%	
	Dishonored bill rate	・Normal : 0.2% or below ・Attention : 0.4% or below ・Cautious: 0.6% or below ・Alert : 0.8% or below ・Serious : more than 0.8%	
External	Changes in short-term foreign borrowings by depository banks	・Normal : $2.0 bln or below ・Attention : $3.0 bln or below ・Cautious : $4.0 bln or below ・Alert : $5.0 bln or below ・Serious : more than $5.0 bln	
	Yen/dollar exchange rate(monthly average, from previous month)	・Normal : △1.0% or more ・Attention : △2.0% or more ・Cautious : △3.0% or more ・Alert : △4.0% or more ・Serious : △4.0% or below	

The results of the risk monitoring in the financial sector in April 2009 are shown in the table below.

<Table 5-16> The Financial Sector Risk Monitoring Results(April 2009)

	Key Indicators	2008							2009			
		6	7	8	9	10	11	12	1	2	3	4p
Liquidity	① M2 growth(YoY)	15.1	14.8	14.7	14.5	14.2	14.0	13.1	12.0	11.4	11.1	100.3
	② Banks' deposit-loan ratio(+CD,%)	104.2	105.4	104.6	103.3	101.3	101.1	101.5	102.6	99.8	100.8	-
Won-denominated money market	① Banks' liquidity (in won)	106.5	104.0	106.2	104.5	102.5	100.2	104.9	101.8	105.7	105.5	-2.7
	② Net issuance of bank bonds (3MA, trillion won)	2.0	-0.6	2.5	3.8	3.2	1.7	1.1	-0.3	-2.0	-3.4	1.2
	③ Net CD issuance (3MA, trillion won)	2.5	2.9	2.0	-0.6	-1.4	-2.1	-3.1	-3.8	-3.3	-0.6	28.7
	① Loans to large corporations (YoY)	60.8	67.0	69.8	69.6	78.3	72.4	65.6	58.0	51.4	39.1	2.3
	② Delinquency rates on corporate loans (%)	1.0	1.2	1.3	1.3	1.5	1.6	1.5	2.0	2.3	2.0	9.1
	③ Loans to SMEsYoY)	19.0	19.5	18.6	16.5	14.5	12.4	12.7	11.0	10.8	10.4	2.6
	④ Delinquency rates on SME loans(%)	1.1	1.4	1.5	1.5	1.8	1.9	1.7	2.4	2.7	2.3	1.92
	⑤ Corporate bond spread(%p)	0.97	1.03	1.34	1.65	2.86	3.56	4.38	3.91	3.29	2.45	-1.5
	⑥ Net CP issuance (3MA, trillion won)	0.8	0.4	0.1	-0.1	0.1	0.6	2.8	1.7	-0.1	-2.3	9.6
	① Home mortgage loans(YoY)	5.4	6.4	6.6	7.2	7.1	7.2	8.1	8.5	9.6	10.3	0.5
	② Delinquency rates on mortgage loans(%)	0.4	0.4	0.5	0.4	0.5	0.5	0.5	0.7	0.7	0.6	4.6
	③ Purchases by credit card(YoY)	16.1	14.6	6.1	25.0	3.4	1.2	7.9	-2.6	2.6	8.9	2.4
	④ Delinquency rates on credit card payments (%)	1.4	1.6	2.0	1.6	1.9	2.1	1.8	2.4	2.8	2.2	1.03
Foreign-currency money market	① Rollover rate	78.9	106.4	128.1	74.2	39.9	52.9	60.7	92.6	89.1	100.6	110.7
	② Swap basis(bp)	186	174	166	221	280	281	183	194	287	316	88.9
	③ Current foreign debt/foreign exchange reserve(%)	86.1	90.8	95.2	94.9	96.1	94.7	91.2	92.7	93.4	91.0	96.3

	① TED spread (bp)	90	116	107	203	344	210	182	112	96.2	107.0	90.86
	② OIS spread (bp)	69.3	73.5	76.7	123.7	294.0	179.0	157.4	102.2	99.0	102.0	37.7
	① VIX	22.1	24.3	20.7	30.2	61.2	62.6	52.4	44.4	45.4	44.8	157.0
	② itraxx(Europe)	90.5	98.4	96.0	112.6	142.4	157.1	190.2	165.9	164.9	185.0	705
	③ U.S. corporate bond spread(bp)	400	429	445	499	702	770	736	701	672	710	0.10
Real estate	① National Home Price Index(MoM)	0.60	0.39	0.20	0.23	-0.05	-0.40	-0.73	-0.60	-0.20	-0.20	0.30
	② Sale prices of apartments in Seoul(〃)	0.51	0.23	-0.01	0.02	-0.30	-0.84	-1.54	-0.90	-0.20	-0.20	0.60
	③ Apartment leases in Seoul(〃)	0.04	0.07	-0.00	0.09	-0.22	-0.99	-2.70	-1.70	0.20	0.71	0.60

	Normal	Attention	Cautious	Alert	Serious	Indicators
Lineal	55%	55~70%	70~83%	83~94%	94% or more	Short-term deposit ratio, deposit-loan ratio at banks, Won-denominated liquidity ratio, delinquency rates, spreads, roll over rates, swap basis, current foreign debt/foreign exchange reserve, VIX, itraxx
Band	23~77 %	77~88	88~93	93~97	97% or more	Net bond issuance, loan growth rates, credit card use, home price and home lease price indices
		12~23	7~12	3~7	below 3%	

The results show that financial markets both at home and abroad are showing signs of stabilization but it is still too early to tell if the market conditions are on a solid upward path. The global financial market is overshadowed by lingering instability as the global economy is still sluggish and financial troubles have not been cleared up yet.

Overall, market liquidity is in a good condition but credit crunch is not completely resolved as credit risks still persist with surplus liquidity waiting for investment opportunities.

Second, conditions in won-denominated money markets are improving, with the direct finance markets providing much of the momentum. Attention should be paid to the flows of market liquidity and to the possible herd behavior among real estate and stock investors. Banks are becoming increasingly dependent on short-term deposits, which may undermine their profitability, and persistent credit risks may keep the credit spread at high levels while delinquency rates on SME loans can continue to rise.

Third, the demand and supply are balanced in the foreign currency-denominated money markets as the global financial market stabilizes, and consequently, the foreign exchange market is also becoming stable. However, there are still uncertainties that warrant caution, such as possible closing of forward exchange positions due to corporate restructuring and troubles at GM.

Fourth, home mortgage loans are sharply growing particularly in the capital area and a close watch should be kept on the flows of funds for a possible herd behavior.

In short, risk factors intrinsic in the financial markets at home and abroad need to be closely monitored and timely actions should be taken as necessary.

Finally, a few things need to be done in order to improve the macro-response system.

First, the inflation targeting system needs to be changed.[107] The changes should be made in line with the review of the inflation targeting system that is under way in the aftermath of the 2008 global financial crisis. Under the inflation targeting system, the sole goal of the central bank's monetary policy is to keep inflation in check. However, the focus of the system is being shifted onto the aggressive aggregate demand management, which is a more flexible approach. There are two reasons for this change. First, the deflation gap will likely exist for a certain period of time even after the global economy rebounds, and production itself will be in focus rather than GDP growth. In other words, interest rate increases are not likely until unemployment rate falls considerably, surplus production facilities are put to use, and prices rise steeply or the inflation outlook turns clearly worse. Second, sovereign debts rose sharply and it is a global phenomenon. Public debts have reached a level that cannot be sustained any more, and it will inevitably become the top priority for all policy makers to reduce the government deficit once the economy shows signs of recovery. If more taxes are collected while government spending is reduced, it will certainly put a brake on the economic recovery. In this case, the central bank will likely keep the interest rate low so as to prevent an economic slowdown. Therefore, inflation and economic growth will eventually present conflicting policy goals for policy makers, and the government and the central bank will have to choose the most urgent task to be accomplished. So even those countries that previously chose inflation targeting as the sole goal of its monetary policy, will have to change their policy and adopt a more flexible approach.

Second, it is necessary to develop supplementary indicators that can better track

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107 Anatole Kaletsky, Capitalism 4.0: The Birth of a New Economy in the Aftermath of Crisis(2010) changes in asset prices. In this regard, opinions are divided in countries adopting the inflation targeting system, over whether or not the central bank's monetary policy should actively respond to changes in asset prices. Supporters of the central bank's policy response such as Kent, Lowe, and White argue that a preemptive and aggressive approach in dealing with rapid changes in asset prices is necessary even if prices are stable, in order to nip in the bud a possible asset bubble. On the other hand, conservatives such as Greenspan and Bernanke maintain that monetary policy intervention may increase volatility in inflation, growth, and other aspects of the economy and only exacerbate uncertainties in the economy. So it is desirable to make monetary policy responses only when there is an inflationary pressure. Particularly, Korea needs additional indicators because consumer prices do not mirror asset prices as much as in other countries. Since asset price indices including real estate indices are not yet fully developed, liquidity indices should be used as an indirect supplementary indicator.

Third, the financial market monitoring system needs to be augmented on a continuing basis in a way that can manage a wide range of risk factors that affect the financial markets and financial institutions. The new financial risk monitoring system that was set up in 2007 can better detect and monitor risks in a systematic way, but more indicators need to be developed and be made more sophisticated so as to monitor and manage risks on a broader and more encompassing scale. For instance, supplementary indicators on loans to SMEs need to be developed, new risk indicators need to be created, and evaluation criteria should be frequently reviewed. In addition, ways should be sought to raise the effectiveness of the current EWS. The ultimate goal of the system should lie in detecting signs of risk across the economy as early as possible by designing and using the indicators of different parts of the economy in a way that can further increase predictability and timeliness. Financial institutions should cooperate more closely by setting up a channel of communication. The BOK, the FSC(FSS), and the Ministry of Strategy and Finance should make concerted efforts to share statistics and other information, as well as their assessments and views of the economy and finance. One possible policy recommendation can be making the financial conditions monitoring meeting regular or even a permanent body.

Fourth, financial market stabilization measures should be institutionalized. If regulations restrict business activities of financial companies or affect the life of the public, the regulations should rather be made into laws or systems than being implemented with moral suasion. In the same vein, major administrative instructions should also be institutionalized. For example, measures undertaken to manage risks associated with home mortgage loans such as tightened LTV and DTI should be incorporated into the Regulation on Financial Supervision. The internal rules that the financial authorities are implementing should be reviewed and made into laws if necessary. For example, the Guidelines on Administrative Instructions for Financial Companies(the FSS' internal rules) need to be included in the financial supervision regulations, and the supervision criteria and major areas subject to supervision should be in the Regulation on Financial Supervision instead of the Detailed Regulation on the Supervision(of individual financial businesses). Institutional changes need to be made so that the regulators can respond in a timely and flexible manner when financial institutions display a herd behavior in their business activities, putting the entire financial system at a growing risk. It is also necessary for the regulators to follow the guidelines and well-organized manuals when they use moral suasion. The guidelines on administrative instructions should be revised to introduce the sunset system so as to prevent the abuse of administrative authority and increase the predictability in administrative instructions. The code of ethics should be structured to ensure that arbitrariness should be kept at a minimum when using moral suasion and that the administrative instructions are carried out with maximum responsibility and alertness. It is important to conduct internal audits and monitor compliance with laws and the code of ethics. Officers and employees of the regulatory authorities should be educated, trained and evaluated on a regular basis in order to increase the fairness of supervisory administration.

Fifth, liquidity should be induced to flow into productive sectors of the economy. To this end, project financing can play a role because it can be used as an effective tool to redirect and channel short-term liquidity into facility investments, SOC constructions, resources development, and other productive activities. Lease Housing Fund(7 trillion won on annual average from 2007 to 2019) can play a significant role in stabilizing the real estate market by attracting private funds. With institutional changes, bonds should be made available as a financial asset that retail investors can access, some dealers should be allowed to broker retail trade of bonds, and build a bond retail trade system. Small investors including individuals should be able to participate in the bond market by removing restrictions and making necessary institutional changes. Early legislation of the Financial Investment Services and Capital Market Act will add much to the momentum for the development of the capital market. Listing of life insurance companies and Korea Exchange, and sales of shares of companies under restructuring can increase the supply of stocks, and more incentives may be provided for foreign companies to list their stocks on Korea Exchange. National Pension Fund is expanding their investments in the capital markets, but the Fund is still expected to play a bigger role in changing the flow of funds in the right direction.

1.4. Rebalancing of Key Variables and the Governance

So far, coincident indicators, EWS, financial sector risk monitoring, and monitoring of economic crisis factors have been discussed. An analysis of the 3 or 4 crises that occurred in the past shows that a crisis is triggered when there are problems in the following 3 areas. First, in the macroeconomic area, there are two factors: (i) failure to manage the real economy in an open economy, i.e., the trilemma, and (ii) inappropriate inflation targeting. On a microeconomic level, (i) herd behavior cannot be detected early enough, and (ii) there is a time lag between detection or awareness of a herd behavior and actions taken to cope with the behavior. Time lag is a problem particularly in designing and implementing real estate policies because it takes 5 to 7 years before the land is ready for home construction. Lastly, there are issues of efficiency of the response system: (i) The macroeconomic conditions evaluation meeting, the economic conditions evaluation meeting, and the financial market conditions evaluation meeting should be put under a review to clarify the nature of the meetings, the scope of attendees, and the levels of decisions to be made at the meetings. (ii) Intervention as a vehicle for the government to exercise pressure on market participants has limitations in terms of efficiency and any government actions should be firmly based on laws and regulations so as to ensure transparency and accountability.

1.4.1. Rebalancing of Interest Rates

For rebalancing of specific variables, a review of macroeconomic policy changes in advanced countries can offer some insights. When there are clear signs of an economic slowdown, they continue to adjust interest rates in consideration of how serious the slowdown is and how long it is expected to last. Let's take the U.S. for example. The Fed rate remained fixed at 5.25% for many years until August 2007, but immediately before the global financial crisis occurred, the rate was cut by a total of 325 bp in the 6 months from October 2007 to April 2008. This clearly shows that the U.S. government takes bold measures and stick with the measures

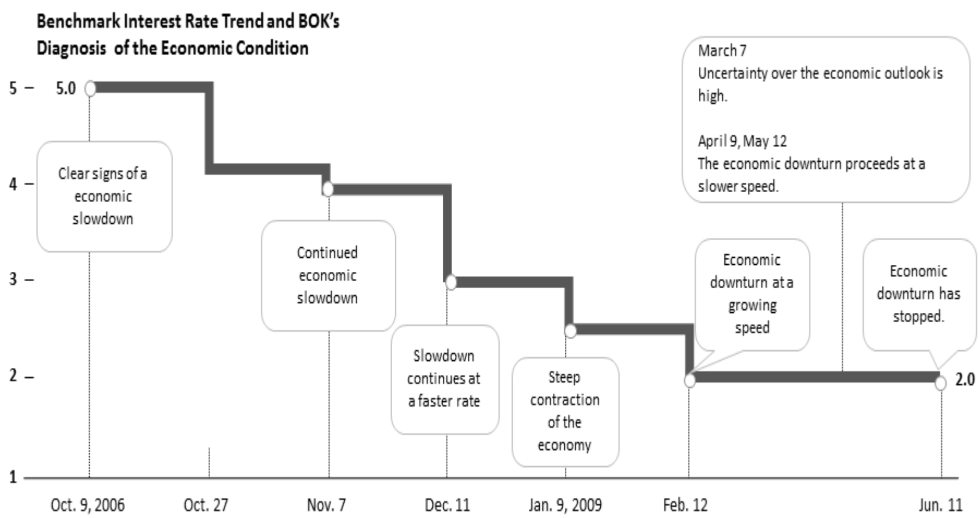
<Table 5-17> Interest Rate Changes in the U.S.

	Aug. 7, 2007	Sept. 18	Oct. 31	Dec. 11	Jan. 22, 2008	Jan. 30	Mar. 18	Apr. 30
Interest rate	5.25	4.75	4.50	4.25	3.50	3.00	2.25	2.00
Change	Frozen	-50bp	-25bp	-25bp	-75bp	-50bp	-75bp	-25bp
Risk level	Inflation risk	Growth risk	Neutral	Neutral	Emergency cut	Growth risk	Growth risk	Assessment put on hold

for an extended period of time when there is a risk of an economic downturn.

Following the 2008 global financial crisis, the BOK lowered the call rate by 300 bp from 5.0% to 2.0% from October 2008 to February 2009. In times of economic downturn, interest rate adjustments can be made timely, but it is difficult to raise the rates back when the economy turns around. The independence and neutrality of a central bank is clearly stipulated in the law in most countries because if the central bank is under the government control, its independence and neutrality can be easily compromised. In this context, more efforts are required to ensure that the BOK can remain independent and neutral in planning and implementing monetary policies.

<Table 5-18> Benchmark Rate Cuts and the BOK's Assessment of the Economy



1.4.2. Communication with the Market on Monetary Policy

Another important element in the execution of monetary policy is communication with the market. Communicating monetary policies to the market is one of the policy tasks that the central bank must accomplish in order to ensure the effectiveness of its monetary policy. Monetary policy make a great impact on the financial market and the real economy by adjusting the expectations of economic subjects and effective communication strategies are essential to achieve the objectives of monetary policy.

Until the early 1990s, most central banks including the U.S. Fed kept the monetary policy decision-making process confidential. So the Fed was referred to as the "temple". However, the monetary policy paradigm was shifted to an open policy approach and communication emerged as an important element for the following reasons. (i) First, as the financial markets advance and other changes take place, the circumstances under which monetary policy decisions are made have changed considerably, and there is a growing need to increase the effectiveness of monetary policy through communication. Since the 1980s, there has been rapid progress in financial liberalization and the financial market has grown both in quality and size, which makes it difficult for the central bank to lead the market the way it needs to like it did in the past. In line with these circumstantial changes, the monetary authority adopted a new approach and chose to provide as much information as it can so as to reduce uncertainties and raise market efficiency, rather than applying pressure or even a shock to the market, as a way to maximize the effectiveness of monetary policy. Particularly, much stress is placed on the importance of expectations for the execution of forward-looking monetary policy, which helped make such changes. (ii) Second, the central bank's democratic responsibility came in spotlight as it was granted more independence.

In the 1990s, the inflation targeting system was adopted and as part of efforts to ensure reliability of monetary policy, the central bank became further independent. In response to the increased independence, central banks around the world began to devise communication strategies to make their policy implementation process as transparent as possible. In the U.S., key communication channels are the press release published on the same day that the FOMC meeting is convened, the minutes of the FOMC meeting that is published 3 week after the meeting, and the testimony of the chairman of the Federal Reserve before the Senate(the chairman testifies before the Congress twice a year ahead of the release of the economic forecast). Private financial companies operate a FRB watcher within their organization and closely monitor every move of the Fed to better understand the intentions of the monetary authority.

Transparency of monetary policy does not simply mean information disclosure, but more importantly is concerned with how information is communicated. It means mutual communication between the central bank and the private sector, instead of the one-sided transmission of information from the central bank to the private sector. This new format of communication has two implications: ① the private sector can better understand the motives and behavior of the central bank and ② the private sector's enhanced understanding of the central bank increase the sensitivity of the private sector's inflation expectations to changes in monetary policy.

Monetary policy should be transparent in three aspects: instruments, goals, and implementation. First, the central bank's policy instruments and the targets that the instruments intend to achieve should be clearly known. Most central banks use short-term interest rates as a policy instrument and this means that even if the central bank does not change the interest rate target, a temporary rise in the monetary demand in the private sector can push up the benchmark rates. If this change is misunderstood by the private sector as a monetary policy change, expectations may rise and volatility of market rates can further increase. (ii) The goals of the central bank should be clearly communicated to market participants. For example, if the central bank's monetary policy aims to promote economic growth as well as price stabilization, market participants should be able to understand how these two conflicting goals are weighted by the central bank. Better transparency in the goals of monetary policy increases accuracy in inflation expectations and thus the central bank's reputation. If the central bank uses lack of transparency to expand the economy, it can raise the expected inflation in the market and eventually decrease the effects of its policy instruments. (iii) Implementation transparency is measured by how much or how specifically market participants know about the process in which economic data is used to make monetary policies. When the central bank publishes its view on the economy, it helps reduce uncertainty and volatility in the market as a more accurate economic outlook of the central bank is shared by market participants. However, there are intrinsic limitations in implementation transparency because it is never an easy task to make an accurate assessment and outlook of the economic conditions. On the other hand, opinions have been consistently expressed that increased transparency in monetary policy lowers the policy effectiveness, which is based on Lucas-type supply function that assumes rational expectations. The argument maintains that monetary policy can achieve the intended goals only when the policy is not what market participants expected. Nevertheless, the better the private sector understands the policy directions of the central bank, the more sensitive inflation expectations of market participants become, and in this sense, the benefits of higher transparency in monetary policy outweighs the negative effects. Central banks in many countries share this view and are moving toward greater transparency.

In light of these changes, Korea also strived to better communicate its monetary policy to the public in the late 1990s. The change was brought about partly by the financial liberalization including interest rate liberalization that began in the early 1990s and accelerated in the process of overcoming the 1997 foreign exchange crisis. Adding to the momentum, inflation the goal of the central bank's monetary policy under the new Bank of Korea Act revised at the end of 1997, and the call rate became the benchmark for monetary policy which turned more market-friendly.

<Table 5-19> The U.S. Fed's Communication Policy

□ The Fed announced its decision on November 14, 2007 to publish its economic forecast 4 times a year instead of two times and to expand the projection horizon to 3 years from previously 2 years in order to raise the transparency in its monetary policy, which was scheduled to apply from November 20 when the minutes of the FOMC meeting are disclosed. • Previously, the Fed released its economic projection twice a year in February and July when the semi-annual monetary policy report is presented to the Congress and the Fed chairman testifies on the report before the Congress. Under the new policy, the Fed will discuss the economic outlook at the FOMC meetings held at the beginning of the second and fourth quarters and the economic projection will be published along with the minutes of these meetings, in addition to the two existing projections the Fed makes. * The FOMC meetings held ahead of the chairman's testimonies before the Congress(February and July) will also discuss the economic outlook which will be released when the minutes of these meetings are disclosed. * The minutes of a FOMC meeting are published 3 weeks after the meeting. • The Fed's economic projection includes real GDP growth rate, unemployment rate, private consumption expenditures(PCE), and inflation rate, but not nominal GDP growth rate. - Risks assumed in the projection and different views expressed by policy makers are also disclosed in the economic projection. □ The Fed chairman Bernanke expected that with the new communication strategies, corporations and households could better understand and predict monetary policies, increase the Fed's accountability, and financial market participants could better understand the Fed's policies, thereby moving asset prices, bond rates, and other trends in the direction that is more compatible with the Fed's policy. • Particularly, under the circumstances where uncertainties are growing across the economy amid sluggish home prices and credit crunch, the Fed's economic projection offer valuable information to the public. □ Bernanke pointed out that it was difficult to implement inflation targeting in its original sense, under the Fed's goals of price stabilization and perfect employment, and that it was intended to facilitate communication with the public, adding that there was no change in the way monetary policy was carried out.

As part of efforts to raise the effectiveness of monetary policy and the central bank's accountability to match the increased independence, expectations of the financial market and the public were managed, and communication was improved to make monetary policy more transparent. In Korea, key communication channels include the press releases published by the Monetary Policy Committee that meets every other week, the minutes of the committee meeting that are published one month after the meeting, Q&A sessions during the press conferences where the Bank of Korea governor is present, and bimonthly Q&A sessions on monetary policy held at the National Assembly, but the media often fail to correctly understand the implications of certain terms and, in some cases, even send wrong signals to the market by interpreting the terms arbitrarily. The media's arbitrary interpretation is becoming less frequent as many financial institutions operate a BOK watcher within their organizations and try to correctly interpret the signals from the Monetary Policy Committee. In reality, however, the BOK faces many challenges in designing and implementing communication strategies, because when uncertainties always remain in the economy, it is a tough task for the central bank to decide how much its assessment and a projection of the economic conditions can cover, to whom and when it should communicated, how it should be communicated differently to different groups such as the government, financial institutions and the media, and how it should respond to the media.

1.4.3. Cooperation System to Harmonize Macroeconomic Policies

Even though the question of to what degree and when macroeconomic variables should be rebalanced is answered, there is never a guarantee that the variables will move in the way the government plans because the decision-making mechanisms for individual variables are different. This complexity of macroeconomic variables and how they work requires a close cooperation system among policy makers and how the governance of the system should be structured is an important element to be considered.

First, the Monetary Policy Committee has the sole discretion in managing interest rates and in this respect, under what framework the committee cooperates with the government is very important. Article 2 of the Bank of Korea Act prescribes that the goal of the BOK's monetary policy is inflation targeting and that the BOK should be independent, neutral, and professional in carrying out its roles, which implies that the BOK should be free from political pressure in making its monetary policy decisions. The U.S. Fed takes the economic conditions and the real economy into much consideration, other than inflation when it makes monetary policies. Unlike the Fed that is completely independent, it is crucial for the BOK to have its independence guaranteed in the law because otherwise, it may be easily subject to pressure from the National Assembly, the president, and the government. In the same context, any revision to the Bank of Korea Act that may compromise the independence and neutrality of the BOK and the Monetary Policy Committee is not desirable. However, it is still an important task for the BOK to work closely with other macroeconomic policy makers to achieve a balanced and harmonized macroeconomic policy while the BOK and the committee should still remain independent and neutral. Therefore, how the government and the BOK should organize a cooperative channel should be viewed from a practical and informal perspective. For example, the Minister of Strategy and Finance and the BOK governor can meet regularly 2 or 3 times a week and discuss economic conditions in an informal and open-minded manner. This way, it is easier for them to work out differences and reach a consensus. Despite the informal nature of these meetings, no opinion should be expressed and no pressure should be exerted on the decisions of the Monetary Policy Committee.

The government intervenes in the market in close cooperation with the BOK to manage foreign exchange rates. Main tools for intervention are foreign exchange reserve and the Korean won reserve of the foreign exchange stabilization fund, and the BOK is responsible for executing these interventions. In this process, the BOK cooperates with the government in order to keep the value of Korean won stable which is mandated to do.

<Table 5-20> The Governance of Foreign Exchange Rate Policy: Intervention in NDF trade

☐ Massive inflows of foreign currencies pushed up the value of Korean won at a steep rate in 2002 and the government purchased foreign currencies with the foreign exchange stabilization fund. As the fund ran out, the government intervened in NDF trade.

• The annual issuance ceiling for foreign exchange stabilization bonds, that was approved by the National Assembly was 11 trillion won(around 1.0 billion dollars), but the interest payments on the balance of the bonds issued previously amounted to approximately 4 trillion won, which left only 6 to 7 trillion won(6.0 billion dollars) in the actual amount of bonds that could be issued.

* The foreign exchange market was fast expanding with the daily spot trading volume of 6.0 billion dollars and the total trading volume reaching 12.0 billion dollars including futures. At least 2.0 billion dollars was needed to defend the Korean won for 30 to 40 won and make an impact on the market. Eventually, the BOK refused to cooperate with the government and intervene in the NDF market.

* So the government had to make a solo intervention in the market, but only provided an opportunity for speculative investors to sell dollars to their advantage because those investors knew that there was little room for intervention. Even though the intervention had some effect on defending the Korean currency, it was only temporary because the balance of payments was in the surplus and an increasing amount of foreign funds was flowing into the stock markets.

☐ Following this incident, the government and the BOK agreed to intervene in the NDF market only when both parties agreed to do so, and sought ways to raise accountability and transparency in the government decisions to intervene.

* Specifically, as a rule, those involved in making intervention decisions are required to make a preemptive decision or an ex post facto report, depending on the amount of the intervention, and to submit a compliance report after a lapse of a certain period of time.

Fiscal policy is at the sole discretion of the government but in fact, the government can make solo decisions only in a limited scope of fiscal policy. In other words, what the government can decide entirely independently includes two things: bringing forward budget spending, and planning investments that government-invested organizations can make. Other aspects of the government's fiscal policy such as determining the size of the fiscal budget and revising the budget as part of adjustment policy, all require cooperation with the National Assembly. Since tax incentives can be also used as an adjustment policy tool, how tax money is spent should also be subject to comprehensive surveillance by the National Assembly.

A review of the balance of consolidated public sector finance, operational budget balance, primary balance, and the fiscal impact is necessary as a way of assessing the impact that the public finance has on the economy.

First, the consolidated public sector finance which includes general and special accounts, and public funds measures the fiscal balance excluding financial funds, the foreign exchange stabilization fund, and regional governments' finance. The balance of the consolidated public sector finance also is an indicator that shows if the government finance works toward expansion or contraction of the economy. In most cases, the government finance works toward contraction because the National Pension Fund and other government-run funds are still in the early stage of growth in Korea.

However, this is only a structural problem and if the balance of the consolidated government finance of the current year is less contracting than in the previous year, it is still viewed as having the expansionary effect. The measured changes and effects of the balance is the fiscal impact.

Operational budget balance which excludes the National Pension Fund and other savings-type funds from the balance of the consolidated government finance, measures the soundness of the government finance. In advanced countries, their fiscal balance is getting worse with the fiscal deficit caused by investments for the future. The future generations will inevitably bear the burden of paying the interests on government debt and in this sense, the financial health is measured by the difference between the current tax revenue and the current tax spending in he primary balance. The fiscal spending less the interest payments on government debt is compared with the fiscal revenue. The majority of leading countries have been in a long-term fiscal deficit and should achieve a primary balance as the foundation for fiscal soundness. Korea quickly eliminated the deficit-causing factors that resulted from the 1997 foreign exchange crisis, with increased tax revenues, but it is struggling to get rid of the deficit caused by the sub-prime mortgage crisis and return to a fiscal surplus. Korea's fiscal balance has been seriously damaged by the economic stimulus packages put together to counter the negative impact of the global financial crisis and expenses to care for its fast-aging population. As a result, Korea is highly likely to follow in the footsteps of leading economies and achieving a fiscal balance will become an important task on the national policy agenda.

2. Macro Risk Management

2.1. Systemic Risk[108]

Systemic risk is not clearly defined yet, but from a microeconomic perspective, it means the contagious effect through exposures of financial institutions to one another, and the ripple effects. It refers to a situation where a shock from an individual event or condition may spread to and threatens the entire financial system through information asymmetry, psychological effects, herd behavior of market participants, etc. On a macro-economic level, systemic risk is the possibility of a large-scale shock that sweeps through the entire financial system, such as a drastic change in the market trend triggered by risk factors that impact the entire market including economic recession, oil price hikes, and sharp increases in interest rates.

With the two definitions combined, it refers to the risks imposed by interlinkages and interdependencies in a system that put the entire financial system under the threat of collapse.

Recently, drastic macroeconomic changes or a prolonged imbalance between sectors of the macroeconomy are in a growing focus when identifying and managing systemic risks. The macro approach is different from the micro approach as follows.

(i) First, in terms of the origin of systemic risk, the risk is considered greater when multiple financial institutions are exposed to the same risk factor than when the shock from individual events such as bankruptcy of individual financial companies is contagious. If market participants share the same view on risk and have similar portfolios, the shock can have the same effect on the financial institutions involved and has a higher possibility of causing a systemic risk.

(ii) Second, how the dynamic process in which risk factors are built and evolve is more important than how the shock spreads out. The accumulation of risk factors is often concealed and prolonged by a booming economy, rising asset

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108 Jung, Dae-yeong, New Risk Management(2005), Korea Banking Institute.

prices, lax risk management, and relaxed lending practices. When the accumulation reaches a certain level, a drastic change occurs, and the risk factors that have been capped may explode and put the entire system at risk. Particularly when the financial system is not sufficiently buffered, the risk may fast transfer to the real economy, causing a steep contraction of the economy and increasing the possibility of a financial crisis. Kindleberger's displacement is an example of the drastic change which also includes the cross-border contagion during the Asian financial crisis and the collapse of the Japanese real estate market that led to the lost decade.

Interactions between the financial sector and the real economy are well illustrated in the case where the negative interactions between the two parts of the economy in the wake of the subprime mortgage crisis led to the global financial crisis.

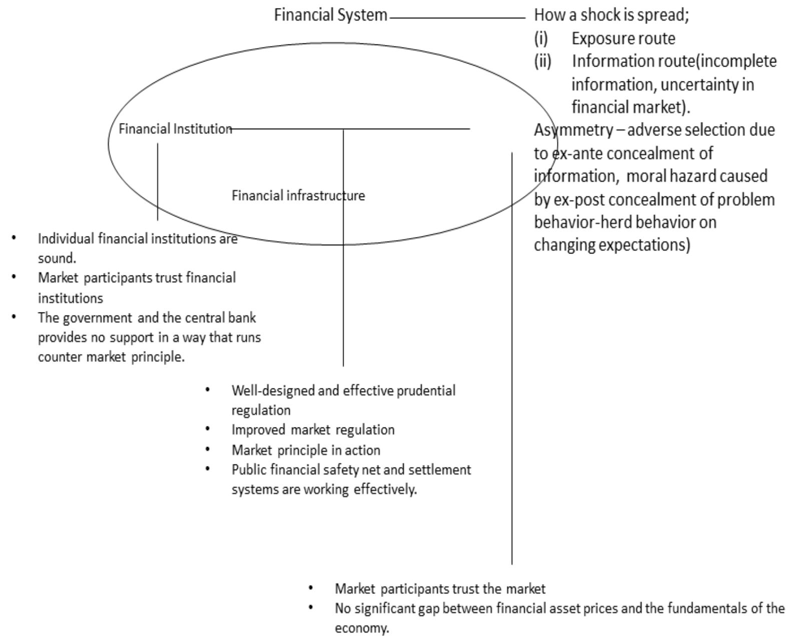
(iii) Third, risk factors are accumulated mainly in the assets side of the balance sheet of a financial institution than in the liabilities side. The credit side plays a major role when a shock evolves and spreads, but the debit side is more involved in accumulation of exposure to same risks and steep changes in asset prices. In other words, problems in the liabilities side such as sudden withdrawals of deposits and restrictions on foreign-currency borrowings are basically attributed to asset impairment and other factors that bring down asset quality at financial institutions.

<Table 5-21> Two Approaches to Systemic Risk

	Conventional(micro approach)	New(macro approach)
Key to systemic risk	Spread of a shock	Nature of a shock
Major targets to control	The path: how a shock develops and spread(e.g., mutual exposures and information asymmetry)	The accumulation process of risk factors in the financial sector or the real economy
The origin of systemic risk on the B/S of financial institutions	Mismatch between assets and liabilities	Asset quality

Source: Jung, Dae-yeong, New Risk Management(2005), Korea Banking Institute.

<Table 5-22> A Financial System and Systemic Risk



2.2. Cyclical Risk

The following macro and micro factors affect the relations between the financial market and economic cycle. Macro factors include monetary supply, interest rate, and foreign exchange rate. Micro factors are financial institutions' lending practices and structure of assets and liabilities, prudential regulation, collateral value and ratio, and financial liabilities of corporations and households. The end result of interactions between the financial market and economy is either counter-cyclical or pro-cyclical. And the interactions are made through the three routes as follows.

2.2.1. Monetary Supply, Interest Rate, and Exchange Rate

① Proponents of monetarism such as Freeman assumed that a currency flows at a stable rate in Fisher's equation of exchange((MV=PQ) and the currency in circulation(M) and nominal quantity(Q) had a proportional relationship. However, as the financial regulations eased and financial innovations were brought about in the 1980s, the private sector's monetary demand or money velocity(V) proved to be not stable and subject to radical changes, measuring surplus liquidity emerged as a critical variable.

② The route of how interest rate influence the interactions between the financial market and economic cycle is as follows: expansion of monetary supply by the central bank → falling short-term interest rates → falling long-term and market interest rates → rising corporate investments and household consumption(the lower corporate investment cost raises profitability and the lower cost of hire-purchase financing or borrowing funds to finance home purchases increase spending capacity)→ rising GDP. If interest rates rise, GDP will decrease through the opposite route.

But corporations and households consider other factors when they make investment or spending decisions, and the impact of interest rate may vary, depending on the sensitivity of investment and spending to interest rate. Like the monetary route may not flow smoothly due to unstable money velocity, if the interest rate sensitivity of investment and spending is low, liquidity trap can occur, and when there are growing uncertainties in the economy such as job insecurity, investment and spending may become less sensitive to interest rate.

Tobin's q theory assumes another route. Tobin's q is defined as below.

Tobin's q= (the valuation of a corporation in the stock market)/(the cost of replacing the physical company)

This theory shows how interest rate affects the value of physical assets by changing asset prices. If stock prices are pushed up by falling interest rates, the market valuation of corporations increases and eventually exceeds the cost of replacing the physical capitals such as machinery and factories. In this case, Tobin's q rises, and companies can issue shares at higher prices. Companies will use the proceeds from stock issues on expanding facility investments including factories and machinery, which will lead to more profitability.

In order for Tobin's q to work, lower interest rates should lead to higher stock prices, but stock prices are influenced by other factors such as overseas and domestic economic conditions and politics. So the interest rate and asset price route does not always work as assumed in the theory.

③ Exchange rate affects the real economy through changes in exports and imports, capital movements, and prices. Exchange rate will have a growing impact on the real economy in countries like Korea where the economy is heavily dependent on exports and imports and foreign investors trade actively on the stock markets.

2.2.2. The Credit Supply Route

One of the micro routes is the route of credit supply including loans. All of the factors that affect the assets in the credit side of financial institutions' balance sheets impact the business cycle through the credit supply route.

First, monetary supply is one factor. If liabilities such as deposits that make up monetary supply increase on the balance sheet of a financial institution, assets also increase, which affects credit supply. However, even though deposits increase due to unique circumstances within the financial institution or restrictions from regulation or government policy, the growth in monetary supply will not likely lead to more investments or consumption, if the increased deposits flock to safe assets such as cash instead of being used to make loans or invested in securities. For example, during the 2007 global financial crisis, growing concerns over counter-party risk triggered a flight to quality which in turn caused a credit crunch.

In what is called the credit view, when financial institutions play a greater role than the financial market in a financial system, monetary supply and credit have a greater impact on the economy. On the other hand, if the direct financing market for stocks and bonds is well developed, even if financial institutions do not perform their financial intermediary role as well as they should, the financial market can replace banks as a credit supplier, adding to the aggregate credit supply. But SMEs and households will remain heavily dependent on financial institutions for loans and therefore, the credit supply route will still have a significant impact.

Financial institutions' lending practices, prudential regulation, and changes in the capital at financial institutions also affect the credit supply.

① Lending practices: Financial institutions change their lending attitude when there is a significant change in the repayment ability and credit rating of companies and households. Even without these changes, the risk acceptance attitude of financial institutions can change when they change their own economic outlook or when they face competition.

② Prudential regulation: Credit supply is also influenced by changes in the BIS capital requirements, the loan loss provisioning criteria, and LTV and DIT.

③ Changes in the capital of financial institutions: Under the BIS capital requirements, capital is an important factor that determines the size of assets. Lack of transparency in accounting standards or a poorly conducted inspection of a financial institution fails to provide an accurate measure of the losses or costs of the institution, which may expand credit supply even though no substantial benefits are generated.

Minsky points out that if credit supply by financial institutions has overly pro-cyclical effects on the real economy, there is a possibility of a financial crisis due to speculative lending.

2.2.3. The Debt Route

Another micro route is the debt route. Debt that corporations and households owe to financial companies is a flip side of the credit supply coin for the lenders, but debt has different effects in the sense that it brings about changes in the disposable funds available to companies and households and that it affects their financial position.

① First, debt has two conflicting effects on the borrowing companies and households: Increased usable funds may expand investments and spending while the burden of repayment can have an offsetting effect. The two aspects of debt have asymmetrical effects. In other words, the positive effect of increased financial liabilities on promoting investment and consumption is significant but short-lived while the negative effect, of reducing investment and consumption is minor but lasts long. For example, household debt grew by more than 20% annually from 2000 to 2002 as credit card loans and home mortgage loans increased sharply, boosting private sector consumption and construction investments. Partly owing to these brisk investments and spending, the Korean economy remained relatively robust in 2001 and 2002 in spite of the global economic slowdown. But the number of credit delinquents rapidly rose in 2003 and households grew increasingly unable to make repayments on time. Financial institutions tightened their risk management and slashed household lending, resulting in a long-term contraction of private consumption. Private consumption declined for 7 consecutive quarters from the second quarter of 2003 to the fourth quarter of 2004. This shows that the household debt route was a major factor that affected the business cycle from 2001 to 2005.

② The financial positions of corporations and households deteriorated by growing debts weakens their capacity to absorb external shocks. When companies and households become vulnerable to shocks, a negative impact of interest rate, prices, and exchange rate can spread to the entire economy at a much faster speed.

During the 1997-1998 foreign exchange crisis, Korean companies had a 380% debt-equity ratio on average and the shocks from high interest rates and high exchange rates threw many of them into a serial bankruptcies, resulting in a raid contraction of the real economy. The price route played out in a similarly in Japan during the prolonged depression of the 1990s. Amid the deflation caused by low growth and falling prices, the nominal income of companies did not increase while they still had to make the repayments, forcing debt-ridden companies to collapse.

Increased debt at companies and households raises their sensitivity to interest rate and any change in interest rate makes an instant impact on investment and spending. However, an excessive sensitivity may restrict monetary policy options. Even when an interest rate increase is necessary to stabilize prices, the central bank cannot raise the rate because it may seriously weaken the financial health of companies and households, generating far-reaching ripple effects on the real economy and the financial system.

③ From the debtor's perspective, the larger the debt is, the more inclined the debtor is to pursue high-risk, high-return investments. When financial institutions' risk management become lax or they become more willing to take risk, high-risk debtors will likely increase their debt by adverse selection, which makes finance more pro-cyclical.

2.3. Financial Crisis

2.3.1. Definition

The concept of financial crisis encompasses different types of crises: banking, foreign exchange, sovereign debt, financial system, etc.

(i) A banking crisis entails one or more of the following: bank runs, failures of banks, suspension of deposit payments, large-scale asset impairments, serial failures of financial institutions, liquidity shortages, injection of public funds, restructuring of financial institutions, etc.

(ii) A foreign exchange crisis is characterized by steep falls in exchange rate, rapid cross-border capital outflows, drastic declines in foreign currency reserve, default, moratorium or bailouts by international financial organizations.

(iii) A sovereign debt crisis refers to inability of a country or the private sector to fulfil external debt obligations. It is caused by depletion of foreign exchange reserve due to a foreign exchange crisis.

(iv) A financial system risk occurs when one or more of the above-described crises intensify, leading to the collapse of the payment and settlement system, massive corporate bankruptcies, and critical damages to the real economy. As cross-border movements of capital continued to increase since the 1990s, a banking crisis and a foreign exchange crisis tend to occur in tandem. The Asian foreign exchange crisis in the late 1990s was also accompanied by a financial crisis.

