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KOREAN BANK REGULATION AND SUPERVISION:
CRISIS AND REFORM
(A CRITICAL EVALUATION WITH RECOMMENDATIONS)

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ABSTRACT
This thesis presents a critical analysis and evaluation of the current Korean banking regulatory and supervisory system. The objective is to identify continuing structural weaknesses of the Korean banking system and to suggest areas of regulatory and supervisory system reform. The focus of this analysis and evaluation is centred around the following three questions:

1. Who should be the regulator?

2. What substantive standards of supervision should be applied? and

3. Administratively, in what manner should these standards be applied?

Finally, the causes, responses, and implications for reform as to the recent Korean financial crisis are discussed.

The Korean banking system has been characterised as a "governmental control system" for credit allocation. This system, with lax prudential regulation and supervision, creates inevitable problems for the banks. For example, Korean banks have been largely precluded from true market and commercially oriented practices and have been exposed to significant credit and other risks due to governmental policy directed lending and other non-commercially induced banking practices.

The main theme of this thesis is that Korea's reformed and restructured regulatory and supervisory system should be structurally removed from undue governmental and political interference; that is, should be sufficiently divorced and protected from governmental economic policy objectives and, more generally, from objectives that are inconsistent with "safety and soundness" based banking regulatory and supervisory objectives and with market oriented practices. Balancing this structural independence and market orientation, a reformed and restructured system should provide a high degree of transparency and accountability.

Reform should aim not only at establishing effective supervisory standards, but also at ensuring effective monitoring and enforcement. A first step to the reform is for the government to define and adhere to a primary policy objective of banking policy, i.e. "financial stability" through sound and effective Korean banking regulation and supervision. To achieve such financial stability, Korea will need to implement appropriate measures that can ensure that the banking system is "safe and sound", consistently with evolving international standards; that banks are free from undue governmental and political interference and control; and that the banking system operates within a competitive and commercially driven market environment.

The financial crisis in 1997 has demonstrated many of the current weaknesses of the Korean financial system. The need for certainty of process, for a clear, realistic and transparent timetable for restructuring, and for an effective exit policy for troubled commercial banks, are some of the lessons to be learned from this crisis.
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THE KOREAN BANKING SYSTEM

Over the last four and a half decades, the Korean banking sector has been subject to intensive governmental regulation and control. Moreover, such governmental control of the banking system has created a number of weaknesses, such as moral hazard and political loan problems. The recent Korean financial and economic crisis has demonstrated many of these current weaknesses and provided an opportunity for fundamental reform of the banking system. In light of the need for reform and restructuring, the basic nature of the Korean banking system should now be reconsidered.

In an attempt to identify the existing primary problem areas of the Korean banking system, this chapter examines this system in general terms, and in the light of its historical development. The focus of the chapter is on those aspects of the law and practice most directly relevant to the banking regulatory and supervisory framework. By way of background, the chapter looks at the structure and functions of banking institutions in Korea; then, outlines the applicable banking statutes, referring to their historical background and development; and briefly describes the institutional structures of the previous, as well as the new banking regulatory and supervisory authorities. Finally, the framework of Korean banking regulatory norms is also addressed.
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I. THE KOREAN BANKING SYSTEM

A. Development of the Korean Banking System to the 1960s

The formation of a modern banking system in Korea dates back to the Japanese invasion and the demand for modern banking facilities to serve Japanese interests. The first branch of a Japanese bank, the Daiichi Ginko, was opened in 1878 in Korea. Thereafter, several other Japanese banks opened their branches in Korea over the next two decades, mainly with a view to serving Korean-Japanese trade. Some Korean-owned banks were also established, but by 1910 only three banks survived. Due to insufficient capital and funds available for lending and lack of experience in banking business, until the formal annexation of Korea by Japan in 1910, the Korean-owned banks carried on limited commercial banking business, mainly in urban areas, and did little to finance the industry and the public sector. Other important developments were the establishment of the Agriculture-Industry Bank and of the Oriental Development Company. The Agriculture-Industry Bank, a government owned and operated institution, was set up in 1906 as a functionally specialised bank for Japanese investment finance. The Oriental Development Company was established in 1909 and served to support the Japanese economic invasion of Korea.

In the early stages of the colonial period, in the 1910s and early 1920s, the banking system expanded rapidly in numbers. After a financial crisis in the mid-1920s, many banks were restructured or merged. By the end of the 1930s, the number of banks had been cut down by half; it decreased further during the Second World War. However, the total number of banks' branches actually increased, and the functional specialisation
of financial institutions was developed during this period. Specialised financial institutions, such as saving banks, financial associations and trust companies, were established. Especially, the financial associations, which engaged in short-term financing to farmers and small firms, grew rapidly. On the whole, during the colonial period, the Korean financial system was used to channel savings into Japanese industrial and commercial expansion and the Japanese war effort. Koreans had some access to modern financial institutions, particularly the financial associations, but they generally relied on their traditional institutions, both as depositories for savings and as sources of borrowings.¹

After independence from Japan, due to the financial instability and the sharp decline in financial operations, the specialisation of functions, which had become a significant feature of Korean financial institutions, disappeared. The banking and other financial institutions became ordinary commercial banks, engaging in the collection of demand deposits and the extension of short-term loans and advances to the primary producers, businessmen, as well as the government agencies. By the end of the 1950s, the Korean banking system had reached a stage of stagnation.

B. The Current Korean Banking System

1. The Bank of Korea

When the modern banking system was introduced by the Japanese banks, the central banking functions were given to the Daiichi Ginko, which in 1905 became the currency

issuing authority within Korea. In 1909, the newly established Bank of Korea - renamed the Bank of Chosun in 1911 - assumed the central banking functions from the Daiichi Ginko. It remained in this role until 1945.2

In the years between independence in 1945 and the establishment of the new Bank of Korea, Korea did not have a central bank. The U.S. Military Government and the Ministry of Finance performed the central banking functions during this period.

The Bank of Korea (BOK) was set up as a specialist central bank in 1950, under the Bank of Korea Act. The BOK is a special juridical person and, legally, is not a branch of the Executive. Therefore, it acts as an independent entity and is represented by its Governor. It initially had capital, all of which was subscribed by the government. However, its capital soon lost all its value, due to continuous inflation. Consequently, in 1962, an amendment to the Bank of Korea Act converted the BOK to a special juridical person without capital.

The Bank of Korea Act provided that the BOK was responsible for:

(1) maintaining the stability of the value of money in the interest of national economic progress; and

(2) promoting economic development and the efficient use of national resources through the sound operation and functional improvement of the nation's banking and credit system.3

Under this and other relevant provisions, the BOK was given responsibility for regulating and supervising banking institutions, mainly commercial banks. In addition to the

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2 The old Bank of Korea also carried on normal commercial operations.
3 Bank of Korea Act art. 3.
function of regulating and supervising commercial banking institutions, it exercised numerous functions and responsibilities as central bank.

In 1997, with the enactment of the Revised Bank of Korea Act, the BOK was confined to its functions as monetary authority only. The Revised Act mandates price stability as the sole objective of the BOK. As central bank, the BOK is responsible for the conduct of the monetary policy and controls the monetary supply; has the exclusive right to issue currency; acts as banker for the banking sector and the government; and conducts foreign exchange operations.

2. Commercial Banks

Commercial banks, called “ordinary banks” (as distinct from the specialised banks), are financial institutions that are established under, and operate in accordance with, the General Banking Act. They are subject to regulations, orders, and instructions issued by the regulatory and supervisory authorities. The commercial banks can be further classified as either domestic or foreign. A domestic bank can be a nationwide commercial bank or a local bank, depending on its geographic business scope.

(a) Domestic Commercial Banks

Domestic commercial banks have the following features:

First, they have nationwide or province-wide networks, comprising large numbers

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4 Revised Bank of Korea Act art. 1.
5 Bank of Korea, Financial System in Korea (1993), p. 43.
of banking branches. Each large nationwide commercial bank has a network of over 300 branches.

Second, they primarily provide short-term financing. Even though they can engage in long-term financing, long-term financing has not been favoured by them. Instead, the demand for long-term funds has customarily been met by frequent rollovers or renewals of short-term loans.

Third, they depend on amounts borrowed from the BOK to meet persistent shortages in their loanable funds. Nonetheless, the portion of funds provided by the BOK has decreased over the years. In the mid-1980s, more than one third of their total loans and discounts were financed by the BOK. Thereafter, the share was reduced, reaching about 20 per cent in the early 1990s.

Commercial banks have played a leading role in the Korean financial market. However, their relative importance in the financial system has gradually decreased, as specialised banks and other non-bank financial institutions have expanded their business.

(1) Nationwide Commercial Banks. As of end 1997, there were 16 nationwide commercial banks in Korea. Five of them were established before 1960; these banks have retained a prominent position in the Korean financial markets. Until the early 1980s, the government held a controlling interest in these five original nationwide banks. The process of gradual denationalisation, which started in 1972, was accelerated in the 1980s, in line with the government’s financial liberalisation policy. By 1983, the government’s shares in those five nationwide commercial banks had been sold, and two new banks had been established in order to promote competition between banking
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institutions. At the end of 1980s, the entry barriers to the banking industry were lowered again. Six additional nationwide commercial banks were established. Furthermore, during the 1990s, three previous specialised banks have been converted to nationwide commercial bank status.

(2) Local Banks. During the period between 1967 and 1971, ten local banks were established under the General Banking Act for the purpose of mobilising domestic savings, achieving a balanced dispersion of banking business, and promoting regional economic development. One such bank was set up for each of the nine provinces, and one for Pusan, the second largest city in Korea.

The local banks were all privately owned from the outset, in contrast to the nationwide commercial banks. They maintain a branch banking system like that of the nationwide commercial banks. Initially, however, they were permitted to open branches only within the province where their head office is located, with the exception of one branch each in Seoul. This restriction has been gradually eased. For each local bank, ten Seoul branches and two branches in each of the five metropolitan cities were allowed. The branching restriction for local banks was finally removed in November 1998.

The local banks carry on the same kind of commercial banking business as the nationwide commercial banks. However, as they originally operated within restricted

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6 Ibid., p. 77. The ownership structures of those new banks presented distinctive features. One was established by Korean immigrants in Japan. The other was set up as a joint venture with Bank of America.

7 The Korean Exchange Bank, concentrating on foreign and international financing business, the Citizen National Bank, providing small loans to households and small-scale businesses, and the Korea Housing Bank, providing housing related finance, were converted in 1990, 1995 and 1997, respectively.

8 Bank of Korea, Financial System, op. cit., n. 5, pp. 80-81.

9 (South) Korea is divided, in terms of administrative districts, into one Special City (Seoul), five
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geographic areas, they were subject, in certain respects, to regulations different than those applicable to the nationwide commercial banks. For example, they were allowed to offer slightly higher interest rates for certain types of deposits. Also, the amounts that could be lent out of their Seoul branches were restricted, so as to prevent them from transferring local funds to Seoul. This restriction was finally removed in April 1998.

(b) Foreign Bank Branches

Foreign banks may open branches in Korea with the approval of the regulatory authorities. Chase Manhattan Bank first opened its Seoul branch in 1967. From the latter half of the 1970s onwards, the number of foreign bank branches and the scale of their business have increased substantially. Foreign bank branches were initially allowed in order to induce foreign capital investments. They usually raised their loanable funds by way of inter-office borrowings from their head offices in foreign countries. To increase the inflow of foreign capital, the Korean government has given them preferential treatment, by expanding swap facilities with the BOK, guaranteeing yields on swap transactions and excluding them from liquidity controls, thus assuring healthy profit margins.

Even though they are established under the General Banking Act, foreign bank branches have not been subject to the same rules as domestic commercial banks. Since 1984, the Korean government has been gradually implementing a program of national treatment of foreign bank branches.

Metropolitan Cities (which are relatively large cities) and nine Provinces.
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Some discriminatory regulations on their business activities have thus been lifted. Foreign bank branches are now permitted to access rediscount facilities at the BOK for export financing and general commercial bills; engage in the trust business; issue negotiable certificates of deposits; and borrow funds from the BOK, in order to finance possible shortages of reserve requirements or settlement funds.

At the same time, their business operation privileges have also been decreased. The BOK has gradually reduced their swap facilities and lowered their guaranteed yield on swap transactions. Starting in 1985, they are also become subject to the compulsory lending ratios for small and medium-size firms.

3. Specialised Banks

In the 1960s, seven specialised banks were established under an equal number of special bank acts. They were created to serve in areas where the commercial banks did not meet the growing financial needs of specific economic sectors and to offer specialised financial services. Three of these banks were subsequently converted into commercial banks. Currently, four specialised banks remain in existence: the Industrial Bank of Korea, the credit and banking sector of the National Agricultural Cooperatives Federation (NACF), the credit and banking sector of the National Federation of Fisheries Cooperatives (NFFC) and its member cooperative, and the credit and banking sector of the National Livestock Cooperatives Federation (NLCF).

The Industrial Bank of Korea was established in 1961 to provide financial support for small and medium-size businesses, which faced difficulties, compared with large
firms, in raising funds and borrowing money from the commercial banks. Most of its capital was subscribed by the government, and the remainder, by the National Federation of Small and Medium Industry Cooperatives. It is authorised to accept any type of deposits which commercial banks are allowed to accept and to issue Small and Medium Industry Finance Debentures, supported by government guarantees, up to ten times the amount of its paid-in capital and reserves. As in the case of commercial banks, its operational funds come mainly from public deposits. Its credit extending business is, however, restricted to financing small and medium-size businesses by making loans and discounts, making equity investments or underwriting debentures with the approval of the MoFE.10

The NACF and its member cooperatives were established in 1961 to help the agricultural program develop effectively. The NFFC and its member cooperatives were established in 1962 to help fishermen and fisheries manufacturers. The NLCF and its member cooperatives were established in 1981 to promote the development of the livestock industry. The credit and banking sectors of the NACF, the NFFC and its member cooperatives, and the NLCF are aimed to serve in the areas of farming and agricultural projects, fishing and the manufacturing of fishing equipment, and livestock farming, respectively. They engage in almost the same lines of business as those of the commercial banks. Their major financial resources come from public deposits and borrowings from the government and the BOK. Their lending to non-members is restricted to the amount of non-member deposits, less the legal reserve requirements.

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10 As an exception, the Industrial Bank of Korea is permitted to finance local self-governing bodies, non-profit organisation, and households, with up to ten per cent of its operational resources, less the legal reserve requirements.
Chapter One

The specialised banks have the following features:

First, they are owned by the government or by the members of associations of cooperatives. The Industrial Bank of Korea is a government owned bank. The NACF, the NFFC and the NLCF are owned by the members of the respective associations.

Second, the specialised banks were, in principle, directed and supervised by the government (the Ministry of Finance and Economy, or MoFE) under the special acts by which they were established. Under the revamped system of financial regulation, introduced in 1998, the NACF, the NFFC and its member cooperatives, and the NLCF are now regulated and supervised by the new financial regulatory and supervisory authorities. The Industrial Bank of Korea was, and continues to be, legally placed outside the jurisdiction of the financial supervisory authorities. Legally, the MoFE and the Board of Audit and Inspection (BAI) are given the job of examining its financial position. Nonetheless, the MoFE and the BAI have delegated their powers regarding the examination of the Industrial Bank of Korea to the Office of Bank Supervision (OBS). In practice, the MoFE and the BAI typically examine the head office of the Industrial Bank of Korea, while the OBS examines its branches.

Although the acts establishing the specialised banks restrict the application of certain provisions of the General Banking Act, these institutions have been subject to the monetary and credit policies of the Monetary Board of the BOK as far as their

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11 However, under the privatisation program, the government's share of the Industrial Bank of Korea was decreased from 99.9 per cent to 64.5 per cent in 1995.
12 Under the old system, the NACF, the NFFC and its member cooperatives, and the NLCF were regulated by the Ministry of Finance and Economy. But the establishment acts required the Office of Bank Supervision of the Bank of Korea to examine them.
13 The Board of Audit and Inspection, which is responsible directly to the President, carries out the accounting audit and the business inspection of the central government and certain public organisations, as
commercial banking business is concerned.

Finally, the specialised banks, in addition to taking deposits from the general public, can also borrow government funds and issue debentures as part of their financing operations. In actual practice, however, the amounts of funds borrowed from the government and debentures issued are very small compared with deposits from the public. This indicates that the specialised banks compete directly with the commercial banks in acquiring deposits.\textsuperscript{14}

Although the commercial banks and the special banks are separately established, classified and regulated, the degree of functional separation has been reduced.\textsuperscript{15} The specialised banks have expanded their businesses into commercial banking areas, while the commercial banks have been required to also serve the sectors where the specialised banks have been active. The commercial banks must provide various "policy loans",\textsuperscript{16} and are also subject to regulations setting out lending ratios for small and medium-size businesses. Therefore, although a relatively high proportion of the specialised banks’ lending goes to their respective sectors, there is no significant functional difference between the commercial banks and the specialised banks.

\section*{4. Non-bank Financial Institutions}

Korean non-bank financial institutions are non-monetary institutions, most of which were

\begin{itemize}
\item provided by legislation.
\item Bank of Korea, \textit{Financial System in Korea, op. cit.}, n. 5, pp. 95-96.
\item "Policy loans" are provided under various selective credit programs, for the purpose of fostering a specific industry or achieving a goal of economic policy. They involve advantageous conditions of
\end{itemize}
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introduced in the 1970s. During the rapid Korean economic growth, they have significantly expanded, both in terms of numbers and of volume of funds. They have been permitted to offer relatively higher interest rates and more autonomy in management, compared to commercial banking institutions. Based on their business activities, they can be broadly classified into five categories: development banks, investment houses, savings institutions, insurance companies and other institutions.

First, development banks comprise the Korea Development Bank and the Korea Export-Import Bank. They provide mainly medium to long-term loans and credits to the key economic sectors, which they finance with government funds, funds from foreign capital, or by issuing special bonds. The Korea Development Bank provides financial assistance to the development plan and governmental industrial projects. The Export-Import Bank of Korea engages in medium and long-term financing for export-import transactions, overseas investment, and overseas natural resource development projects.

Second, investment houses act as financial intermediaries in the money and capital markets. They consist of merchant banking corporations, securities investment trust companies, and the Korea Securities Finance Corporation. The merchant banking corporations were established in 1976. The six initial merchant banking corporations were aimed at inducing and borrowing foreign currency after the first oil shock. In 1991, nine investment finance companies, mainly based outside Seoul, converted into financing, such as favourable interest rates and terms or collateral and preferential fund availability.


18 The investment finance companies were introduced in 1972 for the purpose of absorbing kerb market funds into the organised and regulated financial market. Their main business was short-term financing, financed by means of the issuance of their own paper, as well as discounting, selling, accepting and guaranteeing commercial paper issued by business firms.
merchant banking corporations. The remaining fifteen investment finance companies converted in 1996. The merchant banking corporations have engaged in short-term finance. The securities investment trust companies engage in trust business in the securities market. The Korea Securities Finance Corporation serves areas relating to the securities market.

Third, savings institutions consist of the trust business of banking institutions, mutual savings and finance companies, credit unions, mutual credit facilities, community credit cooperatives, and postal savings. The trust business of banking institutions is allowed as means of activities diversification. It entails receiving money in trust, which is similar to long-term deposits, but the returns are slightly higher than the interest rates on time and savings deposits. Mutual savings and finance companies, credit unions, mutual credit facilities and community credit cooperatives grant small loans, with funds collected in the form of time deposits. Postal savings entail the collection of demand deposits and time and savings deposits by the post offices. Postal savings are free of reserve requirements, and the government guarantees the repayment of deposits.

Fourth, insurance institutions consist of life insurance companies and the postal insurance. The Korean insurance system is divided into life and non-life insurance. No insurance company may engage in both businesses at the same time. Korean life insurance has characteristics similar to savings deposits. The postal insurance entails the provision of life insurance services by the post offices.

Finally, securities companies, investment advisory companies, non-life insurance companies, leasing companies, venture capital companies, and instalment credit companies are classified as other non-bank financial institutions. Although they do not
act as financial intermediaries, these institutions do function as supplementary financial institutions.

II. LEGAL SOURCES OF BANKING REGULATION

A. The Bank of Korea Act

1. Enactment of the Bank of Korea Act

After Korea’s liberation from Japan in 1945, the sudden separation of the national economy from the Japanese economic orbit produced serious dislocation in the financial system. The collapse of the Japanese-run sector of the economy resulted in the disappearance of significant sources of finance and users of funds. The Korean financial institutions could no longer float their debentures in Japan or hold deposits of Japanese enterprises. The Korean enterprises did not generate or require significant cash holdings. Furthermore, the runaway inflation led to financial decline after 1945. During this period, businesses and individuals were reluctant to hold financial assets, so the sources of bank funds were severely limited. Since interest rates on bank loans were below the prevailing inflation rates, borrowers were reluctant to pay back bank loans.

Faced with such economic disorder, the Bank of Chosun suggested the creation of a new central bank in 1947. The U.S. Military Government also set up a committee for drafting financial laws in March 1948. However, the committee was abolished five months later, without producing any draft legislation, when the U.S. Military Government

19 See generally B. K. Kim, Central Banking Experiment in a Developing Economy: Case Study of Korea
was abolished and a new Korean government established.

Towards the end of 1948, the Bank of Chosun again proposed the creation of a central bank. In 1949, the newly established government organised a committee to draft a central bank act. In the spring of 1950, the Korean government invited Arthur I. Bloomfield and John P. Jensen, both of whom held positions in the Federal Reserve Bank of New York. The two Americans produced a draft for a central bank act, utilising earlier drafts produced by both the Bank of Chosun and the governmental committee. Their draft was partially amended, and then passed by the National Assembly in April 1950. The new central bank, the Bank of Korea, was finally established on 12 June 1950.

2. **Subsequent Amendment of the Bank of Korea Act**

The Bank of Korea Act envisaged the creation of a strong, relatively autonomous central bank. The BOK was intended to concentrate primarily on the conduct of monetary policy and the supervision of banks, with a view to controlling inflation and developing the financial system. The act created a Monetary Board within the BOK, with responsibilities for setting monetary policy and overseeing the commercial banking system. The Monetary Board was required to implement forceful anti-inflationary policies and to create stable conditions, favourable to financial growth and further institutional reform.

These initial goals of the Bank of Korea Act were not achieved. Within two weeks from the establishment of the BOK, the Korean War began in June 1950. Most of

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(1965), chapter 3.

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the objectives of the act were abandoned or severely weakened in order to finance the war. After the war, the Korean financial system was required to finance the necessary industrial and agricultural projects for economic rehabilitation.

Following the advent of the military government in 1961, a number of reforms were undertaken. First, the government introduced economic development plans and restructured the financial system, turning it into a tool for supporting such plans. Second, since the governmental economic development plans relied mainly on foreign credits, the government also assumed additional powers with regard to foreign currency controls. Third, in 1962, an amendment to the Bank of Korea Act entrenched the supremacy of the government, especially the then Ministry of Finance (now the MoFE), over the Monetary Board. Under the Bank of Korea Act of 1950, the BOK, as a quasi-autonomous central bank, had extensive powers over monetary, credit and foreign exchange business operations. The amendment, however, deprived the BOK of its independent central banking powers and allowed interventions in the conduct of monetary policy and the internal management of the BOK. In this manner, the government strengthened its influence over the BOK. In particular, the amendment gave the Minister of Finance powers to request the Monetary Board to reconsider resolutions it had adopted, as well as to examine the business of the BOK. The budget of the BOK also became subject to

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21 Cole and Park, op. cit., n. 1, p. 64.
22 The initial Bank of Korea Act of 1950 recognised the importance of the governmental role in the Monetary Board. For example, the government had a majority of the votes, while the Minister of Finance was to be the chairman.
25 Bank of Korea Act art. 39, cl. 1.
26 Ibid. art. 40.
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governmental control. Furthermore, in pursuance to the Foreign Exchange Control Act, regulatory powers over foreign exchange business were transferred to the Ministry of Finance.

3. Revised Bank of Korea Act

In the wake of the 1997 financial crisis, the Bank of Korea Act was revised. The Revised Bank of Korea Act removes the government’s control over the BOK and designates the BOK as the monetary authority. It also mandates price stability as the sole objective of the BOK. Under the revised act, the BOK is responsible to implement its monetary policies in accordance with market principles and to harmonise its policies with the government’s economic policies, but only in so far as this does not conflict with the BOK’s main objective of maintaining price stability. The revised act transfers the banking regulatory and supervisory responsibilities from the BOK to the Financial Supervisory Commission. However, the BOK retains a limited supervisory role in its capacity as the lender of last resort.

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27 An amendment to the Bank of Korea Act in 1982 restored the budgetary powers of the Monetary Board.
28 In July 1997, the Korean government introduced a plan to reform the central banking and financial supervisory systems and submitted thirteen financial reform bills. Due to objections from the financial supervisory organisations, those bills were not enacted until the IMF stepped in. On 29 December 1997, following the Stand-By Arrangement between the Korean government and the IMF that required financial sector restructuring, the bills were finally enacted in the course of a special session of the National Assembly.
29 Revised Bank of Korea Act art. 1.
30 Ibid. art. 4.
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B. The General Banking Act

1. Legislative History of the General Banking Act

The General Banking Act is the fundamental law for banking activities and operations. It provides the principal structure of commercial banking regulation. Its primary objectives are the sound operation of banks, the protection of depositors, and the maintenance of the credit system in the interest of national economic progress.31

Following the drafting of the Bank of Korea Act, it was considered necessary also to enact laws governing commercial banks. Once more, Bloomfield and Jensen were enlisted to make recommendations relating to the restructuring of banking institutions. The Korean government then drafted a banking bill based on their recommendations. In 1950, the National Assembly enacted the measure, simultaneously with the Bank of Korea Act. Unlike the Bank of Korea Act, the General Banking Act did not take effect immediately, because the preconditions for its operation, such as the selling off of confiscated bank shares and an increase of banks’ capital, were not met before the Korean War broke out. Therefore, the General Banking Act actually came into effect in 1954, after the end of the war. During the intervening period, banks were regulated in accordance with the Banking Order of the Japanese colonial rule and certain provisions of the Bank of Korea Act, which had the same purposes as the General Banking Act.

The General Banking Act of 1950 created a regulatory framework basically aimed at the protection of depositors by means of safeguarding banks against failure and runs in

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31 General Banking Act art. 1; Revised General Banking Act art. 1.
the context of a privately owned commercial banking system.32 Thereafter, the General Banking Act was amended several times, usually in tandem with amendments of the Bank of Korea Act. During the 1960s and 1970s, the act was amended to implement tight governmental control over the banking system with the aim of mobilising financial savings and allocating them to support and carry out government-led development programs.33 After the beginning of the financial liberalisation and bank privatisation process, the act was amended to give banks some autonomy in their management and to implement such measures of prudential regulation as were deemed to be necessary in the newly liberalised, market oriented banking environment.

The General Banking Act was revised in January 1998. The revised act reforms the commercial banking regulatory system, defines the responsibilities of banks' management and deregulates banking operations.

2. **Scope of the General Banking Act**

The General Banking Act34 applies to banking institutions operating in Korea.36 Banking institutions are defined as (1) all juridical persons, other than the BOK, which (2) regularly and systematically engage in banking business.37 In its turn, banking business is defined as (3) the business of lending funds (4) acquired through the assumption of

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33 Ibid., p. 193.
35 Hereinafter, references to the General Banking Act are to the Revised General Banking Act. However, in cases where a comparison of the two versions is necessary, the Revised General Banking Act will be specified. In the footnotes, for the purposes of such comparison, the current act is cited as Revised General Banking Act, while the old act is cited as General Banking Act.
36 Revised General Banking Act art. 3, cl. 1.
obligations to the public by way of accepting deposits and issuing securities or other evidence of indebtedness.\textsuperscript{38}

All four criteria must be met for an institution to fall within the definition of a banking institution under the General Banking Act. First, a banking institution raises its resources from either (1) accepting deposits or (2) issuing securities or debentures. A banking institution can accept various types of deposits, comprising demand and savings and time deposits, but it does not need to accept all types of deposits. By accepting any deposit, this criterion will be met.\textsuperscript{39} Issuing securities or debentures also comes within the definition.\textsuperscript{40} Therefore, engaging in lending business by acquiring funds through issuing securities in domestic securities market is open only to banking institutions under the General Banking Act, unless permitted by way of special act.\textsuperscript{41} Until 1991, the General Banking Act required the enactment of other laws for the issuance by the commercial banks of securities or other debentures. An amendment to the General Banking Act in 1991 required a presidential decree for the issuance of such instruments. While the specialised banks and the foreign bank branches were permitted to issue such instruments under their respective special acts and the foreign currency control acts, the nationwide and local commercial banks were not generally permitted to issue securities or debentures until the presidential decree was amended in February 1997. Under the revised act and the current presidential decree, the total volume of debentures and other

\textsuperscript{37} Ibid. art. 2, cl. 1, no. 2.
\textsuperscript{38} Ibid. art. 2, cl. 1, no. 1.
\textsuperscript{39} Bank of Korea, \textit{Commentary on the General Banking Act, op. cit.}, n. 34, pp. 29-30.
\textsuperscript{40} Ibid., pp. 30-31.
\textsuperscript{41} The Office of Bank Supervision decision, No. \textit{Kwansum} 912-1286 (15 Dec. 1977).
bonds issued by a commercial bank is restricted to five times its equity.\textsuperscript{42}

Second, a banking institution engages in lending business. This criterion does not prohibit the banking institution from engaging in other businesses, such as securities investment, with funds collected in the form of deposits. To constitute a banking institution, however, an institution must engage both in acquiring funds from the public and in lending business. An institution, which engages only in one of these activities is not a banking institution.

Third, a banking institution must carry on its banking business, as defined, regularly and systematically. The term “regularly” means that the banking institution should engage in its business repeatedly and continuously.\textsuperscript{43} Accordingly, an institution which engages in banking business temporarily or accidentally, is not a banking institution. A banking institution should have the operational systems and facilities, such as management and operations personnel, capital, a business place, a business name, and bookkeeping facilities, necessary for carrying on its business on a systematic basis.

Finally, a banking institution must be a juridical person. A natural person or partnership of individuals cannot engage in banking business.\textsuperscript{44} In practice, all Korean domestic commercial banks are limited companies, established under the Commercial Code.

Under the General Banking Act, the credit and banking sector of the NACF, the NFFC and its member cooperatives, and the NLCF are deemed to be banking

\textsuperscript{42} Revised General Banking Act art. 33; Enforcement Decree on the Revised General Banking Act art. 19.

\textsuperscript{43} Bank of Korea, \textit{Commentary on the General Banking Act}, op. cit., n. 34, p. 32.

\textsuperscript{44} Revised General Banking Act art. 4.
institutions.\textsuperscript{45} In addition, the General Banking Act clarifies that its provisions do not apply to insurance companies and companies which engage exclusively in the business of mutual savings and finance or in the trust business.\textsuperscript{46} Under the definition of banking institution in the General Banking Act, the specialised banks are banking institutions. However, the specialised bank acts which established these banks, restrict the General Banking Act's application.\textsuperscript{47} The General Banking Act also applies to the overseas branches and offices of Korean banks, even though its scope is defined in terms of "any banking institutions operating \textit{in Korea}".\textsuperscript{48} Finally, the General Banking Act applies to the banking regulatory and supervisory authorities. Even though this is not expressly stated, the banking regulators and supervisors are required, by necessary implication, to follow its provisions.

\textbf{C. Specialised Bank Acts}

Currently, there are four specialised bank statutes: the Industrial Bank of Korea Act, the National Agricultural Cooperatives Federation Act, the National Federation of Fisheries Cooperatives Act, and the National Livestock Cooperatives Federation Act. They stipulate the structures of specialised banks, their ownership provisions, and the scope and type of their businesses. In the hierarchy of Korean law, a special statutory provision takes precedence over a more general one. As compared to the Bank of Korea Act and the General Banking Act, the specialised bank acts are such special laws. All specialised

\footnotesize{\begin{itemize}
  \item \textsuperscript{45} Ibid. art. 5.
  \item \textsuperscript{46} Ibid. art. 6.
  \item \textsuperscript{47} See Industrial Bank of Korea Act arts. 3; Industrial Bank of Korea Act art. 52.
  \item \textsuperscript{48} See Revised General Banking Act art. 3, cl. 1 (emphasis added).
\end{itemize}}
bank acts contain provisions which restrict the application of the Bank of Korea Act and the General Banking Act. 49

D. Act Concerning the Establishment of Financial Supervisory Organisations

In July 1997, together with twelve financial reform bills, the government submitted a bill Concerning the Establishment of Financial Supervisory Organisations. All these bills were enacted on 29 December 1997, coming into effect on 1 April 1998. The Act Concerning the Establishment of Financial Supervisory Organisations establishes a new financial regulatory and supervisory framework. The Financial Supervisory Commission (FSC), established under the jurisdiction of the Prime Minister, is responsible for promulgating and amending supervisory rules and authorising the business activities and operations of financial institutions. 50 The Securities and Futures Commission (SFC) is responsible for overseeing the securities and futures markets under the guidance of the FSC. 51 The vice-chairman of the FSC is to hold the position of chairman of the SFC. 52 Under the Act, the Financial Supervisory Service (FSS) was established as a special juridical person on 2 January 1999. 53 The FSS is responsible for inspecting, auditing, and sanctioning financial institutions under the direction of the FSC and the SFC. 54

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49 See, e.g., Industrial Bank of Korea Act art. 52.
50 Act Concerning the Establishment of Financial Supervisory Organisations art. 3; Act Concerning the Establishment of Financial Supervisory Organisations art. 17. Although it is formally placed under the Prime Minister, in accordance with Article 3 of the Act the FSC shall perform its functions independently from the Prime Minister.
51 Ibid. art. 19.
52 Ibid. art. 20, cl. 2.
53 Ibid. art. 24; Ibid. Addenda art. 1.
54 Ibid. art. 37.
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E. Depositor Protection Act

The Depositor Protection Act was enacted in 1995 for the purpose of introducing a deposit insurance scheme for commercial banks. A 1997 amendment to the Depositor Protection Act, forming part of the package of financial reform bills, consolidated the various investor protection schemes, which were already in existence for particular groups of financial institutions, into the deposit insurance fund, the Korea Deposit Insurance Corporation (KDIC), but retained a system of separate accounts for each group of financial institutions.

Under the act, the KDIC is responsible for managing and operating the deposit insurance fund; levying the insurance premiums and making payments out of the fund; and liquidating insolvent financial institutions. The KDIC is operated by an Operation Committee. The Operation Committee consists of the President of the KDIC; the Vice Minister of the MoFE; the vice-chairman of the FSC; the Deputy Governor of the BOK; the Presidents of the Korea Federation of Banks, Securities Industry, Life Insurance Industry, Non-Life Insurance Industry, Merchant Banks, Mutual Savings and Finance Companies, and Credit Unions; and two members appointed by the Minister of the MoFE, on the recommendation of the President of the KDIC. The MoFE is responsible for regulating and supervising the operations of the KDIC. The MoFE also has the power

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55 Korean deposit insurance schemes for particular sectors of the financial industry have been introduced since 1983. Deposit insurance schemes were introduced for merchant banking corporations and mutual savings and finance companies in 1983; for credit unions, in 1984; for insurance companies, in 1989; and for securities companies, in 1997.
56 Depositor Protection Act art. 18.
57 Ibid. art. 9.
to approve the KDIC's budget.

III. INSTITUTIONAL STRUCTURE OF BANKING REGULATION AND SUPERVISION

A. Bank Regulatory and Supervisory Structure until 1998

The previous Korean banking law system divided the banking regulatory and supervisory functions between two main regulators, the Bank of Korea (BOK) and the Ministry of Finance and Economy (MoFE). In the BOK, the Monetary Board and the Office of Bank Supervision (OBS) were responsible for regulating and supervising commercial banks. The MoFE was responsible for regulating and supervising specialised banks.58

1. The Monetary Board of the Bank of Korea

The Monetary Board was the supreme policy-making organ of the BOK.59 It formulated monetary and credit policy in Korea, and was also responsible for regulating and supervising Korean banking institutions, i.e. the commercial banks. When the Bank of Korea Act was enacted in 1950, the Monetary Board was the main regulator of all Korean financial sectors, because the nationwide commercial banks comprised almost the entire

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58 The MoFE was created in 1994, with the merger of the Ministry of Finance and the Economic Planning Board. Before the creation of the MoFE, the Ministry of Finance was responsible for regulating and supervising the specialised banks.

59 There were two conflicting views on the legal nature of the Monetary Board. See Bank of Korea, Planning & Coordination Department, *Commentary on the Bank of Korea Act by Subject* (1990), pp. 62-65. The first view was that the Monetary Board was not part of the Bank of Korea. According to this view, the Monetary Board was an external institution, which designed policies for implementation by the Bank of Korea and supervised it. In other words, the Monetary Board was merely physically located in the Bank of Korea, rather than forming part of its internal organisation. The second view argued that, on the contrary, the Monetary Board was an organ of the BOK, which was given specific responsibilities in the context of
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financial market. Establishing specialised banks in the 1970s and designating the then Ministry of Finance as their regulator and supervisor turned the Monetary Board into the commercial bank regulator under the Bank of Korea Act and the General Banking Act. The Monetary Board licensed and authorised important commercial banking businesses and activities, including branching; directed the OBS with regard to the supervision and examination of banking institutions; and decided on the conduct of banking activities, including minimum capital ratios, lending limits, terms and conditions of long-term deposits, and ceilings on aggregate lending amounts. It also had the power to recommend to a bank's general meeting of shareholders the replacement of officers who wilfully violated banking laws and regulations; order the bank to cease or suspend its operations; and revoke its authorisation for carrying on banking business.

The board consisted of the Minister of MoFE (the Minister), who would be the chairman of the board, the Governor of the BOK (the Governor), and seven other members.60 The President appointed all members. The Minister was appointed under the Constitution Law. The Governor was appointed on the recommendation of the Minister.61 Of the other seven members, five were appointed on the recommendation of government ministers62 and two by the Board of Representatives of Banking Institutions, which consisted of representatives of all banking institutions.63 The MoFE administrated all matters relating to appointments. Legally, the President could not appoint any of the

performing its objectives.

60 Bank of Korea Act art. 8.
61 Ibid. art. 23, cl. 1.
62 Of these five members, one was recommended by the then Economic Planning Board (current the MoFE); two, by the Ministry of Agriculture, Forestry, and Fisheries; and two, by the Ministry of Trade and Industry.
63 See Bank of Korea Act art. 7; Enforcement Decree of the Bank of Korea Act art. 2.
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seven members without the requisite recommendation. However, in practice, no recommendation was ever made against the President’s presumed intention.

The board’s resolutions were usually taken by a majority of those board members who were present. In case of a tie, the Minister, in his capacity as chairman, had the casting vote. The Minister had the power to request the Monetary Board to reconsider resolutions already adopted. Since there was no limit to the power to request a reconsideration, the Minister could exercise such power whenever he disagreed with a particular resolution. When the Minister requested a reconsideration, the Monetary Board was bound to review its position. If a two-third majority of the board members confirmed the resolution, the President would then make the final decision. In practice, the BOK consulted the MoFE before planning or implementing major monetary and banking regulation policies.

2. Office of Bank Supervision of the Bank of Korea

The Office of Bank Supervision (OBS), established in the BOK and headed by a Superintendent, supervised and examined commercial banks under the direction of the Monetary Board. Even though it formed part of the BOK, the OBS was distinguished from the other organs of the BOK.

First, the appointment procedures were different. Unlike other officers of the

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64 Bank of Korea Act art. 17, cl. 2.
65 Ibid. art. 39, cl. 1. The power to request the reconsideration of resolutions was enacted in 1962.
66 Ibid. art. 39, cl. 2.
68 Bank of Korea Act art. 28; General Banking Act art. 7; General Banking Act art. 32.
BOK, the Superintendent was appointed by the President, on the recommendation of the Monetary Board. The Deputy Superintendent and the Assistant Superintendents were appointed by the Monetary Board, on the request of the Governor and following a recommendation by the Superintendent. The Directors of its departments were appointed and removed by the Monetary Board, also on the request of the Governor and following a recommendation by the Superintendent. Lower-ranking employees were appointed and removed by the Governor after consultation with the Superintendent. Therefore, the Governor participated in the Superintendent appointment process in his capacity as a member of the Monetary Board, rather than that of head of the BOK. As for the other senior appointments, the Governor exercised the right to request them in his capacity as the head of the BOK. The Governor only directly appointed and removed the lower-ranking employees of the OBS.

Second, the Governor's role over the OBS's operations was limited. The OBS was directed and supervised by the Monetary Board. The Governor had no power to direct and supervise its actions, which were authorised by the Bank of Korea Act and the General Banking Act; he could only intervene as a member of the Monetary Board.

The OBS was responsible for enforcing operating regulations. It evaluated commercial banks' applications for authorisation by the Monetary Board;\(^69\) it could authorise banking activities within the powers delegated by the Monetary Board under the Bank of Korea Act and the General Banking Act;\(^70\) it had powers to formulate, order or direct banking activities. It also had responsibility to inspect and examine all commercial

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\(^{69}\) General Banking Act art. 9, cl. 1; Regulations Concerning the Supervision of Banking Institutions (Monetary Board), chapters 2-3.

\(^{70}\) General Banking Act art. 9, cl. 2.
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banks, the NACF, the NFFC and its member cooperatives, and the NLCF. It was required to conduct periodic examinations at least once per year, without prior notice. For the periodic examination, the OBS examined a bank’s head offices and about ten per cent of its branches, which were specially selected every year. The scope of the periodic examination covered all activities and operations of the bank. The OBS could also carry out a special examination when a bank’s situation raised imminent policy issues or there were other serious problems. Following an examination, the OBS should report to the Monetary Board on its results.

3. Ministry of Finance and Economy

The Ministry of Finance and Economy (MoFE) occupied the central administrative position in the Korean financial system. Its main responsibilities included: the compilation of the budget; taxation; the management of national finance; the establishment of economic and social development policies; the regulation of the currency and the financial system; foreign exchange control; and control of overseas economic affairs. The MoFE drafted and presented to the National Assembly bills concerning banking regulation. It also had powers to issue ministerial decrees.

Under the Enforcement Decree on the Organisation of the Ministry of Finance and Economy, which was issued on the authority of the Government Organisation Act, the

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71 The NACF Act, the NFFC Act, and the NLCF Act provide that the provisions on bank examination of the General Banking Act also apply to the NACF, the NFFC and its member cooperatives, and the NLCF.

