

Korea KDIC 1997 (KR AFC)

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March 4, 2020

Abstract

After the devaluation of the Thai baht in July 1997, international banks reduced their exposures to Korean financial institutions, rating agencies downgraded Korea's sovereign rating, and the Korean won lost half its value ([Lindgren et al. 1999](#), p. 70). The government responded by guaranteeing all financial institution deposits and providing emergency liquidity support to the financial sector ([Lindgren et al. 1999](#), p. 71). These measures proved insufficient at restoring market confidence ([Lindgren et al. 1999](#), p. 71). In December, Korea sought an IMF standby arrangement ([Lindgren et al. 1999](#), p. 71). As part of the IMF program, the Korean National Assembly consolidated financial sector supervision into a new Financial Supervisory Commission (FSC) and broadened the scope of the Korea Deposit Insurance Corporation (KDIC) ([Lindgren et al. 1999](#), p. 71). The KDIC recapitalized both bank and nonbank financial institutions, beginning with the largest banks in January 1998 ([KDI Kwon 2016](#), p. 41, 57-96). The first round of capital injections, between January 1998 and August 2000, focused on financial sector restructuring. The second round, between September 2000 and September 2002, focused on resolving insolvent financial institutions and improving financial supervision and corporate governance ([KDIC 2003](#), p. 15). From 2003 onward, the KDIC's deposit insurance fund was divided into a new deposit insurance fund and a restructuring fund dedicated to ad-hoc crisis-related activities ([KDIC 2003](#), p. 17). Through 2018, the KDIC and other agencies injected a total KRW 82 trillion (roughly \$60 billion) of capital by contributing capital directly and purchasing subordinated debt, common stock, and preferred equity ([KDIC 2018](#), p. 161; [Baliño and Ubide 1999](#), p. 37). Funded by government-guaranteed bonds, the KDIC injected capital into insured financial institutions, including banks, merchant banks, securities companies, mutual savings banks, and insurance companies ([KDI Financial Reform](#), p. 40; [DPA](#), Ch. I, Article 2 (1)). The Korean government argued that the first round of restructuring had succeeded in reducing systemic risk by resolving non-viable institutions and injecting capital into viable ones ([KDIC 2003](#), p. 15). Recurring criticisms include concerns with moral hazard and the Korean government's asymmetric focus on the banking sector ([Kataoka 1999](#), p. 21; [Myung-Koo Kang 2009](#), p. 245, 250). By end-2018, the KDIC had recouped about KRW 50 trillion of the KRW 69.4 trillion it spent on recapitalizations ([KDIC 2018](#), p. 124, 158).

Keywords: Capital Injections, Equity Participation, Capital Contribution, Asian Financial Crisis, Financial Restructuring, Bank Resolution

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Korea KDIC 1997 (KR AFC)

Summary of Key Terms

Purpose:	“When there is an application for financial assistance or when it is necessary to ensure that a merger of a failed institution goes smoothly, the KDIC may provide financial assistance in accordance with a decision made by the policy committee. In cases where the KDIC finds it necessary to improve a failing financial institution’s financial status for the protection of depositors and to maintain the stability of the financial system, it may provide financial assistance in the form of liquidity support, contributions, or equity participation” (KDIC 1998 , p. 11).
Announcement Date	December 5, 1997 (IMF Press Conference)
Operational Date	1997-2010 (KDIC 1998 , p. 17-24; KDIC 2010 , p. 37)
Funding Window	November 1997 through December 2002 (KDIC 2003 , p. 16-17)
Legal Authority	Depositor Protection Act , No. 6274, Article 38
Peak Utilization	~KRW 69.4 trillion from KDIC; 64 participants (pre-merger) (KDIC 2018 , p. 161)
Eligible Institutions	Insured financial institutions (commercial banks, merchant banks, mutual savings banks, insurance companies, investment companies), determined to be “failed” or “failing” (Depositor Protection Act , Article 2; KDIC 1998 , p. 11)
Administrators	Korea Deposit Insurance Corporation (KDI Financial Reform , p. 41); Financial Supervisory Commission (KDIC 1998 , p. 11)

At a Glance

During the Asian Financial Crisis, the Korean government injected capital in both banking and nonbanking financial institutions to facilitate purchase and assumption (P&A) operations and to restore their capital adequacy ratios. Commercial banks, merchant banks, mutual savings banks, insurance companies, and investment companies could participate. Both the KDIC and Financial Supervisory Commission (FSC) could examine financial institutions and designate failed financial institutions; however, the KDIC actually performed capital injections. The FSC mandated most capital injections. Non-participating depository institutions were able to apply for government assistance if they were interested in acquiring or merging with another institution. The KDIC purchased equity, contributed capital, provided loans, purchased assets, and paid depositors. Along with large-scale financial restructuring efforts, capital injections took place in two phases: between January 1998 and August 2000, and the between September 2000 and September 2002. The KDIC funded these activities by issuing government-guaranteed bonds in two rounds. The FSC and Financial Supervisory Service (FSS) required public fund recipients to sign Memoranda of Understanding (MOUs) and the KDIC held recipient institutions responsible for satisfying performance targets. The KDIC sought to recoup the cost of equity participation by selling its equity stakes, collecting dividends, and selling assets. With no defined maximum investment amount, the KDIC injected about KRW 69.4 trillion into 64 institutions: commercial banks, merchant banks, mutual savings bank, insurance companies, and investment companies. The KDIC has recovered KRW 50 trillion by the end of 2018. As of December 31, 2018, the KDIC had outstanding investments in 4 institutions. At the time of writing, the market value of the KDIC’s remaining investment is about KRW 6.4 trillion, which represents about 12.6% of the KDIC’s total disbursement ([KDIC 2018](#), p. 10).

Summary Evaluation

While the KDIC was praised for quickly restructuring and injecting capital, the Korean government was criticized for encouraging moral hazard with taxpayer money, and pursuing asymmetric economic reforms by focusing mostly on banks ([Myung-Koo Kang 2009](#), p. 245, 250). By end-2018, the KDIC had recouped about KRW 50 trillion of the KRW 69.4 trillion it spent on recapitalizations ([KDIC 2018](#), p. 124, 158).

Korea KDIC 1997 (KR AFC) Context	
GDP	<p>\$557.503 billion (current US\$) in 1997</p> <p><i>Source: World Bank</i></p>
GDP per capita	<p>\$12,131.875 (current US\$) per capita in 1997</p> <p><i>Source: World Bank</i></p>
Sovereign credit rating (5-year senior debt)	<p>Fitch: BBB- (12/23/1997) Moody's: Baa1 (12/04/1998) S&P: BBB- (12/22/1997)</p> <p><i>Source: Bloomberg</i></p>
Size of banking system	<p>\$288.4 billion in total assets</p> <p><i>Source: World Bank</i></p>
Size of banking system as a percentage of GDP	<p>51.5% in 1997</p> <p><i>Source: World Bank</i></p>

<p>Size of banking system as a percentage of financial system</p>	<p>Banking system assets equal to 86.84% of financial system in 1997</p> <p><i>Source: World Bank</i></p>
<p>5-bank concentration of banking system</p>	<p>68.3% of total banking assets in 1997</p> <p><i>Source: World Bank</i></p>
<p>Foreign involvement in banking system</p>	<p>NA</p>
<p>Government ownership of banking system</p>	<p>30% of banks owned by the state in 2001</p> <p><i>Source: World Bank</i></p>
<p>Existence of deposit insurance</p>	<p>100% insurance on deposits from December 1997 through January 2001</p> <p><i>Source: Kim et al. 2006.</i></p>

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I. Overview

Background

After the devaluation of the Thai baht in July 1997, international banks reduced their exposures to Korean financial institutions, and rating agencies downgraded Korea's sovereign rating ([Lindgren et al. 1999](#), p. 70). Korea's won lost half its value in the second half of the year ([Lindgren et al. 1999](#), p. 12). The government responded by guaranteeing all financial institution deposits and providing emergency liquidity support to the financial sector ([Lindgren et al. 1999](#), p. 67). Those measures were insufficient. By late 1997, Korea's government was depleted of foreign reserves and its corporations were unable to roll over short-term debt ([Lindgren et al. 1999](#), p. 71).

On December 4, 1997, Korea entered into a three-year standby arrangement with the International Monetary Fund (IMF) worth \$21 billion ([Lindgren et al. 1999](#), p. 67). Korea also received financial aid from the Asian Development Bank (\$4 billion), World Bank (\$10 billion), and a support line (\$23.35 billion) from 13 foreign countries ([Kyu-Sung Lee 2011](#), p. 90). In total, \$58.35 billion of rescue funding was available ([Kyu-Sung Lee 2011](#), p. 90).

As part of the rescue package, the Korean government employed macroeconomic policy interventions, financial restructuring, and other structural measures recommended by the IMF ([IMF Summary](#)). The government suspended the operations of nine insolvent merchant banks on December 2, 1997, and five additional merchant banks later in the month ([Kyu-Sung Lee 2011](#), p. 96, 129). Financial restructuring included regulatory reform and the consolidation of supervisory bodies into the newly established Financial Supervisory Commission (FSC) ([IMF Summary](#)). The FSC was responsible for the systematic evaluation, and subsequent resolution or rescue, of all financial institutions in Korea ([Lindgren et al. 1999](#), p. 71).

The FSC ordered capital injections as part of larger financial sector restructuring efforts ([Lindgren et al. 1999](#), p. 71). By the end of 1997, most banks were undercapitalized. Banks struggled with nonperforming loans (NPLs) that exceeded 8.5% of GDP, based on lax accounting standards; NPLs would rise during the next two years, as the government tightened those standards ([Baliño and Ubide 1999](#), p. 40; [Myung-Koo Kang 2009](#), p. 246, 247). Bank lending contracted as financial institutions scrambled to meet the prescribed BIS capital standards and became wary of the high default risk of corporate debtors ([Kyu-Sung Lee 2011](#), p. 231). In response, the government sought to inject capital immediately, both to prevent banks from further curtailing lending and to recover public funds as soon as possible ([Kyu-Sung Lee 2011](#), p. 187). The Korea Deposit Insurance Corporation (KDIC) executed those injections.

Program Description

The cost of financial restructuring efforts from the 1997 crisis ultimately totaled KRW 168.7 trillion, which was about 1.7 times larger than what the Korean government originally

planned ([KDIC 2018](#), p. 161; [Myung-Koo Kang 2009](#), p. 250). Korean government agencies collectively injected capital in amounts of KRW 63.5 trillion through equity participation (open bank assistance)² and KRW 18.6 trillion through capital contributions to acquirers in purchase and assumption (P&A) transactions³ ([KDIC 2018](#), p. 161). The KDIC's "Deposit Insurance Fund Bond Redemption Fund" (DIFBRF)⁴ funded KRW 50.8 trillion (80%) of total government equity participation and KRW 18.6 trillion (100%) of direct capital contributions ([KDIC 2018](#), p. 158). Non-DIFBRF/non-KDIC recapitalization came from the Bank of Korea, the Korean Asset Management Corporation (KAMCO), and other fiscal expenditures ([BOK 2000](#), p. 49). The KDIC financed the DIFBRF by issuing bonds with government-guaranteed principal-and-interest repayment ([KDI Financial Reform](#), p. 40). It injected capital in financial institutions by purchasing common stock, preferred equity, and subordinated debt ([Baliño and Ubide 1999](#), p. 37; [KDIC 2003](#), p. 18). About 90% of KDIC capital injections occurred between November 1997 and December 2002 ([KDIC 2002](#), p. 22; [KDIC 2018](#), p. 158). After the beginning of 2003, the KDIC injected additional capital as deemed necessary to complete restructuring efforts related to the 1997 crisis ([KDIC 2010](#), p. 32).

Though there was no explicit maximum allocation of public money, the KDIC had to seek approval from the National Assembly to issue bonds, and the National Assembly set an initial limit of KRW 31.5 trillion for the funding of public fund injections ([KDIC 1998](#), p. 14). By late 1999, the financial sector still needed more funding, so the National Assembly approved a second round of public fund mobilization worth KRW 40 trillion in 2000 ([Shin 2003](#), p. 9). Furthermore, the KDIC created and outlined individual participation limits within publicly disclosed Memoranda of Understanding (MOUs) (AB December 2000; [Kyongnam Bank Memorandum of Understanding](#)).

With respect to capital injection eligibility, the KDIC could provide financial assistance to insured financial institutions, which were protected by the KDIC and subject to the Depositor Protection Act (DPA) ([KDIC 1998](#), p. 4, 11).

² "Equity participation" refers to the public funds used to increase equity through stock purchases ([Myung-Koo Kang 2009](#), p. 249; [KDIC 1999](#), p. 11). This is similar to the open bank assistance that the US Federal Deposit Insurance Corporation provided to many failing banks during the banking crises of the 1980s ([FDIC MTC](#), p. 151-169).

³ "Contributions" refer to the public funds used to supplement a capital deficit when an insolvent financial institution is merged or acquired by a third party in a purchase and assumption (P&A) agreement ([Myung-Koo Kang 2009](#), p. 249; [KDIC 2018](#), p. 122).

⁴ The restructuring efforts (including capital injections) made before 2003 were originally recorded under the "Deposit Insurance Fund" ([KDIC 2003](#), p. 17). In 2003, the Deposit Insurance Fund was renamed the "Deposit Insurance Fund Bond Repayment Fund" ([KDIC 2003](#), p. 17).

Capital injections were the result of a four-step evaluation process: (1.) the supervisory body assessed capital adequacy ratios and issued Prompt Corrective Action (PCA)⁵, (2.) the financial institution submitted a rehabilitation plan, (3.) third-party experts evaluated the plan, and (4.) the Financial Supervisory Commission (FSC) decided and directed the appropriate course of action for the financial institution ([KDI Financial Reform](#), p. 54). Please refer to Figure 1 for details.

Figure 1: Prompt Corrective Action Process

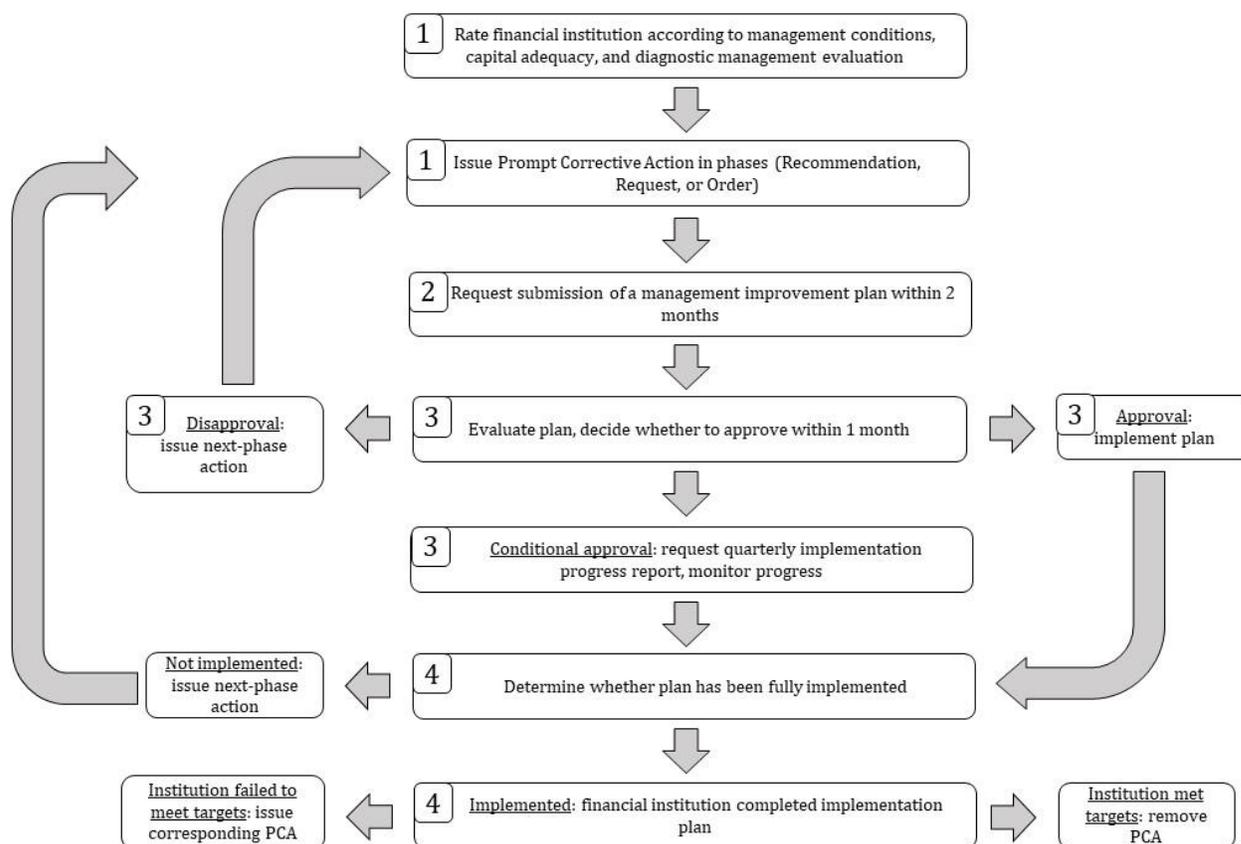


Figure 1 adapted from KDI Kwon 2016, p. 102.

Step One: By December 1997, the Korean government’s priorities were to determine the health of all financial institutions, to close nonviable ones, and to restructure or recapitalize the viable ones ([Dec. 3, 1997 LOI](#)). From December 1997 to April 1998, the Ministry of Finance and Economy (MOFE)⁶ evaluated the capital adequacy ratios of credit institutions,

⁵ “Prompt corrective action” (PCA) is a prudential tool that allows regulators to intervene in the activity of financial institutions, to restore their financial health ([Kyu-Sung Lee 2011](#), p. 192).

⁶ At the recommendation of the World Bank, the Korean government created a restructuring authority, the “Structural Reform Unit” (SRU), within the MOFE on March 7, 1998 ([KDI Financial Reform](#), p. 42; [Kyu-Sung Lee 2011](#), p. 130). Its crisis-related tasks included monitoring institutions and markets, designing big-picture

merchant banks, commercial banks, and specialized and development banks ([Dec. 3, 1997 LOI](#); [KDI Financial Reform](#), p. 42; [Chopra et al. 2001](#), p. 38). The MOFE first determined the viability of commercial and merchant banks because the MOFE considered them the most systemically important financial institutions ([Chopra et al. 2001](#), p. 38). Before the FSC formally codified and executed PCA procedures in mid-1998, the MOFE suspended business operations and ordered rehabilitation plans ad-hoc ([Dec. 3, 1997 LOI](#); [Kyu-Sung Lee 2011](#), p. 192).

After the Korean National Assembly passed the Act on the Structural Improvement of the Financial Industry (ASIFI)⁷ in January 1997, the FSC first exercised PCA on September 14, 1998 ([FSS 2000](#), p. 33; [Kyu-Sung Lee 2011](#), p. 192). Under PCA, the FSC may warn or suspend the senior management and employees, and demand recapitalization, stock write-offs⁸, asset sales, business transfers, and mergers and acquisitions (M&A) if a company's capital ratios were below predetermined standards ([Kyu-Sung Lee 2011](#), p. 192). The extremity of PCA depended on the financial status of the given institution ([Kyu-Sung Lee 2011](#), p. 192). ASIFI amendments in September 1998 also expanded the list⁹ of distressed institutions eligible for government capital injections ([Kyu-Sung Lee 2011](#), p. 205). When a financial institution received PCA, it had to respond with a management rehabilitation plan ([Kyu-Sung Lee 2011](#), p. 192).

Step Two: Management rehabilitation plans outlined sources and quantity of new capital and schedules to meet capital adequacy standards and provisioning requirements; provided confirmation from the supplier of funds; indicated changes in management and ownership, if appropriate; presented business plans going forward; outlined cost-cutting measures; and described steps to improve internal governance, risk assessment and pricing, and loan recovery ([Kyu-Sung Lee 2011](#), p. 98). By the FSC's orders, financial institutions were given

financial reforms, restructuring the corporate sector, and preparing contingency plans ([Lindgren et al. 1999](#), p. 71; [KDI Financial Reform](#), p. 42). The SRU migrated from the MOFE to the FSC on April 30, 1998 ([KDI Financial Reform](#), p. 27, 42; [Kyu-Sung Lee 2011](#), p. 130). On January 1, 1999, the Korean government integrated banking, securities, and insurance supervisory authorities into a single institution, the Financial Supervisory Service (FSS) ([Kyu-Sung Lee 2011](#), p. 130). Gradually, the FSC became the head financial restructuring authority—in addition to the main supervisory authority ([Kyu-Sung Lee 2011](#), p. 130).

⁷ The government first enacted the Act Concerning Merger and Conversion of Financial Institutions in March 1991 ([FSS 2000](#), p. 33). In January 1997, the government “wholly amended” and renamed the Act to the Act on the Structural Improvement of the Financial Industry (ASIFI) ([FSS 2000](#), p. 33).

⁸ In April 1998, the government amended the ASIFI so that the government could order shareholder-capital reductions (KDI Kwon 2016, p. 23). The government also amended Commercial Law to approve shareholder write-downs at board meetings (for “exceptional cases”)—instead of general shareholder meetings ([KDI Kwon 2016](#), p. 23).

⁹ The scope of PCA expanded from only-banks to include securities companies, insurance companies, merchant banks, credit unions, and other financial institutions ([KDI Kwon 2016](#), p. 23). The government outlined “more specific and objective” PCA criteria, and mandated that PCA happen automatically—contingent on a business's performance ([KDI Kwon 2016](#), p. 23, 24).

between one and two months to draft management rehabilitation plans ([Kyu-Sung Lee 2011](#), p. 96-98).

Step Three: Before financial institutions could implement rehabilitation plans, the FSC had to approve them ([Kyu-Sung Lee 2011](#), p. 192). The FSC requested third-party experts, including international audit firms and in-house appraisal committees, to evaluate the plans ([KDI Financial Reform](#), p. 54). Afterwards, the FSC approved, conditionally approved, or disapproved the rehabilitation plans ([KDI Financial Reform](#), p. 57). An “approved” plan obliged the institution to enter into a managerial contract or MOU¹⁰ with the relevant supervisory authority, and the approved institution had to submit implementation plans on a quarterly basis ([Kyu-Sung Lee 2011](#), p. 98; [KDI Financial Reform](#), p. 57). “Conditional approval” required the institution to submit an implementation plan within one month ([KDI Financial Reform](#), p. 57). “Disapproval” permitted the supervisory authority to directly control the underlying institution, and required the institution to merge or to transfer its business via purchase and assumption (P&A)¹¹ agreements ([Kyu-Sung Lee 2011](#), p. 98; [KDI Financial Reform](#), p. 57). If financial institutions voluntarily merged or entered into P&A agreements, the FSC did not require them to cease their business operations ([KDI Financial Reform](#), p. 57).

Step Four: The FSC or MOFE had to request the KDIC to inject capital prior to injections ([KDIC 1999](#), p. 11; [FSS 2000](#), p. 43). The KDIC could inject capital into three types of institutions: (1.) a healthy institution about to acquire an unhealthy/failing institution, (2.) an unhealthy/failing institution to-be-acquired or merged, and (3.) an institution at risk of failing ([KDIC 1998](#), p. 11). The KDIC injected capital to offset balance sheet losses stemming from P&A operations, to prepare institutions for mergers, and to restore BIS capital adequacy ratios ([KDIC 1998](#), p. 17-23; [KDIC 1999](#), p. 20-26; [KDIC 2000](#), p. 15-21; [KDIC 2001](#), p. 20-29; [KDIC 2002](#), p. 22-29; [KDIC 2003](#), p. 21-29). All prospective capital injections were subject to the final approval of the KDIC Policy Committee ([DPA](#), No. 6274 Article 38, Paragraph 2).

To restore Tier 1 capital, the KDIC paid for common stock with cash, shares of publicly owned enterprises, and KDIC bonds ([IMF WP 1999](#), p. 25). To raise Tier 2 capital, the KDIC paid for subordinated debt with shares of publicly owned enterprises ([IMF WP 1999](#), p. 25).

¹⁰ MOUs were agreements to hit performance goals such as financial ratio targets and non-financial requirements ([Kyongnam Bank MOU](#), Appendix I). From MOUs, the KDIC maintained broad informational authority, and could request the institution to provide documentation at regular intervals, to create Implementation Plans, and to notify the KDIC of any interruptions to the institution’s completion of responsibilities ([Kyongnam Bank MOU](#), Articles 3-6). The KDIC could also request information indirectly from the FSC or the Financial Supervisory Service (FSS) ([KDIC 1999](#), p. 12, 15). The KDIC could directly manage institutions when they failed to abide by the terms of the MOUs ([Kyongnam Bank MOU](#), Article 9).

¹¹ “Purchase and Assumption” refers to a “resolution method in which a healthy bank or group of investors assume some or all of the obligations, and purchase some or all of the assets of a failed bank” ([IADI P&A Definition](#)).

The Korean government required capital injection recipients to raise private capital from new shareholders, existing shareholders, or other stakeholders (ex: creditors, borrowers) ([Baliño and Ubide 1999](#), p. 32). The KDIC also collected contributions as a percentage of capital injection amount ([KDIC 1998](#), p. 13). In 1998, the government agreed to support banks that did not merge by matching their private capital raises ([Claessens et al. 1998](#), p. 22). Upon receiving the capital, financial institutions were expected to fulfill their rehabilitation plans or follow memoranda of understanding (MOUs), which contained self-rescue timelines and financial objectives ([KDIC 2000](#), p. 35; [Kyongnam Bank MOU](#)).

The KDIC purchased preferred shares from the five banks, whose rehabilitation plans were rejected in June 1998, to facilitate their P&A agreements ([White Paper 2000](#), p. 118). The preferred shares were non-cumulative, non-voting, and paid one percent annual dividends ([White Paper 2000](#), p. 118). The KDIC purchased preferred shares at KRW 5000 per share ([White Paper 2000](#), p. 118). The recipient institution and the KDIC designed a schedule for the repurchase of preferred shares, and if the institution did not repurchase the preferred shares on time, the shares were converted into common shares ([White Paper 2000](#), p. 118). The author was unable to find other capital terms at this time. English translations of the [KDIC Annual Reports](#) do not specify the types of securities that the KDIC purchased from each institution.

After 2000, the KDIC injected capital and guided public fund recipients on three principles: least cost¹², loss sharing¹³, and self-help effort¹⁴ ([KDIC 2000](#), p. 35). The KDIC recovered the costs of capital injections by selling equity stakes, accumulating equity dividends, and collecting bankruptcy dividends ([KDIC 2001](#), p. 30). The Public Fund Oversight Committee (PFOC), which was housed inside the MOFE, created a Sales Screening Subcommittee that decided when and how to dispose the KDIC's securities holdings ([BOK 2000 Report](#), p. 52). The KDIC was able to appoint financial advisors for equity disposition ([Disposal of Shares in Kyongnam Bank and Kwangju Bank](#)). It is not clear how the KDIC evaluated prospective buyers; however, to speed up the recovery, the KDIC also performed bankruptcy liquidator and administrator roles ([KDIC 2000 Report](#), p. 22, 23).

Outcomes

The KDIC moved all its crisis-related assets and liabilities—including those from capital injections—to the DIFBRF ([KDIC 2018](#), p. 9). Following the Korean government's "Public

¹² "Least cost" meant that the KDIC decided the amount of support after private sector experts and accountants perform due diligence; the goal is to resolve insolvent financial institutions at the minimum cost ([KDIC Resolution](#)).

¹³ According to the loss-sharing principle, shareholders, management, and employees were expected to contribute when institutions relied on public funds to recapitalize ([KDIC Resolution](#)).

¹⁴ To ensure self-help efforts, the KDIC required the public-fund-injected financial institution to sign an MOU on business normalization before receiving the capital injection ([KDIC Resolution](#)).

Fund Redemption Plan,”¹⁵ the KDIC agreed to repay the federal government and KDIC bondholders KRW 82.4 trillion in costs related to financial restructuring (KDIC 2018, p. 9, 10). By the end of 2018, the KDIC paid KRW 30.8 trillion with recovered funds, and KRW 45.7 trillion with government contributions (fiscal loans) (KDIC 2018, p. 9, 10). The KDIC will repay the remaining KRW 5.85 trillion balance with future recovered funds and special contributions¹⁶ from insured financial institutions through 2027 (KDIC 2018, p. 10).

Of KRW 69.4 trillion in capital injections, KDIC has recovered KRW 29.3 trillion in equity investments and KRW 20.2 trillion in bankruptcy dividends¹⁷ by the end of 2018 (KDIC 2018, p. 124, 125, 158). As of December 31, 2018, the KDIC held equity stakes in four institutions¹⁸ collectively worth about KRW 6.4 trillion (KDIC 2018, p. 10). Of the 14 MOUs signed between 1999 and 2001, 12 have been terminated because the underlying institution was either sold or merged with another institution (KDIC 2018, p. 88). Following Myung-Koo Kang (2009), capital injections resulted in the consolidation, nationalization, and privatization of the Korean financial sector (Myung-Koo Kang 2009, p. 246-260).

The Korean government relied on mergers—usually through P&A transactions—as the main tool for resolving unsound institutions (Ro 2001, p. 98). The Korean government believed that mergers would make Korean banks more internationally competitive and efficient in terms of organization and management (Ro 2001, p. 98). Incentives for mergers included preferential tax treatment for merged institutions, and the legalization of financial holding companies (Ro 2001, p. 97, 98). Especially during the second round of recapitalization, the government encouraged mergers between healthy banks and placed some nationalized banks under government financial holding companies to enhance financial soundness and competitiveness (Tsutsumi et al. 2010, p. 11; Ro 2001, p. 97). The government believed that mergers between healthy banks would “also help address lingering problems plaguing domestic banks, including excessive bad assets, low profitability, weak IT investment, and a failure to achieve economies of scale” (AB December 2000).

The KDIC’s merger strategy extended to non-bank financial institutions. Article 3 of the Act on the Structural Improvement of the Financial Industry (ASIFI) allowed financial

¹⁵ On September 5, 2002, the Korean government finalized and announced a plan for the repayment of public funds (KDIC 2002, p. 36). The plan identified the repaying institutions, amounts, periods, and methods (KDIC 2002, p. 36).

¹⁶ From 2003 through 2027, KDIC will continue to collect contributions worth 0.1% of all insured deposits from insured financial institutions (KDIC 2002, p. 36).

¹⁷ Not all bankruptcy dividends were related to capital contributions; the KDIC also collected bankruptcy dividends from institutions whose depositors the KDIC paid off (KDIC 2018, p. 123). KDIC annual reports from the early to mid-2000s suggest that the KDIC contributed capital to banks and insurance companies, and recovered bankruptcy dividends from the same types of institutions through 2018 (KDIC 2003, p. 34; KDIC 2006, p. 59; KDIC 2018, p. 125).

¹⁸ This includes Woori Bank, Seoul Guarantee Insurance Corporation, Hanwha Life Insurance, and Special Account of the Credit Business Unit of the National Federation of Fisheries Cooperatives (KDIC 2017, p. 74)

institutions to change to different types of financial institutions, or to merge with different types of financial institutions while maintaining or changing their types¹⁹ (Ro 2001, p. 98; ASIFI, Article 3). Starting in 2001, the KDIC also merged institutions by incorporating them into government-run financial holding companies (Hahm and Kim 2006, p. 153). The Korean government hoped that financial holding companies would retain more employees and lessen employee resistance—in contrast with the previous P&A approach (Hahm and Kim 2006, p. 153). The Korean financial sector underwent heavy consolidation after 1997; about 39% of total Korean financial institutions had engaged in restructuring efforts (revocation of license, merger, liquidation, business transfer, etc.) that shrank the financial sector from 2,101 companies at the end 1997 to 1,363 companies at the end of 2003 (KDIC 2003, p. 16).

The Korean government nationalized many financial institutions—particularly commercial banks—after tending to their severe capital deficits (Ro 2001, p. 95). By October 1998, the government controlled banks that collectively held about one-third of total bank assets in Korea, which raised questions about interim governance (Claessens et al. 1998, p. 22-23). Both political pressure to recover public funds and underdeveloped Korean capital markets pushed the government to rapidly sell nationalized firms to foreign investors (Myung-Koo Kang 2009, p. 262, 263). Facing hesitant buyers, the Korean government opted to sell its financial sector stakes directly and without first screening foreign capital (Myung-Koo Kang 2009, p. 260). In 1998, the Korean government eliminated caps on foreign ownership of Korean companies, and Korean companies were relatively cheap due to the depreciated Korean won (Myung-Koo Kang 2009, p. 262, 263). The first buyers were foreign investment funds, who aimed to re-sell Korean banks to other buyers, which consisted of foreign banks interested in purchasing Korean banks rather than establishing new branches of their own (Myung-Koo Kang 2009, p. 260). Foreign ownership of the Korean commercial bank sector rose from 12.3% in 1998 to over 70% in 2006 (Myung-Koo Kang 2009, p. 260, 261). Additionally, loans from foreign-controlled and foreign-located banks tripled between 1998 and 2006—a trend that distinguishes Korea from other countries in the aftermath of the Asian Financial Crisis (Myung-Koo Kang 2009, p. 261).

II. Key Design Decisions

1. Capital injections were part of a larger public spending scheme known as “public fund injections.”

In January 1997, the Korean government passed the Act on the Structural Improvement of the Financial Industry (ASIFI)—legislation that permitted the government to invest in insolvent financial institutions (FSS 2000, p. 33; ASIFI, Article 12). When the government responded to the Asian Financial Crisis in late 1997, its top priority was to resolve insolvent

¹⁹ In other words, merchant banks could merge with commercial banks, and the resultant institution could elect to be a merchant bank or a commercial bank. The same principle extended to M&A between any two types of financial institutions.

financial institutions ([KDI Financial Reform](#), p. 40). However, government institutions such as Bank of Korea and KDIC lacked sufficient resources to cover all restructuring costs ([KDI Financial Reform](#), p. 40). Korea's sovereign credit rating declined within international markets, so Korean companies could not easily raise capital from other financial institutions, corporations, or foreign investors ([KDI Financial Reform](#), p. 40). Given constraints on financing its restructuring efforts, the Korean government decided that public funds were necessary to resolve non-viable institutions ([KDI Financial Reform](#), p. 40).

The Korean government uses the term “public funds”²⁰ to describe “capital raised by the Korean Asset Management Corporation (KAMCO) and the Korea Deposit Insurance Corporation (KDIC) through the issuance of bonds with a government guarantee on the payment of principal and interest” ([KDI Financial Reform](#), p. 40). The Korean government used public funds to purchase non-performing assets, to pay out deposit insurance for failing financial institutions, to acquire assets of closed banks²¹, and to recapitalize financial institutions with weak balance sheets ([KDI Financial Reform](#), p. 40). Capital injections, as part of the public funds injections, were subject to the same criteria as public funds injections. Before injecting public funds, the KDIC required financial institutions to sign memoranda of understanding (MOUs) that outlined financial goals (AB December 2000).

2. The Presidential Commission on Financial Reform drafted financial restructuring frameworks and supervisory reforms that later became part of IMF conditionalities.

By 1997, the Korean government recognized the need for regulatory and supervisory reform due to changes in surrounding Asian financial systems: the lack of a clear boundary between bank/non-bank activities, financial market liberalization, deregulation, and globalization ([FSS 2017](#), p. 2). In January 1997, the Korean government assembled the Presidential Commission for Financial Reform (PCFR) to brainstorm new supervisory protocol and procedures ([KDI Financial Reform](#), p. 15; [FSS 2017](#), p. 2). Comprised of 31 members from business, financial, and academic sectors, the PCFR published two sets of policy recommendations in 1997 to reform the Korean financial sector ([KDI Financial Reform](#), p. 15). The PCFR's main objectives were to strengthen the financial industry competitiveness²²,

²⁰ Other sources of public funds included budgetary allocations and asset exchanges ([Balino and Ubide 1999](#), p. 37).

²¹ The KDIC compensated for losses associated with purchase and assumption (P&A) operations by purchasing the insolvent portion of the acquirers' assets ([KDIC 1999](#), p. 21). KDIC asset purchases were also the product of counterparties that executed put-back options after acquiring a Korean financial institution ([KDI Kwon 2016](#), p. 147). When the KDIC funded asset purchases by the Resolution and Finance Corporation (RFC), a KDIC subsidiary, the KDIC recorded the RFC's expenses on its own financial statements—even though the RFC managed the assets ([KDIC 2000](#), p. 16, 26, 27).

²² The PCFR believed that establish Prompt Corrective Action and Early Resolution frameworks were a part of financial sector competitiveness ([KDI Financial Reform](#), p. 17). To achieve this, the PCFR recommended: (1.) Prompt Corrective Action (PCA) for undercapitalized financial institutions, (2.) mergers and acquisitions (M&A) for insolvent financial institutions, (3.) improving the liquidation and bankruptcy procedures for

to foster financial market efficiency, and to stabilize the financial system ([KDI Financial Reform](#), p. 15). On December 4, 1997 the Korean state committed to a stand-by arrangement²³ with the International Monetary Fund (IMF) for Special Drawing Right (SDR) 15.5 billion ([Baliño and Ubide 1999](#), p. 31). The IMF’s conditionalities and policy agenda were already discussed in the PCFR²⁴ ([Baliño and Ubide 1999](#), p. 31; [KDI Financial Reform](#), p. 22, 23).

The PCFR also recommended the consolidation of financial supervisory bodies ([KDI Financial Reform](#), p. 21). On December 29, 1997, the Korean Assembly approved the Act on the Establishment of Financial Supervisory Organizations (AEFSO)²⁵ to consolidate financial supervision into one entity ([FSS 2017](#), p. 1). Supervisory consolidation occurred in two stages to make necessary preparations and to not detract from crisis management ([Lindgren et al. 1999](#), p. 71). The Korean financial supervisory system is two-tiered: while the Financial Supervisory Commission²⁶ (FSC) handles rule-making and enforcement, the Financial Supervisory Service (FSS) conducts safety/soundness examinations, educates and protects consumers, and administers the FSC’s rule-making and licensing activities ([FSS 2017](#), p. 2).

As Korea’s first integrated financial supervisory body, the FSC led financial reform and restructuring efforts—including capital injections—in the wake of the 1997 crisis ([KDI Financial Reform](#), p. 27). The FSC was established on April 1, 1998 under the AEFSO ([FSS 2017](#), p. 3; [KDI Financial Reform](#), p. 27). The FSC is a government agency charged with setting

failing financial institutions, and (4.) improving measure to protect depositors and investors against the failure of financial institutions ([KDI Financial Reform](#), p. 17). The PCA framework, later enacted in April 1998, was triggered by low capital adequacy ratios, and explained the conditions that would require the KDIC to inject capital ([KDI Financial Reform](#), p. 32).

²³ The aims of the IMF program were: (1.) to commercialize the financial system and to strengthen its supervision, (2.) to restructure the corporate sector, and (3.) to restructure and recapitalize the banking system by cleaning up the stock of bad loans and restoring capital bases ([Baliño and Ubide 1999](#), p. 31).

²⁴ Researchers from the Korean Development Institute document suggest that the IMF enacted the PCFR’s policy recommendations “without a major revision to the original draft,” an act that “enabled Korea to save time and resources in overcoming and rebounding from the crisis” ([KDI Financial Reform](#), p. 22, 23).

²⁵ The AEFSO was submitted to the National Assembly for ratification on August 23, 1997, but was not ratified until December 29, 1997 ([KDI Financial Reform](#), p. 26). The “Act on the Establishment of Financial Supervisory Organizations” was renamed “Act on the Establishment of the Financial Services Commission” in 2008 ([FSS 2017](#), p. 2).

²⁶ In 2008, the “Financial Supervisory Commission” assumed the policy functions of the Ministry of Finance and Economy’s Financial Policy Bureau, and was renamed the “Financial Services Commission” ([FSS 2018](#), p. 2).

financial market policies, proposing legislative changes to the National Assembly, granting regulatory licenses²⁷, and enforcing the rules ([FSS 2017](#), p. 3, 4).²⁸

On January 1, 1999, the Office of Bank Supervision (OBS), Securities Supervisory Board (SSB), Insurance Supervisory Board (ISB), and Non-bank Supervisory Authority (NSA) were consolidated into a single supervisory entity: the Financial Supervisory Service (FSS)²⁹ ([KDI Financial Reform](#), p. 27). The FSS examines and supervises financial institutions so that they operate safely and soundly, serves consumers and investors, and follows financial rules and regulations ([FSS 2017](#), p. 1). The FSS also supervises capital markets and mediates disputes between financial institutions, investors, depositors, and creditors ([FSS 2017](#), p. 1; [KDI Financial Reform](#), p. 29).

3. The KDIC was established under the Depositor Protection Act as a financial stability institution, and it was unable to recapitalize institutions before it assumed their depositor protection operations.

The government enacted the Depositor Protection Act (DPA) on December 29, 1995, and established the KDIC on June 1, 1996 ([KDIC 1998](#), p. 3). The KDIC's purpose under Article 1 of the DPA is "to contribute to [the] protection of depositors, etc. and maintenance of the stability of the financial system by efficiently operating the deposit insurance system, etc. in order to cope with a situation in which a financial company is unable to pay back deposits, etc. due to its bankruptcy, etc." ([DPA](#), Article 1).

Between June 1, 1996, and January 1, 1997, the KDIC was a special juridical entity with no capital; thereafter, it launched bank protection operations while non-bank financial institutions³⁰ still had separate insurance agencies ([KDIC 1998](#), p. 3, 6). On April 1, 1998, all depositor protection functions were collected under one institution; the KDIC assumed the assets and liabilities of the Insurance Guarantee Fund, the Korea Non-Deposit Insurance Fund, and Credit Union's Security Fund ([KDIC 1998](#), p. 12). Given its stated purpose, April 1, 1998 was when the KDIC was both legally obligated and enabled to recapitalize any insured financial institution—not just banks ([Lindgren et al. 1999](#), p. 71). Following 1998 changes to the Act on the Structural Improvement of the Financial Industry (ASIFI) and DPA, non-

²⁷ In April 1999, the FSC acquired the power to license/de-license financial institutions and to supervise specialized development banks ([Lindgren et al. 1999](#), p. 71).

²⁸ Housed within the FSC, the Securities and Futures Commission (SFC) oversees securities and futures markets, directs investigations of market misconduct and abuse, and establishes accounting and auditing standards ([FSS 2017](#), p. 4).

²⁹ Legally, the FSS is a quasi-government supervisory authority responsible for all of the financial sector ([FSS 2017](#), p. 1). To examine and supervise institutions, FSS regularly coordinates activities and shares information with the Bank of Korea, the Korea Deposit Insurance Corporation, and the Financial Supervisory Commission ([FSS 2017](#), p. 3).

³⁰ "Non-bank financial institutions" included securities companies, insurance companies, merchant banks, mutual savings and finance companies, and credit unions ([KDIC 1998](#), p. 6).

depository institutions such as insurance companies and credit unions were also required to hold insurance³¹ with the KDIC on deposit-like liabilities ([KDIC 1998](#), p. 12; [Kyu-Sung Lee 2011](#), p. 205). The KDIC also offered blanket deposit coverage from December 1997 to July 1998³² in response to financial market instability ([KDIC 2001](#), p. 86). After markets stabilized, the KDIC raised the limit to KRW 50 million per depositor in October 2000 ([KDIC 2001](#), p. 86).

Within the KDIC, the “Policy Committee”³³ is the highest decision-making body ([KDIC 1999](#), p. 13). At the time, its membership included 14 individuals: the Vice Minister of the Ministry of Finance and Economy (MOFE), the Assistant Director of the Budget Planning Office, the Vice Chairman of the Financial Supervisory Commission, the Vice President of the Bank of Korea, the President of the National Bankers Association, representatives of seven financial industries, and two appointees of the MOFE Minister ([KDIC 1999](#), p. 13). The responsibilities of the Policy Committee included funding support for financial resolution institutions, and institutions looking to acquire, merge, absorb, or take over the operations of other failed institutions ([KDIC 1999](#), p. 13). The Policy Committee’s decisions regarding resolution were subject to approval of the KDIC Board of Directors ([KDIC 1999](#), p. 15).

4. Under the DPA, the KDIC funded capital injections by issuing Deposit Insurance Fund Bonds in two rounds, and the KDIC separated crisis-related funds from the non-crisis deposit insurance fund.

In May 1998, the Korean government estimated that KRW 64 trillion would cover the costs of financial restructuring, and secured approval from the National Assembly to raise bonds through the KDIC and Korean Asset Management Corporation (KAMCO) ([Shin 2003](#), p. 9). This KRW 64 trillion was later regarded as the first “phase” of financial restructuring ([KDIC 2003](#), p. 15). By late 1999, the financial sector still needed more funding, and, in 2000³⁴,

³¹ The KDIC also expanded the scope of insurable deposits to “maintain the stability of the financial system” ([KDIC 1998](#), p. 3, 8). From 1998 to 2001, the KDIC insured the deposits of the government, certificates of deposit, money raised by selling bonds under repurchase agreements, and bank bonds, among other securities ([KDIC 2001](#), p. 85).

³² In July 1998, the KDIC decided to insure principal and designated interest up to KRW 20 million per individual depositor ([KDIC 2001](#), p. 86). Concerned about moral hazard, the KDIC only covered principal for deposit accounts with more than KRW 20 million ([KDIC 2001](#), p. 86).

³³ The “Policy Committee” was renamed the “Deposit Insurance Committee” following an amendment to the DPA on May 29, 2003 ([DPA](#), ADDENDA <Act No. 6891, May 29, 2003>). The shorthand for both is still “the Committee” in relevant documents and legislation.

³⁴ Second-round public fund operations were delayed due to “ill-coordinated policy dialogues and political agenda” ([KDI Financial Reform](#), p. 46). The Korean government recognized the need to raise more public funds to head off any unforeseen complications with financial and corporate sector restructuring, and convened in early 1999 to discuss if and how much additional public funds ought to be raised after the first round had been depleted ([KDI Financial Reform](#), p. 46). However, an “unanticipated happening in the high level meeting masked further discussions on the necessity of public funds” ([KDI Financial Reform](#), p. 46). After a national election for lawmakers in April 2000, the government formally declared the second round of

National Assembly approved a second round³⁵ of public fund mobilization worth KRW 40 trillion ([Shin 2003](#), p. 9). The amount of money used for restructuring does not equal the amount of bonds raised because recouped public funds were re-spent on financial restructuring, and the government relied on multiple funding sources ([Shin 2003](#), p. 9, 10).

Article 24 of the DPA established the Deposit Insurance Fund (DIF) on April 1, 1998, the same day that the KDIC assumed the assets and liabilities of the Insurance Guarantee Fund, the Korea Non-Deposit Insurance Fund, and Credit Union's Security Fund ([DPA](#), Article 24; [KDIC 1998](#), p. 12). The DIF funded deposit payoffs and financial assistance—including capital injections—to distressed financial institutions ([KDIC 1998](#), p. 27). The DIF's financial statements were separated into six different accounts: banks, securities companies³⁶, insurance companies (life and non-life), merchant banks, mutual savings & finance companies, and credit unions ([KDIC 1998](#), p. 27).

Article 26-2 of the DPA permitted the KDIC to issue government-guaranteed³⁷ bonds for the purposes of financial restructuring³⁸; the KDIC bond issuances funded KDIC capital injections ([DPA](#), Article 26-2; [KDI Financial Reform](#), p. 40). The KDIC's subcommittees (ex: Banking Subcommittee, Insurance Subcommittee) discussed prospective bond issuances before submitting them to the Policy Committee, who submitted them to the National Assembly for approval ([KDIC 1998](#), p. 4; [KDIC 1999](#), p. 91-92; [KDI Financial Reform](#), p. 44). The KDIC raised about KRW 87.2 trillion in bond issuances between 1998 and 2002 ([KDIC 2018](#), p. 119). The KDIC issued most bonds with maturities of at least five years because it

fundraising in mid-2000 ([KDI Financial Reform](#), p. 46). Some scholars suggest that the Korean government sought to avoid political backlash before the election, and that the National Assembly waited until financial markets became sufficiently turbulent before expressing the need to raise additional public funds ([Lim and Hahm 2004](#), p. 19).

³⁵ Second round objectives were to: (1.) recapitalize distressed banks to enhance BIS capital adequacy ratios, (2.) uphold Seoul Guarantee Corporation's capital base (so that it could guarantee Daewoo Group and non-Daewoo workout companies), and (3.) offset shortfalls that caused more NPL sales ([KDI Financial Reform](#), p. 46).

³⁶ Before February 2009, the Korean government used "securities companies" and "financial investment companies" interchangeably ([KDIC 2009](#), p. 126). After the enactment of the Capital Market Consolidation Act in February 2009, "financial investment companies" included securities companies, investment dealers, and brokerage firms ([KDIC 2009](#), p. 126).

³⁷ In 1998, the National Assembly guaranteed payment of DIF bond principal, and KDIC borrowed from the central government to pay DIF bond interest payments ([KDIC 1998](#), p. 14, 16). Specifically, KDIC borrowed from the government's "Special Account for Financial Loans" in the form of three-year, zero-interest loans ([KDIC 2002](#), p. 21). KDIC borrowed a total of KRW 18.6 trillion from 1998 through 2002 to make DIF bond interest payments ([KDIC 2003](#), p. 18). Under the Public Fund Redemption Fund Act, KDIC was exempted from repaying previous fiscal borrowings ([KDIC 2003](#), p. 18).

³⁸ Other sources of DIF funding included contributions (from insured financial institutions and the government), the gratuitous transfer of state property, borrowings, collected insurance premiums, recovery (from deposits purchased, or from funds provided for the resolution of failed financial institutions), and income from the operation of the DIF ([KDIC 1998](#), p. 27).

expected repayment to take that long ([KDIC 1999](#), p. 19). A comprehensive list of bond terms, rates, and volume-by-sector are in Tables III, IV, and V of the Appendix.

On January 1st, 2003 and under the “Public Fund Redemption Plan,” the first Deposit Insurance Fund (DIF) was renamed the “Deposit Insurance Fund Bond Repayment Fund” (DIFBRF) to alleviate public concerns about the loss and recovery of public funds ([KDIC 2003](#), p. 17). An amendment to the DPA separated the DIFBRF from the new Deposit Insurance Fund (“new DIF”)³⁹ (DPA, Article 26-3; [KDIC 2003](#), p. 118, 119). The DIFBRF was responsible for completing financial restructuring efforts related to the 1997-1998 crisis—including the relevant recovery efforts and repayment of public funds ([KDIC 2003](#), p. 17). The DIFBRF received the assets, debts, and other rights and duties⁴⁰ of the original DIF registered before January 1, 2003 ([BOK 2002 Report](#), p. 58). KDIC paid for the original DIF bonds with special assessments levied on insured deposits, contributions from the DIFBRF, money raised from DIFBRF bond issuances, and other borrowings ([KDIC 2003](#), p. 18, 19). The original DIF bonds were all repaid by the end of 2008 ([KDIC 2018](#), p. 119)

5. The Korean government announced capital injections through press releases and regular reports. Law required insured institutions to publicly disclose their relationship with the KDIC.

As capital injections were part of massive restructuring efforts, it appears that they did not receive any dedicated announcement before they were conducted. The first English mention of recapitalization efforts took place on December 5, 1997: an International Monetary Fund press release states that troubled Korean financial institutions would be restructured or recapitalized if deemed viable ([IMF Dec. 5, 1997 Press Release](#)). Later public dialogue between the Korean government and IMF officials confirm that capital injections were a part of the government’s restructuring plans ([LOI Feb. 7, 1998](#); [LOI July 24, 1998](#)).

The Korean government usually announced the type, size, and recipient of capital injection on an ad-hoc basis (ex: [KEU August 17, 1999](#)). Other forms of public disclosure included public fund management reports, reports from institutions themselves (as required by law), and press releases from various regulators. The Minister of Finance was required to write quarterly reports on the use of public funds to the Korean National Assembly, and the Public Fund Oversight Committee was required to publish an annual white paper on public fund management by the end of August ([BOK 2000 Report](#), p. 52). All financial supervisors, including the KDIC, Bank of Korea (BOK), MOFE, FSC, and Financial Supervisory Service

³⁹ The new DIF ran normal deposit insurance operations, collected insurance premiums, and dealt with new insolvencies from 2003 onward ([KDIC 2003](#), p. 17).

⁴⁰ The DIFBRF ought to be fully liquidated before December 31, 2027—afterwards, the remaining assets, debts, and other rights and duties will be turned over to the Treasury or the new Deposit Insurance Fund ([BOK 2002 Report](#), p. 58).

(FSS), publish reports at quarterly and/or annual intervals—each describes capital injections in varying levels of detail.

Each insured institution must publicly report the contents of its relationship with the KDIC—in accordance with public guidelines established on August 10, 1998 ([KDIC 1999](#), p. 12). To investigate the compliance, the KDIC may examine passbooks and promotional materials, public availability of pamphlets and posters provided by the KDIC for public distribution, and public availability of pamphlets containing a list of insured financial products ([KDIC 1999](#), p. 12). Furthermore, the KDIC publicly disclosed the contents of MOUs to improve the transparency of public fund injections ([KDI Financial Reform](#), p. 41).

6. The KDIC could inject capital into any failed insured institution or systemically important failing institutions, and the KDIC prioritized systemically important institutions.

The KDIC could assist an insured financial institution in three scenarios: (1.) an institution applied for financial assistance to smooth a merger, or the KDIC deemed financial assistance necessary to facilitate a merger; (2.) the KDIC determined that financial assistance was necessary for depositor security and the “stability of credit order,” or (3.) the FSC requested⁴¹ the KDIC to provide financial assistance ([DPA](#), Article 38).

The ASIFI authorized the KDIC and FSC to designate a financial institution as insolvent/failed⁴² if: (1.) liabilities exceeded assets due to business operations, major financial scandal, or accrual of non-performing loans; (2.) payments of claims (including deposits and money borrowed from other financial institutions) were suspended; (3.) the institution was unable to pay claims without outside support or separate borrowings (excluding borrowings ordinary financial transactions) from the FSC or KDIC’s Policy Committee (Seungkon Oh 2018, p. 17; ASIFI, Article 2; DPA, Article 2). Any institution at-risk of becoming an insolvent/failed institution was regarded as “insolvency-threatened” or “failing” ([KDIC 1998](#), p. 11, 39; DPA, Article 2; [ASIFI](#), Article 2).

With respect to *insolvent/failed* institutions, the KDIC could make deposit payoffs to depositors, arrange mergers, assign the transfer of contracts, or provide financial assistance in support of either of the previous processes (KDIC 1998, p. 11, 51-54; DPA,

⁴¹ Article 12 of the ASIFI permitted the Financial Services Commission to request the purchase of securities from an inviable financial institution ([ASIFI](#)). Article 5-5 of the ASIFI Enforcement Decree clarified that “securities” referred to government bonds, subordinated bonds issued by the inviable institution, or any security recognized by the FSC to be equivalent with the prior two types of securities.

⁴² Before 1998 amendments to the ASIFI, the definition of “insolvency” was limited to the suspension of deposit payments ([KDI Kwon 2016](#), p. 23).

Articles 35-2 to 38). “Financial assistance” referred to: extending loans or depositing funds, purchasing assets, guaranteeing or accepting obligations, and contributing capital ([KDIC 1998](#), p. 39, 54; DPA, Articles 2, 38). The Policy Committee decided which type of financial assistance to use ([KDIC 1998](#), p. 39, 54; DPA, Articles 2, 38). The KDIC could also arrange a merger or contract transfer by establishing new resolution financial institutions to take over the failed institutions ([KDIC 1998](#), p. 52-54; DPA, Articles 36-3 to 36-8).

The KDIC could aid *insolvency-threatened/failing* institutions if the Policy Committee determined that supporting an individual institution was necessary to protect depositors and to maintain the stability of the financial system ([KDIC 1998](#), p. 11; DPA, Articles 2, 38-2). Methods of assistance for failing institutions included liquidity support, contributions, or equity participation (KDIC 1998, p. 11; DPA, Article 38-2). The Ministry of Finance and Economy (MOFE) determined the list of securities that the KDIC Policy Committee could purchase from the failing financial institution ([KDIC 1998](#), p. 55; DPA Article 38-2).

The Korean government focused on the most systemically important institutions at the onset of the crisis, so the first wave of public support in late 1997 and 1998 was aimed at insolvent commercial and merchant banks ([Chopra et al. 2001](#), p. 38). In 1998, public funds capitalized Seoul Bank and Korea First Bank because if two prominent banks were liquidated, all remaining Korean banks likely would have endured bank runs with “severe systemic risk for the financial industry” ([Kim 1999](#), p. 148). Non-bank financial institutions were initially restructured under majority shareholders’ responsibility without government support because they were presumed free from systemic risk—exceptions were Korea Investment Trust Company and Daehan Investment Trust Company, which received public fund support in late 1999 ([Shin 2003](#), p. 10).

The Korean government diluted shareholder equity⁴³ to avoid moral hazard ([Chopra et al. 2001](#), p. 44). In August 1998, Korean authorities amended the ASIFI to further reduce the value of shareholder capital in the event of a write-down ([Baliño and Ubide 1999](#), p. 32; [Kataoka 1999](#), p. 17).

In 1998, the government agreed to support banks that did not merge by matching their private capital raises ([Claessens et al. 1998](#), p. 22). Thereafter, the KDIC had the right to review and assess management performance, and to take appropriate corrective action.

⁴³ Writing down capital was a frequent phenomenon during the restructuring process. For example: when four small banks were recapitalized at the end of 2000, all shareholder equity was written down ([Chopra et al. 2001](#), p. 44). Before the KDIC nationalized Seoul Bank and Korea First Bank in 1998, the FSC ordered them write down capital from KRW 820 billion to KRW 100 billion each, and the shareholders had to take losses ([Chopra et al. 2001](#), p. 148). In September 1998, the government demanded workforce reductions from Korea First Bank and Seoul Bank in exchange for capital injections ([Kyu-Sung Lee 2011](#), p. 214).

7. For potentially non-viable institutions, the Financial Supervisory Commission conducted Prompt Corrective Action (PCA) and could order a capital injection at any stage of PCA.

Prompt Corrective Action (PCA) is a regulatory framework in which financial supervisors can automatically issue orders to institutions that fail to meet management standards ([Kim et al. 2006](#), p. 262). The Korean government relied on PCA to minimize regulatory forbearance and to ease the taxpayer burden from rescuing financial institutions ([KDI Financial Reform](#), p. 32). PCA determinants for banks included the Basel capital adequacy ratio and CAMELS ratings, which are determined by supervisors ([FSS 2000](#), p. 65). The FSC/FSS issued PCA recommendations, requirements, and orders; the severity of PCA reflected the institution’s financial status ([KDI Financial Reform](#), p. 33). Though PCA did not permit the KDIC to directly inject capital, the FSC could order a capital injection at any stage of PCA—subject to the approval of the KDIC Policy Committee ([ASIFI](#), Article 11, Paragraph 2; [DPA](#), No. 6274, Article 38-2). The KDIC could also request the FSC to take action against a distressed financial institution ([KDIC 1998](#), p. 11). A full list of PCA enforcement criteria and actions from the year 2000 can be found in Tables I and II of the Appendix.

In March 1997, the Korean government established the legal basis for PCA procedures through the ASIFI ([Kataoka 1999](#), p. 17). As part of the IMF recommendations, the Korean government announced in late 1997 that all banks failing to meet the Basel minimum capital adequacy ratio of 8% by the end of 1997 would be identified as “potentially non-viable” ([FSS 2000](#), p. 52; [Luna-Martinez 2000](#), p. 17). After the Korean government established the FSC, the FSC subjected twelve banks to PCA for the first time on June 28, 1998, although PCA would only take effect in September ([Luna-Martinez 2000](#), p. 17). The MOFE evaluated merchant banks at the same time as commercial banks ([Kyu-Sung Lee 2011](#), p. 129, 130). The FSC began to evaluate non-bank financial institutions (insurance companies, investment and securities companies, mutual savings and finance companies, credit unions, and credit-specialized financial companies) and to issue PCA orders in the second and third quarters of 1998, respectively ([Kyu-Sung Lee 2011](#), p. 270; see Source Note). Non-bank financial institutions followed similar PCA procedures, with different measures of capital adequacy. Amendments to the ASIFI in September 1998 expanded the list of financial institutions eligible for government support, and increased the number of institutions subject⁴⁴ to PCA by financial supervisory authorities ([BOK 1998 Report](#), p. 42).

⁴⁴ In addition to those whose assets exceed liabilities or suspended deposit liabilities, “insolvent” or “failing” institutions also included institutions that were suspected to be insolvent ([BOK 1998 Report](#), p. 43). Financial scandal or non-performing assets—in addition to insufficient capital adequacy ratios—could warrant PCA ([BOK 1998 Report](#), p. 43).

8. Amidst capital injections and other rescue efforts, the government aligned financial supervision and prudential regulations with international standards.

Korean government's 1998 interventions were characterized by rescue, recapitalization, and resolution. 1999 ushered in new legal frameworks for prudential regulation and supervision ([Kyu-Sung Lee 2011](#), p. 286). The prudential overhaul signaled Korea's shift towards a market-based financial system ([Kyu-Sung Lee 2011](#), p. 286). To bring the Korean financial system up to international standards and practices, the Korean government needed to toughen the state's lax financial supervision and bolster market oversight ([Kyu-Sung Lee 2011](#), p. 287).

Lawmakers modeled banking supervision after the Basel Core Principles for Effective Banking Supervision, which shifted the overall methods⁴⁵ of financial supervision in Korea ([Kyu-Sung Lee 2011](#), p. 269). The government improved the management evaluation of financial companies⁴⁶ by adopting CAMEL bank ratings in October 1996, and added sensitivity to risk in 1998 ([Kyu-Sung Lee 2011](#), p. 270).

On September 2, 1998, the Economic Policy Coordination Committee (EPCC) recommended that banks⁴⁷ with BIS capital ratios lower than 8% raise them to at least 6% by March 1999, 8% by March 2000, and to 10% by December 2000 ([Kyu-Sung Lee 2011](#), p. 187, 270). The target for merchant banks was 8% by June 1999 ([Kyu-Sung Lee 2011](#), p. 270).

Beginning on July 1, 1998, supervisory authorities shortened the delinquency window for "precautionary" loans from 3-6 months to 1-3 months ([Kyu-Sung Lee 2011](#), p. 270). Loans delinquent for longer than three months were designated "substandard" ([Kyu-Sung Lee 2011](#), p. 270). Financial institutions also endured more stringent provision requirements

⁴⁵ Financial supervision shifted from: direct to indirect regulation, positive-list to negative-list regulation, abstract and political supervisory standards to transparent and objective standards, institution-specific supervision to function-oriented supervision, unconsolidated to consolidated supervision (including parent, subsidiary, and overseas branches), and regulation-focused to service-oriented oversight ([Kyu-Sung Lee 2011](#), p. 269).

⁴⁶ Management evaluation ratings for securities firms, insurance companies, and investment trusts came in January 1999 ([Kyu-Sung Lee 2011](#), p. 270).

⁴⁷ Along the same timeline, regional banks with no international clients faced targets of 4%, 6%, and 8% ([Kyu-Sung Lee 2011](#), p. 270).

for loan losses and write-offs in July 1998 ([Kyu-Sung Lee 2011](#), p. 271). Effective in December 31 1999, Forward-Looking Criteria (FLC) is a loan criteria that more accurately reflects the future abilities of borrowers to service their debt ([KDI Financial Reform](#), p. 35; [Kyu-Sung Lee 2011](#), p. 271). The government also revamped loan management practices⁴⁸ and implemented risk-based supervision ([Kyu-Sung Lee 2011](#), p. 271).

The government also changed definitions of capital. Starting January 1999, loan loss provisions for non-performing assets were deducted from Tier 2 capital within the capital adequacy ratio ([Shin and Hahm 1998](#), p. 67). Prior to May 1999, “equity capital” was the sum of paid-in-capital, reserves, and other surpluses ([FSS 2000](#), p. 57). After May 1999, “equity capital” referred to the sum of Tier 1 capital and Tier 2 capital, in accordance with Basel capital standards ([FSS 2000](#), p. 57).

Supervisory authorities gradually introduced mark-to-market accounting⁴⁹ to financial companies between the beginning of 1998 and the end of 1999 ([Kyu-Sung Lee 2011](#), p. 271). Other additions to the supervisory framework include Prompt Corrective Action (PCA), regulations on foreign exchange, reporting and disclosure requirements, and off-site surveillance ([Kyu-Sung Lee 2011](#), p. 269-272; see KDD 5, 7).

Stronger asset classification criteria and higher scrutiny of NPLs aimed to make the Korean financial system more efficient and stable ([Lim and Hahm 2004](#), p. 21). The Korean government introduced forward-looking criteria so that financial institutions would “take decisive actions on distressed firms” and decrease regulatory forbearance⁵⁰ ([Lim and Hahm 2004](#), p. 23). See Table VI for details on changes to asset classification. In light of

⁴⁸ Practices include the definition of equity capital, loans subject to the lending rules, and lending ceilings (to a single person, to a single business group, loans in excess of a certain amount, and to a large shareholder) ([Kyu-Sung Lee 2011](#), p. 292, 293).

⁴⁹ Prior to the new system, financial companies disclosed financial data to satisfy regulatory requirements rather than to inform investors and shareholders ([Kyu-Sung Lee 2011](#), p. 256). Under the old accounting regime, companies could easily distort financial statements by misrepresenting income and expenses ([Kyu-Sung Lee](#), p. 256). [Shin and Hahm \(1998\)](#) suggests that banks overstated their true BIS capital adequacy ratios through two practices: the recognition of parts of loan loss provisions as capital, and the partial recognition of stock revaluation losses (p. 22-25). The authors contend that in the early to mid-1990's, Korean banks overstated their true BIS capital adequacy ratios by 1-2% ([Shin and Hahm](#), p. 24).

⁵⁰ “Forbearance” refers to the “granting of exemptions or delaying intervention action in relation to banks as regards compliance with minimum regulatory requirements or intervention criteria” ([IADI Forbearance Definition](#)).

corporate failures and investor losses⁵¹, the Korean government's institutional reforms appeared credible ([Lim and Hahm 2004](#), p. 21).

The new loan classification and provisioning standards effectively classified most banks as undercapitalized ([Myung-Koo Kang 2009](#), p. 250). Between 1998 and 1999, the new rules increased non-performing loans by about KRW 45 trillion ([Myung-Koo Kang 2009](#), p. 246, 247). After the Daewoo Group's insolvency and failure in 1999, additional financial restructuring efforts appeared inevitable ([KDIC 2003](#), p. 15). In addition to the new rules, overall economic contractions and tightening fiscal and monetary policy created KRW 93 trillion of additional NPLs in the banking sector ([KDIC 2003](#), p. 15; [Myung-Koo Kang 2009](#), p. 247). In response to the deteriorating economic conditions, the Korean government launched the second phase of restructuring in September 2000: raising KRW 40 trillion of public funds bonds and injecting them into the financial sector ([KDIC 2003](#), p. 15; [Myung-Koo Kang 2009](#), p. 247).

9. Non-KDIC recapitalization measures included securities exchanges with government-owned shares.

The Korean government recapitalized financial institutions by purchasing common stock preferred equity, subordinated debt, NPLs, assets, the payout of deposit-insurance policies, and directly injecting cash ([Balino and Ubide 1999](#), p. 37, 38). Non-KDIC government agencies financed these activities through KAMCO bond issuances, the government budget, and the exchange of government shares of subordinated debt—depending on the mode of recapitalization ([Balino and Ubide 1999](#), p. 37, 38). When banks' turnaround plans involved foreign capital, the government recapitalized them by purchasing subordinated bonds ([Kyu-Sung Lee 2011](#), p. 189). To recapitalize state-owned banks, the Korean government directly provided state-owned property⁵² in addition to cash contributions ([Kyu-Sung Lee 2011](#), p. 261). See Table VII in the Appendix for an example of early financial restructuring.

⁵¹ Daewoo was one of the top five chaebol, and it failed in 1999 ([Lim and Hahm 2004](#), p. 23). The government used taxpayer money to allow Daewoo creditors to redeem their corporate bonds at a 5% loss, which was a shift away from "too-big-to-fail" ([Lim and Hahm 2004](#), p. 23).

⁵² Between September 15 and November 10, 1998, the Korean government infused cash worth KRW 1.35 trillion into the Korea Development Bank, KRW 100 billion into the Export-Import Bank of Korea, and KRW 200 billion into the Industrial Bank of Korea ([Kyu-Sung Lee 2011](#), p. 261). The government also transferred its own shares of KT&G and POSCO worth KRW 1.5 trillion to the Industrial Bank of Korea ([Kyu-Sung Lee 2011](#), p. 261). On December 31, 1998, the government transferred shares—including shares of the Korea National Housing Corporation—worth KRW 3.4 trillion to the Korea Development Bank ([Kyu-Sung Lee 2011](#), p. 261). The Export-Import bank also received KRW 450 billion worth of government-owned shares ([Kyu-Sung Lee 2011](#), p. 261).

10. Participating institutions in the capital injection were required to sign a Memoranda of Understanding with KDIC and it could directly manage institutions when they failed to abide by the terms of the MOUs.

In addition to PCA, the FSC relied on informal supervisory actions to improve the relationship between financial institutions and supervisory authorities ([KDI Financial Reform](#), p. 33). The FSC could require institutions to submit management improvement plans, letters of commitment, or memoranda of understanding (MOUs) ([KDI Financial Reform](#), p. 33). Under the SAMPF, public funds recipients were obliged to conclude MOUs with government agencies to prevent moral hazard ([SAMPF](#), Article 14, Paragraph 3; [SAMPF Enforcement Decree](#), Article 8). 14 financial institutions had to enter into MOUs with the KDIC after receiving capital injections, and the majority were signed in 2000 ([KDIC 2018](#), p. 88). The KDIC actively added and adjusted business performance targets from the date of origination through the year 2018 ([KDIC 2018](#), p. 88). The KDIC terminated 12 MOUs after institutions either merged with or were acquired by larger financial institutions ([KDIC 2018](#), p. 88).

Each MOU contains a main text, a business normalization plan, and document attachments⁵³ ([KDIC Risk Management](#)). These plans include details on a financial institution's target capital adequacy ratio⁵⁴, profit-to-assets ratio, bad-loan ratio, restructuring plans, and the written consent of the in-house labor union to restructuring ([BOK 2000 Report](#), p. 52). The government standardized and publicly announced the contents of the MOUs ([KDI Financial Reform](#), p. 41). The government evaluated MOU adherence on a quarterly basis, allowing financial supervisors to take punitive action against non-adherence ([KDIC 2000](#), p. 35). From MOUs, the KDIC maintained broad informational authority, and could request the institution to provide documentation at regular intervals, to create Implementation Plans, and to notify the KDIC of any interruptions to the institution's completion of responsibilities ([Kyongnam Bank MOU](#), Articles 3-6). The KDIC could also request information indirectly from the Financial Supervisory Commission (FSC) or the Financial Supervisory Service (FSS) ([KDIC](#)

⁵³ The main text describes the institution's responsibility to follow the business normalization plan on an agreed-upon schedule ([KDIC Risk Management](#)). The business normalization plan describes the institution's plans to better its balance sheet and measures to strengthen other financial and non-financial indicators ([KDIC Risk Management](#)). The attached documents include a pledge to implement the MOU and management/staff signatures ([KDIC Risk Management](#)).

⁵⁴ Following an agreement with the World Bank, minimum BIS targets for banks were 10% after signing MOUs ([Public Funding FAQ](#)). The Korean government believed 10% was necessary for financial soundness in the business normalization process ([Public Funding FAQ](#)).

1999, p. 12, 15). The KDIC could directly manage institutions when they failed to abide by the terms of the MOUs ([Kyongnam Bank MOU](#), Article 9).

11. KDIC managed and staffed institutions to strengthen their management.

To quickly recover public funds, the KDIC aimed to improve the value of the assets (including equity) by strengthening the financial status of the underlying institution ([KDIC 1999](#), p. 29). KDIC attempted to help the institution by fortifying their human resource management, supporting various restructuring efforts, and establishing and implementing new budgets ([KDIC 1999](#), p. 29). If the management did not comply, the KDIC could assume legal rights to take “appropriate legal actions to accomplish [the KDIC’s] objectives” ([KDIC 1999](#), p. 11). From related government agencies, the KDIC could request information about the assets of failed institutions, their managers, and their officers ([KDIC 1999](#), p. 11). In January 1998, the government amended the ASIFI to order capital write-downs for the existing shareholders responsible for the insolvency of banks that the government has recapitalized or decided to recapitalize ([Kataoka 1999](#), p. 17). The KDIC could demand damage payments from the management (“managerial entity”) of a failed institution ([KDIC 1999](#), p. 11). The KDIC monitored management’s adherence to normalization plans on a quarterly basis, and requested the FSC to take necessary action if the institution failed to hit the MOU targets ([KDIC 2000](#), p. 31).

“Regulations Concerning the Accountable Management of Financial Institutions and the Guarantee of the Transparency of the Financial Administration” was established on November 13, 2000 ([BOK 2000 Report](#), p. 55). Its purpose was to aid the financial supervisory institution to establish financial policy, and to execute its supervisory responsibilities through “objective and transparent procedures” ([BOK 2000 Report](#), p. 55). This law forbade the financial supervisory institution from making unwarranted interventions in its management of financial institutions ([BOK 2000 Report](#), p. 55). The financial supervisory institution must request support or cooperation (from financial institutions) through writing or at a formal meeting ([BOK 2000 Report](#), p. 55). The government and KDIC were requested to dispose of their shareholdings in these financial institutions as quickly as possible ([BOK 2000 Report](#), p. 55).

Other efforts to improve bank management included improvements to governance and ownership structures ([Shin and Hahm 1998](#), p. 60). Rights of minority shareholders were strengthened ([Lim and Hahm 2004](#), p. 24). Controlling shareholders sometimes impeded the restructuring process ([Lim and Hahm 2004](#), p. 20).

12. To recover public funds, the Korean government created a Public Fund Oversight Committee, legalized holding companies, removed limits on foreign and investment trust ownership of domestic companies, and granted the KDIC administrator roles in bankruptcy proceedings.

The KDIC recovered the costs of capital injections by selling equity stakes, accumulating equity dividends, and collecting bankruptcy dividends⁵⁵ ([KDIC 2001](#), p. 30). However, the KDIC did not authorize equity dispositions on its own. The Special Act on the Management of Public Funds (SAMPF) established a Public Fund Oversight Committee (PFOC)⁵⁶ at the Ministry of Finance and Economy (MOFE); PFOC oversaw public funds, including approving and arranging their provision and collection ([BOK 2000 Report](#), p. 52). Within the Public Fund Oversight Committee, a Sales Screening Subcommittee decided when and how the KDIC and other government agencies ought to dispose of assets (including stock holdings and equity participation) ([BOK 2000 Report](#), p. 52). If a recipient of public funds were to become insolvent or to dissolve, the court was required to designate the KDIC or a member of its staff as a receiver or liquidator for a minimum of five years ([BOK 2000 Report](#), p. 52; [KDIC 2000](#), p. 36).

Following a change to the DPA, the KDIC could recover public funds more efficiently by performing liquidator and bankruptcy administrator roles itself⁵⁷, beginning in 2000 ([KDIC 1999 Report](#), p. 31; [DPA](#), Article 35-8). With the goal of completing early bankruptcy proceedings, the KDIC also planned to file subrogation damage claim lawsuits and/or to participate in relevant lawsuits via the revised regulations ([KDIC 1999 Report](#), p. 31).

A major objective of privatization was to recoup public funds injected for financial restructuring, so the Korean government began selling nationalized banks to foreign investors in late 1999 ([Kim et al. 2006](#), p. 262). The Korean government encouraged foreign investment to increase the capital base of viable financial institutions⁵⁸ ([Shin and Hahn](#)

⁵⁵ To effectively recover public funds, including those used for recapitalization, the KDIC studied foreign schemes ([KDIC 1999 Report](#), p. 34). From the United States, the KDIC obtained information on the U.S. FDIC's failed bank resolution and the U.S. Resolution Trust Corporation's (RTC) resolution of failed savings and loan associations ([KDIC 1999 Report](#), p. 34). The KDIC also studied U.S. and Japanese modes of debenture recovery through asset management/disposal contracts ([KDIC 1999 Report](#), p. 34). To prevent moral hazard, the KDIC studied resolution procedures, relevant regulations, and legal actions taken by the U.S. and Japanese governments against financial crime. The KDIC attempted to create effective and preventive anti-failure measures by developing assumptions of damage claim rights ([KDIC 1999 Report](#), p. 34).

⁵⁶ The use of public funds to manage and resolve financial institutions was politically contentious, and there were strong negative public reactions to "the injection of taxpayer money to rescue essentially private financial institutions" ([Myung-Koo Kang 2009](#), p. 248). Korean authorities created PFOC in late 2000—after the majority of capital injections had already taken place ([Myung-Koo Kang 2009](#), p. 248, 250). Myung-Koo Kang suggests that the Korean government created PFOC in an attempt to divert public criticism ([Myung-Koo Kang 2009](#), p. 248).

⁵⁷ KDIC was able to actively seek recovery efforts by convincing courts and bankruptcy estate trustees to adopt an auditor system under Bankruptcy Law ([KDIC 2000 Report](#), p. 23). Under the SAMPF, the KDIC developed criteria for how to dispose of and manage the assets held by bankruptcy estates ([KDIC 2000](#), p. 24; [SAMPF](#)). To analyze performance, KDIC also developed annual plans for recovery and trustee dividend distribution for each estate ([KDIC 2000](#), p. 24).

⁵⁸ The banking sector depended on the flow of foreign capital because the Korean government was only willing to support part of the recapitalization, domestic capital markets were insufficient, and there were legal restrictions on chaebol ownership of banks ([Shin and Hahn 1998](#), p. 59).

1998, p. 49). The Korean government raised the ceiling on foreign ownership from 7% to 50% between November and December 1997, and completely eliminated it by May 1998—six months after the onset of the crisis ([Myung-Koo Kang 2009](#), p. 262). In 1998, the Korean government also eliminated a rule that required the boards of directors to approve a foreign institution’s purchase of at least one third of a company’s outstanding shares ([Lee 2004](#), p. 101).

On September 16, 1998, the government amended the Securities Investment Trust Act, and repealed caps on equity ownership by individual investment trusts ([Kyu-Sung Lee 2011](#), p. 205, 206). The move permitted controlling shareholders of investment trusts to aid restructuring efforts via recapitalization ([Kyu-Sung Lee 2011](#), p. 206).

In the past, the Korean government prohibited financial institutions from setting up financial holding companies (FHC) out of fear that they would stifle the financial sector and create systemic risk ([Ro 2001](#), p. 97). Commercial banks’ refusal to participate in mergers led the government to adopt FHC-friendly⁵⁹ legislation ([Ro 2001](#), p. 97). In October 2000, the Korean National Assembly passed the Financial Holding Company Act, which permitted the creation of financial holding companies with government approval ([Ro 2001](#), p. 97; [Financial Holding Companies Act](#)). In December 2000, the FSC/FSS created the “Regulation on Supervision of Financial Holding Companies” to establish authorization criteria for institutions to either start financial holding companies⁶⁰ or to join them as subsidiaries ([Kim et al. 2006](#), p. 264).

On March 27, 2001, the KDIC established Woori Finance Holdings Company (FHC) as a wholly owned subsidiary through the stock transfers of four banks (Hanvit, Peace, Kwangju, and Kyungnam) and one merchant bank (Hanaro, later “Woori Merchant Bank”) ([KDIC 2001](#), p. 21). Each member received a capital injection to raise its capital adequacy ratio above 10% before it became a subsidiary of Woori FHC ([Hahm and Kim 2006](#), p. 153). The KDIC suggests that Woori’s establishment reflects the KDIC’s own effort to recover public funds quickly ([KDIC 2001](#), p. 21). Later government financial holding companies include Shinhan Financial Group (September 2001) and Dongwon Financial Group (May 2003)—both groups incorporated non-bank financial institutions ([Kim et al. 2006](#), p. 264; [Hahm and Kim 2006](#), p. 154).

⁵⁹ The Korean government hoped that staff resistance would lower for takeovers by FHC than takeovers by other banks because affiliated companies would be able to avoid employee downsizing—in contrast with the P&A approach of 1998, which incited employee resistance ([Ro 2001](#), p. 97; [Hahm and Kim 2006](#), p. 153).

⁶⁰ As with mergers, the Korean government offered relatively healthier banks priority approval if they were willing to integrate voluntarily as holding companies ([Ro 2001](#), p. 97).

III. Evaluation

Evaluations of the Korean government’s financial restructuring efforts were generally positive ([Kang 2004](#), p. 132). Popular topics of criticism included moral hazard, the health of financial institutions after capital injections, the consolidation of the financial system, and the asymmetric focus on the banking sector.

In a March 1999 discussion paper for Columbia Business School, Hinori Kataoka praised the Korean government for injecting public funds (and capital) promptly ([Kataoka 1999](#), p. 21). However, he hypothesized the likelihood of further government spending, as Korean banks were not experienced in commercial risk management ([Kataoka 1999](#), p. 21). The author also expressed concerns over moral hazard for banks that expected capital injections by the government ([Kataoka 1999](#), p. 21). In the author’s view, the 8% benchmark BIS capital adequacy ratio—industry standard for banks in 1999—was too low ([Kataoka 1999](#), p. 29).

Hun-Jai Lee, the former Financial Supervisory Commissioner and Minister of Finance and Economy, argued that there was too much capital injected into banks during the second round of restructuring ([KDI Financial Reform](#), p. 47). He was concerned that banks would have little incentive to self-restructure after receiving excess government capital, and that it would be a challenge for the government to privatize them. Lee was critical of the level of recapitalization in the financial restructuring process ([KDI Financial Reform](#), p. 47).

Stijn Claessens, Swati Ghosh, and David Scott wrote a paper entitled “Korea’s Financial Sector Reforms” for the October 1998 conference [“Korean Economic Restructuring: Evaluation and Prospects.”](#) Yoon Je Cho⁶¹ was a referee for the paper, and commented, “The government just pumped money without ensuring that these things will come in conjunction with bank recapitalization. So, there is risk that the money the government has put in might have been wasted” ([Yoon Je Cho 1998](#), p. 42, 43). Yoon Je Cho questioned the incentives that financial institutions would have to restructure management, to improve credit management, or to reorganize internally (“these things”) after receiving capital injections ([Yoon Je Cho 1998](#), p. 42, 43).

Gongpil Choi argued that the sharp revision of capital adequacy requirements contributed to a credit slowdown that disproportionately harmed small and medium-sized enterprises (SME), which consequently suffered chronic depressions ([Choi 2000](#), p. 111).

In a 2001 BIS paper, Hyung-Gon Ro claimed that the first round of restructuring “cannot be judged a success” because several banks, despite receiving large sums of public fund injections, had significant amounts of bad loans and could not hit the 8% BIS capital

⁶¹ At the time of writing, Yoon Je Cho is Korea’s Ambassador to the United States, and formerly held posts at the Korea Institute of Public Finance, World Bank, International Monetary Fund, and Sogang University ([Sogang Profile](#)).

adequacy ratio by the end of 2000 ([Ro 2001](#), p. 98). The author also suggested that mergers did not guarantee better management performance; though KRW 3 trillion was injected to recapitalize Hanvit Bank (the product of the merger between Korea Commercial Bank and Hanil Bank), it soon required an additional KRW 3 trillion of public funds ([Ro 2001](#), p. 94, 98).

[Chopra et al. \(2001\)](#), written in October 2001, took a more positive tone: “The viability [of the financial system] has been enhanced” (p. 47). The authors highlighted the status of bank capital, which almost all Korean banks held above minimum requirements at the time of writing ([Chopra et al. 2001](#), p. 47). The authors acknowledged that some small institutions (not systemically important) were nationalized rather than closed—partly for political purposes, and partly from cost-benefit analyses of alternative resolution measures ([Chopra et al. 2001](#), p. 51). They warned that the inclusion of four small banks (Peace, Kwangju, Cheju, and Kyongnam) with one large bank (Hanvit) under a single financial holding company could stifle the recovery of all of the institutions involved ([Chopra et al. 2001](#), p. 50, 51). The authors also argued that creating financial conglomerates before properly revising supervisory and regulatory measures could create new vulnerabilities ([Chopra et al. 2001](#), p. 51). The authors emphasized the need for an effective exit strategy from government capital injections; state ownership of banks may result in higher rates of public fund recovery, but it could hinder the banks’ future profitability ([Chopra et al. 2001](#), p. 81). Finally, the authors suggested that foreign capital was vital in stabilizing the economy as well as recapitalizing the financial system ([Chopra et al. 2001](#), p. 81). Considering the constraints on domestic investors, foreign capital was an important source of funding ([Chopra et al. 2001](#), p. 81). The alternatives—allowing *chaebol* to increase their control over banks, or relying on more public funds—would have been politically challenging and led to “disastrous” results ([Chopra et al. 2001](#), p. 81).

A 2010 Korean Development Institute (KDI) report about Korea's post-crisis financial reform suggested that the use of public funds to compensate for the failure of financial institutions and markets “[defied] fairness and the principle of market discipline,” but was a necessary response to the threat of a systemic crisis ([KDI Financial Reform](#), p. 48). The authors argued that the Korean government employed the public funds with utmost scrutiny, as “not a single Won was used outside of aiding financial institutions” ([KDI Financial Reform](#), p. 48). The report emphasized the speed and efficiency with which Korean public officials were able to mobilize public funds after the onset of the crisis ([KDI Financial Reform](#), p. 49). The authors contrasted the smooth roll-out of the first round of restructuring with the delayed second round of restructuring, which elongated the financial and corporate restructuring between 1999 and 2000 ([KDI Financial Reform](#), p. 49).

The KDI authors recognized that the extended restructuring process forced the Korean government to establish a system of public fund management ([KDI Financial Reform](#), p. 49). There was no formal cost-and-benefit analysis before the first round of restructuring, so the need for a second round of public funds galvanized the government into a systematic, transparent, and cost-saving approach ([KDI Financial Reform](#), p. 49).

Commenting on the Korean government's exit strategy, [Myung-Koo Kang \(2009\)](#) expressed skepticism about the increase of foreign ownership of domestic commercial banks and its effect on the competitiveness and efficiency of the Korean financial sector ([Myung-Koo Kang 2009](#), p. 266). The author established a relationship between financial consolidation, nationalization through capital injections, and privatization—the so-called “Shock Therapy” approach ([Myung-Koo Kang 2009](#), p. 265). After the crisis, foreign owned banks engaged in more retail banking than domestically owned banks—which reduced loans to the corporate sector ([Myung-Koo Kang 2009](#), p. 266). Furthermore, Korean households took out loans mostly to finance house purchases, and began to post their homes as collateral ([Myung-Koo Kang 2009](#), p. 266). The author argues that the government's large and fast financial restructuring scheme did not allocate financial resources to the most productive sectors of the Korean economy, and that the government inadvertently shifted costs to “economically and politically underrepresented social groups, in particular, non-homeowners and small firms” ([Myung-Koo Kang 2009](#), p. 266).

Some scholars were wary of the consolidation of the Korean financial sector. Joon-Ho Hahm and Joon-Kyung Kim suggested that consolidation raised the systemic risk potential through direct and indirect interdependencies⁶² between large banking institutions ([Hahm and Kim 2006](#), p. 146). The authors argued that consolidation can also lead to regulatory forbearance, concentration and difficulty of orderly workouts, and opacity and informational asymmetry ([Hahm and Kim 2006](#), p. 159). They also contended that Korean financial conglomerates faced greater risks from non-bank sectors and capital markets ([Hahm and Kim 2006](#), p. 146).

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⁶² Factors of direct interdependencies include short-term inter-bank lending, medium and long-term loans, and over-the-counter derivatives transactions ([Hahm and Kim 2006](#), p. 159). Factors of indirect interdependencies include homogeneous balance sheet structures, homogeneous business/profit structures, and common exposure to market risks ([Hahm and Kim 2006](#), p. 159).

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VI. Appendix

Figure 2: Trend of Banking Industry Change

1997.12	1998.6	1999.1-6	1999.7-12	2000	2001	2002	2003	Current
Commercial		Hanvit			Woori BHC			Woori BHC (Woori) (Kwangju) (Kyongnam)
Hanil								
Peace								
Kwangju								
Kyongnam								
Chohung		Chohung	Chohung				Shinhan BHC	Shinhan BHC (Shinhan) (Chohung) (Cheju)
Chungbuk								
Kangwon								
Shinhan	Shinhan					Shinhan BHC		
Donghwa								
Cheju								
Hana	Hana	Hana				Hana		Hana
Chungchong								
Boram								
Seoul								
Kookmin	Kookmin	Kookmin			Kookmin			Kookmin
Daedong								
Longterm Credit								
Housing	Housing							
Dongnam								
Koram	Koram							Citibank Korea ¹
Kyongki								
First								SC First
Exchange								Exchange
Daegu								Daegu
Chonbuk								Chonbuk
Pusan								Pusan
Agricultural Cooperatives				Agri-cultural Cooperatives				Agricultural Cooperatives
Livestock Cooperatives								
Fisheries Cooperatives								Fisheries Cooperatives

¹ Citibank Korea was established by consolidating the fifteen branches of Citibank in Korea and Koram Bank on November 1, 2004.

Table obtained from Kim et al. (2006), p. 261.

Type of PCA	Table I: PCA Enforcement Criteria				
	Banks	Merchant Bank Corporations (MBC)	Mutual Savings & Finance Companies (MS&F)	Securities Companies	Insurance Companies
Management Improvement Recommendation	<ul style="list-style-type: none"> · BIS capital ratio below 8% · Asset quality or capital adequacy is 4/5, AND the overall CAMELS evaluation is 1/2/3 	<ul style="list-style-type: none"> · BIS capital ratio below 8% · Asset quality or capital adequacy is 4/5, AND the overall CAMELS evaluation is 1/2/3 	<ul style="list-style-type: none"> · BIS capital ratio below 4% 	<ul style="list-style-type: none"> · equity capital ratio below 150% · overall management is grade 3/4/5, AND capital adequacy is also grade 4/5 	<ul style="list-style-type: none"> · solvency margin ratio between 100% and 50% · solvency margin or asset soundness is grade 4/5, AND general evaluation is also grade 1/2/3 · insurer is expected to fall under one of the above
Management Improvement Requirement	<ul style="list-style-type: none"> · BIS capital ratio is below 6% · overall CAMELS evaluation is 4/5 	<ul style="list-style-type: none"> · BIS capital ratio is below 6% · overall CAMELS evaluation is 4/5 	<ul style="list-style-type: none"> · BIS capital ratio below 2% 	<ul style="list-style-type: none"> · Equity capital ratio below 120% · overall management is grade 4/5 	<ul style="list-style-type: none"> · solvency margin ratio between 50% and 0% · insurer is grade 4/5 in general evaluation · insurer is expected to fall under one of the above
Management Improvement	<ul style="list-style-type: none"> · BIS capital ratio is below 2% 	<ul style="list-style-type: none"> · BIS capital ratio is below 2% 	<ul style="list-style-type: none"> · BIS capital ratio 	<ul style="list-style-type: none"> · Equity capital ratio 	<ul style="list-style-type: none"> · solvency margin ratio

<p>Order</p>	<ul style="list-style-type: none"> · bank is determined to be “failing” according to the Act on Structural Improvement of Financial Industry (ASIFI, Article 2; see footnote) · normal operations are hindered, bank unable to implement management improvement plan 	<ul style="list-style-type: none"> · bank is determined to be “failing” according to the Act on Structural Improvement of Financial Industry (ASIFI, Article 2; see footnote) · normal operations are hindered, bank unable to implement management improvement plan 	<p>below 1%</p>	<p>less than 100%</p> <ul style="list-style-type: none"> · assets to liabilities ratio less than 1:1 	<p>is below 0%</p> <ul style="list-style-type: none"> · insurer is determined to be “failing” according to the Act on Structural Improvement of Financial Industry (ASIFI, Article 2; see footnote)
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Notes:

There are three scenarios in which the KDIC or Financial Supervisory Commission (FSC) can designate a “failing” or “distressed” financial institution: (1.) insured financial institutions whose liabilities exceed assets due to an inspection of management conditions, or the occurrence of significant financial losses or non-performing assets, (2.) insured financial institutions that suspend deposit payments and other claims or redemption of borrowed money from other financial institutions, and (3.) insured financial institutions that the KDIC or FSC determines is unable to pay deposits and other claims or redeem borrowed money without financial assistance or separate external borrowing (excluding borrowing from ordinary financial transactions) ([KDIC 1998](#), p. 11; [DPA](#), Article 38; [ASIFI](#), Article 2).

The table was created by the author. Information obtained from [FSS 2000](#), p. 65-67 (banks); p. 80, 81 (non-bank financial institutions); p. 93-95 (securities companies); p. 146, 147 (insurance companies).

Type of PCA	Table II: PCA Enforcement Action		
	Banks, Non-bank Financial Institutions (MBC, MS&F)	Securities Companies	Insurance Companies
Management Improvement Recommendation	<ul style="list-style-type: none"> · improvement of organizational structures · establishment of specific allowances · restrictions on investment into fixed assets · restriction on entry to new business area, new investments, or profit dividends 	<ul style="list-style-type: none"> · improvement of manpower and organization management · curtailment of expenditures · efficient management of branches · disposition of non-performing assets · restriction on any practices causing a decrease in net capital · increase or decrease in pain-in capital 	<ul style="list-style-type: none"> · caution or warning against an insurer or directors · increase in, or reduction of paid-in capital · curtailment of net operating expenses · management improvement of business offices · restrictions on investment of fixed assets · disposal of non-performing assets · improvement of manpower and institution

	<ul style="list-style-type: none"> · reduction or increase of its capital · reduction of non-performing assets 	<ul style="list-style-type: none"> · freeze on new investments 	<p>management</p> <ul style="list-style-type: none"> · prohibition of acquisition of treasury stocks · restrictions on dividend and policyholders' dividend · restrictions of new businesses or new capital investments · rate adjustment advice
Management Improvement Requirement	<ul style="list-style-type: none"> · "Recommendation" measures · closure or consolidation of operating offices · freeze on new investment · a reduction of risk assets · a control of deposit interest rates · a change of senior management and external auditors · suspension from some parts of business · submitting plan for merger with or acquisition by other financial institutions 	<ul style="list-style-type: none"> · "Recommendation" measures · restrictions on holding high risk assets and disposition of assets · closure, consolidation or restrictions on opening places of business offices · curtailment of organization · disposal of subsidiaries · demand for change in officers' duties · suspension of part of business · measures taken in case of management improvement recommendation 	<ul style="list-style-type: none"> · "Recommendation" measures · closure, consolidation, or restriction on opening places of business · demand for change of officers · suspension of part of business · reduction of manpower and institution · planning of a merger, acquisition by a third party, or assignment of all or part of a business · restriction on holding risk assets and disposition of assets · resettlement of subsidiaries · reinsurance placement
Management Improvement	<ul style="list-style-type: none"> · "Requirement" measures 	<ul style="list-style-type: none"> · "Requirement" measures 	<ul style="list-style-type: none"> · "Requirement" measures

<p>Order</p>	<ul style="list-style-type: none"> · write-down of its stocks · suspension from the duty of top management · appointment of a receiver · inclusion in the financial holding company · merger with or acquisition by other financial institutions · suspension from operating business within six months or request for revocation of its banking license, etc. 	<ul style="list-style-type: none"> · partial retirement of stocks (including retirement of all stocks owned by some stockholders) or combination of shares · suspension of business execution by officers and appointment of an administrator · merger · assignment of all or part of business · acquisition of the securities company concerned by a third party 	<ul style="list-style-type: none"> · retirement of part or all of the issued stocks · suspension of business execution of officers and appointment of insurance administrator · suspension of all insurance businesses within six (6) months · transfer of all or part of contracts · merger · assumption of insurance business by a third party · assignment of all or part of business
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Notes:

Many of the extreme “Order” protocol, such as cancellation of share capital, cessation of business operations, etc. were added on September 14, 1998 by an amendment to the Act Concerning the Structural Improvement of the Financial Industry (ASIFI) ([BOK 1998 Report](#), p. 42; [ASIFI](#)).

The table was created by the author. Information obtained from [FSS 2000](#), p. 65-67 (banks); p. 80, 81 (non-bank financial institutions); p. 93-95 (securities companies); p. 146, 147 (insurance companies).

Table III: Issuance of Deposit Insurance Fund Redemption Fund Bonds by Financial Sector (Unit: billions of won)						
	1998	1999	2000	2001	2002	Total
Banks	12,065.0	15,859.1	6,030.7	7,761.7	3,660.0	45,376.5
Securities Companies	16.0	0.3	-	3,218.5	-	3,234.8
Life Insurance Companies	1,153.4	4,142.2	-	2,412.0	-	7,707.6
Non-life Insurance Companies	-	67.8	1,000.0	6,769.9	-	7,864.7
Merchant Banks	6,512.0	-	1,260.0	7,334.2	-	15,106.2
Mutual Savings Banks	991.7	1,597.7	650.0	3,333.2	-	6,572.6

Credit Unions	276.9	817.9	-	202.8	-	1,297.6
Total	21,015.0	22,485.0	8,940.7	31,059.3	3,660.0	87,160.0
Table created by author. Data obtained from KDIC 2003 , p. 18.						

Table IV: Issuance of Deposit Insurance Bond Redemption Fund Bonds by Maturity (Unit: billions of won)							
	1998	1999	2000	2001	2002	2003	Total
3 Year	-	-	-	2,650.0	-	-	2,650.0
3 Year ¹	-	5,866.0	-	-	-	-	5,866.0
3 Years, 3 Months	329.5	-	-	-	-	-	329.5
5 Years	8,112.1	6,566.6	8,940.7	14,528.8	3,660.0	-	41,808.2
5 Years, 3 Months	1,192.3	-	-	-	-	-	1,192.3
5 Years, 6 Months	1,625.0	-	-	-	-	-	1,625.0

6 Years	1,625.0	-	-	-	-	-	1,625.0
6 Years, 6 Months	1,625.0	-	-	-	-	-	1,625.0
7 Years	1,625.0	113.3	-	9,926.0	-	-	11,664.3
7 Years ²	4,881.1	9,949.1	-	3,954.5	-	-	18,784.7
Total	21,015.0	22,485.0	8,940.7	31,059.3	3,660.0	-	87,160.0

1. 1-year deferred; pay 6.25% every three months seven times for two years, and pay 56.25% at maturity. The Korean government exempted the KDIC and KAMCO from borrowings received from Special Accounts for Treasury loans for interest repayment on DIF/DIFBRF Bonds and NPL Resolution Bonds ([BOK 2002 Report](#), p. 57, 58). With less principal and interest to repay on DIF bonds, the KDIC had a lower overall financial burden.

2. 5-year deferred; pay four equal amounts semiannually for over a 2-year period.

Table created by author. Data obtained from [KDIC 2003](#), p. 19.

Table V: Issuance of Deposit Insurance Fund Redemption Fund Bonds by Interest Rate (Unit: billions of won)							
	1998	1999	2000	2001	2002	2003	Total
Fixed Rate	9,201.5	4,950.0	8,940.7	25,216.4	3,660.0	-	51,968.6
Floating Rate ¹	11,813.5	17,535.0	-	5,824.9	-	-	35,191.4

Total	21,015.0	22,485.0	8,940.7	31,059.3	3,660.0	-	87,160.0
<p>1. Floating bond rates were originally linked to the yields of Korean National Housing Bonds (KDIC 2002, p. 20). Beginning in 2003, interest rates became linked to government bonds of equivalent maturity length (KDIC 2003, p. 18).</p> <p>Table created by author. Data obtained from KDIC 2003, p. 18, 19.</p>							

Table VI: Changes in Standards for Asset Classification		
	Previous Standards	Forward-Looking Criteria
Character	-Uniform standards for all banks -Banks have no own standards	-Minimum guideline -Banks establish own standards
Assets subject to classification	-Limited to 13 items including loans, guarantees	-Expanded to all the assets that banks need to classify, including lease assets
Classification of loans	-Based mainly on past performance of borrowers -No distinction between corporate loans and household loans	-Based primarily on borrowers' capacity to repay, and additionally on borrowers' past due, and dishonor -Household loans are classified based solely on past due period
Classification of foreign bills bought	-Separate standards are applied	-In principle, the same standards of loans are applied, except when necessary due to guarantors' different credit
Classification of securities	-Primarily based on valuation and credit risks of issuers Securities subject to market-to-market or equity methods are exempt from classification	-Based on issuers' credit ratings (by banks' own credit risk rating model, or credit rating agencies) -All securities are subject to classification without exemption
Restructured loans	-No standards for restructured loans	-Separate standards for restructured loans
Information obtained from FSS 2000 , p. 53.		

Table VII: Cost of Financial Restructuring in Korea through March 1999		
Action	Method of Finance	Amount in trillions of KRW [percentage of GDP]
December 1997 – January 1998 Measures		
Equity Purchase	Exchange of Shares	4.5 [1.1]
	KDIC Bonds	1.5 [0.3]
Subordinated Debt Purchase	Exchange of Shares	4.4 [1.1]
Purchase Non-performing Loans (NPLs)	KAMCO Bonds	7.5 [1.2]
Deposit Insurance Payout	KDIC Bonds	5 [1.1]
May 20 th Plan		
Recapitalization	KDIC Bonds	16 [3.7]
Purchase of Non-performing Loans (NPLs)	KAMCO Bonds	25 [5.8]
Deposit Insurance Payout	KDIC Bonds	9 [2.1]
August 1998 Supplementary Budget		
Recapitalization	Government Budget	1.3 [0.3]
	Total:	74.2 [17.5]
Table created by author. Data obtained from Balino and Ubide 1999 , p. 38.		