2.3.2. Theories on Financial Crisis[109]

A financial crisis is most commonly caused by a sluggish real economy characterized by a chronic current account deficit, an accumulated fiscal deficit, excessive foreign debts, and a slowdown of GDP growth, growing threats to the stability of the financial system such as serious asset impairments at financial institutions, and policy failures including foreign exchange policy. There are 4 models that describe the mechanism of how a financial crisis occurs.

(i) The first generation of the crisis models is so called "the attack model" that is used to explain the financial crises in Central and South American countries in the 1970s and 1980s. According to the model, when macroeconomic policies that conflict with the exchange rate continue to be in effect in a fixed exchange rate system or a managed flexible exchange rate system, or when the exchange rate remains incompatible with the economic fundamentals for an extended period of time, speculative attacks began. These attacks are a rational response of the market in dealing with the conflicts of external and internal economic conditions that persist in the economy. For example, when a chronic fiscal deficit and a balance of payments deficit continue under a fixed exchange rate system, prices will stay high and expectations of a devaluation will emerge. Consequently, a flight to foreign currency-denominated assets will occur, and a growing number of investors will switch the local currency-denominated assets to foreign currency-denominated assets, fast depleting the foreign currency reserves. The government will intervene in the foreign exchange market in response, but the intervention will be soon impossible as the reserve runs out. The bursting demand for foreign currencies will eventually bring the fixed exchange rate down, leading to a large devaluation of the currency.

(ii) In the second generation model, financial crises that erupted in European countries in the early 1990s are explained by speculative attacks fueled by self-fulfilling expectation. The first generation model focuses on the impaired fundamentals while the key concept in the second generation model is self-fulfilling expectation. Currency crises in some European countries occurred even though fiscal and monetary conditions were relatively healthy, prices were kept in check, and the balance of payments was in a decent condition. The governments of the affected countries had policy options available to use such as foreign borrowings and interest rate increases. But they fell victim to a financial crisis because they stopped defending their currencies because the fears of a soaring unemployment

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109 Kim Yong-deok, The Asian Foreign Exchange Crisis and a New Global Financial System(2007), Park Young Sa.

rate and a severe contraction of the economy outweighed the benefits of defending the currencies. When the government decides that defending the currency is too costly as it entails serious risks of a sharp interest rate hike, a rising unemployment rate, and growing uncertainties in the financial sector, market participants share the same perception and act accordingly.

If the majority of market participants share the same view, the surging foreign exchange demand by speculative investors will trigger a crisis even when the fundamentals are solid. In other words, market participants act on the judgement that the volatility of the financial market is far greater than the volatility of the economic fundamentals, eventually fulfilling the self expectation.

(iii) The third generation model deals with the simultaneous occurrence of a financial crisis and a foreign exchange crisis which struck many Asian countries in the late 1990s. The governments of the crisis-struck Asian countries had the full intention of defending their currencies and the fundamentals such as government finance, prices, unemployment and BOP deteriorated but to a relatively small degree. However, doubts arose over the financial soundness and liquidity of financial institutions, and the foreign exchange reserves were small relative to the size of the economy, which left the economies vulnerable to a crisis once bank runs and withdrawals of funds by foreign investors began and the foreign exchange supply and demand equilibrium was quickly broken. The crisis was triggered by doubts over the external solvency of financial institutions rather than speculative attacks. In this case, microeconomic indicators such as corporations' interest coverage ratios and debt-equity ratio are more important than macroeconomic indicators such as the fundamentals. When corporate profitability and financial health weaken, bad assets increase at financial institutions, which in turn, hurts the financial soundness and liquidity at their lenders, resulting in a crisis.

(iv) The contagion model stresses the contagious effects of a crisis that were commonly found in Asia, South America and Europe in the 1990s. It refers to when a crisis in a country affects its neighboring countries in a healthy financial condition as investors withdraw massive amounts of funds from the neighboring countries or countries with similar economic conditions for fear of a possible crisis in these countries. ① There are three contagion paths. First, it spreads through the routes of trade and foreign exchange. When the exchange rate falls in one country, it hurts the competitiveness of other countries that compete with the country. ② Second, investors grow doubtful of other countries whose macroeconomic conditions are similar to those of the crisis-struck country, generating contagious effects. ③ Third, with growing financial interdependency among countries, a foreign bank incurs losses, it withdraws loans to other countries in order to meet its BIS capital requirements, negatively affecting those countries.

Shortcomings of international financial organizations play a part in creating the contagion effects. When hedge funds make speculative attacks leading countries such as the U.S., Japan, and the euro-zone countries have chosen to uphold the capital liberalization and independent monetary policy while adopting the benign neglect approach about exchange rates. Consequently, changes in the exchange rates among key currencies, for example the dollar-euro exchange rate posed the following problems: ① The value of a currency can change depending on which of the key currencies is the settlement currency. ② Countries that pegged their currency to the U.S. dollar are susceptible to attacks. ③ If external confidence is adversely affected by this susceptibility, a crisis can become fast contagious. In addition, G3 countries remain independent with their monetary policy, further expanding interest rate volatility. This led to increasing capital movements across borders(from the U.S. and Japan to developing countries) and financial markets(between stocks and bonds). Herd behavior also accelerates the contagion effect. Information asymmetry leads investors to follow the behavior of those who have more information than they do. This tendence is clearly illustrated in the growing ground that credit rating agencies have gained over the years. The problem is that there is no mechanism to prevent this in times of crisis. In the wake of the Asian financial crisis, discussions were extended to regulation of hedge funds, the IMF reform and Chiang Mai initiative, but came short of taking effective actions, which led to failure to stop the 2007 subprime mortgage crisis from spreading across borders and developing into a global financial crisis.

2.3.3. A Review of Financial Crises

The following individual crises show how the factors reviewed above play out in reality.

2.3.3.1. Financial Crises in Central and South American Countries

This region has experienced multiple crises since the 1970s and the crises often spread to other countries in the region. The major reason of contagion was poor fundamentals such as high prices, chronic fiscal deficits, BOP deficits, and high unemployment rates. In addition, politics were unstable and labor disputes were common in the region due to the wide spread adoption of populism. The macroeconomic policies lacked practicality and market participants had no confidence in the policies. For example, many of the countries in the region were implementing either a fixed or a managed flexible exchange rate and thus were highly subject to speculative attacks when the fundamentals and macroeconomic policies remain out of synch for an extended period of time.

Argentina implemented the currency board system in April 1991. The system is different from inflation targeting that is commonly adopted in advanced countries, and its primary goal is to keep the value of the currency stable. The main characteristics of the currency board are summarized below.

① The exchange rate is pegged to a particular key currency(the US dollar, for example at a ratio of 1:1)

② The exchange between the local currency and the key currency at a published fixed rate is guaranteed.

③ The entire amount of bank notes and coins issued is held in the key currency(US dollar).

④ Interest rate is entirely determined by the market and the central bank abandons the function of making and implementing monetary policy(discarded the roles of taking over treasury bonds and the lender of last resort. Exchange rate is the anchor while interest rate is discarded).

However, what actually happened in Argentina ran counter to many of the basic principles of the currency board. As the fiscal deficit and BOP deficit continued to expand and the financial system grew unstable, the government replaced some of the key currency assets with domestic financial assets and made special loans to commercial banks. As a consequence, market participants lost much of confidence in the perfect exchange ability. In 2001, the growing possibility of a devaluation of peso drove 2.0 billion dollars out of the country and the interest rate soared up to 60%. At the end of 2001, Argentina declared suspension of external payments. In January 2002, the country switched to a dual exchange rate and in February 2002, Argentina abandoned the peg to the US dollar and switched to a managed flexible exchange rate regime.

The crisis in Argentina spread to its neighboring countries including Brazil, Uruguay, Peru and Venezuela in 2002. Prior to the contagious effect reaching the country, Brazil was already in trouble with a slowing economic growth, rising prices, BOP deficits, and other fundamentals of the economy weakening. Signs of financial instability became even more ominous particularly around the presidential election in October 2002, with capital outflows, a devaluation of real, and falling stock prices. However, with the inauguration of the Lula administration, the new president's policies garnered increasing international confidence, putting a brake on the growing threat of a crisis, and the managed flexible exchange rate regime that was adopted in 1999 proved to be capable of absorbing external shocks.

2.3.3.2. The 1992 Currency Crisis in Europe

The currency crisis erupted in September 1992 as the members of the community became consumed with worries over the European Exchange Rate Mechanism or ERM. Under the ERM, central exchange rates were used to determine exchange rates between two different currencies, and currency fluctuations had to be contained within a margin of ±2.25% which was expanded to ±15% in August 1993, and if a currency breaks out of the margin band, the country is obligated to intervene in the market. The ERM increased the stability of foreign exchange rates in the participating countries and laid the foundation for the launch of the euro, but sometimes, it invited speculative attacks. In the U.K, and Italy, the fundamentals often became worse as prices surged and the BOP deficits widened, triggering massive sell-offs of the currencies of the countries. The central banks of the two countries attempted to defend their currencies by raising interest rates and making interventions, but failed to curb the sell-offs. In September 1992, the U.K. withdrew from the ERM and Italy also followed suit. Subsequently, Spain, Ireland, Portugal, and France fell victim to speculative attacks, and actions were taken to defend their currencies, such as tightening the control over capital transactions, and making interventions. Spain, Portugal, and Ireland were forced to devalue their currencies. With relentless speculative attacks extending in 1993, and the margin for exchange rate fluctuations was expanded to 15% in August 1993, except for Germany and the Netherlands. This change virtually indicated a switch to a floating exchange rate regime.

The lesson from the currency crisis in Europe is that countries of which fundamentals are poor become the primary target of speculative attacks under the ERM which is also known as a semi-pegged system. France's fundamentals such as prices and BOP were better than those of German, but France fell prey to more aggressive attacks by speculators while Germany fared better. This implies that market participants had a strong confidence in Bundes Bank of Germany but France did not gain as much confidence. Despite ruthless speculative attacks, France was able to defend its currency because Bundes Bank consistently supplied the German mark to France, keeping liquidity intact.

2.3.3.3. The Southeast Asian Crisis

In May 1997, speculators seeking to gain from foreign exchange fluctuations began to sell massive amounts of the Thai baht, triggering the foreign exchange crisis in Southeast Asian countries. The massive selling of the currency was attributed to the forced overvaluation of baht that the Thai government adhered to in order to reduce the burden of sovereign debt obligations and to prevent outflows of foreign capitals despite continued BOP deficits. Hedge funds engaged in the yen-carry trade in which they borrowed in yen at low interest rates and invest in higher-yielding assets in other currencies such as baht and rupiah. But as Japan was expected to raise the interest rate, hedge funds began to unwind their yen-carry trade by selling baht and redeeming the yen-carry trade. As the value of baht plunged by 4% in May 1997, the central banks in Singapore, Malaysia, Hong, and Thailand made the concerted move of intervening in the foreign exchange market, and Thailand markedly raised the off-shore interest rates. Thailand gave in to the growing pressures from persistent speculative attacks and implemented the managed flexible exchange rate system in July 1997. Speculators expanded their offense to Indonesia, Malaysia and the Philippines, leading to the outbreak of the Asian financial crisis. In order to resolve the foreign exchange liquidity squeeze, Thailand and indonesia asked the IMF for a bailout, and the IMF approved a bailout of 16.7 billion dollars for Thailand in August 1997, and 18 billion dollars for Indonesia in October. In return for the bailout, the recipient countries were required to take intensive fiscal austerity measures combined with a financial sector restructuring, which resulted in a further spread of the financial crisis as the countries fell into recession Korea was also entangled in this foreign exchange crisis and major business groups including Hanbo, Sammi and Jinro collapsed in 1997. In July 1997, Kia Motors became practically insolvent, causing its lenders to incur massive losses. So foreign borrowings by private sector became practically impossible and in October 1997, the government decided to nationalize Kia Motors. In October 1997, the stock market in Hong Kong crashed and foreign investors, particularly small Japanese banks that speculated on the Hong Kong dollar withdrew their funds. Massive capital outflows ensued and the foreign exchange reserve was fast depleted. In December 1997, a 55 billion dollar bailout program was launched. Japan, Taiwan and China remained relatively less affected by the currency crisis. Financial institutions in these countries also sustained large amounts of losses, but they successfully fended off speculative attacks with BOP surplus and large foreign exchange reserves.

2.3.3.4. Korea's Foreign Exchange Crisis

Korea's crisis can be explained by all of the four models mentioned above. It is close to the second generation model in the sense that the crisis was escalated, in spit of healthy fundamentals, by the growing doubts among market participants that arose in connection with vulnerabilities of the financial market, excessive NPLs at financial institutions, the BIS capital adequacy, and insufficient regulatory capacity.

The third generation model is relevant as well because the crisis was caused by vulnerabilities in the corporate and financial sectors[110], deepening social conflicts, and moral hazard among market participants. Capital transactions were considerably liberalized after Korea joined the OECD, but excessive short-term borrowings made the sovereign debt structure highly vulnerable to external shocks, and the overvaluation of the currency broadened the BOP deficit. Under these circumstances, Japanese banks began to withdraw their funds after they were hit hard by the Asian financial crisis, acting as a catalyst for the crisis.

2.3.3.5. Cross-Border Contagion[111]

The 1997 Asian financial crisis eventually got Russia and Brazil involved. Large foreign debts, overvalued currencies, and corruption which was particularly prevalent and problematic in Russia were pointed out as the factors that contributed to the crisis. The Russian economy was booming in the early 1990s as the communism was abandoned and privatization swept across the country. The apparent economic prosperity boosted expectations for a further growth, prompting excessive transactions and capital investments. The stock market collapsed on August 11, 1998 as massive amounts of funds from dubious sources and funds associated with corruption moved out of the country, and Russia was forced to switch to a floating exchange rate system on August 19, 1998. Brazil fell into a large fiscal deficit in th midst of an aggressive deregulation drive to facilitate lending and capital movements. There was an abrupt and steep drop in the capital inflows and exports to Asian markets were also struggling amid the ramifications of the financial crisis that engulfed the region. Key export items such as wood raw materials and pulp nose-dived and it became inevitable to let its currency float in 1999. During the last 15 years of the 20th century, 4 crises including the Asian financial crisis in the last 1990 were caused by asset price bubbles, and a close

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110 These vulnerabilities refer to the external growth-oriented corporate management, unhealthy financial structures, bankruptcies of large conglomerates such as Hanbo and Kia Motors, the corporate resolution system that lacks transparency and is inefficient because of the under-the-table dealings and favoritism instead of a law-based, transparent and efficient exit system, the too-bit-to-fail myth founded upon the government's implicit guarantee of protection, corny capitalism and corruption. These undesirable business practices were again combined with the vulnerable financial structure of chaebols, inadequate financial supervision, and financial institutions' failure to manage risks to put mounting pressure on the Korean economy that became incapable of taking actions in time to preclude a crisis. In addition, short-term investment finance companies and merchant banks were facing a growing mismatch between their assets and liabilities while investing mainly in high-risk assets.

111 Charles P. Kindleberger, "Manias, Panics and Crashes: A History of Financial" Crisis(2006), Good Morning Books. Kindleberger identified as signs of a crisis ① long-term availability of surplus liquidity, ② herd behavior, and ③ displacement of key variables, suggesting that these factors need to be closely monitored.

look at the contagion pathology reveals that bubbles are bound to burst and when they do, a crisis The financial crisis in Northern Europe in the early 1990s was due in large part to a rapid growth in offshore lending from yen-carry funds in the late 1980s. Two things coincided as a prelude to the crisis: Japan relaxed regulations on overseas investments and Northern European countries eased their regulations on foreign borrowings by their banks. Later, the unwinding of carry funds caused a foreign exchange crisis in the region. The Asian financial crisis at the end of 1990s broke out as the bubbles burst in Bangkok, Kuala Lumpur, Jakarta, and Hong Kong in the mid 1990s. After the bubbles burst in Japan, funds continued to flow out of Japan and into these countries over a long period of time, creating bubbles in these economies. And the funds flowed from Tokyo into these countries via two routes: ① Japanese companies outsourced their production to Southeast Asian countries to cut cost(so called, the flying geese theory), accompanying capital inflows of capital. ② Yen-carry funds flocked to this region as part of diversifying investment portfolios, and as witnessed in the crisis of Northern Europe, the subsequent unwinding resulted in a foreign exchange crisis. In the late 1990s, the bubbles on Nasdaq occurred as massive amounts of funds withdrawn from the Asian markets following the bubble burst in the region flowed into the U.S. market. With the crash of the real economy in Asia, the balance of payments in Asian countries turned to large surpluses while the U.S. deficit snowballed, drawing large amounts of funds into its stock markets and creating bubbles. As illustrated in the cases above, the value of the currency invariably rose and asset bubbles occurred in the real estate and stock markets. when large capital inflows occur in a country. Overshooting and undershooting in exchange rates occur when capitals move across borders and there is a time lag in price adjustment. More funds flow into a booming economy and a decreasing amount of funds heads for a sluggish economy due to information asymmetry, leading to surpluses(over) and shortages(under) in different countries. Index funds and day traders also played a part in exacerbating this phenomenon.

CHAPTER 6

Global Financial Crises and Responses

The predicament that we have to deal with now is completely different from what we faced when the Breton Woods system was launched in the aftermath of World War II. By designing an optimal system for global economic governance, we can let democracy solve problems in individual countries and still enjoy the fruit of economic globalization

"One Economics, Many Recipes: Globalization, Institutions, and Economic Growth" (2009), Dani Rodrik

Charles Kindleberger, a renowned author said that a financial crisis is a "hardy perennial". Throughout history, there have been major financial crises around the world that were caused by economic or asset price bubbles: the Dutch tulip mania in 1636, the 1720 South Sea Bubble in Britain, the Mississippi Company of France, the U.S. stock market boom immediately before the Great Depression in 1929, and Japan's real estate bubble in the 1980s.

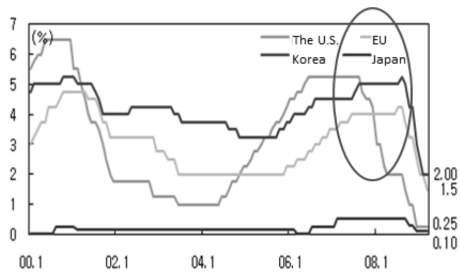
In the 1990s, Northern Europe, South America, and Asia experienced financial crises one after another. The 2008 subprime mortgage crisis occurred in the U.S.,, the world's most well developed and sophisticated financial market and spread to the rest of the world. When large corporations such as Barings of the U.K., LTCM, S&L and posed threats to the entire financial system, Enron, and Tyco of the U.S., collapsed, the governments had to aggressively intervene to cope with the systemic risk. This chapter will examine why financial crises keep occurring with focus on the specific case of the 2008 subprime mortgage crisis, and also review the recent discussions at the G20 summits, the future outlook and strategies of financial banking, and finally efforts to create financial hubs.

1. The World Economy after the Global Financial Crisis

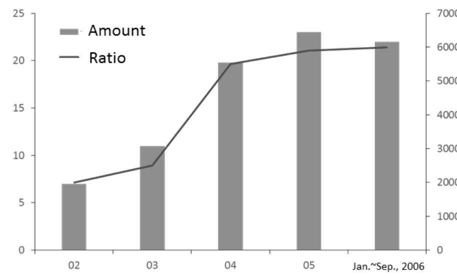
1.1. The Subprime Mortgage Crisis

Inadequate financial supervision and regulatory system is the main reason for the subprime mortgage crisis. The U.S. monetary policy kept the interest rate low, creating excess liquidity. Debt-financed investments and trading in derivatives sharply increased, but neither the regulators nor the regulatory system was capable of properly and timely supervising the bulging activities in the market.

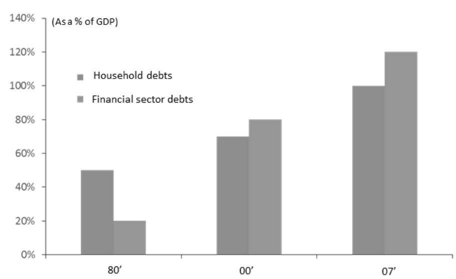
<Table 6-1> Benchmark Interest Rates in Major Countries



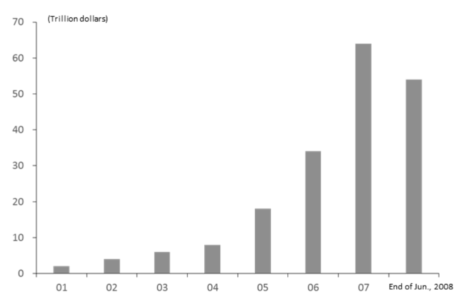
<Table 6-2> The Size of Subprime Mortgage Loans



<Table 6-3> The U.S. Household and Financial Sector Debts



<Table 6-4> Amounts of CDS



Financial companies failed to manage risks associated with securitized assets when liquidity risk is intrinsic in such assets, and excessive leveraging and a blind pursuit of profit often paired with moral hazard also contributed to the problem. The U.S. government is responsible for the crisis for the following reasons.

First, the macroeconomic policies caused an asset bubble.

Current account deficits widened in the U.S. and other countries amid the continued global imbalance and funds kept flowing into those major countries that needed the funds to meet payment obligations. High interest rates in these countries lured investors seeking to invest in high-return assets, bringing in more funds and pushing up asset prices. Following the burst of the IT bubble, interest rates were kept at extremely low levels, creating a credit bubble, but it was mistakenly viewed as the effect of financial innovations. In spite of signs such as decreasing risk premiums on junk bonds, the economy continued on an upward trend, misleading people to think that it was not a bubble, but "the capital market was structurally transformed". A bubble was growing bigger in the M&A market and there was a wide-spread perception that "there is no company in the market that cannot be bought over."[112]. Covenant-lite, a type of loan arrangement that offers much less invasive terms for borrowers became increasingly popular among investment banks that stood to gain much by brokering buy-outs and making loans to finance the buy-outs. But the subprime mortgage crisis dried up funds available for buy-outs, and financial institutions that took over LBO loans and junk bonds sustained heavy losses.[113]

Second, the regulators failed to detect and respond to rising risks in a timely and effectively manner. Risk preference further increased due to inadequate risk management and a reward system that encouraged risk taking, but the regulators were not equipped to effectively deal with the changing circumstances. Specifically, the pro-cyclicality of finance(lenders competitively offer loans in a booming economy, but they are quick to call in their loans as soon as they see signs of an economic downturn) and financial engineering continued to bring new derivative products to the market, but the regulatory system was lagging behind such changes leaving the regulator blind spots broadening. The growing presence of derivatives considerably lowered the transparency in the market and products and raised the counter-party risk, which triggered the subprime mortgage crisis with a sharp reduction in liquidity.

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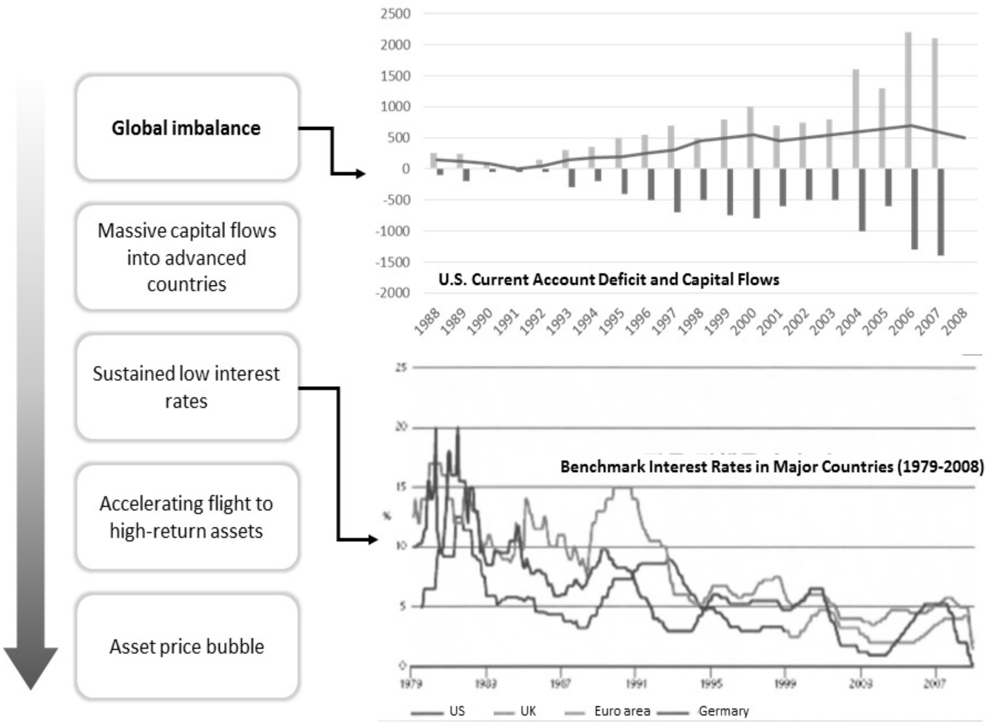
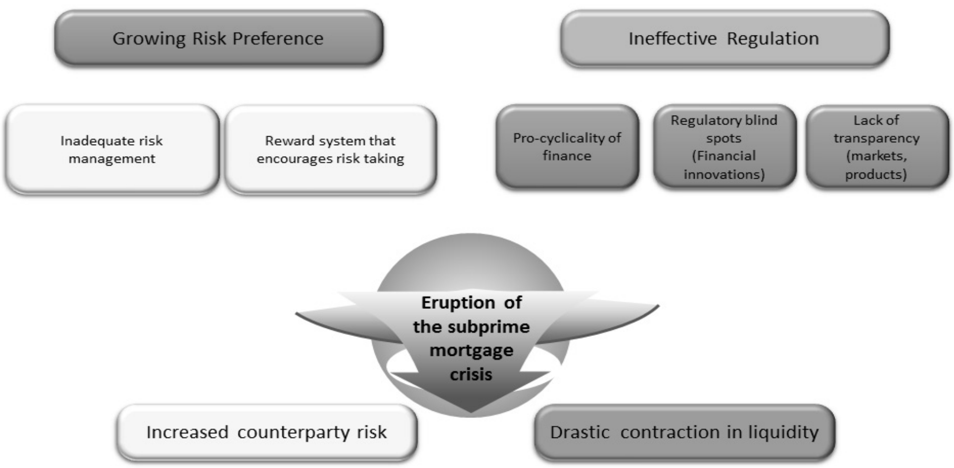
112 A number of M&A deals was made in a LBO: KKR acquired RJR Nabisco for 25 billion dollars in 1987 and the chain hospital HCA of Merrill Lynch for 33 billion dollars. Black Stone took over the REITS giant Equity Office Property for 39 billion dollars in February 2007, immediately followed by KKR's purchase of Texas Pacific, a TRX asset for 45 billion dollars.

113 A UBS' internal report identified aggressive growth strategies employed by investment banks as a key reason for the credit bubble burst, and added that the growth-focused management and lax internal risk control churned out huge losses.

<Table 6-5> The Mechanism of Macroecnomic Policy Triggering an Asset Price Bubble



<Table 6-6> Growing Risk Preference and Ineffective Regulation



Individual corporations were faced with the following problems.[114]

First, liquidity risk is intrinsic in securitized products. The present value of securitized assets based on which the exchange value is determined is overvalued beyond the use value despite the possibility of bankruptcy. Originally, securitization was a process of removing from the balance sheet immovable assets such as loans and real estate, but it evolved into engineering products that could appeal to investors. Bankers Trust chairman Charles Sanford is the originator of particle finance in which credit risks are separated and then sold to a third party. Sanford was forced to resign after the company got involved in lawsuits involving derivatives against Proctor & Gamble and Bankers Trust was merged with Deutsche Bank in 1999. Subprime mortgage-backed securities packages multiple assets into one box and the aggregate size of risk does not change. However, different types of securities are produced with different credit ratings on the basis of assets in the box, and theses products are to be sold to investors who have varying degree of risk appetite. Probability of default which is a measure of credit risk is a random variable that changes vertically with the business cycle. There was a possibility of a steep increase in the probability because the asset type was uniform in subprime mortgage-backed securities, and the size of leverage involved was not clear. Assets of a low use value are repackaged into subprime mortgage-backed securities based on their present value and obtain an exchange value. The financial engineering technique itself is meaningful, but assets were over-priced in the process of product design and credit rating. Critics say that the subprime mortgage crisis is a product of blind trust in credit rating agencies, and overconfidence and hubris of investment banks. In addition, once assets are securitized, there is no more securitization going forward and therefore, it remains a challenge to maintain the liquidity of the securitized assets.

Second, the government failed in concentrated risk management. Previously, resale of risk was largely viewed as positive in the sense that risk is shared by multiple asset holders and the cost is split among them, and it held the market steady when Enron and WorldCom went into bankruptcy and the credit ratings of GM and Ford dropped. But even though it is not a company, subprime mortgage-backed securities increased the risk of bankruptcy by concentrating high-risk assets of the same nature in a group.

With the increasing use of derivatives, advanced risk management techniques such as VaR[115] were introduced, but the figures generated by using these

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114 Yasuyuki Kuratsu, Toshiginko Bubble No Syuen(The End of the Investment Banking Bubble)(2008), Shinwon Book

115 VaR is a statistical technique to measure and quantify the risk of loss based on the past volatility of the market, but the possibility of severe fluctuations on the fat tail was overlooked.

techniques did not reflect the risk stemming from other attacks(credit rating, liquidity, off-balance risk) than market volatility. As off-balance sheet transactions increased, there was a growing uncertainty over what kind of risk a counter-party would bring to a transaction, leading to much higher counter-party risk. Credit rating agencies[116], bond guarantee providers such as monoline insurance companie s[117], and regulators that failed to properly regulate off-balance transactions were found to be partly responsible for the increased risk.

Third, excessive leveraging and profit-oriented moral hazard prevailed. Investment banks that invested in subprime mortgage-backed securities reverted to the strategy of using the balance sheet and became actively involved in PI, PEF, and M&As. To do this, they turned to excessive leveraging such as leveraged loan and covenant-lite. A booming, yet stable economy and low default rates made them risk-insensitive and purchase high-risk assets in the hopes of making high returns, thereby exposing themselves to increased risks.[118]

PEFs and commercial banks as well as hedge funds jumped on the band wagon and became increasingly competitive. Product developers at these organizations were asked to design products that could generate more profits. Product design was directly linked to their pay and the incentives for their team, which caused moral hazard fueled by profit-centered product design and asset management. Investment banks were highly prone to conflicts of interest because they were practically the world's largest PEFs and at the same time carried out investment advisory business. For example, Goldman Sachs managed the 45 billion dollar acquisition of the power company TXU and was the 3rd largest shareholder in the company after TPG and KKR, making Goldman Sachs both the manager and the seller at the same time. And it often managed multiple deals and advised multiple clients simultaneously, putting itself at a growing risk of causing conflicts among clients it served.

In hind sight, the 2008 subprime mortgage crisis bears surprisingly much

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116 Market participants ignored the fact that companies and structured securities are analyzed and rated by credit rating agencies in two completely different ways. Credit analysis of structured securities looks at the cash flow that a collateral is expected to generate, not at the finance of the issuing company, but investors and the market were confused. Investors put blind trust in credit rating agencies and investment banks became overly confident or reckless.

117 Monoline insurance companies provided guarantees on municipal bonds and specialized only in bond guarantees unlike multiple line insurers that handled different types of guarantees. Other guarantee providers associated with subprime mortgage loans include Fanny Mae and Fredie Mac(GSE). These guarantee providers which were previously government-owned organizations, but later privatized, purchased home-related loans from private lenders and issued mortgage bonds by repackaging these loans, as well as guaranteeing these bonds. But the regulators failed to understand the credit supply effect generated through the government's implicit guarantee.

118 At the end of 2007, the asset-equity ratio was 27.8 at Merrill Lynch, 28.2 at GS, and 32.8 at MS, indicating the scale of leveraging employed by investment banks.

resemblance to the crises in the past. LTCM that collapsed in 1998 was dubbed as the "Smart Company"(the company hired two Nobel Prize laureates in economics), or the "Money-Making Machine", and was already using the strategies that hedge funds use today, such as high leveraging and long/short strategy. The company borrowed large amounts of funds(its capital was 5 billion dollars and assets were 129 billion dollars) and invested as much as 1.2 trillion dollars of the borrowed funds in derivatives. LTCM bought emerging market bonds for its long-term long positions and went short on US treasury bonds. As Russia's financial crisis spread to emerging markets, dragging down the prices of emerging market bonds, a flight to quality occurred, and LTCM sustained losses on its long positions. To make matters worse, the FRB loosened the rein on its monetary policy and expanded the liquidity supply. As a result, the prices of the US treasury bonds that the company shorted rose, it made losses on the short positions. After all, both long and short positions taken to hedge risks ended up in loss.

Prior to the 2008 subprime mortgage crisis, hedge funds employed the same strategy. They massively invested in securitized products backed by subprime mortgage loans such as CDOs, with leveraged funds. But with the eruption of the crisis, the stocks of financial companies dropped and short selling further brought down the prices. Subsequently, short sale was banned. The ban of short sale meant that one(short) of the pillars of hedging collapsed, and hedge funds went long on stocks in preparation for redemption requests, leading to steep declines in profits of hedge funds. Stock prices dropped in emerging markets and 20% of hedge funds were liquidated.

Another similarity can be found in junk bond. Junk bond which is praised as a “great financial innovation of the 1980s” is a high-yield bond that sells ‘fallen angels’ to investors. Junk bond was developed by Michael R. Milken. ‘Fallen angels’ refer to bonds that were once investment grade, but have since been reduced to below-investment grade. These fallen angels were packaged into a structure in which even if some of them fail, the profitability can still be maintained with the principals and interests from the rest of the assets. This is exactly the same structure of the CDO backed by subprime mortgages. Drexel Burnham Lambert where Milken worked was a second-class investment bank that took over and sold junk bonds issued by below-investment grade companies in order to raise funds for LBOs. Savings banks were the main buyers of these bonds. Competition grew fiercer in drawing deposits as regulations eased, and savings banks offered higher interest rates on deposits and turned their eye to high-yield bonds as they were allowed to invest in securities other than mortgages thanks to relaxed regulations in the asset management sector. In the early 1990s, one half of all junk bond-issuing companies went bankrupt and caused enormous losses(approximately 10 billion dollars) to savings banks that were major investors in their bonds. Later, savings banks incurred major losses once again on mortgage loans. They made loans at fixed rates when the interest rates were low, but the FRB raised the rate and the interest rates on deposits sharply rose, leading to the collapse of S&Ls.

The problem was that the two financial crises were handled in a way that moral hazard still remained. The FRB coerced the banks that lent to LTCM into taking over 90% of impaired assets from LTCM, and there was no regulatory reform to supervise high leveraging and long/short strategy that entailed excessive risks. Investigation into junk bonds was strictly limited to illegal activities and wrapped up without digging further into the underlying problems. If the investigation had looked closely at the quality of the debt, the subprime mortgage crisis would not have occurred.

What junk bond and subprime lending have in common is that the quality of the debt is so bad as Ponzi finance.[119] Assets in a junk bond are rated A on the premise that theoretically, even if some of the assets go bankrupt, the repayment of the principals and interest of the rest of the assets will be made, but the possibility of loss is determined by probability based on the past market volatility. On the other hand, in the case of subprime mortgage-backed securities, the volatility sharply increases because home mortgage loans are originated for countless low-income borrowers, which creates a distribution that is quite different from a normal distribution. The possibility of a fat tail in this type of distribution was overlooked. In other words, risks derived from other factors than market volatility were not considered.

Why do financial crises keep occurring? Perhaps, a crisis happens when finance meets the human nature or inability to learn and remember the lessons from past crises. Although financial regulators tend to lag behind fast-evolving financial markets, greedy human beings often turn a blind eye to risks. For example, separation of front and back-office businesses became a common practice in the wake of the collapse of Barings and accounting firms were required to keep their audit and consulting businesses separated as a result of the Enron scandal. The Korean regulators failed to detect and cope with the risky herd behavior associated with the 2003 credit card crisis. The subprime mortgage crisis brought into the spotlight another area where better supervision is needed, and the G20 summit has been discussing specific actions toward this end, including strengthening the regulation of derivatives, hedge funds, and credit rating agencies, and tightening

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119 Minsky categorized funding into 3 groups: ① Hedging finance(expected return > principal to be repaid), ② speculative finance (expected return > interest), ③ Ponzi finance (expected return < interest). Pozi finance is a type of funding that is not sustainable.

capital requirements for financial institutions. Again, this is another example of financial regulators struggling to catch up with the fast-changing financial market and taking belated actions. Herd behavior in anticipation of profit in a speculative asset price bubble and the short-term performance-based reward system adopted by investment banks show how human greed play a role in causing a financial crisis. If the coin is flipped over, it shows a solution: if human beings are determined to learn lessons from previous crises and act on those lessons, crisis can be averted. When a real estate bubble was emerging in 2006, the Korean regulators imposed stricter LTV and DTI requirements, nipping a crisis in the bud.

Throughout history, humans and financial industry have repeated the process of overcoming crises and making progress. The Dow Jones Industrial Average plunged 14% after the 9.11 terrorist attack, but bounced back in 2 months. It took 4 years to recover from the 2001 dotcom bubble burst, and to rebound two times higher than the lowest point that the market hit when the bubble burst. Both advanced and less developed economies are subject to a financial crisis and the key to overcoming a crisis is how capable the economic subjects are of coping with financial problems. It is the chicken or the egg dilemma: it is hard to establish the causality between finance and crisis. Was the crisis caused by what went wrong in the finance or the finance went wrong because of the crisis? But what remains certain is that financial repression can not help any economy grow and financial advances bring economic prosperity. As long as the demand for efficient financial transactions exists, finance will continue to advance and regulatory systems will also evolve accordingly.

1.2. The Outlook for Financial Markets

Analysts point out that the criteria for what is normal should be changed because the financial market as we knew prior to the subprime mortgage crisis is over and a new phase of evolution will begin. Prior to the crisis, regulations were loosened based on confidence in the market, and finance and the real economy grew at high rates. The high growth was accompanied by growing uncertainties, and risky investments increased as the financial industry expanded at a rapid pace with investment banks playing a leading role, and with much growth momentum created by deregulation, IT innovations, and financial innovations such as securitization and introduction of sophisticated derivatives. Growing leveraged high-risk investments by households and financial institutions drove the economic growth, but at the same time created asset price bubbles. As asset prices rose, consumption in advanced countries increased, stimulating international trade, but on the other hand, global trade imbalances further deteriorated. Despite the notable growth of emerging markets, the global economy was still ruled by the single key currency of the U.S. dollar and a group of leading countries, and the voices of emerging economies were not heard enough.

However, there are clear signs of changes appearing after the global financial crisis. In the past, major changes were brought about by economic crises, changes in the regulatory environment, and technological innovations. The government role expanded after the Great Depression, and the deregulation since the 1980s and IT developments paved the way for financial innovations that followed.[120] Opinions remain divided on what the definition of New Normal as opposed to the previous normal but the New Normal features the three major components: (1) New power paradigm, (2) new rules, and (3) new needs.[121]

1.2.1. A New Power Paradigm

The new power paradigm is characterized by a shift to multipolarization,, the weakening of the U.S. dollar as a key currency, and the intensifying competition for resources amid the rapid growth of emerging countries.

1.2.1.1. A Shift to Multipolarization

First, the U.S.-centered monopolar system is shifting to a multipolar system, which present a possibility of growing conflicts between advanced countries or between advanced countries and less advanced countries. In the monopolar system prior to the crisis, the U.S. was the distant leader and the G7 followed the U.S. lead, but the world order will move toward a multipolar system and will likely be reshaped into a bipolar system led by the U.S. and China as China is expected to form the G2 with the U.S.

Since the Soviet Union collapsed in the early 1990s, the U.S. as the only superpower had led global issues including globalization and the global integration

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120 "New Normal" refers to a new set of criteria that reflects changes taking place in the market, and it characterizes the world economy in the 5 to 10 years after the crisis.
It encompasses changes that existed prior to the crisis but have deepened or materialized, as well as contrasts to what was considered as normal prior to the crisis. The Davos Forum held in January 2010 dedicated a conference session to the theme of "new normal". (Reference: "The New Normal of the World Economy Beyond the Crisis", CEO Information, March 2010, Samsung Economic Research Institute.)

121 Mohamed El-Erian, CEO of PIMCO, the world's largest fixed income investment management company listed low growth, stronger regulation, consumption contraction, and a smaller role of the U.S. as the major elements of the New Normal while the former director of the National Economic Council of the U.S. Lawrence Summers refuted the low growth prospect and argued that the growth potential of the U.S. would not be eroded.

of financial markets before the global financial crisis erupted recently. International bilateral or multilateral negotiations, G7 meetings, and operations of the IMF, the World Bank, and BIS represented the interests of mainly the U.S. and European countries. The role of BRICs and other emerging countries expanded after the global financial crisis, and the G20 including these countries emerged as a major pillar of international cooperation. As it has become clear that any international cooperation attempt cannot be successful without getting these countries involved, international organizations are being restructured in a way that their governance reflects this change.

The first meeting of the Strategic and Economic Dialogue between the U.S. and China that was held in Washington in July 2009 was a symbolic move that publicly indicated a budding bipolar system. The upgraded mechanism replaced the former Senior Dialogue and Strategic Economic Dialogue that began in the mid 2000s. The dialogue discusses a broad range of international issues including economic recovery, climate change, energy and environment, nuclear threats from North Korea and non-proliferation of nuclear weapons. China is not a genuine match for the U.S. in terms of economy and military capacity and China itself may not feel entirely comfortable or confidence for being dubbed as one pillar of the bipolar system. However, considering China's ever-growing economic power, it is highly likely that the world order will be reorganized into a G2-led bilpolar system, and a bipolar system and a multipolar system can coexist as the G7 and the G20 will function as the leading cooperation frameworks in the transition stag e.[122]

As explained earlier, as the U.S.-led monopolar system wanes, conflicts of interest within the circle of leading countries and between leading and emerging countries may increase. The U.S. and the U.K. tend to expand their fiscal spending and postpone the implementation of exit strategy to the extent possible as part of efforts to escape economic recession while Germany and France with a well developed welfare system and an economic stabilization system including unemployment benefits and a progressive income tax scheme maintain a negative view of a low interest rate policy and a fiscal deficit that last over a long period of time. Some emerging countries are seeking an alternative to the U.S.-dominated

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122 The third meeting of the U.S.-China Economic and Strategic Dialogue was held in Washington from May 9-10 2011 and the two countries agreed to expand comprehensive bilateral cooperation in 4 major areas including macroeconomic cooperation, balanced growth of trade and investment, financial cooperation, and regional and international cooperation. The participants of the meeting include the U.S. Secretary of State Hillary Clinton, U.S. Treasury Secretary Timothy Geithner, Chinese Vice Premier Wang Qishan, and State Councilor Dai Bingguo. The two countries failed to reach a consensus on human rights and other issues, but they agreed to expand practical cooperation in a broader scope and the bilateral cooperation is expected to further increase down the road.

gobal financial order. At the summit meeting of the BRICs held in Russia in May 2009, Russia suggested the concept of a super currency, and China emphasized that the U.S. should act responsibly as the issuer of the key currency and the international community should monitor the issuance of the dollar more closely at the London G20 summit in April 2009. The U.S. is demanding a revaluation of the Chinese yuan in order to reduce the global imbalance and change its domestic consumption-based growth strategy so that its economy is driven more by exports and investments. On the other hand, China denounced President Obama's meeting with Dalai Lama and the U.S. arms sale to Taiwan, and urged the U.S. to respect China's unique political circumstances, demonstrating that the two countries remain in conflicts in many areas.