72 Presidential Decree No. 14,438 of 1994. By stipulating many regulatory matters as functions of the ministry, this Presidential Decree, however, conflicted with the Bank of Korea Act. Under the Bank of Korea Act, the MoFE should transfer all powers, duties and functions, which should consequently be exercised by the Bank of Korea. Bank of Korea Act art. 109. The previous Enforcement Decree on the
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MoFE had powers to regulate and supervise the BOK, the financial regulation system, and the specialised banks. With regard to the BOK, the MoFE was responsible for approving the amendments to the Articles of Incorporation of the BOK; received the statement of accounts of the BOK; appointed the Auditor of the BOK; and examined the business of the BOK.73 With regard to commercial banking, the decree stipulated that the MoFE was responsible for establishing and supervising the financial regulatory system and for deciding on policy issues regarding the banking industry, as well as for exercising control over banks' lending.

The MoFE was also responsible for directing and supervising the specialised banks. It approved their operation plans and business activities, including fund raising and lending plans, interest rates, and lending limits to single borrowers. It could request reports and statistical data from the specialised banks for supervisory purposes. It also recommended nominees for the chairmanship of the board of directors, the presidency, and the auditorship of the Industrial Bank of Korea to the President, who had the power to appoint these officers.

B. New Commercial Banking Regulatory and Supervisory System74

During the recent financial crisis, Korea established a new commercial banking regulatory and supervisory system. Under the reformed system, a Financial Supervisory Organisation of the Ministry of Finance included more explicit provisions, under which the ministry could take direct charge of the direction of commercial banks' management. The 1994 decree removed some direct powers from the reorganised MoFE, but the basic structure remained in place.

73 However, the MoFE had not exercised the business examination since 1982.

74 For further discussion of the new Korean commercial banking regulatory and supervisory system, see
Commission (FSC) was established for the purpose of assuming banking regulatory and supervisory responsibilities, including the promulgation and amendment from time to time of supervisory rules and the authorisation of the business activities and operations of the financial institutions. In May 1999, the FSC was also granted authority to license commercial banks and to supervise specialised banks, in so far as prudential matters are concerned. Under the direction of the FSC, a Financial Supervisory Service (FSS) has been given responsibility for supervising and examining financial institutions.

As part of the revamped system, the Revised Bank of Korea Act designates the BOK as the monetary authority and mandates price stability as its sole objective. Regarding banking supervision, the BOK is only given a limited role as a lender of last resort. In addition, the new system removes substantial powers from the MoFE. The MoFE no longer retains the chairmanship of the Monetary Policy Committee (MPC), which is the policy making organ of the BOK. The MoFE's authority over banking regulation and supervision is now limited to its representation by a member to the FSC and a power to request data from the FSC.

IV. THE NORMATIVE FRAMEWORK OF KOREAN BANKING REGULATION

A. Evolution and Types of Korean Banking Regulations

The Korean banking industry is one of the most extensively regulated areas of the Korean economy. Past and current bank regulations have interfered with almost every aspect of banking business and operation. The evolution of Korean banking regulatory norms can

The creation period began with the enactment of the Bank of Korea Act and the General Banking Act. Enacted in 1950, when the present Korean banking regulation system was created, these two acts were initially intended, as discussed above, to create a competitive and independent banking system, with privately owned commercial banks. However, at this stage, the regulatory and supervisory system and detailed bank regulations had not yet been fully developed.

The extensive regulation period started when the military government came to power in 1961 and government-led economic development plans were undertaken. During this period, the Korean banking system came under tight governmental control and was subjected to various types of regulatory and supervisory measures, promulgated under the amended Bank of Korea Act and General Banking Act.

Following nationwide commercial bank privatisation in the early 1980s, the deregulation period was launched. In this phase, as will be discussed later on, some governmental controls and interventions were eased and several deregulation programs were launched. At the same time, new forms of regulatory measures, such as prudential regulations, were introduced.

Finally, the economic and financial crisis, which began in 1997, precipitated substantial financial and banking reform, especially with regard to the regulatory and supervisory system.

Korean banking regulations can be divided as either structural or conduct.
Conduct regulations can be further classified as economic, allocative, prudential or consumer protection oriented. Structural regulation comprises regulatory measures concerned with the structure of an industry. Through such regulations, the government decides which firms or individuals are allowed to engage in particular types of business; which activities they can engage in; and where they engage in such activities. Conduct regulation comprises regulatory measures concerned with how a particular industry should conduct business in its chosen field of activity. The following sections discuss the Korean banking regulation framework, together with its historical development, based on the above classification. They focus on the development of banking regulations up to 1997, together with the reforms undertaken since 1998.

B. Structural Regulation

Korean banking structural regulations generally encompass rules on entry authorisation, branching restrictions, banking activity limitations, and bank ownership controls.

1. Entry Control

Entry control is a typical example of regulatory intervention over industry structure. The

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The distinction between structural and conduct, however, is sometimes blurred. For example, a restriction on banks' ability to offer a particular service might be seen as a form of conduct regulation. The industry participants' behaviour in the market is determined by structural conditions, especially by the conditions of entry. Moreover, those two categories are not necessarily mutually exclusive. In a number of cases, structural regulation and conduct regulation are alternatives to each other. For example, entry barriers can be lowered to combat anti-competitive behaviour. Conduct regulation can also be used to alter the structure of the industry by encouraging new entry. Despite such blurring of conceptual lines and overlap, the categories provide a useful way of organising and separating the types of regulatory
traditional method of bank entry control involves the licensing or chartering of banking institutions. By requiring entry criteria, such as minimum start-up capital requirements, regulators can effectively shape the banking market structure, where only those who fulfill such criteria can engage in the business. In Korea, before being able to legally engage in banking business, an institution must obtain a charter from the appropriate authorities. Until April 1998, the Monetary Board of the BOK had the power to charter commercial banks. Under the Revised General Banking Act, the MoFE was responsible for the licensing of specialised banks. The MoFE was also responsible for authorising foreign bank branches. From May 1999 onwards, the FSC has assumed the licensing function with regard to commercial banks in Korea.

Commercial banking business can be carried on by creating a new bank or by converting existing non-bank financial institutions into banks. The Monetary Board used to be responsible for deciding whether a commercial bank charter should be granted. Before its final deliberation on the matter, the OBS of the BOK was responsible to evaluate the application and make recommendations to the Monetary Board. The original General Banking Act provided several authorisation criteria: the adequacy of the capital, the integrity of the institution’s founders or managing group, the contribution to the public interests and the minimum start-up capital requirement.

The authorisation procedure was stipulated by the Monetary Board and the OBS.

interventions.

76 General Banking Act art. 12; General Banking Act art. 16.

77 Under the Revised General Banking Act, the commercial bank chartering authorities, should check: (1) the feasibility of the applicant institution’s business plan, (2) the adequacy of its capital, the composition of its shareholders and the subscription funds for shares, (4) the integrity and ability of its founders or managing group, and (5) the potential contribution to public interests. See Revised General Banking Act art 8, cl. 2; Revised General Banking Act art. 9.
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An applicant was required to submit an application for preliminary authorisation. The OBS also required the applicant to submit a statement on the activities which the applicant proposed to carry on, an operating plan, future earnings prospects and dividend proposals for three years after establishment, the establishment purpose or conversion purpose, as the case might be, biographical information regarding the institution’s founders, and other information or documents that the OBS might require for the purpose of evaluating the application.\(^\text{78}\) After considering the propriety of the institution’s establishment, including the effects on the financial industry, the competition between banks, its operating prospects, and the impact on the public interest, the OBS, if satisfied, recommended the preliminary authorisation to the Monetary Board.\(^\text{79}\) If a preliminary authorisation was granted, the applicant began organising a banking institution or undertaking conversion procedures. After the completion of such procedures, the final authorisation application was submitted. Then, the Monetary Board decided whether a full authorisation should be granted, following a recommendation by the OBS and verification of compliance with the statutory requirements. There were no different statutory and regulatory criteria between nationwide banks and local banks, except of the amount of the minimum capital requirement.\(^\text{80}\) Under the General Banking Act, local banks were required to have only a quarter of the amount required by nationwide banks.

Before 1945, there were four commercial banks in Korea. During the creation period, only one bank, Bank of Seoul, was authorised in 1959 as a local bank, and became a nationwide bank in 1962. During the extensive regulation period, new entry to the

\(^{78}\) Detailed Enforcement Regulation for Supervision of Banking Institutions (OBS) art.3.

\(^{79}\) Bank of Korea, Commentary on the General Banking Act, op. cit., n. 34, p. 52.

\(^{80}\) General Banking Act art. 16, cl. 1.
nationwide commercial banking sector was not allowed, except in the case of the Korea Trust Bank, which specialised in trust business together with restricted commercial banking business.81 Unlike the nationwide commercial banks, all current local banks and most of the specialised banks were established in this period. During the deregulation period, eight nationwide commercial banks were authorised and three specialised banks were converted into nationwide commercial banks. The lowering of the entry barriers was claimed to promote competition between banks. In some cases, the establishment of new banks was politically motivated and resolved. For example, the Dongnam Bank and the Daedong Bank were authorised after one presidential candidate, who was thereafter elected, promised to establish banks for supporting medium and small-size businesses and the then MoF issued a guideline for establishing such banks.

2. Branching Restrictions

Branching restrictions contain a bank’s geographic expansion.82 Korean commercial banks have operated with a branch banking system from the outset, even before the General Banking Act was enacted.83 Under the General Banking Act, the establishment, closure, or relocation of branches by commercial banks has been subject to special authorisation.

81 The Korea Trust Bank was established by consolidating the trust departments of the commercial banks in 1968. It was designed to focus functionally on the trust business, but was legally established under the General Banking Act, classified as a commercial bank, and allowed to carry on commercial banking business. It was merged with the Bank of Seoul in 1976.

82 Even branching of existing banks might be seen as an entry control. For example, in the U.S., the McFadden Act and the Douglas Amendment prohibited existing banks from branching across state lines. State laws determine whether existing banks can branch within states.

83 See Korea Finance Association, Twenty Years of Monetary Administration in Korea (1967), p. 54.
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Under the old system, the Monetary Board had the power to authorise such actions. However, the Monetary Board delegated this power to the OBS, except with regard to the authorisation of the establishment or closure of foreign branches of Korean domestic banks. The Revised General Banking Act removes the authorisation requirement for branching. The act only requires the FSC to formulate the standards and procedures for the establishment, closure and relocation of bank branches.

Bank branching was tightly regulated during the extensive regulation period, when the government pursued a policy aimed at the prevention of over-competition. In 1971, the Banking Institution Branch Adjustment Board, chaired by the Assistant Minister of the Ministry of Finance (MoF), was created within the MoF by presidential decree. The board controlled the establishment, relocation, closure, and merger of branches. Its guidelines stipulated conditions and limitations for branching, especially the establishment of new branches. This depended on the types of area (e.g., whether it was a commercial area), the population, and the number of existing banking branches in the area.

During the deregulation period, branching restrictions were eased and the Banking Institution Branch Adjustment Board was abolished in May 1994. The Korean commercial banks could branch under a guideline of the Monetary Board, which stipulated the maximum number of branches that a bank can establish within one year, based on its condition, including the result of an operations evaluation by the OBS, asset condition, capital adequacy ratio, and existence of financial problems. The local banks could branch inside the authorised business area. There were exceptions for branches in

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84 Revised General Banking Act art. 13.
Seoul, metropolitan cities, and neighbouring provinces. The Monetary Board allowed each local bank to open seven branches in Seoul and one branch in every metropolitan city, as well as branches in the neighbouring provinces. In November 1998, the FSC abolished its guidelines and restrictions for commercial bank branching, thus removing all branching restriction yet in existence.

3. Scope of Banking Activities

In the banking area, statutes or regulations usually define the economic scope of the market by stipulating which activities banks are allowed to offer or, sometimes, which prohibited activities banks cannot engage in. Broadly speaking, defining banking activities can be a means of differentiating between various types of financial institutions on the basis of their activities. After the banking crises of the early 1930s, many countries imposed strict specialisation of banking activities. By ruling out mixed and universal banks, many countries imposed a segmentation of financial intermediaries, separating depository institutions from non-depository institutions. Moreover, in some cases depository institutions were sub-divided into different types of specialised institutions, for example, commercial banks and saving banks.

The Korean financial sector has been generally designed based on the theory of functional separation. In principle, banking business is separated from insurance business, securities business, and trust business. The separation of banking from insurance business is required by the General Banking Act and the Insurance Business

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Act. 87 The Insurance Business Act provides that insurance companies are prohibited from engaging in other types of financial business. 88 The Securities and Exchange Act prohibits, in principle, banks from engaging in securities business other than operations authorised by the MoFE. 89 Moreover, banks should obtain authorisations from the MoFE and the FSC to engage in the trust business. 90

During the creation period in Korea, banking operations were underdeveloped and commercial banks only engaged in limited operations. In the extensive regulation period, the functions and operations of commercial banks were restricted to the mobilisation of savings and the administrative allocation of credit to strategic industries. Since 1982, several new banking activities were introduced in order to diversify the business of commercial banking.

Apart from the prohibitions under the insurance, securities, and trust laws, the scope of banks' activities is generally determined by the General Banking Act. Under the act, Korean commercial banks can engage in any operations relating to banking business permitted under the General Banking Act and other laws. 91 The General Banking Act does not, however, define what banking business is. The OBS was empowered to decide what is the nature of banking business. 92 Under the revised act, the MoFE was to define the range of banking operations. 93 Therefore, the practical scope of banking business

86 Ibid.
87 General Banking Act art. 4; Revised General Banking Act art. 6. This provides that insurance companies are not deemed to be banking institutions.
88 Insurance Business Act art. 9.
89 Securities and Exchange Act art. 29.
90 Trust Business Act art. 3.
91 General Banking Act art. 18, cl. 1; Revised General Banking Act art. 27 cl. 1.
92 General Banking Act art. 18, cl. 2.
93 Revised General Banking Act art. 27, cl. 2.
activities depends on the interpretations based on banking institutions’ traditional functions, the General Banking Act, and other related legislation.

Under the old system, the OBS classified commercial banks’ permissible activities into two groups: primary (or essential) activities and incidental activities. The primary activities consisted of taking deposits, issuing securities and other debt instruments, lending funds, discounting bills, and exchanging credits. The incidental activities included (1) guaranteeing liabilities and accepting bills, (2) mutual instalment savings business, (3) securities investment, lending and selling, (4) underwriting, selling and subscribing securities under the Securities and Exchange Act, (5) sales of government and public bonds on repurchase agreements, (6) factoring business, (7) safe deposit business, and (8) brokerage of mergers and acquisitions.

Apart from banking operations, commercial banks can engage in other activities (concurrent business), which are not considered to be banking business, subject to authorisation by the MoFE and the regulatory authorities of the proposed operation. Currently trust business and credit card business are allowed.

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94 Under the General Banking Act, banks could engage in any banking business without authorisation. However, the OBS required banks to apply for its permission whenever they wanted to carry on an activity other than the activities stipulated as banking businesses.
95 Regulations Concerning the Supervision of Banking Institutions (Monetary Board) art. 28. Under the Foreign Currency Control Act, the foreign credit exchange business is subject to the MoFE’s approval.
96 Ibid.
97 Revised General Banking Act art. 28. Under the old system, the Monetary Board authorised the concurrent business. General Banking Act art. 25.
98 The specialised banks’ activities are subject to the acts under which these are established. The specialised bank acts generally set out the permissible acts and empower the MoFE to approve further activities for the purpose of carrying out the respective bank’s purpose.
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4. Ownership Restrictions

After Korea's independence from Japan, Japanese property in Korea was confiscated. The confiscated bank shares were transferred to the Korean government in 1948. At the end of 1953, just before the General Banking Act came into effect, the government owned about seventy per cent of bank shares. In 1954, the government began selling off the bank shares; the process was completed in 1957. The sale of bank shares created a banking industry owned and controlled by several conglomerates. At the beginning of the extensive regulation period, the nationwide commercial banks were renationalised by the government. The government confiscated the bank shares of those who had allegedly amassed wealth illegally. Moreover, in June 1961, the Temporary Law for Financial Institutions was introduced to restrict the voting rights of the private majority shareholders.

During the privatisation of nationwide commercial banks, an ownership ceiling was introduced in 1982. This aimed at preventing industrial conglomerates from controlling banks and impeding any further concentration of bank credits to them. This ownership ceiling was tightened in 1994. A single person was prohibited from owning or actually controlling shares in excess of four per cent (previously, eight per cent) of voting stock. For local banks, a fifteen per cent ceiling was applied. As an exception, in 1994 an amendment to the General Banking Act allowed a single person who only engages in financial businesses to acquire, with the permission of the OBS, up to twelve per cent of

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99 General Banking Act art. 17.3. Article 5 of the Enforcement Decree of the General Banking Act provided the scope of the term “single person”. An institutional investor who had no intention of controlling a bank’s management was allowed to acquire up to eight per cent. A joint venture bank was excluded from this regulation.
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the voting stock of a nationwide commercial bank.\textsuperscript{100}

The Revised General Banking Act maintains the principle of the four or, for local banks, fifteen per cent ownership restriction. The revised act, however, allows participations in commercial banks to exceed the ownership ceilings under certain conditions. A person or an organisation can own up to ten per cent of a nationwide commercial bank's voting stock by reporting to the FSC.\textsuperscript{101} A person or an organisation can own more than ten per cent of a nationwide commercial bank's, or fifteen per cent of a local bank's, voting stock with the approval of the FSC.\textsuperscript{102} The approval process must take place for every new acquisition which brings the total ownership interest of the person in question above ten, twenty-five and thirty-three per cent.\textsuperscript{103} The Enforcement Decree on the Revised General Banking Act also restricts the range of persons who can own more than four or fifteen per cent of a nationwide or local commercial banking institution, respectively.\textsuperscript{104}

C. Conduct Regulation

1. Economic Regulation

Economic regulations include reserve requirements, credit and deposit ceilings, and interest rate controls. Interest rate controls may be imposed on deposits and/or loans. Regulators set interest ceilings or limits for different classes of deposits, and differentiate

\textsuperscript{100} Ibid. art. 17.4.

\textsuperscript{101} Revised General Banking Act art. 15, cl. 2; Revised General Banking Act art. 15, cl. 4.

\textsuperscript{102} Ibid. art. 15, cl. 3.

\textsuperscript{103} Ibid. art. 15, cl. 3, no. 3.

\textsuperscript{104} Enforcement Decree on the Revised General Banking Act arts. 5-7.
among institutions on the basis of location or type of depositors. In Korea, economic regulations comprise reserve requirements and interest rate controls.

(a) Reserve Requirements

Reserve requirements on Korean banking institutions are imposed on the deposit liabilities, demand deposits, and time and savings deposits, by the MPC under the Bank of Korea Act and other banking laws. The requirements apply to all banking institutions, including commercial banks, specialised banks and branches of foreign banks, as well as the Korea Development Bank and the Korea Long Term Credit Bank. The requirements are applied uniformly to all similar deposits of banking institutions, at the reserve ratio not exceeding fifty per cent. Until they were unified in July 1981, the reserve requirement ratios were different for demand deposits and time and savings deposits. In periods of accelerating inflation, the MPC can impose marginal reserve requirements, directing banking institutions to hold minimum reserves of up to 100 per

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105 For example, in the U.S., the Banking Act of 1933 and the Federal Deposit Insurance Act prohibited the explicit payment of interest on demand deposits, and required the Federal Reserve to set ceilings on the interest rates that could be paid on savings and time deposits (Regulation Q).

106 Banking institutions' non deposit liabilities, such as trust accounts, are not subject to the requirements. Non-bank financial institutions are not subject to the MPC's reserve requirements, but they were subject to the MoFE's payment reserve ratios, which were less stringent and relatively lower than the reserve requirements. See B. H. Yoo and J. K. Lee, "A Proposal for Reserve Requirement System Reform," Bank of Korea Monthly Bulletin (Sept. 1994), p. 19; B. C. Ahn, I. S. Kim, and S. Y. Kang, "Suggestions for the Improvement of the Reserve Requirement System," Bank of Korea Monthly Bulletin (May 1990), pp. 26-28.

107 Bank of Korea Act art. 57, cl. 2; Revised Bank of Korea Act art. 56, cl. 2.

During the period between September 1968 and June 1981, the Monetary Board applied preferential ratios to the NACF and the NFFC for increasing financial support for the relatively underdeveloped agricultural and fisheries sectors. Under the NACF Act, the Monetary Board was authorised to impose different ratios to the NACF, but the Monetary Board lacked similar authority for the NFFC, since the NFFC Act did not provide for any derogation from the uniform application rule.

108 The Monetary Board actually imposes lower ratios to specific long-term time and savings deposit accounts.
cent of any increase in deposits. The reserve requirements are held in the form of deposits with the BOK. The MPC can allow banking institutions to hold vault cash as part of their reserves.

In the 1950s and early 1960s, the reserve requirements were imposed depending on the banking institutions' profitability and their availability of funds, rather than for monetary control purposes. In the mid-1960s, when a surplus in the balance of payments generated excess liquidity in the financial markets, the reserve requirements were raised to thirty-five per cent for demand deposits and twenty-five per cent for time and savings deposits. Moreover, marginal reserve requirement ratios of fifty per cent for incremental increases in demand deposits and forty-five per cent for increases in time and savings deposits were temporarily imposed from October 1966 to March 1967. In the late 1960s and 1970s, when the imposition of monetary controls became necessary, the Monetary Board depended on changes in the reserve requirement ratios. In this period, the reserve requirement ratios were relatively high, at between twelve per cent and thirty-five per cent.

High reserve requirement ratios, however, reduced the profitability of banks. In many cases when banks were not able to meet the required reserves due to the high ratios, they usually made up the reserve deficiency through general loans from the BOK. This practice weakened the effectiveness of the instrument. Due to this problem and the current account deficit in the early 1980s, the Monetary Board lowered the ratios. Afterwards, the ratios remained between 3.5 per cent and 5.5 per cent, until the late
1980s. The Monetary Board raised reserve ratios again to control the excess liquidity supplied by the foreign sector after the current account shifted into surplus in the middle of 1980s. In April 1989, the Monetary Board introduced marginal reserve requirements at thirty per cent on the average incremental increases in demand deposits and time and savings deposits, in order to cope with the rapid growth of money demand from the private sector. This marginal ratio was lifted in February 1990, when the reserve requirement ratios were raised. The current reserve requirement ratio is five per cent, except for several types of long-term time and savings deposits.

(b) Interest Rate Controls

The MPC can set ceilings on the deposit and lending rates of banking institutions. Until the official interest rate liberalisation in 1988, the maximum interest rate on each type of deposit was set by the Monetary Board and interest rates on loans were subject to guidelines set by the Governor of the BOK, to whom this task was delegated by the Monetary Board.

In 1965, the government introduced a major interest rate reform, doubling the nominal rate so as to yield a high real return and, thereby, increase domestic resource mobilisation. By 1972, however, the government had returned to the previous low interest rate policy. The interest rate remained negative for most of the rest of 1970s. Until the early 1990s, the maximum interest rates set by the Monetary Board and the Governor became the actual interest rates of banks due to the excess demand for credit

and the prevailing negative interest rates. Furthermore, in practice the then MoF and the Monetary Board decided all interest rates of deposits and loans, and then notified accordingly the banking institutions, which would uniformly follow the relevant decisions.\footnote{Revised Bank of Korea Act art. 28, no. 12; Revised Bank of Korea Act art. 28, no. 13.}

In December 1988, the government undertook an official liberalisation of the interest rates of banks and non-bank financial institutions. However, inflation in 1989 caused a significant rise in interest rates under the liberalised regime and led to the reimposition of interest rate controls through window guidance. In August 1991, the government reverted to the liberalisation policy and introduced new plans for this purpose. The plans intended to gradually deregulate short term lending rates and rates on deposits with long maturity.

\section*{2. Allocative Regulation}

Allocative regulations include selective credit programs, compulsory investment requirements, and preferential interest rates. The allocative regulations control the direction of credits, either to ensure that a particular activity or industry receives at least as much funding as the government desires or to prevent banks from financing activities that the government considers undesirable.\footnote{Chung, \textit{op. cit.}, n. 14, p. 288.}
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(a) Policy Loans

As part of the centrally controlled economic development process, the Korean government introduced various types of instruments to control a company's access to bank credits and lending and to ensure industry's compliance with the government's official plans. The priorities of credit allocation policy in Korea changed from fostering export industries in the 1960s, to developing heavy and chemical industries in the 1970s, to promoting small and medium-size firms in the 1980s.

Credit allocation was justified on the ground that bankers could not carry out the economic development plans without the government's control. The most important credit allocation instrument of the Korean government was the "policy loan". However, as policy loans were generally funded by recourse to the rediscount facilities of the BOK, which operated automatically within pre-decided amounts, they reduced the effectiveness of monetary controls.

Policy loans included various types of loans based on supporting programs and fund resources. As of 1981, there were 183 types of policy loans out of a total of 257 types of bank loans. During the period between the 1960s and 1980s, more than half of all bank credits were allocated through policy loans. Even if the BOK's rediscount

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118 See Chapter Three Section III C 2 (b).
119 See Kim and Park, op. cit. n. 14, p. 352 (Table 2).
facilities also performed liquidity control and lending of last resort functions, they were primarily utilised for funding policy loans, and their interest rates were lower than banks’ lending rates. Since the 1960s, the financing of the export industry in the form of a commercial bill rediscount system has been an important instrument for policy lending. More specifically, banks financed qualified international traders for trade purposes within the required amounts, and then the BOK rediscounted automatically between thirty and fifty per cent of the lending amount. Preferable lending rates were also applied to export finance. To support other industrial sectors, the Monetary Board introduced guidelines regarding the eligibility of commercial bills for rediscount. In addition, general loans were provided for small and medium-size firms and equipment loans for export oriented industries. The BOK automatically rediscounted a certain percentage of banks’ lending amounts, on the basis of policy loan outcomes.

During the deregulation period, export finance was reduced. The large corporations, the major beneficiaries of the policy loans, were excluded from financial support in the form of rediscounts. Since, however, the support to small and medium-size industries increased and emergency financial support was provided for industrial restructuring and for troubled investment trust companies, policy loans did not decrease. In 1994, the Monetary Board introduced a ceiling system on the BOK’s lending to the commercial banks. This system abolished the automatic rediscount system in connection to policy loan activities. Under the new system, the total amounts of BOK lending to banks are decided by the MPC.

The Korean government’s interventions in the banking industry produced

inefficiencies and distortions in the allocation of credit. Since the policy loans were assigned based on a firm's activities, rather than on its financial situation and overall economic prospects, a firm could raise bank credits for its operations by increasing its involvement in activities qualifying for policy loans, instead of improving its underlying economic conditions, e.g., its capital structure. Moreover, since the policy loans were assigned mainly to the conglomerates,

(b) Principal Transaction (Main Credit) Bank System

To correct problems arising from the policy loans system, the principal transaction bank system was introduced.

Thus, in 1974, under the Agreement of the Council of Banking Institutions, all companies of industrial conglomerates were subjected to monitoring by banks. A bank having major business relationships with the principal company of a conglomerate, became the principal transaction bank for the conglomerate. The principal transaction bank was assigned major functions with regard to: the improvement of the

121 During the creation period, the BOK's rediscount facilities were utilised for liquidity control purposes.
122 The Korean industrial conglomerate, chaebol, is a group of companies usually controlled by a family. A conglomerate usually had a central financial department that controlled all its member companies' financial affairs.
125 The agreement was entered into under the government's administrative guidance.
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conglomerate’s capital structure;\textsuperscript{126} setting credit ceilings on operating capital; and consulting on new credits from non-principal banks. The principal transaction bank system was strengthened in 1976. The principal transaction banks supervised the overall borrowing practices of large conglomerates and gave managerial guidance to their companies. In 1978, the principal transaction banks’ roles were again strengthened. Under a revised agreement, the conglomerates should now consult with their principal transaction bank before borrowing more than a specified amount from non-principal transaction banks. Dividend plans also became subject to consultation with the principal transaction bank. During the deregulation period, the principal transaction banks focused on preventing the conglomerates from real estate acquisitions and business expansion into new industries.

Even though the principal transaction bank system had its formal origin in a voluntary agreement among banks, in practice the OBS controlled the system. The lack of legal authority for this purpose precipitated increasing opposition on the part of the conglomerates, especially because the government forced them thereby to sell their real estate and remove some member companies. The agreements also raised anti-trust questions under the Monopoly Regulation and Fair Trade Act. Those problems were solved by an Amendment to the General Banking Act in 1982. Under the amendment, the Monetary Board was given powers to restrict the extension of bank credits to any individual business group by fixing ceilings.\textsuperscript{127} Under the Monetary Board’s regulations,


\textsuperscript{127} General Banking Act art. 30.2.
any large conglomerate, defined as a "large interlinked business group," with an aggregate volume that exceeded 250 billion Korean won, became subject to the principal transaction bank system controls. The principal transaction banks were required to manage corporate information; promote capital structure improvement; and lead crisis management.

The FSC changed the name "principal transaction bank" to "main credit bank," and later on to "key bank." Currently, the key bank system focuses on corporate restructuring.

3. **Prudential Regulation**

Even though the General Banking Act was ostensibly enacted with the philosophy that the bank regulatory system should protect depositors by safeguarding banks against failures, there were only nominal provisions to uphold that purpose. They included single borrower lending limits and restrictions on insider lending. During the extensive regulation period, prudential regulations were also nominal. Since allocative control was the priority and the government controlled every aspect of the banking institutions, the supervision of banking institutions focused on examining whether the banks complied with the government's economic policy directions, rather than strictly enforcing the prudential regulations. After privatisation and liberalisation of bank operations during the deregulation period, the government's formal control over structural and functional

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128 The large interlinked business groups are determined on the basis of their assets by the Monopoly Regulation and Fair Trade Act.
129 Regulations Concerning the Supervision of Banking Institutions (Monetary Board) art. 32.
130 Ibid. art. 33.
regulation has been gradually eased. At the same time, several prudential regulatory measures have been introduced. Some of the current regulations include single borrower lending limits, a system of ceilings on the size of large loans, lending and management restrictions on transactions between banks and their subsidiaries, restrictions on insider lending, and standards regarding bank management.

The limit to loans to a single borrower was in place from the outset. This limitation prohibits banking institutions from lending to any single individual or juridical person amounts in excess of fifteen per cent of their equity.\(^\text{132}\) In addition, guarantees of the obligations of any single individual or juridical person are restricted to thirty per cent of a bank’s equity.\(^\text{133}\) The Revised General Banking Act also restricts the total amount of outstanding guarantees of commercial banks.

The commercial banks are also subject to a similar lending limit with respect to any interlinked business group.\(^\text{134}\) Loans and guarantees of obligations to any interlinked business group taken as a whole should not exceed forty-five per cent of a bank’s equity.\(^\text{135}\)

An amendment to the Revised General Banking Act, enacted in 1999 and taking effect on 1 January 2000, provides that the outstanding amount of credits (loans and guarantees) of a banking institution to any single individual or juridical person should not

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\(^{131}\) Park and Kim, *op. cit.*, n. 24, p. 192.

\(^{132}\) Revised General Banking Act art. 35, cl. 1.

\(^{133}\) *Ibid.* art. 35, cl. 2. The General Banking Act provided for restriction of the total amounts of bank guarantees or assumptions of obligations. The revised act removed the assumption of obligations from the scope of the restrictions.

\(^{134}\) *Ibid.* art. 35, cl. 4.

\(^{135}\) Regulations Concerning the Supervision of Banking Institutions (FSC) art. 58, cl. 1.
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Exceed twenty per cent of its equity. 36 This amendment also prohibits banking institutions from granting credits to any interlinked individuals or juridical persons in excess of twenty-five per cent of their equity. 37

Moreover, a 1994 amendment to the General Banking Act empowered the banking regulators to set ceilings on the aggregate amount of outstanding loans and guarantees or assumptions of obligations from a banking institution to single individual or juridical persons or interlinked business groups when the amounts exceed fifteen per cent of the institution's equity. 38 A banking institution's aggregate amount of large outstanding credits should not exceed 500 per cent of its equity. 39

Banking institutions may own subsidiaries, but this is subject to various restrictions imposed by the FSC. In 1991, an amendment to the General Banking Act erected "firewalls" between the commercial banks and their subsidiaries. 40 The FSC imposes various restrictions on the aggregate amount of loans and other credits provided by banking institutions to their subsidiaries. 41 The banks are also subject to limits on the loans they are allowed to extend to the officers or employees of their subsidiaries. 42 Furthermore, a bank's officer or employee is prohibited from concurrently acting as an officer or employee of a subsidiary, unless the FSC approves of it. 43

To ensure sound management of banks, banking institutions are subject to

136 Revised General Banking Act art. 35.1, cl. 3.
137 Ibid. art. 35.1, cl. 1.
138 Ibid. art. 35, cl. 6.
139 Regulations Concerning the Supervision of Banking Institutions (FSC) art. 60, cl. 1.
140 Revised General Banking Act art. 37, cl. 3.
141 Ibid. art. 37, cl. 3, no. 1.
142 Ibid. art. 37 cl. 3, no. 3.
143 Ibid. art. 20, cl. 2.
industry standards set forth by the General Banking Act. First, banking institutions should maintain a minimum eight per cent, risk-weighted capital ratio, based on the Basle Committee capital adequacy standards. Second, they are required to maintain a liquidity ratio of more than thirty per cent of their deposit liabilities. Finally, they are required to maintain a ratio of loans to deposits and capital available for lending of less than 100 per cent.

D. Consumer Protection Regulation

In 1991, an amendment to the General Banking Act created the Financial Disputes Settlement Committee (FDSC). The FDSC was established within the OBS to deliberate and resolve customer disputes resulting from banking operations. The Act Concerning the Establishment of Financial Supervisory Organisations places the FDSC in the FSS structure and changes its composition. Under the act, the FDSC consists of the chairman and less than thirty members. The Superintendent of the FSS nominates one of the Deputy Superintendents as chairman of the FDSC.

A person who is a party to a financial transaction may request the FSS to mediate in a dispute arising out of the operations of a financial institution. Upon a mediation request, the Superintendent can recommend to the parties to settle their dispute amicably. If the parties fail to reach a settlement within thirty days after the receipt of a

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144 Ibid. art. 45, cl. 1; Regulations Concerning the Supervision of Banking Institutions (FSC) chapter 5.
145 General Banking Act art. 40.4.
146 See Act Concerning the Establishment of Financial Supervisory Organisations arts. 51-52.
147 Ibid. art. 52.
148 Ibid. art. 53, cl. 1.
149 Ibid. art. 53, cl. 2.
mediation request, the Superintendent must, without delay, refer the case to the FDSC.\textsuperscript{150} The FDSC makes its recommendation within sixty days.\textsuperscript{151} If any of the parties initiates court proceedings at any time during the mediation procedure, the Superintendent terminates the mediation process.\textsuperscript{152} The Superintendent may recommend and advise the parties to agree to settlement terms suggested by the FDSC.\textsuperscript{153} If accepted by the parties, the settlement terms suggested by the FDSC acquire the same force and legal effect as a court settlement.\textsuperscript{154}

The amendment to the General Banking Act of 1994 also requires banking institutions to report to the FSC the contractual provisions of their standardised contracts when they intend to originally adopt or amend them.\textsuperscript{155} The FSC can recommend to banking institutions the amendment of such provisions, in order to protect the good order of financial transactions.\textsuperscript{156}

V. GOVERNMENT CONTROLLED BANKING SYSTEM

The Korean banking system has acted as a significant tool for the development of the national economy in accordance to governmental plans. Under the governmental economic development plans, Korea’s banking system was intended to give preference in its lending operations to those sectors of the economy that the government had selected. Korea’s relevant banking acts (the Bank of Korea Act and the General Banking Act) were

\begin{itemize}
\item \textsuperscript{150} Ibid. art. 53, cl. 3.
\item \textsuperscript{151} Ibid. art. 53, cl. 4.
\item \textsuperscript{152} Ibid. art. 56.
\item \textsuperscript{153} Ibid. art. 53, cl. 4.
\item \textsuperscript{154} Ibid. art. 55.
\item \textsuperscript{155} Revised General Banking Act art. 52, cl. 1.
\end{itemize}
adopted with an eye to subjecting the bank regulatory and supervisory authorities (the Monetary Board and the OBS) and the commercial banks to continuing governmental control.

This government controlled banking system created an environment in which the banking regulatory and supervisory authorities are guided by the government and subject to its interventions. As a result, the regulated banking sector has been largely precluded from developing genuinely market and commercially oriented practices.

In the next two chapters, Korea's government controlled banking system will be analysed and evaluated in detail, with a view to suggesting proposals for a reformed banking system. In Chapter Four, the recent Korean financial and economic crisis will be examined, with an emphasis on the following issues: how the weaknesses of the government controlled banking system caused the crisis, and what further reforms Korea needs in light of the suggestions made in Chapters Two and Three.

156 Ibid. art. 52, cl. 2.
CHAPTER TWO

INSTITUTIONAL STRUCTURE OF THE COMMERCIAL BANKING REGULATOR AND SUPERVISOR

Having examined the basic nature of the Korean banking system, Korea’s institutional arrangement of banking regulatory and supervisory authorities has had an important role in shaping Korea’s “government controlled” banking system and creating weaknesses in both regulatory and supervisory systems and the banking sector. The previous Korean banking regulatory and supervisory structure (regulation and supervision by the Bank of Korea) allowed the government’s control over and intervention in the banking sector.

It is necessary to consider in further detail the institutional structure of the Korean commercial banking regulator and supervisor, in order to identify the sorts of problems and weaknesses which arose; how the government controlled and intervened in the Korean banking system through the regulatory and supervisory structure; and what structural arrangement can correct these problems and weaknesses.

This chapter seeks to answer the question of who should be the Korean banking regulator and supervisor. This chapter takes a comparative approach by utilising relevant practices in the regulatory and supervisory systems of several countries, such as the U.S., U.K., and Japan, in order to make a more detailed and critical analysis of the banking regulatory and supervisory problems and weaknesses in Korea. The major objects of this comparative analysis are directed towards the institutional arrangement of banking
regulatory and supervisory authority. The chapter concentrates on the institutional structure and role of bank regulatory and supervisory authorities, analysing the strength and weakness of each approach, \textit{i.e.} whether the government, the central bank, or the independent agency has the power to regulate and supervise.

The issue of the relationship between the government and the central bank is examined and analysed, as is the problem of unfettered government intervention in bank regulatory and supervisory powers. This chapter also notes the relationship between the regulatory and supervisory authorities, the government, the monetary authorities, and the judicial system. This chapter suggests a proper structure and role of banking regulation and supervision in Korea. Finally, this chapter assesses the structure of the new Korean banking regulatory and supervisory authorities (the Financial Supervisory Commission).

\section{Institutional Structure of the Korean Commercial Banking Regulator and Supervisor}

\subsection{Bank of Korea}

After the second world war, the Board of Governors of the Federal Reserve System of the U.S. (FRB) assisted in the drafting of new central banking legislation in some developing countries, such as Paraguay, Guatemala, the Dominican Republic, the Philippines, and Ceylon.\footnote{See, \textit{e.g.}, \textit{Federal Reserve Bulletin} (March 1946), p. 259 (for Guatemala); \textit{Federal Reserve Bulletin} (Sep. 1950), p. 1133 (for Ceylon).} Those central banking systems which were established after the assistance provided by the FRB had two important features. First, a committee type organ of central bank, called monetary board, had the supreme decision-making power for the policies of
the central bank. Second, the central bank had the responsibilities for banking regulation and supervision through its bank supervision department, headed by the Superintendent, which was directly accountable to the monetary board.²

The original structure and functions of the Bank of Korea (BOK) followed the central banking system adopted in the above developing countries.³ In 1949, the Korean government requested the FRB to advise and assist in a reorganisation of the central bank and other financial institutions. Bloomfield and Jensen of the Federal Reserve Bank of New York⁴ studied the structure, operation and policies of the Korean banking system and examined all aspects of the Korean economy and finances bearing upon the special problems. They submitted their recommendations for banking reform in Korea including drafts of the central banking and the general banking statutes. With some amendments, most of which related to the wording and arrangement of certain articles, two banking drafts, submitted by them, were passed by the National Assembly.

The Bank of Korea Act has been amended several times afterwards. The first amendment in 1962 was the most significant because it set up the banking regulatory and supervisory structure until 1998.⁵ The following sections discuss the development of the BOK's institutional structure. They also focus on the problems of government's control over and intervention into the BOK.

³ Arthur I. Bloomfield and John P. Jensen, Banking Reform in South Korea (1951), p. 5. The differences between the Korean system and other systems were the BOK's loans to the government and the government agencies, and the foreign exchange operations and policies.
⁴ Arthur I. Bloomfield was the Chief of the Balance of Payments Division. John P. Jensen was the Assistant Chief of the Auditing Division.
⁵ Although it did not change the overall structure of the BOK, the amendment reduced the functions of the BOK, and changed practical way of banking regulation and supervision.
1. **Monetary Board**

Under the Bank of Korea Act, the BOK had four organs: the Monetary Board, the Governor, the Office of Bank Supervision, and the Auditor. The Monetary Board was the supreme organ of policy making and the regulator and supervisor over commercial banks.

Until the Bank of Korea Act was enacted in 1950, the Financial Institution Bureau of the Ministry of Finance was responsible for bank supervision and examination in Korea. According to Bloomfield, the transfer of bank supervision function to the BOK, specifically to the Monetary Board was "in keeping with the modern trend in banking legislation, which favours an integration of activities of bank supervisors and central banks in the interests of a more effective and unified control of commercial banks." The initial Monetary Board was composed of seven (titular) members and seven alternates. The initial members were the Minister of Finance, the Governor of the BOK, two members elected by the banking institutions, one member recommended by the Korea Chamber of Commerce and Industry, one member recommended by the Minister of Agriculture and Forestry, and one member recommended by the Economic Board of the Office of Planning. The seven alternate members were the Deputy Minister of Finance, the Chief Deputy Governor (the Ranking Deputy Governor) of the BOK, and five

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6 The Bank of Korea Act was revised in December 1997 and the revised act came to effect on 1 April 1998. In Chapter Two, the old act which was revised in December 1997 is cited as the Bank of Korea Act. The current act is cited as the Revised Bank of Korea Act.


8 Until 1994, the Economic Planning Board and the Ministry of Finance were major executive departments concerning economic matters. The two ministries were merged to the Ministry of Finance and Economy. When discussing structural matter, the Ministry of Finance and Economy will be usually used rather than the Ministry of Finance, except focusing of the role of the Ministry of Finance.

9 Bank of Korea Act of 1950 art. 8.
members who elected or recommended in the same way as titular members. All members and alternates, except the Minister and the Deputy Minister of Finance and the Chief Deputy Governor of the BOK, were appointed by the President subject to the confirmation of the National Assembly.

