

Financial Supervision of Merchant Banking Corporations as a Cause of Korea's Currency Crisis*

Doo-Yull Choi** · Yeonho Lee***

This study investigates the ineffectiveness in the financial regulations and supervision of Korea's merchant banking corporations (MBCs) prior to the 1997 currency crisis, whose behavior is thought to trigger a vicious circle of credit contraction from Korea's MBCs to conglomerates. The study is based on the presumption that large parts of MBCs' business behavior are endogenously determined under the given financial regulations and supervision system. The main point of this study is that the financial regulations and supervisory system surrounding MBCs were very much out-dated and ineffective. In particular, MBCs were supervised based on an anachronistic paradigm that foreign and domestic currency businesses undertaken by financial institutions were distinctively separate from each other. This is a good example showing the dangers when institutions and cognition do not catch up with changing circumstances. Even under the new supervisory system, bureaucratic sectionalism and no cooperation among the supervisory agencies, which had resulted in the gray areas of supervision of MBCs, are still often found in reality. In fact, the supervisory agencies still rarely share the information on supervision and hardly cooperate in examination. It cannot be overemphasized, therefore, that these bad practices among supervisory agencies should be corrected for the soundness of Korea's financial system.

JEL Classification: F3, G2

Keywords: merchant banking corporation, financial regulation,
financial supervision, currency crisis

* Received October 10, 2005. Accepted November 30, 2005. We are mostly grateful to the anonymous referees for their helpful comments.

** Author for correspondence, Dept. of Industrial Management, Korea University of Technology and Education, 307 Gajeon-ri, Cheonan, Chungnam, 330-708, Korea, Tel: 81-41-560-1435, Fax: 81-41-560-1439, E-mail: dychoi@kut.ac.kr

*** Dept. of Economics, Chungbuk National University, 12 Gaeshin-dong, Cheongju, Chungbuk, 361-763, Korea, Tel: 81-43-261-2215, Fax: 81-43-271-1713, E-mail: leeyh@chungbuk.ac.kr

1. INTRODUCTION

A somewhat superficial view of the evolving processes of Korea's 1997 currency crisis summarizes its development as follows. The series of bankruptcies of large conglomerates since around the beginning of 1997 had placed a number of domestic financial institutions near insolvency. International creditors, worried about the near insolvency of Korea's financial institutions, reacted by squeezing their credit lines on Korea's financial institutions. Adding to squeezing of credit lines of international financial market, the authorities' imprudent exchange rate defense eventually depleted the foreign currency reserves.

Therefore, Korea's 1997 currency crisis may be characterized as being evolved from financial crisis, combined with the policy failure on exchange rates. In the evolving process of the financial crisis, the business behavior of Korea's merchant banking corporations (hereafter referred to as MBCs) were singled out as one of the most fatal impetus fueling the outbreak of Korea's currency crisis. Specifically, the criticisms have been based mainly on two grounds.

Firstly, MBCs have been criticized for triggering a chain reaction of bankruptcies of Korea's large conglomerates, "*chaebols*". MBCs, which typically lacked capabilities in credit ratings and analysis, had extended non-secured credit to low credit-rated conglomerates under the traditional myth that large conglomerates were too-big-to-fail. As large conglomerates began to show signs of bankruptcy from early 1997, MBCs were pressed to desperately attempt a withdrawal of their outstanding loans from faltering conglomerates. MBCs' indiscriminate demand for return of their loans from corporations is said to have caused domino-like bankruptcies of large conglomerates. The chain reaction of bankruptcies in effect led to the deterioration of Korea's financial institutions, which were driven to almost complete insolvency. Such a vicious circle of credit contraction from Korea's MBCs to Korean conglomerates has been thought of as having fueled the financial panic in the midst of Korea's weakening financial sector.

Secondly, MBCs have been criticized as having aggravated Korea's foreign liquidity crisis, in particular, by their reckless behavior in international business markets. They usually borrowed short-term foreign capital at attractively lower interest rates, and then invested in long-term lease assets and/or illiquid junk bonds in a number of developing countries. When MBCs were cut off from the short-term international financial markets and the junk bonds of developing countries in which MBCs invested defaulted, they immediately fell into a foreign currency liquidity crisis. This is said to have accelerated Korea's foreign currency liquidity crisis.

The two arguments above constitute the main arguments why Korea's MBCs were believed to have played a major pivotal role in the outbreak of the 1997 currency crisis. Before placing the blame on MBCs for destroying Korea's financial system, however, it should be noted that MBCs were commercial enterprises that seek to maximize profit, and whose behavior is affected by the given exogenous environment: law, regulations, national strategies, policies, societies, politics, cultures, etc. From this point of view, special attention should be taken to the financial regulation and supervision system that had a decisive impact on the business practices of financial institutions.

It is also notable that besides Korea's MBCs, financial crises have occurred repeatedly on international scene and a similar kind of blame has gone to the impetuous growth and sudden collapse of non-banking financial institutions. The Japanese Jusen (housing loan companies) and Thailand's finance companies are examples.

Despite this, similar mistakes continue even today. What is more, the financial regulation and supervision system that had played a critical role in the collapse of non-banking financial institutions has yet to be properly reviewed. There are hardly any systematic studies of the currency crisis from the point of system's approach (i.e. failure of institutions or regulations). In the same manner, despite numerous denunciations of MBCs, very little effort has been made to understand their behaviors within an institutional setting which are primary factors behind their insolvency.

In contrast with the typical macroeconomic approach,¹⁾ the role of MBCs and the financial regulation and supervision system concerning them are investigated here. A study of the financial regulation and supervision system is essential if one is to properly appreciate the reasons for the reckless business behavior of MBCs before the crisis.

An important aspect of this study is that even under the general severe financial suppression, MBCs had been operating in a relatively more liberalized commercial environment based on market principles. It is in this sense that the business behavior of MBCs is more likely to be endogenously determined under the given business environment, especially financial regulations and supervision, than otherwise. This study will argue how financial regulations and supervisory system surrounding MBCs were out-of-date, containing many defects which made them improper instruments in regulating the business activities of MBCs.

An overview of the growth of MBCs and their tasks is provided in section 2. Section 3 provides the main evidence for this study by taking a careful look at the weak financial regulations and supervision that induced MBCs' unsound business activities. Section 4 closes the study with a summary and conclusion.

¹⁾ Most of the existing literature adopt a macroeconomic approach in analyzing the causes of the Korean currency crisis. As such they tend to miss the most important factor causing the change in macroeconomic variables, namely, the financial regulation and supervision systems governing financial institutions. For example, Lee and Lee (1998), Choi (1998), and Radlet and Sachs (1998) argue that the Korea's currency crisis was caused by exogenous shock. Chung (1998), and Corsetti, Pesenti and Roubini (1998) emphasize structural problems in the Korean economy, while Krugman (1988) stresses moral hazard of financial institutions as the major factor. Lee and Eo (2000) look at big conglomerates, while Yu (2000) takes on the impact of government regarding the crisis. Oh (1998) emphasizes the role of capital market liberalization; Cho (1999) emphasizes the adverse effects of short-term financial markets. Park and Choi (1999) emphasize the impact of real exchange rate appreciation; Park and Lee (1998) point to the government and the civil sectors' naive response to Southeast Asia's currency crises; Kim, Nam and Lee (2000) focus on over-consumption before the outbreak of crisis in 1997.

2. THE GROWTH OF MBCS AND THEIR BUSINESS SCOPE

In the early 1990s, initially 6 MBCs were operational in the market. In 1994 and 1996 respectively, 9 and 15 investment finance companies (hereafter referred to as IFCs) were transformed into new MBCs. The initial 6 and transformed 24, totaling 30, MBCs were in operation immediately before the 1997 currency crisis.

Because most of the existing MBCs then were in fact IFCs, discussing the role of MBCs in the process of Korea's currency crisis requires reference to the growth processes and functional scopes of IFCs before they were transformed into MBCs. IFCs were established by the legislation of the Short-Term Financial Business Law in August 1972. The Law aimed to bring out the underground private financial sector into the open after the so-called 8.3 Private Loan Freeze Emergency Order in 1972 and create short-term banking institutions for business enterprises.²⁾

On the other hand, Korean MBCs had appeared based on the legislation of the Law of MBCs in December 1975. Between 1976 and 1979, the "initial 6 MBCs" were established. Contrary to the Short-Term Financial Business Law, the Law of MBCs was originally legislated to establish long-term financial institutions. To encourage long term financing to the industrial sector, MBCs were originally modeled on the Merchant Banks of England. To make appropriate adjustments to fit Korea's actual financial circumstances, the Ministry of Finance and Economy (hereafter referred to as the MOFE) also added the function of investment banking and medium/long-term equipment financing, as well as the typical functions of Merchant Banks of England. Interestingly, the Law of MBCs allowed MBCs to do almost all the financial businesses. MBCs had much broader scope and functionality than IFCs. In detail, the major businesses of MBCs consist of five categories; short-term financing, international financing,

²⁾ What is noteworthy is that IFCs were modeled on the finance companies of Thailand, which, as already mentioned, had played a pivotal role in Thailand's 1997 currency crisis. For more details, see Man-Su Kang (2000. 8), pp. 440-448.

medium-term financing, long-term financing, and securities brokerage.

The most important difference between the business scope of IFCs and MBCs is that the latter were allowed to participate in international financial businesses. This included the introduction and brokerage of foreign capital, overseas investment, as well as the introduction of foreign capital on their own account for re-lending to domestic enterprises. At the beginning, as with the IFCs, the main business of the MBCs was short-term financing, like selling CPs. However, as time went by, largely to avoid competition with IFCs in short-term finance, MBCs began to place more emphasis on medium/long-term financing and leasing. However, this kind of ecological balance between IFCs and MBCs in the non-banking sector was destroyed by the massive conversion of IFCs into MBCs in the mid-1990s. IFCs had customarily conducted their business by pursuing high-risk and high-return investment activities. They did not break from this customary business behavior even after they were transformed into MBCs. Consequently, the effect was to turn MBCs into a high-risk and high return financial industry.

Before going on to further details of MBCs, it is necessary to look at the process of the rapid growth of IFCs and MBCs. The aggregated market share of IFCs and MBCs in Korea's financial sector had rapidly increased up until the 1997 currency crisis.³⁾ Table 1 shows the aggregated market share of MBCs in terms of total assets. Total assets of MBCs had reached 155,910 billion won in 1996, which constituted almost 45.6% of commercial banks' total assets of 341,558 billion won. Such a staggering figure would be abnormal given that the non-banking sector, which mainly engages in short-term financial business, would constitute such a huge market share in financial businesses.

We now move on to provide reasons why Korean MBCs had become so dominant compared to commercial banks. Firstly, MBCs had been placed under a more relaxed set of regulations and restrictions concerning interest rates compared to commercial banks. Secondly, they had been allowed more

³⁾ All remaining IFCs were eventually converted into MBCs in 1996, by which time the market share of MBCs includes that of IFCs.

Table 1 Yearly Assets and Equities of MBCs

(unit: billion won)

End of year	Assets of MBCs ¹⁾	Equities of MBCs	Assets of Commercial Banks	Equities of Commercial Banks ²⁾
1990	48,308	2,440	135,519	12,339
1991	54,720	2,035	161,516	13,781
1992	61,590	2,246	180,615	14,891
1993	75,261	2,544	194,988	16,223
1994	88,973	3,181	228,961	18,917
1995	123,878	3,657	288,687	21,380
1996	155,910	3,969	341,558	23,237
1997	166,771	3,884	483,498	22,290

Notes: 1) Includes new MBCs including existing IFCs that were transformed on July 1, 1996; data before July 1996 are aggregated accounts of IFCs and MBCs.

2) Includes Nation-Wide Commercial Banks, Local Banks and Foreign Banks in Korea.

Source: The Bank of Korea, "Money & Banking Statistics," various issues.

autonomy in their management, thereby allowing them to manage their businesses as a profit-making corporation on the basis of commercialism and not as a public enterprise.

Before the conversion of IFCs into MBCs, the latter had enjoyed high profitability. Their ROE (Return On Equity) was well over 10%, for example. However, after the massive conversion of IFCs into MBCs, a total of as many as 30 MBCs began to face competition amongst themselves, thereby sharply eroding profitability. This excess competition in the short-term financial business became a major reason behind their dwindling profitability. Faced with this sharp drop in profitability, MBCs decided to extend their business scale so as to remedy this deteriorating situation. However, such decisions often were made without considering accompanied risks. In particular, MBCs extended their credit to conglomerates with unsound financial structure.

Table 2 Foreign Currency Liabilities of Financial Institutions

(unit: 100 million dollars)

	1994	1995	1996	1997	1998	1999	2000
Foreign Currency Liabilities of Financial Institutions	650.9 (100.0)	896.4 (100.0)	1,165.3 (100.0)	899.0 (100.0)	709.8 (100.0)	609.8 (100.0)	507.7 (100.0)
Domestic Banks	360.8 (55.4)	496.9 (55.4)	630.9 (54.1)	330.2 (36.7)	278.6 (39.3)	256.0 (42.0)	213.3 (42.0)
Development Institutions	147.7 (22.7)	203.3 (22.7)	265.3 (22.8)	294.3 (32.7)	251.5 (35.4)	200.0 (32.8)	154.9 (30.5)
MBCs	33.6 (5.2)	62.9 (7.0)	103.9 (8.9)	79.0 (8.8)	40.7 (5.7)	16.3 (2.7)	9.9 (2.0)
Foreign Banks in Korea	108.8 (16.7)	133.3 (14.9)	165.2 (14.2)	195.6 (21.8)	139.0 (19.6)	137.5 (22.6)	129.5 (25.5)

Note: Figures inside the parentheses are %.

Source: Bank of Korea, "Annual Report of Foreign Exchange Statistics," various issues.

They are also contrived to have raised their profitability by the so-called "riding the yield curve" strategy; borrowing short-term foreign capital from international financial institutions and investing them in long-term investments in order to reap the yields between them. Their long-term investments, however, mainly consisted of illiquid assets, which included long-term leases in domestic financial businesses and junk bonds of developing countries like Thailand, Indonesia, and Russia, amongst others.

Table 2 shows the foreign liabilities of Korea's financial institutions. Among the total of 116.53 billions dollars of foreign liabilities of financial institutions at the end of 1996, MBCs constituted 10.39 billions dollars or 8.9% of the total. The total amount of the foreign liabilities of financial institutions showed a 180% increase from 1994 to 1996. Even more noticeable is that foreign liabilities of MBCs showed more remarkable growth, jumping from 3.36 billion dollars (5.2% of the total) to 10.39 billion dollars (8.9% of the total), which is an increase of about 310% over the same period.

Table 3 Bad Loans of 7 Bankrupt Chaebols

(unit: 100 million won)

	Han -bo	Sam -mi	Jin -ro	Dae -nong	Kia	Hai -tai	New -coa	Total
Commercial Banks	46,274	8,108	13,897	6,986	44,403	13,104	9,373	122,679
(Collateralized)	24,182	4,448	8,871	2,952	19,545	900	6,733	67,631
MBCs	530	105	4,331	5,253	36,042	17,425	2,030	65,716

Source: Korean Federation of Commercial Banks, Maekyung Daily News, "Are MBCs nearly Bankrupt?" November 6, 1997, p. 7.

With the advent of the Asian currency crisis, liquidating such illiquid assets into liquid assets to redeem short-term loans that were not rolled over became considerably difficult. As will be discussed later, the foreign currency liquidity crunch of MBCs thereby began to fuel the problems at the outset of the Korean currency crisis. In addition, the bad loans of MBCs began to rapidly grow following a chain of bankruptcies of large conglomerates from the beginning of 1997.

Table 3 shows the amount of bad loans of commercial banks and MBCs linked to 7 bankrupt conglomerates at the end of 1997. The amount of bad loans of MBCs stood at 6,571.6 billion won, which far surpasses their total equities of 3,884 billion won. This unsecured credit risk exposure adversely affected MBCs' external credit worthiness, which isolated them from international financial market.

3. FINANCIAL REGULATION AND SUPERVISION OF MBCS

3.1. Financial Supervision and Examination System of MBCs

Various ways of classifying financial regulation and supervision are possible. However, for the purposes of this study, we will classify financial

supervisory activities into three broad categories: entry regulation, ex-ante, and ex-post supervision. Firstly, we refer to the authorization, permission, and licensing by the supervisory body regarding financial institution as “entry regulation”. Secondly, we consider the making and amending of rules and regulations for prudential reasons as “ex-ante supervision”. Lastly, we refer to financial supervision including the examination and punishment functions as “ex-post supervision”.⁴⁾

Before we look into the financial supervision system of MBCs, a glance over the entire framework of Korea’s financial supervision system should be useful. Table 4 shows the whole framework of supervisory jurisdiction on Korea’s financial institutions up until the crisis. Among various supervisory institutions, the Office of Bank Supervision (hereafter referred to as OBS) and the MOFE were the two main supervisory bodies.⁵⁾ The Office of Bank Supervision has legal authority of supervision over commercial banks. It was established under the Bank of Korea (hereafter referred to BOK) and was subject to the instructions and directives of the Monetary Board of the BOK. The OBS exercised both ex-ante and ex-post supervision over commercial banks.

Except for commercial banks, the MOFE took legal authority of supervision over most of specialized banks and non-banking financial

Table 4 Supervisory Jurisdiction in Korea

⁴⁾ In Korea’s financial supervisory statutes, there is no official terminology distinguishing between ex-ante and ex-post supervision explicitly. However, it is clear that separately treating these two concepts is important, especially when considering the fact that supervisory bodies that are responsible for each might be different. Until the currency crisis, generally ex-ante supervisory power and ex-post supervisory power were separated, as is seen in table 4.

⁵⁾ In Korea, there have been serious disputes among supervisory bodies, especially between the OBS of the BOK and the MOFE, over the jurisdiction of supervision of financial institutions. The supervisory jurisdiction has had an important meaning for the placement of ex-officials of supervisory institutions. Traditionally supervisory power had been exploited as an important revolving door for ex-bureaucrats of supervisory institutions to finding jobs in supervised financial institutions. Leveraging on their supervisory power, the supervisory institutions had controlled high-handed personnel administration over the supervised financial institutions, where ex-official of supervisory institution could be placed as CEOs or auditors. Such revolving doors of ex-bureaucrats of regulating institutions to take up important posts in regulated institutions can also be found in Japan, which is called “Amakudari”.

Financial Institutions	Supervised by	Examined by
Commercial Banks	OBS ¹⁾	OBS
Specialized Banks	MOFE	MOFE
Non-Bank Financial Institutions (Development Institutions, Investment Institutions, Savings Institutions)	MOFE	MOFE
MBCs	MOFE	MOFE
Securities Institutions	MOFE, SSB ²⁾	SSB
Life Insurance Institutions	MOFE, ISB ³⁾	ISB

Notes: 1) OBS means the Office of Bank Supervision of the BOK.

2) SSB means the Securities Supervisory Board.

3) ISB means the Insurance Supervisory Board.

institutions, including MBCs.⁶⁾ In fact, the MOFE has had ultimate power of financial supervision over MBCs. But compared with those of commercial banks, financial regulation and supervision of MBCs turned out to be much weaker.

Regarding ex-ante supervision on MBCs, the MOFE seemed to have outdated financial rules and regulations and did not meet timely the needs to amend supervisory standards and provisions. Not only did the ex-ante supervision become outdated, the MOFE turned out to have been negligent regarding ex-post supervision, e.g. surprise on-site examination, on-site-confirmation of reports, field confirmation of constructing financial risk management system, and so on. Such ineffective financial supervision allowed MBCs to undertake risky business activities, which finally led to their collapse with the outbreak of the currency crisis.

There were three main reasons why the MOFE's financial supervision of

⁶⁾ MBCs may be considered similar to banks if we consider that MBCs and commercial banks have few functional differences and are exposed to similar credit risks. Therefore, there is little reason why MBCs should be supervised by different supervisory bodies from commercial banks. Nonetheless, financial supervision of commercial banks has been assigned to the OBS of the BOK, while the supervision of MBCs has been assigned to the MOFE.

MBCs became ineffective. Firstly, the MOFE was primarily a policy-making institution rather than an executive organization. It did not have important executive organizational structures, nor did it develop specialty for supervising financial institutions. As a result, the MOFE had frequently relied upon partial delegation of ex-post supervision to the OBS, SSB, Korea Credit Guarantee Fund and others. However, such ex-post supervision by ways of partial delegation had some critical defects as will be discussed later.

Secondly, even under the partial delegation of the supervision system, coordination of supervision of the MOFE turned out to be extremely poor. Although it was the prerogative of the MOFE to systematically and comprehensively organize the supervisory activities of MBCs, in reality it failed to do so. Moreover, under the supervision system by partial delegation of ex-post supervision, many gray areas of supervision cropped up. Most of these occurred when the scope of partial delegation was not clearly defined or when the MOFE failed to properly coordinate financial supervision among the entrusted supervisory agencies. As the business areas of MBCs were highly diversified, the laws, which govern their businesses, were also multifarious and complex.

Even within the MOFE, the power of supervision of MBCs was dispersed into several departments.⁷⁾ Because MBC governing laws and supervisory agencies were diversified, it was even more vital that the MOFE coordinate the supervisory activities of entrusted agencies more comprehensively. However, consolidated planning and coordination of financial supervision of the MOFE had proved to have been extremely weak, plagued with many gray areas over financial supervision.

For example, supervision over the foreign exchange businesses of MBCs was commonly plagued by weak financial supervision. Regarding MBCs' foreign exchange business, neither ex-ante nor ex-post financial supervision

⁷⁾ Such departments included the followings; Capital Market Department, Industrial Fund Department, Securities Business Department, International Finance Department, Securities Business Department, International Finance Department, etc.

had been properly conducted especially from 1994 to 1996 when the newly-converted MBCs had began to engage in international financial business recklessly. On the side of ex-ante supervision of MBCs foreign exchange business, rules and regulations to secure their soundness had not been updated to meet the changing times. Necessary guidelines were not established, for example, regarding the level of adequate foreign currency liquidity; exclusion of lease loans from regulating medium/long-term foreign currency ratio; exclusion of overseas securities investment from the limit on securities investment; exclusion of foreign currency loan from the limit on short-term loan, etc. On the side of ex-post supervision of foreign exchange business, the performance of MBCs in the foreign exchange business from 1994 to 1996 went unexamined especially during the critical period in which the newly-transformed MBCs engaged in the international financial sector without due proper preparation. As the supervisory institutions had not checked whether MBCs observed even the outdated rules and regulations, MBCs ended up recklessly expanding their businesses.

The MOFE manages the “Foreign Currency Exchange Transactions Regulation,” which regulates the soundness of foreign exchange banks among which MBCs are included, and it is therefore responsible for ex-ante supervision of MBCs’ foreign exchange business. The related law prescribes that if necessary, the MOFE may entrust to the OBS parts of ex-post supervision of foreign exchange businesses, including examination and reporting.⁸⁾ However, regarding ex-post supervision of MBCs’ foreign exchange business, the MOFE did not explicitly include the examination of MBCs’ foreign exchange businesses when the MOFE requested examination of MBCs to the OBS, even though it could have done so. In the process of parliamentary inspection after the currency crisis on the causes of currency crisis, the MOFE and the OBS blamed each other for irresponsibility over MBCs’ foreign currency business.⁹⁾ Be as it may, neither the MOFE nor

⁸⁾ The Law of Managing Foreign Currency specifies that the MOFE has the ultimate power of supervising foreign exchange businesses in foreign exchange banks and if necessary, it may delegate part of supervision to other supervisory agencies.

⁹⁾ The MOFE defended itself arguing that it was not necessary to request the OBS explicitly to

the OBS performed appropriate financial supervision on MBCs' foreign exchange business.¹⁰⁾

Thirdly, there is also an important institutional factor that hindered the effective financial supervision of MBCs. There had been a long-standing practice in Korea's financial industry whereby ex-bureaucrats of supervisory bodies took up senior positions in financial institutions under their supervisory jurisdiction after their retirement.¹¹⁾ Ex-bureaucrats who have taken over posts in non-banking financial facilities including MBCs from the MOFE made supervision of target financial institutions incapacitated. It is

examine MBCs' foreign exchange businesses, saying that the Law of Managing Foreign Currency could be interpreted to have comprehensively entrusted the power of examination of foreign exchange businesses of foreign exchange banks to the OBS. On such grounds, the MOFE argued that the OBS was responsible for neglecting the ex-post supervision on MBCs' foreign exchange businesses. On the other hand, the OBS insisted that the MOFE should have remained the responsible institution. The OBS defended itself saying that it was never entrusted comprehensively the right to examine the foreign exchange businesses. As the right to examine the MBCs was given in the form of special request of the MOFE, so far as there was no explicit request of examination from the MOFE on the foreign exchange business of MBCs, it had absolutely no right to examine the MBCs' foreign exchange business by itself. Before making any judgment on these two opposite assertions, we need to consider the usual practices of delegating ex-post supervision of other business areas of MBCs. Customarily, when the MOFE requested the OBS to examine financial institutions, the MOFE specified target financial institutions and the scope of businesses to be examined. Therefore, the examinations of the OBS were mainly restricted to ex-post supervision. Under such circumstances that related laws and regulations ambiguously defined the delegation of supervisory power, we can infer that the OBS may have believed that the MOFE's delegation was the result of coordination among the MOFE's departments and did not include MBCs' foreign exchange businesses in its examination.

¹⁰⁾ Even after the crisis, the conflict and sectionalism of supervisory agencies are not clearly dissolved. After the crisis, Korea integrated diversified financial supervisory bodies into the Financial Supervisory Commission (FSC) and the Financial Supervisory Service (FSS). However, it is not yet distinctly resolved who takes the control of examination on the foreign exchange businesses of financial institutions. There are still some conflicts between the FSS and the BOK surrounding the examination on financial institutions' foreign exchange business. The BOK, which is now given the right to co-examine with the FSS on financial institutions, wants to perform the co-examination with the FSS on the foreign exchange businesses of all the financial institutions. But the FSS insists to restrict the co-examination on the foreign exchange business of financial institutions with the BOK only to the commercial banks, for fear of transferring part of its supervisory right to the BOK. For more detail, read Munwha daily news, "Disputes between the FSS and the BOK surrounding the supervisory right on FOREX businesses of financial institutions," 2005. 11. 7.

¹¹⁾ Such practices are known as "Nakhasan" in Korea, which literally means "parachuting," say, from an airplane, and "Amakudary" in Japan, which means "coming down from heaven".

not easy to expect supervisory bodies to properly supervise financial institutions where their former colleagues or bosses are working as CEOs. They even acted as lobbyists by rendering rectifying measures incapacitated and, even in some cases, making various financial regulations favorable to their financial institutions. These customary practices impaired the effectiveness of financial supervision by solidifying a close relationship between the supervisory power and the supervised institution.¹²⁾

3.2. Entry Regulation of MBCs

As mentioned before, a total of 30 MBCs were operating in the market before the outbreak of crisis. In the middle of the 1990s, all IFCs tried eagerly to acquire entry permission into the MBC business. For Korean financial institutions, the foreign exchange business was regarded as a golden-goose-like business. Around the middle of the 1990s, coupled with Korea's increased foreign exchange liberalization, financial institutions that had been allowed to introduce foreign capital enjoyed economic rent that resulted from differences in interest rates between international and domestic markets.¹³⁾ While MBCs had been allowed to bring in foreign capital, IFCs were not, because MBCs and not IFCs were classified as Foreign Exchange Banks. This is one important reason why IFCs desperately wished to become MBCs. As both of IFCs and MBCs could receive short-term

¹²⁾ What is interesting is that such practices have also been common in other Asian non-banking financial institutions as well, especially in the case of the Japanese Jusen. The Ministry of Finance in Japan had supervisory jurisdiction over the Jusen and had directly supervised them. Almost all of Jusen executives were ex-bureaucrats from the Ministry of Finance, and in lieu of this, Jusen obtained various kinds of regulatory favors in their business from the Ministry of Finance. Such practices were important reasons why the supervision of Jusen by the Ministry of Finance became so ineffective.

¹³⁾ In the then-international financial market, there had been abundant international liquidity around the world. Several countries including the US and Germany maintained low interest rates. Especially, Japan's interest rates were particularly low thereby causing cheap Japanese capital to flood into international financial markets. Many financial institutions engaged in the so-called "Yen Carry Trade"; borrowing in Yen denominated funds and investing into dollar denominated assets or in emerging markets' junk bonds. Korea's MBCs were known to have actively engaged in this "Yen Carry Trade".

financial business licenses, excessive competition in short-term financial business had occurred among them, which in turn resulted in low rates of return.

In this respect, it is important to verify whether entry regulations, i.e. authorization of the conversion of IFCs into MBCs in 1994 and 1996, had been appropriate from the point of financial supervision. The Kim Young-Sam's regime announced the principles governing the authorization of the conversion of financial institutions in the Financial Reforming Parts of the 5-Year New Economy Plan. The original principles emphasized the following: firstly, IFCs should specialize in comparatively superior businesses among the commonly operated ones in international finance, short-term finance, corporate banking services, etc.; secondly, IFCs should provide comprehensive one-stop financial services for local companies. Instead of the original strict principles of new 5-Year Economy Plan, however, very relaxed requirements were applied to the conversion of IFCs into MBCs in 1994. The newly relaxed requirements for conversion are as follows: (i) IFCs must have equity capital of more than 40 billion won; (ii) IFCs must not have any records on tax avoidance and suspension of business over the latest 3 years, and; (iii) IFCs must hold more than 30 billion won after deducting doubtful capital from their equity capital. The 9 new MBCs, which were licensed under such easier requirements, were also allowed access into the foreign exchange business.

What thickens the story further is that the lowered standards for conversion in 1994 were lowered again regarding conversion in 1996; the requirement on the size of equity capital was alleviated subsequently. With the requirement for equity capital alleviated, 8 IFCs in Seoul and 7 in local areas were permitted to become MBCs as from July 1996. Thus, through imprudently lowering the standards of licensing of MBCs, in merely three years, the MOFE had effectively authorized a total of 24 new MBCs.¹⁴⁾

¹⁴⁾ After the currency crisis, investigation by prosecutors was carried out regarding the process by which IFCs were transformed into MBCs, based on the opposition parties' assertion that some IFCs had bribed government bureaucrats and politicians for permission to be transformed into MBCs.

From the point of financial supervision, the license of conducting foreign exchange business of the newly converted MBCs should have been suspended until their actual viability to engage in such businesses is properly evaluated. However, without such a filtering mechanism, the MOFE *de facto* authorized automatically the opening up of all kinds of businesses to the newly-transformed MBCs in one or two years.

If we reflect on the licensing policy of the transformation of IFCs into MBCs, we can see that the MOFE should have given business permission to transformed MBCs only in specialized business areas, as was initially scheduled in the original policy. In order to decide the business areas, the MOFE could have mandated IFCs to submit comprehensive business plans explaining scheduled job scopes, work to be specialized, method of operation, prospect of results, ways of fund raising, recruiting plans of specialized personnel, etc. Only after evaluating the feasibility of their plans thoroughly should the MOFE have approved MBC business licenses only in viable specialized business areas. In addition, the MOFE should have set up a strict criteria for measuring the capability of performance in new areas in the form of a licensing condition, and in accordance with their achievements, should have decided whether to permit MBCs to continue their new business areas.

Unfortunately, such supervision-oriented licensing policies and procedures were completely absent. Especially, the newly-transformed MBCs in provincial areas hardly had proper infrastructure and experience to conduct international financial businesses. Most of them considered international financial businesses simply as an extension of domestic short-term finance. MBCs typically pursued profits mainly in two ways; firstly, by seeking differences in long-term and short-term international interest rates; secondly, by seeking differences in international and domestic interest rates. However, in constructing their international financial portfolios, they pursued profits neglecting the associated risks of their financial position.

What is interesting are the different ways in which businesses were carried out between original and newly-transformed MBCs. During the currency

crisis, it was mostly the newly-transformed MBCs that experienced a severe foreign currency liquidity crisis. In contrast, the pre-existing MBCs maintained a relatively better foreign currency liquidity status. One of the reasons for this difference lies in the different funding costs of foreign capital between original and newly-transformed MBCs. Mostly, from their establishment, the major shareholders of the original MBCs were internationally well-known foreign investors. Thanks to the reputation of their foreign major shareholders, the original MBCs borrowed from international markets at more favorable conditions than the newly-transformed MBCs. On the other hand, most of the major shareholders of newly-transformed MBCs were local firms. Therefore, they could not benefit from their ownership structure in raising funds. As such, the newly-transformed MBCs had little choice but to borrow short-term capital with higher interest rates. This added further commitment to their risky portfolios. Moreover, the original MBCs were better able to roll over their foreign debt given that they were of higher credit rating in lieu partly of their foreign major shareholders. They even borrowed foreign capital from their foreign major shareholders themselves. In contrast, the newly-transformed MBCs did not enjoy similar kind of protection from their major shareholders.

There is also another important issue regarding entry regulation of MBCs, the licensing of overseas branches. In the middle of the 1990s, all MBCs tried to establish overseas branches. The problem is that the MOFE licensed too many overseas branches of MBCs in Southeast Asia. This unbalanced licensing of overseas branches resulted in the scrambling of Korean MBCs, creating as a result excess competition among them for funding, which in turn increased funding costs. MBCs had created a total of 13 branches around the end of 1997, most of which were concentrated in Southeast Asia (11 in Hong Kong, 1 in Singapore, etc.).¹⁵⁾ The reason why

¹⁵⁾ Unlike the licensing policy of overseas MBC branches of the MOFE, the OBS that was in charge of the supervision of commercial banks had restricted the number of branches in the same area to prevent excess competition among Korean banks. As a result of this balanced entry regulation, commercial banks had overseas branches that were far more diversified, i.e.

MBCs tried to locate overseas branches mainly in Hong Kong may be that for MBCs, which had relatively low credit rating in international finance, Hong Kong was a relatively easier market for funding foreign capital than, say, the US or Europe.

As Korean MBCs' overseas branches scrambled for Hong Kong's limited financial market, the interest rates of borrowing foreign capital that were applied to Korean financial institutions stiffened with the excessive competition among them.

3.3. Regulation and Supervision of MBCs' Capital Adequacy

Another regulatory failure that had aggravated MBCs' financial structure was the poor ex-ante regulation system regarding their capital adequacy. Up until the currency crisis, the MOFE had overlooked introducing appropriate regulatory system like the BIS standards regarding capital adequacy for MBCs.

In the case of commercial banks, the OBS had already introduced the BIS regulatory standards in 1992. Consequently, Korea's commercial banks had been required to adopt the BIS capital adequacy ratio of above 8%. The OBS also adopted an early rectification system, which was activated according to the amount of risky assets of supervised banks. However, it was not until April 1998 that the FSC and FSS introduced a BIS capital adequacy ratio for MBCs. Compared to Korean commercial banks, the introduction of a BIS regulatory system for MBCs was rather late. Regarding the capital adequacy requirements, at least until the currency crisis, the MOFE regulated MBCs by means of naive financial gearing ratios like the capital ratio.¹⁶⁾ Regulations for capital adequacy based on naive

47 in the US, 27 in Japan, 50 in Europe, 34 in Hong Kong, 15 in Singapore, and 83 in other countries.

¹⁶⁾ The financial gearing ratios are sort of simple capital ratios; MBCs were regulated not to exceed credit expansion 20 times their equity capital and not to issue corporate bonds exceeding 10 times their equity capital. However, even such naive gearing ratios had not been strictly observed given the poor ex-post supervision.

financial gearing ratios could not give precise information on the level of risk held by MBCs. As MBCs had extended their credit mostly by un-collateralized discounts, sales of CPs, and payment guarantees, this simple gearing ratio could not provide the precise information on how much risky assets MBCs had been bearing compared to their equity capital.

Such a naive regulatory system on capital adequacy had left MBCs expanding their risky assets imprudently and, furthermore, made it difficult to refrain them from recklessly extending their credit. Consequently, MBCs' management continued recklessly and unabatedly their risk-taking business activities. With such out-of-dated ex-ante regulatory measures, the ex-post supervision could hardly be effective. International financial institutions could not trust the financial status of Korean MBCs because it was difficult to evaluate properly their capital adequacy by means of such out-of-dated gearing ratios.

Despite the changing circumstances with MBCs rapidly expanding their credit and offshore financing in international financial markets, the MOFE had reacted too slowly in introducing a BIS capital adequacy requirement for MBCs. It was only after the outbreak of the currency crisis that the supervisory body introduced a risk-weighted BIS capital adequacy requirement for MBCs.

3.4. Regulation and Supervision of Credit Concentration and Connected Lending

Another piece of institutional failure that aggravated MBCs' financial structure was the weak regulation and supervision of MBCs' credit concentration and connected lending. In fact, MBCs had little ability to evaluate the credit ratings of their borrowers even though most of their credits were unsecured. Therefore, they had strong tendency to concentrate their credit to large "*chaebols*," under the naive belief that the *chaebols* were "too-big-to-fail".

In order to prevent MBCs from recklessly concentrating credit to *chaebols*,

supervisory authority placed strict credit ceilings to refrain credit from exceeding certain limits to large *chaebols*. However, the then supervisory standards on MBCs' credit ceiling to conglomerates were largely defective and contained in them many loopholes. MBCs credit ceiling on a *chaebol* were three times as high as that of commercial banks. Specifically, the credit ceiling by MBCs on a single *chaebol* was restricted at 150% of their equity capital, while that of commercial banks was set at a maximum limit of 45% of equity capital. In addition to this, even though a company belonged to a *chaebol*, if it could be classified as a so-called "company with decentralized ownership structure," then the credit and lease loans to such companies were excluded when calculating the total credit ceiling of the *chaebol*.¹⁷⁾

As most credit of MBCs were unsecured, they carried higher credit risk than commercial banks, and so the MOFE should have enforced credit ceilings on *chaebols* more strictly than, say, commercial banks. However, this common notion of supervision was not observed then. The supervisory standard permitting credit concentration of MBCs to reach 3 times that of commercial banks was a seriously unbalance in financial regulation. This unbalanced credit concentration increased MBCs portfolio risk, eventually leading to their insolvencies when one of their main borrowers, particularly the *chaebols*, faced bankruptcy during the currency crisis.

In addition, there was yet another piece of regulation on credit concentration that also contributed to increasing MBCs' portfolio risk. The supervisory standard on credit limits of financial institution lending to large shareholders was aimed at preventing a situation in which financial institutions would become a private vault for large shareholders. Up until the currency crisis, the supervisory standard on the credit limit of MBCs to large shareholders, including all interrelated companies, was set within 100% of their equity capital. However, mutual savings and finance companies,

¹⁷⁾ From the point of financial supervision, placing a credit limit aims at reducing the concentration of credit to specific firms or *chaebol*. In this respect, there is usually no reason to exclude credit and lease loans to "companies with decentralized ownership structure" in the credit limit to a *chaebol*.

which are also non-banking financial institutions, were completely banned from providing credit to their large shareholders. Considering the purpose of such credit limits on large shareholders, we find that the supervisory standard on credit limit to large shareholders of MBCs had been far too loosely set up.

Combined with such loose supervisory standards on credit concentration, weak ex-post supervision of MBCs ended up aggravating the concentration of MBCs' credit. Table 5 shows results of a special investigation in the process of disclosing non-viable MBCs after the outbreak of crisis. Among the violations of supervisory standards by disclosed MBCs, cases in which the excess of the credit limit to the same borrowers recorded the largest amount at 2,279.5 billion won out of 4,056.8 billion won.

Other typical violations on the regulations on credit concentration included cases in which major shareholders used an assumed person's name (this being a violation of the "real name system in financial transactions") particularly when money was borrowed from MBCs, and in which major shareholders of different MBCs swapped loans with each other. These violations were not easily detectable without intensive on-site examinations because they involved assumed names as well as behind contracts. Up until the currency crisis, illegal acts by MBCs like using an assumed name when borrowing had been quite common. This implies that ex-post supervision was hardly effective and was unable to prevent such illegal violations regarding supervisory standards.¹⁸⁾

Table 5 Incidence of Violation of Regulations of Disclosed MBCs

(unit: 100 million won)

¹⁸⁾ After the outbreak of the currency crisis, as it became evident that ineffective regulation on credit concentration of MBCs was a major factor in the collapse of MBCs, the supervisory authority revised supervisory standards on credit concentration; the concept of a single business group was redefined as inter-linked companies sharing common credit risk; the credit limit to a single business group was changed from 150% to 25% of MBCs' equity capital based on the new concept of a single business group; credit limit applicable to majority shareholders of MBCs was reduced from 100% to 50% of their equity capital; concept of major shareholders was redefined as inter-related major shareholders sharing common credit risk; and based on the new concept of inter-related major share holders, credit limit to the major shareholders were reduced to up to 25% of MBCs' equity capital etc.

Name of MBCs	Types of Violation of Regulations					
	Excess of the Limit on Same Borrowers	Inadequate selling of unsecured bills	Illegal Management of Credit	Illegal Management of Foreign Exchange Business	Others	Total
Kyungnam		1,865	274	90		2,229
Kyongil	160	259				419
Koryo	269	806	141	42		1,258
Taegu	356	1,869	253			2,478
Daehan	9,813	1,681	285	29	1,626	13,434
Samsam	672	575				1,247
Samyang	7	150		279	35	471
Saehan	2,617		181			2,798
Shinsaegie	378	330				708
Shinhan	393				35	428
Ssangyong	99	246	149		9	503
Jaeil	1,969	190				2,159
Chungsol	359	241				600
Hangil	4,607	624	25		58	5,314
Hansol	408	2,032	139	383		2,962
Hanwha	569	708				1,277
Hangdo	119	2,041	123			2,283
Total (17)	22,795	13,617	1,570	823	1,763	40,568

Source: Korea Deposit Insurance Corporation, "The 3rd Investigation on the Causes of the Insolvencies of the Disclosed Financial Institutions," Report for the Press, 1999. 12.

It is reasonable to assume that violation of regulations by financial institutions would occur when expected revenue from violation was greater than expected cost of violation in the event that it be detected. The expected cost of violation can be viewed as the product of the probability of being detected and the degree of penalty inflicted if detected. On this basis, the supervisory body could diminish incentives of financial institutions and

prevent them from committing illegal acts by intensifying punishment and thereby increasing expected costs.

Another important channel of reckless credit expansion by MBCs was the endorsing of payment guarantees to CPs beyond their limit. CPs are by themselves unsecured accommodation (kite) bills. Unlike commercial bills that are issued for the settlement of real transactions, CPs are basically unsecured accommodation bills that are issued as short term financing for enterprises. In related regulations, MBCs are restricted from taking liabilities of more than twenty times their equity capital. Payment guarantees by MBCs are included within the limit of approved liabilities. However, prior to the currency crisis, MBCs recklessly issued payment guarantees beyond their approved limit on liabilities in an expedient way by selling CPs to investors. Ex-post supervision on MBCs was so ineffective that it could not refrain MBCs from illegally granting payment guarantees beyond the limits on their CP sales.

The payment guarantee on CPs beyond their limit had been conducted mainly through so-called “side-guarantees,” which are behind the scene contracts between MBCs and purchasers of CP (mainly institutional investors), certifying that MBCs would pay the CPs instead in the event that CPs were dishonored by the issuers.

Although supervisory authorities in fact prohibited such side-guarantees on sales of CPs as unsound financial behavior, side-guarantees themselves are perfectly legally valid contracts between the concerned parties. Therefore, aside from the issue of punishment by supervisory bodies, when the issuers dishonored side-guaranteed CPs, MBCs were left with the obligation to pay investors. In addition, payment guarantees are not fixed liabilities, but contingent liabilities. For this reason, they are not qualified to be listed as balance sheet items, but are simply recorded in the notes of balance sheets. Therefore, the amount of payment guarantee is not disclosed clearly, to say nothing of side-guarantees.

Accordingly, until before the onset of the currency crisis, the amount of side guarantees by MBCs increased remarkably. Although there is no

precise statistic showing how large side-guarantees were,¹⁹⁾ we can gauge the relative importance of side-guarantees regarding the collapse of MBCs through table 5. According to the table, the severest (worth 2,279.5 billion won) had been assumed by violations on limitation of credit to the same person. The second (worth 1,361.7 billion won) was the inadequate selling of unsecured bills, which comprised selling CPs with side-guarantees.

Conclusively, MBCs contained excessive contingent liabilities compared with their equity capital by way of side-guarantees. In 1997, when the *chaebols* that issued CPs became bankrupt and the CPs which MBCs side-guaranteed were dishonored, MBCs collapsed under the burden of their outstanding obligations that became inevitable.

3.5. Regulation and Supervision of Foreign Currency Assets Liquidity

The supervisory body's regulatory failure concerning MBCs is most evident with regards to the foreign currency liquidity regulation of MBCs. As was mentioned earlier, IFCs, after their transformation into MBCs, were permitted to conduct quite unreservedly international financial businesses. They devoted themselves to the so called "riding the yield curve strategy" and "Yen Carry Trade": borrowing short-term funds, especially Japanese funds from Hong Kong at low interest rates, and investing them in long-term assets such as leases, equipment loans and developing countries' junk bonds, while neglecting the risks of maturity mismatching between foreign currency assets and liabilities.

The maturity mismatch risk was finally realized in late-1997 when international lenders refused to roll over short-term loans to MBCs. Early in 1997, when some large conglomerates including Sammi and Hanbo began to experience insolvency problems, international financial lenders became concerned about the financial health of Korean financial institutions. Consequently, they began to squeeze credit lines on Korean banks,

¹⁹⁾ Kang (1998) estimates the amount of side-guarantees at a huge 52 trillion won as of the end of 1996, which is almost 27% of money supply (M2) at the time.

withdrawing loans in some cases. And, for the same reasons, they also refused to roll over short-term loans to MBCs. Under such a situation, MBCs' long-term assets, especially in emerging market junk bonds, long-term leases and long-term loans, became illiquid in the wake of Asian currency crisis. With illiquid long-term foreign currency assets, MBCs could not roll over their maturing short-term liabilities, causing MBCs to immediately fall into a foreign currency liquidity crisis. With MBCs' international financing clogged, they rushed into Korea's weak domestic spot foreign exchange market for funds to repay their maturing short-term foreign currency borrowings. This accelerated the shortage of foreign exchange in the already weakened domestic foreign exchange market, thereby leading to skyrocketing won/dollar exchange rates. Referring to table 6, the amount of MBCs' due foreign currency denominated liabilities was 4.9 billion dollars in November 1997, and 1.6 billion dollars in December 1997. The total foreign currency liability of MBCs due was almost 6.5 billion dollars at the end of the year.

To understand the unsound business behavior of MBCs, we need to examine the financial regulation environment. The change in Korea's financial regulation environment started with the inauguration of the Kim Young-Sam's regime in February 1993. In November 1994, President Kim declared the so called "Saegyehwa" (globalization) as his political slogan. Kim's regime, without second thoughts, aimed at joining the OECD. He did not consider seriously whether Korea was able to fulfill the requirements for joining the OECD. In the process of hastily de-regulating capital inflows to satisfy the entry requirements in the OECD, the regulators had produced something of a reverse discriminative financial

Table 6 Amount Due of MBCs' Foreign Currency Denominated Liabilities in November and December of 1997

(unit: million dollars)			
Classification	Nov. of 1997	Dec. of 1997	Scale of Overnight ¹⁾
Incumbent MBCs in Seoul	2,139	710	162

Transformed MBCs in Seoul	839	435	273
Incumbent MBCs in Local area	1,729	412	932
Transformed MBCs in Local area	199	71	34
Total Amounts	4,906	1,628	1,401
Size of Korea' FOREX market ²⁾	22,800	21,500	

Notes: 1) Includes daily averages from October 1, 1997 to November 5, 1997.

2) Monthly trade volume of Korea's spot foreign exchange market.

Source: Maekyung Daily News, November 9, 1997, p. 7.

regulatory environment between short-term and long-term foreign currency borrowings.

More specifically, very few measures had been imposed on financial institutions' short-term borrowings of foreign currencies, while lots of regulations and bureaucratic red tape had remained on long-term borrowings of foreign capital. According to the Foreign Currency Exchange Transactions Regulations, financial institutions that induced short-term foreign capital had no obligation to declare this transaction to the MOFE. On the other hand, when financial institutions induced long-term capital inducement, they were mandated to declare the transaction to the MOFE. In addition, if the amount was greater than 10 million dollars, they had to notify to the MOFE beforehand.

Moreover, what made financial institutions prefer short-term capital were the quota restrictions in inducing foreign capital. Regarding short-term foreign capital, there were no quota restrictions in inducing foreign capital, while for long-term capital, strict quota restriction had been set up. Such asymmetric regulation against long-term borrowings made financial institutions including MBCs prefer short-term borrowings to long-term borrowings. In fact, as a result of such unbalanced regulations, financial institutions including MBCs were encouraged to replace long-term borrowings by short-term borrowings. This contributed to distorting the foreign currency exposure toward short-term borrowings.

Another piece of regulatory failure that led to the deterioration of foreign exchange maturity mismatches of financial institutions was the relaxation of the “Long-term Borrowing Ratio for Foreign Currency Loans.” Prior to the President Kim Young-Sam’s regime, foreign exchange banks were required to finance 70% or more of their foreign currency loans for longer than 3 years by foreign currency borrowings of maturity longer than 3 years.

Long-Term Borrowing Ratio for Foreign Currency Loans

$$= \frac{\text{Foreign Currency Borrowings (longer than 3 years)}}{\text{Foreign Currency Loans (longer than 3 years)}} \geq 70\%$$

However, with the new regime under Kim Yong-Sam, as part of the “New Economy Plan for 100 Days,” the minimum long-term borrowing ratio for foreign currency loans was lowered to 50% from 70%. This relaxation of regulations encouraged foreign exchange banks including MBCs to increase overseas short-term borrowing that carried lower interest rates. This deregulation was another important factor that aggravated MBCs’ maturity mismatch of foreign currency assets and liabilities.

What is noteworthy is that the maturity mismatch of foreign currency assets and liabilities was much more severe in MBCs than in commercial banks. Table 7 shows the consolidated foreign currency assets and liabilities of MBCs immediately before the currency crisis. Considering the funding side of the foreign currency liabilities, 64.7% (9.33 billion dollars) were short-term borrowings. However, regarding the operating side of foreign currency assets, around 92.9% (13.52 billion dollars) were operating in the form of medium/long-term assets. Thus, the previous-“Long-term

Table 7 Foreign Currency Assets and Liabilities of MBCs (1997. 8. 10)

(unit: 100 million dollars)

Foreign Currency Assets			Foreign Currency Liabilities		
Long-term Assets	135.2	(92.9)	Long-term Liabilities	50.8	(35.3)

Loans	16.2	(11.1)	Bank Loans	23.8	
Leases	95.3	(65.5)	Issuance of Securities	24.5	
Securities	23.7	(16.3)	Trust Money of BOK	2.5	
Short-term Assets	10.4	(7.1)	Short-term Liabilities	93.3	(64.7)
Deposits	2.5		Ultra Short-term Liabilities	25.4	
			Other Short-term Borrowings	67.9	
Total	145.6	(100)	Total	144.1	(100)

Note: Figures inside the parentheses are %.
Source: The Bank of Korea.

Borrowing Ratio for Foreign Currency Loans” covering MBCs stood at only 37.5%, far below the newly revised minimum required level at 50%. Compared with MBCs, commercial banks turned out to have managed their foreign currency liquidity much better. As is shown in table 8, the long-term assets of banks was 47.1%, while their long-term liabilities was 29.2%, thereby bringing the “Long-term Borrowing Ratio for Foreign Currency Loans” of commercial banks to 61.7%.

What caused MBCs to expose themselves to far riskier foreign currency maturity mismatch than commercial banks? We find an answer to this question by looking at the ex-ante and ex-post supervisory failures of MBCs. First, the supervisory failure was ex-ante; most importantly, the amount of foreign currency short-term borrowings had not been included when calculating the upper limit of short-term borrowings of MBCs. Related regulations had limited short-term borrowings of MBCs not to exceed three

Table 8 Foreign Currency Assets and Liabilities of Commercial Banks (1997. 8. 10)

(unit: 100 million dollars)

Foreign Currency Assets	Foreign Currency Liabilities
-------------------------	------------------------------

Long-term Assets	276.2	(47.1)	Long-Term Liabilities	170.6	(29.2)
Loans	211.2		Bank Loans	8.3	
Securities	34.0		Issuance of Securities	75.9	
			Trust Money of BOK	85.7	
Short-term Assets	310.0	(52.9)	Short-term Liabilities	413.0	(70.8)
Foreign Currencies	210.0		Ultra Short-term Liabilities	44.7	
Deposits	56.8		Other Short-term Borrowings	98.2	
Total	568.2	(100)	Total	586.2	(100)

Note: Figures inside the parentheses are %.

Source: The Bank of Korea.

times their equity capital. However, in practice, when calculating the upper limit of short-term borrowings of MBCs, the supervisory standards included only domestic currency short-term borrowings, excluding the amount of foreign currency short-term borrowings.

The second supervisory failure was ex-post; supervision on MBCs' lease accounts and its own accounts had been conducted separately without considering systematically insider trading aspects between the two accounts. To understand this, we need to go over some technicalities regarding MBCs' business behavior. The related law on lease business activities required that lease business activities be accounted separately from other activities in managing funds and in analyzing performance. In accordance with such a requirement, MBCs managed two respective accounts, namely, its "own account" for merchant banking business, and a "lease account" for leases in general. These two accounts were stipulated to have been independently managed with a kind of firewall in between them. In fact, however, these two accounts were managed as if integrated without any real separation between them.

Regarding merchant banking and the lease business, there were separate responsible departments within the MOFE. Because of bureaucratic sectionalism and a lack of cooperation among supervisory bodies, however, authorities seldom cooperated in supervising “own accounts” and “lease accounts” of MBCs. Until the currency crisis, MBCs’ own and lease accounts had never been supervised in a consolidated way.

MBCs exploited the loopholes in this unconsolidated supervision system to escape regulations on foreign currency liquidity. This regulation-escaping business practice had been conducted in the following way. MBCs borrowed short-term foreign capital through their own accounts, and loaned these short-term borrowings to their lease accounts on a long-term basis. Exploiting the loophole of unconsolidated supervision, MBCs could easily disguise their own accounts’ virtually long-term foreign currency loans to their lease accounts as short-term foreign currency loans. By doing so, MBCs could raise the “Long-term Borrowing Ratio for Foreign Currency Loans,” as the denominator of the index was reduced, and could escape the regulation of the “Long-term Borrowing Ratio for Foreign Currency Loans”.

As a matter of fact, in the lease business also, there were indeed regulations on foreign currency assets and liabilities maturity. Such regulation required that leasing financial institutions had to use only long-term funds. This regulation was also applicable to the lease business of MBCs. However, MBCs could circumvent this regulation on the lease business by simply using a similar way to avoid the regulation on MBCs’ own account. Most long-term loans of MBCs’ lease accounts were actually supplied from short-term foreign currency borrowings of MBCs’ own accounts. However, virtually short-term funds of lease accounts were disguised as long-term funds in a similar way as was mentioned above.

3.6. Regulation and Supervision on the Limit of Investing in Foreign Currency Securities

MBCs’ reckless investing in foreign currency denominated securities were another component of their risky international business behavior. Up until

the currency crisis, MBCs had invested a significant portion of their foreign currency assets in high yield junk bonds of emerging market countries such

Table 9 Funding and Operating Side of Foreign Capital of MBCs

(unit: million dollars)

Classification	1992	1993	1994	1995	1996	1997
Foreign Currency Assets	4,123	4,624	5,633	8,971	13,347	13,576
1. Overseas Assets	83	66	185	338	2,432	2,408
Foreign Currency Securities	16	31	131	274	2,152	1,811
2. Domestic Assets	4,037	4,557	5,436	8,604	10,881	11,159
Foreign Currency Loans	772	650	571	861	1,426	1,330
Leases	3,010	3,747	4,642	7,315	8,935	9,422
Foreign Currency Liabilities	4,123	4,624	5,633	8,971	13,347	13,576
1. Overseas Liabilities	1,774	1,450	1,820	3,872	5,942	4,179
Bank Loan Borrowing	730	727	491	435	327	398
Other Borrowing	573	283	608	1,910	3,132	1,578
Bond Issuances	437	419	674	1,470	2,388	1,970
2. Domestic Liabilities	2,345	3,172	3,805	5,095	7,349	6,240

Source: The Bank of Korea, "Annual Report of Foreign Exchange Statistics," various issues.

as Russia, Indonesia, Thailand, amongst others. As was already mentioned, their funding sources were mainly short-term foreign currency borrowings, especially cheap Japanese funds from Hong Kong. However, when the Asian currency crisis broke out, the high-yield junk bonds of emerging markets became insolvent and illiquid, thereby accelerated the foreign

currency liquidity crisis of MBCs.

Table 9 shows the trend of MBCs' overseas securities investment. According to the table, investments by MBCs in foreign currency securities were negligible in 1993 and 1994, merely recording 31 million and 131 million dollars, respectively. However, this rapidly increased during 1995 (274 million dollars) and 1996 (2,152 million dollars). In 1996 alone, MBCs' overseas securities investment showed a tremendous jump of 780% over the previous year.

Looking at table 10, among the total balance of 2,152 million dollars investment in foreign currency securities in 1996, MBCs had invested 86% (1,860 million dollars) in emerging market securities. At the time, MBCs' total equity capital was only 4,716 million dollars, implying that MBCs invested as much as 40% of their equity capital in illiquid emerging markets' high yield junk bonds.

The main reasons that incited MBCs to increase rapidly their investment in emerging market junk bonds is related to the process of financial deregulation in 1996. From 1996, the amount of overseas securities investment was excluded from the calculation of the ceilings in all securities investments. With this deregulation, MBCs were encouraged to increase investment in overseas junk bonds funded by short-term foreign currency borrowings with hardly any limits.

Actually, the "Merchant Banking Corporations Act" defines the ceiling of MBCs' investment in securities as 100% of their equity capital. The aim of this ceiling was to help to keep the MBCs financially sound and to refrain them from taking too much risks from excessive investment in stocks and bonds. Considering such an aim, overseas securities investment should have been included in calculating the ceiling of MBCs' securities investment.

Table 10 MBCs' Investment in Securities

(unit: million dollars)

Classification	1992	1993	1994	1995	1996	1997

Equity Capital	3,089	3,149	4,218	5,004	4,716	2,895
Amount of Securities Investment	4,575	5,097	7,404	8,104	10,254	8,828
Amount of Securities Investment / Equity Capital	1.48	1.62	1.76	1.62	2.17	3.05
Balance of Investment in Foreign Currency Denominated Securities	16	31	131	274	2,152	1,811
Balance of Investment in Securities in Domestic Currency	4,559	5,066	7,273	7,830	8,102	7,017
Balance of Emerging Market Securities Investment					1,860	1,160
Balance of Emerging Market Securities Investment of Commercial Banks					3,440	2,710

Note: Emerging Market includes Thailand, Indonesia, Malaysia, China, Mexico, Brazil, Columbia, Rumania, Hungary, and Russia.

Source: The amounts of investment in emerging market are from Financial Supervisory Service. Others are from The Bank of Korea, "Annual Report of Foreign Exchange Statistics".

However, previous supervisory standards did not support such a common notion. Since 1996, the MOFE allowed the exclusion of overseas securities investment when calculating the ceiling of total securities investment. This exclusion allowed MBCs to increasingly invest in emerging markets' junk bonds without any supervisory ceiling. This deregulation measure was an important ex-ante supervisory failure that had induced MBCs' excessive overseas investment in securities, rendering other parts of the supervision system for restricting excessive investment in securities quite ineffective.

3.7. Other Prudential Regulations

3.7.1. Prudential Regulation on Won-Liquidity

Prior to the currency crisis, there was no prudential regulation on MBCs'

won-liquidity. It was not until 1998 that the FSC/FSS set up supervisory standards on MBCs' won-liquidity, namely, that MBCs should maintain at least a 30% won-liquidity ratio. Unlike MBCs, however, commercial banks had long been regulated by the measure, which required them to maintain at least a 30% won-liquidity ratio. This loophole in supervisory standards was another regulatory environmental factor that helped increase MBCs' portfolio risk.

3.7.2. Risk Management

The supervisory body's negligence in introducing proper ex-ante regulation and supervision standards is also evident in the area of MBCs' risk management system. Until the onset of the currency crisis, there had in fact been no ex-ante regulation and supervision on MBCs' internal risk management systems, in particular, regarding how MBCs should prepare their internal control system to cope with different kinds of financial risk such as credit risk, market risk, and operational risk.

Generally speaking, the supervisory body should have made guidelines for financial institutions to set up their own internal risk management system so that they could properly manage financial risks. However, until right before the outbreak of the currency crisis, no ex-ante regulation and supervisory standard for MBCs requiring them to set up their internal risk management systems were in place. This lack of supervision regarding risk management of MBCs had left the management of MBCs focusing only on profitability, while neglecting proper assessment and control for accompanied risks.

Unlike MBCs, however, commercial banks, even before the crisis, had been mandated to set up an internal control system for risk management. They had been required to establish a comprehensive risk management system that included asset liabilities management. Based on this, commercial banks themselves tried to set up their own risk management system. As a matter of fact, the direction and monitoring of MBCs by a comprehensive risk management system is no less urgent than that of commercial banks, if not anything else but for the reason that with their

mostly unsecured credit, MBCs contain higher credit risk portfolios than commercial banks. However, ex-ante supervision and regulation of MBCs had not kept up with developments like that of commercial banks.

3.7.3. Asset Classification and Provision

Another example of the lack of ex-ante prudential regulation was that MBCs had not been supervised or regulated for their soundness regarding their holding of assets. Normally, regulations of asset classification and provisioning require that financial institutions classify their assets on a regular basis into one of five categories; “Normal,” “Precautionary,” “Substandard,” “Doubtful” and “Estimated Loss”. According to categorization into the above asset classifications, financial institutions must then accumulate and maintain adequate loss provisioning, including allowances for payment guarantees.

However, prior to the currency crisis, no minimum guidelines on MBCs’ asset classification and provisioning were in place. This vacuum in the regulation system left MBCs insensitive to reckless lending and endorsing payment guarantees. In contrast, commercial banks had been controlled by strict asset classification and provisioning standards even before the currency crisis.

Only after the outbreak of crisis, the supervisory body introduced similar asset classification and provisioning system for MBCs. This can be counted as another example of negligence and irresponsibility regarding the regulation of MBCs prior to the crisis. Trough the hardship periods of IMF era, most of the unsound behavior of MBCs that had driven MBCs to insolvency had been removed after the currency crisis. Under the new supervisory system, the FSS are in charge of the supervisory business of almost all financial institutions and the BOK and the KDIC (Korea Deposit Insurance Corporation) possess limited on-site examination functions.

However, bureaucratic sectionalism and no cooperation among the supervisory agencies, which had resulted in the gray areas of supervision of MBCs, are still very often found in reality. In fact, the supervisory agencies

still rarely share the information on supervision and hardly cooperate in examination. These kind of bad practices among supervisory agencies should be corrected for the soundness of Korea's financial system.

4. CONCLUSION

This study analyzed the financial regulations and supervision systems of Korean MBCs (Merchant Banking Corporations). This study is carried out on the premise that the financial regulation and supervision of MBCs has not been fully investigated so far. We emphasize that MBCs were financial institutions that had been operating with relatively more autonomy among domestic financial institutions. As relatively more liberalized for-profit enterprises in a financially repressed economy, large parts of their business behavior could be viewed as simply the outcome of endogenously generated business behavior given the business environment. It is for this reason that this study finds it important to focus on the regulations and supervision of MBCs.

The main point of this study is that the financial regulation and supervisory system surrounding MBCs right before the outbreak of the currency crisis were very much out-dated and ineffective. In particular, the regulations and supervision system were managed based on an outdated paradigm that foreign and domestic currency businesses undertaken by financial institutions were distinctively separate from each other. Such a view was no longer valid in the modern era of increased capital flow liberalization.

Since the beginning of the 1990s, the business environment surrounding MBCs had changed in many respects, and most notably in terms of the increased number of new entries into MBC businesses as well as increased financial market and capital liberalization. These factors resulted in higher competition among MBCs raising their business risk generally. Despite rapid changes in the business environment, the financial regulations and

supervisory system hardly kept in pace, and thereby was generally ineffective until the outbreak of the currency crisis. Such ineffectiveness in the financial regulation and supervision of MBCs came to be a main environmental factor behind their domino-like insolvencies during the period around the crisis.

In this study, the factors analyzed were as follows. First, the MOFE, which had the ultimate responsibility for financial regulation and supervision of MBCs, were found not to have had appropriate organizational infrastructure and specialty to conduct important financial regulation and supervision functions. The ex-ante supervision system was hardly updated in a timely manner, nor was the ex-post supervision system strictly conducted, and both weaknesses rendered financial regulation and supervision on MBCs ineffective.

Second, regarding the entry regulation of MBCs, the MOFE's licensing or transformation of unqualified IFCs into MBCs between 1994 and 1996 had encouraged reckless and risk-taking business behavior among the newly-transformed MBCs. The newly-transformed MBCs had expanded their business size by competitively entering into the international financial markets and establishing their branches overseas, especially in Hong Kong. This ended up with ruinous results as accompanied risks had been largely overlooked.

Third, the supervisory body's negligence in introducing an appropriate capital adequacy requirement system for MBCs did little to check the expansion of MBCs' risky assets. Before the crisis, the equity capital of MBCs had been regulated by gearing ratios based upon simple financial ratios like equity to total assets. Such naive gearing ratios were too coarse an index to reflect properly the risk borne by MBCs.

Fourth, the loose ex-ante regulation especially regarding credit concentration helped intensify MBCs' concentration of credit. MBCs credit ceiling on *chaebols* had been permitted to be three times higher than that of commercial banks. Moreover, loans and leases to the so-called "dispersed ownership companies" were excluded from the credit ceiling on *chaebols*.

Fifth, behind the extreme maturity mismatch of foreign currency assets of MBCs, there were various unbalanced ex-ante supervisory factors. Such unbalanced ex-ante supervisory factors included the followings: unbalanced regulation between short-term and long-term foreign currency borrowings, the exclusion of foreign currency short-term borrowings when calculating the ceilings set for total short-term borrowings, and the exclusion of foreign currency lease loans when calculating MBCs' foreign currency long-term loans.

Sixth, in the extreme maturity mismatch of foreign currency assets and liabilities of MBCs, various critical ex-post supervisory failures were also identified; there had been no consolidated supervision on both lease and own accounts of MBCs in any systematical manner. This loophole in the ex-post supervisory system had left MBCs to circumvent the so called "Long-term Borrowing Ratio for Foreign Currency Loans".

Seventh, MBCs' local and overseas investment in securities had been regulated asymmetrically. Overseas investment in securities had been excluded from the ceiling of MBCs' total investment in securities, which was another critical regulatory environmental factors that allowed MBCs' excessive investment in emerging market junk bonds.

Eighth, supervisory standards of MBCs' risk management systems were hardly updated. Significant parts of the regulations in risk management were outdated, and did not keep up with the changing times. It was not until the outbreak of currency crisis that the authorities introduced prudential regulations on MBCs' won-liquidity, internal risk management systems, and on asset classification and provision.

Summarizing the above points, up until the outbreak of the currency crisis, we see that MBCs had been operating under a very fragile regulation system that was outdated not least in terms of ex-ante and ex-post supervision. Judging only from outward appearances, such historic regulatory failure would seem to have occurred by misallocations of supervisory power to an unqualified administrative organization, namely the MOFE, which was hardly equipped with the proper infrastructure and specialty for financial

supervision. However, a closer look beneath these ostensibly unrelated chains of regulatory failures shows a hugely mistaken, deep-rooted cognitive paradigm, which divided local and foreign currency businesses of financial institutions in a dichotomous way. Such an outdated paradigm was responsible for the making of the above inappropriate regulations, including the various exemptions and asymmetries in rules and restrictions.

This is a good example showing the dangers when institutions and cognition do not catch up with changing circumstances. Regulators must keep up with the changing environment. The currency crisis was a precious and, indeed, an expensively obtained lesson that made the nation suffer miserably. Without overcoming such an anachronistic paradigm that regards domestic and foreign exchange businesses distinctively and separately, all financial policies, including financial supervision, are doomed to the same failure again as capital flow liberalization continues. It cannot be overemphasized therefore that history will repeat itself unless such outdated paradigm is completely replaced with a new one that acknowledges financial institutions' domestic and foreign exchange business as identical.

REFERENCES

- Bank of Korea, *Counterplan of Japanese Government for Jusen*, Bank of Korea Research Materials, 96-14, 1996.
- Cho, Yun-Je, "Analysis on the Path of Korea's Financial Liberalization in the 1990's and Financial Crisis," *Korea Economic Research Journal*, 2, Korea Economic Research Association, 1999 (in Korean).
- Choi, Doo-Yull, *On the Causes and Development Processes of the 1997 Asian Currency Crisis*, Korea Economic Research Institute, 1998 (in Korean).
- Choi, Chang-Kyu, "Speculative Attack and Korea's Currency Crisis," *Economic Analysis*, 4(2), 1998, pp. 123-157 (in Korean).
- Chung, Woon-Chan, "IMF Relief Loan and Macroeconomic Policy," Korea

- Money and Finance Association, presented at the symposium on the Monetary and Fiscal Policy and Restructuring of Korea's Financial Industry, 1998 (in Korean).
- Corsetti, G., P. Pesenti, and N. Roubini, "What Caused the Asian Currency and Financial Crisis?" NBER Working Paper, 1998.
- Financial Supervisory Committee, "Report Materials for the Press," various issues.
- Kang, Man-Su, "A Sad History of Korea's Merchant Banking Corporations," *Monthly Chosun*, 2000, pp. 440-448 (in Korean).
- Kang, Cheol-Jun, "An Analysis of Economic Crisis and Policy Direction from Now on - Government's Policy Part," *Korean Economic Research Institute Policy Report*, 98-04, 1998, pp. 69-111 (in Korean).
- Kim, Chang-Jin, Kwang-Hee Nam, and Chong-Uk Lee, *Korea's Currency Crisis and Over-Investment from the Perspective of Long-run Equilibrium*, Korea Economic Research Institute, 2000 (in Korean).
- Korean Federation of Investment & Finance, *The 10 Year History of Korean Federation of Investment & Finance*, 1990.
- Krugman, Paul, "What Happened to Asia," mimeo, 1998.
- Ministry of Finance and Economy, *Fiscal and Monetary Statistics*, various issues.
- Lee, Jaemin and Woon-Sun Eo, "Economic Crisis and Chaebol's Bankruptcy," *Development Economics Journal*, 6(1), 2000, pp. 33-62 (in Korean).
- Lee, Young-Seob and Chong-Uk Lee, "Korea's Currency Crisis; Was it Predictable?" Symposium Paper, International Finance Society, 1998 (in Korean).
- Oh, Sang-Keun, "Empirical Analysis on the Determinants of Private Corporation's Over-Borrowing Ratio," mimeo, 1998 (in Korean).
- Park, Dae-Keun and Chang-Yong Lee, "Currency Crisis of Korea; Development and Its Instructions," *Korea Economic Journal*, 46(4), 1998, pp. 351-389 (in Korean).

- Park, Won-Ahm and Gong-Pil Choi, "Empirical Analysis of the Causes of Korea's Currency Crisis," *International Economic Journal*, 5(3), 1999, pp. 1-26 (in Korean).
- Radelet, Steven, and Jeffrey Sachs, *The Onset of the East Asian Financial Crisis*, Harvard Institute for International Development, 1998.
- Yu, Seung-Min, *Chaebols, Are They Really the Principal Factor of Crisis Indeed?*, The Bibong Publishing Company, 2000 (in Korean).