1.2.1.2. The Weakening of the U.S. Dollar-Centered Key Currency System

The dollar-centered key currency system sis expected to weaken. The U.S. dollar is likely to weaken as the international community is making various moves to reduce the dependence on the dollar and the U.S. economy is expected to exert a decreasing clout in the global economy. The supply of the dollar sharply increased as the U.S. government maintained the expansionary policy in dealing with the large twin deficits and the global financial crisis.

Furthermore, the dollar is anticipated to further depreciate in line with the declining weight of the U.S. economy in the global economy.[123]

<Table 6-7> The U.S. Dollar in the Changing Global Economy

		2000~2007	Recent (the 2008 financial crisis to present)
The International monetary system	Discussions in the global community	- Flexible exchange rates under the dollar-based key currency system	- New international monetary system
	Regional currencies	- The launch of euro	- Ideas of creating a regional currency are supported by the Middle East, Asia, and South America - Attempts are being made to use regional currencies
Status of the U.S. economy	Twin deficits	- Twin deficits narrowed.	- Massive twin deficits
	Competition	- EU rose as a leading economic bloc	- China's economic power has been fast growing.

123 In 2010, the U.S. budget deficit stood at 10.6% of the GDP, and the current account deficit was 2.2%. In 2018, the U.S. economy is forecast to account for 17.8% of the global GDP, and China is estimated to make up 18.1%, placing China ahead of the U.S.

However, no alternative currency that can replace the U.S. dollar is likely to be available at this point, and even if there is such an alternative, the dollar will likely remain as the key currency for a significant period of time by the inertia from the long-standing dependence on the currency in cross-border transactions. Candidates as alternatives to the U.S. dollar such as euro, yuan, and SDR have limitations in terms of liquidity, the size of the currency-issuer countries, and their financial industry.[124] In the long term, the possibility remains that multiple key currencies can appear as SDR plays a growing role, euro and yuan emerge stronger, and the introduction of regional currencies is under consideration. If dollar continues to weaken, international flows of capital will be redirected and risks may increase. A growing amount of capital is heading for China and Europe and invested in commodities such as gold and raw materials. Funds are increasingly moving out of the U.S. and flowing into China and Europe. As a result, China and Europe are emerging as the major investors with massive funds at their disposal. The weakening dollar made gold even more attractive and prices of crude oil and other raw materials that are paid for mainly in dollar are on the rise. If excessive amounts of speculative funds flow in to emerging markets and raw materials markets as international flows of capital are redirected, bubbles may occur in these markets, leaving them subject to the risk of economic instability with the burst of the bubbles. In addition, the Bank of England and the Bank of Japan declared their plans to provide massive liquidity, taking cues from their U.S. counterpart, in an active effort to promote export competitiveness through devaluation of their currencies. So there is a growing possibility of conflicts between these two countries, and euro-zone and emerging countries.

With the diversification of currencies used in international trade and moves to introduce regional currencies, the U.S. dollar may be used less as the key currency, which may present new risks. As more currencies become popular for international payments, severe fluctuations occur in foreign exchange rate and other financial indicators, and with the introduction of regional currencies, major areas around the world can organize blocks, giving rise to regional protectionism.

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124 When the British pound was the key currency, the U.K. was overtaken by the U.S. in the size of the economy and exports in 1872 and 1915, but the currency remained the key currency until 1944 immediately prior to the outbreak of World War II.

<Table 6-8> Trading Ratios of Major Currencies

(unit: %)

	The U.S. dollar	Euro	Pound	Yen	Others
Foreign exchange reserves	65.1→61.6	25.8→27.7	4.0→4.3	2.9→3.2	2.3→3.0
Outstanding loans provided by international banks in the currency	59.1→56.5	21.8→22.9	6.0→5.9	3.0→3.4	10.2→11.4
Outstanding balance of international bonds issued in the currency	37.5→35.5	46.7→48.1	7.8→8.3	3.0→2.8	5.0→5.3

(Sources: BIS (2010), Statistical Annex, *BIS Quarterly Review March 2010.* : IMF. International Financial Statistics

1.2.1.3. Growing Competition for Resources

After the global financial crisis, China and other emerging markets are making a growing impact in the global resources market where countries are competing harder to secure a stable supply of resources. Despite the disruptions from the global financial crisis, emerging countries have remained on a solid growth trend, and their ever-increasing demand for resources has made the role of these countries even bigger in the world economy. On the other hand, advanced countries are in a continued economic recession and consequently, these countries are consuming less resources.[125] Over the next 10 years, the demand for resources is forecast to sharply increase as the economy will grow at a fast rate, and the population and income will rise in major emerging markets, especially in China and India.

China is making aggressive moves to secure resources in overseas markets by taking advantage of its rich foreign exchange reserve that exceeds 3 trillion won, and by having its state enterprises get involved. China is believed to have invested 21 billion dollars since the global financial crisis, in overseas resources development projects particularly in Africa, and South and Central America where undeveloped resources abound. India is actively seeking to make peace with Pakistan with which it has long been at odds, in order to promote bilateral

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125 Average annual demand for petroleum declined 3.8% in OECD countries and rose 2.9% in non-OECD countries from 2007 to 2009. Despite the global economic slowdown, China's imports of iron ore increased 41.6% and its petroleum consumption grew 6.1% in 2009, indicating a growing influence that China has in the global resources market.

cooperation in developing and securing resources. India is closely cooperating with its neighbor Myanmar with regard to crude oil supply and construction of gas pipe lines. In a bid to keep China's excessive or monopolistic consumption of resources in Africa, India's state-owned petroleum company ONGC made a 6 billion investment in Nigeria in 2006 to obtain two mining claims. India paid 720 million dollars for a 25% stake in an oil reserve in the upper region of the Nile and invested in a 200 million dollar project to build pipe lines in Egypt.

<Table 6-9> Change in Oil Demand

(unit: 1,000 B/D, %)

	Old Normal 2002~2006		The global financial crisis (2008~2009)		Average annual growth		Ratio(average)	
	2002	2006	2008	2009	Old Normal	Financial Crisis	Old Normal	Financial Crisis
OECD	47,964	49,515	47,570	45,488	0.8	-3.8	59.8	55.2
Non-OECD	30,253	35,736	38,673	39,517	4.3	2.9	40.2	44.8
China	5,025	7,245	7,892	8,511	9.6	6.1	7.5	9.3
Global	78,217	85,250	86,243	85,005	2.2	-0.9	100	100

Source: International Energy Agency, IEA, MODS.

The growing competition for resources may bring about a new resource nationalism driven by the demand and supply imbalance for industrial raw materials such as non-ferrous metals and rare metals as resource-rich major emerging countries that have rich reserves of these metals will sway an increasingly clout in the global economy. Competition will likely intensify particularly for non-ferrous metals such as aluminum and copper and rare metals that are used in major growth industries to produce secondary batteries, LED, and motors for hybrid cars since emerging economies consume large quantities of these resources to fuel their continued growth.[126]

1.2.2. New Rules

The global crisis has brought about the need for new rules because under the

126 China accounts for 90% of the global reserves of rare earth elements(REE). As China imposed export restrictions on REE, trade disputes arose and the U.S. and Europe that are major REE importers brought the case before the WTO.

previous rules, financial institutions were granted perhaps too much discretion in managing their risks, resulting in inadequate regulation and supervision. As a result, risky investments by financial institutions were not properly supervised and risks were not managed as they should be. Eventually, financial institutions failed to maintain their financial soundness and the stability of the financial system was undermined. Reforms were initiated to strengthen capital regulation and supervision. To this end, the focus of the reforms was placed on ensuring the micro soundness of financial institutions and the macro stability of the financial system.

First, the capital adequacy ratio for banks was raised, and the Tier I capital such as common stocks that can better cushion losses was made subject to additional regulation under the new rules. The impact of the new rules is not expected to be significant in Korea, China, and other Asian countries, but financial institutions in Europe and the U.S. will likely need to expand their capital or adjust their asset size in order to meet the stricter capital regulations. As borrowers default on home and commercial real estate mortgage loans, and consumer credit standing deteriorates amid rising unemployment, more assets of financial institutions will get impaired, restricting the needed expansion of assets, and slowing the economic growth. Financial institutions will be required to reduce investments using their own capital and other risky investments including ABS with increased risk weights. First-class investment banks such as Deutsche Bank and Goldman Sachs took 10 years to return to the earnings that they used to generate prior to the crisis, and since now they will be tempted to pursue high-risk, high-return investments, they are expected to devise new growth strategies under the new rules.

On the regulatory front, the U.K. is moving toward a fragmented supervisory system, but the majority of countries are consolidating their regulatory regimes to achieve consistency in financial supervision. Also, countries are working to expand their supervisory capacity for systemic risk management as financial companies and products are becoming increasingly complicated and expanding in size, and their risks are more likely to transfer to the entire system. Countries published their list of 30 large financial companies that can cause systemic risk, and tightened regulation on these companies' assets and liquidity as well as capital adequacy in order to dispel the too-big-to-fail myth. Derivatives, ABS, and hedge funds which were previously regulatory blind spots are now subject to stronger regulation. For example, it was suggested that ABS originators or issuers should be required to own 10% of their ABS so that they remain linked to their products after securitization, and clearing and settlement of CDS that are traded in OTC markets were centralized. More risk weight has been assigned to short swing profit-seeking accounts and re-securitized products, and more penalties are imposed on risky investments. The EU suggested that financial companies should set aside 3 times the CDS for reserve. In order to regulate high leveraging by hedge funds, they are now required to register and monitored by independent supervisors.

Changes are taking place in corporate governance as well in ways that better empower shareholders. For example, management's pay is more closely tied to long-term performance of their company than to short-term performance, and golden parachute is banned.

Investor protection has been strengthened. Sellers of structured financial products are required to provide accurate and complete information to investors, and credit rating agencies have been made subject to more stringent transparency and accountability rules. Under, they should disclose their track record and credit evaluation methods and conduct annual due diligence while use of credit rating agencies and their rating information has been reduced.

The U.S. and Europe agreed to harmonize their accounting standards for greater transparency in accounting practices by 2014, and separately, individual countries are accelerating their efforts to introduce IFRS.[127]

The Volcker Rule that restricts investment activities by commercial banks was adopted to a lesser degree than originally proposed[128], but it remains to be seen how the rule will play a growing role in the future in light of the regulation that is getting stringent in this area.

<Table 6-10> The Volcker Rule

The Volcker Rule

- The rule restricts banks(banks, bank controlling companies, bank holding companies) from holding or investing in hedge funds and PEFs, and from proprietary trading unless it is necessary for new customer services such as market making and hedging.
- The basic aim of the rule is to ban commercial banks from using public funds that they receive from the government as part of liquidity support on making speculative investments(Paul Volcker, from the speech before the Senate Banking Committee on February 3, 2010)

127 120 countries adopted IFRS by 2010, and Korea and India plan to implement it by 2011, followed by Japan in 2015, and the United States by 2014.

128 The rule was adopted with modifications because the EU finance ministers maintained that the Volker Rule ran counter to their traditionally upheld principle of universal banking under which commercial banking and investment banking can be conducted at one financial institution.

Finally, behavioral economics is drawing an increasing attention after the 2008 financial crisis. The Turner Review, a financial reform package released by the Financial Services Authority of the U.K. listed an irrational market, overconfidence in mathematical models, and failed market disciplines as the causes of the crisis. The global financial crisis brought a major change in the way people viewed rational expectations or conventional mathematical models: they are not a valid or effective tool any more that can predict or explain asset price bubbles or the burst of these bubbles. Conventional economics which is based on the assumption that humans behave rationally is being superceded by behavioral economics that combines psychology, biology, and other disciplines, on the assumption that humans can make irrational decisions.

1.2.3. New Needs

Financial markets are witnessing the emergence of new needs. Particularly, how risks should be handled is becoming an important task. Resale of risks helped the market stay relatively stable by separating and distributing risks when Enron and WorldCom collapsed. However, the fat tail issue remained a serious threat to the market as low-quality debts were concentrated in a group as was in the subprime mortgage crisis. So there are 3 major trends expected to take place in risk management: ① Flight to quality will become more conspicuous, ② diversification of portfolio will become more common, ③ Risks associated with off-balance sheet transactions such as derivatives will be managed more strictly.

Environmental regulation that is getting tightened will create new needs in the financial market. Stronger environmental regulation will act as a new source of regulation on production and trade and add to incentives for technological development by companies in their struggle to cope with the new regulation. Under REACH and automobile gas emission regulation, companies are urged to implement environmentally-friendly production process and products, to develop new technologies and substitute materials, and to recycle resources. As more consumers become aware of environmental concerns, they are becoming more active in asking corporations to fulfil their social responsibility. People will become more concerned about saving energy to reduce low gas emissions and alternative energies will be widely used. Consumers will increasingly prefer recycled or environmentally-friendly products. All these changes in attitude will lead to responsible or good consumption as opposed to reckless and conspicuous consumption. Consumers become more sensitive to corporations' environmental protection initiatives and performance, and consider these elements when they make purchase decisions. As part of such efforts, consumers will rely much on environmental certifications, gas emission and environmental conservation performance data, and the green store accreditation system. In line with these changes among consumers and regulatory changes, companies will put a growing emphasis on green management and make more efforts to create new investment opportunities in environment and gas emission-reduction technology.

<Table 6-11> Global Environmental Regulations

Sources: Compliance in Advance and Supporting System <http://www.kotrack.or.kr>

1.3. Fiscal Crises in Southern European Countries

Another major pillar of the global financial crisis is fiscal crises in Southern European countries. Greece, Ireland, and Portugal were the main epicenters of the crisis and 5 members of the PIIGS including Italy and Spain have long been in fiscal deficits as a result of serious mismanagement of their budgets. These countries further expanded their deficits in the process of coping with the global crisis, only to exacerbate their finance. The financial trouble in these countries does not only put a drag on the recovery of the global economy but also weighs heavily on the EU integration and the future of euro.

1.3.1. Fiscal Crises in Greece and PIIGS

Greece's fiscal crisis was caused by the fiscal mismanagement and the resulting fiscal deficit that had accumulated since the early 1980s. Its sovereign debt as a percentage of GDP was 22.3% in 1980, but it rose sharply to 103.4% in 2000. Given the financial status, Greece was not qualified to join the euro zone, but it did so in 2001 by manipulating the fiscal statistics on its fiscal deficit and sovereign debt. After it joined the euro zone, labor cost jumped, hurting its exports, but Greece could not adjust the exchange rate and the rise in the unit labor cost translated directly to its lower export competitiveness, deepening its current account deficit.

Bowing to the pressure from interest groups under the populist policy, the government offered various subsidies to agricultural and other industries, guaranteed employment, and raised wages while keeping pension reform, labor flexibilization, and other policy initiatives that are not popular with the public on hold. Even though the country was under obligation to implement a fiscal reform as part of the conditions for the bailout program, citizens went on a strike each time the government announced a fiscal reform plan, and the government stirred up nationalism and negative sentiment toward the IMF and failed to build a social consensus for the reform, instead of convincing the people that the reform was necessary.

While the ECB makes monetary policy for the entire euro zone, fiscal policy is a matter of sovereignty and thus made by individual countries. So there is only so much that individual governments can do to respond to the changing business cycle and the possibility of asymmetrical shock within the region remains. The EU's budget earmarked to help member countries in times of economic recession is so limited that short-term fiscal transfers are not possible, and the laws of the ECB ban providing bailouts, making it difficult to cope with a crisis in a timely manner. To address this problem, the EU members were going to discuss how to collectively respond to crises at the European summit but Germany that was supposed to lead the discussions remained passive ahead of the regional election. In April 2011, an agreement was reached on a bailout for Greece, which was needed to keep the EU and euro going. The EU agreed to provide 80 billion euro, the IMF 30 billion euro, totalling 110 billion euro over the next 3 years.[129] In addition, an emergency agreement on the EU financial market stabilization mechanism was reached, securing a total of 500 billion euro reserved to use in cases of financial crises, including 440 billion euro for new mutual guarantees for government debts, and 60 billion euro added to the international payments balance fund.

Despite these measures, Greece is still ridden with structural problems, and the country's fiscal spending capacity and debt repayment capacity remain in doubt as Greece is expected to face an economic slowdown and falling tax revenues. (i)

129 Greece became the third country that received a bailout, following Ireland(November 21, 2010) and Portugal(April 6, 2011), and the bailout programs are summarized as below.

First, Greece is a member of the euro zone, which means it cannot make monetary and exchange rate policy. So Greece has no option of adjusting interest rate and exchange rate to cope with a crisis. For example, the optimal interest rate considering the growth rate and inflation is estimated at 0.5%, but the ECB raised the interest rate to keep prices in check[130], and if the global economic recession continues at a faster rate, the ECB will lower the rate. (ii) The sale of state-owned companies and properties may not proceed as planned, and the government has not made a restructuring plan for other state-owned companies than those put up for sale. (iii) The Greek government agreed to cut its fiscal deficit by 28.1 billion euro by 2015 as part of the bailout program, but the fiscal austerity will likely aggravate the household economy. (iv) It remains a tough task to raise the industrial competitiveness because the country's industrial technology is still underdeveloped, R&D investments are lackluster, and equipment investment is expected to drop considerably. (v) The current account deficit is forecast to decrease in 2011 to around 8% of GDP, compared to around 10% in 2010, but currently, it is still quite high and is very likely to pull the growth down to a large degree amid falling industrial competitiveness.[131] The bailout is only a stopgap measure and the recurrence of a crisis remains a high possibility because the solvency has not been

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- o Greece: the bailout was decided on April 11, 2010. On May 2, Eurogroup and the IMF raised the amount to 110 billion euro.
  - ➢ The euro zone countries pledged a support of 80 billion euro, and the IMF agreed to provide 30 billion euro.
  - ➢ In the first year, 30 billion euro will be injected with the bailout spanning a total 3 years. The loans will be subject to a combination of the fixed rate(Euro swap rate + 300bp) and the floating rate(3m Euribor) → 5.2% on average, with an one-time service fee of 50bp to be added . Under a bilateral agreement, the fiscal deficit should be reduced to 7.4% by 2012 and to 3% or below by 2014.
  - ➢ The EU summit held on March 24-25 agreed to extend the repayment deadline from 3 to 7 years.
- o Ireland: EU and the IMF agreed to a 85 billion euro bailout on November 21, 2010.
  - ➢ EFSF agreed to provide 17.7 billion euro, the IMF 22.5 billion euro, the National Pensions Reserve Fund of Ireland 17.5 billion euro, the U.K., Sweden and Denmark agreed to provide 4.8 billion euro in bilateral loans.
  - ➢ In early 2011, EFSM delivered 5.0 billion euro. The IMF charged approximately 3%(floating rate), EFSM around 4%, and EFSF 6%. The average interest rate including bilateral loans is 5.8%. The fiscal deficit should be reduced to 3% or below by 2014, and by 15 billion euro over the following 4 years.
- o Portugal: officially requested a financial aid on April 6, 2011
  - ➢ On April 18, EU/IMF held a formal round of negotiations on the details of the aid. Market participants expect the amount to be 75 to 80 billion euro.

130 The ECB raised interest rates by 0.25% from 1.25% to 1.5% in July 2011.

131 Nomura Securities forecast the growth rate to be -4.4% in 2010 and -3.7% in 2011.

fundamentally improved, in which case an aggressive debt rescheduling will be inevitable.

The financial trouble in Greece is spreading to other PIIGS countries where fiscal deficits and sovereign debts have steeply increased since 2009, and there are little signs of economic recovery, prompting credit rating agencies to lower their sovereign credit ratings.[132] Investor confidence in PIIGS may collectively decline, triggering massive and simultaneous sell-offs of treasury bonds and withdrawals of bank loans to these countries in attempts to reduce potential losses that may be incurred in the future, leaving these countries susceptible to contagion among themselves, and raising the risk of deteriorating global investor sentiment. Concerns are growing that if Spain bows to the pressure and falls prey to a crisis, the euro zone may enter a long-term recession like Japan's lost decade.[133]

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132 Fiscal deficit is expected to reach 11.7% of GDP in Ireland in 2010(the European Commission), and remain at high levels in other countries-9.8% in Spain, 9.3% in Greece, 8.5% in Portugal, and 5.3% in Italy. Sovereign debt is expected to be 145% of GDP and 135% in 2014 in Ireland and Portugal, respectively even though their planned austerity measures are taken, and may face a debt restructuring like Greece did as obstacles persist due to their monetary and foreign exchange policies subordinated to the ECB, deteriorating industrial competitiveness, prolonged current account deficits, and accelerating economic slowdown.

133 Spain faces the following difficulties.

- S&P rated Spain AA from previously AA+ at the end of April 2010 and Fitch revised its sovereign rating to AAA from AA+.
- The economy is struggling with a housing market bubble, excessive private sector debts, financial troubles at savings bank, and high unemployment rate.
  - The housing market boomed from 2002 to 2007 and reversed the trend from the second half of 2008, following the same global trend in the U.S., the U.K, Ireland and other countries, with housing prices plunging 10.7% from the previous high reached in the first quarter 2010.
  - Private sector accumulated excessive debts that rose to as high as 193.8% of GDP in 2009 amid the booming housing market, soaring home mortgage loans, and expanding borrowings by construction companies.
  - Savings banks with relatively large home-related exposures incurred growing losses. Their NPL ratio rose from 5.34% to 7.5% by the end of 2010, and loans with a 80% or higher LTV ratio accounted for 19% of all loans, posing a risk of massive losses on the homes pledged as collaterals in case of further declines in home prices.
  - Unemployment rate hovered around 20%. As the real estate market is expected to become sluggish(construction workers make up as much as 13% of the country's workforce) and the global economy slows further, cutting tourism-related demands(tourism-related employment accounts for 11.3% of all employment), the unemployment rate is feared to further rise.
- Excessive debts can cause debt deflation and the economic crisis will very likely affect both the private sector and the government finance.
  - If the private sector debts continue to increase and the home market remains sluggish for a prolonged period of time, there is a possibility of the Japanese-style long-term recession: A growing home supply→falling home prices→decrease in lending and credit squeeze→declining employment and falling demand→deflation→falling asset prices→increased debt payments.
  - In order to cut the vicious cycle, fiscal spending should be intentionally expanded, but a strict austerity program is required to improve the distressed government finance and restore sovereign confidence, limiting options of policy responses available for the government to choose from.
- In this case, the government finance may fall apart on multiple fronts via the following path: troubled household finance→financial distress at savings banks→deteriorating balance sheets of commercial banks, putting the private sector economy at the risk of a long-term recession→ failure to meet the objectives of the austerity program→aggravating market sentiment.

1.3.2. The Crisis of Euro

The euro was launched in January 1999 as 11 European countries[134] adopted euro as the official currency and transferred the monetary policy authority from the central banks of individual countries to the European Central Bank(ECB). Initially, the euro zone consisted of 11 countries and 5 more countries[135] joined the zone. Only 11 European countries[136] It was widely recognized that the euro had made a positive impact on the euro zone economy until Greece and other countries in Southern Europe were struck by a sovereign debt crisis. Individual countries lost their autonomy in monetary policy but the euro zone did not have a unified fiscal policy that could complement the lost autonomy. As a result, serious questions have been raised on whether the euro zone will grow into a truly integrated currency union and if the euro will function as a viable currency on a long-term basis.

The euro was born out of the France-Germany struggle for hegemony in the region. France was concerned about keeping Germany in check after Germany waged the two world wars, and Germany was under a constant threat due to its geopolitical location between France and Russia. As a result, the two countries ended up creating the single-currency zone with themselves being the two major pillars. European Coal and Steel Community(ECSC) was first launched in 1952, followed by the European Economic Community(EEC) in 1957, Customs Union in 1968, and the European Economic Area(EEA) in 1993, and finally the European Economic and Monetary Union(EMU) was launched with the conclusion of the Treaty of Maastricht.[137] Along the path toward integration, more East European countries joined the union, tipping the power scale more toward Germany and leaving France out of the leadership. Conflicts grew among the member countries over Turkey's accession, and the European Constitution was voted down in France and the Netherlands.[138] Germany should take a leading role in working out a solution to the 2011 fiscal crisis in Greece because the country has benefited most

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134 Germany, France, Italy, the Netherlands, Belgium, Luxembourg, Ireland, Spain, Portugal, Finland, and Austria

135 Greece adopted the euro in 2001, Slovenia in 2007, Cyprus and Malta in 2008, Slovakia in 2009.

136 The U.K., Sweden, Poland, the Czech Republic, Hungary, Estonia, Latvia, Lithuania, Bulgaria, and Rumania

137 Under the treaty, it was scheduled to be officially adopted by June 2002 after a transitional period from 199 to 2001.

138 After it was voted down and subsequently reconsidered for a period of time, a new treaty for the constitution was proposed. Under the new treaty, the constitution was simplified while leaving various reform plans intact, which drew a consensus among the member countries, The existing EU treaty was replaced with this new treaty which was passed by the majority of the member countries.

from the integration of Europe, but it failed to garner enough support for helping Greece out from its people who were concerned about the financial burden. Germany revealed limitations in what it could do to respond to financial crises within the euro zone as the country's right-wing coalition government led by Merkel failed in a series of regional elections. Eventually, Germany and the IMF agreed to a joint bailout in order to relieve the political pressure and cooperate with the IMF when emergency funding is necessary, and also in consideration of additional financial support that Western and Southern European countries down the road. However, the euro zone and the value of the euro inevitably suffered negative consequences. Doubts were expressed over the euro zone's capability to solve its own problems, undermining the solidarity of the currency union. When individual member countries cannot use their own monetary and foreign exchange rate policy to deal with the changing external and domestic circumstances, they face serious limitations in what they can achieve with the fiscal policy tool alone. Since there is no mechanism to effectively help members in trouble, concerns within the euro zone are likely to grow further. When Greece was unable to sell its treasury bonds within the euro zone, it turned to the U.S., and Asia for buyers, which illustrates how the euro zone is losing its control over the regional financial health. It may have a negative impact on non-euro zone countries that are considering joining the euro zone and the EU. With capital inflows from the IMF, the role of the IMF is also increasing and it may adversely impact the long-term confidence in the euro.[139] Reaching a policy consensus within the euro zone is such a complicated and time-consuming process, and even if a consensus is reached, it may not have enough substantiality to quell worries of market participants, which throws the euro zone's problem-solving capacity into serious doubt. This is a structural problem that warrants a long-term solution and if a member country faces a fiscal crisis similar to what Greece suffered, investors will be reluctant to take long-term positions on the euro.

In hind sight, the euro has continued to rise in value, expanded the size of the region's economy and trade, and contributed to the macroeconomic integration.

(i) The effective exchange rate of the euro remained weak for the first 3 years after its launch, amid the uncertainty over whether or not it would succeed as a single currency. However, the euro continued on a robust upward trend from 2002 to 2008, due to the impact of the 9.11 attack, the slowing economic growth of the U.S., and its growing twin deficits. The demand for the U.S. dollar rose in the aftermath of the 2008 financial crisis and the euro turned weak, but the fall in the

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139 The ECB president Trichet maintained his opposition to the involvement of the IMF because he thought it would damage the ECB's authority and independence, but Merkel and Sarkozy agreed and Trichet had no other option but to agree as well.

value of euro was limited as the U.S. implemented measures to bring down the value of the dollar, such as QE2 and QE3. The euro's performance will depend mainly on the fiscal health of the euro zone countries, and the U.S. economic performance. The ratio of the combined U.S. dollar reserve held by central banks fell to the record low of 61.3% at the end of 2010 from 71.0% in 1999 while the ratio of euro reserve increased significantly from 17.9% to 26.9% during the same period. The ratio of the Japanese yen holding by central banks dropped from 6.4% to 3.6%. The issued amount of euro-denominated bonds is an important indicator of the currency's status. The outstanding balance of global bonds issued in euro has exceeded that of dollar-denominated global bonds since 2003, and the gap has continued to widen. However, the euro was weakened by the sovereign debt crises in the region in 2011.

(ii) The region's GDP more than doubled after the launch of the euro and outstripped the U.S. GDP in 2009[140] Trade volume expanded 1.8 times in the same period, and the size of the economy and trade volume also increased, leading to job creations and falling unemployment rates. Economic integration was further accelerated by the use of the single currency. Trade and FDI within the euro zone increased, and exchange rate risk was diminished by the integrated monetary policy. Trading cost fell, and e-commerce was stimulated. Overall, the gap in GDP growth rates among the euro zone countries was reduced and prices converged. After the fiscal crises in Southern European countries, the GDP gap between North and South Europe is increasing, and this trend is expected to continue because the two regions remain far apart in their fiscal austerity, industrial competitiveness, and growth potential. PIIGS in a fiscal crisis need to tighten their fiscal spending far more than other countries do,[141] the manufacturing technology of South Europe remains at 60-70% of that of North Europe, and high prices in South Europe keep the real effective exchange rate relatively high, which weakens export competitiveness. South Europe was rated at the bottom in the Lisbon performance indicators that measure market liberalization, corporate management environment, labor market, and sustainability, which indicates low growth potential. It means that low-growing South European countries will take a long time to overcome their fiscal crises, and unbalanced growth may pose obstacles to harmonizing economic and social policies among difference countries in the region.[142]

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140 The region's GDP as a percentage of the global GDP increased only slightly from 22.1% to 22.5% because emerging markets including BRICs sustained a raid economic growth.

141 PIIGS' government spending cut is forecast to be 6.9% of GDP in 2011 while the euro zone's spending reduction is expected to be only 0.7%.

142 It will likely present problems in implementing Europe 2030 Strategy, a new EU economic strategy released in March 2010, particularly in such areas as senior employment expansion, R&D investments, poverty reduction, and regional integration initiatives.

In spite of the limitations that the euro zone faces in making policy responses, the above-listed benefits of joining the zone are still drawing countries to the membership, but the poor economic performance in the euro zone makes it hard for aspiring member countries to meet the membership requirements. Of the 11 EU member countries that have not joined the euro zone, the U.K., Denmark, and Sweden have made it clear either officially or unofficially that they do not have the intention of joining the euro zone.[143] All the other countries except Estonia are unlikely to satisfy the convergence requirements[144] within a forseeable future in light of the deteriorating financial conditions in the euro zone.

In summary, the future of the euro will be influenced heavily by two major factors: if the euro zone will experience another fiscal crisis(weak euro and strong dollar) and if the U.S. economy will sustain its growth trend(any delay in the economic recovery will weaken the dollar and strengthen the euro)? In the long term, major questions that need to be answered for the future of euro are as follows: How will the euro zone shape its identity? In other words, can it present a vision for Europe that transcends domestic political situations in Germany and France? Can it achieve a genuine economic integration? Can fiscal policies of individual members be harmonized to a deeper level to complement the lost autonomy in monetary policy?[145]

2. Discussions at G20 Meetings

2.1. Implications of G20 Meetings

The 2008 global financial crisis clearly showed that the role of emerging countries as an important pillar of the global economy is crucial in achieving a

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143 EU members that meet the convergence requirements are obligated to join the EMU, but the U.K. and Denmark were granted the option to choose whether or not to join the EMU and delivered their intentions of not joining the EMU in 1997 and 1992, respectively. Sweden met all the other requirements but it has been intentionally postponing switching to the required exchange rate regime(i.e., pegging it currency to the euro for better stability), which is translated as practically indicating that it does not intend to join the EMU.

144 Prior to joining the EMU, candidate countries are required to meet the conditions stipulated in the EC Treaty(prices, pubic finance, interest rate, and exchange rate) as part of the process of converging economic conditions within the euro zone to achieve better price stability. For example, the fiscal deficit should be 3% or less of GDP, and sovereign debt should be 60% or less of GDP.

145 Despite all these challenges, some view that the euro zone will continue to integrate albeit at a slow pace because Europe has overcome numerous crises over the past half-century, become more capable of dealing with crises, and learned the lesson that it can become stronger by accepting differences and joining forces.

shared growth. The G20 summit led by the U.S. President Bush was held in November 2008 in Washington. The meeting adopted the principle of actively collaborating in macroeconomic policy including cycle-responsive fiscal and financial policies to stimulate the real economy, diagnosed the causes of crisis, discussed reform tasks to prevent recurrence of crisis, and listed 47 tasks designed to reform the financial market. More G20 summit meetings followed in April 2009 in London, in September 2009 in Pittsburgh, and in November 2010, positioning G20 as the supreme forum for economic and financial cooperation. Specific outcomes of these meetings include the adoption of BASEL III that tightens the regulation on financial institutions' capital and liquidity, initiatives to reform international financial organizations, creation of financial safety net, and an agreement on the deadline for setting the guidelines for evaluating current account balance to ease the imbalance in the global economy. Many worried that G20 meetings would struggle to find a consensus because there are conflicts of interest among the member countries, but it beat the expectations and cemented its place as a comprehensive cross-border cooperation that encompasses both advanced and less developed countries. Whether G20 will turn out to be a lasting international forum for economic and financial cooperation hinges on how it will compare to G7 or G8 by expanding the role of emerging countries within the forum.

2.2. Major Issues on G20 Agenda

G20 meetings have discussed a wide variety of issues including such financial issues as financial regulator reforms, reforms of international financial organizations, global financial safety nets, and inclusion of the financially-disadvantaged class, and non-financial issues such as a global cooperation framework for sustainable and balanced growth, exit strategies, funding to cope with climate changes, energy subsidies, DDA negotiations, opposition to protectionism, food security fund, development goals for the new millenium, and labor market reform. The titles and weights of individual agenda items varied according to the host country. From 2008 to 2012, coping with financial crises and preventing future crises was a top priority and G20 discussions concentrated on creating a new financial regulatory system, reforming international financial organizations, and building a global financial safety net. Discussions on individual tasks are summarized in the table below.

<Table 6-12> The Summary of G20 Summit Discussions

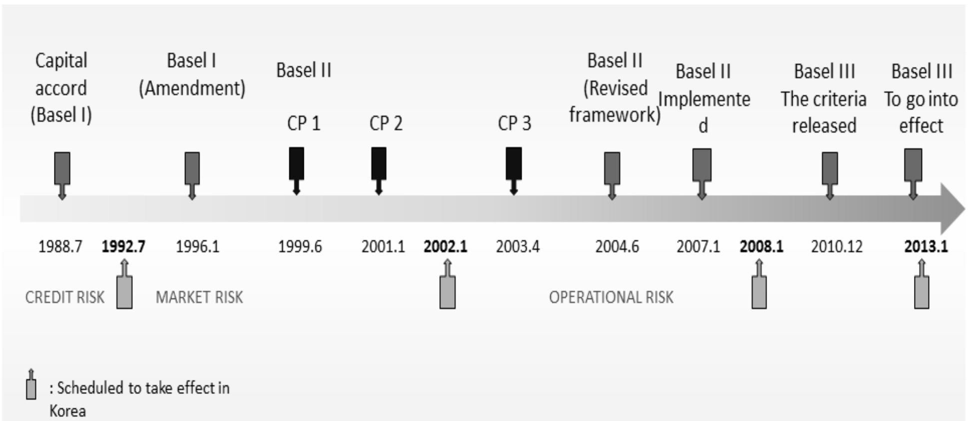
	G20 Process			
	Agreement on the basic principles	Adoption of international standards	Adoption of international standards	Implementation by individual countries
Prudential regulation		BCBS, standards were set at end 2010		Delayed in some countries, implemented in phases
Too-Big-To-Fail		'Standards were set at end 2010 (FSB)		
Reform of international financial organizations	Agreed to the basic principles	Specific details under discussion		
Burden sharing with private financial sector				Implemented by individual countries
Compensation system				Implemented by individual countries
OTC derivatives market				Implemented by individual countries
Hedge funds				Implemented by individual countries
Non-cooperative regions				Implemented by individual countries
Credit rating agencies				Implemented by individual countries
Accounting standards				Delay in formulating unified accounting standards
Creation of FSB /stronger roles				

2.3. A New Financial Regulatory System

2.3.1. Prudential Regulation

Prudential regulation was crystallized in BASEL III, and the progress in developing BASEL indicators and the implementation plan in Korea are shown in the table below.

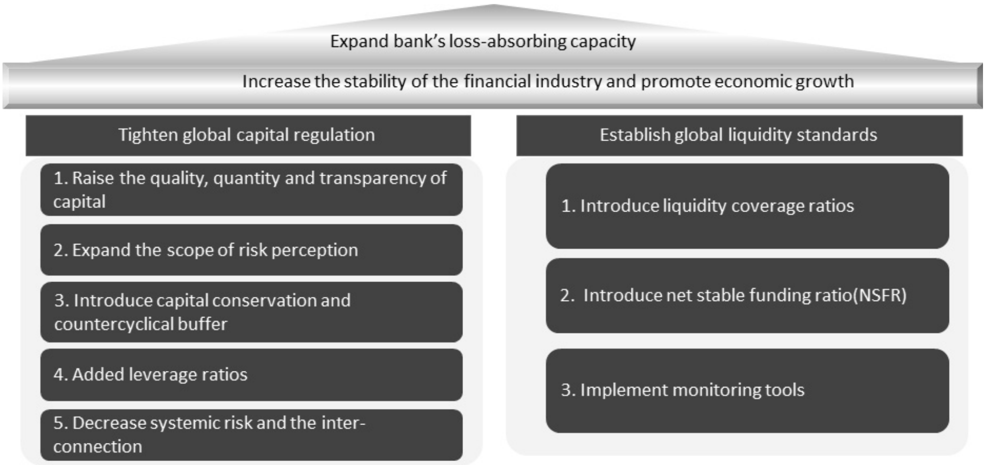
<Table 6-13> Development of BASEL Indicators and Introduction in Korea



Source: the Bank of Korea (BOK).

BASEL indicators which were developed by the BIS' BCBS to regulate banks' capital measure the financial soundness and safety of financial institutions. These safety indicators recommend that banks maintain more than 8% of their capital set aside against risk-weighted assets. BASEL III was adopted to strengthen global capital regulation and introduce global liquidity standards, thereby seeking to expand bank's loss-absorbing capacity as shown below.

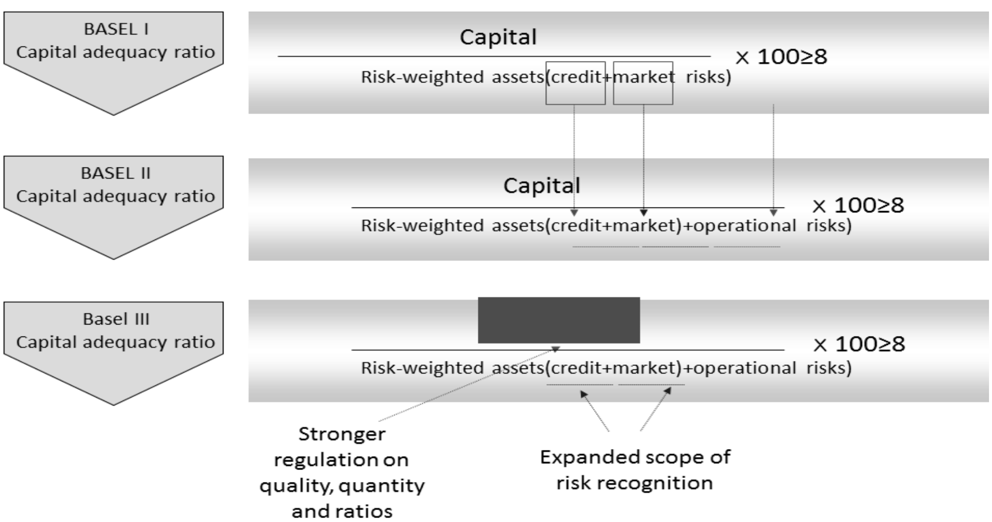
<Table 6-14> Background to Introduction of BASEL III



Source: the Bank of Korea (BOK).

In comparison to BASEL I and BASEL II, capital on the numerator side is regulated more strictly for both quality and quantity while the scope of credit and market risks on risk-weighted assets on the denominator side has been enlarged.

<Table 6-15> BASEL I, II, and III



Source: the Bank of Korea.

BASEL accords consist of three pillars and how the components of the three pillars have been changed in BASEL I, II, and III is summarized below.

<Table 6-16> The Three Pillars of BASEL Regulation

		BASEL I	BASEL II	BASEL III
Minimum capital requirements(Pillar 1)	Credit Risk	Standardized requirements -Sovereign(0%) - Banks(20%) - Corporations(100%)	① Standard requirements: differentiated risk weighting according to credit ratings assigned by qualified outside credit rating agencies	Stronger capital requirements for exposures to securitization, etc.
			② Internal Models Approach 1)FIRB: banks can estimate their default rate and loss given default(LGD) rate and exposures are determined according to the accord. 2) AIRB: banks can estimate default rate, LGD rate, and exposure.	
	Market risk	Standard requirements & IMA	Same as Basel I	Stricter rules on counterparty risk and individual risk. Stress VaR
	Operational risk	-	① Basic indicator approach(BIA): 15% of positive annual gross income ② Standardized approach(TSA): the sum of the fixed percentage of gross income generated in each of the 8 business lines ③ Advanced measurement approach(AMA): banks develop their own empirical model to quantify required capital for operational risk.	
Supervisory Review(Pillar 2)		-	Supervisors inspect the internal capital adequacy evaluation process and require high-risk banks to meet higher capital adequacy ratios which can be higher than the minimum 8%.	Tighter capital requirements(including stress test)
Market Disciple(Pillar 3)		-	Banks should disclose details of their capital and specific risk assessment techniques for each risk type.	

Note: IRB=Internal Rating Based, FIRB=Foundations Internal Ratings Based, AIRB=Advanced Internal Ratings Based, AMA=Advanced Management Approach.
Source: the Bank of Korea.

The new BASEL accord will have the following effects.

(i) Banks will be required to create a risk management unit and manage the process, to manage their lending process, change their funding and fund management practices, to set up capital plans and improve related strategies, and to follow new reporting and disclosure requirements.

(ii) Borrowers such as companies will have their lending rates and limits revised according to their credit ratings, and borrowers' repayment ability based on their future cash flow will become more important than collaterals.

(iii) From the macroeconomic perspective, fluctuations in procyclicality may increase and thus BASEL III introduced procyclical buffer capital. Stress test plays a bigger role and economic growth may slow somewhat in the short term as banks are required to raise their capital, but in the long term, expanded bank capital will help keep the economy stable.[146]

Major features of BASEL III are as below.

① Capital regulation was tightened for quality, quantity and transparency. Bank capital was divided into three categories subject to different capital adequacy ratios: common equity, Tier 1 capital, and total capital.

- Common equity ratio=(common equity/risk-weighted assets)≧4.5%
- Tier 1 capital= {(common equity+Tier 2 capital)/risk-weighted assets} ≧6.0%
- Total capital= {(basic capital+supplementary capital)/risk-weighed assets} ≧ 8.0%

Common equity consists mainly of common stock with voting rights and retained earnings and excludes innovative Tier 1 capital and intangible assets. Capital adjustments(goodwill, own stock, investments in non-consolidated subsidiaries operating financial businesses, etc.) are deducted from common equity.

<Table 6-17> Regulation of Minimum Required Capital(BASEL II vs. BASEL III)

Minimum Capital Requirements			
	BASEL II	BASEL III	Enhancement of Capital Quality
Ratio of total capital	≥8%	≥8%	
① Basic capital(Tier1)	≥4%	≥6%	• More strict criteria for inclusion of other capital than common equity(preferred stock, hybrid capital securities)in Tier 1 capital [2]
Common equity	2%[1]	≥4.5%	• Consists of common stocks and retained earnings[3]
② Supplementary capital(Tier2)	(②+③)≤①	• Removal of regulatory capital restrictions	• Subordinated bonds should have at least 5 years of maturity and are subject to equal installment depreciation staring 5 years from the maturity date, with no redemption incentives. • The restriction that the supplementary capital limit cannot exceed the basic capital limit was lifted.
③ Short-term subordinated bonds(Tier3)		• Removed	• Short-term subordinated bonds with a maturity of 2 years or longer is no longer recognized as part of the capital against market risk.[4]

Notes: 1. 2% is a globally accepted criterion.
2. Tightened criteria includes, among others, no maturity and no redemption incentives
→ Capital classified as unqualified as regulatory capital(basic or supplementary capital) should be reduced by 10% each year over the 10 years from January 2013.
3. Deferred corporate tax, goodwill and other intangible assets, and investments in own stock do not constitute common equity
→ Korea is already using this criteria, but some countries treated these as part of common equity.
4. In meeting the capital requirement against market risk, short-term subordinated bonds were removed from the capital so that the regulatory capital required for market risk meets the same quality criteria that is applied to capital set aside to manage credit and operational risks.

Source: the Bank of Korea.

146 According to the cost-benefit analysis on a 1% increase in the BIS ratio, GDP dropped 0.19%(the BCBS' macroeconomic impact report), and the benefit was estimated to be 1.4% of GDP(BCBS' long-term impact report), resulting in a net benefit of 1.2% of GDP.

② The mandatory capital conservation buffer was introduced and it consists of the following two items. The buffer is intended to allow banks to better absorb losses from future crises by requiring banks to set aside additional capital of at least 2.5% of common equity. If the buffer is used, dividend payment is banned until the buffer is restored to the minimum target of 2.5%.

The counter-cyclical capital buffer is additional capital banks can set aside at their discretion in order to ease the procyclicality. In times of economic boom, banks can reserve capital and use the capital in times of financial difficulties so that banks remain solvent and able to provide credit. The buffer ranges from 0%(normal) to 2.5%(in times of credit expansion) of risk-weighted assets.

③ BASEL III introduced a minimum leverage ratio. This is a simple, non-risk based measure designed to complement the risk-based capital regulation approach. Banks with large amounts of accumulated leverage will come under equally large de-leveraging pressure and may amplify the shocks across the entire financial system and the economy. So the minimum leverage ratio was newly imposed to regulate excessive leveraging. The global financial crisis revealed that financial companies looked financial healthy with sufficient capital on their balance sheets, but those that accumulated excessive leverages in off-balance sheet transactions proved to be at the center of the problem. For this reason, banks are required to maintain their Tier 1 capital in excess of 3% of their exposures.[147]

④ New liquidity ratios were introduced under BASEL III. Two liquidity ratios, i.e., liquidity coverage ratio(LCR) and the net stable funding ratio(NSFR) were introduced based on the judgement that tighter capital regulation alone cannot guarantee the stability of the financial system as was witnessed in the global financial crisis,[148] and liquidity regulation can be more effective than capital

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147 Exposures include assets(above-the-line) plus payment guarantees, contracts, and other off-balance sheet items(below-the-line) and excludes cash and cash equivalents, and deductibles. Credit-risk reduction contracts and collaterals, and off-settings within the same account do not have effects on exposures. However, offsetting of derivatives is allowed according to BASEL II(transactions under a legally-binding offsetting contract).

$$\textbf{Leverage ratio} = \frac{\text{Basic capital}}{\begin{array}{c}\text{Total assets + off-balance sheet items(payment guarantees,}\\ \text{contracts, potential exposures to derivative products)+assets sold}\\ \text{for securitization} - \text{cash and cash equivalents(cash, treasury}\\ \text{bonds)-deductible items(treasury stocks, intangible assets)-}\\ \text{unconditional cancellable commitments}\end{array}}$$

* Of exposures to derivative products[=present exposures+ potential exposures(PFE: Potential Future Exposure)], present exposures are carried on the balance sheet while potential exposures are treated as off-balance sheet items.

regulation as long as negative external effects exist.

(i) First, a bank is required to hold sufficient high-quality liquid assets(100% or more) to cover its total net cash outflows over 30 days.

Short-term liquidity ratio=(high-quality liquid assets/30-day net cash outflows)≧100%[149]

(ii) Under the NSFR ratio requirement, a bank's available stable funding(liabilities and capital) must exceed 100% of its “required stable funding(assets)”[150]

NSFR=(available stable funding/required stable funding)≧100%

BASEL III is set to be implemented according to the following schedule.

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148 In the past crises, banks faced the rising funding risk even though they had sufficient capital, and a resulting liquidity crisis was amplified through payment and settlement systems, forcing the banks to sell their assets at fite-sale prices. As a result, the asset prices plunged, further spreading the risk.

149 Stress situations are set by the financial regulators on the assumptions of a 3-notch drop in credit rating, a partial outflow of retail funds, inability to secure unsecured wholesale funding, a drop in LTV due to increased market volatility, or a pledge of additional collateral. High-quality liquid assets refer to assets that are not held for the purpose of pledging collateral or hedging and can be quickly liquidated even under challenging circumstances such as crisis. High-quality liquid assets include cash and cash equivalents, deposits at central banks, claims to sovereign states or government organizations, and sovereign or public sector securities.

150 Available stable funding is the sum of capital, preferred stock with maturities of one year or longer, liabilities with effective maturities of one-year or longer, and stable non-maturity deposits. Required stable funding refers to assets that cannot be cashed easily in the duration of a liquidity crisis that lasts one year.

<Table 6-18> Implementation Schedule for Capital Regulation under BASEL III

Implementation Schedule for Capital Regulation (unit:%)										
		BASEL II	BASEL III	Schedule						
				2013	2014	2015	2016	2017	2018	2019	2020
Minimum required capital (A)	**Total capital ratio**	≥8.0	≥8.0	8.0	8.0	8.0	8.0	8.0	8.0	8.0	8.0
	Basic capital(Tier1) ratio	≥4.0	≥6.0	4.5	5.5	6.0	6.0	6.0	6.0	6.0	6.0
	Common equity ratio	≥2.0	≥4.5	3.5	4.0	4.5	4.5	4.5	4.5	4.5	4.5
	Supplementary(Tier1) capital ratio	≥4.0	≥2.0	3.5	2.5	2.0	2.0	2.0	2.0	2.0	2.0
	Short-term subordinated bonds(Tier1)	Included in (A)	Removed	-	-	-	-	-	-	-	-
Supplementary capital	**Capital conservation buffer(B)**	-	≥2.5	-	-	-	0.625	1.25	1.875	2.5	2.5
	Counter-cyclical capital buffer	-	≥0~2.5	-	-	-	0~2.5	0~2.5	0~2.5	0~2.5	0~2.5
Required capital adequacy (A+B)	Total capital ratio + capital conservation buffer	-	≥10.5	8.0	8.0	8.0	8.625	9.25	9.875	10.5	10.5
	Basic capital ratio + capital conservation buffer ratio	-	≥8.5	4.5	5.5	6.0	0.625	7.25	7.875	8.5	8.5
	common equity ratio + capital conservation buffer ratio	-	≥7.0	3.5	4.0	4.5	5.125	5.75	6.375	7.0	7.0

Note: Banks consistently requested that the implementation of BASEL III accord be postponed because it is expected to restrict lending, slow economic growth, and weaken the banking system, but the BASEL committee is pressing ahead with the planned implementation schedule. The committee remains open to the possibility of revising the standards for assets to be held against liquidity crises, and of easing the liquidity-measuring rules. Initially, the U.S. decided to put off the introduction of BASEL III, but agreed to implement it according to the original schedule after adjusting the standards by the end of 2013, as the U.S. and the EU agreed to embark on bilateral FTA negotiations. The Korean financial regulator FSC announced a plan to postpone the adoption in January 2013 in line with the same moves by the U.S. and other countries, but did not mention by when it would be put off.

Source: the BOK.

<Table 6-19> Implementation Schedule for LCRs and Liquidity Regulation under BASEL III

Implementation Schedule for Capital Regulation under BASEL III (unit:%)										
	BASEL II	BASEL III	Implementation schedule							
			2013	2014	2015	2016	2017	2018	2019	2020
Leverage ratio	-	≥3.0	Supplementary indicators will be used. (PARALLEL RUN)					3.0	3.0	3.0
LCR	-	≥100	Observation period		Implemented					
NSFR	-	≥100	Observation period					Implemented		

Source: the BOK

An analysis of the FSS on 8 domestic banks found that the effects of BASEL III as of the end of 2009 were minimal. The banks' capital adequacy ratios and leverage ratios far exceeded the required levels, and only the liquidity ratios fell slightly short of the requirements.[151] The reasons are as follows: First, both quantity and quality of capital improved significantly at Korean banks as a result of rights offers and accumulated retained earnings. Second, some of the BASEL III requirements are already being implemented in Korea, including deduction of good will and deferred corporate taxes from basic assets. Third, Tier 1 capital makes up a relatively large portion of equity capital and common stock is a major component of Tier 1 capital. The pre-set implementation schedule allows banks sufficient time to prepare for compliance, and the BASEL committee can make changes to the requirements based on the impact assessments on individual countries.

2.3.2. Too-Big-To-Fail

Many countries often cannot resolve troubled significantly important financial institutions(SIFI) for fear of the impact on the real economy, and injected public funds instead. Multinational financial institutions pose even greater difficulty in their resolution process because multiple countries may come into conflicts of interest. So the definition of SIFI has been further clarified, based on size, substitutability and interconnectedness. Regulation of SIFI focuses on the following:

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151 According to a quantitative evaluation of 8 leading domestic banks(Group 1: Kookmin, Shinhan, Woori, Hana, and IBK), the common equity ratio, the Tier 1 capital ratio, and total capita ratio stook at 10.3%, 10.4%, and 13.5%. Even medium and small banks(Group 2: Nonghyup, Daegu, and Busan) posted relatively healthy ratios of 9.7%, 10.0%, and 13.4%. The leverage ratios were 4.6% for large banks and 5.1% for smaller banks, which were higher than required under BASEL III accord. Liquidity ratios were not as healthy as they should be. LCR was 76% for large banks and 75% for smaller banks, and NSFR was 93% and 99%, respectively.

① taking preemptive actions to prevent financial trouble, ② expanding the resolution capacity in case of failure, and ③ improving the financial market infrastructure to prevent the spread of risk. Countries are required to set their own policies to deal with domestic SIFIs while SIFIs that have a global impact are designated as G-SIFI and subject to stronger regulation. Specifically, SIFI and G-SIFI is regulated as follows: (i) Loss-absorbing capacity should be expanded in order to prevent financial institutions from falling into financial distress and to this end, capital surcharge, contingent capital, and bail-in[152] can be used as regulatory options. Different regulatory options and policies will be combined in consideration of correlations to enable SIFIs to absorb greater losses, and initially, G-SIFIs will be obligated to follow such measures or combinations of measures. (ii) Second, individual countries are required to upgrade their resolution regimes by empowering their resolution agencies and creating a restructuring mechanism using bail-in. In addition, the global cooperation mechanism has been improved by ensuring the authority of resolution agencies and eliminating legal obstacles to cross-border cooperation. Resolution agencies have been empowered with the authority to make legal and operational changes to financial institutions, and to determine overseas operations and the scope of operations that foreign financial institutions can conduct in their domestic market, thereby enhancing resolvability. (iii) Third, regulatory authorities are required to have a clear mission, remain independent in conducting regulatory duties, and secure adequate resources, and they should be authorized to perform stress tests and make early interventions. International evaluations will be conducted to monitor if individual countries are faithfully implementing these regulatory empowerments. (iv) Global standards have been upgraded for core financial infrastructure such as payment and settlement systems and central counterparty(CCP) for OTC derivatives. Countries are required to promptly implement the G20 recommendations on OTC derivatives including ① standardization, ② increasing the role of CCP, and ③ reporting of trading data. (v) Fifth, regulatory authorities have been provided with tools for prudential regulation such as liquidity surcharge, restriction of large exposures, levy, and structural methods. (vi) Sixth, G-SIFIs are obligated to implement the following: ① conducting a coordinated risk assessment by a joint monitoring group, ② making mandatory, firm-specific recovery and resolution plans for G-SIFIs, and entering into a crisis cooperation agreement with crisis management groups, ③ An

152 Bail-in refers to writing off certain parts of debts such as bonds issued by the bank or converting debt into equity in case of financial distress. Contingent convertible bond or CoCo bond is one example. It has not been yet decided whether or not the BIS will recognize it as part of capital conservation buffer, but CoCo bonds were successfully issued several times in the euro zone in 2011.

independent, high-level peer review council will be set up within the FSB to monitor and evaluate the effectiveness of G-SIFI policies of individual countries. (vii) Finally, as for the work process and time line, ① FSB, BCBS, and other related international financial organizations will list up financial institutions to be designated as G-SIFI for imposition of the recommendations by mid 2011, and conduct the initial cross-evaluation of G-SIFI policies by the end of 2012. ② FSB and BCBS will set the targets for increased loss-absorbing capacity of financial institutions and come up with specific actions to meet the targets by the end of 2011. ③ FSB member countries should make plans to strengthen their resolution regimes and submit the plans to FSB by the end of 2011. FSB will conduct cross-evaluation on the resolution systems of individual countries in 2012. ④ The progress in implementing the FSB's regulatory empowerment principles will be monitored by the end of 2011. ⑤ An overhaul of global standards on core financial infrastructure such as settlement system and OTC derivatives will be completed by the end of 2011.

2.3.3. Reform of International Financial Institutions (IFIs)

Reform of IFIs had been discussed prior to the G20 summit.[153] However, there was a growing consensus at each of the G20 summit meetings held, that emerging countries should be fairly represented based on their economic power in order to devise effective responses to financial crises. Against this backdrop, discussions on IFI governance have been crystallized in a series of G20 summit meetings held in Washington[154](November 2008), London(April 2009), and Pittsburgh(September 2009)[155]. Finally, the G20 summit held in Seoul in November 2010 produced an agreement on the most drastic reform of international financial institutions ever in history. First, the IMF quota was increased by 100%, the largest quota increase ever in the IMF history. By October 2012, 6.2% of the IMF quota will be

153 Discussions prior to the G20 summits are summarized in the table below.

IMF Quota Reform (April 2008)	The World Bank's governance reform(October 2008)
Introduce a new quota formula that is simple and transparent	
Increase the quota for emerging countries (11.5% of the total quota)	Increase the voting rights of emerging countries(1.46%)
Increase the basic votes(250→750)	Increase the basic votes(250→500)
Increase the number of alternate directors in the Directors' Office of African Department	One more alternate director in the Directors' Office of African Department

154 The Washington summit discussed the following.

transferred to under-represented countries, and 6.05 to dynamic emerging countries, thereby raising the combined quota of BRICs to 6.0% or more or placing them among the top ten countries. The quota formula will be revised by January 2012, and the quota adjustments will be completed by January 2014. As a result, emerging countries are expected to assume a growing importance. The governance structure will be changed so that emerging countries are better represented. The number of directors will remain unchanged at 24, but 2 of the European seats will

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IMF reform (WG 3)	Reform of MDB including the World Bank (WG 4)
Review adequacy of financial resources, and improve lending practices	Expand MDB's ability to respond to business cycle
Cooperate with FSF to increase expertise and strengthen macroeconomic policy recommendation and surveillance functions.	Replenish MDB's financial resources and reform its governance structure
Reform the governance in a way that reflects the growing economic power of emerging countries.	

155 The London and Pittsburgh G20 Summits agreed to the following(General Review of Quotas(GRQ) is conducted every 5 years to assess and adjust the size of the overall quota and allocation of quotas among member countries)

	London Summit	Pittsburgh Summit
IMF reform	Implement the agreed quota reform of April 2008	Reconfirmed the agreements reached at the London Summit.
	-	At least 5% of quota to be transferred from over-represented countries to under-represented emerging countries(January 2011).
	Bring forward the next GRQ(January 2011)	Proposed details of corporate governance reform(January 2011) ① The size of quota increase ② The size and composition of the board, and greater efficiency ③ Expand the role of Governor ⑤ Recruit staff from more diverse backgrounds
	Consider increasing the participation of Governor in the decision-making process	
WB reform	Implement the World Bank reform plan that was agreed upon in October 2008	-
	Complete additional reform tasks(transfer of voting rights) as early as possible(the spring meeting in 2010)	Transfer at least 3% of the voting rights from advanced countries to emerging countries(the spring meeting in 2010)
	-	Develop a dynamic shareholding formula(by the spring meeting in 2010)
Applicable to both IMF and WB	Performance-based election of the Governor and senior executives	Reconfirmed the agreements reached in London(January 2011)

be transferred to emerging countries. The IMF governance has been criticized for being dominated by advanced countries. By ensuring fair representation of emerging countries, the IMF will have greater legitimacy and significantly improve its finance, thereby being able to play a better role in supporting the stability of the international financial market and the world economy. Increased participation of emerging countries will create a broader forum where in-depth discussions are possible on a wider range of issues including crisis-preventive monitoring activities, a stronger global monetary system, and a global financial safety net. Korea's IMF quota has been increased from 1.4% to 1.8% and Korea now ranks 16th from previously 18th.

Further discussions will be necessary on selection of the managing director, recruitment of staff from more diverse backgrounds, and creation of a quota formula for the World Bank that reflects the economic power of individual countries and their contribution to the World Bank.

In addition to the governance reform, the discussions expanded to the reform of operating mechanism or creation of a global financial safety net. Global financial safety net is a preemptive credit line designed to prevent a liquidity crisis triggered by rapid outflows of foreign funds due to external shocks when the country in trouble is not responsible for the outflows.

The safety net consists of three elements including a stronger global cooperation system and regional safety nets.

① Under the preemptive credit line under discussion, the IMF preemptively opens a credit line when it deems a certain country at the risk of liquidity shortage. Specifically, (i) flexible credit line(FCL) will be used to provide funding without conditions and limits to otherwise healthy countries. (ii) Preventive credit line will be newly introduced to provide financial aid with some conditions to countries that are not qualified for FCL but still financially sound, thereby allowing even more countries to benefit from the financial safety nets.

② A global cooperation system will be strengthened to better cope with financial crises of a global magnitude. The multi-country FCL has been established to provide liquidity support preemptively and simultaneously to multiple countries that are exposed to same shocks. Financially troubled countries often fail to make a timely move and ask the IMF for financial aid for fear of the stigma that it will attach to them. This collective support system can get rid of this problem and precludes the first-mover stigma. (ii) Countries agreed to collaborate in designing and taking structured approaches to improve their systemic crisis-coping capacity.

③ Regional financial arrangements such as the Chiang Mai Initiative Multilateralization(CMIM) have been created and a framework for closer cooperation between RFA and the IMF has been built so as to expand synergy effects of bilateral cooperation and to enhance the crisis-prevention capacity. With these cooperation frameworks in place, Asian countries that were previously antagonistic toward the IMF changed their attitude and became more open to cooperation with the IMF.

RFA is a key component of the international monetary system(IMS) that warrants continued discussions, and will contribute to strengthening the global competence of dealing with rapid cross-border capital movements and to ensuring that countries sustain an open economy in the midst of intensifying integration of the global economy and achieve economic prosperity on a continuing basis.

2.3.4. Burden-Sharing with the Financial Sector

The subprime mortgage crisis required massive injections of public funds into the financial sector in various countries to recapitalize their financial institutions, which seriously damaged their government finance. So it has become necessary to have the financial sector to share the burden and to make the sector capable of paying the cost of dealing with future crises. The Pittsburgh summit asked the IMF to come up with a plan to share the burden with the financial sector, and the final report was presented to the summit meeting held in Canada in June 2010. The report argued for imposition of backward-looking tax as a way of splitting the financial burden after the crisis, and also stressed that consideration should be equally given to both responding to and preventing crises. According to the report, the financial sector should bear part of the financial cost associated with a crisis and incentives for the too-big-to-fail assumption should be reduced in order to decrease the likelihood of future crises. To do this, two major categories of policies were suggested: levy on financial companies and other taxes.

Imposition of levy is aimed at recovering the cost of salvaging financial companies from financial trouble and stopping financial companies from taking excessive risks, and the levy can be either saved into a resolution fund or reverted to general government revenues. Other taxes include financial transaction tax and financial activities tax. Financial transaction tax is imposed on a wider range of financial transactions than what is covered by Tobin tax, but critics point out that the financial transaction variables are not fully representable, that there is not enough correlation between financial transactions and risks, and that consumers may end up assuming a financial burden. Financial activities tax which is levied on the sum of bank profits and bankers' remuneration packages, hold financial companies directly responsible for their financial mismanagement and can be imposed in different forms. Eventually, the IMF proposed financial stability contribution(FSC) as the first option and financial activities tax(FAT) as the second. FSC applies to all financial institutions, and the proceeds will be accumulated into a fund or included into government revenues. It can be raised on an as-needed basi to prepare for future crises or to recover the funds already invested into financial institutions. Initially, the levy rate is uniform, but can be adjusted differently for individual financial companies according to their degree of risk and the impact on the financial system. As mentioned earlier, FAT is raised on the sum of bank profit and remuneration packages and the proceeds will go into general government revenues. Since financial institutions in different countries may bear varying degrees of financial burden, thus distorting the tax systems, countries should closely cooperate in promoting healthy cross-border competition among financial companies, and saving and regulating large multinational financial companies

The follow-up G20 summit discussions converged on the adoption of bank levy and financial transaction tax, and countries are working on legislations to introduce them.

<Table 6-20> Bank Levy vs. Financial Transaction Tax

<table>
<tr><th colspan="2">Type</th><th>Purpose</th><th>Targets for imposition</th><th>Developments in countries</th></tr>
<tr><td rowspan="2">**Bank levy**</td><td>Ex-post imposition</td><td>To cover the losses already incurred</td><td rowspan="2">Liabilities on B/S, wages (stock)</td><td>Financial Crisis Responsibility Fee(U.S.)</td></tr>
<tr><td>Ex-ante imposition</td><td>To prepare for future crises</td><td>Dissolution Fund(U.S.), Stability Fund(Sweden, already implementing)</td></tr>
<tr><td colspan="2">**Financial Transaction Tax**</td><td>To cover existing losses, raise funds for developments and climate changes, and curb capital movements</td><td>Financial transactions (flow)</td><td>Financial Transaction Tax(Brazil, already implementing)</td></tr>
</table>

The U.S. is working on both ex-ante and ex-post measures to hold the financial sector responsible for crises by imposing bank levy, but remains negative about introducing financial transaction tax. Legislations have been passed to introduce the Systemic Dissolution Fund for management of future crises and Financial Crisis Responsibility Fee for recovery of funds injected into the Troubled Asset Relief Program(TARP) during the recent crisis.

<Table 6-21> The Systemic Dissolution Fund and Financial Crisis Responsibility Fee of the U.S.

※ **Systemic Dissolution Fund**
· Targets: financial companies with consolidated assets of 50 billion dollars or more, financial companies and hedge funds with assets of 10 billion dollars or more
· Total amount : up to 150 billion dollars
· Imposition criteria and rates : delegated to FDIC
※ **Financial Crisis Responsibility Fee**
· Targets : financial companies with assets of 50 billion dollars or more
· Imposition criteria : 0.15% of non-deposit liabilities
· Imposition period and amount : 90 billion dollars in 10 years, and 117 billion dollars in 12 years.

The U.K. proposed a burden-sharing package including systemic levy, financial transaction tax, contingent capital, and insurance fee in its December 2009 HM Treasury report, and stressed close collaboration among G20 members. The report maintained that ① bank levy should be compatible with globalization, ② double taxation on multinational banks should be avoided, ③ countries should have discretion over how the proceeds from bank levy are used, and ④ bank levy should be introduced within the context of financial regulatory reform. The proceeds should be used to recover the public funds injected into the financial sector or to prevent future crises or to add to general government revenues if no public funds have been provided. The U.K. supports the introduction of bank levy by all countries, either ex-ante or ex-post, through collaboration among G20 members.

Sweden began to implement stability fund in October 2008 in an effort to better deal with crises that may arise in the future.

<Table 6-22> Stability Fund of Sweden

※ **Stability Fund** (in effect since the end of December 2009
· Targets : banks and other credit institutions
· Criteria: 0.36% of liabilities(0.18%(half the rate) for 10 years)
· Period and amount : up to 15 years, 2.5% of GDP

Canada is against creating a resolution fund with bank levy and other taxes and maintains the position that future financial crises can be best avoided when financial institutions set aside additional capital.

The EU reached an agreement on creating a resolution fund. Under the agreement, countries in the crisis-affected region will share the financial burden if the crisis is limited to a particular region, but in case of a systemic crisis, all of the EU member countries will bear the burden as a group.

Korea set up the Deposit Insurance Fund Bond Resolution Fund to recover the public funds that have been already injected in previous crises, and financial institutions are required to pay a fee for a fixed period of time, that goes into the resolution fund. A fee is also imposed on deposits and it is collected into the fund for the purpose of creating financial resources with which to deal with future crises. In order to avoid a steep rise in short-term foreign debts, financial institutions' positions will be managed more strictly, and a fee will be levied on foreign-currency borrowings.

2.3.5. Changes to Remuneration System

The global financial crisis revealed that remuneration is focused on short-term performance, and performance is asymmetrically recognized and rewarded for. In other words. performance is measured only in the positive term and no negative growth performance is recognized. This reward system induces excessive risk-taking and undermines the stability of the financial system. The FSB reward principles were adopted at the London summit. The principles are as follows: ① create an effective governance structure for remuneration system, ② build a remuneration system that corresponds to risk exposures, and ③ establish a mechanism for effective supervision and shareholders' participation. Under these principles, France, Germany, and the U.K. set stronger and more detailed enforcement standards including deferral, clawback, restrictions on guaranteed bonus payments, limiting the total remuneration amount to a certain percentage of net profit, and sanctions for failure to comply, but the U.S. proposed an ineffective alternative that focused on improving remuneration-related governance and disclosure rules.[156]

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156 The Corporate and Financial Institution Compensation Fairness Act that was passed by the House of Representatives in December 2009 only brought about a tepid reform: setting up an independent remuneration, introducing say on pay(giving shareholders a non-binding vote on executive compensation to put pressure on the board), and disclosing remunerations paid to top 5 executives. The remuneration guidelines published by the Fed in October 2009 provide only the principles in the implementation standards for the FSB remuneration principles and require that separate examinations should be conducted on remuneration systems of large financial companies and small banks. Even though U.S. tax payers' money equivalent to 12% of its GDP has been spent since the subprime mortgage crisis occurred, not a single person has been indicted, no special prosecutor has been appointed, and no financial company has been accused of securities fraud or accounting fraud. On the contrary, former Merrill Lynch CEO Stanley O'Neal was allowed to resign, instead of being dismissed and consequently to receive 151 billion won, and 5 top executives at Lehman Brothers together collected 1 trillion won from 2000 to 2007, none of which was regorged for the losses they caused to the company and its shareholders. AIG received 160 trillion won in public funds when it exited the market, but Joseph Cassano, head of AIG's Financial Products Division was paid 315 billion won in remuneration, and even though Goldman Sachs that purchased CDS from AIG received 61 trillion won, the Treasury Department pressured nationalized AIG not to sue Goldman Sachs for selling subprime products that were practically junk(Ferguson, Inside Job, 2011)

Since the U.K. is already regulating governance and disclosure, it is more concerned about restricting the remuneration structure, and authorized FSA to set regulations on remuneration, ban contracts that violate these regulations, and restore remuneration back to what is in compliance(the Financial Services Act of HM Treasury, November 2009). Under the remuneration regulations approved by FSA, half of a remuneration committee should consist of independent directors, bonus payment can be deferred, and clawback is applicable. In connection with the burden-sharing plan, a plan is under consideration to impose a 50% tax on a bonus that is 25,000 pounds or more.

France and Germany decided to introduce deferral in bonus payment, clawback, and ceilings on total bonus payments in line with the policy focus on restricting remuneration structure and setting remuneration ceilings.

2.3.6. Regulation of OTC Derivative Products

One of the reasons that the global financial crisis spread across borders to such a large degree is that trade in OTC derivatives including CDS expanded, adding to uncertainty in the market and creating higher counter-party risk, but the heightened uncertainty and risk were not properly dealt with, and the supervision and regulation was inadequate. So the London summit worked out an agreement to establish a central counter-party(CCP) as a clearing agency and to promote standardization of credit derivative products through effective supervision of CCP. At the Pittsburgh summit, member countries agreed to have all standardized OTC derivative products through CCP by 2012.

Following these agreements, a number of CCPs were launched in the U.K. and Europe, and in the U.S. the rule-writing process is under way by SEC and CFTC for the Dodd–Frank Wall Street Reform and Consumer Protection Act that was signed into the federal law in July 2010.[157] Major components of the law include clearing of standardized OTC derivatives via CCP, significantly high capital requirements for non-standardized products, disclosure of total trading balance and trading amount, restrictions on trade in banks' derivatives, revisions to the Volcker Rule, and ban on conflicts of interest among financial institutions.[158] Major issues

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157 The details of the law were scheduled to be written within one year. SEC is working on the regulations on spot-linked security-based swaps and CFTC is responsible for writing the regulations on the rest of swap-related matters. Given the time and budget restrictions, it is worried that they will be able to work out a final proposal that can best accommodate the needs of the market. On the other hand, IOSCO proposed 14 recommendations on CCP including the legal basis for creation and operation of CCP, qualifications, collateral requirements, bankruptcy procedures, measures to ensure transparency and efficiency, payments, governance, and regulation and supervision surrounding the law are definitions of key terms such as swap participants, the structure of CCP, swap execution facility, and position limits on speculative trades. For example, participants are categorized into three groups: swap dealers, swap participants, and end users. The definitions of these participants will determine the scope of regulations including the mandatory record-keeping, mandatory clearing via CCP, and stringent capital requirements. ICE Trust, CME Group, and other existing clearing houses require high levels of capital for new members while CFTC significantly lowered the entry barrier by putting a cap of 50 million dollars on the minimum capital requirement and it is also undertaking various initiatives to change the monopolistic structure, such as improving the governance of its clearing unit by increasing the number of outside directors into the board. To better cope with speculative trading in commodities, a proposal has been made to place position limites on trades in 28 commodities that require physical delivery such as gold, wheat, and crude oil, but critics remain skeptical about the regulators' capacity to regulate such positions.

As for standardization, the International Swaps and Derivatives Association (ISDA) announced the protocols on standardization of CDS(Big Bang Protocol in April 2010, and Small Bang Protocol in June 2010) and BCBS is revising capital regulations that reflect risks of OTC derivatives.

The EU also announced its proposed legislations in October 2009 that included mandatory clearing of standardized derivatives via CCP, higher capital requirements for non-standardized products, bringing derivatives onto registered exchanges, and empowering regulators in supervising derivatives trading.

Korea is planning to introduce CCP and should revise regulations accordingly, in light of developments in the U.S.

2.3.7. Regulation of Hedge Funds

Under the consensus that hedge funds cause systemic risks through collective behaviors, the London summit agreed to make registration and information disclosure mandatory for hedge funds, and to require them to effectively manage counter-party(banks) risks. In line with these changes, IOSCO decided to set 6 principles on supervision of hedge funds and regulations on short selling in June 2009.

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158 The revised Volcker Rule bans hedge funds of banks and bank holding companies from investing in PEFs and engaging in proprietary trading. Hedge funds and PEFs are allowed to invest up to 3% of their capital and banks are required to dispose of the positions in excess of the proprietary trading limit. ABS-issuing financial companies cannot take offsetting positions, and financial companies that sell MBS should hold at least 5% of the credit risk if the related loans fail to meet the risk-reduction criteria, thereby holding them responsible for their own losses.

<Table 6-23> IOSCO's Hedge Fund Supervision Principles and Regulations on Short Selling

<Supervision Principles> ① Hedge funds and hedge fund managers/advisors are required by law to register(**mandatory**) ② They should meet the regulatory requirements on **organization and management standards, conflicts of interest, disclosure, and prudential regulation**. ③ **Prime brokers and banks** are required by law to register and subject to regulation and supervision ④ They should provide **information on systemic risk** to regulatory authorities ⑤ Regulatory authorities should **develop best practices** for the industry, and promote the implementation and consolidation of best practices. ⑥ Regulatory authorities should cooperate and share information based on the MMoU of IOSCO. **<Regulations on Short Selling>** ① Short selling should be regulated so that potential risks of short selling that may undermine fairness, effectiveness and stability of the market can be minimized. ② Reporting rules should ensure that short selling information can be reported and disclosed to market and regulatory authorities in a timely manner. ③ Effective compliance monitoring execution systems should be in place. ④ Short selling activities that can help raise market efficiency should be allowed as exceptions to the regulations.

BCBS tightened collateral requirements for better management of risks of counter-party financial institutions, and improved the implementation methods.

In the same context, the Dodd–Frank Wall Street Reform and Consumer Protection Act that went into effect in July 2010 contained regulations on hedge funds featuring mandatory registration with SEC and tightened reporting rules, and restrictions of investments by commercial banks. Managers of hedge funds or PEFs that amount to 150 million dollars or more are required to register as investment advisers with SEC, and advisers with 100 million dollars or more of hedge funds or PEFs under their management that are involved in public placements are also subject to the same registration requirement. Venture capital advisers that were treated as exceptions under the previous regulations still remain exempted from the registration requirement. SEC can require investment advisers to keep the records of the funds under their management and report the details. In addition, SEC can request them to furnish information if it is deemed necessary to measure systemic risk. The rules have been eased compared to the originally proposed Volcker Rule that entirely banned banks from investing in hedge funds, but the equity investment in a particular fund is limited to 3% and the total investment should be less than 3% of Tier I capital.

Europe is planning to introduce similar regulations. The most controversial issue is on restricting access of hedge funds located in non-EU countries to EU investors. Specifically, the EU is considering two options: whether it will opt for the passport approach that allows only hedge funds in countries with regulations similar to those of the EU to invest in the EU or it will be left to individual EU member countries. Restrictions on banks' investments in hedge funds may put independent hedge funds owned by non-bank institutions at an advantage, but increased cost is expected to have varying degrees of impact on funds in different sizes. Particularly, Asia's hedge fund industry is still in its infant stage and the size is so small that it is not ready to catch up with new regulations. Therefore, access to European investors such as the U.K. and France is crucial to these fledgling funds, and if funding from these European investors becomes less available or accessible, they will become more dependent on the U.S. and the Middle East as their sources of funding. Singapore simplified the requirements for setting up a hedge fund and reduced taxes on hedge funds. In addition, it decided to rent part of One-North, a biotechnology research complex under construction, to hedge funds so that it will be developed into a hedge fund cluster, suggesting that competition among financial hubs is expected to accelerate despite regulators' efforts to tighten supervision.

In Korea, the revised Financial Investment Business and Capital Markets Act that took effect in December 2009 provided a legal framework for setting up hedge funds, but the Act requires that hedge funds should invest 50% or more assets under their management in restructuring-eligible companies and other stringent regulations are stifling the growth of the hedge fund industry.

2.3.8. Closer Cooperation with Non-Cooperative Jurisdictions

A growing volume of financial transactions that hedge funds conduct via tax havens and offshore financial centers is viewed as one of the factors that caused the global financial crisis. Many financial companies set up paper companies but these paper companies are not adequately regulated, and no enough information on them is available to share with regulatory authorities, thereby posing obstacles to identifying and managing risks that they generate. These tax havens and offshore financial centers also cause significant losses to the government revenues in related countries, and they are also used as a venue for money laundering. To address these issues, G20 members agreed at the London summit to work closely toward protection of the global financial system and prevention of losses to government revenues in the following three areas: ① exchange of information for tax purposes, ② prudential regulation, and ③ anti-money laundering(AML) and combating the financing of terrorism(CFT).[159]

OECD Global Forum, previously an irregular council was restructured into an official independent organization in September 2009. The forum organized a peer review group to perform peer reviews of all member countries from 2010.

In the area of AML/CFT, ICRG is working on the process to identify high-risk areas. The FATF general meeting in October 2009 decided to conduct close examinations into 25 countries, and listed 28 regions as high-risk areas for money laundering in February 2010.

FSB set out the peer-review procedures and the evaluation process to identify non-cooperative jurisdictions to improve prudential regulation. Peer review consists of country review and thematic review and is scheduled to begin in 2010. Criteria for identifying non-cooperative jurisdictions have been established and the identification process will begin in the first half of 2010.

2.3.9. Regulation of Credit Rating Agencies

One of the causes of the global financial crisis is over confidence that investors put in credit rating agencies and inappropriate credit ratings that they assigned. Countries agreed to the need for ensuring the quality and transparency of credit rating, and for resolving conflicts of interest involved in credit rating practices. During the London summit, member countries agreed to achieve international consistency in credit rating and reduce the role of credit rating through stronger regulations such as registration requirement and cross-border exchange of information.

Under the Dodd-Frank Act, the Office of Credit Ratings was set up to monitor activities of credit rating agencies and punish them for any wrong doings. OCR carries out examinations at least once a year for possible conflict of interests, internal controls, and other aspects of their operations, and publishes the major findings. Credit rating agencies are required to set up internal controls to monitor adherence to credit rating policies and procedures and to comply with higher disclosure standards for the benefit of investors and the public OCR is authorized to cancel the registration of credit rating agencies that repeatedly assign inappropriate credit ratings. Previously, the Securities Act(Rule 436g) treated as simple opinions, credit ratings that rating agencies issued on bonds, and exempted rating agencies from legal liability for ratings that they assigned. The exemption remains in effect on issuance of regular bonds, but credit rating agencies are now exposed to expert liability for ABS issuance, upon their consent. This was met

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159 The OECD Global Forum will be responsible for tax matters, FATF for AML/CFT, and FSB for prudential regulation.

with strong backlash from rating agencies which in response, refused to issue ratings, leading to a temporary shutdown of ABS market. SEC initially set a 6-month grace period and then made the grace period permanent in January 2011, resolving the conflict with the industry.

Regulation Fair Disclosure mandates that issuers must disclose material information to all investors at the same time but only rating agencies were exempted from this requirement, allowing them to obtain undisclosed material information from issuers. however, this exemption was rescinded, considerably restricting rating agencies' access to such information.

Regulations in the federal laws that mandate referral of credit ratings were eliminated, thereby reducing the dependence on rating agencies, and OCR set a set of internal rules that can replace credit ratings to report to the Congress.[160]

Filing lawsuits against rating agencies has become easier under vastly eased criteria. A lawsuit can be filed against a rating agency when it did not conduct a due examination of the information used in determining a credit rating, intentionally or inadvertently. Rating agencies can be also sued when they did not reasonably review information provided by a third organization when they issued ratings.

Code of ethics and professional standards that employees of rating agencies must follow will be established, and a separate organization will be set up to oversee compliance. Issuers will be restricted from choosing rating agencies when they issue structured products, and instead, SEC will create an independent organization which will select rating agencies to assign initial ratings to those products.

In Europe, there is a growing support for regulation of credit rating agencies as rating agencies are accused of being a major culprit in aggravating the fiscal crises in Souther European countries by rapidly downgrading credit ratings during the fiscal crises, thereby adding to economic uncertainty and raising the cost of funding. The proposed Financial Regulatory Reform Act that was passed by the European Parliament in September 2010 authorized European Securities and Market Authority(ESMA) scheduled to be launched in early 2011 to oversee credit rating agencies. Since rating services are not linked to particular territories, ESMA will directly oversee rating agencies. Specifically, ESMA will have the authority to demand information, conduct investigations and examinations, and perform on-site inspections, while regulatory authorities in individual countries will no longer have any powers or responsibilities over rating agencies. Banks and other institutions that

160 In order to reduce the role of rating agencies, SEC proposed in 2011 that in case of simplified registration for securities issuance, issuers can be rated based on their past performances instead of having to get an investment-grade credit rating assigned by a rating agency. SEC also proposed that the board should be allowed to decide in which products money market funds can invest while removing the regulation that required that money market funds can invest only in products that were assigned invest-grade ratings by rating agencies.

issue structured products should provide the same information to other rating agencies as well as the rating agency that assigns ratings to them so that other agencies can also assign their own ratings. Ideas that will be further explored include creating an Europe-wide credit rating agency, imposing sanctions on rating agencies for losses caused by inappropriate credit assessments and steep credit downgrades, reducing overdependence on credit ratings, and resolving conflict of interests inherent in the business model of rating agencies.

2.3.10. Harmonization of Accounting Standards

Based on the consensus that absence of harmonized global accounting standards makes cross-border comparability of accounting information difficult, G20 member countries agreed to establish harmonized global accounting standards at the Washington summit, and specified the deadline for harmonization at June 2011 at the Pittsburgh summit. In October 2009, IASB and FASB agreed to the harmonization plan and embarked on specific steps toward harmonization according to the plan under the MOU that they signed, aiming to complete the harmonization by June 2011, but the process has stalled. IASB revised its bylaws to increase participation of stakeholders in the process of establishing harmonized standards. As a result this revision, IASB formed an outside oversight committee, increased the number of its members, and set the regional allocation principle.[161]

2.3.11. Creation of FSB and the Expanded Roles

FSB was established after the G-20 London summit in order to develop a more effective international cooperation framework by improving cross-border financial regulation so as to prevent financial crises and better cope with them if they occur. FSB was officially launched at the London meeting of financial ministers held in March 2010 and it included all FSF members, 11 G20 member countries that were not members of FSF, Spain and the EC. FSB consists of the general assembly, the steering committee, and 3 permanent committees in the areas of supervisory and regulatory cooperation, vulnerability evaluation, and compliance). The FSB's charter

161 Discussions on establishing harmonized global accounting standards are stalled as the U.S. has remained lukewarm about the issue. However, discussions are expected to move forward as FASB of the U.S. decided in November 2012 to join IASB that will advise on the harmonized accounting standards. SEC did not include any comment in favor of the introduction of IFRB in the final working-level report on aligning the U.S. accounting standards with IFRS, that was released in July 2012. On the other hand, the report stated that the shift to IFRS would put significant burden on U.S. companies and thus the majority of companies were against the adoption of IFRS.

sets out its purpose and mission, membership, and duties of members, and the permanent committee on compliance established peer review procedures(by theme and country) to monitor compliance with regulatory standards in member countries.

2.3.12. Financial Inclusion

The Pittsburgh G20 summit agreed to form the Financial Inclusion Expert Group(FIEG) to improve access of the poor and SMEs to financial services, with two sub-groups: Access Through Innovation(ATI) and Small and Medium-sized Enterprises(SME) Finance.

<Table 6-24> Sub-Groups of FIEG

① (ATI Sub-Group) improve access of the poor to financial services through innovative medium of delivering financial services such as branchless banking.* * ways of delivering financial services using IT and non-bank retail channels such as mobile banking, as opposed to conventional bank branches. ② (SME Finance Sub-Group) collects and analyzes success cases of SME Finance, and invites private sector participants to present innovative ideas in a competition that it hosts for the purpose of encouraging the private sector to get involved in SME Finance.

FIEG's discussions pertained to the following issues. First, FIEG decided to a global partnership which is an organic network of G20 members and non-G20 members, international organizations, and private organizations. The partnership joined by G20 economies, non-G20 members, international organizations(ADB, AfDB, IaDB, ILO, OECD, UN, WEF), standards-setting agencies(BCBS, IAIS, IADI, FATF), private organizations(Grameen Foundation, Bill & Melinda Gates Foundation, Rockefeller Foundation), and bilateral donors(USAID, AUSAID, BMZ), is expected to serve as the premier forum where all issues regarding financial inclusion can be discussed. FIEG will also develop methodologies that countries can use to improve data that is used to measure access to financial services and to set financial inclusion targets.

In addition, it will collect success cases of expanding financial support to SMEs from the private sector and promote best practices of SME finance by hosting competitive exhibitions. A fund will be set up to support this initiative, and the action plan will be made to help G20 countries implement the principles of proliferating innovative financial services.

2.3.13. Other Items on G20 Agenda

2.3.13.1. Development

Critics raised the question over why G20 meetings need to discuss development agenda that is dealt with at the UN and G8 meetings. However, proponents argued that G20 that includes both advanced economies and emerging economies can utilize its advantages of broader representation and create added values. In this sense, G20 discussions on development issues focused on complementing the exiting development discussions and expanding synergy effects. For example, G8 is discussing its financial commitment for agenda under discussion at MDG. So G20 shifted the focus of discussions to address other aspects of development such as removing obstacles to economic growth in developing countries and expanding their growth potential. These discussions culminated in the adoption of Seoul Development Consensus and Multi-Year Action Plan.

(i) Seoul Development Consensus: Seoul Development Consensus for Shared Growth which will be the basic charter for G20 development discussions sets out the direction and principles of G20 discussions on development and focuses on promoting economic growth through increasing the economic capacity of developing countries. In other words, changes will be made to policies and regulations to get rid of factors that hinder economic growth in developing countries and to facilitate participation and innovation in the private sector while efforts will be made to enhance the resilience for sustainable economic growth in low-income countries. To attain these goals, 9 core areas have been selected as listed in the table below.

<Table 6-25> 9 Core Areas of Seoul Development Consensus

① Infrastructure, ② development of human resources, ③ trade, ④ private sector investment and job creation, ⑤ food security, ⑥ growth with resilience, ⑦ financial resources for domestic development projects, ⑧ financial inclusion, ⑨ knowledge sharing

(ii) Multi-Year Action Plan: The plan lists specific and attainable tasks in the 9 areas and specifies who will be responsible for implementing each task and by when these tasks will be completed.

<Table 6-26> Multi-Year Action Plan

▪ Eliminate institutional obstacles to infrastructure investment and increase funding ▪ Develop occupational technologies to increase job opportunities for workers in developing countries and raise their productivity ▪ Expand trade capacity of developing countries to promote economic growth through trade ▪ Encourage private sector investments that can create jobs and added value in developing countries ▪ Fulfill commitments to food security and reduce volatility in food prices ▪ Strengthen social safety nets to improve responses to economic crisis and resilience ▪ Expand funding for development in developing countries by lowering remittence costs and improving taxation resources. ▪ Share development knowledge and apply it with modifications to fit the circumstances of developing countries. ▪ Improve access to financial services for SMEs and others that have been denied adequate access.

(iii) Effects: Since support from developed countries is limited due to their weakened government finance, it is important to help developing countries expand their own capacity and growth potential so that they can be self-sufficient and become capable of achieving their development targets on their own. Using cases of other countries that successfully developed their economy as benchmarks, development policies should be designed to fit the unique needs and circumstances of individual countries, and they should be taught "how to catch fish", instead of "giving them fish", or applying the one-size-fits-all approach. Discussions on development should be focused on thinking about how developing countries can catch fish on their own.

Opinions were widely collected from the UN, and developing countries in Africa, Asia, and Central and South America so that the needs and interests of those countries and civic society were sufficiently reflected in the process, as well as concerns and interests of NGOs and academia through international conferences and dialogues with civic groups. Korea came into spotlight as a successful model of economic development, raising expectations of close cooperation with developing countries in this area.

2.3.13.2. Climate Finance

High-Level Advisory Group on Climate Financing was created in order to discuss potential sources of revenue to finance climate actions on the UN level and countries involved met in Copenhagen in 2009. The discussions at the meeting are summarized below.

<Table 6-27> Major Outcomes of the Copenhagen Accord

*** Major Outcomes** · **(Emissions reductions)** Leading countries(Annex I Parties) agreed to submit their mid-term(20 years) emissions reductions targets by January 31, 2010, and developing countries(Non-Annex I Parties) agreed to present their voluntary reduction actions. · **(Transparency)** Emissions reductions actions by developing countries that do not receive financial support should measure, report, and verify their emissions every two years and submit a country report. · **(Finance)** <u>**Leading countries**</u> will raise 30 billion dollars from 2010 to 2012, and 100 billion dollars each year from 2013 to 2020 to establish the Copenhagen Green Climate Fund and assist developing countries with their reductions and adaptations. * Korea submitted a reduction action to the UN on December 30, 2009, under which it pledged to reduce its emissions by 30% compared to business as usual(BAU)* by 2020. * BAU(Business As Usual): refers to the estimated emission level in the future without reduction actions(emission forecast).

G20 discussions included the setup of an Expert Group, the size of climate finance, who should manage climate finance and how, the role of public finance, criteria for granting financial support, and relations between ODA and climate finance. Leading and developing countries(China, Brazil and India) failed to iron out their differences on key issues such as the size of the fund, the cost-sharing scheme, and fund management system, and remained divided over whether or not climate finance should be discussed at G20 meetings, overshadowing the prospect of future discussions.

2.3.13.3. Energy

Energy-related agenda consists of three major themes: fossil fuel subsidy, energy price volatility, and protection of marine environment.

(i) Fossil fuel subsidy: The Pittsburgh summit in September 2009 agreed to rationalize subsidies for fossil fuel and to abolish these subsidies in phases. Subsidies for greenhouse gas reduction technology and for clean and renewable energies will be treated as exceptions, and energy support for the disadvantaged class remained an important task. At the Toronto summit in June 2010, countries submitted their implementation strategies and schedule including plans to improve subsidies provided for production and consumption of fossil fuels such as coal, petroleum and natural gas. IEA, OECD, OPEC, and WB adopted a joint report that included recommendations on how the scope of subsidy should be determined and how the subsidies should be abolished. The Seoul summit in December 2010 agreed to review the progress in implementing the plans that countries submitted at the 2012 France summit, signaling that discussions to achieve the long-term goal of reducing the dependence on fossil fuels were right on track.

(ii) Energy price volatility: In order to mitigate the impact of steep fluctuations in oil prices, the Pittsburgh summit agreed to the following: ① improve the quality of oil market data, ② coordinate the medium- and long-term outlook of oil demand and supply between oil-producing and oil-consuming countries, and ③ enhance financial market transparency and improve regulations. Building on the foundation of cooperation laid by this agreement at the Pittsburgh summit, the Seoul summit agreed to discuss ways to deal with fluctuations in prices of other fossil fuels than oil, such as coal and natural gas, thereby improving the prospect of a tool to mitigate the negative impact that rapid oil price changes may have on economic recovery.

(iii) Protection of marin environment: The Toronto summit raised the need for sharing best practices in preventing and dealing with marine oil spills caused by oil drilling and marine transport, following the oil pill in the Gulf of Mexico[162], and as a follow-up to the discussions, G20 members agreed to identify and address potential threats to marine environment on an ongoing basis at the Seoul summit. Given that there is no effective global cooperation framework for prevention and handling of marine oil spills that may occur during oil drilling, it was a step in the right direction that G20 committed to protecting marine environment from threats of oil spills.

2.3.13.4. Trade

Following the Washington summit, ministers were instructed to reach an agreement on the details of DDA, and heads of states agreed to get involved if necessary. Member countries expressed a strong commitment to concluding DDA negotiations which were in limbo, at the earliest date possible at the Seoul summit, and subsequently, reconfirmed their commitment that they made at the Toronto summit, to creating no new trade and investment barriers and bringing export restrictions to a stand still by 2013.

DDA was launched in November 2001, with the aim of working out an agreement within 3 years. However, leading countries including the U.S., and the EU and developing countries such as Brazil and India have remained sharply divided over matters of market access including reductions of tariffs on agricultural and non-agricultural products. As a result, discussions are still under way well

162 In April 2010, an oil drilling ship exploded in the Gulf of Mexico, causing 20 billion dollars in direct damages, and the indirect damages to the environment, tourism, and fishing industry were estimated at 100 billion dollars.

beyond the initial deadline.[163]

Two rounds of ministerial meeting were held in Cancun in 2003 and in Hong Kong in 2005, but failed to reach an agreement on modalities[164] for agricultural and non-agricultural products, bringing the negotiations to a halt in June 2006. Later, the negotiations resumed at the Davos Forum in January 2007. The small-scale ministerial meeting held in Geneva in July 2008, produced a tentative agreement, indicating that there was a working-level consensus on specific modalities on market access for agricultural and non-agricultural products, but they failed to hammer out a final agreement on the modalities as they still remained far apart on SSM.[165]

Recently, as part of efforts to overcome the global economic crisis, G8, G20, APEC, and other summits and ministerial meetings are boosting momentum for reopening DDA negotiations, and it is becoming an important task to take advantage of this growing momentum and accelerate the negotiations.[166]

3. The Future and Strategies of Investment Banking

3.1. Introduction

In 1823, British poet Lord Byron described Rothschild and Barings as the true rulers of Europe, and in 1907, J.P. Morgan acted as the lender of last resort in place of the central bank in the face of the financial crisis caused by trusts that recklessly sprawled out amid lack of regulation. The bailout by J.P. Morgan brought to attention the risk of an individual's excessive influence on the stability of the financial system, giving birth to the launch of the FRB in 1913. Since the

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163 Initially, there were 9 items on the agenda: agriculture, NAMA, services, regulations(anti-dumping, subsidies, and regional agreements), dispute resolution, trade facilitation, intellectual property rights, and development). NAMA or non-agricultural market access refers to market access for manufactured goods, forestry and fishery products, and other non-agricultural products. Key issues that need to be worked out are how much the U.S. will reduce its agricultural subsidies, and to what degree the EU will open its agricultural market and reduce tariffs on imports of manufactured goods.

164 Modalities include, among other things, formulas for determining reductions of tariffs on, and subsidies for agricultural and non-agricultural products. Once modalities are determined, countries should draw up and submit a concession schedule based on these modalities.

165 SSM or Special Safeguard Mechanism imposes additional tariffs on agricultural products in cases the imports of such products drastically increase or the prices sharply fall(this option is available only to developing countries)

166 The conclusion of DDA negotiations is expected to increase the global exports and GDP by 280.4 billion dollars and 2,827.8 billion dollars, respectively(based on the current proposal, Peterson Institute for International Economics), and the value of the current proposed plans, if converted to tariffs, is estimated at 150 to 500 billion dollars(WTO Director General Lamy).

1980s, investment banks have grown rapidly as direct financing became a common source of corporate funding. Innovative financial products did not only meet the demand but even created new demands. Investment banks emerged as the leader of the financial industry and large financial institutions rushed to turn themselves into investment banks. In the process, investment banks depended on excessive borrowings for growth, and generated negative effects such as spreading risks, underestimating the risk of securitization, creating a profit-oriented corporate culture that puts the interests of individual companies and employees first, and promoting blind trust in credit ratings assigned by rating agencies, all of which contributed to the 2008 credit bubble and the consequent subprime crisis. The subprime crisis is a product of moral hazard at investment banks, the sprawl of investment banks including commercial banks-converted investment banks, and regulatory failure.

In this context, a massive overhaul of financial regulatory system, reform of international financial organizations, creation of global financial safety nets, and financial inclusion are emerging as major issues that need to be discussed in order to prevent global financial crises. The freedom of investment banks, their best tool is expected to be restricted but investment banks still perform an important role in the capital market and they should seek new growth strategies in the face of more stringent regulation of investment banks and credit bubbles. In Korea, investment banking is still in its fledgling stage and the industry is building the infrastructure by accumulating capital, nurturing highly-skilled human resources, and establishing institutional frameworks. In spite of their role in the past financial crisis, much support should be provided to advance the investment banking industry in Korea that is poised to leap forward.

3.2. Brief History of Major Investment Banks

3.2.1. The Birth of Major Investment Banks

Rothschild, Barings, and J.P. Morgan are the big names in the investment banking industry and the following is a brief history of how they have grown into major global investment banks.

Rothschild is an international financial group found in 1764 by Jewish money exchanger Mayer and his five sons, and grew into one of the two pillars of the British financial market along with Barings during the 19th century. Mayer built a fortune as a supplier for Wilhelm IX, the lord of Hessen in Frankfurt. Rothschild means “red shield” in German. The Rothschild family, migrated Jews who lived in a ghetto accumulated wealth through money-exchanging business in the Middle Ages when interest on money was considered evil.

<Table 6-28> Top Global Financial Institutions(2013, League Table by Vault)

2013 RANK	2012 RANK	CHANGE	FIRM	SCORE	LOCATION
1	1	—	J.P. Morgan Investment Bank	8.585	New York, NY
2	24	↑	The Blackstone Group	8.408	New York, NY
3	2	↓	Goldman Sachs & Co.	8.067	New York, NY
4	5	↑	Houlihan Lokey	7.767	Los Angeles, CA
5	3	↓	Morgan Stanley	7.684	New York, NY
6	6	—	Greenhill & Co., Inc.	7.676	New York, NY
7	7	—	Evercore Partners	7.462	New York, NY
8	8	—	Perella Weinberg Partners	7.388	New York, NY
9	9	—	Centerview Partners	7.319	New York, NY
10	4	↓	Credit Suisse	7.306	New York, NY
11	25	↑	Lazard	6.763	New York, NY
12	10	↓	Jefferies & Company, Inc.	6.740	New York, NY
13	11	↓	Moelis & Company	6.658	New York, NY
14	15	↑	Citi Institutional Clients Group	6.647	New York, NY
15	20	↑	William Blair & Company	6.446	Chicago, IL
16	19	↑	Gleacher & Company, Inc.	6.443	New York, NY
17	17	—	Robert W. Baird & Co. (Baird)	6.440	Milwaukee, WI
18	13	↓	RBC Capital Markets	6.368	Toronto, Canada
19	21	↑	Cowen Group, Inc.	6.198	New York, NY
20	14	↓	Royal Bank of Scotland Group plc	5.981	Edinburgh, United Kingdom
21	18	↓	Piper Jaffray Companies	5.677	Minneapolis, MN
22	22	—	SunTrust Robinson Humphrey	5.517	Atlanta, GA
23	NR	—	Keefe Bruyette & Woods, Inc.	4.248	New York, NY
24	26	↑	Deutsche Bank AG	2.734	New York, NY
25	27	↑	Barclays (Investment Banking)	2.628	New York, NY
26	29	↑	Bank of America Corp.	2.435	Charlotte, NC
27	28	↑	UBS Investment Bank	2.300	New York, NY
28	30	↑	Rothschild	2.191	New York, NY
29	33	↑	HSBC North America Holdings	2.029	Mettawa, IL
30	31	↑	Wells Fargo & Company	1.993	San Francisco, CA

Wilhelm XI was known as the first capitalist lord who raised capital through his army. Mayer's eldest son provided funding to Prussian finance minister, and the second son provided financial services to Austrian Chancellor Metternich.[167] The other sons established financial businesses in Britain, Italy, and France, respectively. The family prospered over 250 years by expanding their business throughout Europe and providing funding to the Waterloo War, the construction of Suez Canal by France, the Louisiana Purchase by the U.S., the construction of European railways, and Britain's colony management in Africa. The family's influence grew weaker due to London's diminished status as a financial hub, France's nationalization of banks, Jewish persecution by Hitler, and its struggles to make inroads into the U.S. market. However, it remains an influential financial institution and ranks 30th largest global financial institution.

The Barings family started a wool trading business in London in the 1700s, and emerged as a large merchant bank as it grew rapidly during the Industrial Revolution and later flourished providing funds and financial services to major governments in Europe and the New Continent. Barings' status began to decline after it received a bailout in connection with the Argentina's default crisis in 1980 and the bank collapsed in 1995 after suffering losses of 1.3 billion dollars resulting from poor speculative investments in futures contracts conducted by its Singapore branch manager Nick Leeson. Following the bankruptcy, ING of the Netherlands took over all of Baring's subsidiaries in exchange of liabilities + 1 pound, merging into the new company ING Barings. After the subprime crisis, the company abandoned Barings in its name and reverted to ING, and the family name disappeared from the global financial community. Nick Leeson's speculative investments and the subsequent losses is considered as one of the major cases showing failure of operational risk management by financial institutions.

The origin of J.P. Morgan dates back to 1838 when George Peabody from the U.S. established a merchant bank in London. The bank made fortunes by taking over and selling bonds issued by the North army during the Civil War. The partnership was ended when Peabody retired, and Junius Morgan was named the successor. As a late mover, Morgan took the risk of supporting France during the Franco-Prussian War as the Rothschild refused to take it. After Napoleon III lost the war, Morgan that underwrote and circulated the French government bonds had to buy back the bonds dumped by investors at a loss. But the French government

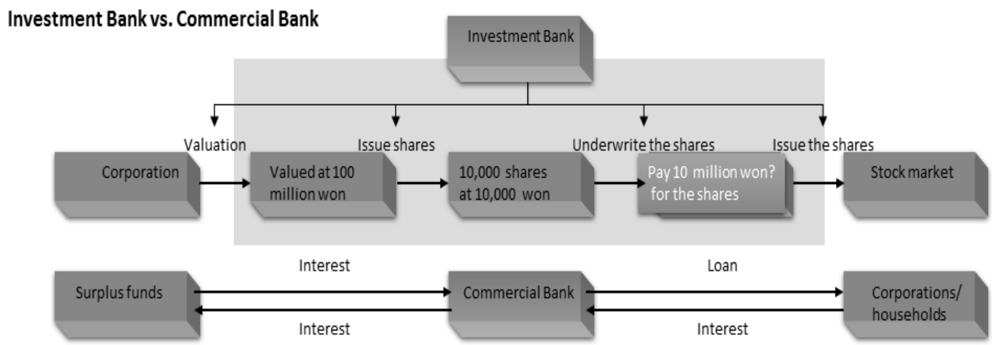
167 Marie Louise, a cousin of the Austrian empress Maria Theresa and Napoleon's second wife was sent back to Austria after Napoleon's abdication, causing a headache to Metternich. Metternich asked Mayer's second son to manage her properties and finance. Later Austria's finance deteriorated after a series of wars and the Rothschild family got actively involved in helping Metternich deal with the financial crisis. In recognition of the family's role in overcoming the financial crisis, the Austrian emperor conferred the title of baron on all of the five sons.

promised to repay the government bonds and the price skyrocketed, rewarding Morgan for boldly taking the risk and paving the way for Morgan to rise into a global investment bank. Junius' son Pierpont took over the control of the firm and the bank rose as the No. 1 investment bank of the U.S.. When the global financial market was thrown into a growing debt crisis as U.S. state governments fell into bankruptcy from their failed investments in major construction projects involving railways, canals, and high ways, the bank represented the U.S. in the debt restructuring negotiations on behalf of state governments of Maryland, Pennsylvania, and others, and led the negotiations with European investors. When U.S. state governments declared insolvency in a row, the bank took the responsibility for underwriting and circulating their bonds and repurchased the bonds at a loss, but as the state governments began to pay the interests, the prices of the bonds soared, and the bank reaped huge profits. When there was no central bank in the U.S., J.P. Morgan acquired treasury bonds to keep the gold standard working in the U.S., played a crucial role in restructuring the overly-invested railway industry, and led the syndication of loans to fund the construction of industrial trusts for the steel industry(US Steel) and North Atlantic Shipping. It also played a major role in saving the financial market from panic by bailing out trust and securities companies in times of crises. However, capitalists' pursuit of profit during the financial turmoils was heavily criticized, providing the background to the creation of the Federal Reserve System in 1913. Massive bankruptcies of banks during the Great Depression resulted in the enactment of the Glass-Steagall Act of 1933 that separated baning from securities business. Under the Act, J.P. Morgan was divided into J.P. Morgan, the commercial banking unit and Morgan Stanley, the investment banking arm.

3.2.2. Types of Investment Banks

There are three types of investment banks: securities IB(specializes in securities only), holding company IB, and universal banking IB. Securities IBs are controlled by their parent securities companies directly or indirectly(as a subsidiary or a subsidiary of a holding company). This type of IBs include Goldman Sachs, Morgan Stanley(obtained a commercial banking license and turned into a financial holding company after the global financial crisis), Blackstone, and Lazard. Holding company IBs refer to investment banking subsidiaries of commercial banks, that are controlled directly or indirectly(via a holding company) by their parent commercial banks. Citigroup, JP Morgan Chase, and HSBC fall into this category. Universal banking IBs mix commercial banking and investment banking and they are commonly found in West Europe. Deutsche Bank, Barclays, and UBS are major universal banking IBs.

<Table 6-29> Investment Banking vs. Commercial Banking



3.2.3. The Role of Investment Bank

A commercial bank is basically an indirect financing institution that takes deposits from customers and make loans out of the deposits. In this sense, a commercial bank is a financial intermediary and profits from loan-deposit margins. Investment banks help corporations obtain funds and advise them on securities issuance or M&A deals. Originally, investment banks started from a simple fee-based business like securities companies, but expanded their business to advise on the entire process of corporate funding for commissions. Advisory fee income is not significant, but follow-up businesses that advisory services generate are 5 to 8 times more lucrative. For example, such derivative businesses include advising on maturities of bonds, interest rates, and stock pricing, and an investment bank should mobilize the entire spectrum of its professional resources and expertise for an IPO. Once the type of security to issue is determined, an investment bank guarantees the price and underwrites the issue of the security(underwriting can be done independently or by a syndicate). The bank approaches potential buyers such as banks and insurance companies or advertise the security to the investing public to sell the security. In addition investment banks broker M&A deals and provide funding for acquisitions such as LBO loans and covenant-lite loans. Investment banks have been actively involved in securitizing locked assets by creating various credit derivative instruments such as CDO and CDS, engage in private investments(PI) out of leveraged funds or their own money, and set up PEFs to finance investments. In short, investment banks act as a risk warehouse by taking on and managing risks for profit.

3.2.4. Rapid Growth of Investment Banking Industry

Investment banking is viewed as a major driving force that has increased both the scope and the depth of financial instruments by engineering and pioneering innovative financial techniques as the alchemist of the financial market. Swaps, options, securitization, leveraged loans, and other innovative financial instruments developed by investment banks drastically increased the size of financial assets around the globe. Investment banks quickly emerged as the market leader by capitalizing on their unique strengths such as off-balance sheet businesses, and risk diversification and management, as opposed to less competitive traditional commercial banking practices such as long-term lending to retail clients, long-standing relationships with clients, and balance sheet-based businesses. From the investor's perspective, the focus of financial activities was shifted from deposits to investment[168] The 1999 repeal of the Glass-Steagall Act brought about growing competition between commercial and investment banks, and UBS, CS, and Deutsche Bank struggling to survive in their overly competitive home markets, PEFs, hedge funds, and boutiques all rushed to the U.S. investment banking market. Commercial banking-based Citi and JP Morgan joined the bank wagon, taking advantage of their low-cost funding capacity and massive assets.

The rapid expansion of investment banking industry is attributed to the following factors.

① First, swaps and options were born out of the initial financial innovation. A swap allows future cash flows such as interest rates to be converted into their present value in a transaction. The first swap was a currency swap that Solomon Brothers brokered between the World Bank and IBM that wanted to exchange their debt in two different currencies. In the 1970s and early 1980s, floating rate notes that are transferable and have a broader investor base became popular while syndicated loans were less preferred than previously. Low-cost FRNs emerged as a new market-leading instrument, shifting the investor focus away from loans. So until then, commercial banks were still a dominant force in the market.

In the 1980s, the market for swaps fast grew and when fixed rate bonds that

168 Changing Ratios of Global Financial Assets(1980-2005)

	1980	2005
• Global financial assets/Global GDP(%)	109	316
• Ratio of deposits in financial assets(%)	42	27

were issued at a cost lower than the floating interest rates came along, investors flocked to fixed rate bonds amid the rising inflation and the falling interest rates on the U.S. dollar, reversing the trend and placing investment banks at an advantage over commercial banks.

An interest swap needs two parties to the transaction but since it is not always possible to find both parties at the same time, a financial institution initially takes over unmatched transactions. In this sense, commercial banks with high credit standing have the upper hand. Financial institutions in the U.S. and other countries where commercial banking and investment banking were separated executed swaps through their London branch, and practically tapped into the domain of investment banking. Overheated competition distorted business practices and some financial institutions got involved in off-balance sheet transactions for speculative investments.[169]

An option is a financial instrument that prices a future potential risk at its present value and the trading of options began in earnest with the opening of Chicago Board Options Exchange in 1973. With the development of the Black-Scholes model, stock options trading was sparked in the late 1970s, followed by currency options and BW in the 1980s and beyond.

Investment banks traded heavily in stock and currency options, and commercial banks diversified their balance sheet-oriented businesses into lending to institutional investors, thereby adding to the growth of investment banking.

② Financial innovation of securitization transformed leaden assets into liquid assets. Instead of low-return, but safe treasury bonds, investment banks created and traded in credit derivative product such as CDS and CDO to make large profits. Trading in these products made up more than half of their revenues. Financial institutions grew less dependent on traditional financial products such as stocks, bonds, commodities and foreign exchange instruments and traded increasing volumes of derivatives such as options, futures and swaps, stretching the application of innovative derivative instruments to virtually all aspects of daily life such as weather, survival risk, emissions, natural disasters, and other calamities.[170]

Modeled after the asset management practices of hedge funds, investment banks set up funds like 130/30 and charged high fees and as a result, their assets in FICC(fixed income, currency and commodities) accounts sharply increased. They dealt with a wide variety of assets such as subprime mortgages, Japanese yen, copper futures, insurances against natural disasters, GE bonds, and Zambia-related

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169 Bankers Trust fell victim to the overheated competition and speculative investments and collapsed.

170 Derivatives trading expanded from 3.5 trillion dollars in 1990 to 286 trillion dollars in 2006, 6 times as much as world GDP.

bonds. The profit from FICC assets was normally half of the profit from stock investments, but the former increased to twice as much as the latter in 2006. Credit derivatives such as CDS and CDO were particularly lucrative, and ABS(securities backed by commercial or home mortgages) emerged as a high-growth area, but risks on subprime mortgages were not properly managed, triggering the global financial crisis.

③ There was a marked growth in balance sheet-based trading. Financial investments engaged in growing volumes of principal investments and leveraged investments. Initially, investment banks, like real estate agents do, matched up buyers and sellers for a financial transaction and charged fees, but later they expanded their businesses to making loans, developing structured products, making direct investments, moving back from off-balance sheet to balance sheet businesses. Leverage loan[171] became a key funding source for PEFs, and stronger control of PEFs as borrowers led to growing covenant-lite loans, and PEFs even asked banks to provide bridge loans and bridge equity.

Growth of investment banking was further catalyzed by enormous profits from the triple play of advisory, funding, and PI.

<Table 6-30> Traditional Balance Sheet Business vs. Modern Balance Sheet Business

[Traditional Balance Sheet]

Securities held for trading	Borrowings(debt)
	Capital

[Modern Balance Sheet]

- Bonds - Real estate - Investments in funds - LBO loans - Corporate buyouts, etc.	Borrowings(debt)
	Capital

④ The customer base and the market vastly expanded around the world. Investment banks' profit base was seriously eroded as Internet-based trading systems were introduced in advanced countries and brokerage fees that they charged mutual funds, the largest client group, dropped considerably due to growing competition with hedge funds and listed index funds. However, the reduced fee income was more than offset by profits from an enlarged customer base which included hedge

171 Bank loans giving a priority in repayment in case borrowers fall into financial trouble.

funds and PEFs. In 2007, there were 10,000 hedge funds with 1.6 trillion dollars under their management, and this newly emerging group of customers frequently changed their portfolios, resulting in large trading volumes. As prime brokers, investment banks charged high fees for execution and settlement of transactions, lending securities and funds, and promoting new funds to investors. They came up with new investment products in response to the changing demands of customers, which again translated into more fee incomes. For example, the mutual funds market was split into two groups of products: low-return simple index products and high-risk, high-return products that can compare well with hedge funds. Investment banks successfully satisfied the needs of investors by developing 130/30 fund that employed an investing strategy similar to the long-short strategy commonly employed by hedge fund. A 130-30 fund goes long on 130 stocks that are expected to rise and sells 30 stocks short in a bet that their prices will fall, thus maintaining a net long position on 100 stocks. It requires a highly sophisticated stock-picking ability and generated higher fee incomes. As a result, research services targeting the general investing public declined and instead, customized research services for hedge funds and other institutional investors gained growing ground.

One of the most important changes was development of new overseas capital markets and customer base. Investment banks moved beyond the U.S. market and expanded their presence in Europe and Asia. In 2006, the U.S. stock market was outgrown by the combined stock market outside the U.S., and the revenues of investment banks in Europe and Asia outstripped those of their U.S. counterparts. The U.S. was lagging behind Europe in bond and stock issues, as well as in M&As. Asian and East European markets considerably expanded. Of Citi's 1,000 largest corporate clients around the world, only 40 of them were operating in developing countries in 1992, but the number jumped to 140 in 2007. Major IPOs such as ones by Gazprom of Russia and ICBC of China took place in developing countries, and BRICs, N11, and the resources-rich Grand Crescent drew a growing attention as new major target areas where investment banks can expand their sales. Sovereign wealth funds and petro-dollars abound in these regions, and as large corporations in developing countries such as CNOOC, Tata and Gazprom became able to obtain funds at lower costs, they increased their investments in advanced economies and resources development projects. Japan also saw a rise in both domestic and cross-border M&As in spite of the adverse business environment characterized by companies' adherence to the old management practices, a strict fire wall between corporate financing and investment banking, lack of regulatory transparency, and lack of qualified professionals and skilled labor force In light of this changing global market dynamics, Citi, Morgan Stanley and other major investment banks revised their investment strategy and began to invest heavily in

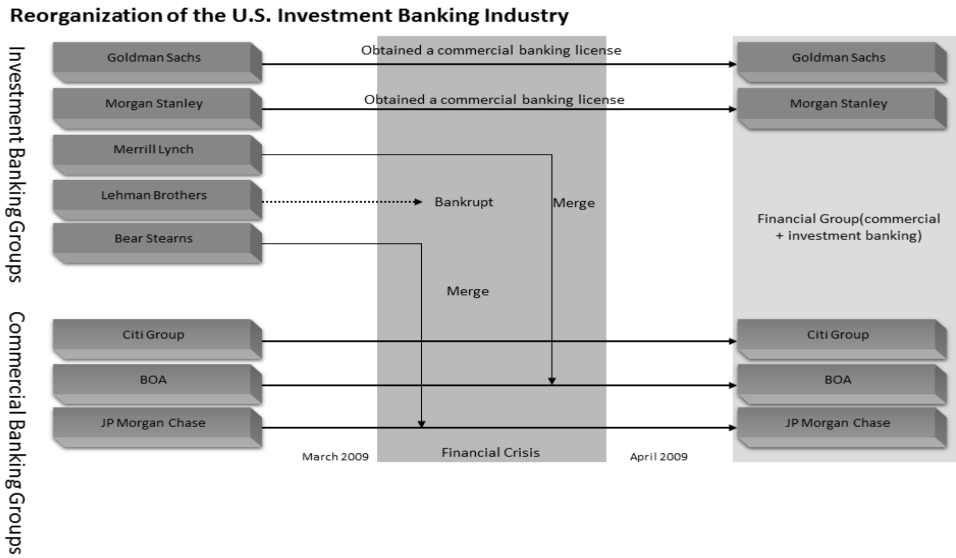
China, Russia, and other major emerging markets with huge domestic markets. Even after they made investments in these countries, they chose to stay, and they adopted the strategy of building business in countries where the business existed(e.g., establishing large-scale corporations in Dubai).

They faced challenges in risk management in developing countries. Credit Suisse sustained a loss of 1.3 billion dollars in connection with the Russian Default of 1998, and some European banks of countries like Sweden and Austria incurred heavy losses from their exposures to the East European countries that fell into a default crisis.

3.2.5. The Decline and Reorganization of Investment Banks

The subprime mortgage crisis brought about the decline of investment banks, but the fundamental reasons that underlie their collapse are failure to manage risks associated with high-risk derivative products, excessive leveraging, and moral hazard that made investment banks put the interests of individual bankers and companies before those of investors. Goldman Sachs and Morgan Stanley, No 1 and 3 investment banks, respectively, turned into financial holding companies, and the fourth-largest Lehman Brothers went bankrupt. Merrill Lynch and Bear Stearns which ranked 6th and 13th, merged with BOA and JP Morgan Chase, respectively. High leveraging, risks from massive PIs, failure to manage risks on derivatives, and moral hazard caused by profit-focused business practices are considered as the main culprits of the global financial crisis. Investment banks were transformed into bank holding companies and became eligible for financial aid from the central bank, but the aid came with tightened regulation, which is viewed as the end of the investment banking model or the collapse of the U.S.-style capitalism. However, the economy needs someone to provide investment banking services such as bond underwriting, M&A advisory services, loans, securitization, and more, and the assets of investment banks that set them apart from commercial banks will still create important growth opportunities. Even after Michael Milken was indicted, the junk bond market survived and even further grew. This attests to the fact that efficient financial transactions that investment banks pursue will not disappear, and investment banks will have to reposition themselves in the market under the changing circumstances including a shift from the old global economy led by the dollar, the U.S.-style neo-liberalism, and investment banking toward more regulation of the financial system for an expanding global capital market, diversification of key currencies, and economic stability. This shift indicates that investment banks will continue to evolve under the new regulatory framework including the G20's prescriptions to fend off a financial crisis.

<Table 6-31> Reorganization of the U.S. Investment Banking Industry



3.3. Trends in the Global Investment Banking Industry

3.3.1. The U.S.

Following the Great Depression and massive bankruptcies that followed, banks were increasingly criticised for engaging in investment banking. In response to such criticism, the Glass-Steagall Act of 1933 was enacted, separating banking and securities business. Under the Act, First Boston, Morgan Stanley, and others split their banking and securities businesses in 1934.

As the skyrocketing oil prices in the 1970s made investors shy away from long-term investments, securities companies invented MMF and banks developed CMA, blurring the business boundaries between the two sectors. In securities business, professional expertise and specialization became an important factor to stay ahead in the market, which worked in favor of Goldman Sachs. The 1980s saw the expansion of securities underwriting business and Merrill Lynch and Salomon Brothers that were strong in retail finance emerged as market leaders. The enactment of Gramm-Leach-Bliley of 1999 allowed a commercial bank to own an investment bank, and commercial banks turned into bank holding companies into which they consolidated investment banks. As such, investment banks strengthened their specialized services and continued to evolve. Commercial banks and securities houses competed fiercely to increase their share of investment banking business, bringing down the wall even lower that separated the two sectors. This trend is expected to accelerate with investment banks increasingly changing themselves into financial holding companies after the global financial crisis.

3.3.2. Europe

In Europe except the U.K., commercial banking and investment banking have been mixed. Major banks such as Deutsche Bank(Germany), BNP Paribas(France), and UB(Switzerlan) expanded their size through M&As with other banks, maximizing synergy effects of sharing their client information, and utilizing a larger pool of financial resources and sales networks. On the other hand, critics expressed concerns that the consolidation of banks might increase conflicts of interest and that the payment ability of a commercia bank might be compromised by losses of its affiliated investment bank.

In Germany, universal banking became commonly practiced in the 19th century, and it quickly took root because the German government eager to catch up with the Industrial Revolution was supportive of large banks so that they could cater to the corporate funding demands.

Prior to the Big Bank, there were two categories of banks: clearing banks that provided short-term retail finance to corporations, and merchant banks that specialized in wholesale finance such as long-term finance, securities underwriting, and investment advisory services. After the Big Bang of 1986, merchant banks were transformed into full-service securities companies.

3.3.3. Japan

Mixing banking and securities had been prohibited in Japan. The relevant laws were revised in 1962 to allow banks to branch out to securities market by setting up securities houses as their subsidiaries. With leading Japanese banks ranked among the world's top ten, and surplus foreign capital flowing in through yen-carry trade, Japan to began to actively pursue investment banking by taking over small foreign investment banks. However, the rising value of the Japanese yen in the 1990s led to corporate restructuring and economic depression, and the ineffective financial system made the country's financial sector unable to compete globally. Financial system reforms continued from 1996 to 2001, and finally, mega-investment banks such as Nomura Holding, and Daiwa Securities Group were born.

U.S. and European investment banks dominate the M&A market in Japan while the majority of IPOs are brokered by Japanese investment banks. The growth of investment banking industry in Japan is still suppressed by old management practices(relationship-based lending practices keep big banks from adopting advanced techniques and becoming competitive, and collateral-dependent lending stifles the expansion of risk-hedging market), a strict fire wall between corporate financing and investment banking(banning exchange of information between commercial banks and investment banks), lack of regulatory transparency, and inadequate supply of high-quality, highly skilled human resources.

3.3.4. Performances of Major Global Investment Banks

The Glass-Steagall Act of 1933 in the U.S. drove the growth of investment banks that specialized in securities, but the Act was superceded by the Financial Services Modernization Act of 1999, laying the groundwork for the emergence of holding company-type investment banks.

The 1986 Big Bank of the U.K. brought locals and foreigners on an equal footing, and a growing number of foreign investment banks launched business in the country. This created the so-called Wimbledon Effect referring to acquisitions of domestic investment banks by foreign capitals[172], but eventually, London has risen as a global financial hub, creating more jobs in the financial sector and added values.

<Table 6-32> Evolution of Major Investment Banks in the U.K. and the U.S.

Goldman Sachs	• Acquired the brokerage business from ABN Amro in 2004, and strengthened retail finance including credit card business(ranked No. 1 in 2005 and 2006 in a row. • Merged with BlackRock and strengthened asset management business(994 trillion won in assets under management) → merged into BOA following the financial crisis.
BARCLAYS	• Ranked No. 1 in bond underwriting(2006) • Took over Travelers Group in 1998) and reorganized itself into a financial holding company • Augmented the PEF business and set up a large subsidiary that specialized in emerging markets • Operated the Fund of Fund(Tribeca Global Management)
Merrill Lynch	• No. 1 in asset management • Took over ABN AMRO • Net profit before tax increased 35% year on year in 2006 on the back of strong performance in IB and funds(71.4 billion pounds)
citi	• Ranked No. 1 in 2006 in stock underwriting and M&A advisory services • Merged with Pear, Leeds & Kellogg, entering the asset management market(2000) • Securities, M&A(narrow scope of IB) → LBO, real estate investments(PI) → turned into a financial holding company in the wake of the financial crisis

172 Deutsche Bank took over Morgan Grenfell Group in 1989, followed by UBS group's acquisition of SG Warburg in 1995, an Citi Group's purchase of Schroders PLC in 2000.

<Table 6-33> Rankings of Global IBs in Major Business Categories(H1 2012)

	Stock underwriting	Bond underwriting	M&A
1	JP Morgan	JP Morgan	Morgan Stanley
2	Morgan Stanley	Citi	Goldman Sachs
3	Citi	Barclays	JP Morgan
4	BOA Merrill Lynch	BOA Merrill Lynch	Citi
5	Goldman Sachs	Deutsche Bank	BOA Merrill Lynch
6	Deutsche Bank	HSBC	Credit Suisse
7	Credit Suisse	Goldman Sachs	UBS
8	UBS	Morgan Stanley	Barclays
9	Barclays	UBS	Deutsche Bank
10	Nomura	Credit Suisse	Lazard

Source: Bloomberg(stock and bond underwriting) and FT(M&A)

As Table 6-34 shows, the top 9 global investment banks dominated all of the three business areas, and investment banks that made to the top ten list, other than those 9 IBs, are only Nomura(10th) in stock underwriting, HSBC(6th) in bond underwriting, and Lazard(10th) in M&A.

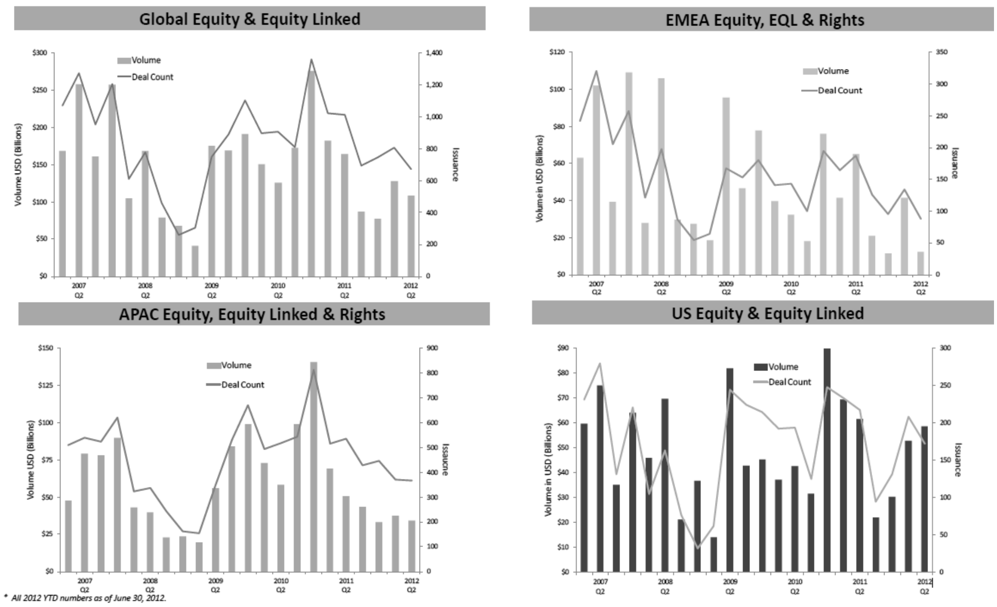
3.4. Trends in Global Investment Banking

3.4.1. Stock Underwriting

Global stock issuance in the first half of 2012 decreased 33.% to 258.6 billion dollars from 388.6 billion dollars in the same period a year ago. Particularly, East Europe experienced an 86% drop with the amount being only 1.72 billion dollars, and Middle East and Africa together saw their stock issuance decline by 39.8% to merely 2.41 billion dollars. North America and the Asia-Pacific region performed relatively better. Stock issuance in North America fell 15.8% to 126.8 billion dollars in the first half of 2012 while the issuance in the Asia-Pacific region stood at 120 billion dollars in 2011 and 71.7 billion dollars in 2012. By percentage of the total global amount, North America accounted for 53.8%, Asia-Pacific 27.5%, West Europe 14.1%, Central and South America 2.83%, Middle East and Africa 1.03%, and East Europe 0.73%. Europe performed worst as it still was reeling from the aftermath of the global financial crisis and the fiscal crises in some countries in the region while North America and Asia-Pacific fared somewhat better than the rest of the regions. After the global stock issuance peaked at 764.3 billion dollars in 2006, it shrank to 751.0 billion dollars in 2007 and plunged to 471.5

billion dollars in 2008. It climbed up a little to 596.0 billion dollars in 2010, but then fell back to 425.2 billion dollars in 2011. Looking back, the stock-issuing market continued in a boom from 2002 to 2006 on the back of rising stock prices and growing new issues of stocks in emerging countries such as China and East Europe, and rich global liquidity amid low interest rates also provided an additional boost for increased stock issuance.

<Table 6-34> Stock Underwriting Trends in 2012

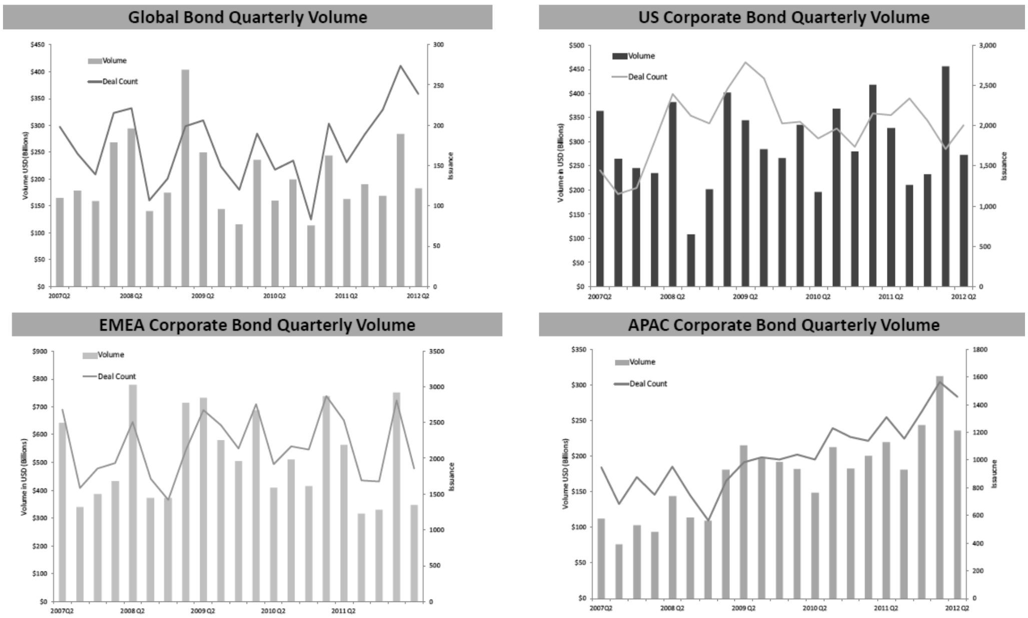


Source: Bloomberg. EMEA refers to Europe, Middle East and Africa, and APAC means Asia-Pacific.

3.4.2. Bond Underwriting

Bond underwriting in the first half of 2012 dropped 2.86% to 1,932 billion dollars from 1,987.2 billion dollars a year ago. By industry, financial industry underwrote 52% of bonds issued during the period, making it a distant leader, and by region, West Europe made up 42%, followed by North America accounting for 31%, Asi-Pacific 18%, Central and South America 6% East Europe 2%, and Middle East and Africa 1%. Global issuance of corporate bonds expanded in 2005 and 2006 in tandem with the growing volumes of MBS issuance before sharply contracting in the face of the 2008 subprime mortgage crisis. Issuance of treasury bonds increased to 5 trillion dollars in 2011, but it is 7% down from the previous year.

<Table 6-35> Bond Underwriting Volumes in H1 2012

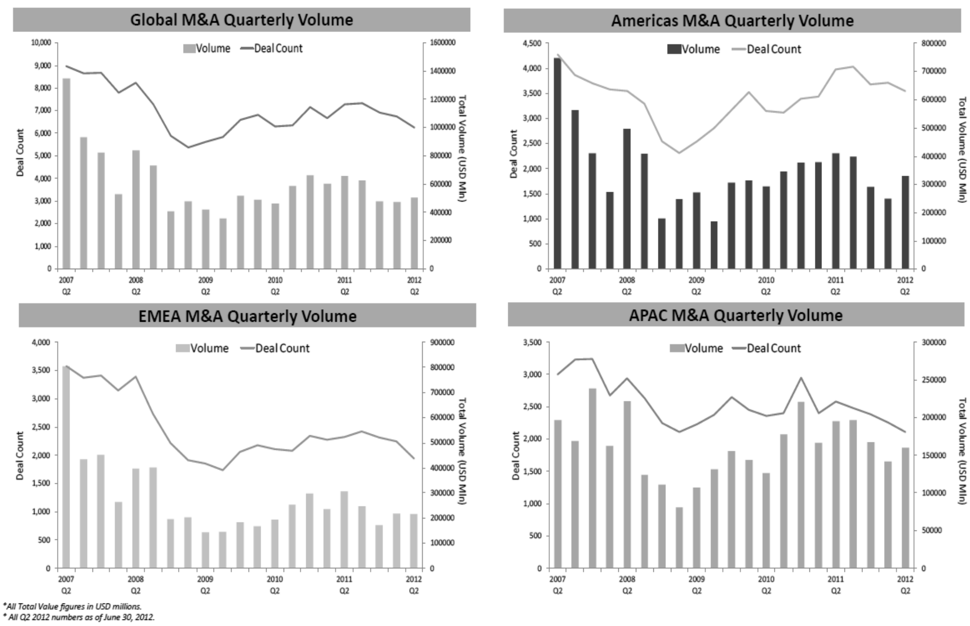


Source: Bloomberg.

3.4.3. M&A

In the second quarter of 2012, global M&A market shrank 14% from a year ago, and 7% from the previous quarter to 505.0 billion dollars, dipping to the lowest since the third quarter of 2009. The U.S. led the M&A advisory services market with 187 billion dollars or 37% of the total M&A deal volume, with its engagements primarily on the buy side, Japan and China made up 17.6% with their combined acquisitions amounting to 187.0 billion dollars. West Europe advised on 117 billion dollars of M&A deals, accounting for 23.1%, mainly on the sell side, posting a 38% decline from the previous year. EMEA saw their combined M&A advisory services fall 29% and Asia-Pacific region also suffered a loss of more than 20%. By smaller region, North America made up 40% of the total, followed by West Europe with 24%, Asia-Pacific with 23%, South and Central America with 8%, East Europe with 3%, and Middle East and Africa 2%. The combined total during the first half of 2012 dropped 22.2% to only 980 billion dollars. By region, the volume in North America dropped 24% to 448.5 billion dollars, and West and East Europe saw their M&A deals fall 23% to 308.9 billion dollars. Asia-Pacific region excluding Japan posted a 21% decline with 178 billion dollars, and Japan alone reached 41.4 billion dollars with a 5.6% fall. From 2002 to 2006, stock markets in the euro one boomed, resulting in easy access to capital and increased liquidity, As a result, PEFs flourished and companies expanded their sizes through consolidations, increasing the demand for M&A advisory services. M&A deals amounted to 1,128 billion dollars in 2002, which grew 3.3 times to 3,691.8 billion dollar in 2006. The U.S. and China led the growth in M&As through stock swaps, capital increase or LBO. M&As within the same industry also increased as companies's perception of globalization, brand power, and economies of scale changed. Companies in different industries also joined forces in an attempt to diversify their business portfolios, and PEFs added to the growing number of M&As by engaging in speculative M&As. Following the 2008 subprime mortgage crisis, the M&A market showed signs of slow recovery with 1,260 billion dollars in the first half of 2011, but the trend was reversed in 2012.

<Table 6-36> Global M&A Market Trends in Q2 2012



Source: Bloomberg.

3.5. Investment Banks in Korea and their Growth Strategies

3.5.1. Development of Korea's Financial System

Korea is viewed as being in the transition from a market-center to a securitization-centered financial system. In the first stage of development in which banks play a central role in the financial system, corporations depend mainly on bank loans for their external funding, and interest income is a major source of banks' revenues. In the second stage of a market-centered financial system, stock investments by individuals and institutional investors increase, and non-bank financial institutions intensify competition with banks by offering quasi-deposit instruments such as MMA. The third stage of development is ushed in by securitization. Banks reduce traditional deposit-taking and lending businesses while expanding proprietary trading, securities underwriting, asset management, and other investment banking activities. Financial markets are the primary channel of external funding for financial companies and corporations, and financial companies raise capital from securitizing mortgage loans and retail financial bonds while corporations increasingly turn to corporate bonds and CPs rather than bank loans to raise funds. Banks tend to focus their resources more on proprietary trading, securities underwriting, and asset management than on conventional core businesses such as deposit-taking and lending. Korea is in a transitional period, moving from the second to the third stage.

<Table 6-37> Development Stages of a Financial System

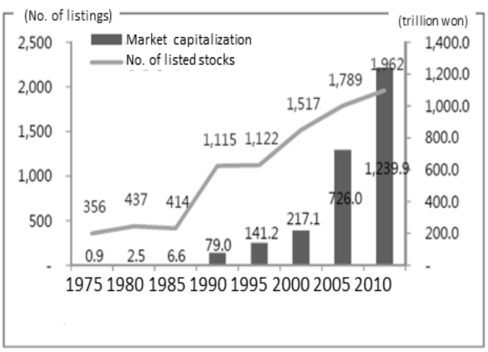
1st stage: bank-centered	- Bank loan is th primary source of corporate funding - Interest income is the primary source of revenues for banks
2nd stage: market-centered	- Stock investments by individuals and institutional investors increase - Non-financial companies compete with banks by offering quasi-deposit accounts such as MMA - Banks slash the ratio of traditional deposit-taking and lending business and instead increase investment banking activities such as proprietary trading, securities underwriting, and asset management.
3rd stage: securitization-centered	- Financial market is the primary channel through which financial companies and corporations raise capital * Financial companies raise capital by securitizing mortgage loans and retail financial bonds, and corporations issue corporate bonds and CPs, rather than borrowing from banks in order to raise capital. - Banks move away from their traditional core business of deposit-taking and lending and shift their business focus onto proprietary trading, securities underwriting, financial advisory, and asset management.

3.5.2. Korea's Capital Market and Financial Investment Industry

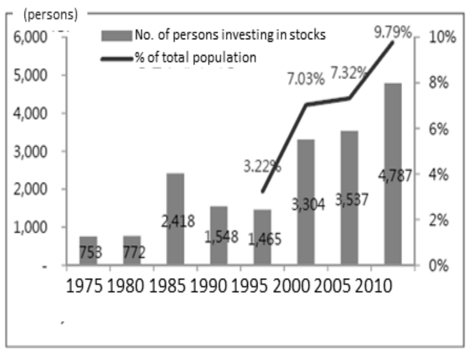
Korea's capital market and financial investment industry have grown considerably in size, but the role of capital market in supporting the broader economy such as stabilizing the financial market and aiding the real economy, has not matched the quantitative growth. Financial investment companies cannot compare to major global investment banks in size, and they have a poor profit base that is focused on brokerage, limiting their growth potential as investment banks through bold risk-taking.

From the quantitative perspective, the number of stocks traded on the exchange and the market capitalization grew 5.5 times and 1,300 times, respectively from 1975 to 2010. Stock-investing population increased from 753,000 at the end of 1980 to 4.79 million in 2010, or 9.8% of the total population.

<Table 6-38> Listings, Market Capitalization, and Stock-Investing Population



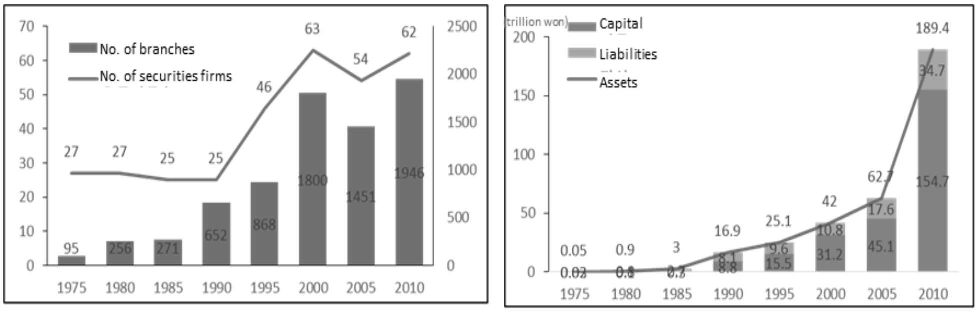
*Source : Stock Market Statistics(KRX), Annual Securities Statistics Report(KRX)



*Source : Annual Securities Statistics Report(KRX)

Securities companies and their branches rose to 62 and 1,946, respectively at the end of 2010 as the economy expanded and the investing population increased. The enactment of the Financial Investment Business and Capital Markets Act in 2005 enabled securities companies to diversify their businesses and grow in size, but their equity capital did not increase as much.

<Table 6-39> Number and Size of Securities Companies and their Branches



*No. of branches: branches of domestic securities firms
**Sources: The 55-Year History of Korea's Capital Market(Korea Financial Investment Association), Monthly Financial Statistics(the FSS)

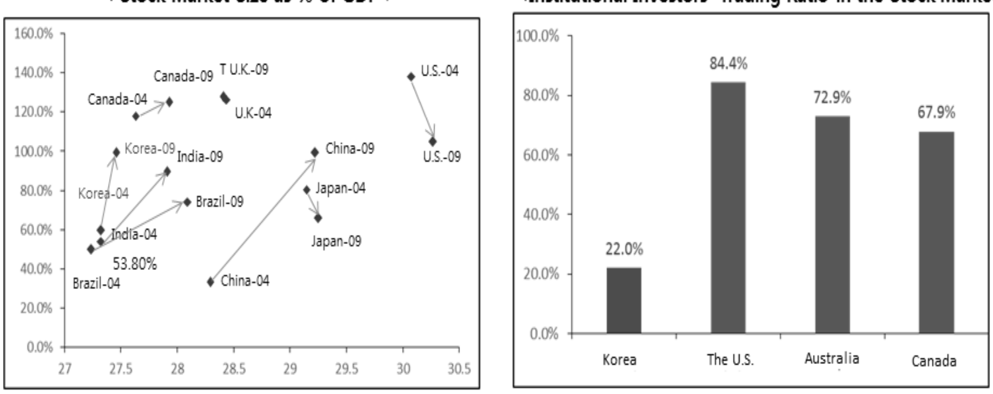
* Sources: The 55-Year History of Korea's Capital Market(Korea Financial Investment Association), Monthly Financial Statistics(the FSS)

The stock market was 100.5% of GDP in 2009, up from 59.4% in 2004, but it is still at a low level compared to the U.S.(1,005.8%) and the U.K.(128.6%). The ratio of institutional trading was low at 22.0% in 2009 and institutional investors tend to trade for the short-term, contributing to the market volatility and posing potential risks to the market.

<Table 6-40> Size of Stock Markets (as % of GDP) and Share of Institutional Trading

< Stock Market Size as % of GDP >

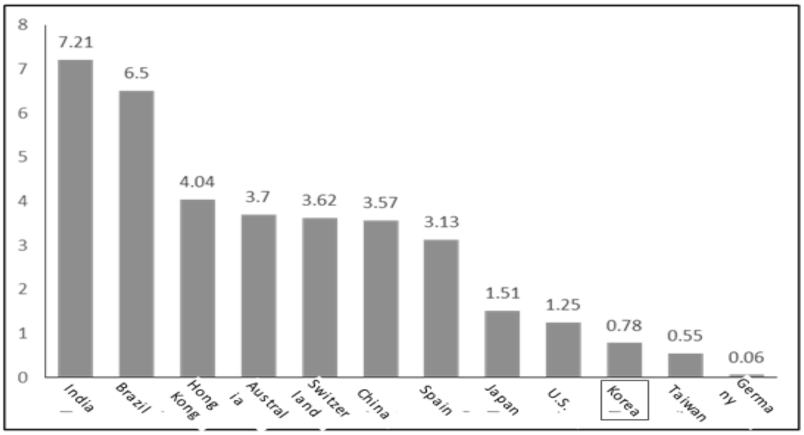
<Institutional Investors' Trading Ratio in the Stock Market>



*Data for the U.S., Australia, and Canada is as of 2008

Recently, direct financing has become popular, but far less amount of capital is raised through capital markets than in other major countries, and the ratio of capital raised through stock markets to the market capitalization was only 0.78% in 2010.

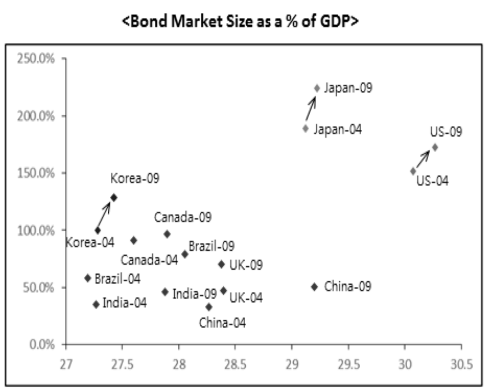
<Table 6-41> Capital Raised through Stock Markets as Percentage of Market Capitalization(2010)

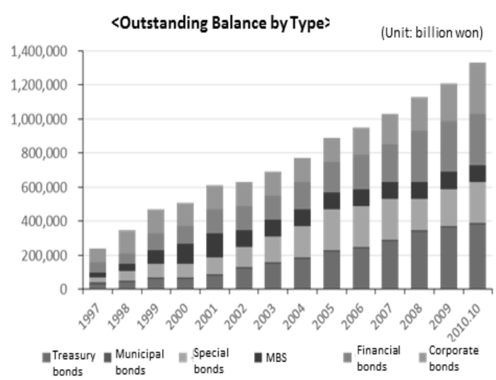


Source: Korea Capital Market Institute(original data from WFE)

The bond market was up at 130.4% of GDP in 2009 from 100.8% in 2004, but it is still lower than other major economies such as the U.S.(175%) and Japan(227.4%). Treasury and public bonds led the market growth, leaving the corporate bond market underdeveloped. Trading volume of stock-linked, exchange-traded derivatives is higher than those of other countries, but OTC derivatives market is far less active than in other countries.

<Table 6-42> Bond Market as Percentage of GDP and the Outstanding Balance by Bond Type





Shareholders' capital of Korea's securities companies is much smaller than that of global investment banks, and the top 5 companies in Korea had an average capital of 2.68 trillion won. This is only 1/30 of Goldman Sachs' capital, 1/10 of Nomura's and only 1.4 times that of Citic Securities of China. The capital position of the securities sector compares poorly to other sectors as well. The average capital of all securities companies is 1/10 of that of the banking sector, and 1/3 of the life-insurance sector.[173]

Securities companies depend heavily on brokerage fees that account for half of their revenues, which lowers their competitiveness against global IBs.[174] They

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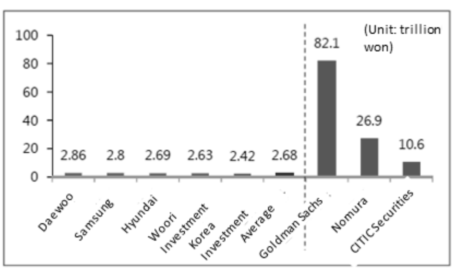
173 The combined assets of 9 Korean banks was only 1.4 times the assets of JP Morgan in 2011, and their net profit was only 46% of JP Morgan's net profit. The capital was 62%, and market capitalization was only 43% compared to JP Morgan. Korea's asset management companies made up merely 1.2% of the global asset management market in 2010, and the industry's size as a percentage of GDP was 33%, compared to 328% in Hong Kong and 403% in Singapore.

	Assets	Net Profit	Capital	Market Capitalization
Woori Financial Holding Co.	312.8	2.433	22.07	8.90
Kookmin Financial Holding Co.	277.6	2.429	23.10	13.95
Shinhan Financial Holding Co.	288.1	3.273	26.86	16.86
Hana Financial Holding Co.	178.2	1.303	14.82	8.63
Nonghyup Bank	248.5	0.597	16.85	-
IBK	186.0	1.440	13.20	6.58
KEB	100.5	1.655	8.64	5.41
Daegu Bank	31.3	0.025	2.29	1.73
Busan Bank	39.4	0.400	2.96	2.16
Total	1,662.3	13.735	130.79	64.22
JP Morgan(billion dollars) (trillion won)	1,036 (1,191)	26.75 (30.07)	183.57 (211.11)	131 (150)

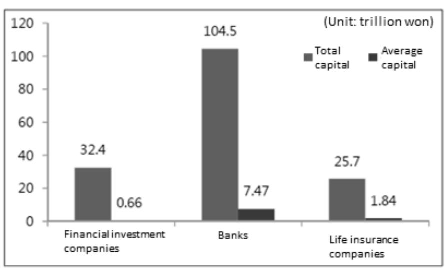
The graphs below compare the sizes of equity capital owned by domestic and foreign securities companies and by industry in Korea.

<Capital of Major Domestic and Foreign Securities Firms>



* As of FY 2010 for all companies except CITIC Securities(as of end-2009)

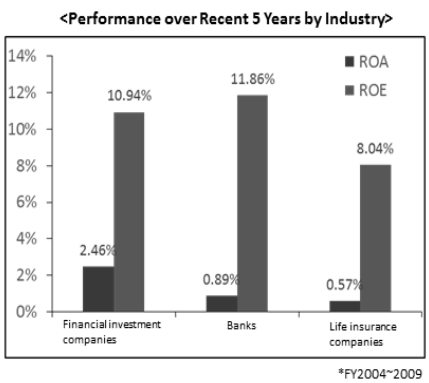
<Amount of Capital by Industry>

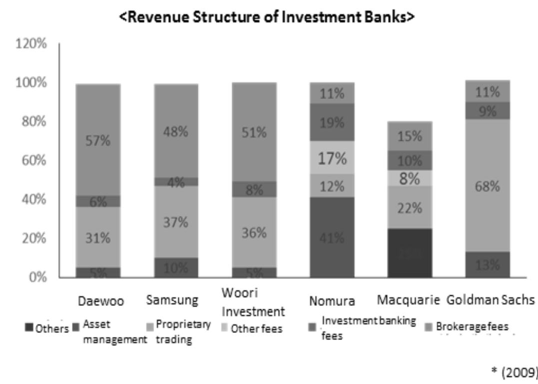


*As of end-2009

174 According to the revenue structure of securities companies(2007) in Korea, 59.3% was generated from brokerage fees, and 23.2% from PI&IB. Brokerage fees, and PI & IB contributed 15.1% and compete among themselves in almost all business areas because they all basically run the same types of businesses. Herfindahl-Hirschman Index(HHI) was 420 for the securities industry, meaning that the industry is more competitive than the banking industry(1,044) and the insurance industry(2,081). Their ROE for the recent 5 years was 10.94% on average, lower than 11.86% posted by the banking sector. With no clear market leader, it is a perfectly competitive market, and services are becoming homogenized regardless of the size of service providers, resulting in a race-to-the-bottom competition.[175] The result is that higher value-added businesses such as M&A and overseas bond issuance are conducted mostly by foreign investment banks, and domestic securities firm depend on simple brokerage services for the majority of their revenues. Korean securities companies shun risks from proprietary trading while foreign IBs act as a risk warehouse and actively take on and mitigate risks, as well as generating high profits by developing new financial products that distribute risks.

<Table 6-43> Performance by Industry and Revenue Structure of Investment Banks





Korean IBs remain dependent on simple brokerage because they are unable to offer total solutions that companies demand and the infrastructure is so weak that it cannot support the conduct of other investment banking activities. Services that support investment banking such as credit rating, legal services and accounting are not sufficiently developed. The corporate credit rating agency NICE Investor Services Co. launched sovereign credit rating services and is trying to expand the scope of their business with efforts under way to offer corporate and individual

57.3%, respectively in the U.S., and 27.0% and 43.6% in Japan.

175 Fee for IPO was 7.0% in the U.S., and 3.0% in Korea. For rights offering, Korean securities companies charged 3.0% and their U.S. counterparts collected 1.6%. The fees for corporate bond issue was 0.5% in Korea and 0.1% in the U.S..

<Table 6-44> Korea's IB League Table(2010)

Ranking	IPO	M&A	Overseas bond issuance
1	*Korea Investment Securities*	*BoA Merrill Lynch*	*Deutsche Bank*
2	*Goldman Sachs*	*Morgan Stanley*	*BoA Merrill Lynch*
3	*Shinhan Financial Investment*	*Goldman Sachs*	*BNP Paribas*
4	*Morgan Stanley*	*Macquarie*	*Citi Group*
5	*Merrill Lynch*	*HSBC*	*RBS*

credit rating services in overseas markets. Nevertheless, their size and financial position are still lagging far behind their counterparts in leading countries. Their pool of corporate credit information is limited and they are not yet capable of pulling the high-risk, high-return bond(junk bond) market ahead. Legal and accounting services are not sufficiently developed so as to timely meet the fast-growing needs of corporations and financial transactions.

A small pool of investment bankers is one of the reasons for the lackluster growth of the industry. In advanced countries, over-compensation for investment bankers is causing moral hazard, but Korea has the opposite problem, i.e., the investment banking industry is having trouble attracting highly-skilled professionals due to poor compensation.

According to the 2012 Global Competitiveness Report by IMD, Korea ranked 46th in the financial workers competitiveness index(Korea ranked 22nd in overall competitiveness). Denmark ranked first, Japan 34th, and Hong Kong 10th. Financial experts accounted for 16.4% of the total financial workers in the U.K., 43.8% in Hong Kong, and 51.3% in Singapore, but it was only 8.9% in Korea.

3.5.3. Growth Prospect for Korea's Investment Banks

With the Financial Investment Services and Capital Markets Act taking effect in February 2009, the minimum groundwork was laid for the investment banking sector to take itself to a new level, and quantitative and qualitative improvements are being made to make it happen. The number of financial investment companies rose to 62 at the end of 2010 from 54 at the end of 2008, and that of asset management companies grew from 63 to 80, providing around 10 trillion won per year on average to more than 200 companies by advising on IPOs and rights offerings. The adoption of the negative list system brought much diversity to the lineup of financial investment products, and trading volumes of ELS, ETF, wrap accounts, and other new products designed to meet new investor demands are growing by leaps and bounds[176]. There has been much progress in investor protection as advanced systems such suitability rule and duty of disclosure have been introduced. However, the global financial crisis caused a major setback in the growth of the investment banking sector and expectations of innovative changes such as the emergence of an advanced investment bank, harbored by many with the enactment of the Act were largely unmet.

It is no easy task to create a domestic investment bank that can compete with major global IBs. HSBC and UBS were once minor regional banks, but grew into major global banks through M&As. On the contrary, some of the Japanese banks that made the global top 10 list in the 1990s failed to keep the growth momentum going and collapsed. The momentum for the growth of capital markets is growing stronger in Korea with the launch of the Financial Investment Services and Capital Markets Act, improving financial soundness and profitability of the domestic financial industry, growing wealth within the country, and the establishment of the basic framework for nurturing financial experts. Now the challenge is how the industry will keep the momentum growing and move up to the next level. The investment banking industry is expected to lead the development of innovative financial instruments, and provide funding to innovative SMEs, thereby playing a key role in advancing domestic financial institutions and revolutionizing the financial industry.

The corner stones of the growth of the investment banking industry were laid as follows.

3.5.3.1. Legal framework

The very basic legal framework for the growth of the investment banking industry was created. Under the Capital Markets Act, 6 financial investment businesses(investment trading, investment brokerage, collective investment, discretionary investment, investment advisory, and trust business) were allowed to mix. The negative list system was adopted for financial investment products, which is expected to trigger the creation of innovative financial instruments such as CDS, CDO, and emissions trading schemes, and inducing the birth of large financial investment companies. However, G20 discussions raised the need to implement new

176 ELS issuance rose to 25 trillion won in 2010 from 20.7 trillion won in 2008, ETFs from 3.4 trillion won to 6.1 trillion won, and wrap accounts held in trust from 13.2 trillion won to 35.7 trillion won.

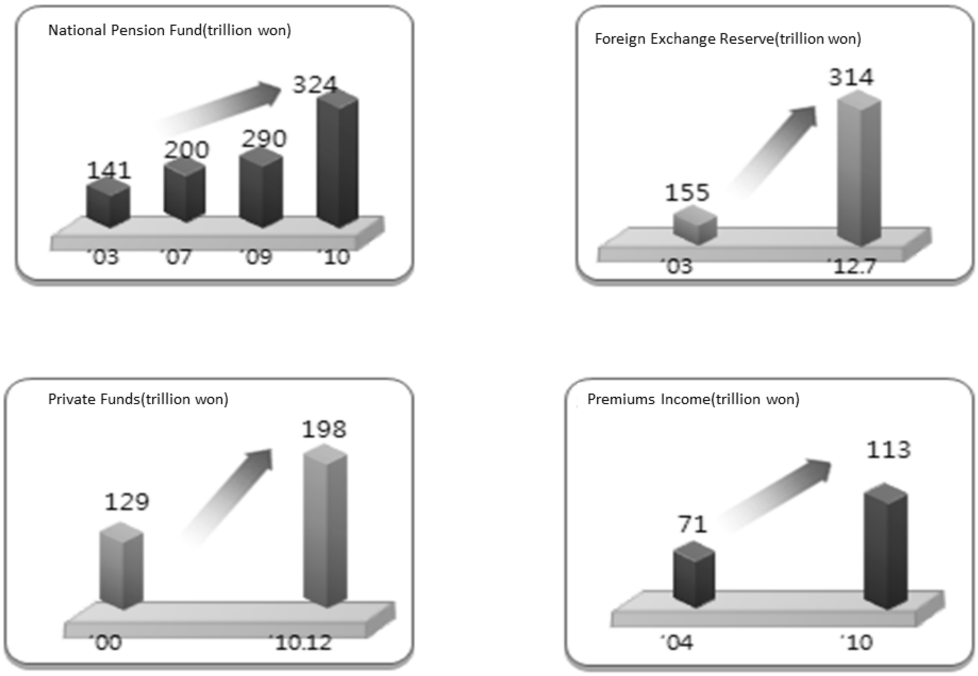
regulatory regimes in order to control risks of capital markets. It has been suggested that as part of renovating the capital market infrastructure, multilateral trading company, license system for exchanges, and CCP for OTC derivatives should be introduced. In addition, it is also necessary to diversify fund-raising tools for listed companies, improve the utility and productivity of shareholders' meetings, and tighten regulation over unfair trading.

3.5.3.2. Growth of Wealth

With the growing domestic wealth, assets under management is expected to reach 1 trillion dollars. Australia became a regional financial hub as the pension fund reform generated 1 trillion dollars in assets that needed to be managed, drawing major global investment banks into the country. Korea is anticipated to experience the same situation. Assets under management are growing exponentially in the public sector, and the private sector is witnessing a similar trend. So the combined assets under management are forecast to exceed 1 trillion dollars by 2015. As life expectancy is rising and many live to the age of 100, there is a growing demand for customized financial services for diverse financial assets. This trend is clearly verified by a constantly increasing demand for high-risk, high-return financial products such as wrap accounts offered by securities companies, that have been growing at an average annual rate of 8.6% since 2000.[177] The accumulated sum of sovereign wealth funds reached 386.8 trillion won at the end of June 2011, including National Pension Fund(340.5 trillion won), Korea Post Fund932.3 trillion won), Teachers' Pension Fund(9.5 trillion won), and Government Employees' Fund(4.5 trillion won)

177 Asset management is the world's fastest-growing financial sector. Assets under management globally reached 100 trillion dollars, and the figure sharply rose from 138.3 trillion won at the end of 2000 to 318.8 trillion won at the end of 2010. Wrap accounts held in trust also increased from 22 trillion won at the end of March 2010 to 36 trillion won at the end of October 2010.

<Table 6-45> Growth of Assets under Management



3.5.3.3. Human Resources

Changes are being made to the way high-quality financial professionals are educated and trained. The ratio of financial sector workers is much lower than in other leading economies, and theory-oriented school education is not much of use at workplace. Professionals make up only a small portion of the entire financial sector workers and the most of the workers do simple jobs such as general duties and sales(ratio of simple work: banks 91%, securities 67%, insurance 93%).

The financial industry and the government need to work out a basic framework to educate and train high-quality human resources. A long-term human capital development plan should be set up based on the demand and supply forecast, and financial MBA programs including KAIST College of Business should be constantly upgraded to compete with globally-renowned MBA programs.[178] Finally,

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178 The FT survey published in January 2011 ranked only one Korean MBA school, KAIST College of Business among the global 100 MBA programs, and 7 Asian MBA programs were listed among the top 100. In 2013, Sungkyungkwan University and Korea University MBA programs were added to the list.

compensation for financial professionals should match their expectations so that domestic financial companies can attract highly qualified financial professionals.

3.5.4. Success Factors for Investment Banks

A successful investment bank should have 3 things: brand, human resources, and capital.

3.5.4.1. Brand(reliability and reputation)

Investment banks in advanced countries often have close relationships with their clients that go back generations, and reputation is crucial in making this possible. For example, UBS clients have average 40 years of relationship with UBS, and Goldman Sachs paid 110 million dollars to SEC to settle a dispute on conflict of interest involving its research service.

3.5.4.2. Human Resources(Professional)

The average annual pay at top 5 U.S. securities companies was 400,000 dollars in 2010 and Goldman Sachs spends 44% of its operating revenues on paying its employees from 150 different national backgrounds. HSBC are training a pool of derivatives experts and exerting other efforts to expand its investment banking business.

3.5.4.3. Money

Equity capital of investment banks in advanced economies is at least 10 times as much as that of Korean securities firms. Goldman Sachs raised a large amount of capital in 2007 to finance investment banking activities including 20 billion dollars of PEF investments, 145 billion dollars of alternative investments(hedge funds and commodities), and 70 billion dollars of equity investments in commercial banks. Around 1/3 of total revenues was generated from their principal investments as they actively increased their role of principal investor.

Next, it is necessary to examine how investment banks take advantage of these factors to ensure their success. The core basic elements that financial companies need to carry out investment banking are capital-raising capacity, risk management ability, financial professionals, and network. These elements work together to create a combined impact on investment banking activities, rather than acting individually to produce distinct effects. Since investment banking entails high risks and brings high returns, it is essential for an investment bank to have capital capacity to handle large-scale leveraging and the ability to distribute risk through effective risk management, to develop hedging instruments and hedge-trading techniques, and finally to secure a pool of qualified professionals to execute all these activities. Unlike simple brokerage, investment banking requires professional knowledge and expertise on specific tasks and market conditions, networking to attract customers, and a sales network to sell underwritten securities. A fair and reasonable compensation is also an important component of a successful investment bank to create a competitive pool of professionals, and the organization and its ideas should remain flexible to keep abreast with rapid and constant changes in products and markets. Since investment banking organically combines a series of activities such as matching securities issuers and investors, pricing, and sales, it is critical to establish an investment bank corporate culture in which all the above-listed success factors work together in an organic and integrated way.

3.5.5. Core Components of Individual IB Businesses[179]

Below is a brief summary of 6 major IB businesses including consulting, IPO, underwriting, M&A, PI, and asset management.

3.5.5.1. Advisory Services

Advisory services are a core business from which investment banking begins. Growth strategies of a corporate client and structural changes that need to be made are determined through consulting. For example, if a client needs to improve its credit side needs under the growth strategies, its capital will be replenished by issuing bonds or stocks(including IPO), and the debit side can be improved through a business portfolio reorganization or M&A. These follow-up activities are likely to be assigned to the investment bank that provided advisory services.

Korea as a country has a unique set of experiences that investment banks can draw on to advise on major national policies. Korea went through rapid economic developments, a major financial crisis, and paralleled growth of democracy and market economy over the last half century or so, and many of the policy makers and others who were closely involved in all of these processes are still alive and active. If these experiences are human capital are well matched up with private-sector businesses, it may create the much-needed basis for growing a

179 Source: A Plan for Stimulating Investment Banking by Korea's Financial Companies(February 2008), by Byeong-cheol Lim, Jung-han Gu, Byeong-ho Seo, and Jong-man Gang: Korea Institute of Finance.

globally competitive investment banking industry. However, experiences of the private sector are limited and promoting international consulting business should be among the priorities. To this end, Korea needs to take advantage of trust funds operated by KSP, KOICA, and MDB while working more closely with EBRD, ADB, WB, and other international organizations,

Korea has provided consulting services to Indonesia and other countries in a range of areas such as growing a bond market, launching an exchange, building the credit market infrastructure, introducing IFRS, improving accounting disclosure and corporate governance, creating an integrated supervisory organization and training supervisory personnel, and establishing IT-based tax and financial supervisory systems. Korea will also target Central Asia, South America, and Africa to sell similar consulting services, as well as Southeast Asia, paving the way for private financial institutions to establish or expand their presence in these regions. One of the ways to educate and nurture financial professionals, is that the government can invite senior officials from finance ministries of major countries on full scholarship to share their experiences and know-how and to build a network. Both Korea and the other countries can benefit from this exchange.

3.5.5.2. IPO

IPO business consists of two categories: pre-IPO services that include pricing, marketing and stock allocation, and post-IPO management services such as price stabilization, market making, and research. The low price elasticity of demand keeps underwriting fees at a high level of 7% in the U.S., and clients choose their investment banks based on the quality of post-IPO management services and reputation. Post-IPO management is considered more important than market making and price stabilization because investors remain keen on whether or not the stock is covered in reports by renowned analysts after the IPO. One lead manager and multiple mangers are often hired together for an IPO because the stock will more likely draw attention from analysts and thus be covered in their reports, than when only one manager is appointed. As such, employing highly-qualified analysts is crucial for an investment bank to be competitive in IPO business.

Managing IPOs requires a certain level of fixed cost, regardless of the scale of IPOs, which means that large-sized investment banks tend to land large-scale IPO deals due to the effects of economies of scale. So investment banks that manage small-scale IPOs are often offered an option to buy the shares of the issuing company in addition to the IPO fee. Banks can obtain information on the industry where their corporate clients belong and they can access client information because they have a connection to their clients via loans. This means that banks can develop a niche market for IPO services to SMEs, an unchartered territory on which securities companies do not have enough information.

3.5.5.3. Underwriting

Building a long-term relationship with corporate clients and possessing information-production capacity is essential for bond underwriting. Keeping a long-term relationship is mutually beneficial because generally, client corporations benefit from low fees by maintaining a long-term relationship with a small number of lead managers while underwriting financial companies can save the cost of producing information. For companies that are little exposed to capital markets or have a low level of confidence, hiring their lenders who are commercial banks may be more beneficial.

3.5.5.4. M&A

For M&A brokerage, it is essential to secure financial professionals and to build trust on a long-term basis. An investment bank should be able to identify financial problems of a corporate client and to present solutions upon a client's demand. The mutual trust established between the investment bank and its client over a long term allows the investment bank to access the client's insider information, to detect and respond to changes in the industry better and faster, to create synergy effects through M&A, to better meet the client's capital demands, and to determine a fair price, thereby accumulating specialized knowledge and expertise on individual clients.

3.5.5.5. PI

An investment bank needs to secure sufficient capital and professionals who are qualified and able to make investments and manage risks effectively in order to be a successful principal investor. PI is a high-risk, high-return business that involves leveraging supported by a sufficient capital capacity. Particularly, trading in derivative instruments should be accompanied by proper market risk and liquidity risk management by qualified professionals.

3.5.5.6. Asset Management

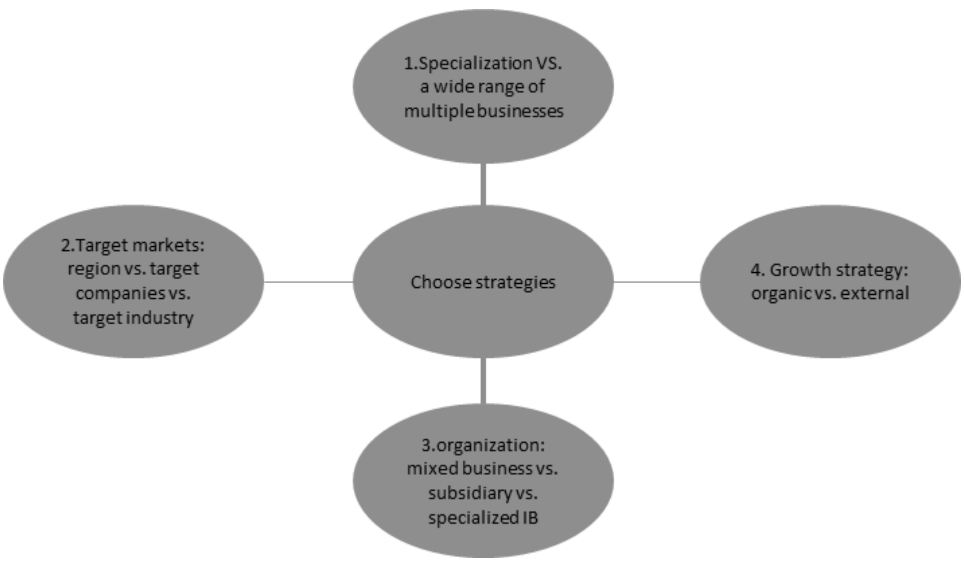
Reputation matters most in asset management. High-quality human resources and long-term relationship with clients are the key to success. Asset management should be held to high standards, which requires superior human resources, and it is important to create higher profits for clients by developing new products designed to fit specific needs of clients and providing customized services.

3.5.6. Growth Strategies of Leading Investment Banks[180]

A review of how leading investment banks have grown into what they are today can provide a benchmark for Korea's fledgling investment banking industry. The focus of the review should be placed on whether the expansion of major IBs was driven by organic growth or external growth, and if they specialized in investment banking or were part of a financial group. The selection and concentration strategy employed by smaller investment banks offer important implications for Korea's aspiring investment banks with little experiences. In other words, the key question for them is how they specialized in certain businesses, created a unique customer base, and brought such specialization to an industry-level.

There are 4 basic pillars of IBs' growth strategies: specialized business areas, selection of target markets, organizational structure, and growth strategies.

<Table 6-46> Basic Pillars of IBs' Development Strategies



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180 *Source*: *ibid*.

3.5.6.1. Business Areas

Individual financial companies need to identify and concentrate on their areas of strength, while maximizing opportunities and potential, based on SWOT analysis. Generally, major global IBs are strong in all areas, but it is also true that they certainly have speciality areas in which they have an absolute advantage over others. For example, Goldman Sachs emerged as the distant No. 1 in M&A advisory services and PI in the 1990s, and Lazard ranked among the global top 10 players with a relatively small size of capital by specializing in 3 advisory areas: M&A, corporate restructuring, and asset management that can maximize synergy effects together. The SWAT analysis on Korean financial companies show the results as listed in Table 6-47 below.

<Table 6-47> SWAT Analysis on Korea's Financial Companies

Strengths	Weaknesses
• Domestic networks	• Lack of capital • Lack of professionals • Weak overseas network
Opportunities	**Threats**
• Much growth potential of the domestic capital market • Changing asset structure amid the aging population • Corporate reorganization in line with the changing domestic industrial structure	• High entry barriers because the IB industry is an oligopolistic market. • Negative perception of M&A • SMEs are reluctant to use, or unaware of their financing opportunities via capital market

Source: A Plan for Stimulating Investment Banking by Korea's Financial Companies(February 2008), by Byeong-cheol Lim, Jung-han Gu, Byeong-ho Seo, and Jong-man Gang: Korea Institute of Finance.

3.5.6.2. Target Markets

Global IBs are particularly strong in handling large-scale deals because they have a superior global network, and they dominate such businesses as overseas bond issuance and sale, and overseas IPOs by domestic companies. In order for Korean companies to gain a comparative advantage over these major players, they should (1) develop a specialized target group such as newly-established companies with solid growth potential or SMEs, (2) target industries that demand industry-specific professional knowledge such as IT, biotechnology, pharmaceuticals and medicine, and (3) gradually expand their presence to neighboring regions that they are familiar with, after they accumulate sufficient experiences and expertise in the local market.

<Table 6-48> Specialization Based on Corporate Size and Industry

	Company	Notes	Differentiation Strategy
Specialize in SMEs	Jefferies & Co (r13th in the US stock underwriting business)	Provided IB services to newly-established companies and SMEs for 45 years (dubbed "Mid-Market Goldman ")	- Strengthened research on SMEs neglected by large investment banks and built a strong network with them. - The CEO remained closely involved in individual deal, providing differentiated customer relations services. - Hired IB specialists who were laid off, following the IT bubble burst
Specialize in specific industries	Thomas Weisel (16th in the US stock underwriting business)	Concentrate on IT and medical industry	- Concentrated marketing efforts on emerging IT companies neglected by large investment banks. - Recruited IT and medical industry specialists who were laid off from large investment banks, following the IT bubble burst, thereby expanding the professional expertise - Unlike at large investment banks, senior executives get involved in deals and play a role in setting up a long-term plan for clients.

Source: ibid.

Lazard, Cohen & Steers, and FBR are examples of late-mover IBs that achieved success by clearly identifying target markets and business areas to specialize in, and concentrating on the targets.

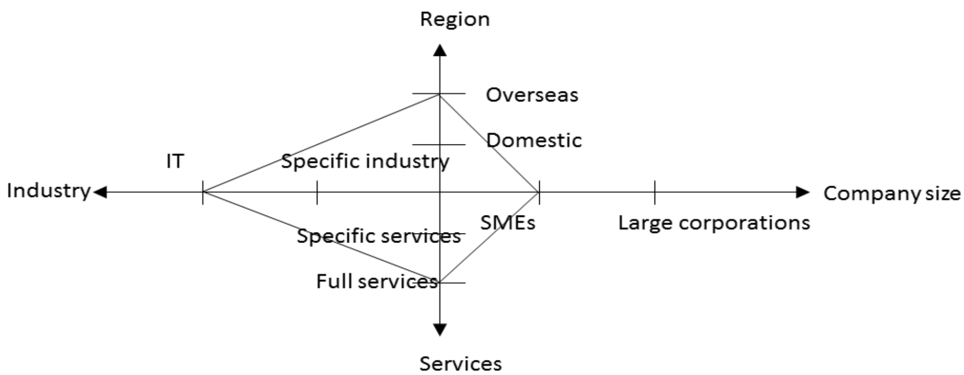
Lazard's assets were only 2 trillion won in 2006, but ranked 10th in global M&A advisory. Originally a food company, Lazard branched out to financial services and specialized in advising on financial aspect of M&As, corporate restructuring, and asset management. All these three areas have the common denominator: they are all advisory services, and thus created synergy effects.

Cohen & Steers chose to concentrate on real estate-related asset management and became No. 1 in this particular field in the U.S.. The company first started with sale and management of real estate funds in 1986, turned into an investment bank in 1989, and attained a remarkable success by building a global network.

Friedman, Billings, Ramsey, Inc. or FBR posted a per-capita net profit of more than 500,000 dollars in 2006 which was higher than 380,000 dollars of Goldman Sachs. In 1989, FBR selected and concentrated on research on financial and real estate markets, and consignment sales, and later expanded their speciality areas to home mortgage loans and securities.

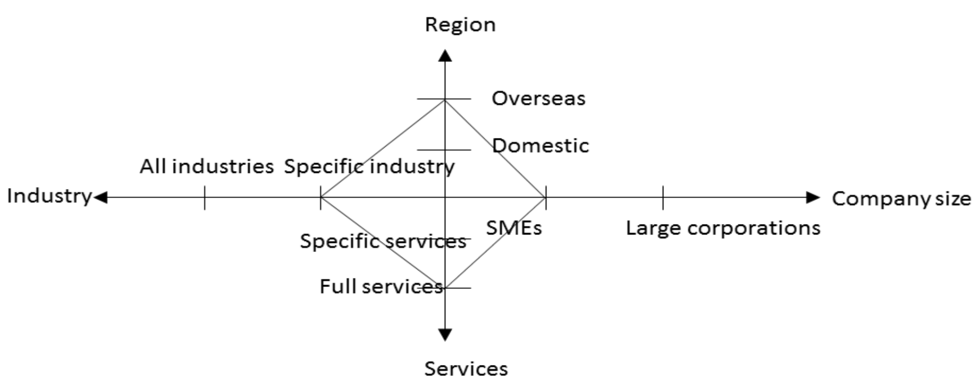
Jefferies & Co., and Thomas Weisel Partners succeeded in specialization by choosing the right target companies and industries. Jefferies & Company started with one employee in 1962 and concentrated all of its resources on SMEs. The company linked its network and research and won a large number of SME clients. The CEO personally met with individual clients and supervised the details of each project, offering differentiated services. The company hired former employees of major investment banks to secure highly-qualified professionals. On the other hand, Thomas Weisel Partners, a small investment bank founded with only 300 million dollars of assets in 1998, specialized in IT, medicine and consumer goods, and focused on marginalized emerging IT companies for growth momentum. The bank initially concentrated on IT industry, but later added medicine and consumer goods after the IT bubble burst. The bank also employed the selection and concentration strategy, built a network, and increased its expertise by recruiting experts who were knowledge about individual target industries. In addition, the bank was able to achieve high returns on investments because all senior executives got involved in every deal to create differentiated services and contributed their insights and expertise into creating long-term investment plans for clients.

<Table 6-49> Specialization in SME: The Case of Jeffreies & Co.



Source: ibid.

<Table 6-50> Specialization in Specific Industries: The Case of Thomas Weisel Partners



Source: ibid.

3.5.6.3. Organization

There are 3 organizational options: (1) mixing investment banking with other businesses within the same organization, (2) engaging in investment banking through a subsidiary, (3) setting up an organization that specializes in investment banking. Each of the three types of organizational structure has its own pros and cons so the choice should be made in consideration of the company's strengths and possible regulatory changes in the investment banking sector. In Korea, most of banks have an investment-banking subsidiary and securities companies operate a specialized investment bank while the mixed type is used by KDB and in overseas operations of some banks.

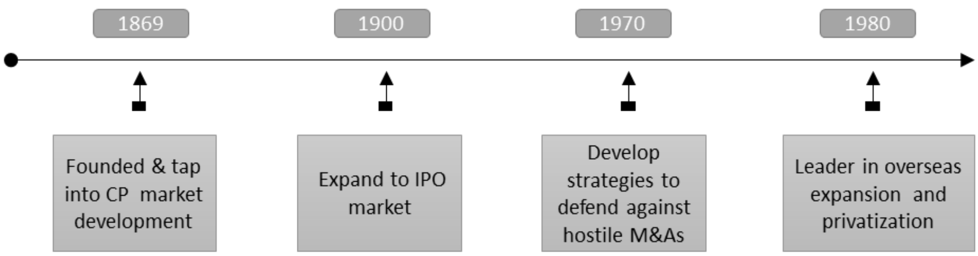
<Table 6-51> Pros and Cons of 3 Organization Types

	Business mixing within organization	Subsidiary of a financial holding company	Independent IB
Pros	- Easier to create synergy with existing businesses - Utilize the existing corporate clients and investors network	- Easy to create and manage a cooperation system among subsidiaries - Benefit from the network of corporate clients and invests that the holding company has already created - Easy to establish an independent corporate culture as an investment bank	- Can create a unique corporate culture as an independent investment bank - A flexible organizational structure
Cons	- Business boundary is restricted by regulations - Possible conflicts between the existing corporate culture and the unique culture of investment bank - Potential conflicts of interest	- Restrictions in setting and implementing independent strategies because it is a part of the larger group.	- May face difficulty in securing sufficient capital that is required to match the growth in different stages. - Building a network independently is time-consuming and requires cost.

Source: ibid.

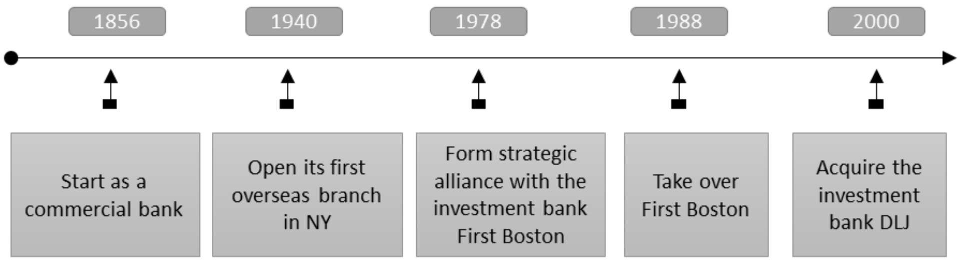
Goldman Sachs is a success case as an independent investment bank. Most global investment banks concentrate on their local markets initially and gradually expand their business beyond the national borders to other regions with geographical proximity. Founded in 1869, Goldman Sachs was originally a corporate bill dealer and branched out into other investment banking activities such IPO. The bank opened its first overseas branch in London and built a solid reputation as a pioneer in risk arbitrage by aggressively investing in companies that were M&A targets, in the 1940s. Building upon its success in Europe as an M&A and financial advisor, Goldman Sachs turned its eye to Asia where it participated in privatization of state-owned enterprises. Later, the company firmly placed itself as the world's No. 1 investment bank by pursuing strict quality management, launching new businesses, and accumulating superior risk management expertise.

<Table 6-52> The Growth Path of Goldman Sachs



Credit Suisse is a good example of mixing investment banking within a large group that offers multiple financial services. These financial groups dominate the bond underwriting market because bond underwriting has much in common with lending and it often involves a large amount of capital. For this reason, financial companies affiliated with capital-rich, large banks have a comparative advantage in bond underwriting because they can take advantage of extensive lending experiences and expertise, a broad network that encompasses both large and small corporate clients, and rich capital that their parent banks can have to offer. Credit Suisse started its business as a commercial bank in 1856 and became a global investment bank through acquisitions of First Boston and DLJ. Particularly, DLJ considerably raised the competitiveness of Credit Suisse by bringing its experiences and expertise in bond underwriting.

<Table 6-53> The Growth Path of Credit Suisse



Source: ibid.

3.5.6.4. Growth Strategies

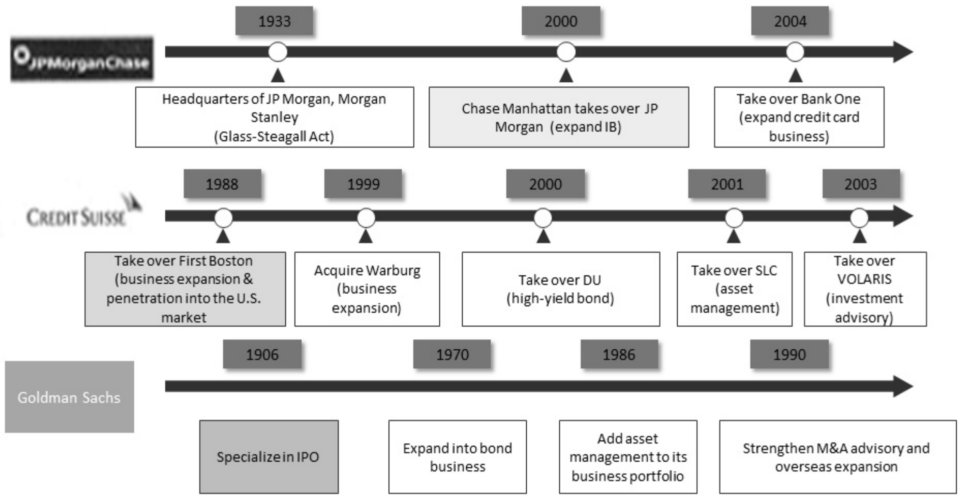
There are 3 types of growth strategies: organic growth, M&A, and combination of both. A company can choose one of the three strategies that can best meet their business goals: whether it intends to further expand its existing investment banking business, or step into a new area of investment banking, or develop new overseas markets, or create synergy with existing businesses. Organic growth and M&A have the pros and cons as shown in Table 6-54.

<Table 6-54> Organic Growth and M&A: the Pros and Cons

	Organic Growth	M&A
Pros	- Can maintain or develop a consistent corporate culture - Closer relationships among members of the organization and strong loyalty of employees to the organization	- Can acquire a business and human capital within a short period of time - Provides easy access to new markets
Cons	- The company should bear the entire cost if a new business needs to be set up. - Takes time and cost in raising the expertise of human resources - May face limits in developing new markets	- Takes time and cost in integrating two distinct organizations - Hard to build a consistent, harmonized corporate culture

Source: ibid.

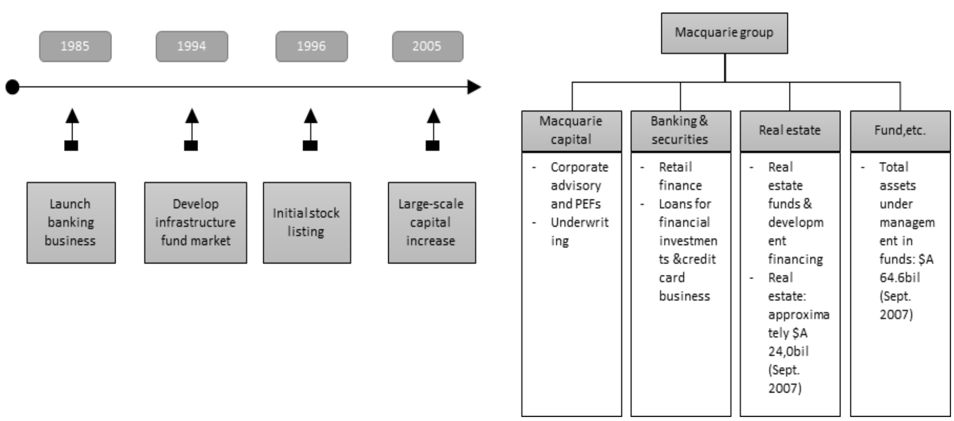
<Table 6-55> Growth Paths of Leading Global IBs



Source: ibid.

Macquarie of Australia adopted the organic growth strategy. Under the strategy, a company grows its business by developing new markets. It allows the company to retain its unique corporate culture and technologies, but it can only achieve so much growth that it is a not an attractive option for late-movers to take. In addition, it may cause the company to fall into mannerism. Macquarie based in Australia has grown into a major investment bank that represents Asia without resorting to major M&As, by creating niche markets for infrastructure funds and real estate developments that escaped the attention of major global financial companies.

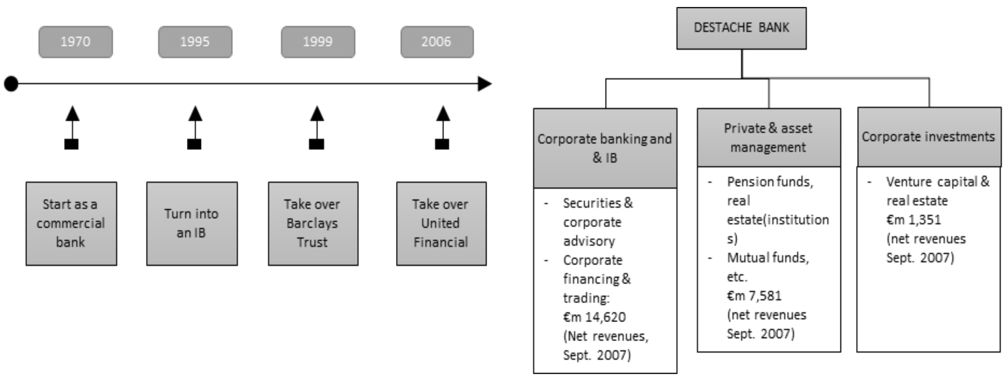
<Table 6-56> Macquarie's Growth Path and Organization



Source: ibid.

Deutsche Bank is a case in point that shows how an investment bank can achieve a rapid growth through M&As. External growth strategies refers to absorbing knowhow and networks of another company within a relatively short period of time through business alliances, acquisitions or mergers. The strategy is effective for late movers, but it is often difficult to achieve synergy without a chemical integration through careful harmonization of the two companies involved in a deal.

<Table 6-57> The Growth Path and Organization of Deutsche Bank



Source: *ibid*.

3.5.7. Financial Investment Services and Capital Markets Act[181]

The Act should be revised in a way that can accomplish the 4 tasks: advancing the asset management industry, building a globally competitive market infrastructure, facilitating corporate funding, and providing better investor protection.[182]

① First, asset management as an industry needs to be brought up to a new level. Korea's pool of institutional investors is much smaller than those of advanced economies, and retail investors make up the bulk of the trading volume.[183] The regulatory framework for the asset management industry needs to be upgraded so as to preemptively respond to changes to the economic structure and assist the people to accumulate wealth. Investment bank should be defined clearly and legally distinguished from a general securities company under the Act. In order for

181 Zhin, Woong-seob, KAIST Lecture Notes(2011).

182 The proposed revision to the Act was presented to the National Assembly, but it remains pending

183 Institutional investors as a percentage of all investors(2008): 20.7% in Korea, 84.4% in the U.S., 72.9% in Australia, and 67.9% in Canada
Trading volume by investor type(2010): Individuals(64.2%), institutional investors(17.2%), foreigners(15.9%), and others(2.7%).

investment banks to be able to flawlessly conduct a full range of corporate financing services, they should be allowed to extend credit to corporations, internally execute orders on unlisted stocks, and strengthen its role of prime broke r[184], while the regulatory regimes should be improved.

"Credit extension" by investment banks refer to making funding arrangements such as bridge loan in the process of advising clients on M&A deals, using their own capital(PI) to provide loans or payment guarantees in their endeavors to support newly-established companies, and offer structured financing that combines multiple financial resources. Credit extension should be permitted within the credit limits including the credit limit on same corporation as imposed by supervision regulations in order to minimize potential side effects.

Leading countries allow investment banks to provide long-term credit to companies and investment banks coordinate their credit with that extended by commercial banks.[185]

<Table 6-58> Credit Extension by Commercial Bank and IBs

		Commercial Bank	Investment Bank
Loan Size		Small	Large
Maturity (months)		47.5	34.3
Secured (%)		43	38.3
Type (%)	Term Loan	33.3	23.2
	Revolving Credit	52.9	19.4
	Bridge Loan	9.5	56.3
	Other	4.3	1.1
Purpose (%)	Working Capital	20.8	1.9
	General Corporate	16.1	7.8
	Takeover	16	20.4
	LBO	18.1	49.5
	Debt repayment	17.8	15.5
	Other	11.2	4.9

Source : Booth & Booth (2004)

184 A prime broker provides a full range of financial services to hedge funds, including credit extension, securities lending and borrowing, and custody of securities. (1) Custody business includes safekeeping and management of assets of a fund, responding to margin calls, paying dividends, exercising voting rights as a proxy, and providing a performance report. (2) Clearing refers to clearing and settlement of contracts traded between hedge funds and multiple execution brokers. (3) Financing is intended to support investment strategies such as short selling by providing leverage, and lending and borrowing securities. (4) Other activities are contacting potential investors, advising on risk management, providing technological and operational support, and renting office.

185 In 2010, Goldman Sachs extended credit equivalent to 4.6% of its total assets.

"Internal execution of orders on unlisted stocks" means that an investment bank execute orders placed by multiple clients within the bank, instead of matching them on an exchange or ATS, permitting comprehensive financial investment business operators to act as a market for those unlisted stocks and match orders, thereby helping investment banks to develop a broader client base including unlisted companies and generate information better and faster.

"Strengthening the role of prime broker" means that investment banks should be allowed to extend credit to hedge funds for other investments than securities investments so as to help investment banks build knowhow on providing a full range of financial services to institutional investors, raise profitability and diversify portfolio, and improve risk management capability.[186] In so doing, follow-up regulatory actions need to be taken, such as requiring prime brokers to use a standardized contract when they provide such services. Capital requirements should also be tightened in line with greater risks that comprehensive financial investment business operators will assume. In addition to the NCR requirement, these operators should be subject to the capital adequacy requirements under the BASEL accord given the increased risks from additional credit extension. Lastly, actions to improve the regulatory framework include allowing investment banks to exercise voting rights on the stocks, or assets of a fund in the best interest of investors, simplifying the merger procedures for small funds, and ensuring that investment advisors must avoid conflicts of interest. Greater autonomy should be granted for fund management[187], and trust business operators should be allowed flexibility in adding more to the currently 7 eligible types of assets under management(cash and cash equivalents, securities, financial bonds, movables property, immovable property, rights to immovable property, and incorporeal property rights). Regulations that restrict banks and insurers from engaging in trust business should be eased, and they should be allowed to manage retirement pension plans, ABS, and secured bond trust under a single unit within their organization.

② A reform of the capital market infrastructure is necessary. Introduction of ATS and a licensing system for exchanges can promote healthy competition in the secondary market. Korea's capital market ranks 10th globally, but the trading cost, matching speed, and matching systems are not as competitive as the ranking may

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186 Amid signs that the global economy is recovering from the global financial crisis, revenues of prime brokers are also rising(9 billion dollars in 2010) Large investment banks are increasingly concentrating on prime broker services. Big 3(JP Morgan, Goldman Sachs, Morgan Stanley) had a combined market share of 51.4% in 2009 which rose to 55.8% in 2010.

187 For example, under the current law, a real estate fund should have at least 50% of its assets invested in real estate within 6 months from its establishment. This time limit can be extended to 2 years, or PEFs can be allowed to invest more in CBs than in BW, or measures can be taken to stimulate investments in mezzanine securities.

suggest.[188] As major exchanges in other countries are expanding their size and accelerating globalization on all fronts, through M&As and IPOs while making massive investments in upgrading their electronic matching systems, cross-border and cross-market competition is becoming fierce. Alternative trading systems(ATS) that compete with regular exchanges have been introduced in major global capital markets such as the U.S, Japan, and EU(84 ATS in the U.S., 26 MTFs in Europe, and 200 in Asia). In 2010, ATS had a 42% market share in the U.S. and a 30% market share in Europe. If ATS is to be introduced in Korea, it should be able to handle auction, too, and if the trading volume on an ATS reaches a certain level, it should be converted into an exchange. KRX should be put in charge of clearing trades executed on ATS and conducting market surveillance on ATS. Since ATS also performs the role of an exchange, the government should switch to a licensing system for the opening of an exchange. Considering that most exchanges around the world are privately-organized entities, it is not desirable that KRX enjoys a monopolistic status under the government's auspice or is designated as a public institution. If an exchange meets the minimum capital requirements and obtains a license, it has the duty of listing stocks, and performing market surveillance and other SRO functions. Financial investment business operators should be required to follow the best execution rule and execute trades in the best interest of investors by comparing quotes both on KRX and ATS.

CCP should be set up to handle OTC trades in derivative products. This is part of the G20 agreement and CCP is essential to reduce counter-party risk when derivatives trading is expected to increase. Financial investment companies should be allowed to clear commodities trades, and a clearing house should be permitted to open upon approval so that multiple types of clearing services can become available.

Credit rating business should be regulated under the Capital Markets Act, instead of the Act on Use and Protection of Credit Information so that the scope of credit rating agency's business can be broadened to fund evaluation and rating agencies should be made subject to tightened regulations on investor protection and disclosure.

③ Corporate financing options should be diversified. In addition to the 6 types of bonds listed in the Commercial Law, listed companies should be allowed to issue contingent capital securities that can be converted into stocks if trigger events occur, and independent warrants with the right attached to ask listed issuers to issue new shares at the pre-determined price.

How stocks that are not subscribed by stockholders should disposed of should

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188 Trading cost in Korea is higher than in the U.S. and Japan, and latency on KRX is 40 ms, compared to 5 ms in North America and Europe, and 1 ms or less on ATS. KRX is working on creating a system that can bring the latency down to 0.1 ms by 2013.

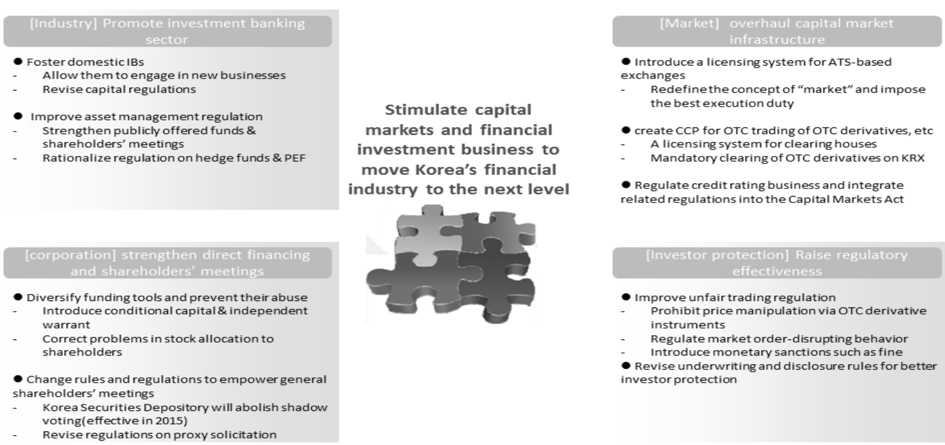
be regulated so that unsubscribed stocks are not allotted to third parties at favorable prices. When a stock is issued at a low price, the issuer should issue a certificate of preemptive right to new stocks in order to protect the interests of shareholders who cannot participate in capital increased and minimize the possible financial loss from under-subscription to the issuing company. The shadow voting system of Korea Securities Depository should be abolished to prevent the potential abuse of power by the management, and rules on proxy solicitation should be amended so as to extend the solicitation period.

④ Regulations on unfair trading should be revised. Korea's regulations on stock price manipulation and use of undisclosed information are relatively lax, compared to the laws and regulations of other countries to the same effect The regulations need to be amended so as to eliminate incentives for foreign IBs and hedge funds to get involved in unfair trading. Penalties for acts that disturb market order, that are not subject to criminal punishment should be raised to effective deter those acts. Provisions on prevention of the investigative power should be held to the same standards set forth in the Far Trading Act in order to prevent double sanctions that may be imposed by criminal punishments, and the abuse of investigative power.

As part of measures to hold securities companies more accountable for underwriting activities, placement agents should be required to assume the same liability for damage that an underwriter does. Secondary market disclosure rules need to be tightened but primary market disclosure rules should be adjusted in a way that alleviates burden on issuers.

The proposed revisions to the Capital Markets Act are summarized in Table 6-59 below.

<Table 6-59> Major Changes to the Capital Markets Act



3.5.8. Growth Strategies for Korean Investment Banks

Based on the analysis of the pros and cons of different growth strategies for investment banks, the following strategies can be recommended for Korean securities companies and banks.

3.5.8.1. Securities Companies

Large securities companies have restrictions such as retained earnings requirements and rights offering in pursuing organic growth. So they can choose to grow bigger in size through M&As and in quality through overseas expansion. Small firms can opt to specialize in niche markets such as SMEs and venture capitals.

3.5.8.2. Banks and Bank Holding Companies

Banks and securities firms can work together within a holding company, further expand the current businesses including M&A advisory services, securities investments, and derivatives trading, and broaden the scope of high-value added businesses by tightening risk control. They can work more closely together with financial investment companies in such areas as product selection and human resources development.

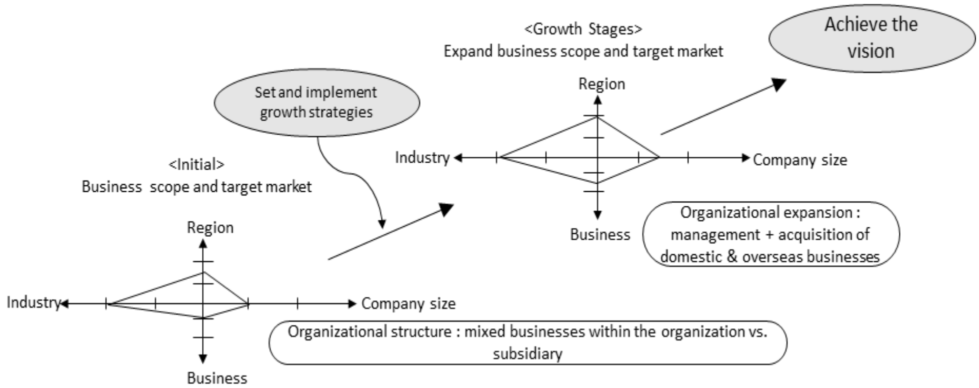
From the perspective of the target businesses and target markets, various strategies are available to choose from, depending on what the long-term vision is for the financial company.

(i) They can first build superior competitiveness in a particular business, choose a target market within the country, and gradually expand the business to the global market(a global player in a particular business).

(ii) The second strategy is to expand the scope of business in phases, but limit the target market to the domestic market and the regional market(a regional player that provides full investment banking services). (iii) Under the third strategy, they expand their presence both in the domestic and overseas markets simultaneously and attempt to achieve phased growth as a full-service global investment bank).

As for the organizational structure, initially, commercial banking and investment banking can be mixed within the same organization to derive synergy from the resources that are already available, and these two businesses can be spun off into subsidiaries as the company expands the business scope and target markets. Many options are available for overseas expansion, including setting up a branch, a local corporation, a joint venture with a local company, or acquiring or merging with other investment banks.

<Table 6-60> Growth Strategies for Korean Investment Banks



Source: ibid

Banks and securities firms need to establish their vision and goals, as well as phased growth strategies in consideration of the circumstances under which they conduct their investment banking business. Initially, they should focus on the domestic market where they have a superior advantage such as networks, and subsequently, move on to the next step in which they seek to grow into a leading regional IB in Northeast Asia.

If the financial system advances to the 3rd stage, domestic IBs will have a better chance of branching out to global markets and becoming a global player. Not all domestic financial companies should aspire to become global IBs and leading financial companies should take the lead in such endeavors. The basic strategy for growth is that aspiring investment banks should recruit specialists and build the infrastructure to achieve specialization in a particular area and to become sufficiently competitive in the chosen area, and then enlarge the size of their organization and business through organic growth or M&As, in consideration of customer demands, profitability and growth potential.

3.5.9. Overseas Expansion Strategies

3.5.9.1. Why overseas expansion?

Domestic financial companies need to look to overseas markets for the following reasons. The domestic market is saturated and becoming increasingly competitive with growing presence of foreign players after the market opening, and financial companies need to diversify risks as more derivative instruments become available and traded, and short-term foreign currency-denominated assets are growing in their portfolio. Demand for loans is declining with shrinking net interest margins and slowing growth rates. In addition, funding costs are also rising as consumers become more sensitive to interest rates. In light of these changes, financial companies need to develop sustainable sources of profit in overseas markets as well as the domestic market.

3.5.9.2. Potential

Domestic financial companies as late movers face some limitations such as inferiority in size, lack of localization and qualified professionals, and low R&D capacity. They tend to concentrate on certain countries such as Vietnam for overseas expansion.

3.5.9.3. Strategies

Given the not so great potential that they have, (i) domestic financial companies need to strengthen their core competences. For example, domestic banks clearly have a comparative advantage in retail finance and IT. They can take advantage of these strengths to train specialists and upgrade their R&D capacity. (ii) They should determine the target markets and target businesses. It is important to target areas that they are familiar with and where global IBs have relatively small presence, such as some provinces in China, India, Southeast Asia, and CIS. (iii) In determining how they should enter the target market, they should consider various options including branch, local corporation, strategic alliance(JV) and M&A and find the one that best fits their risk tolerance and the required speed of localization. Additionally, they can establish a cooperation system with global financial companies and pursue M&As as a member of a consortium.

Major global IBs employ different strategies to grow in overseas markets. (i) Goldman Sachs is expanding its presence in BRICs and it has identified so-called Next 11 as the next target markets which include Korea, Bangladesh, Egypt, Indonesia, Iran, Mexico, Nigeria, Pakistan, the Philippines, Turkey, and Vietnam. What these countries have in common is that they have a sizable population, and they are either building momentum for economic growth or they have just entered the high-growth stage. Therefore, these countries are likely to take over BRICs that are reaching their limits and drive the next-stage global economic growth. (ii) Citigroup categorizes around 100 countries into 3 group and selected 13 countries as priority targets to focus on. The first group of mature markets are Germany, Japan, Spain and the U.K. that are growing steadily, and highly competitive, and have low sovereign risk. The second group of high-growth markets includes Korea, Brazil, India, Mexico, and Poland. These countries have a fast-growing economy, an expanding middle class, and medium-level competitiveness and risk. The last group is 4 emerging markets. These countries display high economic growth rates, an emerging middle class, a high ratio of state-run financial institutions, and high sovereign risk. China, Indonesia, Russia, and Turkey are classified into this group.

Banco Santader present a case of a late mover that successfully branched out to overseas markets. The bank acquired Banesto in 1995, becoming the largest bank in Spain. Prior to the acquisition, Santander and Banesto were ranked 4th and 5th, respectively. From 1996, the bank continued to take over small banks in South and Central America where they speak the same language Spanish, and the takeovers only cost small amounts of capital. By bringing these small banks under its roof, the bank attained the two goals of creating a global network and diversifying risks. As the bank gained knowhow on local operations, it acquired large banks and emerged as the largest bank in South America, and later used the same strategy of acquiring banks in East Europe to which it already had some business ties. In the years that followed, the bank made inroads into the U.K. the Netherlands, and the U.S., and eventually became one of the world's top ten banks. Santander's M&As were successful for the following reasons. (1) Decisions were made fast. The decision-making process involving major issues including M&As was simplified and centralized. (2) Many M&A specialists were recruited into the top management and these specialists played a crucial role in all of the M&A deals. (3) The head office strictly managed credit risk so that it was able to maintain financial soundness and provide funding for M&As.

<Table 6-61> A Brief History of M&As by Banco Santander

BONCO SANTANDER	1994	2000	2004	2007
	Take over Banesto	Take over Banco Banesto	Take over Abbey National	Take over part of ABN AMRO's businesses
	Took over Banesto that was at the brink of bankruptcy in 1994, rising to be the largest bank in Spain(ranked 65th globally in 1995)	Began to take over small local banks in Central and South America in 1996 and with the acquisition of Banespa of Brazil , established a solid market position in the region(jumped to 36th in the global ranking in 2000)	Successfully established a firm network in the U.K with its long-standing strategic alliance with RBS, and took over Abbey National that was in deficit following the latter's failed investment in Enron, which placed the bank as the world's 12th largest bank.	Acquired part of ABN Amro's businesses(in Brazil and Italy) jointly with RBS when the world's 13th largest bank was reeling from the subprime mortgage crisis, and moved up to the world's 9th place in 2008.

Source: Seo, Byeong-ho, Overseas Expansion Strategies of Domestic Financial Companies and Policy Implications (June, 2009), Korea Institute of Finance.

3.5.10. Making IBs Competitive[189]

In order for investment banks to raise competitiveness, they should (i) create a sufficient pool of professionals, (ii) adopt advanced risk management techniques, (iii) provide satisfactory remunerations, (iv) expand domestic and overseas networks, (v) keep their organization flexible, and (vi) grow larger in size.

3.5.10.1. Quality Human Resources

The ratio of professionals to all employees at domestic financial companies is considerably lower than those of other aspiring regional financial hubs, and one of the reasons is that retail finance makes up the bulk of their business. Given that the absolute number of financial professionals is small in Korea, there are limits to how much they can grow by luring employees away from other companies. In addition to internal employee training programs run by individual companies, it seems necessary for the government or the industry as a whole to create and implement systematic professional development programs.

<Table 6-62> Professional Development Programs in Other Countries

Financial Professionals Development Program(Australia)	Internal Employee Training Program(ICBC, China)
• The Australian government established AFSTA(Australian Financial Service Training Alliance) in 2000 to train financial professionals. • AFSTA designs and operates professional development programs for financial companies. It also creates and runs business-specific training programs, and provides financial certification services.	• After Industrial and Commercial Bank of China sold a 6% stake to Goldman Sachs, the bank had its employees work with employees of Goldman Sachs so that the Chinese employees can learn from their US peers. • The on-site education program covered wealth management, risk management and all the other aspects of the job.

Soure: ibid

3.5.10.2. Advanced Risk Management Systems

Risk management is one of the key success factors for IBs because investment banking itself generally entails high risks and uses leverage. So investment banks need

189 Lim, Byeong-cheol, *et al.*, *ibid*

to dedicate considerable resources to risk management, including an IT system, a separate risk management unit that remains independent from sales, and secure risk management specialists. Risk management specialists are a critical component of a successful risk management system as risk-based derivative instruments are growing fast.

3.5.10.3. Adequate Compensation

Compensation should fairly reward professionals for their performance and be able to offer adequate incentives for them to reach their potential in performing their job. In leading countries, financial companies that received tax payers' money sometimes pay excessive remunerations to their employees or their compensation system is designed to reward employees for mainly short-term performance, causing controversies. In light of potential problems that may arise in connection with compensation, it is necessary to create an effective compensation scheme based on mid-term performance.

<Table 6-63> Ratios of Performance-Related Pay(PRP) at Domestic and Foreign Financial Companies (%)

	Fixed Salary	PRP
Domestic Securities Company A	69.6	30.4
Goldman Sachs	1.6	98.4

3.5.10.4. Networks

As domestic capital balance turns into a surplus, domestic financial companies may switch their long positions to short positions, but they are not yet ready for the switch. For example, domestic banks generated only 3.2% of their revenues from overseas operations in 2010 while UBS derived as much as 73% from overseas businesses, HSBC 68.4%, Citi 46.8%, DBS 38.2%, and RBC 32.8%. Global financial companies have established networks in the Korean market by acquiring control in domestic banks. Citi has a 14.71% stake in Kookmin Bank, BNP Paribas owns 9.06% of Shinhan Bank's shares, and Allianz holds a 9.62% stake in Hana Bank. Most of domestic financial institutions are approaching overseas markets by setting up branches and not capable of responding to growing demands of domestic companies operating overseas.[190] Networking forms the

190 KIC's acquisition of a stake in Merrill Lynch was criticized as a wrong investment choice at the

foundation for basic investment banking businesses such as M&A, security underwriting, PEFs, IPOs, and advisory services. In this sense, leading domestic banks should take the lead in acquiring or increasing stakes in foreign financial institutions, and keep expanding their networks with global IBs because they are expected to increase their presence in the domestic asset management market with growing surplus capital looking for overseas investments. Since networks can begin from professional education and training programs, more efforts should be made to recruit students from target countries to enroll in domestic MBA programs and to build human networks with them.

3.5.10.5. Organizational Flexibility

Financial companies need to remain in their organization and personnel management so that their investment banking activities can respond to customer demand and the changing market conditions. Investment banking can grow better when performance is evaluated from a long term perspective, rather than a short-term perspective.

3.5.10.6. Scale-Up

Domestic financial companies pale in comparison with global IBs in many aspects such as asset size, capital size, and human resources pool, and cannot really compete with them. So they need to pump up their size through M&As and other means in order to expand their investment banking over a long term through risk management and leveraging.

3.5.11. The Role of the Government

In synch with revisions to the Capital Markets Act, a two-phase plan seems necessary: First, incentives for structural changes to the market should be offered by making short-term institutional changes and imposing shocks on the market. When changes to the market structure are detected, the government should induce differentiation. To achieve this, the government and the private sector can work out a two-track approach. The government's job is to encourage and support M&As

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National Assembly, but if risk is not taken, high return is less likely, and other sovereign wealth funds such as Temasek also have made investment decisions that proved to be inappropriate. However, these decisions should be viewed and respected as management decisions and the management should take the responsibility and be dismissed. Domestic securities companies are undertaking initiatives to create networks by setting up joint ventures dedicated to developing new products for portfolio investments by domestic investors, moving ahead in the right direction.

among investment banks so as to create clear market-leaders who are large enough in size. Government-owned IBs tend to have more experiences than private IBs and government support places these IBs at an advantage over private IBs in growing competitive and gaining market leadership.[191] The private sector, on the other hand, needs to take a two-step approach. The first step is to strengthen market discipline and in the second step, financial companies will be sorted out into large and medium-sized IBs that will take on different paths of growth. Details of these steps are explained below.

3.5.11.1. The first step: structural reform through stronger market discipline

Stronger market discipline is imposed to promote structural improvements. To make this possible, the Capital Markets Act should be revised to tighten the primary market discipline for healthier and greater competition, and overhaul the institutional framework including prime broker rules. Increased competition resulting from stricker primary market discipline will drive weak securities firms out of the market, expand the share of the corporate financing pie for the remaining companies, and possibly lead to consolidations among themselves. Advanced security underwriting refers to creating high added value with a superior ability to design and operate products and to manage risks. The discipline in the market for corporate financing such as security underwriting and IPO will be made more strict and securities companies that survive the tightened market discipline will crowd out weaker players that are not capable of taking on as much risk as necessary. As a result, competitive securities firms will be encouraged to increase their market dominance while actions will be taken to promote a healthy culture in the primary and secondary markets.

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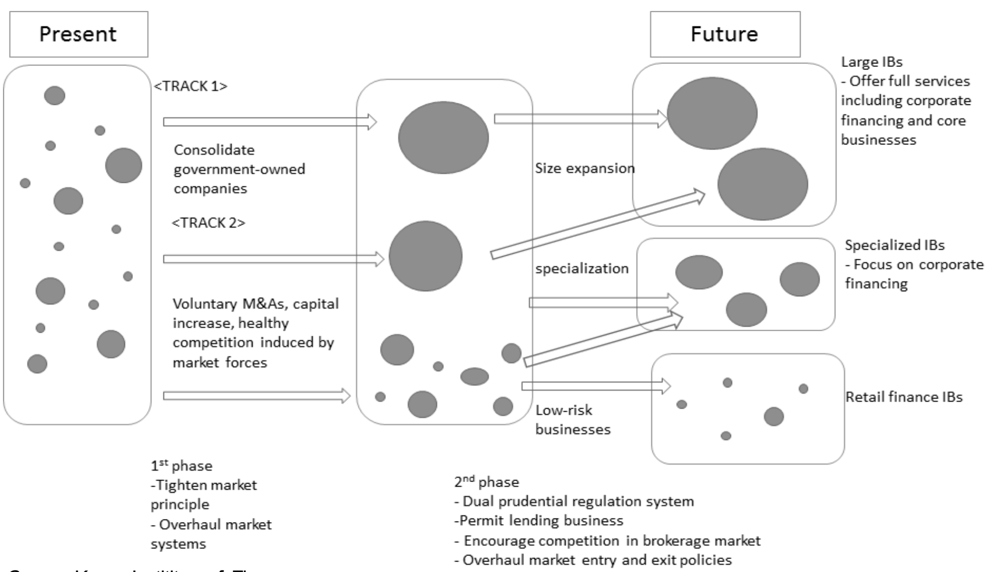
191 For example, the industry research capacity of Korea Development Bank(KDB) still remains strong and as a state-run financial institution, it has the experiences of working with global IBs as co-managers in overseas IPOs and security underwriting. The Participatory Government led by former President Roh Moo-hyun had a plan to combine the investment banking business of KDB and Daewoo Securities for the scale-up, and make it into a leading investment bank that can take advantage of high external confidence as a government-owned bank. But the Lee Myung-bak administration discarded the plan and decided to privatize KDB first and to let competition in the market create or determine leading investment banks. Both of the approaches have pros and cons, but which of the two, privatization of KDB or stimulation of investment banking had to come first in order remains a question to ponder upon further. A close look at the domestic market share reveals an interesting fact. The majority of the top 25 in the five key IB areas including consulting, underwriting, IPO, M&A, and PEF were foreign companies, and only KDB and Daewoo Securities ranked among the top 5 in two categories mainly because they were able to attract more businesses than other domestic companies due to their affiliation with the government. But there is no Korean company on the list. After KDB embarked on privatization, it received no more government support, and it lost its ties to the government and also its appeal to global IBs as their domestic partner. The result is that the domestic IB sec색 is dominated by foreign companies.

3.5.11.2. The second step: differentiation

As the second step, prudential regulation, differentiation needs to be pursued in permissible lending activities by investment banks, and competition for brokerage. Prudential regulation on medium and small-sized securities companies needs to be relaxed on the premise that they have a low possibility of spreading risks to the broader system with a client and creditor protection scheme in place. In the process of differentiation, the minimum capital requirement should enforced on a progressive basis, in tandem with easing of prudential regulation, thereby facilitating specialization and acting as a tool to curb the octopus-type business lineup. More competition needs to be brought in the brokerage market. Market entry barriers such as licensing requirements should be lowered to bring more players into the market and bring down brokerage fees, with the ultimate goal of inducing a reform of capital market through a restructuring of the securities industry.

In summary, the private sector can stimulate the investment banking industry by encouraging sound competition. For the short-term, the institutional framework should be overhauled, incentives for market structure-improving behavior should be provided, and market discipline should be strengthened to increase competition. For the long term, investment banks should be allowed to explore new business areas and differentiated regulations are desirable to help them grow larger in size and achieve specialization.

<Table 6-64> The Government Role in Supporting the Growth of Investment Banks



Source: Korea Instititue of Finance

4. Financial Hubs

4.1. Overview

Traditional financial powerhouses are leading financial innovations and performing the role of global financial center. On the other hand, emerging countries and later movers are increasingly becoming aware that developing financial sector is an integral part of national growth strategy and they are accelerating their efforts to become a regional financial center. The U.K. successfully pulled off a bold financial liberalization or better known as the Big Bang under tough circumstances including a contracting real economy and the opening of the ECB in Frankfurt, and solidified London's status as a global financial center. Under the Big Bang, (1) barriers to market entry were brought down, and exit rules were strictly implemented in order to promote competition. (2) The financial market was opened to actively lure foreign investments and stimulate international M&As, (3) As part of the institutional reform, the Financial Services Act was enacted, and the integrated financial supervisory authority was launched. The U.S. repealed the Glass-Steagall Act that drew lines between baning, insurance, and securities in 1999, to allow financial companies to grow their size and mix different financial businesses, and relaxed the Sarbanes-Oxley Act. The U.S. federal and state governments have worked closely together to make the financial industry more competitive. Since the 2008 financial crisis, financial regulation has been renewed and becoming stricker with the passage of Dodd-Frank of 2010, but major investment banks including JP Morgan and Goldman Sachs have raised their profits back to the pre-crisis levels, and they are seeking new growth strategies under the new regulatory regime led by G20. Japan, however, is not fulfilling the role of international financial center amid lackluster financial reform.

Emerging countries are also striving to increase their chance of becoming regional financial hubs by fostering their financial sector as a national strategic industry. Hong Kong took full advantage of its geographical location as a gateway to China in the process of growing into a regional financial center, but recently, its regional financial center status is threatened as it faces growing competition from Shanghai and Singapore. In response to growing competition, Hong Kong embarked on a package of carefully-designed policies to support its financial industry, such as tax cuts on off-shore financial businesses. Singapore rose as Asia's No. 1 financial hub on the back of the government's aggressive policy initiatives. Singapore has become the foreign exchange hub of Asia by actively accommodating the demand from leading countries for an Asian dollar market. Singapore offered tax incentives and went through deregulation to attract hedge funds, and the total overseas trading volume of Singapore-based banks ranked 6th, following London, New York, and Tokyo. Singaporean government has been engaging in aggressive international investments with Temasek, GIC, and DBS leading these investments. As a result, Singapore has become a regional asset management hub. Dubai built the Dubai International Financial Center(DIFC) and successfully positioned itself as a financial hub of the Middle East under the strong government leadership. Unlike the rest of the country, DIFC is a financial free zone(one country, 2 systems) where a completely different set of financial laws and regulatory systems apply. The zone has KIFC Courts(judiciary), DIFC Authority(administrative), and DFSA(regulator). The creation of DIFC drew in global financial companies such as Merrill Lynch and Barclays and put Dubai ahead of its competitors like Qatar and Bahrain in the race to become an Islamic financial hub.

As a slightly different concept, a specialized financial hub focuses on niche markets. Australia chose to promote itself as the Asia-Pacific financial hub and concentrated its efforts on growing its asset management industry, in a bid to redirect the flow of outgoing global financial capital into the country. The results are impressive. Over the past 10 years, its financial industry has achieved a phenomenal growth, expanding at an annual average rate of 5.3%, much higher than the 3.6% average GDP growth rate. Australia attracted funds by revising its retirement pension system and offering tax incentives, and as a result, became No. 1 asset management market in Asia and the fourth largest in the world. Australia is also a growing foreign exchange market in Asia where the regional headquarters of Deutsche Bank is located(Sydney).

Although Ireland is struggling with a fiscal crisis, it is also acting as a regional financial hub by specializing in the back-office services that support financial transactions in London and Edinburgh. Ireland created IFSC, a special financial zone in Dublin where half of the world's top 20 insurers and half of the global top 50 banks established presence. Language is one of the key success factors because IFSC specialized in providing back-office services to financial companies based on London and Edinburgh where the same language is spoken. Another success factor is the Investment and Development Agency(IDA) that was set up to provide one-stop services for foreign investor. Luxemburg attracted investments from West Europe and the U.S., and has emerged as a global center in the fields of investment funds, private banking, and euro bonds. Luxemburg also acts as a fund-launching center where asset managers can launch their funds and sell them to all of the EU member countries. Particularly, it was able to specialize in private banking as well by guaranteeing strict confidentiality in financial transactions. Luxemburg ranks second in the world's private banking sector, with a 19% market share, after Switzerland with a 27% share.

Late movers such as Korea, China, and India are stepping up efforts to become a financial hub. Financial industry in these countries is not mature enough, but they are diligently working on plans to get ahead of others and become a leading financial hub in Asia. Korea designated Gwanghwamun, Yeoido, and Busan as financial centers and is fostering their growth as such. China concentrated foreign financial companies in Pudong Area in order to grow Shanghai into a financial hub of Asia-Pacific region. China is also planning to develop Huangpu District into a center of financial services including consulting, accounting and legal services. India created an international financial center in Mumbai, the home of stock exchanges, but the financial market is not fully open and thus activities of foreign financial companies are restricted.

4.2. Success Factors for a Financial Hub

What successful financial hubs have in common is examined below.

First, they implemented a bold financial regulatory reform. The U.K. pushed for a bold financial liberalization called the Big Bang of 1986 in spite of the unfavorable circumstances such as the shrinking real economy and the relocation of ECB to Frankfurt, and the reform helped London establish itself as a global financial center. The salient feature of the Big Bang was financial deregulation. Some of the major changes brought about by the Big Bang include (1) lowering barriers to market entry to promote competition, and strictly enforcing exit rules, (2) opening the financial market to attract foreign investments and stimulate international M&As, and (3) enacting the Financial Services Act and launching an integrated financial supervisory authority as part of a regulatory reform. The Big Bang saw domestic financial companies being taken over by large foreign capitals, which is dubbed the Wimbledon Effect, but eventually, London solidified its position as a leading global financial market, leading to a remarkable growth in financial transactions and added value and driving the national economic growth. The U.K. has been ranked either first or second globally in the following areas: ① cross-country bank-lending ② foreign stocks trading, ③ foreign exchange transactions, ④ OTC derivatives trading, ⑤ international bond trading, and ⑥ marine insurance premium revenues.

The U.S. abolished the Glass-Steagall Act in 1999 that kept banking, insurance, and securities business separate in order to allow financial companies to enlarge their size and mix different financial businesses. In addition, the federal and state governments collaborated closely in addressing over-regulation that was widely criticized as the main culprit of the falling competitiveness of the U.S. financial industry. The consensus was that the federal and state governments should make concerted efforts to improve competitiveness of the U.S. financial industry in light of the rise of London as a major global financial hub. The federal government organized the Capital Market Regulation Committee that was put in charge of formulating strategies to make the U.S. capital market more competitive. The City of New York where the Wall Street is located hired McKinsey as an advisor to assess the strengths and weakness of the city and the city set a plan to make itself even more financially competitive, based on the results of McKinsey's consulting. The plan features the following: ① implementing overly strict Sarbanes Oxley Act with moderation, ② change the regulations to make it easier for foreign professionals to work in the city, ③ increasing compliance with global accounting and audit standards, and ④ forming a financial market competitiveness committee as a federal government body. The 2008 subprime mortgage crisis resulted in stronger regulation of the financial industry including the enactment of Dodd-Frank Act, but major investment banks are making as much profit as they did prior to the crisis and taking actions to grow their business under a new regulatory system.

Second, they developed niche markets. Ireland took full advantage of its language and specialized in the back office business to the U.K., acting as a hinterland. Australia channeled much of its resources including retirement pensions into fostering the asset management industry and emerged as a financial powerhouse in the Asia-Pacific region. Luxemburg successfully brought in funds from West Europe and the U.S. and rose as a global center of private banking and fund-launching.

Third, they created a large pool of high-quality financial workers. China(CEIBUS) and Singapore(WMI) had their central and local governments get directly involved in creating education programs such as MBA to nurture financial professionals. They hired first-class faculty and forged alliances with renowned MBA programs. Such education programs including that of Melbourne University are viewed as having contributed significantly to the emergence of Sydney as a global financial hub.

Fourth, they created financial clusters. Putting together a full range of services that financial companies need, such as legal and accounting services, in a single area can produce synergy effects. DIFC in Dubai, The City and the Canary Wharf in London, the U.K., and IFSC in Ireland are examples of a financial cluster.

Fifth, investments by the public sector played an important role. Singapore is making successful overseas investments through government-owned financial companies, and Dubai is seeking to make the most use of sovereign wealth funds in expanding its overseas investments. Singapore's aspirations to become a financial hub of Asia are well supported by effective management of the government's surplus financial resources through GIC, Temasek, and DBS, and by investments in the banking sector in other countries. Singaporean government set up GIC and Temasek as wholly-owned governmen subsidiaries to manage government assets such as foreign currency reserves, on behalf of the government. GIC invests primarily in long-term assets in global financial markets while Temasek performs the role of a holding company for publicly-owned companies and gained high returns on its overseas investments in Asia that it increased after the Asian financial crisis. It is consistently expanding its investments in Asia, in light of the fast-growing economic and political powers of Chindia, i.e., China and India.[192] Singapore recognized, early on, the need for banks to go beyond national borders and established strategic presence in retail finance in Southeast Asian countries to develop niche markets. Singapore's top 3 banks including DBS, OCBC, and UOB have around 30% of their total assets invested in overseas markets, and assets that DBS, Singapore's largest bank have under management in Asian markets including Hong Kong and China make up as high as 80% of the total overseas assets.

<Table 6-65> Overseas Assets of Singapore's Top 3 Banks(2006)

DBS*		UOB		OCBC	
Total assets (100 million dollars)	Overseas assets (%)	Total assets (100 million dollars)	Overseas assets (%)	Total assets (100 million dollars)	Overseas assets (%)
1,083	**33.4**	872	**35.6**	789	**25.2**

Note: * As of the end of 2006 : 130.0 billion dollars.

Japan built enormous wealth in the 1980s amid rapid economic growth and its financial industry flourished, with 7 or 8 banks listed among the world's top ten. But Japan's financial sector grew weaker due to economic recession, growing NPLs, and a flawed and inefficient financial system. Tokyo Stock Exchange accounted for 1/3 of the world's total market capitalization in 1990, but it dropped to 1/10 in 2007 immediately before the global financial crisis occurred, and the number of foreign companies listed on the exchange remains at a very low level (446 foreign companies were listed and traded in New York, 315 in London, 150 in Singapore, 25 in Tokyo in 2007). In the 2000s, mega-banks such as Mizuho and Mitsubishi UFJ were born out of M&As, but there was only one Japanese bank

192 GIC is the owner of twoo of Seoul's landmarks buildings, Seoul Finance Center and Star Tower Building. Temasek is the largest shareholder of Hana Financial Holding Company with a 9.62% stake, and also a 11.99% stake in Standard Chatered Bank, the parent company of SC First Bank.

ranked among the world's top 50 financial companies, which is Nomura. The decline of Japan's financial industry is attributed to the following reasons.

First, Japan set up walls between financial businesses that ran counters to the broader trend of mixing them. Banks' lending heavily dependent on collaterals, mainly real estate, and lending decisions were influenced much by lender-customer relationship. These outdated practices stunted the development of financial companies, providing little incentives for them to create new products. Second, Japan's high-handed regulatory system resulted in lack of transparency in financial regulation, and financial companies' attempts to launch business in Japan are often thwarted by the heavy-handed attitude of the regulator and complicated regulations. Third, interest rates remained extremely low, narrowing loan-to-deposit margins, banks' profits declined and their growth potential shrank. Fourth, investments in professional development such as sending employees overseas to work and learn, and language training were slashed, hurting the global competitiveness of Japan's financial industry.

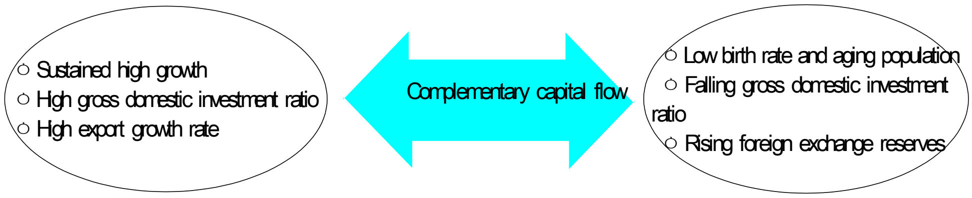
4.3. Korea's Potential

Korea's financial industry has the growth potential that it needs to become a core growth engine for the national economy.

First, there is rich surplus capital. Internally, surplus capital has been on the rise as National Pension Fund, foreign exchange reserves, retirement pension, private investment funds, and export insurance premiums continue to increase. Externally, neighboring countries in Northeast Asia also have growing surplus funds from foreign exchange reserves and sovereign wealth funds.

Second, Korea has diverse investment targets(sources of profit) in the geographical proximity. Asia's leading countries such as Korea, Japan, and Hong Kong have a rising aging population with ample financial assets and this population is a significant source of capital supply while emerging economies such as China, India, and Vietnam have a growing demand for capital as their economy grows rapidly, which presents expanding opportunities to make profits by matching the demand and supply of funds flowing from Asia's leading economies to emerging markets.

<Table 6-66> The Capital Flow in Asia



(Emerging developing countries) (Leading countries)

Third, Korea's financial infrastructure is expected to improve significantly. Korea is globally competitive in Internet banking and other IT areas, and its derivatives market is booming with KOSPI 200 options being the world's most actively traded derivative instrument, and KOSPI 200 futures the world's 5th largest. Korea's financial system remains stable after it was overhauled in the wake of the 1997 foreign exchange crisis.

4.4. Strategies

Four strategies can be recommended in order for Korea's financial industry to move up to the next level on its path toward becoming a regional financial hub: improving corporate governance of financial companies, reforming regulations to make different sub-sectors of the financial industry develop their specialized competence, find a niche in the East Asia's asset management industry, encouraging and supporting overseas expansion by domestic financial companies, and improving the financial infrastructure and nurturing financial specialists and professionals.

4.4.1. Regulatory Reform to Grow Competence of Financial Companies[193]

193 There is a growing consensus on the need to reform the corporate governance of financial companies after Shinhan suffered negative consequences from the power struggle and disputes on succession of the top management and individuals with close ties to President Myung-bank Lee were appointed to lead some of the major financial companies. Improving corporate governance is a critical part of enhancing the capacity of financial companies so it certainly deserves careful consideration. Issues surrounding corporate governance have centered around empowering outside directors so that they can better provide checks and balances against potential abuse of power by CEOs. However, it may cause other problems if outside directors are given too much power to influence the management when institutional investors' involvement in management is not as significant as it is in leading economies where they own a significant stake in financial companies and play a central role in the corporate governance. The management and outside directors may come into conflict in the decision-making process, and such conflicts will leave the company's management strategies at stake, damaging corporate value and undermining responsibility management. There should be a good balance in power and responsibility between management decisions and outside directors' role to monitor corporate activities, but there are no clear guidelines available on this matter. The OECD pointed out problems arising from a board of directors that is controlled by outside directors and recommended in June 2009 that the market should be made the

Leading countries have been moving toward stronger regulation of financial industry since the 2008 global financial crisis, but it should be viewed as a reaction to over-liberalization, which is different from Korea's circumstances. In other words, any side effects of eased regulation should be avoided as much as possible, but over-regulation is clearly a problem in Korea which needs to be addressed with specific actions as follows.

First, Korea needs to create a major investment bank that is capable of leading Northeast Asia's capital market. To achieve this goal, business models should be diversified and the scale of organization and business should be expanded so that investment banks become capable of taking on risks as needed and generating profits. Investment banks should develop new business models that can create more profits through a wider variety of activities such as PI and structured products. They should also increase their risk-taking capacity by expanding their capital and enlarging their size through M&As. To make all these possible, the Capital Markets Act should be revised. The Act went into effect in 2009, but has not produced any tangible effects yet. The proposed revisions to the Act should be passed at the earliest date possible, and financial companies should be encouraged to increase their capital so that they can secure personnel and physical resources for product design and risk hedging, as well as raising their capacity to take on risk from securities issuance. The scope of auxiliary services to support corporate financing should be expanded. Financial investment companies should be

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judge and supervisor of corporate activities by strengthening the fit-and-proper rules for outside directors and disclosure rules, and that the qualifications of directors should be thoroughly verified. In Korea, the Act on Corporate Governance of Financial Company of which legislation is scheduled for December 2011 contains provisions regarding dynamic evaluation of large shareholders' qualifications, increased restrictions on appointment of officers and employees, stricter qualifications for outside directors, creation of a risk management system and a risk management committee, and ban on officers and employees of a holding company from being appointed a outside directors of a subsidiary of the holding company. However, all these provisions are already pat of the supervision regulations of the FSS and reflected in the management evaluation of banks, and CEO succession system is also included in the CAMELS rating system and therefore in the management evaluation, but it remains uncertain if these provisions can bring about necessary changes to the governance of financial companies. It is clearly necessary to tighten the fit-and-proper rules for outside directors and large shareholders, and to increase the professional knowledge and expertise of the board as a group. If necessary, special committees should be set up, and disclosure rules should be made stricter and serve as a tool to evaluate and monitor CEO performance. Other issues that can be considered include how management decisions can be evaluated and how the management as the decision maker should be held responsible for their decisions, how remuneration and extended terms of office should be regulated in case of ex-post evaluations, how a financial company can make sure that its outside directors have enough professional knowledge and expertise(evaluation by outside experts, etc.), how a compliance monitoring system can function effectively to improve self-regulation, whether or not a whistle-blowing system should be introduced and how it can be evaluated, appointing one of outside directors as the chairman of the board, barring former officers and employees from serving as outside directors(5-year cooling-off period), and holding regulators accountable for regulatory failure.

encouraged to mix businesses and grow large in size so that they can compete with global IBs. Market entry regulations should be implemented with flexibility so that competition can be promoted and stimulate M&As among financial investment companies. Government-owned financial companies should be consolidated to accumulate the critical mass in capital, competitiveness, and expertise. Tax incentives should be provided to support M&As among financial investment companies. Companies should be allowed to defer taxes resulting from a merger by easing the relevant regulations, and laws and regulations including M&A-related regulations should be reviewed on an ongoing basis to identify problems that need to be addressed.

Second, banks should pursue organic growth by focusing on high value-added businesses, and for this, banks should improve the efficiency of their intermediary functions by enhancing their loan review system. Banks should increase credit loan based on sophisticated and accurate client and credit analysis in order to promote credit-based financial transactions. It is necessary to expand financial services that can meet the practical demands of corporate clients such as the SME relationship management system. Banks should increase their investments in securities and assume a bigger role in the capital markets so as to diversify revenue models and shift to a high value-added industry, and they should also be able to provide comprehensive financial services with enhanced selective evaluation tools. Banks should work in collaboration with financial investment companies in a broader scope of businesses, and develop new revenue sources from the demands of corporate financing that newly emerge in different industries and development stages. For example, banks can work together with financial investment companies in providing services such as IPO, rights offering, loans for working capital, and M&A advisory services.

In order to cope with the changing business environment, banks should be offered incentives for investing in building a better management infrastructure including IT and specialists, that will enable them to become more competitive in their core competences. Such incentives are necessary because banks are reluctant to invest in the management infrastructure due to the long gestation period. Since Shinhan Bank, Kookmin Bank and others experienced conflicts over CEO succession, Korean banks clearly need to reform their corporate governance, and to keep developing new revenue models, taking advantage of the growing capital markets. The scope of derivative products that banks can deal with should be widened so as to raise the synergy effects of financial intermediation and to allow banks more options in managing and using risks.

Third, walls between financial businesses should be torn down to facilitate the growth of world-class global insurance companies. Insurance companies should be given a broader array of management strategy options that they can choose from according to the unique needs and characteristics of individual companies. Large insurers should seek to grow their size through M&As and other strategies to be able to compete globally while small insurers can specialize in a particular group of client, products or sales channels. This way, they can offer services that can better meet the newly-emerging demands arising from the aging population and the various asset and risk management needs of individuals and the society.

Korea's insurance system can be taken to the next level when insurance companies are given greater autonomy in asset management and be able to act as a pivotal long-term asset investor in the capital market. Asset management regulations and limits should be changed to allow for greater flexibility and the subsidiary ownership regulations should be switched from a positive to negative system, and a review of laws and systems of EU, the U.S. and other leading economies should be done to guide the changes. Specifically, insurance companies should be allowed to own a subsidiary that meets the risk and financial soundness requirements set forth in the relevant law, upon obtaining approval from the FSC. Regulations should be amended again to allow insurance companies to transfer risk and increase profit via capital markets. For example, insurance companies take on large-scale risks such as natural disasters and set up a SPV to securitize such risks for sale in capital markets.

The targets of regulation under the Insurance Business Act should be clarified by redefining insurance products, and new criteria is necessary to clearly distinguish insurance products from derivatives instruments that resemble insurance. The scope of mixed businesses and auxiliary businesses including investment advisory and discretionary investment management that insurance companies can engage in should be broadened, and product development and evaluation procedures should be simplified to promote the development of creative products that can cover a wider variety of complicated risks. With these changes, insurers can provide comprehensive financial services. Insurances should be encouraged to actively engage in M&As to reach a competitive size. To this end, it is necessary to relax the controlling shareholder requirements, and entry and exit rules.

Lastly, insurance companies should be required to meet RBC requirements. With these requirements, insurers will be better equipped to manage their interest rate and credit risks and to build a more sound portfolio, thereby better performing their original role of risk taker. In addition, their roles of managing and covering risks from the aging population and natural disasters should be expanded. For example, catastrophe insurance should be introduced to cover natural disasters that cause market failure, and micro insurance should be allowed to provide low-income class access to insurance coverage.

4.4.2. Asset Management: Find a Niche in Northeast Asia

It is necessary to foster the asset management industry as a niche market in Northeast Asia. As a first step, asset management companies need to increase their competitiveness by growing their size and the National Pension Fund can help with their growth by entrusting more asset management business. Asset management companies can create synergy through mergers, and better diversify their risks with the expanded size, which will lead to enhanced global competitiveness. They should create more investment opportunities through development of new products in order to attract more funds from the National Pension Fund.

Derivatives market, the breeding center for financial innovations should be fostered by offering a wide variety of products and stimulating both exchange and OTC markets. Derivative product development capacity of financial companies should be increased so that they can create new derivative instruments including credit and weather derivatives. Product development can be better supported by switching from a positive to a negative list system for underlying assets that can be used for derivatives. OTC derivatives market should be also further developed by introducing a CCP as leading countries did, that can expand counter parties and provide stronger investor protection.

The treasury bond-centered bond market should find a balance by stimulating the corporate bond market, and contribute more to the advancement of the asset management market by offering varied investment opportunities. Ways should be sought to reinforce credit for corporate bonds through market functions such as increasing issuance of synthetic CDOs and introducing financial guarantee such as monoline insurance. The corporate bond market infrastructure can be improved by changing the credit rating system, building a system to collect data on recovery rates of dishonored bonds, and revising the corporate bond custody system, while increasing the retail demand for bonds by introducing the bond retail primary dealer system.

Second, PEFs, hedge funds and other innovative capital market players should be fostered because they can expand capital markets by maximizing corporate value and offer high-return investment opportunities. PEFs raise corporate value by participating in the management of the invested company and restructuring it, and distribute the profits to investors. It may be necessary to consider exemption of asset management and borrowing regulations for investments in overseas assets through an off-share SPC to promote PEFs. It is also important to create an infrastructure for the growth of PEFs by training professionals and encouraging long-term investment.

Measures need to be taken to facilitate the setup and management of hedge funds in order to create new investment opportunities for domestic investors and advance financial techniques. Hedge funds can correct price imbalances through arbitrage, provide liquidity, and create new investment techniques, thereby contributing to financial market reform.

4.4.3. Overseas Expansion of Domestic Financial Companies

Domestic companies should be encouraged to expand to overseas markets. First, the government needs to encourage and support overseas expansion of private financial companies. Globalization through overseas expansion is essential given that the domestic market is becoming increasingly competitive and thus less profitable, and Korean companies' overseas revenues make up a very small ratio of the total revenues compared to foreign companies. Leading global financial companies are aggressively expanding their overseas operations through M&As to raise their international standing. Citi took over Travelers in 1998 and Banamix in 2001, catapulting the company to the No. 1 spot in 2006 from 21st in 1990. HSBC rose to the second place in 2006 from 30th in 1990 after it acquired Household International in 2003. Banco Santander purchased banks mainly in South America that have the same language and similar cultures. A series of acquisitions in the region and elsewhere placed the bank 10th in 2006 from 73rd in 1990. On the other hand, ABN Amro was acquired by Barclays as it adhered to organic growth strategy which ended in failure.[194]

Asia has high demands for financial services that derive from the complementary intra-regional population structure and rapid economic growth of emerging countries. The region offers rich opportunities for financial companies to act as an intermediary between aging countries such as Japan with surplus capital and emerging markets such as China, Vietnam, and Indonesia that need the capital.

One of one overseas expansion strategies is to target a familiar region where they can establish their presence through M&As or equity investment. They should possess sufficient knowledge and understanding of the target region, and the region should be not a market that is preoccupied by major financial companies. Few opportunities exist in China where major banks are operating actively. But some areas in China still present investment opportunities for banks. The restructuring of state-owned companies was completed and the government is accelerating efforts to attract foreign investments in Indonesia. India is still in the early stage of market opening and its non-bank sector is more accessible. CIS presents opportunities in

194 The government of the Netherlands bought back the stakes of Barclays and RBC that jointly took over ABN Amro to make it a state-owned bank, and the bank is currently in the process of privatization.

IPO services because state-owned enterprises are being privatized and foreign capital is in high demand.

Previously, the most common form of overseas expansion by domestic companies was setting up branches or a sell-side approach but it should be replaced by the buy side approach such as M&A and equity investment. In the past, overseas branches of financial companies served as a channel for issuing sovereign bonds and bringing in foreign funds when Korea was in shortage of capital, but now Korea is in capital surplus and the buy side approach such as M&A and equity investment can be more effective than the sell side approach. With equity investment in, and M&A with local banks, financial companies can overcome, with relative ease, the problems that they may face in conducting local operations, such as a weak network and lack of credit information, and circumvent local regulations that may discriminate against foreign companies. But it does not mean that M&A is a panacea for all companies, and this exogenous growth strategy is probably most suitable for large companies.

The government should exercise as much economic diplomacy as possible to aid financial companies with their overseas expansion. The government should arrange for meetings with economic ministers of the target countries, form task forces to promote bilateral or multilateral economic cooperation with those countries, launch knowledge-sharing projects(KSP), and utilize the networks and experiences of KOICA in order to share Korea's regulatory reform experiences and strengthen networks with these countries.

A review of how leading global financial companies established and expanded their presence in overseas markets can be useful. After World War II was over, Corporate America headed for overseas markets and their global operations grew at a consistent rate from the 1950s to the 1970s, and consequently, financial companies set up their branches in the same overseas markets to provide financial services to U.S. companies. In the 1980, U.S banks concentrated on retail finance that had a relatively better growth potential amid the U.S economic recession, the foreign debt crisis in South America and the stock market crash. After it merged with Travelers Group in 1998, Citi stepped up its insurance and IB sales and began operations in Japan. Beyond 2000, Citi has been stretching its business horizons to East Europe, Asia and emerging markets in Central and South America.

In the early years of operation, HSBC's cross-border expansion was primarily in Asia, but it began to branch out to North America and Europe in the late 1970s. In the early 1990s, HSBC further solidified its position in Europe ahead of the 1997 transfer of Hong Kong back to China and relocated its headquarters to the U.K. in 1993. In the late 1990s, under the banner of rising as the world's largest financial group, it strengthened its IB and asset management segments, and undertook massive efforts to raise its share in the private banking market targeting rich clients in the U.S. and Europe. With the advent of the 21st century, HSBC turned its eye to emerging market including South America, China and India.

<Table 6-67> Global Expansion of HSBC Group

Year	Acquired Company	Price(US$)	Notes
1980	Marine Midland(US)	310 million(51%)	HSBC acquired the remaining 49% stake in 1987, securing an bridgehead into the U.S. market.
1992	Midland (UK)	£3.6 (85%)	Increased its activities in Europe
1997	Banco Bamerindus(Brazil) Banco Roberts(Argentina)	940 million 690 million	-
1999	Republic New York(US) Safra Holdings(Luxemburg)	9.85 billion	-
2000	Credit Commercial de France(France)	10.4 billion	-
2002	Grupo Financiero Bital (Mexico)	1.1 billion	-
2003	Household International(US)	14.0 billion	-
2004	UTI (India) Bank of Bermuda Bank of Communications(China)	70 million(15%) 1.4 billion	UTI had 250 domestic branches.
2005	Ping An Insurance(China)	Acquired an additional stake of 9.9%	HSBC acquired a 10% stake in Ping An in 2002

Banco Santander(BSCH) has been expanding its business in Latin America since the 1980s mainly in the form of acquiring stakes, and concentrated on growing the company's size to survive the competition, following the Council of Europe's decision to liberalize capital movements in 1993. In the late 1990s, Santander took over banks primarily in Central and South America that have much in common in terms of culture and language, successfully emerging as the world's top 10 banks in the 2000s from 73rd in 1990s.

<Table 6-68> Global Expansion of BSCH Group

Year	Acquired Company	Stake	Asset-size ranking in the country
1996	Banco Santander Chile(Chile)	90%	2
1996	Banco Asunsion(Paraguay)	39%	9
1997	Banco Rio de la Plata(Argentina)	98%	4
1997	Banco Geral Do Comercio(Brazil)	100%	5
1997	Banco Santander Uruguay(Uruguay)	100%	10
1998	Banco de Galicia(Argentina)	10%	3
1998	Banco Santa Cruz(Bolivia)	90%	2
2000	Grupo Financiero Serfin(Mexico)	100%	3
2000	Banco do Estado de Sao Paulo(Brazil)	98%	-

Second, the public sector should also play a supportive role. Korea Investment Corporation(KIC) should measure up to its purpose by assuming a central role in creating a financial hub, including promoting sovereign wealth, nurturing financial professionals, and promulgating advanced investment techniques. Given this purpose, the government should grow KIC into a consolidated manager of foreign currency-denominated assets for the public sector including National Pension Fund, and give KIC discretion in creating its own portfolio and managing assets according to its own strategies and tactics, within the limits permitted under the KIC Act. KIC should diversify its portfolio to include PEFs, real estate and hedge funds, gradually increase the ratio of stock investments in the portfolio up to around 50%, and expand its target regions to BRICs, Asia, and other emerging markets in order to reap the benefits of a diversified portfolio and raise its return on investment. Over the mid to long term, KIC should expand its assets under management to a similar level of major sovereign wealth funds managing-agencies, which is around 200 billion dollars to achieve economies of scale, and it should recruit more professional asset managers to meet this goal. Government of Singapore Investment Corporation(GIC) and Temasek of Singapore have 300 billion dollars under its management, NBIM of Norway 250 billion dollars, and CIC of China 200 billion dollars.

Korea Development Bank(KDB) is scheduled to be privatized by 2014, but the role of KDB should be reconsidered and redefined in light of the growing demand for development financing to fund the planned development projects in Northeast Asia including China's plan to develop 3 provinces in the West and Northeast, Russia's Siberia gas field development project, and development projects in North

Korea. Once the Northeast Asian region remains stable and the planned development projects begin in earnest, the combined demand for development financing in the following 10 years is forecast to be at least 200 billion dollars, according to a KDB's estimate. In spite of such high demand, Korean private financial companies are unlikely to step in the market because they lack knowhow on development financing and the funds will be locked in for a long term, and KDB is expected to play a role instead.[195]

4.4.4. Financial Market Infrastructure and Professionals

Lastly, a well-built infrastructure and a broad pool of qualified professionals are important components of a successful financial hub. First, the growth of an efficient capital market requires an expanded infrastructure, and one of the ways to do this is to introduce electronic securities. Under the electronic securities system, issuance, registration and circulation of securities will be performed on an electronic basis without involving physical certificates, and the system is intended to raise the efficiency of primary and secondary securities markets and the convenience in protecting the rights. The official launch of the system is slated for 2013, and the system will be used initially for CPs, under the Act on Issuance and Circulation of Electronic Short-Term Bonds(September 2011). Eventually, the system will expand to CD, bonds and stocks. The market's price discovery function needs to be enhanced by improving credit information and evaluation systems. More information should be classified as public information that can be used for credit rating as part of efforts to improve the credit information infrastructure, and

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195 If KDB is privatized, it needs deposits to raise funds, which requires a merger with another commercial bank. In this case, KDB may face two problems. First, KDB will have to merge with Woori Financial Group or IBK that are currently owned by the government and put up for sale. However, the merger with these banks will not be an easy task because the public sentiment is still negative about mega banks, reeling from the 2008 subprime mortgage crisis. Increasing the number of branches drastically to catch up with its commercial peers is not a viable option for KDB because the loan-to-deposit margin is on the decline amid heated competition in the domestic market. Without the deposit-taking base, KDB cannot access the lowest-cost fund, which is deposits, and it cannot issue low interest-rate bonds because it will be no longer a government-owned institution, seriously eroding its competitiveness. Second, the ICB project that KDB has been working on will likely be discarded because the project aims to bring two completely disparate businesses, i.e, commercial banking and investment banking, under a single organization, but without any history and experiences of European-style universal banking, it has a slim chance of success. Ultimately, the future of KDB lies in investment banking in which it has a comparative advantage over the rest of financial companies in Korea. It is necessary to consolidate investment banking businesses of government-owned financial companies into KDB and to create a government-led investment bank model. If this plan materializes and Korea gains access to the Northeast Asian development financing market, KDB will be able to lead other domestic financial companies into other overseas markets and reduce conflicts with commercial banks.

the credit rating demand base should be expanded to grow the credit rating industry. Exchanges needs to be further privatized and globalized. As long as it is not a controlled economy, stock exchanges customarily start as a private organization and they are run as such. So Korea Exchange(KRX) currently designated as a public institution should be reverted to a private entity as soon as possible.

On the globalization front, KRX needs to include Chinese companies listed on Hong Kong and Singaporean exchanges(H shares and S shares) and companies listed on exchanges of Vietnam and Kazakhstan among its targets to list on KRX. KRX should continue supporting the growth of the exchanges that it helped create in Vietnam, Cambodia, and Laos. The infrastructure development plan should include actions to improve the back-office services such as accounting, legal services, and consulting so that they can better support the growth of areas designated as financial clusters including Gwanghwamun, Yeoido, and Busan.

Second, transparency should be enhanced by bringing financial regulations in line with global standards. All regulations should be revamped and aligned in line with global standards, and steps need to be taken to ensure that regulations should be fair and equitable across different financial sectors from the perspective of regulatory services users. Ineffective regulation, and over-regulation and/or overlapping regulation should be either discarded or fixed on a continuing basis. With regard to globalization of accounting standards, the government should ensure that Korea's views are reflected in the proposed plan to harmonize GAP and IFRS, that the U.S. and Europe agreed to at the G20 meeting.

Third, financial companies should implement sophisticated risk management techniques in order to raise confidence in finance as a whole. They should prepare for BASEL III and RBC requirements and build a system to keep tail risk in check as tail risk is inherent in many of derivative instruments is unpredictable. Deposit insurance premium should be lowered to ease the financial burden on financial companies, and the target fund system should be run smoothly so that the burden of future insurance premiums can be more predictable. Deposit insurance premiums should be graded to encourage financial companies to improve their finance. Given that confidence in financial regulators was seriously damaged in the wake of the savings bank incident, efforts will be required on an ongoing basis to earn back the trust. The financial supervisory system should function on a preemptive basis so that risk factors can be identified early on and deterred while the supervisory system should be structured along the functional lines to provide user-oriented regulatory services

Fourth, high-quality financial workers form the basis for the development of a financial industry. Since the financial industry depends heavily on the quality of human resources, education and training should be practical and field-oriented so that it can produce elite professionals who are capable of designing innovative products and managing assets effectively. Superior faculty including qualified foreigners and endowed-chair professors should be recruited to upgrade the quality of MBA programs. Statistics on financial workers should be revised and used as part of the basic infrastructure to nurture and manage human capital more effectively. In addition, a survey should be conducted to come up with a forecast of human resources demand and supply, and education and training programs should be planned based on the forecast. Singapore and Malaysia set up the Financial Sector Development Fund(FSDF) and the Capital Market Development Fund(CMDF), respectively to finance the nurturing of financial professionals, an integral part of the financial infrastructure.[196] More incentives should be offered to attract high-quality financial professionals both from home and abroad, and they should be rewarded fairly for their performance, creating a virtuous cycle in the management of human resources.

4.5. The Future of Korea's Financial Industry

With all these efforts, Korea's financial industry will be able to accomplish the following targets by 2020. First, per-capita GDP will reach 40,000 dollars, and the financial industry will account for 11% of GDP from 7 to 8% in 2011. Knowledge-based services including finance will contribute to 35% to GDP from 22 to 23% in 2011.

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196 Korea, too needs to create a fund dedicated to developing high-quality human capital. For example, a possible exclusion of KRX from quasi-public entity list in the future will entail an IPO, and part of the financial gains from the IPO can be regarded as public funds because KRX has enjoyed the monopolistic status granted by the government since its inception, and the funds can be used to support the development of human resources. The size of the fund should be determined by an agreement between KRX and its shareholders in consideration of the estimated profits generated from its monopolistic operations, cases of other countries, and the annual budget of the fund. Banking and insurance sectors also need to contribute part of their retained funds and work out a similar plan.

<Table 6-69> The Future Outlook of Korea's Financial Industry