The composition of the initial Monetary Board had two features. First, it was intended to compromise the various interests of national economy. The Monetary Board's diversified representation was based on the principle that "a central bank is much too strategic and vital a factor in a country's financial and economic welfare to be guided by any one man or any one group." Second, it allowed the government the majority vote in the Monetary Board. Even though, in their view, the failure of the Bank of Chosun (the Korean central bank before the BOK) to perform its roles had been due to a lack of appropriate control powers, Bloomfield and Jensen accepted the principle that the government should be entitled to have the majority vote, where an economy was heavily dominated and controlled by the government.

Together with the government's majority vote, the importance of the Minister of Finance (Minister) had been recognised from the outset by the Bank of Korea Act. The Minister was given the chairmanship of the Monetary Board. The presence of the Minister in the Monetary Board was conceived as the chief instrument for achieving a close co-ordination and integration between policies of the government and the Monetary

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10 Ibid. art. 8. The alternate members were entitled to attend the Board's meeting without voting right. In the time of accident over the titular member, the relevant alternate member (e.g., the Deputy Minister of Finance for the Minister of Finance) took the full member's role, such as voting.

11 The Chief Deputy Governor was appointed by the Monetary Board. In 1962, the title of the Chief Deputy Governor became the Deputy Governor and those of Deputy Governors became the Assistant Governors.

12 Bloomfield and Jensen, op. cit., n. 3, p. 44.

13 Ibid., pp. 43-45.
Board, by acting as an avenue of communication between the government and the BOK. The Monetary Board was designed to allow for compromise between the various interests of national economy. The Minister as the chairman was also aimed at arbitrating the conflicts between financial industry and the other industries in the diversified representations.

After the military revolution in 1961, the government needed a banking system to support its economic development plans. The government amended the Bank of Korea Act in 1962. The amendment to the Bank of Korea Act in 1962, drafted by the Ministry of Finance, increased the power of the President and the Minister. Under the amendment, the supremacy of government, especially the Ministry of Finance, over the Monetary Board was clearly established, with the intention to reduce the powers of the Monetary Board. First, even if the English name of the Monetary Board was not changed, the amendment changed its Korean name. The initial Monetary Board’s Korean name would be translated as “the Finance and Monetary Board.” The term of “operation” was added into its name by the amendment. Therefore, it would be translated as “the Financial and Monetary Operation Board.” This implied that the operational role of the Monetary Board was emphasised rather than its role of national monetary and financial policy making. The Ministry of Finance and the Economic Planning Board, which engaged in budgetary matters and overall economic plans, were given ultimate powers to formulate economic policies including the banking area. The government established and decided national economic policies and was responsible for all financial affairs. Therefore, the

14 Kim, op. cit., n 7, p. 77.
16 Kim, op. cit., n. 7, pp. 86-87.

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Monetary Board was to perform its monetary function and banking regulatory and supervisory function in accordance with the government’s policy decisions.

Second, the amendment discarded the system providing for alternate members. The alternate member system had served the dual functions of enabling representatives from a variety of industries to attend the meetings of the Monetary Board and eliminating the risk of lacking a quorum. However, it was possible that the responsibility of the Monetary Board could be ambiguous when the alternate members voted against the intention of their titular members. It is unclear that the alternate member system actually provided the ambiguity of responsibilities. By abolishing alternate members, however, the government removed three alternative members elected or recommended by the private sectors (banking institutions and the Korea Chamber of Commerce and Industry). Instead of eliminating the alternates, the number of members increased to nine. Among the members, only two members were recommended by the banking institutions.

Third, the Minister remained as the chairman and was granted more powers to control the Monetary Board. The Minister was given powers to (1) request the Monetary Board to reconsider resolutions it adopted; (2) administer the appointment process of other members; (3) appoint the Auditor of the BOK; and (4) carry out business inspections of the BOK. Furthermore, in the appointment process of the Monetary Board members, the amendment did not require the National Assembly’s confirmation when the President appointed the members of the Monetary Board and the Governor of the BOK.

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18 Ibid., p. 40.
19 The power to request reconsider made the Minister the controller of the Monetary Board rather than the arbiter of different interests during the policy making.
20 See Bank of Korea Act art. 8; Bank of Korea Act art. 23.
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The President could appoint all members at a whim.\textsuperscript{21} The Bank of Korea Act did not limit the power to remove.\textsuperscript{22} It only provided restrictions against appointees.\textsuperscript{23} A member could be removed for the restrictions provided by Article 15.\textsuperscript{24} It may be argued that the Article 15 of the Bank of Korea Act stipulated the limitation of removal power. Therefore, the members of the Monetary Board could not be removed without cause, provided the Article 14 as appointment restrictions.\textsuperscript{25} However, without the explicit provision which limits removal power, it is difficult to protect the full terms, especially when the appointment is at the President’s whim. In the history of the BOK, of 19 Governors, only four actually completed their tenures of office. The other Governors usually resigned when there was conflict between the BOK and the government.\textsuperscript{26}

Fourth, the amendment transferred the foreign currency operation function to the Minister. It reduced the Monetary Board’s monetary control power, where the exchange rate policy was very important because of the export-led economic development with foreign currency credits.

2. Governor

The Governor, assisted by the Deputy Governor and five Assistant Governors, represented the BOK, administered and directed its operations, and implemented the monetary policies formulated by the Monetary Board. The majority of the departments

\textsuperscript{21} In theory, the appointment process with recommendation system can check the presidential power. However, it is not practical that ministers, who can be removed at the president’s pleasure, act against his intention.

\textsuperscript{22} For example, the members of U.S. independent regulatory agencies can be removed for cause.

\textsuperscript{23} Bank of Korea Act art. 14.

\textsuperscript{24} Ibid. art. 15.

\textsuperscript{25} Bank of Korea, \textit{Commentary on the Bank of Korea Act}, op. cit., n. 17, p. 57.
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of the BOK were under direction of the Governor. Those departments included the Planning and Co-ordination Department for annual and long-term strategic planning, organisational co-ordination, budget, and accounting; the Personnel Department for personnel administration; the Research Department for researching national and world economic activities; the Payment System Department for planning, developing, and managing payment system including BOK-wire; the Monetary Policy Department for formulating and implementing monetary policies, researching and analysing financial markets.

3. Office of Bank Supervision

When the Office of Bank Supervision (OBS), the then Department of Bank Supervision, was established within the BOK, according to Bloomfield the power of bank supervision and examination was transferred to the OBS from the Ministry of Finance because the bank supervision and examination by the central bank would be more effective.27

The legal responsibilities of the OBS had not changed significantly since its establishment. But as the number of commercial banks increased and the scope of examination expanded to the specialised banks and the non-bank financial institutions,28 the structure of the OBS had been expanded.29 The initial OBS had two departments: the Supervision Department and the Examination Department. As the operations of the OBS

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26 See B. S. Lee, op. cit., n. 2, pp. 141-144.
27 See Bank of Korea, Commentary on the Bank of Korea Act, op. cit., n. 17, pp. 97-98.
28 The Ministry of Finance and Economy and the Board of Audit and Inspection delegated their power to examine to the OBS.
29 Currently, the OBS examines all commercial banks and specialised banks, saving institutions, including mutual savings and finance companies, credit union, and investment companies, including investment and finance companies and merchant banking corporations.
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expanded, the Examination Co-ordination Department, the Credit Management Department, the Consumer Affairs Department, and the Administration Department had been established. Furthermore, the Examination Department had expanded into six Examination Departments due to the increase of number of examination operations. The Administration Department conducted personnel management, organisation, and accounting affairs of the OBS. The Supervisory Policy Department was responsible for planning and analysing banking supervision, banking affairs authorisation, and international operations. The Credit Management Department was responsible for planning, guiding and analysing credit operations of banks, mainly for the allocative regulations. The Consumer Affairs Department was responsible for the consumer protection regulations. The Examination Co-ordination Department and six Examination Departments engaged in examining banks and other financial institutions.

4. **Auditor**

The Bank of Korea Act provided for an Auditor of the BOK and the Auditor was to set up an assistant department for his operations.\(^{30}\) The Auditor was appointed by the Minister with the consent of the Monetary Board for term of three years, which was renewable.\(^{31}\) This appointment power of the Minister was established by the amendment to the Bank of Korea Act in 1962. Prior to the amendment, the Monetary Board appointed the Auditor.\(^{32}\) The employees for the Auditor were appointed by the Monetary Board through the recommendation of the Governor after the consultation with the

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\(^{30}\) Bank of Korea Act art. 22; Bank of Korea Act art. 27-3.
\(^{31}\) *Ibid.* art. 23, cl. 3.
\(^{32}\) *See* Bank of Korea Act of 1950 art. 35, cl. 1.
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Auditor. The low-ranking employees were appointed by the Governor after the consultation with the Auditor.

B. The Financial Supervisory Commission and the Finance Supervisory Service

Under the Act Concerning Establishment of Financial Supervisory Organisations, the Financial Supervisory Commission (FSC) is responsible for regulating and supervising the Korean financial institutions. The composition of the FSC demonstrates that its main focus is regulatory and supervisory functions rather than various interests of the national economy. Unlike the then Monetary Board of the BOK, only one member of the FSC represents the business sector. Other members in the FSC are either from the relevant authorities for financial matters or for supporting the FSC's regulatory and supervisory functions as specialists.

The Financial Supervisory Service (FSS) consolidates decentralised financial supervisory entities -- Financial Inspector of MoFE, Office of Bank Supervision, Securities Supervisory Board, Insurance Supervisory Board, Credit Management Fund -- into a single agency under the jurisdiction of the FSC. The FSS is a special corporation with no capital. The FSS is engaged in the supervision, examination and enforcement of business activities of regulated financial institutions as well as matters delegated by the FSC and the SFC. The FSS comprises departments and offices, which are divided into

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33 Bank of Korea Act art 27-3, cl. 3.
34 Ibid. art 27-3, cl. 3; Articles of Incorporation of the Bank of Korea art. 25.
35 The FSC consists of seven members: the chairman, the vice-chairman, the Vice Minister of MoFE, the Deputy Governor of the BOK, the President of the consolidated Korea Deposit Insurance Corporation (KDIC), a financial expert nominated by the chairman of the FSC, an accounting specialist nominated by the Minister of MoFE, a legal expert nominated by the Minister of Justice, and a representative of the
five functional areas: authorisation/supervision, examination/enforcement, supervision support, consumer protection, and administration/general affairs.

II. REGULATION BY CENTRAL BANK

A regulatory program is usually created by legislation and then delegated to an administrator (regulator) who performs the actual implementation of the regulatory statute through rule-makings and decisions. Within this formula, a body capable of adequately setting in motion the regulatory programme must be identified. In the following sections, various institutional structures for banking regulation and supervision are examined to answer whether there are any criteria for more effective banking regulation and supervision.

According to a survey to the IMF member countries, the institutional arrangements for the banking regulation and supervision vary between countries.36 Even if the distribution of the responsibility for banking regulation and supervision is not a clear-cut, the institutional arrangements can be divided into two groups: (1) central banks which have monetary authority and banking regulatory and supervisory authority, and (2) system providing for a separation of banking regulatory and supervisory authority from central banks. This section discusses whether a central bank is more suitable for the banking regulation and supervision than other types of institutions.

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Chapter Two

A. Arguments for Integration of Banking Regulatory and Supervisory Authority and Monetary Authority into Central Bank

During the twentieth century, numerous countries have adopted central banking system. Although subject to a great deal of economic debate, political motives and historical events played a more important role than systematic and consistent arrangements in the development of central banks. In Europe, central banks had the sole or principal right of note issue and took a role as the government's banker and fiscal agent. Their initial purpose was not to provide supervision over the banking system. Instead, governments intended to obtain financial advantages from the relationship and support of such banks.

Other central bank functions, such as the lender of last resort function, were developed later in different ways. In the U.S., the central banking system, the Federal Reserve Board, was established in 1914 after the financial panic of 1907. In contrast to the gradual development of central banks in Europe, the Federal Reserve Board were granted, from the outset, a monopoly of note issue and became the fiscal agent of the government, the custodian of banking reserves, the bank of rediscount, and the lender of last resort. This development was reflected world-wide and the resolution of the International Financial Conference in 1920 encouraged countries which had not yet established a central bank to do so. Since then, most countries have established central banks. Therefore, at present there is virtually no country, which has not established its

37 Vera C. Smith, The Rationale of Central Banking (1936), pp. 1-2. The reasons for the decision in favour of a central banking as opposed to a free banking system were not that the central banking was superior to the free banking in economic principles.
39 The U.S. experienced central banking before the Federal Reserve System. The First Bank of the United States (1792-1812) and the Second Bank of the United States (1816-1830) were acting as central banks but failed to obtain a renewal of the charters.
own central bank. In Korea, the BOK was, from the outset, granted the power of note issue, the roles as government’s banker and fiscal agent, and the function of lender of last resort as well as banking regulation and supervision.

Even if there are substantial differences in development, constitutional structures, and powers between various central banks, the control of the monetary system has been the essence of central banking. A central bank performs monetary policy either as sole monetary authorities or as the executive agent to carry out the strategic policy decisions by the Executive (e.g., Treasury or Ministry of Finance). Under the Bank of Korea Act, the BOK, especially the Monetary Board and the Governor, were responsible for the Korean monetary policies. However, the Monetary Board carried out the monetary policy as, practically, a government agent due to the actual control of the BOK by the government.

1. Closely Related

While the primary goal of monetary policy is ensuring stability of the currency, the goal of banking regulation and supervision is, in general, ensuring the safety and soundness of banking system. Even if the goals of monetary policy and banking regulation and supervision are different, they are closely related each other. Their goals, therefore, cannot be attained independently. First, monetary authorities need a safe and sound banking system. Monetary policy can be effectively implemented when the banking system is safe and sound. 

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41 Ibid., pp. 9-12.
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system is able to expand and contract its aggregate balance sheet in response to policy initiatives without adversely affecting the efficiency of intermediation or depositor confidence. Formulating and performing monetary policy would be difficult through an unsound banking system, because the unsound banking system affects the transmission of the monetary policy signal. For example, banking systems characterised by a high percentage of non-performing loans usually have a high interest rate spread that generally translates, at least in the short run, into a high lending rate. This causes disintermediation, and, in turn, weakens monetary controls.

The Korean banks' non-performing loans rose significantly in the first half of 1980s, and exceeded seven per cent of total assets in 1986. This significant proportion of non-performing loans was an obstacle to the flexible implementation of monetary policy. Even if it tried to implement a stabilisation policy, the Korean government was forced to act as the lender of last resort during the financial scandal of 1982. This financial scandal started from a curb mark fraud, but the ongoing problems of ailing firms and businesses resulted in the banking problems. The government, therefore, was forced to relax monetary policy and the BOK granted loans to the banks at annual three per cent interest rate, which was far lower than market rate.

Second, an unsound banking system affects resource allocation, magnifies banking crisis, and increases cost of monetary policy. An unsound bank may continue

43 See Tuya and Zamalloa, op. cit., n. 36, p. 668.
47 See Tuya and Zamalloa, op. cit., n. 36, p. 668.
lending to insolvent debtors to prevent defaults. The extension and refinance of overdue loans tend to limit credits to new borrowers, and to increase credit loses that would in turn result in insolvency of the bank.\(^{48}\) Furthermore, under the deposit insurance or guarantees, which may be either explicit or implicit, a moral hazard problem will arise and amplify the crisis.\(^{49}\) If banks are owned or controlled by the government, the government will take some measures for the banks, which have large non-performing portfolios in order to keep the banking system from collapsing. Those measures, including non-performing loan acquisition and central bank special loan, however, will create a government deficit growth in excess demand and instability in the economy.\(^{50}\)

In the Korean situation, the government's implicit deposit guarantee\(^{51}\) and its direct intervention in financial resource allocation allowed the banks to finance riskier projects. The projects were usually part of the government’s economic plans (e.g., the Heavy and Chemical Industry Plan) and the Korean banks financed them without proper loan evaluation or appropriate monitoring borrowers. When the projects failed and the loans became non-performing, the banking system had to extend new credits to the troubled firms to keep them alive and, thus, to secure the loans in their books rather than write them off, with the hope that the government eventually rescues the banks and solve

\(^{48}\) During banking crises, even the healthy surviving banks tend to increase the share of liquidity in their portfolios and the borrowers face unusual levels of risk premiums. See John J. Merrick, Jr. and Anthony Saunders, “Bank Regulation and Monetary Policy,” 17 Journal of Money, Credit, and Banking 691, p. 700.


\(^{50}\) See Wilbert O. Bascom, The Economics of Financial Reform in Developing Countries (1994), pp. 173-175.

\(^{51}\) Until the Korean deposit insurance scheme for commercial banks was established under the Korea Deposit Insurance Corporation in 1996, it was deemed that the government guaranteed deposits in the commercial banks implicitly. The actual deposit insurance function started on 1 January 1997 under the Depositor Protection Act. Furthermore, during the financial crisis started in the late 1997, the government announced that most of deposits or the equivalent would be protected until the end of 2000.
the economic problem. Therefore, the banking system could not serve more productive areas where funding was needed.52

This problem extended into non-government-led areas. The Korean government has regarded the large conglomerates (chaebols) as pillars of the economy, and implicitly guaranteed that they would not fail. Banks, therefore, have no qualms about lending to them, whatever the health of underlying business. This was especially evident of loans secured with collateral, usually real property. As of June 1997, the ratio of collateralised commercial loans of the Korean commercial banks to total Korean won dominated loans was 50.6 per cent.53

Third, banking regulatory and supervisory instruments impact on the operation and effectiveness of monetary policy.54 Even the risk-weighted capital adequacy requirement, which is deemed to have less direct impact on monetary policy than interest rate control or constraints on bank business activities, also affects on the monetary policy in the short run. It limits asset growth, distorts credit allocation, induces banks to adjust interest rates, and thus alters the nature of bank response to monetary policy.55

On the other hand, banking regulatory and supervisory authorities are also interested in having a stable currency. Unstable monetary policies or abrupt policy changes increase the risk of bank failure.56 A high and volatile inflation may provide inadequate market signals, causing misallocation of resources and endangering the credit

52 See Il Sakong, Korea in the World Economy (1993), pp. 75-76.
55 Tuya and Zamalloa, op. cit., n. 36, pp. 669-670. See also Lindgren, Garcia, and Saal, op. cit., n. 44, pp. 143-147. They argue that the prudential regulation impacts on macroeconomic policy, thus, the implementation of the prudential policies can be adjusted accordingly.
56 See Andrew Sheng, “Role of the Central Bank in Banking Crisis: An Overview,” in Patrick Downes and
decisions of bankers. For example, due to the excessive credit demand and inflation in the mid- and late 1980s in numerous countries, a sharp monetary policy change tightened the money supply with much higher interest rates. This resulted the marginal borrowers were unable to meet their servicing commitments or renew short-term loan facilities. Accordingly, the banks were threatened by the corresponding fall in the asset and collateral values.57

The various facets of the interrelationship between the monetary and the regulatory and supervisory functions have been involved as a justification for locating the banking regulatory and supervisory authority within the central bank. The Federal Reserve Board even argues that:

A basic continuing responsibility of any central bank -- and the principal reason for the founding of the Federal Reserve -- is to assure stable and smoothly functioning financial and payments systems. ... [In fact, the “monetary” functions were largely grafted on to the “supervisory” functions, not the reverse.58

In Korea, during the debate of banking regulatory and supervisory structure reform in 1997, the BOK argued that it should retain the power to regulate and supervise under a closely related argument. Against the MoFE’s proposal of removing the banking regulatory and supervisory powers from it, the “general view”59 of the BOK was that it had to retain at least the prudential regulation function because without the function it cannot fulfil the monetary function.60 This view was partly adopted under the Revised

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59 This argument was not the “official view” of the BOK because the Governor agreed with the MoFE.
60 The MoFE argues that if the BOK has the supervisory power it would operate its monetary function by the direct measure through its supervisory powers. The MoFE also argues that, without the supervisory power, the BOK could perform its monetary operation without difficulties if it is granted the power to request information of the commercial banks and bank examination to the supervisory authorities. The
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Bank of Korea Act and the Act Concerning Establishment of Supervisory Organisations. The BOK has the right to request the FSS to conduct an on-site or, in conjunction with the Bank, joint examination of specific banks. Furthermore, the BOK may request, from the FSS, the findings of the examinations; and, on the basis of these findings, the BOK may ask the FSS to order banking institutions to take corrective measures. In the above situations, the FSS shall accept the requests from the BOK. The BOK can also request information from the MoFE and the FSC when it is necessary for formulating its monetary policies.

2. Lender of Last Resort

As outlined above, the privilege of note issue has traditionally been associated with central banking. The position of monopolist of note issue allowed granting the lenders of last resort role to central banks. Under the classical doctrine of lender of last resort, in the face of the possibility of systemic failure, a central bank should lend freely and

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62 Ibid. art. 62, cl. 2.
63 Ibid. art. 62, cl. 4.
64 Revised Bank of Korea Act art. 94.
65 See generally Rosa Maria Lastra, Central Banking and Banking Regulation (1996), pp. 126-130.
66 See de Kock, op. cit., n. 40, pp. 18-21. The issue of note as of other currency was claimed to be a prerogative of the state, but the state decided to hand its prerogative over to banks because of either the need for means of facilitating the exchange of goods or the loss of public confidence in state note issue due to the heavy depreciation. The note issue power was ultimately granted a bank which became the central bank. The main reasons of monopoly in the note issue are that the uniformity in note circulation and its effective supervision can be achieved desirability through the central bank; the sole right of note issue tends to give the central bank a better opportunity of exercising credit control over undue credit expansion by the commercial banks; in a crisis, the concentration of note issue in one bank gives such notes a distinctive prestige not attaching to notes issued by several banks; and, since the note issue can be a source of profit, it appears to be more advantages for government to concentrate the note issue in one bank and provide for participation in its profits.
unsparingly but at a penalty rate to all sound banks.67 Others observe that the lender of last resort operations have rescued insolvent banks because, in banking crises, a central bank has difficulty in distinguishing between the illiquidity and the insolvency of banks.68 In any case, since the lender of last resort function provides some degrees of insurance to the commercial banks, there are possibilities of moral hazard.69 Even if there are legal restrictions against granting central bank’s loan, such as penalty rate, the banks may take undue risks and careless strategies in quest of profits. This can lead to bank failures and create systemic risk of banking system.

This moral hazard problem cannot be resolved simply by relying on the market mechanism.70 Availability of correct and costless information about each bank’s current portfolios and future contingent plans, on the other hand, can enforce good banking behaviour. However, perfect and costless information is not available in practice. Individuals as users of financial services are not likely to be able to obtain sufficient information to protect themselves from banks with more risky strategies by inquiring the relative credit worthiness of different banks. Thus, a consequence of those moral hazard and information problems lead to the involvement of central banks the regulation and supervision of banking system.71 Accordingly, there is a case for the involvement of the central bank in laying down minimum standards or guidelines for activities, not least

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68 C. A. E. Goodhart and Dirk Schoenmaker, “Institutional Separation between Supervisory and Monetary Agencies,” (1993), reprinted in C. A. E. Goodhart, The Central Bank and the Financial System (1995), p. 350. They also note that, during the period between the early 1980s and early 1990s, of about 120 problem banks of 24 countries, only one-third has been liquidated and others have been bailed out.
69 Goodhart, op. cit., n. 38, p. 7. See also George A. Selgin, “Legal Restrictions, Financial Weakening, and the Lender of Last Resort,” 9 Cato Journal 429 (Winter 1990), p. 437. He argues that the lender of last resort function encourages banks to take on excessive risks which is leading to trouble.
70 See Goodhart, op. cit., n. 38, pp. 57-59.
71 But see Robert S. Pasley, “Consolidation of the Federal Banking Regulatory Agencies,” 9 Annual
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where it is difficult for an individual to find the risk of loss in a particular transaction and/or where the cost of being wrong might be relatively severe.\textsuperscript{72} Moreover, when the central bank has to decide whether to exercise its lender of last resort function, the judgement is made more easily and more speedily if the central bank also has the information customarily obtained from conducting supervision.\textsuperscript{73}

B. Argument for Separation between Regulatory and Supervisory Authorities and Monetary Authorities\textsuperscript{74}

1. Cost of Bank Rescue

In general, in the management of banking crisis, the central bank’s lender of last resort role is limited by the size of its available fund.\textsuperscript{75} The central bank can generate cash without limit by its open market operations, but the size of losses it could absorb is limited. Consequently, the central bank’s role in crisis may be a leader of organising rescue operations with other commercial banks able and/or willing to provide necessary funding.\textsuperscript{76} Moreover, if the crisis can not be solved by the scale of funding from the central bank and commercial banks, the government and eventually the taxpayers must pay the final cost.\textsuperscript{77} Therefore, as rescues are increasingly being financed by the...
government, the responsibility for regulation and supervision of banking system has been passing more and more from the central bank to separate agencies established under the aegis of the authorities.78

This argument has some merit for Korea’s bank rescues in the 1980s. The BOK Special Loan (Special Loan) was introduced in August 1972 and disused in April 1982. In July 1985, the BOK reintroduced it. There were three kinds of Special Loans to the commercial banks: B1, A1 and A2. The B1 loan was supplied when a commercial bank had difficulty to maintain the reserve requirement due to the “relief lendings” to insolvent companies. It was for the liquidity of commercial banks at an annual interest of eight per cent. The A1 loan was aimed for liquidating insolvent companies at an annual interest of six per cent.

In the early 1980s, many Korean companies, especially construction companies working overseas and marine transportation business companies, became insolvent due to world-wide economic slowdown. Consequently, the amount of bad loans of the Korean commercial banks increased. The Korean government’s schemes to overcome the economic depression were outlined three measures: issuing long-term debentures, reducing or exempting interests, and exempting the principals. All those measures made the commercial banks more fragile because such measures forced Korean commercial banks to absorb all losses even though the losses resulted from the government directed financing. The BOK was forced to lend its Special Loan again. The Special Loan provided for in 1985 was termed the A2 loan. The ostensible reason of the Special Loan was to redeem the banks’ losses and reduce the financial pressure of commercial banks,

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which suffered from the non-performing loans due to the industry reorganisation (i.e., loans to insolvent companies under the direction of government). The A2 Special Loan was provided to the Korean commercial banks at an annual interest of three per cent, which was far less than market interest rates. Even if the BOK’s Special Loans did not fit in the definition of the classical doctrine of lending of last resort, they were considered as lendings of last resort by the BOK. Since the Special Loans, especially A2, were designed for recovering banks’ losses due to the government’s intervention into their lending activities and the recovery of the Special Loans depended purely on the earnings and profits from the Special Loans, the final cost was paid by the taxpayers.

In 1997, several measures were employed jointly by the MoFE and the BOK to rescue the Korea First Bank, one of the big Korean nationwide commercial banks. After long debate and initial resistance, the Korean government eventually decided to grant the BOK’s Special Loan to the bank. This was justified by the government and the BOK justified as, unlike the A2 Special Loans in 1985, providing liquidity, not profitability, for the bank. The BOK extended 100 billion won at an annual rate of eight per cent. The amount was determined on the basis of the size of the bank’s liquidity shortage and the interest rate was decided at the Korean banks’ average funding costs at the time. But, the 1997 Special Loans also turned out that the government eventually paid the cost as the bank became technically insolvent.

Where the banking system and the regulation and supervision system thereof controlled by the government, or where there is scope for government intervention (i.e.,

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78 Goodhart and Schoenmaker, op. cit., n. 68, pp. 334-337.
79 In 1985, the annual interest rate in Korean market was 15.6 per cent.
81 See Ministry of Finance and Economy Press Release, “The BOK’s Special Loans to Korea First Bank
Korea's banking system and the then BOK), the "cost of rescue" argument provides a weak ground for the separation of banking regulatory and supervisory power from the central bank. The rescue cost problems actually come from the government's failures of regulations and supervisions (e.g., creating moral hazard), and its inappropriate measures for the troubled banks (e.g., providing implicit guarantee not to fail and financing troubled banks). In this situation, the central bank (BOK), which is "legally" responsible for regulating and supervising commercial banks and for deciding whether it exercise its lender of last resort function, is, at best, partially responsible for the result of bank rescue.

2. Conflict of Interest

It is argued that a number of conflicts of interest arise when the banking regulatory and supervisory powers are vested in the monetary authorities (e.g., central bank). First, the conflict of interest argument is based generally on the conflict of objectives between the monetary function and the regulatory and supervisory function. The health of the banking system, which in the concerns of the regulatory and supervisory authorities, needs a "judicious laxity," while the monetary policy requires strict measurements. In such a situation, it is difficult to separate the mandate for a sound monetary policy from the mandate for maintaining safe and sound banking system. In such a conflict, regulatory and supervisory action may be delayed or not implemented so as not to...
aggravate the impact of monetary policy actions on the banking industry.84

During the deregulation period in Korea (1982-1997), the conflict of interest between the monetary function and the banking regulatory and supervisory function came to the fore. While the banking regulatory and supervisory authorities advocate banking deregulation (e.g., interest deregulation) for the health of banking system, the monetary authorities, during the period of inflation, adapt the stability policy and they may fear the influence of interest rate deregulation. Authorities combining monetary function and regulatory and supervisory function may be tempted to sacrifice the financial reform for the monetary purposes. After serious banking problem due to the policy loans and control over banking industry, the Korean government commenced the financial reforms in 1981.85 The reforms included bank privatisation and interest rate deregulation. In 1987, major interest rate deregulation was introduced. The preferential lending rates for policy loans were abolished. This deregulation program was de facto abandoned because the government feared the effects of higher interest rates on the real economy. In 1988, the government again announced the official interest rates deregulation for most of banking lending rates. In 1989, however, the Korean economy experienced increasingly unfavourable macroeconomic conditions, such as declining export, rising labour costs, and rising real estate prices. Moreover, the interest rates moved upward in response to the deregulation. The government resumed its interest rates control by the window guidance to prevent interest rates from rising further.86 Afterward, the government even

lowered banking lending rates.

Second, a central bank, carrying out both monetary and regulatory functions, might use instruments intended for the protection of bank depositors to carry out its monetary control activities because the conventional tools for monetary purposes have shown themselves to be either ineffective or too painful in their effects on the economy.  

A conflict of interest could also arise from balance sheet ratios, imposed ostensibly for prudential reasons, being relied upon to implement a restrictive monetary policy. Therefore, if the central bank has both monetary and regulatory functions, it has to consider the banking system stability when determining monetary policy. In Korea, this was one of the MoFE’s justifications for separation between the BOK and the banking regulatory and supervisory authorities.

However, some commentators argue that if the conflict of interest does arise, it cannot be resolved by institutional separation. The main issue is one of efficiency rather than of principle. Folkerts-Landau and Garber argue that the integration of monetary policy and banking regulatory and supervisory role into the European Central

87 Quinn, op. cit., n. 73, p. 261.
89 See the U.S. example in less developed countries (LDC) debt problem. Goodhart, op. cit., n. 78, p. 341. It is believed that the Federal Reserve was under pressure to abandon the non-borrowed reserve base scheme in Summer Autumn 1982 because of the effects of the level/volatility of interest rates upon both LDC debt problem and the solvency of major money-market commercial banks in the U.S.
90 See Ministry of Finance and Economy News Brief, op. cit. n. 60.
91 But see U.K. House of Commons, op. cit., n. 88, p. XXV. Witnesses before the Committee argue either that there is not any conflict of interest or that the conflict has been never experienced even if there is possibilities.
93 Quinn, op. cit., n. 73, p. 262.
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Bank would avoid inter-agency conflict of interest. They explain that such conflict would arise if the central bank puts its resources at stake, while another agency is responsible for establishing the solvency of central bank debtors.

III. REGULATION BY THE EXECUTIVE

One alternative arrangement for the banking regulation and supervision is the Executive of government. In the institutional arrangements for banking regulation and supervision by the Executive, two types of regulators and supervisors can be distinguished: executive branch (e.g. the finance ministry), and regulatory agency within the executive branch. Regulatory agency, established within an executive branch, basically consists of a hierarchical organisation and is under the direct control of the head of the Executive. The head of the Executive has ultimate responsibilities through the regulators who are usually the heads of the executive departments or the agencies within the departments. Therefore, the head of the Executive may appoint and remove the regulators at his discretion. These types of regulators, especially the heads of the executive departments, are usually political appointees rather than experts.

A. Regulation by Executive Branch: Japanese Banking Regulation and Supervision Structure

A good example of bank regulation by the executive department was Japan's bank

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94 Folkers-Landau and Garber, op. cit., n. 92, pp. 101-103.
95 The head of the Executive can be the president or the prime minister. In Korean administrative structure, the President is the head of the Executive.
regulation structure before June 1998. Historically, the Japanese banking system was developed under the direction of government. Furthermore, the government's department, the Ministry of Finance (MOF), assumed the banking regulatory and supervisory role when the modern banking system was introduced and organised. Commercial banks and special banks were established for efficiently serving the needs of rapid industrialisation and national finance. The MOF, created in 1869, was granted legal authority to regulate and supervise banks in 1890 under the National Banking Act. During this period, the Japanese government was only interested in establishing a financial structure, not in regulating the internal operations of the banks. This lack of banking regulation and supervision enabled the banks to engage in unsound financial practices. Partly as a consequence thereof, Japan experienced a financial crisis in 1927. The crisis caused widespread bank runs and fears of a financial collapse. In response to the financial crisis, the Banking Law of 1927 laid the foundation for the Japanese bank regulation not only in the pre-second world war period, but also for the

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97 However, the Bank of Japan began examining banks in 1928 on the basis of its contractual agreements with client banks. In 1942, the Bank of Japan Law gave the Bank of Japan the mission of maintaining and fostering a safe and sound financial system. Currently, the Bank of Japan performs some of the supervisory functions in the areas of bank information reporting and analysis, bank inspections and examinations, failure resolution, crisis management, and payment clearance system. Since it is not a governmental entity, in order to its responsibility stipulated in the Bank of Japan Law, the Bank of Japan has contractual arrangements with all commercial banks as well as other financial institutions, that allow it to examine these institutions and provide advice.

In June 1998, the Financial Supervisory Agency took over banking supervision and inspection from the Ministry of Finance.


100 Even if the MOF was responsible to regulate and supervise the banks, there were actually no legal means for the regulation and supervision. The government only controlled the special banks directly and the commercial banks indirectly, not regulated or supervised. See Tsutsui, *op. cit.*, n. 98, pp. 3-4.

101 The Japanese banks engaged in speculative advances, made extensive loans to directors, and concentrated their lending on one customer. Furthermore, while vast majority of banks were poorly capitalised, they tended to extend loans beyond their financial capacity. See ibid.
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post-war period.\textsuperscript{102} The bank act designated the MOF as main bank regulator. A significant feature of the MOF's regulatory and supervisory powers was a large degree of discretion in carrying out bank regulatory policy, since the act did not state the details of bank regulations explicitly.\textsuperscript{103} The large degree of discretion of the government regulatory body could be utilised for implementing government policies.\textsuperscript{104}

After the second world war, the Japanese banking system was reorganised. The U.S. officials in Japan concluded that the problems of Japanese banking practices had stemmed from the \textit{zaibatsu} banks\textsuperscript{105} and the government's financial administration. The intention of the reorganisation of the banking system was to encourage competition by abolishing the \textit{zaibatsu} banks as well as to create a firewall between the banks and the securities industry. However, no significant changes in the banking regulatory and supervisory system were implemented.\textsuperscript{106} Since there was no significant legal reform, the Japanese post-war banking regulatory system was similar to the wartime system and

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\textsuperscript{103} Ibid., p.91.
\textsuperscript{104} During the Second World War, Japanese financial institutions, including banks, were under tight control by the government for the purpose of channelling funds into military industries and financing large government budget deficits.
\textsuperscript{105} In Japan, the \textit{zaibatsu} were vast horizontal conglomerates, presided over by semi-feudal family dynasties, each with a holding company, trading firm, and bank at the centre of an extended group encompassing numerous sectors of industry, commerce, and finance. Banks which associated with the \textit{zaibatsu} were called the \textit{zaibatsu} banks. They were a central and vital component of each \textit{zaibatsu} by supplying capital to associated enterprises and employing excess combine funds in productive uses. See Tsutsui, \textit{op. cit.}, n. 98, pp. 5-6.
\textsuperscript{106} The reform of government financial regulation was studied by C. E. Cagle, a senior analyst from the U.S. Federal Reserve Board on loan. His reform plan of the regulator was heavily influenced from the structure of the Federal Reserve Board. He proposed the Banking Board to establish a new and autonomous power centre in the Japanese government with full responsibility for the regulation of banking and a commitment to sound democratic principals. One of the main reasons not to adapt his reform plan was that the priority of the U.S. were to temper the inflation as quickly and thoroughly as possible, and to reorganise banking industry on a peacetime basis. The U.S. authority did not view that the militarist administration had been 'fundamentally' responsible for Japan's 'undemocratic' economic development. The U.S. only offered a suggestion that the discretion which the laws entrust to the MOF should be greatly reduced. However, this suggestion was not implemented either. See ibid., pp. 76-81.
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structure in many respects. The "paternalism," the most important feature of the Japanese banking regulation by the MOF, was not changed either. During the economic development period between 1945 and the 1970s, the major goal of the financial system was shifted to aiding the reconstruction of economy and later to promoting high growth from backing the government's war effort during the second world war.

Between 1981 and June 1998, the Japanese primary law governing banking regulation and supervision was the Banking Law of 1981 which was complete revision to the Banking Law of 1927. Under the act, the MOF was regulator and primary supervisory authority of the banking industry as well as other financial industries including insurance industry.\(^\text{107}\) The MOF consisted of one secretariat and seven bureaus. The seven bureaus were Budget, Tax, Customs and Tariff, Financial, Securities, Banking, and International Finance. The Banking Bureau had responsibility for regulating and supervising the Japanese banks through its three divisions -- the Commercial Banks Division, the Special Banks Division, and the Small Banks Division. The Securities Bureau was responsible for supervising banks' securities activities as well as securities firms. The International Finance Bureau had responsibility for supervising the foreign activities of Japanese banks. Bank inspections were conducted separately by the individual bureaus prior to 1992. Afterward, the Financial Inspection Department of the Secretariat was responsible for conducting all inspections.\(^\text{108}\)

The Japanese banking regulatory and supervisory arrangement had several advantages. The MOF, as the executive department, had capacity to ensure speedy

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implementation of legislative instruments. The broad powers and responsibilities for formulating and carrying out policies relating to banks, together with the Japanese attitude giving government ministries considerable latitude in their interpretation and implementation, could help the MOF to adjust any changes and to act against banking problems. On the other hand, an executive department, as a bank regulator and supervisor, is more likely to lose its ability to act independently, particularly when the government stands to bear the costs of bank closures or other supervisory actions. For example, in response to the problems of jusen (housing loan companies) established by the Japanese banks and other financial institutions such as insurance companies and securities firms, the Japanese government employed rescue plan aiming at preventing a chain reaction of withdrawals from the financial institutions, including banks, which had providing financing to the jusen companies.

B. Regulation by Autonomous Agency within Executive Branch: U. S. Office of Comptroller of the Currency

The Office of Comptroller of the Currency (OCC), created in 1863, is the primary regulator and supervisor of the U.S. national banks. In its structure, the OCC is an executive bank regulator within an executive department, the Treasury. After experimenting twice with a central bank, the U.S. Congress passed the National Currency Act (the National Bank Act) in 1863. Under the act, the federally chartered national bank system was introduced and the OCC, as a separate bureau and the administrator of

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109 Under the system of banking regulators and supervisors who have no capacity to implement legislative instruments, the regulatory and supervisory programmes of those agencies would be delayed if there is any conflict between the regulator and the government.

110 Until 1874, the National Bank Act was known as the National Currency Act.
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the act, was established within the Treasury. After the passage of the Federal Reserve Act in 1913, the existence of the OCC was in serious doubt upon the ground of duplication of functions. First, since the Federal Reserve System carried out the monetary policy and acted as lender of last resort to banks, the OCC was functionally the bank regulator without those powers. Second, from the outset, the OCC intended to ensure state-chartered banks to convert their status into federally chartered national banks. Therefore, the OCC acted as guardian of national banks who competed with state chartered banks and other non-bank financial institutions. There was possibility that the OCC might contribute to bank vulnerability. For example, before the bank crisis in the 1930s, the OCC had been relatively unrestrained in chartering new banks. However, several attempts by the Congress to abolish the OCC failed, and it remained the regulator responsible for the supervision of federally charted national banks.

Even established within the executive branch, the OCC has a unique position from the outset. Unlike other agencies or executive bureaus, the discretion of the President is limited. First, the Comptroller is appointed by the President with the advice and consent of the Senate for five-year term. His early removal by the President is also subject to the advice and consent of the Senate. Second, unlike other heads of executive departments, the Comptroller is required to report annually to the Congress at the beginning of its session. The reports are sent to the Congress directly, not through the

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112 The bank oversight structure is still controversial within the U.S. system for banking regulation and supervision. Some commentators argue that its structure is based on institutional type and redundant. Others argue that the current structure encourages financial innovations and provides checks and balance to guard against arbitrary oversight decisions or actions. See U. S. General Accounting Office, *Bank Oversight Structure: U.S. and Foreign Experience May Offer Lessons for Modernizing U. S. Structure* (1996), pp. 36-54.
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Secretary of the Treasury. Third, the OCC is funded through fees paid by the national banks for supervision and administration of national banking industry, such as approving mergers, branch offices, and other business combinations and expansions. This self-funding status provides additional formal autonomy. Moreover, even if, according to the National Bank Act, the OCC is to function under the general direction of the Secretary of the Treasury, in practice, the OCC enjoys a high degree of autonomy from federal government.114

However, there are certain limits to the authority of the OCC. As an executive bureau, until 1989 the OCC operated to a large extent under the same rules and policies as the Treasury Department.115 For example, treasury regulations on personnel caps and salary scales for the department employees applied also to the OCC.116 Despite the formal distance of the OCC from Treasury regulations, the Treasury department and the Office of Management and Budget (OMB) have exercised their prerogative for oversight over the OCC's activities, particularly during banking crisis in the 1980s. Thus according to several managers, the frequency of meetings increased and the OMB's review of the agency's congressional testimony and regulatory actions became the norm.117

The institutional arrangement of banking regulator and supervisor within the executive may not preclude governmental intervention, especially when the regulator and supervisor deals with banking crises. When a regulatory agency is established within the

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116 This restriction was removed in 1989 by the Financial Institutions Reform, Recovery and Enforcement Act.

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Executive, on a day-to-day basis, the agency can operate without interference from the other components of the executive branch. However, a greater potential for direct control does exist in major policy decisions by the chief executive.  

C. Problems of Government Control over Banking System

1. Government Control over Banking Regulator and Supervisor

In Korea, the government controlled the banking industry in two ways. First, the government (especially the MoFE) had a legal and practical control over the regulator and supervisor of the banking industry, the BOK. The MoFE's role and position in the banking regulation and supervision were different from the MOF of Japan and the OCC of the U.S. Unlike the MOF, the MoFE had no legal power to regulate and supervise the commercial banks directly. Unlike the OCC, the Financial Policy Office of the MoFE, which was the principal department for the banking sector, had no autonomy, legally and/or practically.

The issue of independence or autonomy of central banks has long been the subject of discussion. However, most of the debates relate to the independence or autonomy for central banks as monetary authorities not as bank regulators and supervisors. When analysing the autonomy of the U.S. Federal Reserve System (the Fed), Sylla provides two

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117 Khademian, op. cit., n. 115, pp. 89.
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tests for the autonomy of the system as monetary authority.\textsuperscript{120} The first test is whether the authorities can, without prior approval of the Executive, the Legislative Body or any interest group outside the authorities themselves, implement and sustain a policy not necessarily preferred by either of these bodies. The second test concerns the ability of the authorities to achieve their goals independently against the actions of these bodies. Sylla’s analysis and discussion are exclusively about the Fed’s macro-function (\textit{i.e.}, monetary function) as the central bank of the U.S. It is also worth, however, to analyse the micro function (\textit{i.e.}, bank regulation and supervision) under the same tests.

As seen in Chapter One, Korean banking regulation can be divided into four periods: the creation period (1950-1960), the extensive regulation period (1961-1982), the deregulation period (1982-1997), and the reform period (1998-present). In the creation period, the banking regulatory structure was relatively independent from the government. The Bank of Korea Act of 1950 was intended to transfer the banking supervision power to the BOK from the Ministry of Finance (MoF). The BOK’s scope of banking regulation and supervision covered most of the Korean financial industries. In this period, with Sylla’s first test, the BOK was “structurally” autonomous because the Monetary Board could decide its own policies against the will of the Executive, the Legislative, or other interest groups. Even if the Minister of Finance was the chairman of the Monetary Board and had a casting vote, the other members of the Monetary Board could vote against the Minister. The Legislative had no practical means to check decisions of the Monetary Board. Furthermore, there was no possibility to involve interest groups, other than banks because the Korean financial system was not yet

appropriately evolved. Even the banks did not have power to exercise influence banking regulation and supervision policies.

The answer to the second test is negative. The notion that the independent Monetary Board, which was separated from the Executive (especially the MoF), was responsible exclusively for banking regulation and supervision, turned out to be illusory and unrealistic. The BOK could not fully perform its role as banking regulator and supervisor. The Korean financial situation was in confusion after the liberalisation from Japan and the following Korean War. The BOK's priority was control of inflation and management of foreign currency accounts. With social disturbance and high inflation, the Korean banks could not carry out their roles, such as intermediation.

Under the stability policy, the government undertook the major task of financing industries. The government financed the industries by its budget account. The Lending Restriction System, which controlled the banks' lending qualitatively and quantitatively, also became the part of government's stability plan. The government also supplied the required funds through the Korea Development Bank (KDB), the state-owned development institution. The fact that the total amount of the KDB lending was slightly less than the total amount of whole Korean banks' lending in the second half of 1950s illustrated the importance of government's role in the real economy sector. Consequently, the government's leading position of distributing industrial funds over the banking system did not allow the BOK to have the grounds to perform its responsibility

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121 B. K. Kim, op. cit., n. 7, p. 91.
123 During the 1950s, the total amount of deposit in the banks was less than the total amount of the currency issue.
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for both monetary and regulatory activities.\textsuperscript{124} Under this situation, the under-developed banking and financial system led the BOK only engaging into guiding banking and financial developments. In this period, therefore, the OBS’s priority in banking supervision was to eliminate profit-loss branches of banking institutions in order to improve profits.\textsuperscript{125}

In the extensive regulation period, the answers to both Sylla’s tests are negative. The extensive regulation period actually started in 1961, but the legislation for the period was enacted in 1962. In 1962, an amendment to the Bank of Korea Act and an amendment to the General Banking Act created the fundamental institutional structure of the Korean commercial banking regulation and supervision for the next three and half decades. By establishing the supremacy of government over the Monetary Board and the Office of Bank Supervision,\textsuperscript{126} the MoFE intervened and controlled every aspect of their operations. The fact that the MoFE has not exercised its power to request the Monetary Board to reconsider its decisions demonstrates that the Monetary Board has never been conflict with the MoFE. In this situation, the priority of the BOK was to assist the MoFE in attempting to achieve goals of the economic plans and the financial stability plans, and to supervise commercial banks to ensure that they operated in accordance with the MoFE’s directions.

In the deregulation period, the answers to Sylla’s both tests are still negative. Even if several deregulation measures were introduced and commercial banks were privatised in the 1980s, the MoFE’s legal, practical controls over the Monetary Board and the OBS remained intact. The example of the BOK’s Special Loan to commercial banks

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well illustrates the government's control over the BOK in the deregulation period. As
will be discussed below, the origins of the commercial banks’ problems was, it has been
argued, the lack of managerial autonomy of commercial banks and the fact that banks
were not allowed to decide their own lending activities. Frequently, the government was
forced to arrange rescue operations for the commercial banks when the commercial
banking industry was in trouble. On the other hand, the BOK, as bank regulator and
supervisor as well as supplier of the Special Loans, had only passive roles between the
government and the commercial banks. The BOK did not make decisions whether the
Special Loans were granted and which commercial bank should be provided.

2. Government Control over the Banking Industry

As seen above, in the creation period, the Korean commercial banks needed to be
developed with the government’s help. The Korean government’s controls over
commercial banks actually started in the extensive regulation period. In the extensive
regulation period, in addition to a reduction of the powers of the Monetary Board, the
government renationalised the commercial banks. And Korean commercial banks in
essence acted as government agents during the economic development periods, in the
1960s and 1970s, to support the government’s economic development plans. The
government-led economic development plans were made and carried out by the
government’s bureaucratic elite. They made decisions for entire sectors of the economy,
such as industries, foreign trading, financing, and foreign currency operations. Their
priority was to achieve the economic development as set forth in the economic plans.

126 See Chapter One Section II A.
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The government used the banking industry as a means of channelling credit to specific economic sectors to achieve its goals. Banks were required to supply sufficient credit to industries that the government decided to invest in and foster. To give these selected industries cheap capital, the government set the interest rates for them, below market rates, at a level it thought were reasonable. The government’s control over the commercial banking industry was intensified in the late 1970s when it began promoting heavy and chemical industries that required massive amounts of capital.

(a) Policy Loans

During that period, the government’s control over the banking industry could be characterised as credit allocation with policy loans. As part of the centrally controlled economic development process, the Korean government introduced various types of instruments to control a company’s access to bank credits and lending to ensure the industry’s compliance with the government’s official plans. The most important credit allocation instrument of the Korean government was the policy loan. Policy loans could be defined as bank loans allocated for specific activities, industries, economic sectors, or even to specific corporations with favourable interest rates and availability of funds to support the government’s objectives. Policy loans may be viewed as subsidised loans for specific economic sectors or industries since the banks gave priority to these loans with more favourable financing terms than for the general loans. However, since the

127 See Chung, op. cit., n. 80, pp. 158-60.
interest rates were controlled at a level below competitive market rates, except for a short time between 1965 and 1971, and the government intervened in the general lending practices of the banks, each loan transaction could be considered a policy loan. Furthermore, the abolition of policy loans' preferential lending rates in 1982 blurred the distinctions between policy loans and general loans. Thus, after 1982, the only difference between the policy and general loans was in having priority over availability of credit. Afterward, the Korean economic policy has focused on supporting small and medium-size firms.\textsuperscript{130}

During the country's years of economic development, the inefficiency of government intervention in the banking system, and especially the lending activities, became increasingly apparent. The intervention left an inefficient and unstable banking sector that gave inadequately secured loans to corporations. This, in turn, has led to a highly leveraged and undisciplined corporate sector. Even with all the data that points to the fact that only inefficiency will result from government intervention in the market, Korean commercial banks' major activities have still been controlled even after privatisation and deregulation in the 1980s.

\textit{(b) No Managerial Autonomy}

Together with the government's control over credit allocation, banks had no managerial autonomy. Under the Korean Commercial Code, bank presidents, directors, and auditors are to be appointed at the general meeting of shareholders since all Korean commercial

\textsuperscript{130} The small and medium-size firms are generally defined as an industrial firm with less than 300 employees or a commercial firm with less than twenty employees. Small and Medium Industry Basic Act
banks are limited corporations established under the Code. However, more often than not, the officers would be decided unofficially by the influence from the government and politicians before the shareholders’ general meeting. The influence over appointment of bank management by the government and politicians eliminated the managerial autonomy of banks. This lack of managerial autonomy presents problems because it causes the bank managers, especially the presidents who have significant power over lending decisions, to follow the government’s decisions and directions rather than do what is financially sound for the bank.

(c) Implicit Loan Guarantees

An important aspect of Korean commercial lending activities is the practice of mutual payment guarantees within interlinked business groups. Under this practice, companies within a business group guarantee each other’s loan payments. This practice was used to pursue the chaebols’ expansion. When the affiliated company or companies have financial difficulties, the problems are passed on to the guarantor; and, typically, the guarantor company is the parent company of the business group. Many of these parent companies of the collapsed chaebols went bankrupt because of their payment guarantees in favour of the interlinked companies in 1997.

The government has implicitly guaranteed that chaebols will not fail. Furthermore, the government’s bailout practice deepens the moral hazard problems. The banks continue their lending to inefficient and failing businesses in the belief they will be bailed out by the government. This has created excessive risk taking not only by the
financial institutions but also by the corporations. The banks preferred to lend to big 
\textit{chaebols}, which were supposed to be less risky because the banks believed that the
government guaranteed the loans. The practice of lending to \textit{chaebols} created a situation
in which the banks had to continue lending to highly leveraged companies even if there
was a high probability of default.\textsuperscript{131} These practices resulted in deterioration of the
health of Korean commercial banks.

During the economic development period, the government forced banks to soak
up the industrial firms' losses when the restructuring of industries was needed.\textsuperscript{132} Having
absorbed the losses, banks would be required by the government to solve such problems
(\textit{e.g.}, liquidity) on its own through restructuring. If the loss was too big for an individual
bank to absorb, the government persuaded the banking industry to share the loss through
co-operative lending or joint payment guarantees. If that was inadequate, the next step
was for the BOK to provide special loans to the bank. As a last resort, the government
introduced measures such as using interest from the reserve in the BOK to cover the
losses.\textsuperscript{133} These government measures not only caused the banking problems, but also
compounded the corruption within the banking system.

Influence over lending by the bureaucrats and the politicians intensified the
banking problems. Interrelationships between the bureaucrats, politicians, \textit{chaebols}, and
banks created political loans, motivated by political or non-business considerations. The
\textit{Hanbo} scandal illustrated well the political loan problem.\textsuperscript{134} In January 1997, Hanbo

\textsuperscript{131} Y. Kim, "The Inefficiency of Bank Intermediation in Korea and Its Effects," \textit{Bank of Korea Monthly}
\textit{Bulletin} (July, 1993), pp. 10-11

\textsuperscript{132} J. B. Choi, \textit{op. cit.}, n. 124, p. 201.

\textsuperscript{133} \textit{Ibid.}, pp. 203-06.

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Steel, the fourteenth largest chaebol declared bankruptcy. Korea First Bank, which was the main creditor bank of Hanbo, had lent US$ 1.3 billion,\textsuperscript{135} 18 per cent of which was not collateralised.\textsuperscript{136} Three bank presidents, four members of the National Assembly, and one cabinet minister were found guilty of corruption in relation to the scandal.

IV. REGULATION AND SUPERVISION BY AN INDEPENDENT AGENCY

A. The Board of Governors of the Federal Reserve System\textsuperscript{137}

The Federal Reserve System consists of 12 regional or district banks which are "technically owned" by the member commercial banks. The ownership is technical because member banks subscribe to the stocks of their district banks in a fixed proportion of their capital but the ownership does not carry proprietary rights.\textsuperscript{138} The Board of Governors (FRB) is the centre of the system. Under the provisions of the original Federal Reserve Act, the FRB was composed of seven members: the Secretary of the Treasury, who was the ex-officio chairman, the Comptroller of the Currency, and five appointive members. The original term of office was ten years. In 1922, the number of appointive members was increased to six, and in 1933 the term of office was increased to twelve years. The Banking Act of 1935 changed the name of the Federal Reserve Board to the Board of Governors of the Federal Reserve System and dropped two ex-officio members.

\textsuperscript{135} In terms of April 1997 US dollar to Korean won rate.
\textsuperscript{136} It was revealed that Hanbo had debt twenty times its equity.
\textsuperscript{137} The Federal Reserve Board is analysed here as an independent regulatory agency. Even if it is functionally the central bank of the U.S., its organisation structure can be classified into an independent regulatory agency.
from the Board. Currently, under the Banking Act the FRB consists of seven members appointed by the President subject to the Senate confirmation. Terms of office are for fourteen years. Members serving a complete term cannot be reappointed; those appointed to uncompleted terms may be reappointed to one complete term. The President appoints one member of the board as chairman for a four-year term. The chairman may be reappointed for additional terms within the constraints of the fourteen-year term as a member of the FRB. The FRB has sole responsibility for all regulatory and supervisory duties assigned to the system. The FRB is responsible for regulating and supervising member banks of the Federal Reserve System in conjunction with other regulatory agencies,\(^\text{139}\) and regulating bank holding companies. The FRB sets legal reserve requirements for depository institution; has sole responsibility for approving the formation of bank holding companies, and bank and non-bank acquisitions by bank holding companies; determines the non-banking activities in which bank holding companies and foreign banking organisations may engage either directly or through a subsidiary; regulates U.S. banking organisations’ overseas activities and foreign banks’ non-banking operations in the U.S.; charters, regulates and supervises Edge Act corporations; specifies pre-notification requirements for changes in the control of state member banks and bank holding companies; and is responsible for examining state member banks, approving mergers in which the surviving institution is a state member bank, authorising their new branch offices and, when necessary, declaring them insolvent.

The independence of the FRB comes from the long and staggered terms of

\(^{139}\) Since the Comptroller of the Currency has the primary responsibility for the national banks, the FRB is primarily responsible to regulate state member banks.
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governors and a source of income that is not subject to congressional approval. In the absence of resignation, the President can appoint only two governors per four-year term, and maximum four over two four-year terms. Furthermore, unlike other commission chairpersons who serve at the pleasure of the President in most instances, as the only clear exception, the chairman of the FRB serves for a fixed four-year term.

The Federal Reserve System derives most of its revenues from interest income on its large portfolio of Treasury securities purchased in the course of open-market operation. Other revenues come from charges on bank services, such as check clearing. Therefore, it is not subject to the review of the Office of Management and Budget (OMB). Moreover, unlike other independent regulatory agencies, it is not subject to audit by the General Accounting Office (GAO), the audit arm of the Congress. The FRB had been subject to government audit until 1933. When the Congress created the GAO in 1921, auditing of the FRB was transferred from the Treasury Department to the GAO. But the Banking Act of 1933 exempted the FRB from the audit of the GAO.

Under the original Federal Reserve Act of 1913, the members of the Federal Reserve Board should represent the different commercials, industrial and geographic divisions of the country. In 1922 it was amended to the effect that, regarding the appointment of the members of the FRB, the President shall have "due regard to fair representation of financial, agricultural, industrial and commercial interest, and geographical section of the nation." This provision implies that members of the FRB

140 Kaufman, op. cit., n. 138, pp. 527-528.
141 The General Accounting Office is an independent, nonpolitical watchdog agency which assists the Congress in carrying out its legislative and oversight responsibilities.
143 Federal Reserve Act of 1913 Sec. 10 Par. 1.
144 12 USC § 241.
do not represent the experts of monetary policy or banking regulation. Under this provision, the first appointive members of the FRB had backgrounds in business, investment firm, railroad, bank, and professorship in finance. Thereafter, the appointments of the FRB’s members have been influenced by the political considerations rather than their expertise. For example, in 1978, G. W. Miller was appointed as a member of the FRB and its chairman by President Carter. By his admittance, he was not an expert in the Federal Reserve System, and he lacked economic training and policy experience. However, President Carter chose him for the pro-growth policies and, in confirmation procedure, the Senate failed to resolve the question of his expertise and experience in favour of those concerning suspected payments to foreign officials.145

B. Advantages and Disadvantages of an Independent Agency

I. Expertise

Independent regulatory agencies can be created for specific regulatory purposes. A structure of independent regulatory agencies is usually intended to create a neutral environment of regulatory activities, free from partisan political considerations. This can be carried out by qualified experts who are not partisan and who know well the regulated area. Furthermore, a form of commission is considered the ideal structure of an independent agency for regulation, since a group of commissioners will be better equipped than a single administrator to make sound decisions, interpret the public interest faithfully, develop staff expertise, and remain independent from both partisan politics and

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the regulated interest.\textsuperscript{146} An independent regulatory agency with a staff of experts can handle new and increasingly complex form of technology in the regulatory area. Experts of independent regulatory agency are able to give full-time attention to oversight of the regulated area and to handle large numbers of cases rapidly and relatively economically through specialisation of functions.\textsuperscript{147}

However, the expertise of independent agency has its limits in performing the regulatory functions. First, experts cannot necessarily solve problems of basic policy formation where a high degree of discretion as well as political choices are involved. Experts tend to be influenced by the precedents through professional judgements and to be less sensitive to subtle changes in the context and nature of regulatory problems. Therefore, in situations where the scope of discretion is great and the complexity of problems is considerable, the contribution of experts to the process of policy formation is severely limited.\textsuperscript{148} Second, expertise of independent regulatory agency does not automatically lead to the development of a comprehensive view of public interest in regulation of economic affairs. Rather, expertise sometimes applies only to scientific and technical problems.\textsuperscript{149} Third, the expertness of regulatory agencies lacks the capacity for planning their long-term regulatory programs. Since the expertise is confined to specific problem solving and rule-application in a single field, this narrow speciality creates disadvantages in continuous long-time policy planning.\textsuperscript{150} Therefore, expertise in regulatory agencies appears to be most valuable and acceptable when the agencies are

\textsuperscript{148} Bernstein, \textit{op. cit.}, n. 146, p. 114.
\textsuperscript{149} Ibid., p. 115.
\textsuperscript{150} Robert E. Cushman, \textit{The Independent Regulatory Commissions} (1941), p. 740.
delegated with the responsibility for solving a range of narrow and technically complex problems with severely limited discretion which does not need to formulate basic regulatory policy and to plan continuous long-time policy.\footnote{Bernstein, \textit{op. cit.}, n. 146, p. 117.} Finally, the expertise is not guaranteed to overcome delay. One illustrative example is the Consumer Product Safety Commission (CPSC) in the U.S. In 1972, the CPSC was established to set safety standards for consumer goods and to ban those providing an unreasonable risk of injury. It focused on rule-making rather than specific case determination to ensure rapid standard setting. However experience did not prove that it performed its objectives rapidly and effectively. For example, to establish the architectural glass standards, one of the first products for which the CPSC issued product standards, more than four years lapsed.\footnote{Bernstein, \textit{op. cit.}, n. 146, p. 117.}

2. \textit{Independence}

The issue of independence raises major questions: how the concept was developed, and the extent to which agencies are independent.

In the U.S., the first independent regulatory agency, the Interstate Commerce Commission (ICC), was created in 1887. But when it was created, the ICC was not fully independent. It was originally placed within the Department of the Interior headed by a board with members appointed for set terms. Its budget, staff, and internal management were under control of the Secretary of the Interior. Just two days before the inauguration of a Republican railroad lawyer, President Benjamin Harrison, the Democratic majority Congress significantly altered its status by lifting the ICC out of the Department of the Interior and by granting the agency sole authority over its own budget, personnel, and
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internal management. Thereafter the concept of independent regulatory commission arose to insulate the regulatory agency from the presidential influence.153 Under the Congressional view, an independent commission is an arm of the Congress or a committee of the Congress, in that, it is assumed to do things that ordinarily the Congress is supposed to do but does not want to do because it lacks time, resources or expertise that is required to administer the complex business of economic regulation.

Because of their independence from political pressures, independent regulatory agencies can discharge their administrative and judicial functions with the greatest possible neutrality; hence they can serve the public interest better. Therefore, in contrast to the executive department or the agency within the executive department, the members of independent agencies are usually appointed for staggered terms and the removal power is limited for cause. The final administrative responsibility is not vested in the head of the Executive.

In the U.K., independent regulatory agencies are developed with different meaning of independence from the U.S. In the U.K., an independent agency takes an important role as insulator between government and the public. The concept of “a buffer of independence” can protect the government from the conduct of a particular activity, which appears to be politically controversial or dangerous. Therefore, by using an independent agency, the government is not directly responsible for a decision taken, and so the government is protected.155 The government may also wish to provide an independent point of influence and power, which can be expected to reflect, promote, and

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defend a particular interest or point of view. The relation between a minister of the
government and an independent regulatory agency is characterised by the degree of
authority that is being delegated to the agency and the degree of authority that is being
reserved to the minister, for example the right of specific direction.

After the privatisation of a number of the public utilities, the U.K. established
many regulatory agencies. These regulatory agencies were originally aimed at
administering what was conceived as a rule-based, non-discretionary approach to
regulation. A utility regulator is usually headed by single administrator who is
responsible to the relevant minister. Another example is the Office of Fair Trading
(OFT) established in 1973. Even if the structure of the OFT resembles a government
department, it is regarded as non-ministerial department. The authority of the office is
concentrated in the Director General of Fair Trading who is an officer of the Crown.
Under the Fair Trading Act, the activities of the OFT are outside the collective
responsibility of government.

However, the nature of independence can be a source of ineffectiveness. Since
the governmental involvement and control in the economic sphere has been expanded,
this expansion needs an integrated national economic policy, for example, for the
prosperous and stable operation of economy. In these circumstances, the regulatory

156 Richard Wilding, “A Triangular Affair: Quangos, Ministers, and MPs,” in Anthony Barker ed.,
157 These include the Office of Gas Supply for regulation of the gas sector, the OFTEL for the
telecommunication, the Office of Electricity Regulation for electricity, and the OFWAT for water and
sewerage.
159 See United Kingdom HM Treasury Cabinet Office, Non-Departmental Public Bodies: A Guide for
160 Leonard Tivey, “Quasi-Government for Consumers,” in Anthony Barker ed., Quangos in Britain:
activities take important roles in the national economy and they are no longer involved only in solving peculiar problems of special industries, and thus, the regulatory policies need to be fitted into the general framework of the national economic policy. The policy integration is difficult to achieve especially in the areas of activity occupied by an independent agency. In the U.S., for example, the hostility between the President and the Congress has discouraged and discredited presidential efforts in the direction of integration. Furthermore, the Congress does not usually provide the integration of policies because it is not organised to focus its resources and attention on broad policy issues, rather it prefers to consider economic policy questions in bits and pieces.\textsuperscript{161} It is also uncertain that the independence of agency by its structure can always provide more independence than the executive departments or other forms of agencies within the executive departments. When the head of the Executive has concerns with the activities of an independent agency, he may try to exercise more influence over the independent agency than over an executive department or its subdivision. Thus, in fact, the executive department can be substantially more independent from direction of the head of the Executive than the independent regulatory agency.\textsuperscript{162}

C. Accountability of an Independent Regulatory Agency

1. Structural Accountability

Even if an independent agency is independent from the government (usually the Executive), it does not mean the agency is not accountable. In the U.S., the problem of

\textsuperscript{161} Bernstein, \textit{op. cit.}, n. 146, pp. 164-169.
accountability of the independent regulatory agency stems from the lack of political accountability. Activities, especially day-to-day operations, of an independent regulatory agency are outside of the Presidential control, and the Congress does not have time or political will to control them.\textsuperscript{163} Since administrators or commissioners of independent regulatory agencies serve fixed terms and are not removable for reasons of political disagreement, the independent regulatory agencies have no direct accountability to any elected officials. It has been claimed\textsuperscript{164} claims that independent regulatory agencies constitute "a headless fourth branch of the government."\textsuperscript{165} This argument is based on the theory of democracy that the operations of government should be accountable to the representatives over whom the people retain direct electoral control. And, in practice, the lack of presidential accountability will lack political supports from the President. The lack of political supports leads to political isolation but to independence at the expense of accountability.\textsuperscript{166}

Therefore, the U.S. legislative framework focuses on accountability to the President. The first device for the control of independent agencies by the President is the financial accountability to the Office of Management and Budget (OMB). The OMB, successor of the Bureau of the Budget, is intended to control matters of fiscal policies and governmental organisations. Regarding independent regulatory agencies, the OMB emphasises the management responsibilities of agencies. The budgets of independent

\textsuperscript{162} Ibid., p. 146.

\textsuperscript{163} The Congressional oversights are not systemic and the Congress has been reluctant to subject to specific agency actions to regular review. See United State Senate Committee on Governmental Operation, \textit{op. cit.}, n. 153, p. 40.

\textsuperscript{164} United States President's Committee on Administrative Management 1937 chaired by Louis Brownlow.


\textsuperscript{166} Ibid., pp. 56-57.
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regulatory agencies are usually under review of the OMB.\textsuperscript{167} The purpose of the review is to ensure that the OMB, as a co-ordinator, can participate more in reviews and evaluations of federal program performances and management processes. Therefore, its key role is the preparation of budget and the oversight of execution by requiring that independent agencies submit budget requests for review and appraisal. The OMB also has statutory authority, at Presidential discretion, to make detailed organisational studies of the independent regulatory agencies in the interest of greater economy and efficiency. This is justified on the grounds that there is no valid reason why all federal agencies, including independent agencies, should not be subject to co-ordination under the Budget and Accounting Act which authorises the OMB’s functions.\textsuperscript{168} Furthermore, the OMB has the authority to review and consider independent agency communications on legislation before they are delivered to the Congress in light of the President’s program and priority. After its review, it may inform the agency of any considerations which it believes the agencies should, or may wish to take into account before submitting the communication to the Congress. As a result, as one Senator observed, the budgetary procedure by the OMB made independent agencies reluctant to ask for what they really need in money and manpower.\textsuperscript{169} OMB’s budget cuts have adverse impact on regulatory programs and performances. It demonstrates that independent agencies are not viewed as fully independent to the President. Instead, they must be considered subject to the President as part of federal administration for the budget purposes.

The second structural control of independent regulatory agencies’ activities is the litigating authority. Implementation of an agency’s regulatory mission often requires

\textsuperscript{167} United State Senate Committee on Governmental Operation, \textit{op. cit.}, n. 153, p. 43.
\textsuperscript{168} \textit{Ibid.}, P. 46.
court action. But, without exemption by the Congress, the Attorney General is vested central control of litigation for all departments and agencies.\textsuperscript{170} In practice, there is no general trend of exceptions for the independent regulatory agencies. But, more often than not, the independent regulatory agencies enjoy a certain measure of independent litigation authority on civil matters. Therefore, an independent agency without litigation power is possibly less independent than one with the power.

In the U.K., many independent regulatory agencies are subject to powers of direction by ministers. However, they still control their own policies and the ministers are reluctant to use their formal ministerial powers of direction. These ministerial attitudes may come from the concept of political buffer of the independent regulatory agency.\textsuperscript{171} Therefore, in the U.K., the independent regulatory agency accountability is focused on control by the Parliament. In general, the independent agencies are accountable to the Parliamentary Commissioner for Administration (PCA) and the Comptroller and Audit-General (CAG), both of whom scrutinise the independent agencies on behalf of Parliament. The PCA was designed to investigate maladministration of central government departments and certain other bodies acting on behalf of the Crown. A number of regulatory bodies have also become subject to the PCA. The Office of the Director General of Fair Trading and all of the new utility regulators are subject to the investigation of the PCA.\textsuperscript{172} The expansion of its investigation to independent regulatory agencies is based on the notion that means of obtaining independent investigation of complaints should be available against non-

\textsuperscript{169} \textit{Ibid.}, p. 47.
\textsuperscript{170} \textit{See} 28 USC §§ 516, 518, 519.
\textsuperscript{171} Baldwin and McCrudden, \textit{op. cit.}, n. 155, pp. 36-37.
\textsuperscript{172} \textit{See} Parliament Commissioner Act Schedule 2.
departmental bodies, including independent regulatory agencies, where the functions carried out by those bodies affect individual citizens or groups and where those functions might, just as appropriately, be those of central government. However, not all non-governmental bodies are subject to the investigation of the PCA. Under the Parliament Commissioner Act, the investigation power is limited to bodies which are subject to some degree of ultimate ministerial accountability to Parliament. The CAG is given power to carry out examination into the economy, efficiency and effectiveness of which any department, authority or other body has used its resources in discharging its functions. This power covers any body believed to receive more than half its income from public funds. However, the CAG is not entitled to question the merits of policy objectives of any such body. Another form of parliament scrutiny of independent regulatory agencies is the select committee system. Under this system, regulators can be summoned to appear before a select committee, required to report annually, and be publicly examined.

Even if the Parliament provides some structures of independent regulatory agency control, the accountability through the PCA, the CAG, and/or select committees is limited to control over independent regulatory agencies. The PCA can not control the agencies’ activities routinely because the needs to take a personal interest in complaints restrict the number and scope of cases that the office can cover. The CAG’s control is in-depth but its action affects only the financial effectiveness not the agency objectives and strategies. The select committee system does not provide consistent monitoring.

The U.K. government recently established a new single regulator for the entire financial industry including the banking industry. Unlike other independent regulatory

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agencies, the government requires the new financial regulator to be accountable to the Executive. The Financial Services Authority (FSA) is responsible, as a single regulator, for regulating and supervising the U.K. financial industry. Its framework for accountability is designed so that the FSA is to be clearly accountable to the Government and to the Parliament. The FSA is required by the Financial Services Act and the Banking Act to submit an Annual Report to the Treasury, which Ministers lay before the Parliament.¹⁷⁵

2. Accountability to Due Process

The due process criterion provides a procedural accountability under the general theory of administration law. The due process, which focuses on the procedure of an independent regulatory agency, requires the agency to act on the basis of certain fair procedures such as participation, consultation, and openness. The due process encourages rationality, reduces uncertainty and abuse of discretionary powers, and leads to better rules. However, the due process requirement has some disadvantages; it is necessary to determine who should have participation rights and in what manner; the due process does not guarantee to produce an efficient decision; it generates administrative costs and delays; and it reduces the importance of independence and expert judgements.¹⁷⁶

In the U.S., the federal Administrative Procedure Act of 1946 (APA)¹⁷⁷ requires independent regulatory agencies to invite public participation before adopting legislative

¹⁷⁶ Baldwin and McCudden, op. cit., n. 155, p. 45.
¹⁷⁷ 5 U.S.C. § 553 (b), (c).
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rules. For the non-legislative rules, under the APA, independent regulatory agencies are not legally required to provide pre-adoption notice and comment procedure, even though they frequently do so.\textsuperscript{178} The only requirement is that they publish rules of general applicability in the \textit{Federal Register} after adoption.\textsuperscript{179} In theory, a legislative rule is essentially an administrative statute which is an exercise of previously delegated power to complete an incomplete legislative action and thus it legally binds the members of the public. However, although there is clear theoretical difference between the legislative rule and non-legislative rule in concepts and legal effects, in practice, their consequences are usually identical.\textsuperscript{180}

In the U.K., the due process requirement does not extend to regulatory rule-making. Even if there is a well-established custom of pre-adoption consultation with interested groups and an increasing tendency for specific legislation to impose duties to consult outside interests and to publish rules,\textsuperscript{181} there is no general obligations to this effect, and the giving of reasons is almost never required.\textsuperscript{182} Under the Statutory Instrument Act of 1946, the delegated legislation is required to be published after adoption. Circulars and other official pronouncements, having general applicability but not made pursuant to statutory delegations, do not need to be centrally published. But it is unclear whether all non-delegated legislation do not have legal effect under the law.\textsuperscript{183}

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\footnotesize\textsuperscript{178} 5 U.S.C. § 553 (b)(A), (d)(2).
\footnotesize\textsuperscript{179} 5 U.S.C. § 552 (a)(1)(D).
\footnotesize\textsuperscript{181} For example, the Control of Pollution Act of 1974.
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D. Accountability of the Bank of Korea

1. Accountability to Auditing and Business Inspection

(a) The Auditor of the Bank of Korea

Until 1997, the operations of the BOK were subject to auditing and business inspection by three separate systems: the Auditor of the BOK (Auditor), the MoFE, and the Board of Audit and Inspection (BAI).  

The Auditor was responsible for constantly auditing and inspecting operations of the BOK. The scope of the Auditor’s duty included the financial auditing and the business inspection. The Auditor performed his duties through the general audit and inspection, the special audit and inspection, and the day-to-day audit and inspection. For audit and inspection, the Auditor demanded the explanation of any operations of the BOK, any reports, other materials, and data from all departments of the BOK. The special audit and inspection could be made at the discretion of the Auditor when particular problem was concerned. After the audit and inspection, if any violation of laws and/or irregularity of operations of the BOK was identified the Auditor could require such activities to be corrected. The Auditor also reviewed financial related reports prior to submit them to outside institutions, for example the MoFE and the National Assembly.

The Auditor was accountable directly to the Monetary Board. The Auditor was required to report occasionally the results of audit and inspection and to submit a  

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184 The scope of auditing is financial areas, such as the accounting. The business inspection covers the activities of whole areas of operations.
185 Bank of Korea Act art. 27-3, cl. 1.
186 Regulation on Office of the Audit of the Bank of Korea (stipulated by the Monetary Board).
187 Bank of Korea Act art. 27-3, cl. 1.
comprehensive audit report to the Monetary Board each year.\textsuperscript{188} This implied that the scope of the Auditor's audit and inspection covered the Governor's general administration and the OBS's bank supervision and examination operations under the Bank of Korea Act. The operations of the Monetary Board could not included into the scope of the Auditor's business inspection because a subordinate authority cannot supervise superior authorities. But the Monetary Board was subject to the financial audit of the Auditor. Therefore, the system of the Auditor was designed to control the operations of the BOK. By appointing the Auditor, the MoFE had a structural device to control the operations of the BOK. The Auditor could not actually ignore the intention of the MoFE who appointed him and could reappoint him after his term. Consequently, the MoFE could even control the day-to-day operations of the BOK through the Auditor since the Auditor had the power to audit and inspect day-to-day operations of the BOK.

(b) Business Inspection by the MoFE

The BOK was subject to the business inspection by the MoFE at least once a year.\textsuperscript{189} This power was also granted by the 1962 Amendment to the Bank of Korea Act. The draft of the Bank of Korea Act by Bloomfield and Jensen did not provide any business inspection by the executive branch, except the financial audit by the Board of Audit and Inspection. The Bank of Korea Act of 1950 only provided that the BOK was required to prove its compliance with laws to the government. This provision was an abstract notion and actually had a "window-dressing" role in the sense that the operations of the BOK

\textsuperscript{188} Ibid. art. 27-3, cl. 2.
\textsuperscript{189} Ibid. art. 40.
should be carried out under the rule of law.\textsuperscript{190} In the line with the expanding power of government in the financial areas, this window-dressing provision became another practical power of the MoFE to control the BOK.

The business inspection by the MoFE covered the entire operations of the BOK.\textsuperscript{191} Therefore, unlike the internal auditing and inspection by the Auditor, the Monetary Board was subject to the business inspection by the MoFE. Since all operations of the BOK were carried out under the direction of the Monetary Board, if the MoFE’s business inspection did not cover the operations of the Monetary Board, theoretically, the business inspection could not cover entire operations of the BOK. However, since the MoFE actually controlled the Monetary Board in practice, the MoFE did not need to inspect the operations of the Monetary Board.

The MoFE has not exercised its power since 1983. The Board of Audit and Inspection Regulations, adopted in March 1995, required the MoFE to consult with the BAI prior to its business inspection unless it had special reason not to do so. The MoFE, however, retained the possibilities to exercise its power whenever it so decided. For example, in 1995 the MoFE threatened to exercise its power to examine the suspicion of a cover-up by the BOK when an employee of one branch of the BOK had stolen large amount of bank notes, which were to be destroyed. The MoFE disclosed its intention to resume the business inspection, at least for this incident. In the end, the MoFE decided not to exercise its power to the extent that the Board of Audit and Inspection audited and inspected the BOK.\textsuperscript{192}

\textsuperscript{190} Bank of Korea, Commentary on Bank of Korea Act, op. cit., n. 17, p. 122.
\textsuperscript{191} See ibid., pp. 122-123.

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(c) The Board of Audit and Inspection

The BOK was also subject to an accounting audit by the BAI at least once a year under the Bank of Korea Act. The BAI, which is responsible directly to the President, carries out the settlement of revenues and expenditures of government, the accounting audit of government and organisations as provided by legislation, and the business inspection of executive organisations and civil servants. Under the Board of Audit and Inspection Act, the BAI also performed business inspection of the BOK's operations, the activities of high-ranking officers, and the activities of employees engaging in auditing affairs as well as accounting audits. These provisions of the Board of Audit and Inspection Act conflicted with the provision of the Bank of Korea Act which authorised the BAI to perform only the accounting audit of the BOK. But the Board of Audit and Inspection Act may be interpreted as that the government expanded its power to control the BOK. The audit and business inspection by the BAI can be understood that the financial and operational affairs of organisation which performs governmental activities should be checked by the institution which is responsible to audit and inspect those activities.

2. Financial Accountability

The budget and fiscal account of the BOK were subject to approval of the Monetary Board. At the end of the fiscal year, the Governor had to submit the statements of accounts for a fiscal year, including statement of profit and loss, balance sheet and

193 Bank of Korea Act art. 40.
194 The executive organisations include the executive departments and other organizations which perform executive roles of the government.
195 Board of Audit Act art. 22; Board of Audit Act art. 24.
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statement of the remainder of net profit, to the MoFE.197

The initial Bank of Korea Act provided that the Monetary Board independently approved the Bank of Korea's budget and fiscal account. There was no requirement to summit the statements of the fiscal account to the government. The 1962 Amendment to the Bank of Korea Act discarded the Monetary Board's power to approve the Bank of Korea's budget and fiscal account. It provided that the Monetary Board should approve the budget and fiscal account after voting in the State Council.198 The 1963 Amendment to the Bank of Korea Act clarified the government's intention to control the BOK's fiscal activities. It provided that the Monetary Board should approve the Bank of Korea's budget and fiscal account under direction of the President after the consideration of the State Council. Furthermore, the Government Investment Institution Budget Account Act of 1962, which intended to control the operations of the government investment institutions, applied to the BOK. However, its application to the BOK was not logically correct. The BOK was not a government investment institution because it had no capital. The purpose of the act was to control the management of profits of such institutions, but the BOK did not aim at making profits through its operations.199 Even if the logic of the act was not sound, the Monetary Board, in practice, under the act, did not have any power to control the budgets of the BOK. The application of the act to the BOK was abolished in 1981.

196 Bank of Korea Act art. 7, cl. 5; Articles of Incorporation of Bank of Korea art. 31, cl. 1.
197 Bank of Korea Act art. 7, cl. 5; Articles of Incorporation of Bank of Korea art. 37.
198 The State Council is the Korean constitutional body composed of the Prime Minister and all Ministers and two Ministers without portfolio headed by the President. Its function is to decide major governmental policies. See Y.H. Park, Administration Law (II) (1997), pp. 61-64.
199 See Bank of Korea, Commentary on Bank of Korea Act, op. cit., n. 17, pp. 35-36.
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3. **Accountability to Judicial Body**

In the Korean judicial system, legal proceedings are divided into three major actions: civil litigation, administrative litigation, and criminal litigation. The major difference between civil litigation and administrative litigation in Korea was that for administrative litigation a procedure of appeal was necessary prior to the judicial review. The subject of the administrative litigation is the activities of administrative organisations. Administrative organisations may be defined as the authorities that conduct general exercise of public power. These activities do not include internal decisions of administrative organisations. Since the BOK was granted power to regulate and supervise commercial banks under the Bank of Korea Act and the General Banking Act, the BOK was the administration organisation in relation to banking regulation and supervision. However, all activities of the BOK were not subject to the administrative litigation. For example, activities based on regulations on the lending operation to the banking institutions and the open market operation were not subject of administrative litigation. These regulations were legally binding only in relation to the BOK, not the commercial banks.

The activities of BOK which were subject to the administrative litigation were orders, directions, demands, approvals, authorisations, and disciplinary actions. If those activities were in dispute, the case had to be reviewed by a review body of the

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200 See Bank of Korea, *Commentary on Bank of Korea Act on Subject* (1990), p. 91.
202 See *Bank of Korea, Commentary on Bank of Korea Act on Subject, op. cit.*, n.200, pp. 91-92.
203 See *ibid.*, p. 87. But the commercial banks can be bound indirectly, for example, if the banks do not follow the regulations they can not borrow from the Bank of Korea.
administrative organisation. Since neither the Administrative Tribunal Act nor the Bank of Korea Act provided the procedure of appeal of the BOK, the general theory and practice should apply to in an analysis of the process of appeal. In the BOK, the Monetary Board would be the review body prior to the administrative litigation, because the Monetary Board was the supreme body of the BOK.\textsuperscript{204} After the appeal procedure, the case could be reviewed by the High Court, the Korean appellate court. Possible defendants was the Monetary Board, the Governor, and the Superintendent of the OBS.\textsuperscript{205} However, it was unclear who represented and controlled the litigation. Under the Bank of Korea Act, the Governor represented the BOK in all judicial actions pertaining to the business of the BOK.\textsuperscript{206} As a consequence, the Governor could represent all three bodies of the BOK. But the Administration Litigation Act provided that "the Superintendent of the OBS shall be a party when its administrative activities are in question."\textsuperscript{207} This implies that the Superintendent of the OBS could represent the administrative litigation concerning its own operations of bank supervision and examination.

4. Liability of Members of the Monetary Board

If the Monetary Board, due to unlawful or gross negligent act, caused damages to the BOK, all members, except members who expressly register a protest, present at the session involving the act were personally and jointly liable to the BOK, should damages be incurred.\textsuperscript{208} A suit for damages against the responsible members would be brought by

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\textsuperscript{204} See Bank of Korea, \textit{Commentary on the Bank of Korea Act on Subject}, op. cit., n. 200, p. 92.
\textsuperscript{205} See \textit{ibid.}
\textsuperscript{206} Bank of Korea Act art. 25, cl. 1.
\textsuperscript{207} Administrative Litigation Act art. 13.
\textsuperscript{208} Bank of Korea Act art. 21, cl. 1.
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the Prosecutor General.\textsuperscript{209} Since there has been no such damage suit brought by the Prosecutor General against the members of the Monetary Board, it is unclear what constituted damages by the members of the Monetary Board. A possible instance was decisions of the lender of last resort operation. When the Monetary Board determined the scale of operation and identified the target banks, it was conceivable that the Monetary Board failed to observe procedures or took decisions in breach of the qualifications and, thus, that its operation damaged the BOK. For example, damages could arise when the operation of last resort failed and the BOK needed to assume the costs. However, this analysis is not practical because, first, it would be difficult to determine whether the decision was one of pure misjudgement or constituted an act of unlawful or gross negligence. Second, since the government had practised the operation under its own decisions, there was no possibility to sue the members of the Monetary Board who followed the government's decisions.

V. SELF-REGULATION

A. The Concept of Self-Regulation

The term "self-regulation" may be simply defined as regulation by neither the State itself nor the public authorities. This negatively defined concept of self-regulation does not include the concern with integrity, honour and self-discipline of an individual firm.\textsuperscript{210} In practice, self-regulation takes various forms and contents. Thus, the concept of self-

\textsuperscript{209} Ibid. art. 21.
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regulation can be described by examining and characterising its different forms.

The forms of self-regulation can be classified by characterising the term "self." If the term "self" is interpreted as "individual," then self-regulation can be described as the disciplining of one's own conduct by oneself as an individual (individualised self-regulation).211 In this sense, the regulation is tailored to the circumstances of a particular individual, such as a firm. One of the individualised self-regulations is Ayres and Braithwaite's enforced self-regulation model. In their model, firms are required to write their own set of corporate rules, which are then publicly ratified. And when there is a failure of private enforcement of these privately written and publicly ratified rules, the rules are then publicly enforced.212 Another individualised example is the consensual self-regulation.213 In this model, legislation lays down general regulatory goals but specific standards are resolved by self-regulatory negotiation at shop-floor level. A public agency plays only a residual role, monitoring agreements to ensure that they are constituent with the statutory goals, and, if necessary, enforcing them. As Ayres and Braithwaite noted, in most circumstances their model is not desirable as the best idea or even as an innovation.214 Furthermore, their model is not feasible to small firms.215 Also the consensual self-regulation is only feasible where the affected group, the potential victim, is relatively homogeneous and externalities are largely absent. Thus, the consensual self-regulation is feasible where bargaining can take place at relatively low

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cost between the risk creators and the potential victims, for example, occupational health and safety areas.216

It follows that the collective character of self-regulation must be stressed. When the term "self" is used to describe collective, self-regulation describes the situation of a group of persons or bodies, acting together, performing a regulatory function in respect of themselves and others who accept their authority.217 In this sense, self-regulation takes place at the industry level as opposed to at a governmental or individual firm level. And the primary responsibilities for formulating and enforcing the regulatory rules rest with an industry self-regulatory body rather than with the government.218

B. Features of Self-Regulation

Self-regulation has several salient features.219 First, self-regulation is conducted by a self-regulatory body which consists of active participants in the regulated activity chosen by the active participants generally.220 Since the forms of self-regulation may vary according to the nature of its participants, outsiders may be involved in the self-regulatory body. Also, an increasing number of outsiders has been allowed to participate in self-regulatory bodies. On some self-regulatory bodies, for example the Advertising Standards Authority in the U. K., the external members are in majority.221 However, even if the majority of the body consists of outsiders chosen by outsiders, such as the

216 Ogus, op. cit., n. 213, p. 100.
217 Black, op. cit., n. 211, p. 27.
220 Ibid.
government or consumer groups, active participants should be present in the self-regulatory body.222

Second, self-regulatory bodies make rules to govern the conduct of their activities.223 Even if there are various amount of external controls, as will be seen below, the external control is not absolute over all activities.

Third, the self-regulatory bodies interpret their rules and apply them to individual cases.224 The rule making and rule applying functions of self-regulatory bodies usually seek to control their own conducts, but some self-regulatory rules can actually affect the third parties who are not represented on the self-regulatory bodies. Some self-regulatory bodies also intentionally seek to control the conduct of third parties. For example, in addition to regulating conducts of its own members, the London Stock Exchange also controls certain aspects of conducts of listed companies. Companies applying for a listing must comply with the London Stock Exchange's admission requirements. Listed companies are required to observe the terms of listing agreement which governs such matters as the disclosure of information and their conduct towards shareholders.225

Fourth, a self-regulatory body has its own enforcement power when the rules are breached.226 The power can include disciplinary action and the imposition of remedy.

Finally, self-regulation has an external control element.227 Since the self-regulation does not imply total absence of external control, a certain relationship with the State can be found. Four types of self-regulation can be identified by the possible

Administration 435, p. 440.
222 Cane, op. cit., n. 219, p. 327.
223 Ibid.
224 Ibid.
225 Page, op. cit., n. 210, p. 146.
226 Cane, op. cit., n. 219, p.327-328.
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relationship with the State. First, in mandated self-regulation, a collective group is required or designed to formulate and enforce norms within a framework defined by the government. Examples are the U.K. financial service regulation under the Financial Service Act of 1986 and the London Stock Exchange. Second, in sanctioned self-regulation, a collective group itself formulates the regulation, which is then subject to government approval. Various codes of practice produced by U.K. trade association and then approved by the Office of Fair Trading would be examples of sanctioned self-regulation. Third, in coerced self-regulation, an industry itself formulates and imposes regulations in response to threats by the government that if the industry does not have a self-regulatory scheme, the government will impose statutory regulation. Examples are the U.K. Press Complaints Commission and the initiation of the City Panel on Takeover and Mergers. Lloyd's is another example of coerced self-regulation since it has been forced to reform its regulatory methods by the threat of statutory, governmental regulation. Finally, in voluntary self-regulation, there is no active State's involvement, direct or indirect, in promoting or mandating self-regulation.

C. Arguments For and Against Self-Regulation

There are several grounds for and against self-regulations. With ideological view, self-regulation is preferable to government's regulation because it allows individuals more freedom to run their own affairs. It allows market forces maximum freedom of operation consistent with protecting the public interest in the maintenance of confidence

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227 Ibid., p. 328.
228 See Black, op. cit., n. 211, pp. 26-28.
229 Cane, op. cit., n. 219, pp. 328-333.

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and in minimising the incidence of unacceptable behaviour. However, it is unclear that what extent measures of self-regulation, introduced under threat of government intervention or supervised by the government, would allow market forces more freedom of operation than direct regulation introduced by the same government. There is also a temptation for industries to introduce self-regulation as a means of insulating themselves from competitive forces. Law makers have recognised that self-regulation can be for the protection of commercial interests rather than consumer interests.231

The second advantage of self-regulation is that it may have a positive cost distribution effect.232 Self-regulation is cheap because the regulated bear the burden of the costs of regulation. It conserves the public resources which go into law making and law enforcement by encouraging industries to police themselves. Under self-regulation, the cost of day-to-day regulation and regulatory processing are paid by the industry.

The third advantage is that self-regulation enables the regulated to decide the rules of the game.233 Practitioners are usually better placed to define the questions to be addressed and to prepare rules to prevent malpractice because they are more familiar with the market. Rules made by a society are more likely to be accepted and followed by those whom they are to be applied to than rules made by outsiders.234 However, since the rules may not properly protect the public interest in the activity or the interests of non-participants who are directly affected by the conduct of activity, there should be certain measures to ensure satisfactory rules. Moreover, the enforcement power of the regulatory regime makes the regulated, who are themselves regulators, impose the most effective

230 Ibid., p. 328.
232 Cane, op. cit., n. 219, pp. 328-329.
233 Ibid., p. 329.
sanctions or grant remedies. Again, because rule making and rule enforcement powers are in the same hands, it is important to ensure open and fair procedures in exercising enforcement functions.

Fourth, self-regulation is justified as regulation by experts who know how the activity being regulated works and what regulatory measures are most feasible and appropriate. However, one can argue that day-to-day regulation is better done by a self-regulatory bodies because it is likely to be able to attract better quality staff, but the development of regulatory policy ought to be in the hands of the government who is more qualified for making the political value judgements required for the formation of regulatory policy.

Fifth, self-regulatory bodies are likely to act with greater speed in decision making than government bodies. Especially in the financial service industry, uncertainty or delay is seen as detrimental to the proper operations of financial markets. It is efficient because the rules are likely to be more closely adapted to the needs of an efficient market, and they can be made more quickly and, if necessary, changed more quickly.

Finally, self-regulation produces greater flexibility in creation, interpretation and application of regulatory rules than government regulators can achieve. In relation to rule making, non-statutory rules can be made and amended more quickly than those contained in statutes or delegated legislation, which are subject to slower and more cumbersome processes. In relation to interpretation, non-statutory rules can be drafted in

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235 Cane, *op. cit.*, n. 219, pp. 330-331.
237 Davison, *op. cit.*, n. 234, p. 34.
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a less detailed and precise way than a statute. By embodying general principles which can readily be adapted to the facts of particular cases, unforeseen circumstances can be more easily dealt with. Non-statutory rules can be applied not only according to the letter but also according to the spirit.

D. Limits of Self-Regulation

I. The Free-Rider Problem

Even if, according to advocates of self-regulation, the advantages of self-regulation seem self-evident, obstacles to self-regulation exist. The first issue is whether it is feasible to establish a self-regulatory organisation in an industry. Since the primary object of a business (e.g., an individual firm) is profit maximisation, as a competitor in the market place it has an interest in minimising its own costs. However, regulations provide collective or public goods such as a cleaner environment, a free market, or a safety in system in financial market. As a part of an industry community, a business is likely to take collective (or public) goods which will increase its cost. Therefore, interests of a business as a competitor in the market place diverge from its interests as a participant of the industry community.

Once collective goods are created by regulations, they are available to all members of the regulated industry irrespective of whether or not a member has contributed. As a result, each member as a competitor has a rational incentive to free ride to leave the cost of providing collective goods to other members. This phenomenon can

238 Cane, op. cit., n. 219, pp. 331-333.
be explained by three theories. Olson has argued that rational, self-interested individuals will not act to achieve their common or group interests.\textsuperscript{239} He identifies three groups, then concludes that the collective goods will be provide only in a small group, the privileged group, in which at least one member pays the entire cost for the provision of the goods on the basis of his sufficiently great return.\textsuperscript{240} In the second group, the intermediate group, an individual member is so important in terms of the whole group that his contribution or lack of contribution to the group objective has a noticeable effect on the costs or the benefits of others in the group. In this situation, Olson concludes that no member receives such a large benefit from the collective good that the member has an interest in providing it, even if he has to pay the entire cost. As a result, it is indeterminate for the intermediate group to produce collective goods. In Olson's third group, the latent group, no single individual's contribution makes a perceptible difference to the group as a whole. He concludes that the collective goods will not be provided unless there is coercion or some outside inducements.

Hardin has analysed Olson's theory and has pointed out that the logic underlying Olson's theory of collective action is identical to that of the prisoners' dilemma. Then he concludes that in the game analysis the latent and the intermediate group are not logically different, but rather are distinguishable only statistically.\textsuperscript{241} Therefore, he suggests that, in the latent group and the intermediate group, the strategy of not contributing toward the cost of collective goods dominates the strategy of paying for it, in the sense that no matter what other members do, any particular member will be better off if it does not

\textsuperscript{239} Mancur Olson, \textit{The Logic of Collective Action} (1965), p. 2.
\textsuperscript{240} \textit{Ibid.}, p. 44.
Both Olson's theory and the prisoners' dilemma theory have been criticised on the grounds that their assumptions regarding human motivations are unduly strict. Runge argues that the incentive to develop political and economic institutions lies in the coordination of expectations. He suggests that members of group prefer to act together in collective goods situation with equal contribution, whether the contribution is large, small, or zero. This preference can be either in favour of or against contribution depending on what is expected of others. Under the assurance problem theory, members of a group regulate their own behaviour in some large interest so long as they are confident that other members are doing the same. However, the ability to predict the behaviour of others is subject to varying limits of confidence. Therefore, in large groups, the estimates of both the probability of contribution by others and the assurance with which these estimates are held are likely to be lower than in smaller and more homogeneous group.

In spite of their differences, all theories of Olson's, the prisoners' dilemma, and the assurance problem involve problems of collective action. In the cases of Olson's theory and the prisoner's dilemma theory, the problem is that it is always in the rational interest of each group member to put its own individual interests ahead of its collective interests. In the case of the assurance problem theory, the problem is that of coordinating members' expectations regarding fair shares.

242 Ibid., pp. 473-475.
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2. **Antitrust Problem**

Even if the free rider problem is overcome and a self-regulatory organisation is established, antitrust problems, and the legal aspects thereof, remain in self-regulatory activities. Since self-regulation is usually carried out by agreements between industry members who are competitors in the industry, a self-regulatory scheme can be sanctioned or severely restricted by antitrust laws which intend to strike at monopoly and attempts toward monopoly, and to control anti-competitive activities. This antitrust issue has been extensively examined in the U.S. where antitrust laws, especially the Sherman Act, are applied to voluntary self-regulation, which has no statutory recognition, as well as government supervised self-regulation which has statutory approved structure and is overseen by a governmental regulatory agencies. Therefore, this antitrust problem analysis will concentrate on the U.S. experiences.

In the U.S., the traditional form of self-regulation is carried out by trade or business associations which are non-profit institutions and usually composed of business firms that are competitors. In the area of professions, professional associations have had same functions as those in trade and business associations. Because of the structure of their membership, self-regulatory efforts may turn out to be little more than thinly disguised excuses for anti-competitive conduct such as price fixing, economic boycotts or other prohibited anti-competitive conducts.

In the U.S. the antitrust provision particularly relevant to self-regulatory activities is Section 1 of the Sherman Act. In determining whether any organised conduct, such

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246 15 U.S.C. § 1 (1988). It provides, “every contract, combination in the form of trust or otherwise, or conspiracy, in restraint of trade or commerce among the several states, or with foreign nations, is declared
as conduct of self-regulatory institution, violates the antitrust laws, the courts will address three questions. The first question is whether the self-regulatory conduct is immune from antitrust laws by federal statute. The self-regulatory conduct can be immune from antitrust review by explicit or implicit statutory languages. Therefore, under the Supreme Court’s ruling, self-regulatory activities need express statutory language to be exempt from antitrust review by courts. Without express language, the exemption will be granted under the narrowest scope with implicit language. Voluntary self-regulatory activities with no statutory ground cannot escape from antitrust challenge.

The second question is whether a self-regulatory activity that is not immune from judicial review under the antitrust law does violate those laws. Certain anti-competitive conduct is so inherently anti-competitive that it is considered a *per se* violation of the antitrust laws. The application of the *per se* rule precludes any argument that the conduct is pro-competitive or otherwise justified. Anti-competitive conduct that is not a *per se* violation of the antitrust laws is subject to the rule of reason test. The rule of reason test determines whether the long term pro-competitive effects of conduct outweigh the short term anti-competitive effects. If the balance is favourable, the conduct will not be considered a violation of the antitrust laws. The rule of reason test requires the court to analyse the ambiguous motives underlying the conduct complained of, and the


248 But See Silver v. New York Stock Exch., 373 U.S. 341, 357 (1963). In the case of implicit statutory grants of immunity from the antitrust laws, the Supreme Court has been reluctant to find the repeals of the antitrust laws by implication and when found only if necessary to make the statute of self-regulation work and then only to the minimum extent necessary.

249 See Northern Pac. Ry. Co. v. United States, 356 U.S. 1, 5 (1958). Price fixing, territorial agreements, group boycotts, and tying arrangements are deemed to be *per se* unlawful, consequently without inquiry to determine whether putative benefits to competition of activities outweigh the harm they have caused to
economic effects thereof, to determine whether the primarily anti-competitive or pro-competitive.250

Group boycott cases arise most often as attempts by self-regulatory organisations to adopt or enforce uniform regulations or standards having exclusionary potential without the participation of government.251 The group boycott cases include direct agreements not to buy or sell, blacklists by industry groups, sanctions of members by associations, and establishment of product or professional standards.252 The formation and enforcement of agreement which prohibits members from dealing with potential competitors is deemed per se illegal. In Silver v. New York Stock Exchange,253 the governing body of the New York Stock Exchange passed a rule which prohibited members from providing direct wire communication to the floor of exchange for non-member brokers. The Supreme Court held that the removal of wires by collective action of the Exchange and its members was per se illegal because of its blatant anti-competitive impact on the excluded brokers.254 Another type of boycott activity involves a concerted response to the conduct or qualifications of particular competitors that are deemed detrimental by an industry group or association. When a blacklist causes competitors to stop dealing with the blacklisted party, the conduct is per se illegal as a group boycott.255 While blacklisting targets outsiders, sanctions of members by associations focuses on targets who are already members of the group. This type of sanction may or may not

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251 Ibid., pp. 6-7.
254 Silver, p. 347.
constitute a *per se* illegal group boycott, depending upon the exclusionary effect upon the sanctioned member. For example, the suspension of competing tournament golfer by the association, which resulted in excluding the golfer from tournament play was classified as an antitrust boycott. But a fine imposed upon an association member would generally not be viewed as a *per se* illegal boycott. The establishment of industry-wide product standards by associations of industry members may produce similar results of group boycott, but to be classified as group boycott activity, an intended refusal to deal and consequent exclusionary impact must be found.

The third question is only relevant to activities of regulatory organisation which is overseen by the government regulator under the specific legislation. It must be determined whether anti-competitive conduct of governmentally recognised and supervised self-regulatory organisations is actionable under the antitrust laws. In other words who, the court or the governmental regulator, has jurisdiction in hearing antitrust challenges to self-regulatory conduct? In *Ricci v. Chicago Mercantile Exchange*, for example, government supervised, statutory recognised self-regulators were not accorded immunity solely by virtue of their status as government supervised self-regulators. Nor do they gain immunity form having received prior approval of their conduct from the federal regulatory agency that had the statutory responsibility to review their conduct. On the matter of jurisdiction, the role of the federal regulatory agency in adjudicating antitrust challenges to self-regulatory conduct is limited to deciding whether the self-

regulator's acts has violated the regulatory statute, and to acting as a fact finder.260

E. Self-Regulation and Korean Commercial Banking

As part of a credit control system, a "principal transaction bank system" was introduced in 1974. The system was designed to control the concentration of bank loans and the economic power of large business groups (chaebols). But since, when created, the system was based on agreement by the banking industry, the "principal transaction bank system" may be analysed as self-regulatory.

In May 1974, the Korea Federation of Banks adopted the Agreement on Credit Control to Affiliated Business Groups. The agreement was prepared with the administrative guidance of the government.261 In July 1976, the OBS arranged for the Korea Federation of Banks to make the Agreement on Operation of the Principal Transaction Bank System.262 Finally, in June 1978, the Agreement on Credit Control of the Principal Transaction Banks was made. The 1978 agreement combined the 1974 and 1976 agreements and expanded the role of principal transaction banks in enforcing them.263 Under the agreement, the principal transaction banks decided the upper limit of a working fund within which credit may be provided; supplied equipment funds; arranged financing in co-operation with other financial institutions; guided business management; and provided fund management after borrowers entered into credit contract with the

262 Ibid.
263 Ibid.
bank.264

The principal transaction bank system had some self-regulation features. It was conducted by the banks in accordance with the agreement made by them. The banks had supervisory powers in the areas of real estate acquisitions and investment in other companies. As for the external control element, the system could be classified as mandated self-regulation. But, the government decided the details of agreement rather than providing framework.

The “voluntary” principal transaction bank system faced two problems. First, since it lacked the legal foundation, the discontent voiced by chaebols increased as credit control became tighter and the government forced sales of real estate and disposal of some of their member companies.265 Second, the agreement had antitrust problem under the Monopoly Regulation and Fair Trade Act.266 Under the act, any abuses of market-dominating power and undue collaborative activities were prohibited.267 Even if there was no challenge against the agreement, the possibility of violating the act remained. Therefore, an amendment to the General Banking Act in 1982 transformed the system into official regulatory system.268 The Monetary Board issued “Regulation on Credit Operations of Banking Institutions.” This regulation was afterward stipulated in Regulations Concerning the Supervision of Banking Institutions.269

265 Nam and Kim, op. cit., n. 261, p. 455.
266 Ibid.
268 See General Banking Act art. 30.2.
269 See Regulations Concerning the Supervision of Banking Institutions arts 32-34.
VI. REFORMING THE STRUCTURE OF BANKING REGULATION AND SUPERVISION IN KOREA

Among the various institutional arrangements for banking regulation and supervision, there is no theoretically "ideal" framework for general application in banking regulation and supervision. The structure thereof has usually been developed within and on the basis of the historic context of each country individually. Therefore, the reform of the Korean banking regulation and supervision structure must be discussed on the basis of the Korean situation.

A. Institutional Arrangements

An executive branch, such as a ministry of finance, can regulate and supervise banking industry effectively. However, to achieve effective regulatory and supervisory operations, the regulator and the supervisor should be given some degree of independence, free from political interference and especially from governmental objectives, which may be inconsistent with regulatory and supervisory objectives. For example, the OCC has degrees of independence from the Executive (the Treasury). Its independence is "practical" rather than "legal". The Korean banking industry has experienced significant controls by the Executive, especially the MoFE, and the failure of regulatory and supervisory system in 1997. First and most importantly, the reform should be focused on ensuring that Korea's commercial banks are regulated and

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270 The government-controlled structure has advantages for economic development for the developing countries. However, the experience has not proved that all developing countries succeed the economic development under the government guidance and the control of banking system.

271 See Bascom, op. cit., n. 50, pp. 175-177. The regulation and supervision by the Executive can be
supervised by authorities who have appropriate legal powers. In Korea, the MoFE has actually regulated and supervised the commercial banks without proper legal powers. It created unfettered intervention in the BOK and the commercial banks, which in turn led to problems of moral hazard in banking as well as in other economic areas. Second, Korea's new banking regulator and supervisor must be free from interventions. In this respect, "practical independence" is more important than "legal independence." To ensure the practical independence, however, it is also important to have a legally independent regulatory and supervisory body. Therefore, it would not be practical to locate the regulatory and supervisory body inside the MoFE, as a separate bureau, and to give independent status, legally or practically, such as the OCC. It must be questioned whether a "practically" independent bureau could be created within the MoFE. Even if an independent bureau is established, the question of effective co-ordination with national policy goals remains unanswered.

The first alternative is self-regulation of the banking industry. The questions are whether the self-regulation is feasible generally in banking regulation and supervision area, and especially in Korea. In financial areas, self-regulation has been established for the securities industries in the U.S. and in the U.K. Would it be feasible also for the banking industry to introduce self-regulation? In order to answer the question, the issue of need for regulation should be addressed. One of the main arguments for the regulation of banks is systemic risk of banking industry. Banks have liquid liabilities (deposits) and illiquid assets (loans). Moreover, it is well established that banks' assets are generally worth significantly less in liquidation. These facts create an inherent

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vulnerability of banks. In order to prevent system risk, a deposit protection scheme and/or other support systems, such as lender of last resort, are provided. Since such protection may lead to moral hazard problems, regulation and supervision should be performed by a body where the lender of last resort and the deposit insurer participate. However, in securities industry, investment firms are generally less vulnerable than banks.\textsuperscript{273} Their assets consist largely of marketable securities and, therefore, there will be little difference between their value on a going-concern basis and in liquidation. On liabilities side, the investments firms have much of secured funding, and, unlike bank deposits, it can not be immediately withdrawn. Therefore, their vulnerability is less significant than that of banks. Accordingly, investment firms do not have the need for a lender of last resort.\textsuperscript{274} This different nature between the banking industry and the securities industry illustrates why the securities industry has the self-regulatory system but the banking industry does not.

In the Korean regulatory system, self-regulation is rare and not well developed. To introduce self-regulation into the banking system would be perceived as radical. Even if self-regulation were ideal structure in Korean banking regulation and supervision, in any event, some kind of external control elements will be involved. This implies that the public authorities, the MoFE or/and the BOK, will be involved in the self-regulatory system, illustrated by the mandated self-regulation of the U.K. financial service regulation under the Financial Service Act. This assumption is practical because self-regulation does not imply total absence of external control and, thus, at least, the BOK who is the lender of last resort will not be excluded from the banking regulation.

\textsuperscript{273} \textit{Ibid.}
Therefore, if there is no significant argument for excluding the public authorities and the advantages of the self-regulation are not decisive, there is no reason why the public authorities should regulate the banks directly. And if the BOK or/and the MoFE is involved in banking regulation and supervision, there is a possibility for the MoFE to intervene in the self-regulation.

The second alternative is to make the BOK, especially the Monetary Board, independent. An independent BOK could perform its responsibility of banking regulation and supervision free from the problem of governmental interference. However, it is unclear whether a central bank, which has monetary responsibility, can always ensure the safety and soundness of banking. The independent central bank could sacrifice the independence of banking regulation and supervision at the expense of the independence of monetary policy. In such case, the government will try to control banking industry to influence its objects indirectly.

The third alternative is to create an independent regulatory and supervisory agent. Its structure should be independent "legally" and "practically." To assess the feasibility of a new regulatory and supervisory agent, current Korean administrative organisation should be examined. In Korea, three types of administrative organisations have been established in relation to the administrative "operations." The first type the advisory board. An advisory board can be set up by the presidential decree, usually when an executive branch needs expert consultation for its operation or policy decision. The role of the advisory board is purely advisory. Even if its opinions and recommendations, in

\[^{274}\textit{Ibid.}, p. 335.\]
\[^{275}\textit{See Bascom, op. cit., n. 50, p. 176. The Latin American experience has indicated that, with few exceptions, the countries that experienced the most serious financial crisis were the ones where bank regulation and supervision was the responsibility of the central banks.}\]
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practice, affect the decision of the government, it does not have any legal power to enforce or implement the decisions and the government does not have any legal obligation to accept them. Currently most committee type organisations are advisory boards.

The second type is the administrative board. An administrative board can be established by legislation. Administrative boards are intended to perform governmental operations, which may be carried out by non-governmental bodies. Their functions and structures differ according to the purposes of the establishments. An administrative board, unlike the advisory board, is granted legislative power and/or judicial power. The administrative board has a degree of autonomy within the existing governmental structure. Most current administrative boards in Korea are administrative tribunals, which have judicial functions in the specific area, such as the Fair Trading Committee.

The third type is the regulatory committee. In Korea, only two organisations, the Election Management Committee and the Monetary Board of the BOK, may be classified as regulatory committee. The Election Management Committee is responsible for regulating of the election process: thus, it is not the regulatory body for economic activities. Since the Monetary Board is not a separate entity for regulation and supervision, but a internal body of the BOK, as discussed in the Chapter One, it is not an independent regulatory agency in the strict meaning of the word. However, due to its

\[276\text{ See M. S. Park, Korean Public Administration (1990), pp. 146-148.}\]

\[277\text{ The administrative boards are established by the specific legislatures rather than the Government Organisation Act which provides general structure of the government. For example, the Fair Trade Commission is established by the Monopoly Regulation and Fair Trade Act.}\]

\[278\text{ The Fair Trading Committee and the Central Labour Committee are the example of the administrative board which has legislative power and judicial power.}\]
structure, the Monetary Board is the only independent regulatory committee which regulates and supervises economic activities in Korea, and it has important features of independent regulatory agency.

To establish an independent banking regulatory and supervisory agent, the committee type institution is more suitable than an institution controlled by a single administrator because the committee type institution is more familiar to the Korean administration and it can consolidate various interests. Some lessons can be learned from the structure of the Monetary Board. In its structure, as seen, it is doubtful whether the structure of the Monetary Board is focused solely on the expertness of banking regulation. Actually the members of the Monetary Board had financial expertness for their background. However, in its original structure, when the Minister of Finance was excluded, half of the members, including the Governor of the BOK, represented financial area and the other half represented other commerce and industry. It suggested that the structure of the Monetary Board intended to consolidate various interests of different industries rather than to appoint experts of monetary policy and bank regulation.280

After the 1962 Amendment to the Bank of Korea Act, the intention of the initial act that the members should represent different industries remained. Two members represented financial industry, and the other five members represented various industries. However, it is uncertain whether this industry representation system works for the purpose of consolidating the interests of different parts of economy and industries. Rather, the composition of the Monetary Board was viewed as an effective control system of economy as well as financial area. The Minister of the MoFE was the head of

279 See Y. H. Park, op. cit., n. 201, p. 57.
280 See Bank of Korea (1955), p. 15.
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the financial authorities and the government representative for the financial control. The Governor of the BOK could be another representative of financial authorities. The five members recommended by the government ministers could act as the authorities who control the industries. It is also doubtful whether the two members recommended by the banking institutions would act for the interests of the banking institutions because the appointments of most of important positions of banking institutions, for example the presidents and the directors of the banks, were under influence of government.

B. Assessment of the Financial Supervisory Commission

1. Structure of the Financial Supervisory Commission

(a) Composition of the Financial Supervisory Commission

Since the Bank of Korea Act assigned the banking regulatory and supervisory power to the BOK, the MoFE has attempted to take back the power several times. The MoFE again introduced the financial regulatory and supervisory system bill in 1997. It intended the separation between monetary authority and regulatory and supervisory authority for banking industry. It was to give the BOK independent monetary power and to create a new regulatory and supervisory agency under the Prime Minister. The new agency, the Financial Supervisory Commission (FSC), would regulate and supervise banks, securities industry and insurance industry altogether.

Under the Act Concerning Financial Supervisory Organisation, the composition of the FSC focuses on the objectives of financial regulation and supervision. Unlike the previous Monetary Board of the BOK, the FSC's composition does not follow the
principle of compromising the various interests of national economy. Only one member, who represents the business sector, is recommended by the President of Korea Chamber of Commerce and Industry. Five members (the chairman, vice-chairman, Vice Minister of MoFE, Deputy Governor of the BOK, and President of the Korea Deposit Insurance Corporation) are related to governing financial matters. The other three members are experts in financial, accounting and legal areas.

The FSC’s composition can increase efficiency and expertise when each member contributes his/her expert without seeking any control over the FSC. Within this context, the Deputy Governor of the BOK needs to act as an avenue of communication between the BOK and the FSC. By separating financial regulatory and supervisory authority from monetary authorities, the conflict of interest problem is avoided. But, since there is a close relationship between the safety and soundness of banking system and the monetary policy, the FSC and the BOK should co-operate with each other, especially during a financial crisis. Together with the data supply requirements, through the Deputy Governor, the BOK will be provided with sufficient information concerning banking system, and it can introduce its proposal for banking regulatory and supervisory matters. The FSC will be also provided the monetary information from the BOK.

The Deputy Minister of the MoFE (Deputy Minister) needs to represent the government’s policies and obtain information about financial regulation and supervision. But, the Deputy Minister must not seek any control over the FSC. For governing economic matters, the MoFE needs to be sufficiently informed through the Deputy Minister. The President of the Korea Deposit Insurance Corporation needs to represent

281 Act Concerning Establishment of Financial Supervisory Organisations art. 4, cl. 1.
282 Ibid., art. 65.
and inform the deposit insurance operations.

(b) Appointment, Term and Removal of the Financial Supervisory Commission Member

The President appoints all members of the FSC. The chairman is appointed after the State Council deliberation. The vice-chairman is appointed on the recommendation of the Minister of the MoFE. The chairman administrates recommendation procedures for members of the FSC.\(^{283}\) By removing appointment administration power from the MoFE, the possibility of intervention by the MoFE over the FSC is decreased. Except the ex-officio members (the Vice Minister, Deputy Governor and President of the KDIC), the FSC members are appointed for three year term, which is renewable once. The establishing act restricts the President power to remove the FSC’s members.\(^{284}\) A member can be removed only when (1) the member falls under any disqualification for membership,\(^{285}\) (2) the member can not perform his/her duties due to mental or physical disability; or (3) the member becomes inappropriate to fulfil his/her duties as a member by violating his/her functional obligations under the Act Concerning Establishment of Financial Supervisory Organisation.

(c) Location of the Financial Supervisory Commission

Under the establishing act, the FSC is under the jurisdiction of the Prime Minister, but the

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\(^{283}\) Enforcement Decree on Act Concerning Establishment of Financial Supervisory Organisations art. 2.

\(^{284}\) Act Concerning Establishment of Financial Supervisory Organisations art. 10, cl. 1.

\(^{285}\) Ibid., art. 8.
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FSC shall operate its functions independently from the Prime Minister. This arrangement is similar to the Korea Fair Trading Committee (FTC) which is responsible for overseeing the antitrust activities and unfair competitions. The FTC is located under the jurisdiction of the Prime Minister, therefore, in structure, it is separated from the MoFE. It is doubtful that separation from the MoFE ensures sufficient independence or autonomy of the FTC from the MoFE. The new institutional arrangement of the FSC under the jurisdiction of the Prime Minister may change the way of the MoFE's influence to the FSC's regulatory and supervisory activities. Even if the act provides the "functional independence," Korea's experiences have revealed that the Secretariat of the President usually intervenes in most of important government's activities including banking regulatory and supervisory activities. This arrangement being located the FSC under the Prime Minister can not solve the problems of government's, both the MoFE and the Secretariat of the President, intervention. Therefore, the FSC must seek a "practical way" to have autonomy in its operations.

2. Accountability of the Financial Supervisory Commission

It is essential for the regulatory and supervisory authorities to be independent not only from the government but also from the politicians to achieve credibility and stability of

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286 Ibid., art. 3.
287 Antitrust and Fair Trading Act art. 1. See J. H. Chung, Korean Economic Law (1994), pp.170-176. The FTC consists of seven members. The chairman and the vice-chairman is appointed by the President after recommendation by the Prime Minster. Other five members are appointed by the President after recommendation by the chairman.
288 Until 1994, the FTC was located in the Economic Planning Board, which was merged with the MoF into MoFE.
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the banking system. Since independence does not mean that the regulatory and supervisory authorities are not accountable to anyone, it is necessary to arrange measures for the accountability. But the measures must not be used as means of intervention or control under the guise of accountability.

Even if the FSC is under the jurisdiction of the Prime Minister, the establishing act grants it a “functional independence.” The act does not provide any explicit accountability of the FSC. One of the possible accountability measures is “reporting.” The FSC is not required to submit any report concerning its regulatory and supervisory operations. By requiring to submit reports to the Prime Minister, the FSC will be accountable. But this accountability will be restricted. Under the current arrangement of placing the FSC in jurisdiction of the Prime Minister, the Prime Minister will review the reports. Then the report will be published and available to the public. The Prime Minister will have no power to intervene the FSC.

Moreover, the FSC should publish its minutes. By publishing its minutes, the FSC can increase the transparency in decision-making processes and supervision processes. It can also improve the FSC’s independence because the transparency in the procedures decrease the possibility of intervention from the other parts of government and politicians.

VII. CONCLUDING REMARKS – INDEPENDENCE OF BANK REGULATORY AND SUPERVISORY AUTHORITIES

The Korean banking system can be characterised as a “government controlled system”

289 See Lastra, op. cit., n. 65, pp. 151-152.
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for credit allocation for government objectives through legal and practical means. This system provided weak bank regulation and supervision when the government pursued objectives which were inconsistent with "safe and sound" banking regulatory and supervisory objectives.

The most important aspect of a new reformed banking system should be an appropriate structural arrangement for bank regulatory and supervisory authorities in Korea. This structural arrangement can ensure that possibilities of undue governmental and political interference are removed. This aim can be achieved by giving "legal and practical" independence to the bank regulatory and supervisory authorities (the FSC).

Despite the "legal and practical" independence of the FSC, however, further areas of reforming the Korean banking system remain with regard to effective supervisory standards, monitoring and enforcement. The significant problems in the Korean banking regulatory and supervisory system are lax and inadequate prudential regulation and supervision, and forbearance policies in enforcement. The further issues which arise with regard to prudential standards, monitoring and enforcement are considered in Chapter Three.
Although new banking regulatory and supervisory authorities may secure their "legal and practical" independence, such "independence" will not remove all possibilities of "control and interference" by the government. Banking regulatory and supervisory authorities, while technically independent, may nevertheless follow government objectives that are inconsistent with "safe and sound" banking regulatory and supervisory objectives. In such a case, the regulatory and supervisory authorities may try to control or otherwise interfere in the banking sector. This practice will create a "regulatory controlled" banking system.

A "regulatory controlled" banking system creates the same problems and weaknesses in the banking sector that a "government controlled" banking system does. This leads to issues of primary policy objective, prudential standards, monitoring and enforcement, which restrict the operations of banking regulatory and supervisory authorities.

In the search for an adequate policy objective, this chapter first discusses the objectives of Korean banking regulation and supervision. This discussion focuses on the areas of capital adequacy, loan classification, loan loss provisions and internal control
systems for establishing appropriate reforms that can ensure that the Korean banking system is “safe and sound” consistent with evolving international standards. This chapter further discusses issues related to effective monitoring and enforcement practices designed to ensure that banks apply and maintain relevant regulatory and supervisory standards.

I. OBJECTIVES OF KOREAN BANKING REGULATION AND SUPERVISION

A. National Economic Progress

1. Legal Interpretation of Banking Acts

In Korea, the objectives of banking regulation and supervision can be found in the General Banking Act and the Act Concerning Establishment of Financial Supervisory Organisations. The General Banking Act, which is the primary act for regulating and supervising commercial banks, provides:

[the purpose of this Act shall be to contribute to the national economic progress by directing the sound operation of banking institutions, protecting depositors, and maintaining the order of the credit system.]

Under this article, four objectives of the Korean banking regulation and supervision can be identified: (1) contribution to the national economic progress, (2) sound operation of banking institutions, (3) depositor protection, and (4) maintenance of the order of the credit system. The Act Concerning Establishment of Financial Supervisory Organisations...

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1 General Banking Act art. 1. This article was enacted in 1982. Before the amendment to the General Banking Act in 1982, there was no explicit provision for its purposes and objectives.
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Organisations, which establishes Korea’s new financial regulatory and supervisory framework provides:

[the purpose of this Act shall be to establish the Financial Supervisory Commission and the Financial Supervisory Services in order to contribute to the national economic progress by establishing the order of a sound credit system and fair financial business practice, and protecting financial users, such as depositors and investors.]

The act also outlines four objectives for financial regulation and supervision: (1) contribution to the national economic progress, (2) order of a sound credit system, (3) fair financial business practice, and (4) protection of financial users.

The legal interpretation of those two provisions, if interpreted word for word, is that “contribution to the national economic progress” is the primary goal of the General Banking Act and the Act Concerning Establishment of Financial Supervisory Organisations. Accordingly, the Financial Supervisory Commission (FSC) and the Financial Supervisory Service (FSS), as new Korean banking regulatory and supervisory authorities, should achieve “national economic progress” through their operations. The remaining objectives, (1) sound operation of banking institutions, depositor protection, and maintenance of the order of the credit system in the General Banking Law, and (2) order of a sound credit system, fair financial business practice, and protection of the financial users in the Act Concerning Establishment of Financial Supervisory Organisations, are thus “subordinate” to the objective of contribution to national economic progress. Although the banking regulatory and supervisory authorities should still make their efforts to achieve the “subordinate objectives,” their “primary objective” is the national economic progress. According to this interpretation, when there are...
conflicts between the national economic progress and other subordinate objectives, the subordinate objectives must be conceded to the primary objective of national economic progress. Thus, the subordinate objectives, such as sound operation of banks, could be restricted and damaged. In practice, this argument has been used as justification for controlling the banking industry in order to support the growth of the real sector economy during the economic development period and even after the deregulation period in Korea.3

2. Problems of Legal Interpretation

The interpretation that “contribution to the national economic progress” is the primary objective of Korea’s banking regulation and supervision raises two questions: (1) what is the definition of the national economic progress? and (2) who shall define it? First, the meaning of national economic progress is very broad and abstract. In the 1960s and 1970s, the growth of the real economy was considered national economic progress in Korea. In the 1990s, however, it is unclear whether the real sector growth is still assumed to be national economic progress.

Second, there is no ultimate authority to define what is “national economic progress.” Nevertheless, a number of Korean acts relating to economic activities generally provide that “the national economic progress” or “contribution to the national economic progress” are the objectives of their enactment.4 According to the literal

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2 Act Concerning Establishment of Financial Supervisory Organisation art. 1.
4 See for example, Bank of Korea Act; Act of Managing Bad Assets of Financial Institutions and Establishing Korea Asset Management Corporation; Labour Act; Export Act; Securities Investment and Trust Business Act; Futures Trading Act; Small- and Medium-size Business Basic Act; Foreign Exchange
interpretation, "the contribution to national economic progress" is the primary objective of each of the acts. Under the acts, authorities who are responsible for enforcing them are given the power to define the meaning of national economic progress. Moreover, the authorities form their policies and official decisions according to how "national economic progress" is defined. When conflicts arise between the definitions, authorities must take action to harmonise the definitions. For example, the Ministry of Finance and Economy (MoFE), the Korea Deposit Insurance Corporation (KDIC), the Bank of Korea (BOK), and the Financial Supervisory Commission (FSC) have the power to define separately what is "national economic progress." If there is any significant discrepancy between the definitions, then obvious conflicts over the policies and decisions will likely arise. In such a case, the MoFE might try to intervene in the decisions of other authorities, such as the FSC, under the guise of economic progress. In such a situation, it is possible that the FSC might bend to the political pressure applied by the MoFE. If this happens, then the MoFE will prevail over the FSC. If the MoFE can successfully exert its political influence over the FSC, it would diminish or destroy the independence of the FSC. On the other hand, if the independence of the FSC is firmly established and the MoFE can not intervene in the FSC's decisions, "national economic progress" could have more than one definition and this could lead to policy confrontations between the MoFE and the FSC due to their differing views or interests.

Management Act; Credit Card Business Act; Long-Term Credit Bank Act; Insurance Business Act; Korean Export Import Bank Act; Credit Insurance Fund Act; Securities and Exchange Act. But see Financial Industry Restructuring Act; Depositor Protection Act; Merchant Banking Corporation Act; Trust Business Act. Those acts do not provide "national economic progress" as their objectives.

It is possible that the courts can make the definition ultimately. However, the courts can not guarantee the consolidated definition since the conflicts usually arises in detailed, specific cases. Furthermore, it is
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3. National Economic Progress as General Purpose

Even if the Korean economic related acts provide in their context that “contribution to the national economic progress” is the primary objective, “contribution to the national economic progress” should be interpreted as a general purpose rather than a specific purpose. Under this interpretation, Korea’s economic related acts would pursue the national economic progress with regard to the specific objectives of each act. Those specific objectives are the substantial objectives which the acts try to eventually achieve respectively. In such an interpretation, any substantial objective can not be restricted or damaged in the guise of national economic progress, because without achieving the substantial objectives, the objective of national economic progress can not be achieved either. Therefore, the substantial objectives of the General Banking Act are the sound operation of banking institutions, depositor protection, and maintenance of the order of the credit system, which will eventually contribute the national economic progress. Equally important, the order of a sound credit system, fair financial business practice, and protection of financial users are substantial objectives of the Act Concerning Establishment of Financial Supervisory Organisations.

difficult for the courts to solve the conflicts when the urgent decision is needed, since the courts tend to have long procedures.
B. Implementation of Substantial Objectives in the Korean Banking Regulation and Supervision

1. The Sound Operation of Banking Institutions and Fair Financial Business Practice

The objectives of sound operation of banking institutions and fair financial business practice have as their focus the immediate need of ensuring that individual banks operate in a prudent manner and with fair business practices.

The objectives of sound operation of banking institutions and fair financial business practice are embodied into various structural and prudential regulations in Korea. In relation to the structural regulations, when the FSC authorises a banking institution's charter, the FSC will examine whether the bank applying for the charter has sufficient starting capital with which it can operate business prudently and efficiently.6 The General Banking Act prohibits bank shareholders from compelling or exercising influential power over the banking institution to commit any action prejudicial to the soundness of the financial business order.7 Furthermore, any person who poses a threat to the sound management of a banking institution is prohibited from being appointed as a bank officer.8

The objectives of sound operation of banking institutions and fair financial business practice also play a role in Korea's prudential regulations. In conducting its banking business, a banking institution shall ensure the soundness of its management.9

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6 Regulations Concerning the Supervision of Banking Institutions art. 4 no. 1.
7 General Banking Act art. 16 cl. 8.
8 Ibid. art. 18. cl. 2.
9 Ibid. art. 45 cl. 1.
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The FSC establishes and imposes management guidelines in order to secure the soundness of banking institution management. When a banking institution seriously threatens the soundness of its management by failing to comply with the management guidelines, the FSC may require the banking institution to take corrective actions such as increasing its capital or restricting dividends in order to improve its management status.  

For example, when a banking institution’s financial status is unstable, such as when its capital adequacy ratio is below the required level, the FSC may order the banking institution to undertake “management improvement measures.”

2. The Order of the Credit System

The objective of maintaining the order of the credit system is concerned with the stability of the Korean credit or financial system in general. Before authorising a banking institution’s merger or financial institution’s transfer to a bank, regulatory authorities will consider whether the merger or transfer might damage the order of the credit system.

When it is necessary to preserve the order of the credit system, the FSC may impose on a banking institution “management improvement measures” or a “management improvement order.” Under the Depositor Protection Act, the Korea Deposit Insurance Corporation (KDIC) can request the FSC to examine any financial institution, including banks, when the KDIC deems it is necessary to maintain “the stability of financial system.”

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10 Ibid. art. 45 cl. 3.
11 Financial Industry Restructuring Act art. 10 cl. 1.
12 Ibid. art. 4 cl. 3 no. 1.
13 Ibid. art. 11 cl. 1.
14 Depositor Protection Act art. 21 cl. 3.
3. **Depositor Protection**

When the financial conditions of a banking institution seriously threatens the interests of depositors (such as when the bank is facing bankruptcy or insolvency in regard to its deposit liabilities), the FSC may order the banking institution to restrict its acceptance of deposits and granting of credits, or to suspend repayment of all or part of its deposit liabilities, or take any other actions deemed necessary.\(^\text{15}\) Those actions include "management improvement measures" and a "management improvement order." The KDIC can request the FSC to examine banks when the KDIC deems it is necessary to protect depositors' interests.\(^\text{16}\)

C. **The Need for New Objectives in Korean Banking Regulation and Supervision**

1. **The Failure of Banking Regulation and Supervision**

The Korean government's control over the banking industry and corporations, especially with respect to lending activities, has led to problems of moral hazard.\(^\text{17}\) Furthermore, the government's bailout practices have only increased the potential for moral hazard. Korean banks have historically extended their loans under the directions of the government. Even after the partial deregulation in the 1990s, which gave Korean banks increased autonomy in their lending activities, the Korean banks' lending practices

\(^{15}\) General Banking Act art. 46.  
\(^{16}\) Depositor Protection Act art. 21 cl. 3.
remained the same. The banks continued to lend to inefficient and failing businesses, confident that the government would eventually come to the rescue in times of trouble. This assumption of eventual government assistance has led to excessive risk-taking not only by the banks but also by the corporations. Banks have traditionally preferred to lend to big chaebols which were presumed to be less risky because the banks believed that the government would essentially guarantee the loans. The practice of lending mainly to chaebols has led to overexposure to this borrower sector. Such overexposure has meant that in many cases banks have had no other option a situation in which the banks had to continue lending to highly leveraged companies even if there was a high probability of default. Such practices have resulted in a marked deterioration of the health of Korean commercial banks.

While the government’s control over the Korean banking industry focused on the credit allocation of banks, the banking regulatory and supervisory authorities failed to implement or enforce adequate regulation and supervision. Despite Korean commercial banks having a crucial role in the financial market infrastructure, they had lax lending standards and inadequate regulation and supervision of their activities. This situation is a substantial cause of the systemic nature of the banking crisis.

Even though the General Banking Act was enacted with the ostensible philosophy that the bank regulatory system should protect depositors by safeguarding banks against

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19 See also Chapter Two Section III C 2 (c).
failures, there were only nominal provisions in the act to uphold that purpose. Once the
privatisation and liberalisation of bank operations were completed, the government’s
formal control over structural and functional regulations were gradually eased. At the
same time, several prudential regulatory measures were introduced. However, these
regulatory measures have been unable to provide a safe and sound banking system. For
example, even when Korean commercial banks conducted business through trusts, their
trust accounts were not subject to the single borrower credit ceilings. This permitted the
banks to breach the single borrower lending limit by lending through trust accounts. In
February 1997, after the Hanbo scandal, the Office of Bank Supervision (OBS)
investigated four commercial banks and the Korea Development Bank. That
investigation revealed that one commercial bank had lent in excess of the lending limit to
the Hanbo Iron & Steel Company, the principle company of the Hanbo group. It is
unclear whether the bank maintained the limit on its banking account book because the
OBS did not publish the separate ratios. However, the OBS pointed out the problem of
trust account lending.

2. Deregulation

Financial industries over the world have undergone extensive structural change,
domestically and internationally, as a result of regulatory reforms and technological

22 See Office of Bank Supervision Press Release, “Special Examination relating to Hanbo Iron & Steel
Co.” (Feb. 21, 1997); see also Office of Bank Supervision, “The Bankruptcy of Hanbo Iron & Steel Co.
innovations. An increasing ineffectiveness of direct controls forces financial systems to shift to be more market-oriented and regulatory authorities to implement liberalisation measures. With regard to the banking industry, deregulation includes the areas of interest rate controls, quantitative investment restrictions, line-of-business regulations and restrictions on ownership linkages, restrictions on foreign bank entry, and capital controls. In the emerging market economies, the financial and banking reforms are generally aiming to remove "financial repression." Deregulation has led to major economic consequences. In the OECD countries, deregulation has created structural changes in financial markets; changed the internal efficiency and resources allocation; and affected financial stability and macroeconomic policies. The structural changes have led to competition and greater use of securitisation techniques. Deregulation also causes banks to be more cost-conscious as profits margins decrease. However, deregulation in the banking sector also appears to be linked to the instability of banking sector. In emerging market economies, banking sector liberalisation and reform may increase financial market fragility. A number of


24 Edey and Hviding, op. cit., n. 23, p. 4.

25 See ibid., pp. 5-10.


29 OECD, op. cit., n. 28, p. 13.

30 Demirgüç-Kunt and Detragiache, op. cit., n. 26, p. 11.
banking problems and crises have emerged after deregulation. In a liberalised, deregulated banking system, the banks must operate in highly volatile environments, such as with interest rate volatility. Deregulation also increases the opportunity for banks to take on risks where the government implicitly or explicitly guarantees to bail out the troubled banks (moral hazard problem).

Since the early 1990s, Korea’s banking and financial reforms have focused on financial liberalisation and financial market opening. The financial liberalisation reforms include interest rate deregulation, fund operation, fund-raising deregulation, business scope deregulation, and lowering entry barriers. Korea’s interest rate deregulation began in 1991. Under the four-step interest rate deregulation plan, interest rates for lending rates and long-term interest rates have been deregulated. By 1996, all other interest rates except demand deposit rates were officially deregulated. As official policy loans have been phased out, Korean commercial banks have been able to expand their operations to high-yield but high-risk areas, such as securities investment and credit card related lending. Fund-raising deregulation allows banks to increase their share of marketable financial products, such as Certificate of Deposits. At the same time fund-
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raising deregulation has induced large firms to increase direct financing. Pursuant to business scope deregulation and lowering entry barriers, Korean commercial banks and non-bank financial institutions are allowed to expand their scope of operation scope with newly introduced financial instruments.37

While the deregulation policies were formulated to promote a market-oriented banking system, deregulation in Korea has increased the fragility in the banking system. First, business scope deregulation, lowering entry barriers, and interest rate deregulation have all led to increased competition in the financial industries. Rapidly growing non-bank financial institutions (NBFIs), especially merchant banking corporations, were an important source of competition to the commercial banks in Korea.38 Since the NBFIs were generally less regulated and subject to weaker supervision than Korean commercial banks,39 their growth exacerbated problems with the commercial banks’ market shares and profitability. In response to this competition, Korean commercial banks have focused on increasing their volumes of deposits and loans. As the competition among the commercial banks and between the commercial banks and the NBFIs increased, the commercial banks were forced to offer more attractive terms to depositors. This volume-focused practice increased the ineffectiveness in management and hampered their profitability.40 For example, Korea’s commercial banks recorded lower returns compared to U.S. commercial banks before the liberalisation.41 After the deregulation, the lower


39 The NBFIs usually offer higher returns to their funding sources than the commercial banks.


returns continued and returns during the period between 1991 and 1995 actually decreased.\textsuperscript{42}

Second, with unresolved and mounting non-performing loan problems resulting from the policy loans,\textsuperscript{43} the increased competition induced Korean commercial banks to pursue risky investment strategies. For example, the Korean commercial banks' securities investments increased significantly. In 1994, the rate of increase was 73 per cent.\textsuperscript{44} This rate of increase fell to 33.8 per cent and 32 per cent in 1995 and 1996 respectively, but the ratios were still significantly higher than the rate of lending increases.\textsuperscript{45}

3. \textit{Financial Globalisation}

Financial globalisation and integration result from two important financial reforms: internationalisation of financial services and capital market liberalisation. The internationalisation of financial services eliminates discrimination in treatment between foreign and domestic financial services providers and removes barriers to the cross-border provision of financial services.\textsuperscript{46} The internationalisation of financial services, in the emerging market economies, has had a substantial impact on their domestic financial markets. For example, lowering entry barriers to foreign banks and granting national

\begin{footnotesize}
\begin{itemize}
\item \textsuperscript{42} \textit{Ibid.}
\item \textsuperscript{43} For example, Korea's five large nationwide commercial banks had been forced to involve the policy loans and the industrial restructuring programs and had large non-performing loans as a result. The non-performing loans became the major negative factor against their profitability. \textit{See} B. Y. Kim, "Earning Structure of Korean Commercial Banks: Diagnosis and Prescriptions for Improvement," \textit{KIF Financial Paper} (1997), pp. 5-10.
\item \textsuperscript{44} \textit{See} Oh, \textit{op cit.}, n. 36.
\end{itemize}
\end{footnotesize}
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treatment for existing foreign banks has allowed greater competition in the domestic banking market. The increasing number of foreign banks in emerging market economies reduces profits of domestic banks.47

Capital market liberalisation involves a process of removal of capital controls and restrictions on the convertibility of currency.48 Internationally, capital market liberalisation in the industrialised countries has facilitated a greater flow of funds to emerging markets.49 In the emerging market economies, many countries have relaxed controls on international capital movements and have experienced significant capital inflows. Indeed, private capital flows to developing countries increased six-fold over the years 1990-1996.50

In Korea, the financial reforms on market opening51 include the foreign exchange system,52 foreign investment, opening the securities market,53 and foreign financial

48 Claessens and Glaessner, op. cit., n. 46, p. 3.
52 In March 1990, a Market-Average Foreign Exchange Rate (MAR) System was introduced. This system allowed the Korean won to U.S. dollar rate to be determined on the basis of underlying demand-supply conditions in the domestic inter-bank market. Furthermore, in September 1992, a negative-list system for the management of foreign exchange replaced the positive-list system.
53 In January 1992, foreign investors were permitted to by domestic shares directly in Korean domestic market, subject to a certain overall limit on their total holdings of a company’s shares. In the bond market, non-guaranteed convertible bonds and long-term bonds issued by small- and medium-sized companies, and non-guaranteed convertible bonds issued by large-sized companies have been allowed to be purchased. 176
institutions' entry into the domestic market. After opening its financial markets, Korea experienced a large inflow of capital. Korea's total external liabilities increased from US$ 67 billion in 1993 to US$ 170.6 billion as of 30 September 1997. The capital inflows into Korea have had a distinctive feature. Unlike other East Asian countries, capital inflows have been mainly related to portfolio investments and interbank loans rather than foreign direct investments in Korea. Of all total external liabilities, the Korean financial institutions, including commercial banks, were responsible for more than sixty-five per cent. The foreign liabilities of the Korean banking system more than doubled from 4.5 per cent of GDP in 1993 to 9.5 per cent of GDP in mid-1997. Moreover, the structure of external liabilities revealed that short-term liabilities were more than sixty per cent of the total liabilities.

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54 The economic needs test, which had been used in evaluating foreign financial institutions' branch opening application, was also abolished.
55 The Korean government's high-interest rate and tight monetary policy, which set domestic real interest rates way above world markets encouraged foreign borrowings.
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Under financial globalisation, macroeconomic instability can be increased by sudden changes in macroeconomic policies, accumulation of unsustainable fiscal and current account imbalances, heavy reliance on volatile short-term external financing, or defence of exchange rates that is out of line with fundamentals. Financial globalisation makes some countries vulnerable to a loss of investor confidence and reversal in capital flows, when the countries fail to provide regulatory controls and sufficient transparency to allow markets to recognise and correct the problems of excessive risk-taking. First, the high levels of capital inflows place new pressure on under-developed financial systems. In both commercial banks (which are intermediating rapidly growing levels of financing), and banking regulatory and supervisory authorities (which are trying to regulate and supervise rapidly growing activities), the institutional changes generally cannot keep pace with the high levels of international capital flows. Countries with weak financial system, particularly in terms of supervision, have sometimes experienced financial distress following a period of rapid inflows of foreign capital associated with the earlier removal of controls on international capital movements.

Second, excessive capital inflows resulting from globalisation create conditions for excessive risk taking, poor banking judgement, and even outright fraud. Moreover, moral hazard problems occur when banks and other financial institutions are able to borrow with implicit or explicit guarantees from the government on their liabilities.

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62 Alba and et al., op. cit., n. 38, p. 11.
63 Radelet and Sachs, op. cit., n. 49, p. 10.
When the financial system is undercapitalised and/or weakly regulated, banks and other financial institutions tend to make excessive, overly risky investments. Foreign as well as domestic creditors went along with this risky behaviour, as they were confident that the government or international financial institutions would bail them out if problems arose.\textsuperscript{65}

The Korean banking system became more fragile as a result of financial globalisation. After Korea removed capital controls, the banking regulatory and supervisory authorities failed to provide appropriate regulatory and supervisory measures to deal with the high level of capital inflows and its impact on the economy. As a result, the undisciplined foreign lending and volatile international flows deteriorated the international liquidity position of the financial system.\textsuperscript{66} Furthermore, the weak banking regulatory and supervisory system induced the Korean banks to borrow excessively from abroad and finance unprofitable projects with excessively high exchange risk.\textsuperscript{67}

D. Financial Stability as a Goal of Banking Regulation and Supervision

Every banking system is prone to problems and fragility. Such banking problems and fragility come from various factors, such as macroeconomic shocks, structural characteristics of the banking sector, and vulnerability to sudden capital outflows, that lead to systemic banking sector problems and, ultimately, increase the probability of a


In the environment of deregulation and globalisation, not only individual banks but also the banking system as a whole becomes vulnerable. A troubled banking system tends to misallocate capital and encourage excessive risk taking. Furthermore, if a banking crisis occurs and the banking system becomes insolvent, the cost of banking system failure is high, such as severe reduction in real economic activity. Therefore, banking regulators and supervisors need to provide protection against systemic instability in the banking system.

In Korea, one of the major causes of the 1997 financial crisis was the unfettered government intervention in the banking system. To establish a safe, sound, and effective banking system, Korea needs an approach that removes the government’s and the banking regulatory and supervisory authorities’ interventions which deprive banks of commercially-oriented, effective business operations. This approach gives banks greater incentive to act independently in their market operations. For example, non-intervention, incentive-oriented regulatory and supervisory practices improve banks’ autonomy in their lending activities and can avoid policy-induced non-performing loans. However, it is equally important to ensure that investors, creditors, owners and managers, in the pursuit of their private interests, pay heed to the consequences of their actions and take necessary precautions in the face of risks. Together with the risks from deregulation and financial globalisation, the increased autonomy of banks will likely create more instability in the banking system unless the appropriate measures are implemented. Therefore, in the


68 See Lindgren, Garcia, and Saal, op. cit., n. 31.
70 See ibid.
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interest of preserving the stability of the financial system in Korea, especially with regard to the banking sector, the Korean banking regulatory and supervisory authorities need to provide the financial stability in the Korean banking system.72

Korea’s current banking regulatory and supervisory objectives are inadequate for maintaining the stability of the Korean banking system. Even if the Korea’s new banking regulatory and supervisory authorities, FSC and FSS, operate with the mandates of maintaining sound operation of banking institutions and fair financial business practice, order of the credit system, and depositor protection, those mandates can not ensure Korea’s financial stability. The current substantial objectives are more oriented towards individual banks than to the banking system as a whole. As Korea’s recent experience shows, individual bank oriented objectives can create moral hazard, which allows the troubled banks to stay in the banking system and, ultimately, results in banking system instability. An important goal of financial stability should be to remove the moral hazard problem by allowing certain banks to fail as long as such failure will not lead to systemic instability. In most case, an individual bank can fail without causing system instability, and the banking regulatory and supervisory authorities should not intervene in the individual case.73 However, banking regulation and supervision should ensure that the banking system is stable. A stable and robust banking system can lower the risk that problematic real economic conditions will lead to financial crisis, as well as reduce the

71 For the causes of Korean financial crisis, see Chapter Four Section II.
72 See Basle Committee on Banking Supervision, “Core Principles for Effective Banking Supervision” (Sep. 1997) (hereinafter sited as Basle Core Principles), p. 8.
73 The Basle Core Principles supports the notion that “supervision cannot, and should not, provide an assurance that banks will not fail. In a market economy, failures are a part of risk-taking.” Basle Core Principles, ibid., p. 9. Alan Greenspan also observes that occasional failures are an important and normal part of the market process because they promote market disciplines, provided that the failures do not lead to more systemic consequences. Alan Greenspan, “Opening Remarks,” at the Federal Reserve Bank of Kansas City symposium “Maintaining Financial Stability in a Global Economy” (28-30 Aug. 1997).
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damage from a crisis if it occurs. The banking regulation and supervision should contain the systemic risk by reducing financial fragility with appropriate prudential standards, monitoring and enforcement. Accordingly, the financial stability objective does not eliminate the need for current substantial banking regulatory and supervisory objectives, but instead calls for such objectives to be strengthened for the purpose of banking system stability. Moreover, the new objective of preserving financial stability should be codified in the General Banking Act and the Act Concerning Establishment of Financial Supervisory Organisations. Clear objectives and responsibilities will ensure and strengthen the independence of the regulators and supervisors in order to formulate effective regulation and supervision. This is especially important in Korea where the government has historically had extensive controls in the banking system.74

In order to achieve the goal of financial stability, banking regulators and supervisors should establish a comprehensive set of prudential standards. Financial deregulation and globalisation create a situation in which the banks are often induce to take more risks. Unless this incentive is controlled through effective prudential regulation and supervision, the increased risk taking due to moral hazard can become a source of banking fragility.75 The Korean banking regulatory and supervisory authorities therefore must establish standards to resolve the current financial and economic crisis and to promote safety and soundness in the banking system in order to avert or mitigate future problems. To meet those goals, Korea should improve prudential regulation and supervision. Together with the non-intervention, incentive approach, adequate prudential regulatory and supervisory standards for individual banks and the banking system as a

75 Demirgüç-Kunt and Detragiache, op. cit., n. 26, p. 11.
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whole are the answer. The focus of Korea's current prudential regulations must shift from the health of individual banks to the stability of the banking system as a whole. The goal of prudential regulation and supervision should be to identify weak banking practices early so that emerging problems can be addressed before they become large and costly to the banking system as a whole.76

II. PRUDENTIAL STANDARDS OF KOREAN BANKING REGULATION AND SUPERVISION

To achieve financial stability in the Korean banking system, Korea needs to review the current banking regulatory and supervisory standards and establish new standards for the restructured banking system after the financial crisis. The new banking regulatory and supervisory standards should (1) prevent the government, especially the Ministry of Finance and Economy, and the banking regulatory and supervisory authorities from exercising "unfettered and unreasonable" controls, (2) give more autonomy and responsibilities to the banks, and (3) enhance the prudential measures. However, it is important to ensure that the banking regulatory and supervisory authorities have powers to review and assess the standards and intervene to prevent any imprudent practices of banks.

The areas of improving prudential standards include the capital adequacy standards, loan classification standards, loan loss provisions, and internal control systems.

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A. Capital Adequacy Standards

1. The Concept of Capital Adequacy Standards

The capital adequacy measures for banking institutions are a cornerstone of prudential regulation and supervision, designed to ensure that banking institutions do not take imprudent risks and that they manage their assets and sources of funds in a prudent and honest manner in both domestic and international contexts.\(^{77}\) In the domestic banking area, capital adequacy measures are generally justified under reasons of safety and soundness, and also competitive equality and transparency.\(^{78}\) Under the safety and soundness justification, capital adequacy measures (1) establish adequate solvency\(^ {79}\) and public confidence;\(^{80}\) (2) provide general supervisory and examination tools for internal regulatory purposes;\(^ {81}\) (3) provide a degree of governmental insulation for deposit insurance funds;\(^ {82}\) and (4) provide an effective tool for monitoring and instilling bank management discipline.\(^ {83}\) Capital adequacy measures also remove uncontrolled competitiveness in a deregulated banking environment and establish a “level playing field” where every affected party can access information and evaluate his economic

\(^{77}\) For the justifications and criticisms of bank capital adequacy standards, see Joseph Norton, Devising International Bank Supervisory Standards (1995), pp. 22-36.

\(^{78}\) See ibid., pp. 23-31.

\(^{79}\) Capital is a necessary cushion to absorb unexpected losses or sustained losses. Lacking adequate capital, the banks' potential for failure is enhanced. See United States General Accounting Office, “Risk-Based Capital: Regulatory and Industry Approaches to Capital and Risk” (July 1998), p. 21.

\(^{80}\) See R. M. Pecchioli, The Internationalization of Banking (1983); see also United States General Accounting Office, “Risk-Based Capital . . . .,” op. cit., n. 79, p. 32.


positions. In the international area, the capital adequacy requirement framework has been applied to internationally active banks since the Basle Committee on Banking Supervision published its report on “International Convergence of Capital Measurement and Capital Standards” (the Basle Capital Accord) in July 1988. Under the Basle Capital Accord, capital adequacy measures are justified for the safety and soundness of the international banking system and competitive equality and transparency within international banking.

However, the capital adequacy requirement framework has some deficiencies. The major deficiencies stem from the arbitrary way in which the standards have been formulated and from the framework’s inability to adequately cover for banking risks. Notwithstanding the deficiencies of the Basle standards, as Greenspan observes, there is no choice but to continue to plan for a successor to the simple risk-weighting approach to capital requirements embodied within the current regulatory standards. Adding more and more layers of arbitrary regulation would be counterproductive. In addition, regulatory minimum capital adequacy requirements can serve to help ensure the stability

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84 See Norton, op. cit., n. 77, pp. 29-31.
85 The Basle Committee on Banking Supervision comprises representatives of senior officials of the central banks and supervisory agencies of Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, the Netherlands, Sweden, Switzerland, the United Kingdom, and the United States. The Committee meets regularly at the Bank for International Settlements, Basle, Switzerland.
86 See Norton, op. cit., n. 77, pp. 31-36.
87 The initial bank risk-based capital requirements primarily emphasised credit risk, reflecting the predominance of lending activities by the banks. In 1996, the Basle Capital Accord was amended in order to include corporate market risk requirements for specific types of assets that are often traded in the internationally active banks.
89 Ibid.
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of financial markets to which they apply by limiting bank failures and losses to customers or depositors.90

2. Development of Capital Adequacy Standards in Korea

Korea’s capital regulations date back to the enactment of the General Banking Act. The General Banking Act of 1950 prohibited banking institutions from maintaining risk assets in excess of ten times of equity capital.91 Those requirements eased to fifteen times of equity in 1962 for financing economic development programs.92 In 1969, the risk / asset based formula was changed to a payment guarantees based formula.93 The ratio (total payment guarantees and acceptances / capital) was again eased to twenty times of capital in 1977,94 and to twenty times of the bank’s equity in 1982.95

The Office of Bank Supervision (OBS) also required commercial banks to maintain certain “gearing ratios” in order to reflect desired levels of capital for liquidity purposes. In 1981, the OBS set capital-to-deposit guidelines at ten per cent for all banks. In 1988, in line with the ongoing financial liberalisation, the guideline was changed to the capital-to-total asset ratio.96 Under its guidelines, nationwide commercial banks and local banks were required to maintain a minimum of six per cent and eight per cent of

91 General Banking Act of 1950 art. 15 cl. 1. The risk assets were bank’s total assets less cash, deposits in the Bank of Korea and banks abroad, and amount of Monetary Stabilisation Bonds. The equity capital includes paid-in capital, reserved provisions and other surplus. In its allocation of the net profit earned in a fiscal term, a bank should credit at least ten per cent of the net profit to a legal reserve until such time as the reserve equals the amount of its total paid-in capital.
92 General Banking Act of 1962 art. 15 cl. 1.
93 General Banking Act of 1969 art. 15 cl. 1.
94 General Banking Act of 1977 art. 15 cl. 1.
95 General Banking Act of 1982 art. 15 cl. 1.
96 The gearing ratio is calculated as total assets (of banking account and trust account) / capital. The capital to asset ratio directs attention to the asset-side as a possible source of financial deterioration.
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capital to total assets, respectively. The minimum ratios were raised to eight per cent for
the nationwide banks and nine per cent for the local banks at the end of 1990. Actually,
however, the gearing ratios failed to carry out their prudential purposes. First, the ratio
did not weigh the risks of banks’ assets. Second, the OBS did not have or exercise
appropriate enforcement measures. When a bank failed to maintain the minimum ratios,
the OBS did nothing more than call the bank’s attention to the fact.

The amendment to the General Banking Act in 1991 required banks to maintain
prudent management and granted the Korean banking regulatory and supervisory
authorities, the Monetary Board and the OBS, powers to establish measures for banks’
prudent management. Thereafter, the Monetary Board introduced capital adequacy
requirements in July 1992. The capital requirements were based on the Basle
Committee’s risk weighted capital adequacy requirement. The Monetary Board and the
OBS enforced the requirement from the end of 1993. Initially, the banks were required to
maintain minimum 7.25 per cent ratio until the end of 1994. The full eight per cent ratio
has been imposed from the end of 1995.

3. **Shortcomings of Korean Capital Adequacy Requirements**

Although Korea has established capital adequacy requirements for the commercial banks
following the Basle Committee’s rules, the requirements have some shortcomings. First,
the priority of Korea’s capital adequacy requirement was not aimed at establishing
prudential standards for Korean commercial banks. Instead, the new capital requirements
were introduced in order to raise Korean banks’ credit standing in the international
finance markets, to promote preventive measures against adverse effects from the
banking deregulation, and to work toward international regulatory convergence. Although the introduction of capital adequacy requirements may have improved the general health of Korea’s banking system, the requirements have not contributed to the Korean banks’ prudent behaviour. Under the implicit guarantees inherent in the government’s policy of refusing to allow any bank to fail, the Korean banks did not view the capital adequacy requirement as a means to improve their prudential operations, but instead considered only the penalties from the supervisory authorities if they failed to maintain the ratios. Furthermore, the Korean government and the banking regulatory and supervisory authorities focused only on the consequences of Korean banks’ failing to maintain the capital requirement in the international financial markets.

Second, in spite of the fact that the framework of the Korean capital adequacy requirement was similar to that of the Basle Capital Accord, there was inadequate implementation. Pursuant to the requisites of the Basle Capital Accord, Korean capital adequacy ratios are calculated on a consolidated basis; capital includes both core capital (tier one) and supplementary capital (tier two); and assets are weighted item by item to reflect credit risks. The off-balance sheet engagements are also included in risk-

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99 The OBS suggested several strategies for strengthening the capital adequacy ratios in order to improve the Korean banks’ credit standing in the international financial markets. It suggested that if the Korean commercial banks failed to maintain minimum capital adequacy ratio of eight per cent, their credit standings would be deteriorated and their funding cost (borrowings) from the international financial markets would be increased. Thus, the Korean banks would experience unfavourable operational environments. See Office of Bank Supervision Press Release, “Commercial Banks’ Capital Adequacy Ratios ...,” op. cit., n. 97.
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weighed assets after conversion using credit conversion factors. In Korea, however, supplementary capital is made up of revaluation reserves, gains on securities valuation, general provisions for loan losses, and subordinated term debts. Gains on securities valuation may be included up to a maximum of forty-five per cent, and general provisions for loan losses are limited to a maximum of 1.25 per cent (1.5 per cent before the end of 1995) of risk-weighted assets.

Under the Basle standard, general provisions or general loan-loss reserves can be part of the supplemental capital. According to the Basle Committee:

[g]eneral provisions or general loan-loss reserves are created against the possibility of future losses. Where they are not ascribed to particular assets and do not reflect a reduction in the valuation of particular assets, ... Where, however, provisions have been created against identified losses or in respect of a demonstrable deterioration in the value of particular asset, they are not freely available to meet unidentified losses ... Such specific or earmarked provisions should therefore not be included in the capital base. (Italics added).

Korean implementation of the general provisions for loan-loss as supplemental capital is not in accordance with the Basle standards. Most Korean banks' general provisions for loan-losses are reserved for their non-performing loans. The loan loss provisions for Doubtful and Expected Loss loans, and part of Substandard loans are provisions created against an identified deterioration in the value of particular assets although they are not allocated to these assets. Those reserves cannot be used freely to cover unidentified future losses. Therefore, the "general provisions for loan-loss" are not suitable as supplemental capital for the capital adequacy requirement. This inadequate

101 See ibid.
implementation led to a distorted perception of the real status of Korean banks' capital ratios. For example, according to the OBS, Korean commercial banks maintained over ten per cent of capital ratios in 1993 and 1994.\textsuperscript{104} However, the OBS required the banks to maintain eight per cent of "real capital adequacy ratio." The "real capital adequacy ratio" was calculated based on the formula that the bad debts (Doubtful loans and Estimated Loss loans) were written off. Those ratios were not published by the OBS. But, under the "real capital adequacy ratio," five out of six large Korean nationwide commercial banks failed to meet the minimum eight per cent capital adequacy ratios at the end of 1993.\textsuperscript{105} It also revealed that the more bad loans a bank had, the more aggravated ratio the bank had.\textsuperscript{106} The new Financial Supervisory Commission (FSC) recognised this problem and announced an amendment to the definition of supplemental capitals for the capital adequacy ratio. Under the amendment, general loan-loss provisions for non-performing loans (Substandard loans, Doubtful loans and Estimated Loss loans) would be excluded from supplemental capital.\textsuperscript{107} The FSC imposed the new rule from 1 January 1999.

Third, Korean capital adequacy standards allow Korean banks to count up to forty-five per cent of their latent gains on securities holdings as supplemental capital.\textsuperscript{108} Since the Basle standards permit country regulators to have some discretion in their

\footnotesize{\textsuperscript{103} Chae, \textit{op. cit.}, n. 98, p. 56.  \\
\textsuperscript{104} The nationwide commercial banks maintained average 10.40 per cent and 10.19 per cent at the end of 1993 and 1994 respectively. The local banks maintained even higher ratios. They maintained average 14.86 per cent and 13.21 per cent at the end of 1993 and 1994 respectively. See \textit{ibid.}, pp. 54-61.  \\
\textsuperscript{105} See \textit{ibid.}, pp. 55-61.  \\
\textsuperscript{106} One nationwide bank, which had the largest amount of bad loans, had 5.47 per cent of "real capital adequacy ratio," even if its official capital adequacy ratio was 9.84 per cent at the end of 1993. See \textit{ibid}.  \\
\textsuperscript{108} Korean commercial banks are allowed to invest in stocks on their own account. Therefore, their portfolios are directly vulnerable to asset price fluctuations.}
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choice of supplemental capital, the treatment of latent gains on securities holdings is one of the areas where discrepancies arise across countries. For example, U.S. banks cannot count their latent gains on securities holdings as capital while their Japanese counterparts can. The inclusion of unrealised gains of investment securities in regulatory capital may intensify the volatility of capital adequacy ratios, thus having an inappropriate impact on banks' behaviour. 109 For example, Korea's stock market plunged from a high value of 1000 for the Korean stock market index in 1991 to 500 in 1995. After the financial crisis, the index plunged to less than 400. The deterioration of stock market values created large losses of investment securities, which deteriorated the banks' capital requirement ratios.

4. The Use of Capital Adequacy Requirements in Korea

Even if the current risk-based capital adequacy requirements are arbitrarily formulated and have limited coverage of banking risks, the capital requirements should be employed for improving the safety and soundness of Korean banking system and enhancing the transparency in the banking operations and banking regulatory and supervisory operations.

Given that Korean commercial banks now will have greater autonomy in their operations and less intervention, the Korean banking regulatory and supervisory authorities must establish adequate supervisory and examination tools for banking operations and the banks' positions. The capital adequacy requirement ratios provide an objective, rule-based standard. For example, the FSC uses the capital adequacy

109 See Tatsuya Yonetani and Yuko Katsu, "Fair Value Accounting and Regulatory Capital Requirements," papers presented at the seminar sponsored by the Federal Reserve Bank of New York,
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requirement ratios to determine the soundness of individual banks. When the capital adequacy ratio of an individual bank declines below a certain level, this automatically triggers supervisory enforcement measures by the FSC.

Second, the capital adequacy requirements can provide individual banks with a method to improve management discipline. Since the financial crisis in 1997 in Korea, the capital adequacy requirement ratios have attracted particular attention from the public. Bank managers have sought public confidence by increasing the capital adequacy requirement ratios. Now that the Korean banking regulatory and supervisory authorities have abolished guidelines which allowed the banks report better figures than their true positions, bank managers need to act more prudently than before to protect their banks’ capital adequacy ratios.

Third, the capital adequacy requirement ratios as objective standards provide transparency in the Korean banking operations. When correctly implemented, capital adequacy requirements prevent banks from extending political loans, which would eventually deteriorate banks’ financial positions. The Korean banks are thus encouraged to establish more transparent lending policies and standards to maintain the requirements. Moreover, the banking regulatory and supervisory authorities could not cover any irregularities (e.g., those arising from political loans). The objective capital adequacy requirements provide a restraint by limiting the regulatory and supervisory authorities’ forbearance.

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B. Loan Classification and Adequate Provisions

Korea's failure in the area of prudential banking regulations did not arise mainly from the absence of prudential rules, but from weak implementation and poor supervisory practices. Even if the Korean capital adequacy requirements have some shortcomings, the major banking problems come from insufficient and ineffective mechanisms for enforcing those rules. For example, applying the Basle eight per cent capital adequacy rule without adequate loan loss provisioning distorts the information value of the capital ratios. Compliance with the eight per cent capital adequacy rule without adequate reserves for loans of doubtful quality renders the ratios meaningless as banks may boost capital ratios at the expense of provisioning. Therefore, under the Basle capital adequacy rule, the regulatory and supervisory authorities should set out clearly the criteria, rules, and practices for loan classification and loan loss provision.

1. Loan Classification and Loan Loss Provision Requirement before the Crisis

In the past, the Korean banking supervisory authorities required Korean commercial banks to classify their assets into five categories: normal, precautionary, substandard, doubtful, and estimated loss. Pursuant to these regulations, banks' assets included loans and discounts, domestic import usance bills, advances for customers, contra account of acceptances and guarantees, foreign exchange, letters of credit, securities,

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111 Regulations Concerning the Supervision of Banking Institutions of the Bank of Korea art. 20.
advanced payments, credit card loans, and receivable claims.\textsuperscript{112} Among the banks’ assets, loan quality is most important to safety and soundness because loans are ordinarily a bank’s single largest asset and represent the greatest potential for loss.\textsuperscript{113} The FSC also implements the definition of loan classification as the principle standard for other bank assets.\textsuperscript{114} Under the regulations established by the Monetary Board, Korean commercial banks had to classify their loans into five categories:\textsuperscript{115}

1. Normal loans were defined as total credits extended to customers maintaining sound financial condition, credit standing, and business standards.

2. Precautionary loans were defined as total credits extended to customers who call for particular attention in post-management based upon financial condition, credit standing, and business standards. The supervisory authorities required the commercial banks to classify overdue loans in arrears for from three months to six months as precautionary assets.

3. Substandard loans were defined as the estimated amount to collect among the total credits extended to customers who have an unfavourable financial condition, credit standing, or business standard which requires some concrete steps of collecting the credit. The overdue loans in arrears for six months or more were classified as substandard loans. The OBS required the banks to calculate the estimated amount based on its guidelines.\textsuperscript{116}

\textsuperscript{112} Detailed Enforcement Regulations Concerning the Supervision of Banking Institutions of the Bank of Korea art. 46.


\textsuperscript{114} Securities are classified with different standard and the Korean commercial banks need to reserve securities loss provisions separated from the loan loss reserve.

\textsuperscript{115} Detailed Regulations Concerning the Supervision of Banking Institutions of the Bank of Korea app. 4.

\textsuperscript{116} Detailed Regulations Concerning the Supervision of Banking Institutions of the Bank of Korea art. 49; Detailed Regulations Concerning the Supervision of Banking Institutions of the Bank of Korea app. 5.
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(4) Doubtful loans were defined as the portion of credits among total credits extended to customers classified as substandard which is expected to be a loss but has not yet been recognised as such.

(5) Estimated loss loans were defined as the portion of credits among total credits to customers classified as substandard which must be accounted as a loss because collection will not be possible.

Under the regulations, however, industry rehabilitation loans\(^{117}\) were subject to a different classification. Since industry rehabilitation loans extended to non-viable companies, the supervisory authorities required commercial banks to classify them as normal, substandard, and estimated loss loans. Industry rehabilitation loans, which were a type of credit that earns more than the prime-rate, were classified as normal loans. The loans, the interest of which were exempted or given a grace of payment, were classified as substandard loans. If the bank waived the credits, the loans were classified as estimated loss.

After asset classification, Korean commercial banks were required to reserve 0.5, 1, 20, 75, 100 per cent of total amount against normal, precautionary, substandard, doubtful, and estimated loss assets as loan loss provisions.\(^{118}\)

2. **Strengthening of Loan Classification and Loan Loss Provisions Requirements**

Under the agreement with the International Monetary Fund,\(^{119}\) the FSC enhanced its loan classification and loan loss reserve requirements. From July 1998, Korean commercial

\(^{117}\) The industry rehabilitation loans are bank credits to companies which are subject to the government's corporate sector restructuring plans. See J. B. Choi, *op. cit.*, n. 37, pp. 118-123.
banks are required to classify their loans in arrears for three months or more as substandard instead of precautionary, and those in arrears for from one month to three months as precautionary instead of normal loans. The loan loss provision requirements are also tightened. From July 1998, the required provisioning rate for precautionary assets is two per cent from one per cent. The FSC also requires the commercial banks to reserve loan loss provisions for payment guarantees. Even if Korean commercial banks had to classify payment guarantees of which the principal obligation is recognised as contra account of acceptances and guarantees, the supervisory authorities did not require the banks to reserve provisions against them.

Some assets in trust accounts such as commercial paper, guaranteed bills and privately placed bonds are virtually equivalent to credit extensions, but classified as securities which are subject to different provision rules. The FSC includes such assets in the asset category subject to loan loss provisions. In addition, the requirement of 100 per cent of loan loss provisions for trust accounts with guarantees of principal has been added to those with guarantees of interests.

118 Detailed Regulations Concerning the Supervision of Banking Institutions of the Bank of Korea app. 3.  
119 See Republic of Korea, "Memorandum on Economic Programs" (13 Nov. 1998).  
120 Detailed Regulations Concerning the Supervision of Banking Institutions app. 3.  
121 Ibid. art. 38 cl. 1.  
122 The commercial banks are required to reserve 20, 75, 100 per cent of total amount against substandard, doubtful, and estimated loss payment guarantees as payment guarantee loss provisions. Ibid. art. 38 cl. 6.  
123 Ibid. app. 3.  
124 Ibid. app. 2.
3. Loan Classification Standards and Appropriate Loan Loss Reserves

(a) Who Establishes the Loan Classification Standards

To provide the true picture of a bank's condition, the loan classification standards need to reflect the particular bank's environment. Korea's specific loan classification guidance can provide a means for quantifying the credit risk factors. However, if the standards are weak, banks have opportunities to delay recognition of losses in their loan portfolios and to mask the need for regulatory intervention. If the standards are too onerous, banks have to reserve unnecessary loan loss provisions that result in loss of profits. Therefore, each Korean commercial bank should establish its own loan classification standards which adequately reflect its own specific circumstances rather than follow the guidelines in the regulations.

(b) Adequacy and Transparency

To be able to prudently value loans, the loan classification standards should be objective. The current Korean regulatory classification standards are based on the borrower's past or current financial performance and they do not take into account the future performance of a borrower and its projects which affect the prospects for collection of loans. If the bank's assets do not have an objectively determined market value, it is difficult to assess the value of problem loans. For example, if the loan classification is dependent only on

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the loan’s payment status, such as in Korea, without regard to the borrower’s creditworthiness or to the market value of collateral, then the delay in recognising bad loans can be considerable.\textsuperscript{126} Therefore, loan classification should be based on the borrower’s past financial performance, the current financial condition as well as its projections of future performance.\textsuperscript{127}

It is essential that the approach that the individual bank sets in its own loan classification standards require the bank to have adequate policies, practices and procedures for evaluating the quality of loans. The loan classification policies and procedures should be written forms in order to be examined by the supervisory authorities and updated regularly to maintain appropriate standards. The role of the supervisory authorities should be evaluating the bank’s written policies and procedures based upon its own guidelines, and confirming the bank’s practices.

(c) Appropriate Loan Loss Reserve Requirements

Even if banks classify their loans appropriately, adequate loan loss reserves are critical to bank safety and soundness and essential to early identification of deteriorating financial conditions.\textsuperscript{128} First, capital difficulties are frequently caused by losses from bad loans and inadequate loan loss reserves are a common characteristic of banks which fail.\textsuperscript{129} And a misstatement of the loan loss reserve affects capital and earnings, thus failing to

\textsuperscript{127} See Federal Reserve Board, Commercial Bank Examination Manual, sec. 2060.1, Classification of Credits.
\textsuperscript{129} Ibid., p. 2.
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reveal the bank's true financial conditions. If the non-performing loans are systematically understated, the loan loss provisions are apt to be too low, and the bank net income and capital will be systemically overstated. Second, an inadequate reserve also affects the examiners' ability to identify deteriorating financial conditions that may require supervisory action between on-site examinations.

It is unclear that, in Korea, the current loan loss provision requirement practices are adequate to state current financial conditions and provide sufficient protection against future problems. The use of standard percentages derived from historical averages ("rule of thumb approach") is likely to be misleading when applied to an individual bank, since differences in loan portfolio characteristics, as well as current financial conditions, are not considered. Since the Korean loan loss provision requirements are based on the "rule of thumb approach," the same problem arises in Korean banking supervision.

Like the loan classification standards, to take into account the individual circumstance, the FSC needs to impose ultimate responsibility for establishing and maintaining adequate loan loss reserve methodologies on individual banks. Then the FSS should assess the reasonableness of banks' methodologies. The currently used "rule of thumb approach" calculation should not be considered a floor or a safe-harbour level for a bank's loan loss reserve. The FSS should use the current standards as a "general

130 Ibid., p. 33.
131 Song, op. cit., n. 126, p. 24.
134 The FSC does not mention that its requirements are based on the historical averages. But the FSC regulations provide that the estimated loss amounts are same percentage as the loan loss provisions. See Detailed Regulations Concerning the Supervision of Banking Institutions app. 13.
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guidance," taking into account the bank’s individual circumstances.\textsuperscript{136} But the FSS needs to develop a reliable methodology in order to effectively challenge bank managements’ reserving methods and results.\textsuperscript{137}

(d) Preventing Forbearance

Only with realistic loan classification and provisioning criteria are bank supervisors and examiners able to identify asset quality problems and to ensure that banks take the necessary corrective action. When the regulatory and supervisory authorities confirm a bank’s asset classification policies and procedures and the loan loss reserve methodology, it is essential for banks to maintain the standards until proper modification is implemented. Forbearance allows weak banks with distorted incentives to continue operating, or invites looting by insiders, leading eventually to much larger clean-up costs.\textsuperscript{138} For example, the Korean supervisory authorities employed forbearance policies before the financial crisis of 1997. Even if the regulations required the Korean commercial banks to reserve more than 100 per cent of loan loss provisions, the OBS permitted the banks’ reserves to average 94 per cent of estimated loss loans as an interim target ratio in 1997. The Korean forbearance polices distorted the ability to identify and correct the banking problems.

\textsuperscript{136} See \textit{ibid.}


\textsuperscript{138} Financial Stability in Emerging Market Economies, \textit{op. cit.}, n. 61, p. 18.
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C. Internal Control Systems

1. The Need for Internal Control Systems in Korean Commercial Banking

Korea’s past regulatory and supervisory practices have controlled every aspect of banking operations. Such practices resulted in weak internal control systems in the Korean banking system. Together with the weak classification and provisioning requirements for problem loans, the weak internal control systems failed to provide the banks with appropriate incentives to act prudently.

After the financial crisis in 1997, Korea has adopted reform policies which are consistent with economic rationales. Under the policies, Korea’s banking reform enhances the liberalisation of the financial market. The liberalisation policies increase the competitive environment of the banks. A competitive environment needs management soundness in order to promote financial stability. Therefore, when strict regulatory controls are removed, the need for banks to develop sophisticated self-regulatory mechanisms is evident. If the banks do not adopt alternative control systems, the liberal circumstance encourages some banks to engage in imprudent activities, which result in banking problems.

First, a system of effective internal controls is a critical component of bank management and a foundation for the safe and sound operation of banks. It promotes

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bank safety and soundness by preventing problems or irregularities from occurring.\textsuperscript{142} The lack of good internal controls puts banks at risk of mismanagement, waste, fraud, and abuse.\textsuperscript{143} The BCCI affair clearly shows the need for an appropriate internal control system. Owing to the absence of effective prudential supervision, which requires an appropriate internal control system, BCCI was allowed to engage in myriad irregular, often illegal, operations.\textsuperscript{144}

Second, together with the regulatory and supervisory prudential rules, appropriate internal control systems can provide a framework to secure the soundness of banks. A weak economy tends to expose internal problems which may not be evident when a bank is operating in a strong economy.\textsuperscript{145} In a strong economy, a bank with strong management and strong internal controls will most likely be healthy, and even a bank with weak management and weak internal controls may be able to continue to operate, although it may be considered a problem bank. In a weak economy, a bank with strong management and strong internal controls will probably be able to remain sound, but a bank with weak management and weak internal controls is likely to fail.\textsuperscript{146} Therefore, good internal controls tend to serve as a buffer to protect banks from adverse economic conditions and enhance a bank’s viability.\textsuperscript{147}

Third, appropriate internal systems create a sound credit culture necessary to the Korean banking system in the new economic environment. The weaknesses in the

\textsuperscript{142} United States General Accounting Office, “Bank Examination Quality: OCC . . . ,” \textit{op. cit.}, n. 113, p. 15.
\textsuperscript{143} United States General Accounting Office, “Bank Examination Quality: FRB . . . ,” \textit{op. cit.}, n. 133, p. 4.
\textsuperscript{144} For more the internal controls and the BCCI affairs, see John F. Mogg, “Internal Controls: The EC Response to BCCI,” in Ray Kinsella ed., \textit{Internal Controls in Banking} (1995).
\textsuperscript{146} \textit{Ibid.}
management of banks lead to excessive risk taking and undermine corporate governance
and market discipline.\textsuperscript{148} A sound credit culture is one of the key elements necessary to
the development of a robust financial system.\textsuperscript{149} To establish and maintain a sound credit
culture, Korean banks need appropriate internal control systems which create the
foundations of good institutional governance.

Furthermore, in Korea, internal control systems can be used as a “firewall” for the
banks against the government’s unfettered interference in banking operations and
political loans, which are motivated by political or non-business considerations. As
experienced in Korea, government interventions blunt the banks’ incentives to discipline
poor performers. Once an appropriate internal control system is established and well
operated, the possibility of the government’s unfettered interference and the political loan
problems can be greatly reduced. The appropriate internal control system requires the
bank to operate in a transparent manner. Therefore, the irregular transactions, for
example lending influenced by the government or the politicians, can be detected and
subject to scrutiny.

2. \textit{Establishing the Internal Control Systems}

To establish adequate internal control systems in the Korean banking system, it is
essential that the primary responsibility is placed on the individual banks. First, it is
impossible to achieve banking system stability without individual banks’ financial
stability. The essential purpose of internal control systems is to safeguard the financial


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integrity of banks.\textsuperscript{150} By imposing responsibilities for operating in a sounder and more prudent fashion, the banks have to exercise a much higher degree of care. Banks also must realise that they are no longer safe from failures because the government's guarantee is removed. Second, standard internal control systems, designed to fit all commercial banks, are likely to be misleading when applied to individual banks. The current bank restructuring program in Korea would change the banking market into specialised market shares.\textsuperscript{151} Acknowledging their limited administrative capacity, instead of trying to solve all problems by themselves, the Korean regulatory and supervisory authorities should encourage commercial banks to establish their own internal structures to administer lending and manage risks. Since the individual arrangements may differ, the FSC and the FSS should check that banks meet minimally acceptable standards and monitor banks' compliance with those standards.

To impose the responsibilities for establishing adequate internal control systems on the individual banks, it is essential that banks have managerial autonomy. Without managerial autonomy, it is uncertain that banks, especially bank managements, can rebuff the government's undue intervention. For example, when the government can influence appointments of bank management, the bank management tends to follow the government's directions rather than do what is financially sound for the bank.

Even if individual banks have primary responsibilities for internal controls, underlying any solution to enhance bank internal control systems must be a co-operative

\textsuperscript{149} See Financial Stability in Emerging Market Economies, op. cit., n. 61.
effort between banks and regulators. Of them, banks have the primary responsibilities to have an adequate internal control system for bank soundness. Then the regulatory and supervisory authorities have the responsibilities for assessing whether the internal control system is appropriate and is well functioning. By assessing each bank's internal control system and identifying the weaknesses, the regulatory and supervisory authorities can recognise problems as early warning signs of financial deterioration and consider them in assessing bank safety and soundness.

3. Components of Internal Control Systems

(a) Adequate organisational structures

(1) Board of directors

To have adequate internal control systems, banks need a board of directors responsible for (1) approving and reviewing the overall business strategies and operating policies of the bank; (2) approving the organisational structure, especially for adequate internal control structure; (3) ensuring that senior management takes the steps necessary to identify, measure, monitor and control the major risks run by the bank; and (4) ensuring that senior management is monitoring the effectiveness of the internal control system. More specifically, the board of directors is responsible for ensuring that an adequate and

effective system of internal controls is established and maintained. It is also important that, in an effective system of internal controls, the directors can discharge their fiduciary duties without undertaking day-to-day monitoring of management.

The General Banking Act gives the board of directors of Korean commercial banks powers to review and approval matters concerning (1) management targets and appraisal, (2) the amendment of the articles of incorporation, (3) the budget, and (4) important organisation changes, such as dissolution, transfer of business and mergers. Since Korean banks are established as limited companies under the Commercial Code, a board of directors also has the powers to approve the company's operations and oversee the director's work. However, neither the Commercial Code nor the General Banking Act provides clear authority or responsibility for a bank's board of directors to have an adequate internal control structure. It is desirable that the General Banking Act provides clear structural responsibilities for the internal control system in Korean commercial banks. Until then, the FSC should provide that a board of directors of a bank has powers to establish an adequate internal control system and relevant policies, and to review its effective and efficient operations.

To ensure that it carries out its duties effectively, a board of directors should be sufficiently independent from the management. Without independence, the board of directors can not deter unsafe and unsound banking practices and other management

156 Ibid.
158 General Banking Act art. 23. Until February 1999, the board of directors could review and approval matters concerning steps for the resolution of bad loans and financial incidents whose scale was determined by the FSC.
159 Commercial Code art. 393.
abuses. To achieve independence, the non-executive members of the board have important roles to prevent the executive directors from controlling the board. Under the General Banking Act, a bank is required to have both executive directors and non-executive directors. The number of executive directors must be less than half of the total number of directors. The non-executive directors are recommended by the representatives of shareholders (70 per cent of non-executive directors) and by the board of directors (30 per cent of non-executive directors). Moreover, in respect of listed company on the Korea Stock Exchange, at least 25 per cent of board members (minimum one member) in a bank should be independent non-executive directors who are not related to the bank.

(2) Bank management

Once the board of directors approves the relevant bank operating policies, senior bank management is responsible for executing bank operations within the policies. The senior bank management, including the president of bank and the executive directors, is responsible for implementing strategies and policies approved by the board of directors; developing processes that identify, measure, monitor and control risks incurred by the bank; maintaining an organisational structure that clearly assigns responsibility, authority and reporting relationships; setting appropriate internal control policies; and monitoring...

160 General Banking Act art. 22 cl. 2.
161 Regulations on Securities Listing (stipulated by the Korea Stock Exchange under the Securities and Exchange Act) art. 48.5 cl. 1.
162 See H. J. Lee (the Chairman of the FSC), "Policy Directions for Economic Restructuring," address to the Korea Chamber of Commerce (4 Feb. 1999).
the adequacy and effectiveness of the internal control system.\textsuperscript{163} To ensure the management's effective function, the management needs to be free from other interest groups, especially the government. It is doubtful that, in Korea, the current appointment procedure for the bank management, especially the president of a bank, can prevent from the government's interference over appointment of the bank management. A president of a Korean commercial bank is recommended by the candidate recommendation committee, consisting of all non-executive directors, before appointment by the shareholders meeting.\textsuperscript{164} However, it is long argued that bank management appointments have been influenced by the government. It is essential, in Korea, that bank management is selected and appointed free from any unreasonable considerations.

(3) \textit{Internal Auditor}

Korean commercial banks are required to have an internal auditor. The internal auditor needs to review the accounting and other records and the internal control environment. The internal auditor also needs to be independent from the operational management. The internal auditor is essential for an effective internal control system to monitor the system by providing independent assessment of the adequacy of, and compliance with, the established policies and procedures.\textsuperscript{165}

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\textsuperscript{163} Basle Committee on Banking Supervision, "Framework for Internal Control Systems ...," \textit{op. cit.}, n. 141, p. 11.
\textsuperscript{164} General Banking Act art. 24.
\textsuperscript{165} Basle Committee on Banking Supervision, "Framework for Internal Control Systems ...," \textit{op. cit.}, n. 141, p. 20.
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(b) Lending Standards

An appropriate internal control system requires establishing policies governing lending standards and other financial decisions that are explicit, transparent and disseminated throughout the organisation. Among the internal controls, controls over loan operations have paramount importance because loans typically comprise most of banks' assets and involve significant risk. For sound bank management, the lending standards need to include lending policies, prudent credit approval procedures, risk limitation, and administration procedures. To enhance the transparency in the banks' lending activities, the banks need to be required to have "written and detailed" loan policies and procedures which provide assurance that loans are properly extended within the policies and procedures. In addition, throughout the life of the loans, complete and current credit information must be maintained.

In Korea, the lack of autonomous lending activities has been identified as one of the major problems in the banking industry. The lending decisions of Korean banks have not been based on strict analysis of the profitability of borrowers' investment projects. Rather, in the case of big firms, the banks have shown the tendency to lend money in the belief that these are too big to fail, while in case of small and medium size firms the lending decisions have been based mainly on the collateral offered.

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166 See Financial Stability in Emerging Market Economies, op. cit., n. 61, p. 34.
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securing autonomous lending decisions, Korean commercial banks can not be shielded from unreasonable interference by the government and other interest groups. First, in this circumstance, the appropriate lending policies and standards, which are explicit, detailed and transparent, can help to prevent the banks from extending unsound loans. Second, given the Korean banks have full autonomy in their lending activities, the appropriate lending standards will be one of the major areas that the banking regulatory and supervisory authorities review and assess in order to ensure that banking problems do not arise from imprudent lending activities.

(c) Risk Management Standards

Sound internal risk management is essential for the prudent operation of individual banks and for promoting stability in the financial system generally. As financial markets develop and new complex instruments are introduced, effective risk management of banks becomes even more critical. Therefore, an effective internal control system requires that the banks have their own adequate risk management standards that recognise and continually assess the material risks that could adversely affect the banks.

In general, Korea’s banking crisis in 1997 did not come from extraordinary technical transactions but mainly from plain asset quality problems and market risk exposures, especially to currency risk. This resulted from the lack of understanding of the risks entailed in banking by Korean commercial banks as well as Korea’s bank

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173 Financial Stability in Emerging Market Economies, op. cit., n. 61, p. 34.
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regulatory and supervisory authorities and from the weak risk management systems in the
Korean banking system. According to one survey, most of Korean commercial banks
have established asset and liability management (ALM) organisations and operated the
ALM systems as the risk management system.175 But the ALM systems of Korean banks
are at the beginning stage and have not influenced the decision making processes for risk
management.176

The Korean banking regulatory and supervisory authorities need to focus on the
internal risk measurement and management processes of banks with more risk-focused
policies. This approach reinforces market incentives that prompt banks themselves to
invest heavily to improve their management information systems and internal systems for
quantifying, pricing, and managing risk.177 In other words, the regulatory and
supervisory authorities need to supply general guidelines for the risk management
principles, while the banks are encouraged to develop their own risk management
systems. Until the Korean banks develop adequate risk management standards, the FSC
and the FSS need to provide their guidelines for the banks to develop their own risk
management systems. After the Korean banks establish individual risk management
systems, the FSC and the FSS need to continuously assess whether the banks have
adequate policies and procedures for identifying, monitoring and controlling risks. For
example, when banks engage in large borrowing in foreign currency, it is necessary for

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175 In April 1997, of 18 Korean commercial banks, 16 banks had established ALM systems and the other
two were introducing the systems. Y. K. Hahm, “Adoption and Impact of Risk Management System in
176 Ibid., p. 37. The FSC also noticed that the risk management in Korean banks is infant stage. See
op. cit., n. 125.
177 Alan Greenspan, “The Role of Capital ...,” op. cit., n. 88.
banks to have adequate risk management systems to prepare for a large and sudden change in exchange rates.

(d) Adequate Administration Procedures

For effective internal control systems, appropriate administration procedures are necessary to ensure that the established policies are followed and that special interests are not allowed to influence decisions.\textsuperscript{178} Compliance with an established internal control system depends heavily on a well documented and communicated organisational structure that clearly shows lines of reporting responsibility and authority and provides for effective communication throughout the organisation.\textsuperscript{179} A clear allocation of duties and responsibilities can provide a structural framework which helps to remove the possibilities of unreasonable influences. All levels of personnel in the bank will understand that any policy violations or illegal actions are eventually noticed and the responsibilities are located.


\textsuperscript{179} Basle Committee on Banking Supervision, “Framework for Internal Control Systems ...,” \textit{op. cit.}, n. 141, p. 12.
III. MONITORING MEASURES AND PROMPT REGULATORY ACTION

A. Disclosure Standards and Off-Site Surveillance

I. Public Disclosure

(a) Purposes and Benefits of Public Disclosure

Financial markets contain disciplinary mechanisms that can reinforce the efforts of supervisory authorities by rewarding banks that manage risk effectively and penalising those whose risk management is inept or imprudent. The effective functioning of market discipline could produce the optimal combination of financial stability and efficiency and make the regulation and supervision of a banking system minimal. However, since market discipline can work well only if several conditions are met and the conditions are difficult to meet, market discipline should be used as the complimentary means for the banking regulation and supervision.

Public disclosure has several benefits in promoting safety and soundness in the banking system. First, public disclosure helps prevent the occurrence of problems in

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182 See Timothy Lane, “Market Discipline,” IMF Working Paper No. WP 92 42 (1992). Lane classifies the conditions into four categories:
(1) Financial and credit markets must be open and contestable;
(2) Financial operators must react rationally to the incentives provided by prices and risks that they are able to assess;
(3) Information on the activities and financial conditions of borrowers, lenders and intermediaries, must circulate quickly and spread symmetrically over the capital market; and
(4) Bailout of insolvent operators must not be anticipated.
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banks. Enhanced public disclosure allows market discipline to work earlier and more effectively, thereby strengthening the incentives for banks to behave in a prudent and efficient manner.\textsuperscript{183} Second, timely public disclosure can reduce the severity of market disturbance because market participants are informed on a more ongoing basis and, therefore, not as likely to overreact to information about current conditions.\textsuperscript{184} Third, public disclosure can reinforce specific supervisory measures designed to encourage banks to behave prudently by requiring banks to disclose whether or not they are in compliance.\textsuperscript{185} By improving public disclosure, therefore, the banking regulatory and supervisory authorities strengthen market participants’ ability to encourage safe and sound banking practices. To achieve the objective, a bank must provide timely, accurate, relevant and sufficient disclosures of qualitative and quantitative information that enables users to make proper assessment of the institution’s activities and risk profile.\textsuperscript{186}

(b) Public Disclosure in the Korean Banking System

Korean commercial banks are required to publicly disclose (1) annual balance sheet as of the closing date, (2) income statement for the fiscal year, and (3) combined financial statements within three months from the closing date of accounts.\textsuperscript{187} Korean commercial banks are also required to submit their balance sheets to the Bank of Korea by the end of each month, and the Bank of Korea shall publish them in its monthly statistical

\begin{footnotesize}
\begin{itemize}
\item \textsuperscript{183} Basle Committee on Banking Supervision, "Enhancing Bank Transparency," \textit{op. cit.}, n. 180, p. 6.
\item \textsuperscript{184} \textit{Ibid.}, pp. 6-7.
\item \textsuperscript{185} \textit{Ibid.}, p. 7.
\item \textsuperscript{186} \textit{Ibid.}, p. 4.
\item \textsuperscript{187} General Banking Act art. 41 cl. 1.
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Under the General Banking Act, the FSC requires Korean commercial banks to disclose the management performance. The management performance disclosure includes matters relating to (1) the organisational structure and personnel, (2) financial account and income account, (3) fund raising and its management, (4) management indexes for prudence, profitability, and productivity, and (5) important bank management subjects, such as management policies and risk management, which was required by the FSS. Korean commercial banks are also required by the FSC to disclose events which have a significant effect on prudential management. These include the occurrence of bad loans and financial incidents, and the imposition of management improvement orders. In addition, Korean commercial banks are required to report their annual shareholders’ meeting (1) changes in bad and non-performing loans for the fiscal year, and (2) the conditions relating to borrowers whose loans become significant bad loans or non-performing loans. All public disclosures are published in the forms established by the FSC, the FSS, or the Bank of Korea.

Until October 1998, Korean commercial banks were required to publicly disclose fifty-five items relating to the above requirements. From November 1998, the FSC requires the commercial banks to disclose information under the Financial Industry Public Disclosure Standards. Under the standards, the FSC enhances the disclosure requirements. After establishing the standards, Korean commercial banks are required to

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188 Ibid.
189 Ibid. art. 51.
190 Regulations Concerning the Supervision of Banking Institutions art. 38 cl. 1.
191 Ibid.
192 Ibid. art. 38 cl. 3.
193 See Detailed Enforcement Regulations for Supervision of Banking Institutions art. 43.
194 Ibid. art. 44.
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disclose five more items\textsuperscript{195} relating to (1) foreign currency dominated assets and liabilities, including foreign currency liquidity ratios, (2) off-balance sheet activities, including large losses under derivative contracts, (3) credit ratings by the rating agencies, (4) risk management, (5) transactions with affiliates, (6) transactions with the Bank of Korea and other financial institutions, and (7) trust accounts.

\textit{(c) Components of Public Disclosure}

Public disclosure should be relevant and sufficient. The Basle Committee recommends that, for enhancing bank transparency, the regular financial reporting and other public disclosure information, in clear terms and appropriate details, should include (1) financial performance, (2) financial position (including capital, solvency and liquidity), (3) risk management strategies and practices, (4) risk exposures, (5) accounting policies, and (6) basic business, management and corporate governance information.\textsuperscript{196} In Korea, however, public disclosure has been limited to the status of financial statements. Since the FSC has enhanced the public disclosure requirements in the areas of risk management, off-balance sheet transactions, asset classification, and special disclosure items such as those related to financial mishaps and losing a lawsuit involving a large sum, the information from such disclosure can help the market participants, especially the financial market professionals who are able to process highly sophisticated information and directly influence bank behaviour. There are, however, areas to improve the public disclosure in the Korean banking system. For example, trust businesses by commercial


\textsuperscript{196} Basle Committee on Banking Supervision, "Enhancing Bank Transparency," \textit{op. cit.}, n. 180, p. 17.
banks are not subject to the same standards as the banking business generally. The trust business should be disclosed under the same standards as the banking business because, in order to enhance market discipline, disclosure should include the entire spectrums of banks' operations.

Public disclosure should be timely. Information released "too late" considerably reduces the value of public disclosure. To give a meaningful picture of a bank, the information should be provided with sufficient frequency and timeliness.\textsuperscript{197} In Korea, the FSC has increased the frequency of regular disclosure (most disclosure of information required by the General Banking Act and the FSC) from once a year to twice a year. Quarterly disclosure is to be recommended after the introduction of quarterly accounting requirements from September 1999. Information on the occurrence of large bad loans and financial incidents is necessary to disclose immediately in a reliable way. Such information has the strongest potential to trigger market reactions and the banks are always reluctant to provide it.\textsuperscript{198} When such negative information is disclosed involuntarily or indirectly, the markets' reaction can be very harsh.\textsuperscript{199}

Information from public disclosure should be accurate. The bank management and internal auditor have primary responsibilities for providing accurate information. The external audit can ensure the accuracy of information provided by the banks but tends to delay the release of information.\textsuperscript{200} Moreover, it is difficult to ensure that the forward-looking information, such as earning predictions, is accurate or reliable when

\textsuperscript{197}Ibid., p. 16.
\textsuperscript{199}Ibid.
\textsuperscript{200}Basle Committee on Banking Supervision, "Enhancing Bank Transparency," \textit{op. cit.}, n. 180, p. 16.
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released. Therefore, the accuracy of information needs to be reviewed and assessed by the supervisory authorities. Any substantial false or misleading information and omission should be penalised. Furthermore, a key means of ensuring accurate and reliable information is adequate accounting standards. Objective official accounting standards help diminish manipulative practices and avoid confusion on the part of users of financial information.

2. Supervisory Reporting and Off-Site Surveillance

Off-site surveillance provides early warning of actual or potential problems and a means for monitoring banking performance. To have effective off-site surveillance system, the banking supervisory authorities require timely, accurate, relevant and sufficient information. The information, which the banking supervisory authorities need, includes not only the publicly disclosed information but also other information about the banks for their own use. After collecting information, the supervisory authorities need to analyse it in order to assess the condition of individual banks and the banking system as a whole. More specifically, the supervisors need to detect potential problems at an early stage and identify trends not only for particular institutions, but also for the entire banking system.

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201 Ibid., p. 16.
202 The accounting standards will be discussed in Section B.
203 See United States Department of Treasury, op. cit., n. 83, Discussion Chapter XI.
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Korean commercial banks are required to submit to the FSS operation reports (call reports) of the preceding month by the end of each month. The FSS stipulates the types and contents of call reports in its procedures for the detailed enforcement regulations. Under the procedures, the call reports include matters concerning (1) the bank’s structure and personnel, including the articles of incorporation, and stockholding by single stockholders, (2) financial conditions, (3) affiliates, and (4) lending activities. The FSS also requires Korean commercial banks to report the occurrence of business suspension, the suspension and resumption of deposit payment, the changes of directors, and the imposition of supervisory measures by foreign supervisory authorities to the foreign establishments immediately. Moreover, the FSS can require Korean commercial banks to submit reports and data on their operations and finances.

In general, the reporting requirements to the FSS are very broad and the FSS can acquire any reports and data from the banks if it decides that they are necessary to the FSS’s operations. It is difficult to draw a clear line for relevant and sufficient information. However, the reporting requirements must be designed to make more transparent the true position of banks, but not to impose substantial costs on the banks by requiring irrelevant reports or data, because the FSS’s goals of operation are to promote financial stability in the Korean banking system rather than control it. When the FSS decides to require any reports and data, it should consider whether the management

206 General Banking Act art. 47 cl. 1. But the FSS requires the commercial banks to submit the call reports by the 20th day of each month. Detailed Enforcement Regulations for Supervision of Banking Institutions art. 64 cl. 1.
207 Detailed Enforcement Regulations for Supervision of Banking Institutions art. 64 cl. 5.
208 General Banking Act art. 47 cl. 3; Act Concerning Establishment of Financial Supervisory Organisations art. 40 cl. 1.
209 Within well-managed banks, information that is relevant should already be available internally and used by management to operate the business. Basle Committee on Banking Supervision, “Enhancing Bank Transparency,” op. cit., n. 180, p. 10.
and auditor reporting requirements are intended to (1) focus management's attention on its accountability for internal controls and compliance with laws and regulations, (2) improve the regulatory agencies' ability to detect unsafe and unsound conditions at an early stage, and (3) support prompt regulatory action to ensure that deficiencies which may threaten an institution's solvency are corrected in a timely manner.210

Since October 1996, the OBS, now the FSS, has conducted off-site surveillance by establishing a special team in each examination department. The FSC establishes a plan to employ off-site surveillance as one of the main supervisory instruments of consolidated financial supervisory services.211 Under the plan, special task forces, which are dealing with off-site surveillance only and separated from examination teams, are to be established in each examination department.212 However, when the FSC establishes the off-site surveillance structure, it is important to have a clear relationship between the off-site surveillance and the examination teams. The co-operation between the off-site surveillance and the examination teams is crucial because the serious problems detected by the off-site surveillance team would trigger the examination and the examination team needs the information the off-site surveillance team has before and during the examination. With the information, the examination team can make a better examination plan and examine the areas where weaknesses exist. After examination, the off-site surveillance team needs the information from the examination team for better surveillance.

212 Ibid.
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B. Accounting Standards

1. Need for Accurate Financial Information

It is crucial that the information disclosed and reported is based on sound measurement principles and that the principles are properly applied. The accounting standards for public disclosure and reports to the supervisory authorities should be sufficient for describing the true conditions of the banks. If accounting rules allow the bank management considerable latitude in determining carrying amounts for problem loans and repossessed collateral, recognising decreases from historical cost to market value has an adverse effect on a bank's reported financial condition.\textsuperscript{213} This gives bank management an incentive to use the latitude in accounting rules to delay loss recognition as long as possible. As a result, the inaccurate publicly disclosed information misleads the users.

Moreover, the accounting principles used in call reports and other financial statements by the banks need to provide the true financial conditions of a bank to the banking regulatory and supervisory authorities. Only with a sufficiently accurate picture of the financial conditions of banks, can the regulatory and supervisory authorities have efficient off-site surveillance, which gives early warning of troubled banks. Inadequate call reports impair regulatory decision making, resulting in continued operation and losses by unsafe and unsound banks.\textsuperscript{214} Therefore, fostering accurate and relevant

\textsuperscript{213} United States General Accounting Office, "Failed Banks ...," op. cit., n. 152, p. 6.
\textsuperscript{214} Ibid., p. 19.
financial reporting can assist the financial statement users, including regulators and supervisors, in making decisions.\textsuperscript{215}

2. \textit{Implementation of Mark-to-Market Accounting}

(a) \textit{Securities Holdings}

As the most important measure to enhance the accounting transparency of financial institutions, mark-to-market accounting has been introduced in order to make the banks recognise the gains and losses from the securities holdings accurately.\textsuperscript{216} In Korea, financial institutions, including commercial banks did not adopt mark-to-market accounting for securities, while other Korean firms have used it. As a result, distrust of financial statements of financial institutions has arisen due to the weak transparency in accounting practices. Korean commercial banks have implemented mark-to-market accounting principles from the closing date of the first half of 1998 fiscal year. Prior to the recent amendment, the FSC required Korean commercial banks to classify their securities as Korean won or foreign currency dominated securities. Among the Korean won securities, shares were appraised by the lower-of-cost-or-market method. Other Korean won securities were appraised by the historical cost method. Foreign currency securities were appraised by the lower-of-cost-or-market method. Those methods did not reflect the actual conditions of the banks. The amended regulations require the banks to classify their securities, regardless of the denominated currency, as traded or investment securities based on the marketability and the bank’s intention as to whether it holds them

\textsuperscript{215} \textit{Ibid.}, p. 20.
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until maturity. The traded securities, which have marketability and are held for short- 
term fund management, are appraised by mark-to-market valuation. Among the 
investment securities, the marketable securities are appraised by the mark-to-market 
valuation. The non-marketable securities are appraised by historical cost accounting. 
The bank’s subsidiary shares are appraised by the equity method.

(b) Enhancement of Financial Statement Accounting Principles

In Korea, the banks’ accounting standards for public disclosure and the accounting 
standards for supervisory reporting had been integrated for the regulatory and supervisory 
purposes rather than providing accurate information to the financial users. Those 
practices resulted in a lack of comparability across the financial industries. Furthermore, 
the financial statements of financial institutions lacked transparency and consistency. 
The financial supervisory authorities issued guidelines for closing accounts for the 
financial institutions. The guidelines were not only changed from year to year, but also 
allowed the financial institutions’ accounting practices to differ from generally accepted 
accounting principles by other Korean firms.

Since the financial crisis in 1997, there have been numerous demands for the 
reform of accounting practices in Korea. The International Monetary Fund and the 
World Bank demanded Korea to upgrade accounting standards to meet international 
practices. The reform process included the areas of (1) revision of financial accounting

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216 Mark-to-market accounting is an accounting method that values the assets at fair current value at the 
valuation date, amends the book value and recognises the gains or losses from the difference.
217 Financial Supervisory Commission Press Release, “Reform of Accounting Standards in Korea” (11 
218 Ibid.
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standards that are the primary source of Korea's generally accepted accounting principles, (2) establishment of accounting standards for financial institutions, including commercial banks, and (3) establishment of accounting standards for combined financial statements.\(^{219}\)

The accounting standard reforms are intended to provide more accurate and transparent information to financial users as a part of public disclosure requirements. The reformed accounting standards are established and implemented independently by the Securities and Futures Commission (SFC), generally in the corporate accounting standards. The FSC also established the accounting standards for the banks, insurance companies, and securities companies respectively. The reformed standards for the financial institutions, including banks, securities companies, and insurance companies, require (1) the adoption of the mark-to-market method to account for securities including the Fund for Stock Market Stabilisation,\(^{220}\) (2) recognising the restructuring losses as incurred,\(^{221}\) and (3) recognising allowances for potential losses arising from guarantee services and the resulting losses in the current year's financial statement.\(^{222}\) As for the banks, the reformed standards enhance the disclosures of financial information such as maturity of assets and liabilities, transactions with other banks and money market, foreign currency risk exposures, and losses from managing trust accounts.

\(^{219}\) Ibid.

\(^{220}\) The financial institutions must report their securities at market value and recognised 100 per cent unrealised holding gains or losses in the current year's income statement.

\(^{221}\) When the contractual terms of impaired loans are modified, the carrying amount of the impaired loans must be adjusted to the present value calculated based on the modified terms.

\(^{222}\) The Korea's financial regulatory and supervisory authorities have not required the financial institutions to recognise allowances for potential losses from guarantee services. After reforming the account standards, the FSC stipulated the regulation that the commercial banks are required to make provisions for guarantee services.
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C. Bank Examination

1. Objectives and Scopes of Bank Examination

Bank examination is one of the major supervisory instruments for reviewing and assessing banks. The objectives and scopes of bank examination differ among the authorities depending on the goals of banking regulation and supervision and the powers they have. Generally, the common practices are that the examiners check the compliance with laws, regulations, and other regulatory and supervisory guidelines or directions, and assess the financial conditions of banks. Given that financial stability is the primary objective of banking regulation and supervision, the examiners need to help the regulators and supervisors to maintain financial stability. To achieve this aim, the examiners should emphasise on risk-focused examinations.223

Under the risk-focused examination approach, the objectives of on-site examination should be to:224

(1) Test and reach (or reaffirm) conclusions about the reliability of banks’ systems, controls, and reports. The bank examiners should explicitly include an assessment of how effectively banks manage risk and a rating on their sensitivity to risks posed by a variety of market factors.225

(2) Investigate changes or anomalies disclosed by off-site monitoring and analysis.

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(3) Evaluate those aspects of banks’ operations for which portfolio managers cannot rely on the banks’ own systems and controls.

(4) Help ensure that the regulators take timely and forceful corrective action.

Under the risk-focused examination approach, the scopes of examination should be to:

(1) Evaluate the adequacy of the capital adequacy requirement ratios. Under the minimum capital requirement rules, a bank may adopt patterns of making cosmetic changes in order to exploit differences between capital as measured for regulatory purposes and the bank’s true economic capital. The examiners not only ensure that a bank meets the minimum ratios, but also assess whether the bank has any cosmetic changes to adjust its risky asset positions.

(2) Assess the quality of assets, especially loans, and ensure the adequacy of the provisions for losses. It is critical to determine the quality of assets, especially loans and the adequacy of loss reserves, because without proper assessment the examiners have no reliable basis to understand a bank’s true financial condition.

(3) Assess the internal control system. The examiners have to ensure that a bank has an adequate internal control system and evaluate the effectiveness of and compliance with the internal control system.

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227 See McCool, op. cit., n. 225, pp. 6-8.
2. **Bank Examination Practices in Korea**

Bank examination in Korea can be divided into three categories: periodic examination, special examination, and investigation. The periodic examination, as annual examination, examines all head offices of individual banks and about ten per cent of branches. Generally, the scope of the periodic examination covers all activities of the bank. The special examination is carried out when there are impeding policy issues or other serious problems. Investigation is carried out to scrutinise matters relating to the collection of information for bank supervision, and the complaints and appeals from bank customers. Such Korean bank examination is carried out without prior notice at least once a year. This practice is intended to be effective in enabling bank examiners to detect indications of fraud, embezzlement or other criminal activities.

The past examination practices have been focused on whether any wrongdoing has occurred and whether a bank follows the authorities' directions. For example, the examiners checked whether a bank extended financial funds to unqualified industries, and misused funds for purposes other than those originally intended. Those practices helped the authorities to control the banks, but failed to analyse the individual banks' prudential conditions, and therefore, the safety and soundness of banking system as a whole. Even in the cases where the examiners attempted to address safety and soundness concerns, the examination process may only provide a "snapshot" of the bank’s conditions as of a
given date without addressing potential risks and the management systems needed internally by the bank to control risk in a dynamic, changing environment.228

To achieve the goal of financial stability, the FSC and the FSS need to adopt the risk-focused examination approach. Korea's adoption of the risk-focused examination approach needs two preconditions. First, the quality of examiners should be improved. The comprehensive internal control system assessment can only be achieved when the examiners fully understand how the system works and how to test the system. Moreover, if the banks are allowed to have their own loan classification and loan loss provision systems, the examiners should assess the quality of system. Second, the examiners should have a clear written mandate and procedures for the examination. After examination, the examiner should produce a written, detailed report for clear communication with the banks and the other departments. The risk-focused examination approach gives the examiners substantial discretionary powers to determine subjectively whether a system is adequate. The regulators need to establish policies to ensure sufficient documentation of the analysis that underlies the examination report and thorough supervisory review of all examination and inspection procedures. The review process is an important quality control measure to ensure that conclusions reached are properly supported.229

In relating to the risk-focused examination approach, the Korean banking regulatory and supervisory authorities need to enhance the management appraisal system. The Korean regulatory and supervisory authorities have implemented the CAMEL ratings

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228 Polizatto, op. cit., n. 204, p. 23.
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as the management appraisal system. The CAMEL (an acronym for Capital adequacy, Asset quality, Management, Earnings, and Liquidity) rating system quantifies a supervised institution’s condition in five critical areas and assigns an overall composite rating. The management appraisal system makes possible graduated supervision measures based upon the result of appraisal. It can enhance management efficiency by assessing the performance of financial institutions and providing corresponding incentives or penalties. However, the success of the management appraisal system requires adequate accounting standards and the ability to evaluate bank management with proper criteria. The FSS is planning to implement a revised management appraisal system that is focused on risk assessment with a view to providing a service to the financial institutions as their supervisory authorities. Under the plan, the current CAMEL method will be changed to CAMELS, which includes sensibility to market risk. It is a desirable step to enhance the risk-focused approach. Nevertheless, the Korean regulatory and supervisory authorities need to require the bank examiners to develop appropriate criteria for evaluating a bank’s management condition. The bank management evaluation should provide an assessment of bank’s current and future conditions.

3. Role of Internal and External Audit

The financial conditions of banks are essential information for the regulatory and supervisory authorities and the markets to ensure the banks’ prudence. Since the bank

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230 See Detailed Enforcement Regulations for Supervision of Banking Institutions app. 12.
management prepares the financial statements for public disclosures and the supervisory reporting, the financial information is reviewed to obtain reasonable assurance that the financial statements are free of material misstatements. The bank examiners can perform the review to evaluate the financial information, including asset quality and other areas of a bank’s activities. A major disadvantage of this approach is that it can be labour intensive and can be inhibited by budgetary constraints. An alternative approach is the Bank of England system under the Banking Act 1987. By relaxing the duty of confidentiality owed by a bank auditor to the client, the bank subject to the audit, a bank auditor could pass to the Bank of England, whether or not in response to a request made by it, any information which acquired in a professional capacity and which was relevant to the discharge of the supervisory functions of the Bank of England.

In Korea, commercial banks are required to have internal auditors and are subject to an external audit requirement. In December 1998, under the External Audit Act, the Securities and Futures Commission (SFC) published the standards for external auditors to audit Korean financial institutions. An accounting firm to audit commercial banks with assets in excess of 800 billion Korean won should have more than 100 certified public accountants and have an audit quality management contract with an internationally recognised firm. The scope of external audit is financial auditing, while the internal auditor audits not only financial but also business matters.

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232 Ibid.
233 Polizatto, op. cit., n. 204, p. 17.
234 See United Kingdom Banking Act 1987 sec. 47. It is important to note that the Bank of England did not conduct the on-site examinations.
235 The audit quality management contract includes the agreement that the internationally recognised firm manages the quality of audit by the Korean firm and the agreement that the audit reports could be issued under the name of internationally recognised firm. The SFC provides that an internationally recognised firm should have its member firms in more than 30 countries and have more than 2000 professionals. The SFC estimates that there are 28 accounting firms meeting the conditions.
Auditing mechanisms are essential to ensure that accounting norms are effectively applied and maintained in regard to financial matters. Even if the FSS can perform the review to evaluate the banks' financial conditions, both internal and external audits can be used as vital complements to assessments of banks' financial conditions by the bank regulatory and supervisory authorities. Internal audits on an ongoing basis enable problems to be recognised before they are able to impair the financial soundness of a bank.237 External audits on the basis of internationally acceptable standards by independent qualified private entities are important in the accuracy and comprehensiveness of information disclosed to external parties.238 However, reliance should be placed on external auditors only when a well-developed independent auditing profession exists, when supervisors and auditors have a clear understanding of their roles, and where auditors are fully accountable.239

Under the financial stability objective in bank regulation and supervision and the risk-focused examination approach, the full scope audits, including financial audit and business audit, can reinforce the banking on-site examination and supervisory work. In Korea, the internal auditor, who audits banks' business matters (especially the internal control system), can provide benefits such as the early detection and correction of internal control problems and efficiencies in the examination process. However, the bank regulatory and supervisory authorities should only rely on internal control work performed by the banks' audit function after sufficient review and evaluation, and then

236 See External Audit Act art. 1.
238 Ibid., p. 29.
239 Ibid., p. 42. See also Ruth de Krivoy, "Crisis Avoidance," in Ricardo Hausmann and Liliana Rojas-Suarez eds., Banking Crises in Latin America (1996). Krivoy argues that, to ensure their objectivity and
only if the auditors are competent and independent and their audit programs are adequate and effective.240

In Korea, under the External Audit Act, the external auditors can examine the banks' business matters, such as internal control system, only if the auditors need it in relation to their financial audits.241 Since full scope independent audits by external auditors can help fill the need for increased oversight in the present age of financial deregulation,242 Korea can consider bestowing full scope audit powers to the external auditors. In a regulatory and supervisory environment such as in Korea, however, where the on-site examinations provide the primary evaluation of banks' operations, the benefits of full scope external audit should be limited. First, the external audits would not replace the on-site examinations but provide the bank regulatory and supervisory authorities with information from audits in a timely manner, especially when the audits take place between the examinations. Currently, the FSS may request the banks' external auditors to submit information and other documents related to the soundness from audits.243 By requiring the external auditors to submit the audit reports and notify any concerns from the audits directly to the FSS,244 it is more feasible to enhance the off-site surveillance and the early detection of problems. This approach, however, would place an additional burden on the auditors than that of the U.K. Bank Act 1987 where the auditors had discretion. Second, the full scope independent audits can improve the quality of on-site

credibility, the external auditors need to be legally accountable for the competence and integrity of their examinations.

241 See External Audit Act art. 6 cl. 1.
243 General Banking Act art. 48 cl. 3.
244 The External Audit Act requires the external auditors to submit their audit reports to the audited company (the bank), the SFC, and the Korea Institute of CPAs. External Audit Act art. 8 cl. 1.
examination. The external audits can diminish a possibility of failing to identify any material weaknesses by the bank examiners.

D. Prompt Regulatory Action as Enforcement Measure

1. Prompt Regulatory Action in the U.S.

After experiencing the thrift and banking crisis of the 1980s, the U.S. federal regulators were criticised for not taking prompt and forceful action to minimise or prevent losses to the insurance funds due to bank and thrift failures. The Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA) was enacted to make fundamental changes in federal oversight of depository institutions. The FDICIA mandates that the regulators establish a two-part regulatory framework to improve safeguards for the deposit insurance funds. The first part focuses on capital levels of depository institutions, and the second part focuses on other measures of an institution’s safety and soundness.

Section 38 of the Federal Deposit Insurance Act requires the regulators to categorise depository institutions into five categories on the basis of their capital levels and to take increasingly severe supervisory actions as an institution’s capital level deteriorates. The section establishes a system of mandatory supervisory actions that are to be triggered by an institution’s capital levels. Section 39 of the Federal Deposit Insurance Act directs regulatory attention to the non-capital areas of an institution’s activities as they pertain to safety and soundness. The section requires the regulators to develop and implement safety-and-soundness standards in three areas: (1) operations and management; (2) asset quality, earnings, and stock valuation; and (3) compensation. The
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Riegle Community Development and Regulatory Improvement Act of 1994 amended section 39 to eliminate the requirement for quantitative standards for asset quality and earnings and to allow the regulators greater discretion in setting standards as well as in determining whether to take action against institutions that fail to meet the standards. However, the implementation of section 39 should (1) establish clear, objective criteria for what would be considered to be unsafe and unsound practices or conditions and (2) link the identification of such conditions to specific mandatory enforcement actions.245

The prompt corrective action (PCA) approach has several advantages. First, PCA intends to limit the number and the costs of bank failures by intervening earlier in problem banks and by encouraging banks to become better capitalised.246 Second, PCA reduces the possibilities of regulatory and supervisory forbearance. When the banking regulatory and supervisory authorities have wide discretion in deciding both the timing and nature of enforcement actions, the lack of standard measures of unsafe and unsound practices and conditions and the tendency to avoid taking forceful action are major problems in the supervisory process.247 PCA imposes a binding constraint on bank supervisors either by intervening earlier than would be the case with formal actions or by intervening in problem banks that, for whatever reason, did not receive a formal action. Therefore, PCA can remove or reduce the discretionary decision-making of the regulatory and supervisory authorities by providing quantifiable measures for assessing a bank's financial condition. Third, PCA increases the certainty in the banking industry

with which specific practices regarding assets, earnings, or management may be regarded by the regulators as unsafe or unsound. The enforcement process can only be helped by introducing more definitive measures regarding unsafe and unsound practices and by linking regulatory responses to those measures so that bankers, regulators, and others know much more precisely what to expect from the enforcement process.\textsuperscript{248} The U.S. General Accounting Office’s review reveals that when the U.S. banking regulators used the most forceful actions available to correct unsafe and unsound banking practices, the enforcement process produced better result.\textsuperscript{249}

However, PCA has some limitations. First, the focus of PCA is to intervene in banks after their capital ratios have fallen. But, a bank’s capital ratio is a lagging, not leading indicator. The capital-based safeguards are inherently limited because capital does not typically show a decline until an institution has experienced substantial deterioration in other components of its operations and finances.\textsuperscript{250} Secondly, PCA criteria are intended to be applied on the basis of reported bank capital ratios, even in the absence of an examination. This is an offset by the fact that call report data submitted between examinations often are less reliable than those immediately following an examination.

\textsuperscript{249} Ibid., p. 29.
\textsuperscript{250} United States General Accounting Office, “Bank and Thrift Regulation . . .,” \textit{op. cit.}, n. 245, pp. 6-7.
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2. Implementation of Prompt Regulatory Action in Korea

An amendment to the General Banking Act in 1991 established the corrective action provisions in Korea.\textsuperscript{251} Under the provision, the Monetary Board of the Bank of Korea stipulated in its regulations implementing corrective action in 1992. Under the regulations, the OBS could impose management improvement recommendations and management improvement measures on commercial banks. In deciding on the management improvement recommendation, the OBS considered its prudential management ratios\textsuperscript{252} and the management status evaluation (CAMEL ratings). As for the management improvement measures, the OBS could impose the measures when a bank fails to meet the capital adequacy ratio for two consecutive years; fails considerably to meet the other prudential management ratios; fails to improvement its conditions after the management improvement recommendation; deteriorates its asset prudential quality due to large losses; or maintains remarkably unfavourable management. Those provisions bestowed on the OBS wide discretion in deciding whether it applies the corrective actions. The wordings of the provisions, such as considerably and remarkably, allowed the OBS to take into account other considerations rather than the financial stability or other banking regulatory and supervisory objectives for its enforcement actions. Moreover, the regulations did not have compulsory constraints that the OBS had to impose any corrective actions. Therefore, the OBS was allowed to pursue supervisory forbearance.

\textsuperscript{251} General Banking Act 1991 art. 18 cl. 5.
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In 1997, the Financial Industry Restructuring Act was enacted in order to promote financial industry restructuring. One of the major restructuring measures was the corrective action for the ailing financial institutions, including commercial banks. In September 1998, an amendment to the Financial Industry Restructuring Act explicitly provides the prompt corrective action measures.253 The act provides the definition of non-viable financial institutions. According to the act, a financial institution is deemed as a non-viable financial institution when (1) its liabilities exceed the assets; (2) it suspends the payments on obligatory credits, including deposits, and the repayments of other financial institutions; or (3) the FSC or the KDIC decides that it could not pay the obligatory credits and repay loans from other financial institutions without external fund support or special borrowings.254 The FSC has to (1) recommend, require, or order the measures the act provides or (2) require a plan to fulfil the measures when a financial institution fails or the FSC decides that it is evident that a financial institution fails to meet the FSC’s standards.255

In June 1997, under the Financial Industry Restructuring Act, the FSC stipulates its standards and measures for the prompt corrective actions against troubled banks. The FSC implements three measures for the prompt corrective actions: management improvement recommendation, requirement, and order. When a bank (1) fails to maintain eight per cent of risk-weighted capital adequacy ratio or it (2) is rated by the management status evaluation as scale 3 for the composite ratings but scale 4 for the asset

252 They included the capital adequacy, liquidity asset, usable deposit and equity capital to loan, loan loss reserve, retirement reserve, operational real estate, bad loan ratios and other prudent ratios for bank management.
253 Financial Industry Restructuring Act art. 10.
254 Ibid. art. 2 no. 3.
255 Ibid. art. 10 cl. 1.
quality or capital adequacy ratings, the FSS should impose the management improvement recommendation on the bank. Under the management improvement recommendation, a bank is required to:

1. improve its personnel and operational structures;
2. reduce its operational costs;
3. improve its efficiency on the branch management;
4. restrict the fixed asset investment, new activities, and new investment;
5. dispose non-performing loans;
6. restrict the increase or decrease of equity capitals;
7. restrict the dividend pay-outs; and/or
8. reserve special loan loss provisions.

The management improvement requirement is imposed by the FSS when (1) a bank’s capital adequacy ratio becomes under six per cent to the risk-weight assets or (2) its composite management status evaluation ratings are scale 4 or lower. Beyond the above management improvement recommendation requirements, the bank is required to:

1. close or merge its branches and restrict open new branches;
2. prohibit investment;
3. restrict to hold risk assets and dispose its assets;
4. restrict its interest rates on deposits;
5. divestiture its subsidiaries;
6. replace the management and external auditor;
7. suspend partial operations; and/or

The rating scheme is based on a scale of 1 through 5.
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(8) set a plan for merger, acquisition by a third party, or transfer its whole or partial business.

When (1) a bank’s capital adequacy ratio becomes under two per cent or (2) a bank becomes a non-viable bank under the Financial Industry Restructuring Act, together with the measures for the management improvement requirement, the FSC has to:

(1) require the bank to write off or merge its shares;
(2) suspend the management and appoint an administrator;
(3) order merger;
(4) order the bank to transfer its whole or partial business;
(5) order acquisition by a third party; and/or
(6) suspend the bank’s operation within six month time or revoke the bank’s charter.

In Korea, the banking regulatory and supervisory authorities need to enforce regulations in a consistent fashion and must not pursue regulatory forbearance. The moral hazard problems can be reduced in the banking system when the regulators and supervisors pursue prompt corrective action if banks are not complying with the regulatory requirements.\(^{257}\) Therefore, the prompt corrective action is a significant change in that it reduces the potential for regulators to exercise forbearance for undercapitalised banks.\(^{258}\) In addition, the PCA scheme is one of primary formula for the rule-based, objective banking regulation and supervision, what Korea needs. However,

PCA needs to ensure sufficiently flexible banking supervision to allow adjust individual cases. To achieve this goal without limiting the purposes of PCA, the Korean banking regulators and supervisors need limited discretionary powers on their decisions within the Financial Industry Restructuring Act. Then the transparency in the regulatory and supervisory decisions and actions can assure that the banking regulatory and supervisory authorities do not abuse their discretionary powers.

3. Other Enforcement Measures

The enforcement powers of the FSC and the FSS can be divided into two groups: sanctions against banking institutions and against bank officers and employees. When bank institutions (1) violate the provisions of the General Banking Act, regulations, orders or instructions, issued under the General Banking Act or the Act Concerning Establishment of Financial Supervisory Organisations, or (2) engage in conduct in an unlawful or unsound manner, upon the recommendations of the FSS, the FSC may:

1. direct the FSS to take measures such as issuing cease and desist orders or warnings concerning such unlawful conduct;
2. issue an order to cease unsound operational practices;
3. impose business suspension of up to six months; and
4. revoke the relevant banking license.

When officers and employees of banking institutions willfully violate the provisions of the General Banking Act, regulations, orders or instructions, issued under

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Wall and Peterson, *op. cit.*, n. 226, p. 4.

Revised General Banking Act art. 53; Act Concerning Establishment of Financial Organisations art 43.
Chapter Three

the General Banking Act or the Act Concerning Establishment of Financial Supervisory Organisations;\textsuperscript{260} commit any act which greatly impairs the sound operation of a banking institution;\textsuperscript{261} make false supervisory reports or neglect to submit them;\textsuperscript{262} reject, obstruct or evade the supervision and examination of the FSS,\textsuperscript{263} or neglect to take appropriate actions or disciplinary measures required by the FSS,\textsuperscript{264}

(1) the FSC may order the concerned officer to suspend performance of his duties;

(2) the FSC may advise general meetings of banks' shareholders to dismiss the concerned officers;

(3) the FSC may direct the FSS to take appropriate measures such as issuing warnings against the concerned officers; and

(4) the FSS may require heads of banking institutions concerned to take appropriate disciplinary measures against the concerned employees, such as dismissal or suspension from office, reduction of pay, or reprimand.

The enforcement powers of the Korean banking regulatory and supervisory authorities are broad and subject to the discretion of the authorities. For example,

\textsuperscript{260} Revised General Banking Act art. 54; Act Concerning Establishment of Financial Organisations art 41.

The General Banking Act requires "intention" of banks' officers and employees while the Act Concerning Establishment of Supervisory Organisations only requires "violation" of officers. Under article 41 of the Act Concerning Establishment Supervisory Organisations, employees of "financial institutions" (including banking institutions and other financial institutions) are subject to enforcement measures regardless of their intention (by not stipulating "willfully" in the article). Therefore, it is possible to interpret either that, unlike employees of other financial institutions, banks' employees are subject to enforcement measures only when they "willfully" violate relevant acts, regulations or other directions, or that the article 41 of the Act Concerning Establishment of Financial Supervisory Organisations widens scopes of enforcement. To clarify the discrepancy, Korea needs to harmonise differences between two acts.

\textsuperscript{261} Revised General Banking Act art. 54.

\textsuperscript{262} Act Concerning Establishment of Financial Organisations art 41 no. 2.

\textsuperscript{263} Ibid., art 41 no. 3.

\textsuperscript{264} Ibid., art 41 no. 4.
violations of all directions of the FSC and the FSS are subject to enforcement actions. Criteria for enforcement actions are broadly stipulated, *e.g.* “unsound manner.” Furthermore, Korea’s enforcement powers are utilised to ensure Korean banks operate for the government’s purposes, such as financing certain sectors.

Under these circumstances, a “market-competitive and commercially-driven” environment cannot be established. To achieve a banking system which operates with true market and commercially oriented practices, the FSC and the FSS need to exercise their enforcement powers for effective prudential supervision, not for effective control over the banking sector.

**IV. MARKET-ORIENTED COMMERCIAL BANKING**

Korea’s reformed and restructured regulatory and supervisory structure (the FSC) created a system which either ensures a “safe and sound” banking system free from government and political interference or retains a banking system “controlled” by the FSC. To achieve the objective of a “safe and sound” banking system, Korean banks need to have a “market-competitive” and “commercially-driven” environment free from any control or interference by the government, the politicians or the regulatory and supervisory authorities in carrying out objectives that are inconsistent with “safe and sound” banking regulatory and supervisory objectives.

A “market-competitive and commercially-driven” banking sector can be established when the FSC and the FSS regulate and supervise with effective and transparent supervisory standards, monitoring and enforcement for achieving “financial stability.” The objective of “financial stability” removes possibilities of interference
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from the government and politicians and hinders the control by the banking regulatory and supervisory authorities. Furthermore, effective and transparent supervisory standards, monitoring and enforcement, which are consistent with evolving international standards and principles, provide the underlying framework in which Korean banks operate in a market and commercially oriented environment, but are subject to prudential regulation and supervision.
CHAPTER FOUR
KOREAN FINANCIAL CRISIS

In 1997, Korea experienced significant financial and economic turmoil triggered by international concerns as part of a regional financial crisis that was officially recognised with the depreciation of the Thai baht in July 1997. The Korean financial crisis demonstrated many of the current weaknesses of the Korean banking and financial system. Since “official” diagnosis of crisis is important to provide appropriate policy response, this chapter seeks to analyse and identify causes of the Korean financial crisis. This chapter begins by examining macroeconomic conditions in Korea leading up to the crisis environment, which serve to clarify the origins of the Korean crisis (and Asian financial crisis in relevant part). After identifying the origins of the Korean financial crisis, this chapter will evaluate Korea’s policy responses to the crisis and crisis management methodologies. Policy responses and crisis management methodologies crucially involve official intervention (e.g., as lender of last resort), financial system reform, and financial sector restructuring. The Korea government’s policy responses and crisis management methodologies are considered from the following perspectives: (1) whether they were appropriate and effective, and (2) whether they were sufficient to correct inherent weaknesses of the Korean financial system relating to the banking regulatory and supervisory structure and to the supervisory standards and enforcement which were discussed in Chapter Two and Chapter Three.
Chapter Four

I. KOREAN MACROECONOMY TRENDS PRIOR TO THE CRISIS

A. Growth and Trends

Prior to the economic and financial crisis environment officially acknowledged in late 1997, the Korean economy was marked by a puzzling dichotomy between a benign real economy and growing financial market tensions.¹

Table 1 Indicators of Korean Macroeconomic

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<tr>
<td>GDP growth (%)</td>
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<td>5.8</td>
<td>8.6</td>
<td>8.9</td>
<td>7.1</td>
<td>5.5</td>
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<tr>
<td>Savings rate (% of GDP)</td>
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<td>35.7</td>
<td>34.9</td>
<td>34.9</td>
<td>34.6</td>
<td>35.1</td>
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<td>2.4</td>
<td>2.8</td>
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<td>2.0</td>
<td>2.0</td>
<td>2.6</td>
</tr>
<tr>
<td>Inflation rate</td>
<td>9.30</td>
<td>6.22</td>
<td>4.82</td>
<td>6.24</td>
<td>4.41</td>
<td>4.96</td>
<td>4.45</td>
<td></td>
</tr>
<tr>
<td>Government Fiscal Balance</td>
<td>-0.68</td>
<td>-1.63</td>
<td>-0.50</td>
<td>0.64</td>
<td>0.32</td>
<td>0.30</td>
<td>0.46</td>
<td>0.25</td>
</tr>
</tbody>
</table>

Source: Bank of Korea

Chapter Four

The Table 1 data demonstrate that Korea generally maintained robust economic growth throughout the 1990s. Notwithstanding sluggish growth in 1992-93, the average GDP growth was 7.8 per cent during the period of 1990-95. In 1996, although Korea's export prices fell 13.4 per cent, import prices fell 1.2 per cent, and GDP growth was approximately 7.1 per cent. The first quarter of 1997, when GDP growth fell to 5.7 per cent, appeared to mark a successful 'soft-landing' from excessive growth. Inflation was the lowest domestic levels in over a decade and prices were generally stable. Unemployment remained between 2.0-2.8 per cent and very low by international standards. In addition, the government fiscal balance has been prudent. The government budgets registered regular annual surpluses and maintained fiscal responsibility since 1993 after a small fiscal deficit in 1990-92. Thus, as of 1997, Korea's economic fundamentals appeared generally sound, even robust.

B. Current Account Imbalance

Notwithstanding sustained economic growth and falling inflation, Korea's current account deficit became problematic.

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2 This shock was equivalent to some four per cent of national income. Ibid.

3 Ibid.
Table 2 Korean Current Account Balance

<table>
<thead>
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</tr>
</thead>
<tbody>
<tr>
<td>Current Account</td>
<td>-20.03</td>
<td>-83.17</td>
<td>-39.43</td>
<td>99.0</td>
<td>-38.67</td>
<td>-85.08</td>
<td>-230.05</td>
<td>-81.67</td>
</tr>
<tr>
<td>Current Account/GDP</td>
<td>-0.8</td>
<td>-2.8</td>
<td>-1.3</td>
<td>0.3</td>
<td>-1.0</td>
<td>-1.9</td>
<td>-4.7</td>
<td>-1.9</td>
</tr>
</tbody>
</table>

Source: Bank of Korea

The Table 2 data indicate that similarly to other Asian countries whose currencies collapsed in 1997, Korea experienced considerable current account deficits in the late 1990s. The Korean current account deficit was low in the early 1990s (within the 1-3 per cent range of GDP). Korea maintained a small surplus of 0.3 per cent of GDP in 1993. However, the changes in current account position beyond 1993 were significant. The current account deficits were 1.0 per cent, 1.9 per cent, and 4.7 per cent of GDP in 1994, 1995, and 1996, respectively. The widening current account deficits, when coupled with declining productivity growth, progressively reflected investments that were of uncertain quality.4

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C. Capital Flows

Private sector capital flows to developing countries increased six-fold over 1990-1996. Recent studies indicate that during the 1990s, the five East Asian countries (Indonesia, Korea, Malaysia, Philippines, and Thailand) hit hardest by the Asian crisis, experienced massive capital inflows.5

<table>
<thead>
<tr>
<th>Table 3 Capital Flows to Korea</th>
</tr>
</thead>
<tbody>
<tr>
<td>In US$ 10 millions</td>
</tr>
</tbody>
</table>

<table>
<thead>
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</tr>
</thead>
<tbody>
<tr>
<td>Capital flows</td>
<td>256</td>
<td>641</td>
<td>659</td>
<td>274</td>
<td>1030</td>
<td>1679</td>
<td>2333</td>
<td>544</td>
</tr>
<tr>
<td>% of GDP</td>
<td>1.6</td>
<td>3.1</td>
<td>3.9</td>
<td>4.9</td>
<td>2.8</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Direct investment</td>
<td>-2.6</td>
<td>-3.1</td>
<td>-4.3</td>
<td>-7.5</td>
<td>-16.5</td>
<td>-17.8</td>
<td>-23.4</td>
<td>-19.5</td>
</tr>
<tr>
<td>Portfolio investment</td>
<td>0.8</td>
<td>30.5</td>
<td>58.0</td>
<td>100.1</td>
<td>61.2</td>
<td>115.9</td>
<td>151.8</td>
<td>147.6</td>
</tr>
<tr>
<td>Financial institution</td>
<td>28.6</td>
<td>58.6</td>
<td>24.3</td>
<td>12.0</td>
<td>89.8</td>
<td>134.0</td>
<td>141.5</td>
<td>-141.2</td>
</tr>
<tr>
<td>Financial borrowings</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

*Source: Bank of Korea, IMF*

Chapter Four

The Table 3 data demonstrate that the capital inflows to Korea increased on average from 1.4 per cent of GDP between 1986-90 to 6.7 per cent between 1990-96. The capital inflows increased in 1991-92, then decreased down to the 1990 level in 1993 when Korea had a small current account surplus. Since 1994, the capital inflows significantly increased and reached about five per cent of GDP in 1996.

In connection with capital flows, direct investment steadily decreased, but portfolio investment and financial institution borrowings rose substantially. In addition, borrowings of private institutions have similarly increased. In late 1997, global concerns arose about Korea's private sector foreign debt obligations. Until December 1997, Korea's statistics on foreign debt was calculated as defined by the International Bank for Reconstruction and Development (IBRD). The IBRD standard counted as foreign debt Korean residents' debt from non-Korean residents. On 29 December 1997, the Korean government announced its agreement with the IMF for a new definition of Korea's external liabilities. Under this agreement, the total Korean external liabilities as defined by the IBRD included off-shore borrowings of Korean banks and overseas borrowing of overseas branches and subsidiaries of Korean banks, excluding (a) borrowings of overseas branches and subsidiaries of Korean enterprises, and (b) deposits in overseas branches and subsidiaries of Korean banks. Under the new definition, the initial figures showed that Korea's foreign liabilities increased from US$104.7 billion to US$157.5 billion at the end of 1996.

6 ibid., p. 8.
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Table 4 Korean External Liabilities

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<tr>
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</thead>
<tbody>
<tr>
<td></td>
<td>43.9</td>
<td>96.9</td>
<td>127.2</td>
<td>164.3</td>
<td>180.4</td>
<td>180.1</td>
<td>161.8</td>
<td>158.1</td>
</tr>
</tbody>
</table>

Source: Ministry of Finance and Economy

Table 5 Structure of Korea’s External Liabilities as of End 1996

<table>
<thead>
<tr>
<th>Category</th>
<th>In US$ billions</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total External Liabilities</td>
<td>157.5</td>
</tr>
<tr>
<td>Long-term Liabilities (I+II+III)</td>
<td>57.5</td>
</tr>
<tr>
<td>I. Financial Institutions (A+B)</td>
<td>41.5</td>
</tr>
<tr>
<td>A. Domestic financial institutions</td>
<td>38.3</td>
</tr>
<tr>
<td>Resident domestic financial institutions</td>
<td>24.5</td>
</tr>
<tr>
<td>Offshore banking of domestic financial institutions</td>
<td>8.5</td>
</tr>
<tr>
<td>Foreign branches of domestic financial institutions</td>
<td>5.3</td>
</tr>
<tr>
<td>B. Branches of foreign banks</td>
<td>3.2</td>
</tr>
<tr>
<td>II. Domestic Corporations</td>
<td>13.6</td>
</tr>
<tr>
<td>III. Public Sector</td>
<td>2.4</td>
</tr>
<tr>
<td>Short-term Liabilities (I+II)</td>
<td>100.0</td>
</tr>
<tr>
<td>I. Financial Institutions (A+B)</td>
<td>78.0</td>
</tr>
<tr>
<td>A. Domestic financial institutions</td>
<td>65.2</td>
</tr>
<tr>
<td>Resident domestic financial institutions</td>
<td>26.2</td>
</tr>
<tr>
<td>Offshore banking of domestic financial institutions</td>
<td>12.7</td>
</tr>
<tr>
<td>Foreign branches of domestic financial institutions</td>
<td>26.4</td>
</tr>
<tr>
<td>B. Branches of foreign banks</td>
<td>12.8</td>
</tr>
<tr>
<td>II. Domestic Corporations</td>
<td>22.0</td>
</tr>
</tbody>
</table>

Source: Ministry of Finance and Economy (Estimated in 1998)
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Among the foreign liabilities, Korean financial institutions shared 65.7 per cent of total liabilities (66.6 per cent of long-term liabilities and 65.2 per cent of short-term liabilities) at the end of 1996. The external liabilities data also revealed that Korean short-term liabilities represented an alarming 63.5 per cent of total external liabilities at the end of 1996. Furthermore, the short-term borrowings by Korean financial institutions increased substantially in 1994-96.

Table 6 Trends of Borrowings by the Korean Financial Institutions

<table>
<thead>
<tr>
<th></th>
<th>In US$ 100 millions</th>
</tr>
</thead>
<tbody>
<tr>
<td>Financial Institutions (A+B)</td>
<td>28.6</td>
</tr>
<tr>
<td>A. Long-term liabilities</td>
<td>-0.5</td>
</tr>
<tr>
<td>Deposit money banks</td>
<td>-3.3</td>
</tr>
<tr>
<td>Development institutions</td>
<td>0.7</td>
</tr>
<tr>
<td>Merchant banking corporations</td>
<td>2.1</td>
</tr>
<tr>
<td>B. Short-term liabilities</td>
<td>29.1</td>
</tr>
<tr>
<td>Deposit money banks</td>
<td>24.2</td>
</tr>
<tr>
<td>Development institutions</td>
<td>3.6</td>
</tr>
<tr>
<td>Merchant banking corporations</td>
<td>1.3</td>
</tr>
</tbody>
</table>

Source: Bank of Korea

The Korean depository banks (commercial banks and specialised banks) borrowed US$5.38 billion in foreign currency denominated debt obligations in 1994, approximately fourteen times more than in 1993 but about four times more than the
average borrowings of 1990-93. The depository banks substantially increased their foreign currency borrowings over 1995-96. The foreign borrowings data of merchant banking corporations were even more alarming. In 1994, Korean merchant banking corporations borrowed US$0.87 billion in foreign currency, which was about five times more than in 1993. The merchant banking corporations borrowed about 100 times more than average borrowings over the period of 1990-93. In 1994 and 1995, the borrowings in foreign currency by the merchant banking corporations reached US$1.71 and US$3.19 billion, respectively.

D. Growing Numbers of Bankruptcies

In January 1997, Hanbo Steel collapsed under US$6 billion in debts. Hanbo, Korea's fourteenth largest corporate group in terms of assets, was the first bankruptcy of a Korean chaebol in a decade. In the months that followed, other significant corporates/chaebol such as Sammi Steel, Jinro and Dainong, became insolvent, and in July 1997, Kia Motors, the third largest Korean auto-maker, also entered bankruptcy. The debt-to-equity ratio of Korean corporates was approximately 450 per cent by the end of 1996, three times the comparable U.S. ratio, and more than five times the comparable Taiwanese ratio. The top thirty Korean chaebols had even higher leverage, on average more than 500 per cent in 1996. The highly leveraged positions of the corporates and resulting

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8 Pedro Alba et al., op. cit., n. 4, p. 57.
9 Ibid. But, one research estimates the Korea's debt equity ratio was 132 per cent at the end of 1995 when the debt-equity ratio equals a company's debt divided by shareholder's equity. Yet, it still recognises the fact that Korean companies had high debt-equity ratio. Michael Pomerleano, "The East Asia Crisis and Corporate Finances: The Untold Micro Story," World Bank Working Paper No. 1990 (1998), pp. 6-7.
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balance sheet problems, facilitated declining growth in 1997 and thereafter triggered a fifty per cent increase in the number of corporate insolvencies.\footnote{OECD, op. cit., n. 1, p. 29.}

The high leverage meant that small shocks to interest rates \textit{vis-à-vis} operational cash flows of corporates greatly affected their ability to service debts. The \textit{chaebols}, which went bankrupt or had severe financial problems in 1997, tended to have even larger debt-equity ratios.\footnote{In case of Sammi, the ratio was 3,245 per cent, while the Jinro group’s ratio was 8,598 per cent. See Giancarlo Corsetti, Paolo Pesenti, and Nouriel Roubini, “What Caused the Asian Currency and Financial Crisis?: Part I: A Macroeconomic overview,” mimeo (1998), Table 7.} The return on invested capital for the bankrupt firms, and additionally for twenty of the top thirty \textit{chaebols}, was generally well below their respective costs of capital.\footnote{Ibid., pp. 14-15.}

E. Currency Crisis

On 2 July 1997, the Bank of Thailand “officially” abandoned defence of the baht exchange rate and “permitted” the currency to float. The immediate depreciation of the baht eventually triggered the depreciation of several other regional currencies, such as the Philippine peso, the Malaysian ringgit, and the Indonesian rupiah.\footnote{For more Thai financial and economic crisis, see Tull Traisorat, “The Thai Financial and Economic Crisis of 1997-98: An Opportunity to Re-address the Fundamentals,” Studies in International Financial and Economic Law No. 18 (1998).}
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Table 7 Exchange Rate to the US Dollar

<table>
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</tr>
</thead>
<tbody>
<tr>
<td>End of</td>
<td>844.90</td>
<td>895.00</td>
<td>877.90</td>
<td>914.40</td>
<td>964.60</td>
<td>1170.00</td>
<td>1695.00</td>
<td>1695.00</td>
<td>1695.00</td>
<td>1695.00</td>
<td>1695.00</td>
<td>1695.00</td>
<td>1695.00</td>
<td>1695.00</td>
</tr>
<tr>
<td>Period average</td>
<td>805.13</td>
<td>866.27</td>
<td>891.70</td>
<td>898.63</td>
<td>926.10</td>
<td>1033.23</td>
<td>1499.38</td>
<td>1151.23</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
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</tr>
</tbody>
</table>

Source: Bank of Korea

Under Korea’s market average rate (MAR) exchange system, the nominal won/US dollar rate was allowed to float in the interbank market within a daily range around the weighted average of the previous day’s interbank rates for spot transactions, and the range was widened in the late 1993 to plus/minus one per cent. Since the Bank of Korea acted as a buyer/seller of last order to prevent what it considered excessive exchange rate fluctuations, the system was still a “managed float.”

Between July and October 1997, the Korean won depreciated by 2.8 per cent, but initiated a steep decline in mid-October 1997. The Korean won went into a free-fall on 19 November 1997, and devalued nearly 50 per cent during a two-week period after the Korean government widened the daily currency band from eight to ten per cent and thereafter announced that it would henceforth refrain from intervening in the currency markets (i.e., defending the exchange rate band). In early December 1997, the Korean government’s revelation of alarmingly low level of usable foreign exchange reserves and disclosure of excessive short-term foreign currency denominated borrowings resulted in a

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14 In March 1990, Korea adopted the MAR system, in which the exchange rate was determined by market force. However, the system was intended to restrict short-term, speculative capital movements by introducing daily range. See Chiho Kim, "Monetary Policy in a Changing Financial Environment -
sharp decline of rollover rates of interbank claims on Korean institutions and further accelerated downward pressure on the won. The Korean won ultimately depreciated by 55 per cent between October-December 1997.

Table 8 Foreign Exchange Reserves

<table>
<thead>
<tr>
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<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Official gross reserves</td>
<td>20.3</td>
<td>25.7</td>
<td>32.7</td>
<td>33.2</td>
<td>20.4</td>
</tr>
<tr>
<td>Usable gross reserves</td>
<td>20.2</td>
<td>25.6</td>
<td>28.5</td>
<td>29.4</td>
<td>9.1</td>
</tr>
<tr>
<td>In months of imports</td>
<td>2.6</td>
<td>2.6</td>
<td>2.4</td>
<td>2.0</td>
<td>0.6</td>
</tr>
</tbody>
</table>

Source: Ministry of Finance and Economy, IMF

The Korean government mounted an ultimately unsuccessful effort to defend the exchange rate band by direct intervention (spot foreign exchange and forward contract transactions) in October-November 1997, and used over sixty per cent of the nation’s total dollar reserves without achieving its objective. Further, the Bank of Korea shifted large amounts of foreign exchange reserves to offshore branches of Korean banks to help them repay the short-term debt obligations falling due by the end of the year and otherwise maintain international creditworthiness. Thus, Korea lost US$10 billion in measured reserves and US$25 billion in usable reserves during the crisis period, almost exhausting measured official reserves during November and early December 1997 alone. The direct intervention and ensuing capital flight left the Bank of Korea with only US$6 billion in usable foreign exchange reserves by early December 1997.

II. CAUSES OF THE KOREAN FINANCIAL CRISIS

A. Explaining Financial Crisis Generally

In trying to define the underlying causes of banking and financial crises, a number of theories have been postulated. These theories are generally reviewed as follows.

1. Theories of Financial Crises

(a) Macroeconomic Policy-induced Theory

The traditional "first-generation," macroeconomic models explain that banking and financial crises primarily arise as a result of loose macroeconomic policies. A balance of payment crisis (such as currency depreciation, serious depletion of foreign exchange reserves, and collapse of a pegged exchange rate) arises when domestic credit expansion by the central bank is inconsistent with the pegged exchange rate. The credit expansion often results from excessive public sector deficit spending and expansionary monetary policy. Foreign exchange reserves fall gradually until the central bank is vulnerable to a sudden run on reserves, which exhausts the remaining reserves, and pushes the economy to a floating rate.

The traditional "second-generation" (more recent) macroeconomic models generally explain that banking and financial crises arise as the result of direct conflict between a fixed exchange rate regime and the desire to pursue a more expansionary

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15 See Steven Radelet and Jeffrey Sachs, "The Onset ...", *op. cit.*, n. 5, pp. 3-4.
monetary policy,\textsuperscript{17} if certain requirements are present.\textsuperscript{18} The fundamental tradeoff between the costs of maintaining the exchange rate band (currency parities) and/or abandoning it is a predictably deteriorating one, such that at some future date the nation would be likely to devalue its currency even in the absence of a speculative attack. The "speculators" would therefore attempt to get out of the currency prior to a perceived devaluation, ultimately forcing untimely devaluation because such activities worsen the government's tradeoff. Therefore, the crisis is ultimately provoked by the inconsistency of government policies, which make the long-run survival of the fixed exchange rate regime impossible.

\textit{(b) Financial Panic Theory}

The "financial panic" theory analyses the possibility of self-fulfilling crises.\textsuperscript{19} A "financial panic" is defined as an adverse equilibrium outcome in which short-term creditors suddenly withdraw their loans from a solvent borrower.\textsuperscript{20} In general terms, the "panic" can occur due to "herding" behaviour by foreign investors expecting currency realignments, or due to contagion effects from crises in other nations or regions, largely independent from the position of economic fundamentals. The basic notion of a self-fulfilling crisis is that international credit markets are prone to self-fulfilling crises in which individual creditors may act rationally but market outcomes may nonetheless

\begin{flushright}
\textsuperscript{18} First, there must be a reason why the government would like to abandon its fixed exchange rate. Second, there must be a reason why the government would like to defend the exchange rate. Third, in order to create the circular logic drives a crisis, the cost of defending a fixed rate must itself increase when people expect that the rate might be abandoned.
\end{flushright}

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produce sharp, costly, and fundamentally unnecessary panicked reversals in capital flows reversals.\textsuperscript{21} Therefore, this theory hold that financial markets may overreact or "overshoot" and the extent of the exchange rate adjustment exceeds any reasonable estimate of what might have been required to correct the initial overvaluations of the affected currencies.\textsuperscript{22}

(c) \textit{Bubble Collapse}\textsuperscript{23}

A "financial bubble" occurs when investors collectively purchase a financial asset at prices increasingly above its fundamental value in the expectation of continuing subsequent capital gains. In each subsequent period, the bubble may either continue to grow, or suddenly collapse with a positive probability. The collapse of the bubble and timing thereof is generally unexpected but not completely unforeseen, since market participants are aware of the bubble and the probability distribution regarding its collapse.

(d) **Moral Hazard Crisis**

A "moral hazard" crisis generally arises because banks and other non-bank financial institutions (NBFIs) are able to borrow funds on the basis of implicit or explicit government guarantees of their respective liabilities. If banks and NBFIs are systematically undercapitalised or under-regulated, they may use these funds in overly risky or even criminal ventures.

(e) **Disorderly Workout**

A "disorderly workout" occurs when an illiquid or insolvent borrower provokes creditors into a forced liquidation even though the borrower is worth more as an ongoing enterprise. A disorderly workout occurs especially when markets operate without the benefit of creditor coordination through a comprehensive legal framework for corporate bankruptcy. The problem is sometimes known as "debt overhang," wherein coordination problems among creditors prevent the efficient provision of worker capital to the financially distressed borrower, thereby delaying or preventing the eventual discharge of bad debts.

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25 See Jeffrey Sachs, "Do We Need an International Lender of Last Resort?" mimeo (1995).


2. **Explaining the Asian Financial Crisis**

The above referenced theoretical explanations of financial crises can be generally applied to the Asian financial crisis as follows.

(a) **Macroeconomic Theories**

The Asian financial crisis generally does not fit within the macroeconomic theory paradigm. The Asian crisis was generally not the result of conflicts between the pegged exchange rate regimes and the fiscal policies. Thus, unbalanced macroeconomic policies (such as incurring excessive public sector deficits) were generally not the primary characteristic of East Asian nations subject to the crisis. Moreover, the "second-generation" model also does not provide a valid explanation of the Asian financial crisis. Nations with low public debt levels, such as those in the East Asia, should not experience crisis on the basis of macroeconomic imbalances.

(b) **Self-fulfilling Crisis (Market Panic)**

The self-fulfilling crisis theory is based on the idea that the crisis is mainly the result of a self-fulfilling panic of investors. Therefore, the argument is that structural deficiencies of international capital markets were primary responsible for the Asian financial crisis. Radelet and Sachs initially explained that the East Asian crisis resulted from

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27 Radelet and Sachs, "The Onset . . .", *op. cit.*, n. 5.
vulnerability to financial panic that arose from certain emerging weaknesses in these economies (especially growing short-term debt), combined with a series of policy missteps and accidents that triggered the systemic panic. While there were significant underlying problems and weak fundamentals besetting the Asian economies at both macroeconomic and microeconomic levels, the imbalances were arguably not severe enough to warrant a financial crisis of the magnitude that took place in late 1997. In short, the Asian financial crisis was more likely triggered by dramatic swings in creditor expectations about the behaviour of other creditors, thereby creating a self-fulfilling, though possibly individually rational, financial panic. The essence of the crisis was rooted in huge, sudden capital flow reversals, as economies which previously attracted large foreign capital inflows suddenly became subject to withdrawals of short-term lines of credit, an exodus of portfolio capital, and offshore flight by domestic investors.28

Recent studies have argued that there were conditions sufficient to trigger self-fulfilling panic in the Asian financial crisis. For instance, in their second view, Radelet and Sachs argue that the main condition of a self-fulfilling panic is a high level of short-term foreign liabilities relative to short-term foreign assets.29 Chang and Velasco30 also emphasise “international illiquidity” as a principal condition of Asian financial crisis. A nation’s financial system is “internationally illiquid” if potential short-term foreign currency denominated debt obligations exceed the amount of foreign currency that the nation can access on short notice.31 Chang and Velasco further argue that financial

28 Steven Radelet and Jeffrey Sachs, “What Have We Learned, So Far, from the Asian Financial Crisis?,” mimeo (1999), p. 2.
29 See ibid.
31 Ibid., p. 22.
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market liberalisation in the late 1980s and early 1990s, an unprecedented increase in short-term foreign currency denominated liabilities, and an increase in foreign currency debt created a situation of international illiquidity, which made the East Asian countries vulnerable to self-fulfilling financial crises. Additionally, Krugman argues that the role of corporate balance sheets in determining their ability to invest, and that of capital flows in affecting the real exchange rate, are the core effects to produce a feedback loop that can cause a potentially healthy economy to experience a self-fulfilling financial crisis.32

(c) Fundamental Weaknesses (Moral Hazard)

The proponents fundamental weakness/moral hazard argue that the Asian financial crisis generated from deficiencies within the Asian economies themselves.33 In their view, these weaknesses were small enough to be overlooked in the early 1990s, but became much larger and more obvious in 1996 and early 1997. These weaknesses change resulted in a sudden fundamental shift in perceptions about the outlook for continued growth, and a rapid withdrawal of financing and capital flow reversals.

The moral hazard explanation34 emphasises the problem of speculative investment in dubious activities resulting from the moral hazard of implicit guarantees, systemic corruption and cronyism. The Asian financial intermediaries were perceived as having implicit government guarantees for their liabilities, but were essentially unregulated and therefore subject to severe moral hazard problems. The moral hazard problems, combined with the prevalent abuse of political connections, resulted in excessive

33 See, e.g., Corsetti, Pesenti, and Roubini, "What Caused ...: Part I ...," op. cit., n. 11.
speculative investment and a massive boom-bust cycle in financial and related assets, such as real estate, equities, and currencies, largely anticipated by rational market participants. When the boom cycle reversed itself, banks using assets as collateral for their credit obligations entered a sustained and inevitable period of crisis.

Corsetti, Pesenti and Roubini explain that structural and policy distortions are the roots of the Asian financial crisis, even if market overreaction/overshooting and investor herding to facilitate declines in exchange rates, asset prices and economic activity to be far more severe than perceptually warranted by the initial weak economic conditions.\footnote{See Paul Krugman, "What Happened to Asia?," mimeo (1998).}

In 1990-96, the usual conditions indicating a potential currency crisis (slow economic growth, high budget deficits, high inflation, and substantial current account deficits over several years) were not observed in East Asia. However, unsound fundamentals were at the heart of the turmoil. Under political pressure to maintain high economic growth rates, corporates were traditionally given explicit or implicit guarantees to their projects. On the financial side, the moral hazard problem guided banks to borrow excessive foreign currency borrowings and thereafter engage in excessive speculative domestic lending activities, as facilitated by the extensive liberalisation of capital markets during the 1990s. At the international level, the moral hazard problem hinged upon the behaviour of international banks and NBFIs, provided enormous amounts of credits through loan facilities with apparent neglect to sound risk management standards. