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A Critical Overview of Financial Sector Reform in Korea: Experience and Remaining Challenges*

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The long-standing practice of government intervention in credit allocation, as well as in key managerial decisions, has weakened banks in Korea. The attendant implicit assumption of credit risks provided an underlying cause for high leveraging on the part of the corporate sector, the absence of credit analysis and lending concentration on the part of banks, and superficial supervision on the part of regulators. Scant attention to risk management, on the part of all parties concerned, contributed to the onset of the financial distress in 1997. The government implemented a set of corrective measures and prevented a complete paralysis of the financial sector. However, the crucial issue remains whether the financial intermediaries' contributions to the national economy will be in the form of offering autonomous monitoring services or warehousing scarce financial resources to finance government-picked national champion industries.

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1. MOTIVATION AND INTRODUCTION

It is not uncommon to hear central bankers and bank regulators, in countries that have gone through a banking sector crisis, musing about the recurrence of problems, sharing enough common factors with their own experiences, in different parts of the world within a relatively short period of time. One possible reason for the seeming replay of the same bad movie is that there could be enough idiosyncratic factors that make the prevention of problems in different places not easily amenable to a uniform checklist. The resulting policy implication is that would-be problem solvers need to update and prepare different sets of checklists for each place they travel. In the case of Korea, the basic cause of problems in the financial sector was a lack of banking, or credit, culture.[1] [2] In addition, there have been a number of idiosyncratic factors that have contributed to the fermentation of problems over time and the outbreak of the crisis in 1997. The government has since stepped in and has vigorously implemented a set of corrective measures. Coupled with improving macroeconomic conditions, the government's actions, thus far, have prevented a large-scale paralysis of the financial system and restored the soundness of the system in the wake of a near collapse. However, more difficult challenges remain as Korea tries to transform its financial sector into a truly commercially oriented and internationally competitive industry.

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1) By banking and credit culture I mean practices and an environment in which banks make diligent efforts to continuously maintain the information advantage as a financial intermediary over direct trading. A more formal elaboration of this can be found in the framework of Diamond (1984) where a bank (financial intermediary) comes into being due to its comparative advantage as a delegate monitor over individual lenders.

2) An intuitive definition of credit culture "is a set of generally accepted business practices in which, for example, debts are normally honored and the value of assets can be and is consistently evaluated" (Truman, 1995). As suggested by an anonymous referee, there must have been some underlying factors that gave rise to the 'lack of banking, or credit, culture'. Perhaps one contributing factor was a general sentiment against a seemingly harsh enforcement of debt obligations arising from historical plights experienced by farmers and other lower class members at the hands of landed gentry and government officials in 19th century Korea. However, this is pure speculation and a more systematic analysis of this topic is beyond the scope of this paper.

The banking sector has been dominant in Korea's financial sector. The make-up of the banking sector has been relatively stable over time as around fifteen or so large nationwide deposit-taking commercial banks have maintained most of the market share.[3] They have been used as the key financial conduit of the economic development strategy firmly orchestrated by the government since the 1960s. For some time, it has been observed that non-commercial considerations had been overly important in the banks' operations, largely owing to a long-standing practice of intrusive governmen-tal interventions and attendant implicit guarantees of a bailout. For example, no sizeable financial institution had failed in Korea for over three decades until 1997.

The manner in which banks were used, in the process of economic development in Korea in the past thirty years, basically made economic theories of financial intermediaries more or less irrelevant to the explanation of why Korean financial institutions exist. In particular, an influential conventional view in the economics profession emphasizes the role of banks as an institution that offers welfare increasing services by carrying out and monitoring diversified loans for a large number of depositors (Diamond, 1984). Until fairly recently, both interest rates on deposits, as well as lending, were determined by the government. In addition, various governmental guidelines strictly directed where and how much to lend at the industry level (e.g., manufacturers and exporters traditionally) and to which types of firms (e.g., small and medium sized enterprises, of late). At any given time, one could justify these types of restrictions on some grounds, but the total sum of them basically removed enough of both incentives for, and the managerial discretion of, bankers as we know of in many advanced economies.

The financial sector had shown signs of stress, over time, under financial repression. High inflation, that frequently surpassed controlled nominal bank interest rates, officially guided credit rationing, and a persistent excess demand for bank funds all together presented an environment to distort incentives and to hinder the smooth functioning of the money and credit

3) In addition, there are about the same number of regional banks as well as specialized banks fully owned by the government. For an overview of the historical developments of financial markets in Korea, see Kang (1990), Nam (1995).

markets. Partly reacting to market pressures, the government usually responded in a reactive fashion and implemented piecemeal reforms over time. In the early 1970s, a number of non-bank financial institutions (NBFIs) —with somewhat more degrees of freedom than banks to operate within compartmentalized areas of businesses — were established to absorb funds in the informal financial market. Growth in those NBFIs, coupled with a gradual liberalization of interest rates and a loosening of the strict segmentation of different lines of businesses, increasingly complicated the environments faced by various financial institutions, including commercial banks, in the second half of the 1980s.[4)]

The banking sector has received the most attention since the onset of the 1997 financial crisis as troubles in that sector started early in that year and were viewed as a key precipitator of the events in late 1997. In a strict sense, the adverse macroeconomic shocks that are often cited as a key common precursor of banking sector crises (e.g., Evanoff, 1998) became important at a later stage in Korea. The most commonly cited macro shock for the Korean economy, in the 1995-1996 period, was a worsening of the terms of trade shock in the form of a large fall in the prices of memory chips that made up a large part of Korea's exports. However, the first two large business groups, the Hanbo and Kia groups, that fell in early 1997 had nothing to do with semiconductors. The flagship industry of the first was steel and automobile manufacturing for the second. The adverse impact from these failures propagated to the banks unmitigated. Two major banks, in particular, became technically insolvent as a direct consequence. The government had to step in and inject a substantial amount of funds to ensure their solvency.[5)] More than anything, it was the demonstration of a strong resolve, on the part of the

4) For example, banks were permitted to operate in-house trust business as NBFIs increasingly encroached into commercial banks' corporate banking businesses putting pressure on banks' profitability. The size of trust assets at banks grew exponentially and became almost the same as traditional banking assets. Basically, trust accounts allowed banks to both mobilize and allocate funds unencumbered by various rules and regulations attached to normal bank funds to a degree similar to those enjoyed by NBFIs (Balino and Ubide, 1999).

5) Understanding how extraordinary developments, since the end of 1997, have been in the Korean context is imperative to understanding the perception gap about the reforms — outside observers continue to see a need for more and wider reforms than domestic observers —that exist between domestic and foreign observers (eg., "Korean Bank Reforms Slow as Economy Regains," *International banker*, June 14, 1999).

Korean government, to prevent a systemic collapse that put a firm stop to the rapidly deteriorating conditions in the financial sector. It involved wide ranging guarantees to depositors at various deposit taking institutions, as well as to the foreign creditors of Korean financial institutions. Having averted a serious crisis phase, the government got directly involved in the reorganization and rehabilitation of banks and the general financial sector.

The advent of the crisis indeed has brought significant changes to the financial sector that previously had been unimaginable. Numerous merchant banks have been closed and the number of national commercial banks shrunk, as healthy banks were asked by the government to take over weaker non-viable ones using fairly transparent criteria such as first-tier capital adequacy ratios. Closure of a number of commercial and merchant banks might not seem extraordinary to a casual observer, but the fact that it took place at all is an extraordinary development in an economy that had not seen any closure of any financial institution in the past. Another key sign that the crisis has had major impact is that the true extent of the bad loan problem has finally emerged. Official estimates from the pre-crisis period were so low they were not taken seriously and hence the guessing game about the scope of the problem had been an interesting intellectual exercise.[6] Considerable public money has been expended to bolster the capital basis and to take non-performing assets off banks' balance sheets. The Korean government has become the largest shareholder of a number of banks as a result of the capital injection of public funds. They are, in turn, being used as a conduit of government policies to lower the overall leverage ratio of corporations and to consolidate excessive industrial capacity.

Notwithstanding the fact that corrective actions have been boldly implemented, the steps taken so far do not have any direct bearing on the question of whether the modus operandi of Korean banks will change in the future. One particular idiosyncrasy of the Korean economic reality has added a layer of complication to the orderly functioning of the financial sector. That

6) For an example of estimating non-performing loans of Korean banks via the indirect method, see Huh and Kim (1994) and for a more recent example see Nam and Kwon (1999). For a detailed overview of developments and reform efforts in the financial sector see the East Asia Analytical Unit (1999), Balino and Ubide (1999).

is, the dominant presence of businesses belonging to large chaebol groups. Due to the simple disparity in the relative size of corporations and banks, the scope of diversification for banks has been limited as the average business project is likely to be relatively larger when compared to the banks' capital base. Given the importance of these firms, it might be natural that they, as a group, have taken up a commensurate (that is, large) share of bank credit so far, even without the moral hazard problems of banks lending to these businesses based on 'too big to fail' considerations. Whether and how to reduce banks exposure to these businesses is going to be difficult in the foreseeable future. At the same time, it is also possible that when these large businesses shift away from banks to direct financing markets and large international banks, Korean banks might see a worsening of their asset quality.

At a fundamental level, the crucial issue going forward will be whether or not banks in Korea can gain full autonomy and develop a credit culture to offer autonomous monitoring (both in terms of selecting "good" projects to lend and maintaining a post-lending close watch) services on par with international competitors. Otherwise, they will remain as a passive conduit for implementing government policy to channel financial resources to the government designated areas as in the past.

2. LACK OF CREDIT AND BANKING CULTURE: BANKS MOBILIZE FINANCIAL RESOURCES AND THE GOVERNMENT ALLOCATES THEM

2.1. Origin of Governmental Ownership of Banks and Their Role in Development Strategy

The Korean government had been the largest shareholder and, thus, the owner, of all commercial banks in Korea until the early 1980s. The origin of such a relationship dates back several decades. After liberation from Japanese rule in 1945, the Korean government privatized the banks in the 1950s (formerly under Japanese ownership). Subsequently, the military government,

that took power in 1961, confiscated the stocks of those banks held by businesses, justifying this policy with the official line that unfair wealth accumulation should be punished. The new government launched a series of 5-year economic development plans aimed at establishing manufacturing industrial bases over a relatively brief period of time. Building export-oriented industries, as well as the attendant industrial infrastructure, required a large increase in investment, and Korea, being a poor country, did not have the needed financial resources. Faced with such a reality, the government started to actively mobilize both domestic as well as foreign financial resources. As a part of these efforts, the Korean government nationalized the commercial banks in the early 1960s.[7)]

The fact that the government took control of the banks has had a profound ramification on how banks and —more broadly —the financial sector in Korea have evolved over time. First of all, the largest shareholder (the government, until the early 1980s) was not interested in generating profits, hence bank managers did not have to pay attention to profitability. Instead, growing the total asset size as well as that of deposits became the focus of bank operations. However, since there had not been any noticeable differences in the type of financial products that different banks offered with regulated interest rates, efforts to increase deposits emphasized personal and business relationships and proximity to savers and so forth. This might explain why there were so many bank branches in Korea. And this trend was not just based on tradition. For example, the number of commercial bank branches more than doubled, to 5987, between 1990 and 1997. Traditionally, the key for gaining recognition among bank managers was by increasing the size of deposits at their branches.

One way for the government to ensure that banks shared the same focus

7) Given that the military government expressed a definite right wing ideology, the nationalization of then-privately owned banks could only be explained by the economic planners' intentions to use banks as a more direct means of policy implementation. In fact, the historical development that followed supports this view. In addition to economic considerations related to mobilization of funds, there might have been a political rationale for the nationalization of commercial banks. As mentioned earlier, the military government needed to win broad based public support for their regime by vilifying businesses and banks and dismantling extant privileged groups.

on the mobilization of funds, which was the ultimate goal of the government policy, was through direct intervention in the form of appointing bank executives. "Government intervention in the management of banks was most clearly manifested by the *de facto* appointment of presidents and high ranking officials of nationwide commercial banks by the Government, even after these banks were privatized. .., the Government maintained management control, seriously hampering the bank's autonomy" (Nam, 1995, p. 11).

Partly as a consequence of such efforts and partly due to a continuous rise in per capita income, Korea's national saving rate indeed rose rapidly from the mid-teen range of the 1960s to above 20 percent and beyond throughout the 1970s. The government always maintained a disciplined fiscal policy and did not run any budget deficits. However, the share of investment to GDP has almost always been higher than the domestic saving rate, thus, necessitating a continued infusion of foreign capital.

2.2. Direct Governmental Involvement in Credit Allocation

Governmental intervention typically took the form of designated lending. Early on this was implemented as the monetary authorities required commercial banks to lend some fixed proportion of their total lending to designated, sectors such as exporters, heavy and chemical industries (throughout the 1970s), and small and medium sized enterprises (since the 1980s) at subsidized interest rates. All together, these designated policy loans accounted for about 40 percent of the total domestic credit of banking institutions between 1975 and 1990. At the same time, lending to consumers had been actively discouraged (see following section III.1 for a related discussion). The government complemented and reinforced this kind of requirement with a set of positive incentives. The most typical means of inducement was the provision of central bank credit in proportion to each bank's actual

lending to the designated sectors.[8] Furthermore, the fact remains that some of the lending was done because the government compelled banks to extend credit to those industries.

Almost by definition, many of the business areas designated by the government are ones that banks would not ordinarily extend credit to in large amounts, hence the government's prodding was necessary. It could have been due to the banks' shortsightedness, but at the same time those were areas where the expected returns did not justify the related credit risks. Thus, it would be safe to assume that there would have been disproportionately higher non-performing loans in these areas. This was particularly the case when the government's concerted efforts to develop the heavy and chemical industries in the second half of the 1970s led to excessive and duplicative investment in some areas, and led to poor performance in most of these industries. The "Shipping and overseas construction industries were responsible for the majority of the non-performing loans and were the major target" of government-led consolidation efforts (Nam, 1995). Consequently, the practice of government directed lending weakened the government's position as the regulator of banks, holding banks accountable for the performance of their asset management. Furthermore, such an environment proved to offer very fertile ground for moral hazard problems on the part of bank management.

Lastly, the systematic channeling of bank credit, in turn, imposed a credit squeeze on most businesses that were not recipients of policy loans. The resulting excess demand for capital provided a good reason for the existence of active informal markets for credit. Indeed, the curb market had featured prominently for both lenders and borrowers for a long time.

8) One telling indicator of how important this was in a cross context can be found in a multi-country comparison of the relative size of credit from central banks to the overall credit extended by the banking sector. As of 1995, the proportion of credit extended by the Bank of Korea in relation to overall credit was as high as 8%, whereas the comparable ratios were 0.1 (U.S.), 2.6 (France), 3.8 (Japan), and 4.6 (Taiwan) respectively as of 1991(Whang,1995). For related details and extensive discussions about industrialization policies and the financial sector and various related issues, see Nam (1995), Cho and Kim (1996).

2.3. Why did People Deposit Their Money at Banks?

Freezing of the informal credit market in 1972: financial repression, up close and personal

In this section, an event that took place in the early 1970s is examined in an effort to illustrate a measure of the financial repression, in addition to the controlled interest rates and the rationing of credit, that was implemented to discourage any leakage of financial resources out of the formal financial sectors. The point is that the plethora of controls on formal and informal financial institutions might have removed any room for a genuine scarcity of funds to play the key role in determining prices as well as the quantity of credit to borrowers.

The Korean economy faltered in the early 1970s due to a worsening export market environment. Such macroeconomic developments worsened business conditions and debt-servicing costs became a serious burden to most businesses that were heavily indebted. In an attempt to relieve the financial burdens borne by the corporate sector, the Korean government took emergency measures through a presidential decree on August 1972 and froze all private loans.[9] It affected some 360 billion won, an amount equaling 34% of the credit in the banking system. The total money supply (M1) in 1971 was 360 billion won. All creditors and debtors were given a 7-day period during which they were required to report their lending and borrowing. A total of over 200,000 people registered as creditors in the aftermath and about 70% of

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9) It is interesting to see that over-leveraging and heavy reliance on short-term debts, that had been cited as important proximate causes of the 1997 crisis, had been causes for concerns as early as 1972. Dr. Nam Duck Woo, who was the deputy prime minister in charge of economic planning at that time, explains the situation at that time; "Korean companies were faced with a structural problem. There had been no long-term credit facilities whatsoever. The maturity of bank loans did not exceed one year (but) there had been very vigorous investment activities in the past ten years. The companies had to borrow short-term money for long-term investment. It was very natural for them to have a credit crunch.

The business community was crying for some measures to relieve their credit difficulties. FKI chairman Kim Yong Wan appealed directly to President Park, saying that the curb market was the source of all trouble, and that the government should do something to correct this situation. Neither of them were economists and they did not fully understand that this could happen (because) the curb market is really a real money market. [But] President Park gave his instructions to his aides in the Blue house to work out some measures" (Clifford, 1994, p. 101).

them were small lenders with less than 1 million won (less than US$3000) (Bank of Korea, annual report, 1972).

These numbers were believed to be understating the true extent of the number of people affected by the freeze. Apparently, these unofficial market borrowings included borrowings from relatives, friends and neighbors as well as from the professional curb market lenders. The deferment measure included cutting the curb market rate from an average 3.84% monthly market rate to a 1.35% monthly rate and a 3-year deferment with installment payment for 5 years thereafter. Given that annual inflation was running 15 to 20% per year and the official bank interest rate on 1-year time deposits was above 17% before the emergency measures were taken, the conditions forced upon creditors could be said to be very unfavorable.

With the advent of the curb market freeze, the government allowed a host of non-bank financial institutions to start. They were, in general, deposit taking institutions engaged in fewer lines of business than commercial banks but with less stricture on the asset allocations and/or interest rates they paid or charged compared to commercial banks. It was an attempt to provide an outlet for substantial private funds that had previously stayed out of formal financial institutions. The number of such financial institutions started to grow rapidly. Judging from the fact that many newly licensed institutions continued to operate successfully, they indeed provided some measure of relief for private lenders and borrowers.[10)] However, as the real interest rates on official bank deposit had remained slightly negative until the early 1980s, the informal curb market appeared to have remained active. One crucial factor that had contributed to this was the government's drive to develop the heavy and chemical industries in the second half of the 1970s. This required enormous financial resources among others, hence most credit from the formal financial

10) A narrow compartmentalization allowed for the continued growth of the NBIFs, and various financial institutions more or less coexisted for a long time until the early 1990s. As a general liberalization trend started then and the tight market segmentation was loosened, existence of various financial institutions with slight distinction started to become a source of tension. Increased competition started to hurt many financial institutions as a previously segmented line of businesses opened up for different institutions, at the same time gaining more control over pricing their products.

institutions went to support these efforts. Such a focus, in turn, worsened credit availability conditions for many businesses.

One can draw several conclusions from these episodes. One, there existed organized informal credit markets of some substantial size as a consequence of financial repression. Two, historical developments have made the expected return distribution unfavorable over time for a given level of risk for lenders in informal financial markets. Three, these developments might have had a salutary effect and lessened the degree of problems arising from fungibility of financial capital in an environment in which much of the credit which had been ear-marked for specific areas and projects was supplied at below market interest rates.

To summarize Section 2, the model employed by the Korean government throughout the rapid development period could be characterized as one in which banks mobilized private funds and then the government allocated credit. Banks were not really banks in the sense of conventional economic definitions and their operation was not dictated by profit considerations since their de facto owner was not particularly concerned about profits per se. Perhaps it was natural that banks did not expend much energy trying to sort good credit risks from poor ones. Such an environment was, in turn, not conducive to the development of either expertise in the areas of assessing the creditworthiness of borrowers or the management of risks in general.[11)]

11) There are four credit rating agencies in Korea and they were all started between 1985 and 1987. However, the validity of their ratings was brought into question when Cho (1998) noted that the proportion of firms belonging to the top four categories according to Korean agencies was about 60% in 1995. This proportion was 64% in 1996 and 57.4% in 1997. In comparison, the same rating (AAA, AA, A) assigned by the Standard and Poor's for the businesses in the U.S. was about 40% in 1995.

3. SUPERVISION WITHOUT CREDIBILITY AND IMBALANCE IN REGULATORY FOCUS

3.1. Dilution of Regulatory Focus

The following excerpts (page 21 of the Annual Report of 1984, Bank of Korea) provide good examples of the extent of the guidelines given to commercial banks throughout the 1970s and 80s.

"(5) Changes in the Banking Institution Loan System

a. Enlarged Supply of Equipment Funds

On 16 July the Bank (of Korea) established Guidelines on Handling 1984 Loans for Energy-saving Equipment to encourage firms to invest in such equipment, effective from the same date.

The firms eligible for the loans were confined to those installing or replacing energy-saving equipment, excluding newly founded firms. Nationwide commercial banks and the Korea Exchange Bank were engaged in loan business and the maximum loan period was 5 years. Also, the Bank decided to make loans to the banks within 50 per cent of the amount they credited. The total amount of the loans to be supplied by the banks was determined to be 20 billion won, and was increased to 35 billion won on November 1.

b. Restraining Consumer Credit

On 22 May the Bank prohibited banks from extending consumer credit on such durable goods as cars, electric products, etc., …the (Monetary Policy) Board reformed Regulation on Credit Operations of Banking Institutions in an effort to reinforce restrictions on loans to entertainment industries. The new regulation added large-sized restaurants, health clubs and hotel businesses other than tourist hotels to prohibited sectors for loans."

This arrangement, of the government providing asset allocation guidelines,

has had major ramifications for the relationship between banks and the government as the regulator whose main role is typically making sure that banks operate in a prudent manner, to prevent any systemic disturbances. First of all, the checklists for Korean bank supervisors were long, with items that have little to do with the soundness of asset management. That is, they needed to concern themselves with making sure that the bank under examination was in compliance with the official guidelines for lending to designated areas. Though many of these restrictions have been phased out now, they are instructive in understanding the environment that had surrounded banks and regulators for several decades, undoubtedly leaving indelible marks. The key point is that in such an environment, the relative importance of overall risk management and conventional items related to the sound operation of banks per se becomes easily diluted.

The tight control of banks by the government had not changed in a substantive way even in the early 1990s. For example, the Korea First Bank, that technically failed as a direct consequence of the Hanbo and Kia bankruptcies of early 1997, actually had been the leading performer among Korean commercial banks throughout the 1980s and early 1990s.[12] According to some observers, the drastic shift in the fate of the KFB was in good part due to the fact that the Korean government disproportionately relied on the KFB's cushion to deal with problematic cases of corporations in trouble. One way of carrying this out was to designate a new bank as the main bank of the troubled corporation so that the bank could inject the funds needed for rehabilitation.

3.2. Imbalance in the Sizes of Banks and Corporations, Lending Concentration

The Korean government privatized major commercial banks by selling off

12) Indeed, until 1995 the KFB had ranked consistently either first or second since the mid-1980s in terms of either pre-tax or net profit among the 15 nation-wide commercial banks. Then its ranking in terms of net profit fell to 9th and 14th respectively in 1995 and 1996. It appears to be a perfect example of good money being thrown after bad.

its shares in them in the early 1980s. Around this time, the issue of the ownership of banks became controversial as the chaebols, that already enjoyed dominant presence in various industries in Korea, emerged as the most likely buyers.[13] As opinion against the concentration of economic power prevailed, a strict limit has been put on the proportion of the single largest share-holding (4% for major commercial banks since 1995 and 8% before then) of banks.[14]

The separation of industrial capital and banks is common in advanced countries and there are legitimate economic reasons for this. For example, non-separation might lead to leakage and abuse of governmental guarantees on bank deposits by bank affiliated industries. The key mechanism for such abuses is lending concentration. That is, a bank will lend mostly to a small number of affiliated businesses without due diligent assessment, thus, increasing the chance of the bank's failure. This will, in turn, require a government to step in with financial resources to pay off depositors.

The reality of what has happened since 1997 in Korea is exactly what was just described. There was substantial lending concentration and when the borrowing businesses failed, banks technically failed too, thus requiring a large-scale governmental intervention using public funds. For example, in the case of the Korea First Bank, it lent 1.8 trillion won to the businesses of the Hanbo group that failed in 1997. The KFB's capital at the end of 1996 was 1.2 trillion won. In some sense, the imposing of a strict limitation on bank ownership might have given rise to the complacency of concerned parties that

13) The formation of chaebols was closely linked to the development strategy followed by the Korean government. For more a systematic review of chaebol issues, see Jwa (1999). However, in tandem with the rising role of chaebols in Korea's development, there was a growing concern about the concentration of economic powers and a rising anti-chaebol public sentiment. Two factors explain the chaebol's interest in banking. First, due to excess demands for funds, owning a bank, which was the main provider of credit, made sense for it could facilitate easier business financing. Secondly, there were economic rents to be had in the banking sector due to formidable barriers to entry to the sector which received large subsidized governmental credit.

14) However, the privatization appears to have been more nominal. " ..., even after the transfer of ownership, the banking system continued to be operated under government control. The appointments of banks' executives and senior officers was conducted by the government as before" (Cho, 1994).

somehow all major sources of systemic risks were removed by that step. Scant attention to lending concentration eventually led to a near-debacle despite the separation of industrial capital and banks as well as strict limits on who can own how much of a bank.

The relative imbalance in the size of corporations and banks has been one key reason behind the lending concentration. It is a story of dwarf banks and giant corporations. In advanced economies, large banks are usually larger than most industrial firms in terms of asset size. For example, the Fortune 500 list of 1997 ranked the banking industry at the top in terms of the number of individual members included in the list. There were 69 banks well above the runner-up motor vehicle and parts industry with 27 firms included. Thirteen Korean businesses made the list, but no bank.[15)]

It was very likely that the average size of business projects in Korea would proportionately take up a bigger slice of a bank's capital. This means that just due to the disparity in size, Korean banks as a whole were less diversified, and hence faced more risk per lending compared to foreign banks in advanced economies.

4. REACTIVE LIBERALIZATION

Broadly speaking, the deepening of the financial market has taken place gradually since the 1970s. Perhaps the most notable development in the process was the rise of non-bank financial institutions in 1972 with the curb market freezing. Since then, the steps taken can be characterized as more reactive and marginal adjustments. After the privatization of the commercial banks in the early 1980s, the number of nationwide commercial banks increased almost twofold by 1996 with the establishment of new banks and the conversion of existing NBFIs into banks, as well as the conversion of fully

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15) According to The Banker's 1996 list of the 1000 largest banks, the highest ranking Korean bank was the Korea Exchange Bank, ranking 140th. When comparisons are made in terms of assets and revenue for Korean chaebols and banks using 1996 data, the total revenue of the top 5 chaebols (about 260 trillion won) was larger than the total assets of all 15 nationwide commercial banks (231 trillion won, not including trust accounts).

government owned specialized banks into regular commercial banks.

For each of these increases, there were special considerations. Two new banks which started in the early 1980s were joint ventures respectively between Korean and American, and Korean and Japanese businesses. The enhanced mobilization of foreign capital was a key consideration after Korea experienced a foreign exchange shortage around 1980. Conversion of specialized banks into commercial banks was basically due to a weakening of the strict compartmentalization of businesses over time. Commercial banks encroached into the areas in which both specialized banks were focusing on retail services (households and small businesses in one and housing related lending to households in the other). Similarly, the weakening compartmentalization also explains the conversion of NBFIs into banks.

The rapid growth in trust accounts at commercial banks since the mid-1980s is another case in point. Commercial banks were in a disadvantageous position vis-a-vis NBFIs in terms of regulated interest rates (on both deposits and loans) as well as the reserve requirement only being applied to accounts at banks. An increase in non-performing loans, in the wake of the restructuring of the heavy and chemical industrial sectors that had taken place since the early 80s, adversely affected the commercial banks' profitability. To alleviate the pressures on the banks, the government allowed commercial banks to engage in the trust business starting in 1983. The simple fact that funds in trust accounts were not subject to the reserve requirement of upwards of 10 percent imposed on bank accounts could explain why trust accounts at banks have grown rapidly since then. Banks offered higher rates on deposits and also charge higher rates on trust account lending. However, this created an artificial dual regulatory system since the responsibility of overseeing trust businesses was under the Ministry of Finance's control whereas conventional banking businesses came under the purview of the Bank of Korea. Going beyond the awkward duplication of responsibilities, this created a potentially dangerous regulatory blind spot because, for example, the rule against lending concentration did not apply to loans from trust accounts. Since more or less the same bank officials made decisions about lending from both banking and trust accounts, banks could easily side-step the credit limit by shifting between the two different funds. One thing to note is that once you take both

banking and trust accounts held at banks together, the share of banks' deposits as well as loans has not declined much over time. Of course the comparable shares of only banking accounts have shown a distinct continuous fall over time since the mid-1980s (Ahn, 1999).

One particular type of NBFI has received much attention in connection with the 1997 crisis. The overly risky behavior of Korean Merchant Bank Corporations (MBCs) has often been cited as an important contributor to the 1997 crisis and, thus, it warrants a brief background explanation. In 1996, many Investment and Finance Companies (IFCs) converted into Merchant Bank Corporations, increasing the number of MBCs from 6 to 30. Due to various liberalization measures being put into place in the early 1990s, the commercial paper discount businesses, that had been the mainstay of the IFCs, shrank.[16] Hence, the government allowed IFCs to convert into MBCs having more diverse lines of business and those newly transformed MBCs actively engaged in foreign exchange businesses and borrowed abroad, activities that previously were not allowed for IFCs. Large and unsound short-term borrowings and the investment in highly risky international papers by MBCs certainly contributed to the eventual loss of credibility of Korean financial institutions in the international capital markets. Of course, for each of those reckless borrowers, there was a willing lender. However, lenders escaped the crisis almost unscathed.

Cho (1998) offers the interesting observation that the liberalization of interest rates on short-term vehicles might have contributed to the trend of shortening the maturity of overall business borrowing in the pre-1997 period. As a part of a comprehensive interest rate liberalization plan that had been started in the early 1990s, controls on interest rates on short-term deposits and lending were removed in 1995. This led to a surge in competi-

16) In July 1996, 24 Investment Finance Companies were transformed into merchant banks, increasing the total number of merchant banks to 30. "The underlying reason for their transformation was the change in the business environment: IFCs had been able to borrow and lend at higher interest rates than other financial institutions since there was always excess demand for loans. However, large-sized firms can now easily satisfy their capital needs either in the primary market or in overseas markets at lower interest rates, so the IFCs' market dried up. They had no other choice but to expand into new financial services including leasing and international finance" (Korea Institute of Finance, 1996).

tion among various financial institutions to lend to good borrowers, thereby leading to increased short-term credit. Banks and Merchant Banks relied on borrowing abroad where interest rates were much lower than domestic rates.

Also, according to Cho, the loosening of regulations concerning businesses' direct foreign borrowing started a new trend in corporate financing around the same time. Firms of the top 5 chaebols, possessing wide international name recognition, started to borrow directly from abroad by issuing DRs and bonds in international capital markets shortly after capital market liberalization measures allowed this practice. Large businesses, in turn, started to cut back their reliance on traditional domestic finance providers, such as commercial and merchant banks. This created a sort of deterioration in the pool of potential borrowers for those financial institutions.

5. STEPS TAKEN SO FAR

5.1. Taking Bad Apples out and Banking Sector Consolidation

The IMF intervened in late 1997 with substantial emergency credit to alleviate the dire situation in the Korean economy that culminated in the rapid depletion of foreign exchange reserves. A set of conditions was attached to the emergency financial aid, including requirements that a significant overhaul be implemented in the financial sector. The basic thrust of this particular conditionality correctly reflected the critical views, regarding the Korean financial sector, of both domestic and outside observers in the past. Though the outbreak of the crisis was unfortunate, as it turned out to have severe macroeconomic consequences, it proved to be a truly unprecedented catalyst for revamping the financial sector in Korea.

A number of pieces of legislation, that would change the institutional and regulatory framework of the Korean financial system, were finally passed by the National Assembly in the wake of the outbreak of the crisis in December 1997. A new financial regulatory body was created by consolidating the regulatory and oversight functions previously scattered among several separate

Table 1 Significant Progress in Financial Restructuring

Post Crisis Status of Korea's Bank and Non-Bank Financial Institutions

	Share of total assets End 1997 (per cent)	Total institutions end 1997	Closed	Merged with closure	Total Institutions end 1998	Institutions currently under rehabilitation
Commercial banks	54	26[a]	5	3	18[b]	7
Merchant banks	9	30	16	Na	14	14
Insurance companies	12	50	4	1	45	16
Securities companies	4	34	6	Na	28	2
Investment trust co's	11	8	3	Na	5	5
Leasing companies	4	25	10	Na	15	15
Mutual savings	4	230	18	Na	230	31
Credit unions	2	1653	40	Na	1613	Na

Note: a) Excludes trust accounts.
b) Four of these banks have been nationalized. They are Seoul Bank, Korea First, Hanvit Bank and Chohung Bank.
Source: East Asia Analytical Unit (1999).

and disjointed organizations.

In an effort to prevent a widespread bank run, the government guaranteed all financial institutions' deposits until the year 2000 and provided emergency financial support to banks in late 1997. Starting in early 1998, a wide-ranging financial sector reform program was started with the aim of stabilizing the financial sector in the short-run and of improving the soundness and efficiency of the sector in the long-run, under the aegis of the newly created Financial Supervisory Commission (FSC). Corrective measures were taken promptly, as summarized in the following Table 1. Capital adequacy standards were the criteria for the FSC to decide what kind of corrective measures would be adopted.

Starting with banks, the FSC conducted a thorough review of the capital adequacy conditions of institutions and divided them into those meeting the adequacy ratios and those that did not. Financial institutions that did not meet the adequacy ratios were either closed down, absorbed, or merged with those that met the criteria. The Ministry of Finance and Economy's rules regarding these actions are as follows.

"For nonviable financial institutions, three possible methods of proceeding

are:
- purchase and assumption to provide sufficient financial support to the acquiring institution to prevent deterioration of its asset quality
- mergers between nonviable banks to create competitive and efficient banks
- mergers between sound and nonviable banks to allow closure of non-viable banks." (MOFE, 1998).

There have been at least a couple of bank mergers that fit into each of the three modes listed above. For example, the Commercial Bank of Korea and Hanil Bank, two major nationwide commercial banks with long histories, both failed to meet the required adequacy ratios and subsequently merged into a new bank named Hanvit Bank. This is an example of the second modality. Of course, merging two bad banks does not create a good bank. The Korea Asset Management Corporation purchased bad loans from these two banks to clean their balance sheets, and then the government recapitalized the new bank, in effect nationalizing it. In summary, as of the end of 1998, 8 of 26 commercial banks were either closed or absorbed by other banks, and 91 of the 377 NBIFs had been closed down, suspended from operations or put under prompt corrective action programs (EAAU, 1999; EIU, 1999).[17)]

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17) Similar steps were taken with regards to Merchant Bank Corporations. "In mid-December 1997, at the height of the crisis, the Government announced the suspension of 14 merchant banks, of which ten were closed the following January. A bridge merchant bank was formed to take over and liquidate their assets. The remaining 20 merchant banks were required to submit rehabilitation plans to strengthen their capital adequacy according to a time schedule. On the basis of a second-round evaluation of these plans, four merchant banks were closed by the end-April. The remaining 16 merchant banks were required to meet a capital adequacy ratio of 6 percent by end-June 1998 and 8 percent by end-June 1999. As a result of the end-June evaluation, two more merchant banks were closed..." (Balino and Ubide, 1999). Ahn (1999) and Wie (1999) also offer a comprehensive review of developments up to date.

5.2. Cost of Financial Restructuring

The government has earmarked support of about 74 trillion won to date for the purposes of recapitalization, purchases of non-performing loans, and deposit insurance payments.[18] The Korea Asset Management Corporation (KAMCO) and Korea Deposit Insurance Corporation (KDIC) are the main agencies that are involved in dealing with the rehabilitation measures. The estimates for the total amount of troubled loans held by Korean banks and other financial institutions varies. The official estimate, as of May 1998, was about 120 trillion won and other non-official figures are somewhat higher, ranging from 130-150 trillion won. These estimates are partly based on the amount of loans expected to go bad. Thus, if the recently improving macroeconomic condition persists, it might help and reduce these estimates considerably. These are about 30 percent of Korea's 1997 GDP. The government aims to dispose of 100 trillion in the immediate future by arranging a purchase by KAMCO at about half the book value. Indeed, it already has purchased NPLs totaling 44.1 billion won in book value from financial institutions such as banks, merchant banks, insurance companies, and securities firms as of the end of 1998.

Restructuring in the financial sector contributed to creating the 'credit crunch' condition that prevailed throughout 1998, thus adding to the shrinkage in economic activity and 5.6 percent fall in real output in the same year. This might have to be included as part of the costs related to the reform. Along with the highly contractionary monetary and fiscal policies that were in place in the first part of 1998, the tumult in the financial sector substantially disrupted credit flows and credit availability.

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18) Provision of funds took the forms of (1) purchase of shares, (2) purchase of subordinate debt, (3) purchase of non-performing loans, and (4) repayment of depositors. With governmental recapitalization, the equity of existing shareholders by a factor of about 8 to 1 (Balino and Ubide, 1999).

5.3. Implications of Steps Taken So Far

Closing down nonviable financial institutions and taking decisive steps to address non-performing loan problems augurs well for a generally more sound and efficient financial sector compared to the past. At the minimum, by facing the NPL problems squarely, the government is not only cleaning up banking sector balance sheets but also removing the key source of uncertainty regarding the fair valuation of Korean financial institutions for potential customers and investors. As discussed earlier, the opaqueness of official information about the true extent of the NPL problems might have caused wary observers to be fearful of a situation far worse than reality. This is akin to the situation when the Korean foreign exchange authorities tried to hide the fact that official foreign exchange reserves were shrinking rapidly in the fall of 1997. The lack of information made foreign lenders and investors expect the worst and helped them stampede to the exit door. In this regard, also helpful was the willingness of officials to admit that the extent of the problem could vary depending on macroeconomic conditions and the corporate sector's cash flow situation over time. Measures put in place so far have also been very instrumental in convincing international capital markets that conditions in Korea have stabilized and the near-term outlook is positive. These are reflected in a series of upgrades to the credit ratings given to Korean financial institutions, as well as growing indications of foreign interest in equity participation in some Korean banks.

The recent developments in the financial sector, notwithstanding the fact that it has been related to the crisis situation and conditions attached to the IMF's financial assistance, showed that financial institutions can be closed down without irreparably damaging the national economy. Regulatory forbearance and key regulator and economic policy makers not wanting to be the first to take drastic actions against any financial institution must have been part of the reason why Korea had not seen the closure of banks in the past three decades. Also helpful in this regard is the fact that the price tag of the past regulatory forbearance is now out in the open for all to see. Future regulators will be able to rely on the current experiences and use them to persuade political leaders and the public of the necessity of prompt corrective actions including the closure of problem institutions. Perhaps the ultimate

deterrence against the misuse of regulatory forbearance is to actually demonstrate that a financial institution can be closed. In this regard, the recent closure of banks should have set off an alarm and left a lasting impression on depositors, and the equity and debt holders of Korean financial institutions in the future.

Also significant on the "first time ever" list is the shedding of the workforce and the reduction in the number of branches. Between the end of 1997 and 1998, the number of bank employees and bank branches decreased by 34 and 17 percent, respectively. Excess employment in the banking sector has been recognized as a source of inefficiency. "Whereas technological change caused banking employment to remain static or to fall in most OECD countries in the 1990s, Korea's bank workforce increased by 25 percent" (OECD, 1998, p. 63). One reason for such an increase might be the 'relationship' banking tradition practiced in Korea that emphasized personal relationships, as discussed earlier. As mentioned, the increase in the number of bank branches in the 1990s required a commensurate increase in employees in the same period. Furthermore, mergers that have already taken place make it necessary to reduce the workforce to realize efficiency gains. Another potential benefit is that larger banks result as a consequence of on-going mergers. For example, Hanvit Bank, which was formed by the merger between the Korea Commercial Bank and Hanil Bank, both of which were each on the top 5 list in terms of asset size before the merger, now commands total assets of over 100 trillion won (about US$83 billion).[19] Larger asset and capital bases will help alleviate the potential problems related to the mismatch in sizes between banks and non-financial corporations in Korea, as discussed in the previous section. However, the reduction in the number of banks and a growing resemblance among the remaining banks could yield some adverse side effects, to be discussed in the following section.

Another significant "first time ever" is that controlling shares of major commercial banks are being offered to foreign investors. Out of the two

19) This will rank Hanvit Bank at about 100th or so in ranking of global banks in terms of asset size using 1997 data (The Banker, July 1998).

banks (Seoul Bank and Korea First Bank) put on the sale block in early 1998, only the negotiations between potential buyers of the KFB and the Korean government came to fruition in mid 1999.[20] In addition, several other banks have received significant equity participation by reputable foreign financial institutions. Korean regulators and international agencies, such as the IMF and the World Bank, have put much emphasis on the need for Korean banks to adopt international best practices. There have been sporadic and unsuccessful efforts in the same vein in the past. In particular, joint ventures between Korean businesses and the Bank of America (KorAm Bank) and Korean-Japanese bankers (Shinhan Bank) were granted licenses in the early 1980s, when barriers to entry were much higher, in the hope that they would provide a window for international best practices at that time. It seems fair to say that they did not prove to be, or they were not allowed to be the catalysts as some had hoped. For that matter, Korean banks did not have to look very far to find examples of "international best practices" since Seoul boasted over twenty branches of leading international banks for some time. Maybe it is a case of "one swallow does not make Spring." When there is a significant enough number of institutions that are not easily persuaded by intrusive official window guidance and pressures, they could have salutary effects on all other banks. Such a dynamic must be well understood by the government. Thus, the recent increasing presence of foreign participants in the Korean banking sector could signal that the government is ready to take less intrusive roles in the affairs of banks in the future, and/or that the situation has been serious enough not to leave the Korean government any other choice.[21]

Given the state of regulatory discord that existed until 1997, the consolidation of supervisory agencies and responsibilities into the Financial Supervisory Commission is a potentially critical development in enhancing

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20) Shortly before the successful completion of the negotiation between the Financial Supervisory Commission and the Newbridge Capital-led U.S. consortium, the government announced in late June, 1999 that it was injecting 5 trillion won into the KFB. This is in addition to the 1.5 trillion won that was put into the bank in January 1998. Given that the total assets of the KFB were about 27 trillion (39 trillion if trust account assets are included) as of the end of 1996, the total injection suggests that close to 25 (or 17, using the figure inclusive of trust accounts) of the bank's assets were in the troubled category.

21) See EAAU (1999), pp. 190-191 for more details of foreign participation in the Korean banks.

the efficacy of the financial sector regulation. At the least, it makes clear who is the responsible regulator of financial institutions. And this does not apply to cases of cross-over among different financial institutions such as a commercial bank and an insurance company. Even within a commercial bank, the banking and trust accounts, both basically run by the same decision makers for all practical purposes, were under the separate oversight authorities of the Bank Supervisory Board and the Ministry of Finance and Economy, respectively. As such, bank regulators will be in a better position to implement comprehensive oversight about over-exposure of a bank to borrowers.

6. REMAINING CHALLENGES

The steps taken thus far are mostly necessary and appropriate to prevent a large-scale paralysis of the overall financial system and to secure the soundness of the system in the wake of a near collapse. Progress made so far has been adequate in this regard, barring a really serious turn-around worsening of the Korean economy. The current reform efforts appear to aim at more than merely restoring the soundness of the financial system. That is, the government seems to want to see that banks become profitable and well run in the future. Although it would be desirable, it is not under the purview of the government to make banks more efficient or profitable. Banks can not be ordered to become consistently more profitable by regulatory authorities and perhaps that is not the real focus for regulators.[22)]

Rather, the priority needs to be given to what additional changes and improvements should be made to ensure that depositors, creditors (and credit analysts) and equity holders of banks play the crucial disciplinary roles making sure that the banks are well run. Though some steps were taken in the

22) The FSC set specific performance targets for Hanvit Bank as a condition of its financial assistance. It has to achieve 1 percent return on assets, a 15 percent return on equity and a capital adequacy ratio over 10 percent by the end of 2000 (FSC, 1999). Failing to meet these targets will likely mean an end to the current management team. As a provider of financial assistance, this might be a legitimate demand on the recipient and hence it does not constitute a regulatory guideline.

way of strengthening governance so far, these would be insufficient unless outside potential stake holders are part of the disciplinary process.[23) 24)] Making sure that sufficient data is available to interested parties, and at the same time assuring that the accounting information is both transparent and accurate would be more important to enlisting outsiders' roles. That is, building up the infrastructure for a credit culture outside the banks should get more immediate and lasting attention from policy makers. In this way, the government can free itself from the deeply entrenched role of bearing all the risks of business decisions made by banks and other market participants. In addition, several issues expected to become important are discussed in the remainder of this section.

6.1. Durability of Regulatory Discipline

Maintaining the current momentum to allow for heightened prudential regulation to go forward is going to be a challenge. A reduction in the number of banks will likely create an environment where regulatory forbearance could exist due to a 'too-big-to-fail' consideration. This is simply because now each individual bank has a proportionately larger impact on overall financial and payment systems. If a bank was too big to fail when there were some 30 banks, it is definitely going to be too big to fail when there are 10 or so banks and this raises concerns about various related moral hazard problems.

Understanding such a situation, a bank might expect a greater degree of

23) For example, the new rule requires the appointment of a certain proportion of outside members to banks' boards of directors. But in actuality, some observers raise doubts about the effectiveness of this since outside (non-executive) board members are appointed on the basis of relationships with bank managers. Another talked about reform measure is to dilute the power of the bank president in making key lending decisions and delegate the related authorities to various committees within the bank.

24) It is important to note that there is a growing discussion about the role of subordinate debt vis-à-vis bank management by academics as well as central bankers concerned with regulatory issues. The point is that there is substantial overlap between the interests of subordinate debt holders and bank regulators in ensuring that banks are prudently run (Calomiris, 1997, and Federal Reserve Board governor Meyer was cited in the article "Fed Governor Wants Debt Requirements," *American Banker*, June 15, 1999).

regulatory forbearance when it is in serious trouble. It might be possible that some banks might experience difficulties in the future when competition among banks increases, especially when more foreign banks start to operate the full-range of services in the Korean financial market. On the part of regulators, understanding such underlying incentives, they will likely increase prudential oversight. However, increased supervision will also make it easier and provide ample temptation to the regulators (the government) to engage in window guidance. That is, there is a good chance that the relationship between banks and regulators (more broadly the government) might remain tight in the future. The past experience suggests that such a close relationship does not provide a healthy environment since it opens up avenues for the political influence of the government and politicians to flow to the bank managers. It is going to be a difficult balancing act for regulators to maintain an arm's-length relationship with banks and at the same time conduct diligent prudential oversight on an on-going basis.[25)]

One factor that is going to make the regulators' jobs difficult is potential political pressures. There seems to be an almost complete agreement among different players, such as policy makers, academics, and business people , that banks should be freed from the straitjacket of the past *dirigiste* period. However, at the same time, one could easily find newspaper articles about these players making public pronouncements about the faults of banks. Political leaders and policy makers often publicly chastise banks for paying excessively low interest rates on deposits while charging high rates for lending, not lending enough to small and medium sized firms, charging excessively high fees for foreign exchange transactions and, thus, hampering their efforts to export, and so forth. This might not be an unusual occurrence in an open society where different views can be aired unfettered. However, where formal consultative meetings between commercial bank presidents with key government ministers in charge of economic portfolios (and also between business leaders and the ministers) are not unusual, these type of public pronouncements are taken as more than the simple airing of personal views.

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25) For a discussion of the potential difficulty in the financial sector reform process that can arise due to political interests, see Truman (1995).

Ironically, the general public seems to take the government playing such a role for granted. It is quite possible that the public might take an unfavorable view of a government not doing enough if it were not making these kind of announcements and not holding regular consultative meetings. The point is, it seems to be difficult to insulate bank regulators from political pressures at the moment, and prospects for future innovations in this regard are not terribly good.

6.2. How do We Ensure Banks will Operate Differently in the Future?

Many public financial resources are being expended to rehabilitate banks so that they can operate unencumbered by the heavy burdens of the past. In addition, several banks whose future viability seemed questionable have been merged with healthier ones. There exists one potential pitfall. In many cases, the banks that took over and the banks that were taken over were quite similar to each other. Therefore, the key benefit of the mergers seems to lie in obtaining efficiency gains through a reduction in the size of the combined operation.[26] The expected gain will depend on how drastically the restructuring and cutbacks can be implemented, above and beyond what has already taken place. It is also possible that a further consolidation of banks might take place in the near future, thus requiring a further reduction in the size of bank operations. The Korean government has been very concerned about the unemployment rate rising to the historically unprecedented level of 8 percent. Given that the same government has the ultimate control over the restructuring of the banking sector as it is financing these efforts, cutbacks might take place in a restrained manner, if at all.

In one case, the merger of two banks appears to make sense in terms of strategic alliance. Kookmin bank, which had been a fully government owned specialized bank to deal with non-business household sector transactions, has

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26) In the case of a nation-wide commercial bank merging with a regional bank, there seems to be a clearer efficiency gain to be expected if the restructuring and the reduction in business overlaps are carried out sufficiently. For both banks the area of cutback is obvious. For the national bank, it is the region that the regional bank represents and for regional bank, any businesses outside its regional base can be easily handed over to the national bank.

focused on making small loans to households and businesses. The bank that was merged with the Kookmin was the Korea Long-Term Credit Bank (KLTCB), which had been a government owned special bank mainly dealing with medium to long-term loans for development of strategic sectors. From the perspective of the newly merged bank having more balanced business lines in both retail and corporate banking, the merger makes strategic sense. However, the health of the KLTCB was highly questionable when the government orchestrated the merger. At the same time, for the obvious reason of its past focus on retail businesses, the Kookmin did not have much expertise in the area of industrial and corporate banking that the KLTCB had been engaged in. Thus, it is not clear whether the Kookmin is going to have any significant role in the process of improving the quality of KLTCB's assets that are going to be part of the portfolio of the combined bank. In all likelihood, the Kookmin will have to rely on the industrial and corporate banking expertise of the KLTCB, but the latter's track record had been less than stellar. As a matter of fact, a rapid deterioration of the KLTCB's assets in the wake of the series of corporate bankruptcies in 1997 had been the key reason for the merger to begin with. Deterioration of asset quality for the post-merger Kookmin is not an immediate concern in this case as there is a governmental guarantee to absorb non-performing loans that might arise within a certain period after the merger. Rather, the question is whether the new bank will be a successful player in all-around business in the future. On the surface, there is a chance that the merging will dilute whatever advantages the Kookmin had maintained in the past and will make it just one of several look-alike Korean banks.

The challenge is how to turn these pairings, that took place in the wake of the financial crisis, into commercially sensible entities in the future. The government can provide prudential regulations to ensure the safe operation of the banks, but it does not appear that there would be a clear role for the government in encouraging the new banks to succeed. One approach is to allow mergers between commercial and merchant banks based on strictly strategic considerations. Given that some merchant banks (especially those that converted into MBCs from IFCs, as discussed in section 4) tend to have more expertise in corporate banking, they can be tapped as a source for strengthening that part of business for commercial banks that have been less

than successful. Similarly, some MBCs must have a comparative advantage in dealing with funding in international capital markets since that had been their main source of funding in the past.

Another key area where future improvement is called for is how to foster professionalism among bank employees. Traditionally, as in most Korean corporations, the banks' centralized personnel departments hired a large batch of new high school or college graduates once a year and relied on the training system of rotating employees to various areas of operation to produce a batch of indistinguishable generalists. In turn, most of these employees typically remain with the bank until they retire.[27] Under such a system, the cumulative know-how of a bank will likely evolve slowly compared to those with outside training institutions. Unless the bank itself is at the frontier of financial innovations and setting new trends, someone inside the organization has to recognize a new development in terms of financial products or techniques, acquire them, and then train insider employees for the bank to adapt to the new changes.[28]

On the other hand, having a more porous employment structure, where the hiring authorities are delegated to specialized groups, will likely allow more free inflow of new employees with a more advanced stock of human capital and technical know-how. The timing might be right at the moment for Korean banks to consider changing their man-power management system. Already, due to the irresistible momentum of change, various conventional practices are no longer there. When a bank disappears because it has failed to earn an economic profit through banking, employee loyalty harnessed through the traditional system of seniority and harmony are hardly enough to save the institution. Due to many factors, Korean banks have been behind the curve in many areas of business until now. Now is the opportunity to try adopting more flexible hiring practices with a view to increase the overall stock of human capital by bringing in expertise that is available to outside individual

27) The positive motivational benefit of this type of employment relationship, most prevalent in Japan, has been thought to be important to imbue loyalty to employers. It is natural that under such a system that fosters homogeneity and emphasizes harmonious relationships that seniority becomes important and a union of employees becomes very influential.

28) "Banks will also need enhanced technical capacity and institutional development to deal with the restructuring of a large number of corporates and a large magnitude of corporate debt" (Claessans, Ghosh, and Scott, 1998).

banks. Since it might be a while before Korean banks become the originators of new financial engineering and risk management, it might be advisable that such new personnel management styles continue for some time to come. On the part of the government, it could help improve labor mobility in general by changing pension systems so they are more portable and amenable to job changers.

6.3. Exit Strategy of the Government

At the moment, the government has significant shareholdings of four nationwide commercial banks. Though this was an inevitable outcome due to the extraordinary developments of 1997, the current situation is a source of concern for many observers in that it will facilitate the government reverting back to the direct controls seen in the past.[29] Perhaps similar concerns might have prompted the IMF to raise the point in their 'Memorandum on Economic Policies for the First Half of 1999', a consultative agreement between the Korean government and the IMF. Indeed, the government has agreed with the IMF to produce plans to re-privatize banks by divesting shares it is holding. If the key issue is just a matter of financial resources that the government committed to these banks, the currently booming Korean stock market seems to offer an opportune chance. However, it is more likely that the government maintain its shareholding position in the foreseeable future to employ banks as a means to an end in its push to lower the leverage ratio of the corporate sector. Over-leveraging and the attendant high debt servicing burdens have been widely blamed as one of the key causes of the 1997 crisis. As part of the overall drive to de-leverage, 30 chaebols agreed with their main creditor banks to lower their debt to equity ratios to 200 percent by the end of 1999. Due to the fact that banks still remain as the main source of credit for large

29) In June 1998, the FSC required banks to come up with a list of 55 nonviable companies to be forced into bankruptcy. This episode heightened concerns as it did not seem to have any material economic or financial impact other than demonstrating a strong intent on the part of the government.

businesses, the government can exert substantial influence over the corporate sector by controlling the credit pipeline from banks to corporations.[30)]

This issue of lowering the leverage ratio, however, warrants some special interest because the improvement in the capital structure of the corporate sector would significantly improve the business environment for banks. There are a couple of obvious problems with the current drive. One, the capital structure of a firm is typically determined by its internal decision makers, given various relevant external factors such as interest rates, conditions of debt and equity markets, and tax treatment of debt financing costs and so on. Two, there do not seem to be sound economic rationales for the choice of 200 percent as the benchmark. Some commentators point to this as evidence of the government's continued reliance on a coercive modality of managing economic affairs best left to private agents, examples of which were plentiful in the past.

However, there is logical economic reasoning for such a requirement. This particular explanation hinges on the recent experience of the government being forced into bailing out the whole banking sector in Korea. The immediate cause of the chain of events was the failure of several large businesses with large bank borrowings, and the impact reached a systemic crisis proportion almost without any mitigation. In a very short period of time, the event clearly illustrated how costly it had been for the government to assume so much risk when it intervened in their credit allocation decisions over the past several decades. It also clearly showed how the government ended up assuming the risks of private businesses through the financial intermediaries.

Though the corrective actions taken to date have stabilized the situation, the basic nature of the financial linkage between banks and businesses in Korea has not changed materially (It would be unrealistic to expect a drastic change to take place in such a short amount of time). Thus, any new failures of large businesses will put the government in exactly the same position as in 1997. In

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30) Though not explicitly mentioned, suggestions were dropped by officials of the possibility of bank credit curtailment as a punitive measure against chaebols that were not cooperating with the so called 'big deal' in which chaebols were supposed to swap key lines of business for the purpose of consolidating excess industrial capacity.

the face of such a possibility, the government is trying to reduce its direct risk exposure to private businesses.

Such an approach might be advisable as a part of the crisis-management policy prescription. However, the effort itself shows the government's implicit willingness to be the guarantor. There seems to be wide agreement that the moral hazard arising from not facing the downside risk of decisions by various players in the economy had been a key structural weakness in Korea (as well as in other economies). To the extent that such a system of socialized risk has been responsible for weakening economic institutions, the practice of the government assuming the role of the ultimate guarantor of private decisions needs to be discontinued. To this end, the government has to establish mechanisms that will allow an arm's-length relationship between the government and the private decisions makers of banks and corporations. Requiring banks to make loan loss provisions commensurate to the borrower's level of leveraging on prudential regulation grounds is one way to encourage lower leverage taking by businesses.

The current set of policies might be necessary to introduce substantive changes in a relatively short amount of time. However, as discussed above, it will be difficult to maintain the current level of intensity going forward. In addition, it is not clear how desirable governmental edicts, albeit indirect, in private firms' capital structure are. Thus, it is imperative that more thought be given to establishing a financial market infrastructure that could endogenously shield the government from having to bear the excessive private risk arising out of private agents' decisions. In particular, the development of a well-functioning capital market has to be given high priority.

6.4. Long-term Prospects: Less Commercial and Industrial Lending and more Consumer Financing

Ultimately, two dominant developments will likely influence the future shape of the Korean financial sector. First, for the financial sector that does not have a significant international business portfolio like that of Korea, asset composition will likely reflect the make-up of the national economy. To use a

stock market analogy, the aggregate banking sector's assets will resemble the most diversified market portfolio (i.e., with beta equals one). In terms of risk management, perhaps that is the most that can be done. In the case of Korea, a disproportionately large portion of available financing went to the manufacturing industries and a disproportionately small portion was made available to consumers.[31)] In the future, a shift in where financial resources would likely flow will be determined by a tendency to correct such an imbalance.

Second, a general shift and lowering of asset quality are to be expected in the long term. This specifically has to do with lendings to large borrowers. Given the prominence of businesses belonging to the top-five chaebol in the overall Korean economy, it is not surprising to find a large portion of bank credit flowing in that direction. Even when due credit analysis is carried out, the explicit and implicit guarantees attached to being a member of a large business group would make any application from a business belonging to the top-five chaebol groups a good credit risk. If they have been too big to fail, it is hard to imagine those business groups losing that status in the near future. At the moment, due to several factors, including negative perceptions prevailing about the fiscal soundness of some of the Korean large businesses in international capital markets, they are more dependent on Korean banks. However, the reduction in the relative share of large businesses borrowing from banks will take place in the future not because of the banks' retrenching from such lending but because of large businesses shifting away from banks for their financing. Most large businesses will likely regain the good credit standing they enjoyed before 1997 sooner or later, as their current restructuring efforts yield visible results. With the increasing globalization of the capital markets and the growth in domestic direct financing markets in Korea, we should observe the same trend of large businesses with good credit standing relying more on direct financing than banks.

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31) "South Korea's ongoing financial-sector reform has triggered a strategic shift of focus among the providers of financial services, from producer-oriented wholesale finance to consumer-oriented retail finance" (EIU, 1999, p. 19). This also could explain why a couple of banks that had mostly retail-oriented businesses in the past are enjoyinga distinct rise in their share prices compared to the rest of the industry.

The developments in the few years before 1997 are instructive in this regard. With the advent of Korea's joining the OECD in 1994, there was a discrete rise in the credit standing of Korea. The main beneficiaries were large Korean banks borrowing abroad.[32] This also lowered the borrowing costs for the large Korean businesses that already had been well known internationally. Since 1991, changes in domestic rules liberalized foreign subsidiaries of Korean businesses raising capital abroad, thus increasing large businesses' access to international capital markets. Thus, in the mid-1990s, the top-five chaebols increasingly started to rely on foreign borrowing, instead of domestic sources, as international interest rates were substantially lower than domestic rates. Also, large businesses were the first to benefit from the growing domestic debt market. Given that the credit available to domestic banks also increased noticeably around this time, banks increased their lending to the non top-five chaebol businesses. As a consequence, there might have been more risky lending than was warranted.

The point of visiting this episode is that the general trend of superior quality borrowers shifting away from bank borrowing will likely set in sooner or later. The speed with which this trend is going to continue will hinge on two factors. One is the longevity of the government imposed guidelines discouraging banks from extending credit to large businesses as a part of the drive to a lower leverage ratio. Two, and perhaps more importantly over the longer horizon, is the pace of the growth of the debt and equity markets in Korea. Already owing to these the governmental guidelines and a booming stock market, which allows businesses raise capital through new share offers, the demand for bank loans from large businesses has fallen noticeably in 1999. If such a trend were going to present a continuing problem to banks in Korea, they are in for the same unfriendly environment for an extended period.

32) "International interbank lending to Korea soared, …One of the reasons behind this boost was the more favorable capital ratio requirement associated with the country's entry into the OECD, which reduced the risk-weight for loans to Korean banks form 100 to 20 percent, thus raising international banks' return on risk-adjusted capital and lowering spreads for loans to Korean banks" (Balino and Ubide, 1999, footnote 34).

7. CONCLUSION

In a market-oriented economy, governmental oversight over financial institutions is typically justified on two grounds. First are concerns related to the potential failure of a few financial institutions spreading to the whole system, which has serious macroeconomic ramifications. The second justification is the possibility that a deposit taking institution might abuse the benefit of governmental guarantees by engaging in overly risky behavior on the basis of expected return calculations that do not properly take downside risks into consideration. Both tenets had been flagrantly breached in the pre-1997 crisis period, and the government was a part of the problem as it pushed the banks to finance its industrial development policies without paying due attention to the fact that it had retarded the traditional role of banks as financial intermediaries.

In general, the most a government can do is to make sure that financial institutions practice appropriate risk management, contain the spread of problems of individual banks due to idiosyncratic reasons, and take prompt actions when a financial institution gets into trouble. None of these have direct implications for a financial institution's profitability. Markets, on the other hand, for equity and both domestic and international capital will provide a more objective assessment of how well financial institutions are managed and how good their profitability prospects are.

The preponderance of evidence in Korea suggests that the government is not the ideal owner or manager of banks. Evidence from many countries over time also strongly supports this proposition. Thus, sooner or later, the government will have to detach itself from the current entanglement with the commercial banks by selling off its share holdings and keeping an arm's length relationship with them. Otherwise, the current close control of the banks by the government will confirm many agents' perceptions that nothing really has changed with regard to the government taking an activist role, despite the fact that the current engagement was necessary due to the outbreak of the crisis in 1997.

The current drive to lower the overall leverage ratio in the corporate sector

by going through the banks poses a challenge to policy makers. Basically the drive itself is well intended and there could be ways to improve upon the current implementation method of setting a uniform goal. The government could adopt rules to provide incentives for banks to lower their exposure to heavily indebted businesses by putting in place strict guidelines that would escalate required loan loss provisions when lending to such businesses.

One of the key challenges that has not been covered adequately in this paper is how to foster robust capital markets in Korea. The government could play an important role in this regard. A key area is building up the infrastructure for credit culture by ensuring sufficient data is available and that it is both transparent and accurate. Other examples are plentiful. Updating legal codes to enable more securitization of various assets and claims is another area where only the government could effect necessary change. Efforts in these areas might not yield spectacular short-term visible results, but they ultimately will contribute to establishing a financial market infrastructure that could in turn shield the government from having to bear private risk arising out of private agents' decisions.

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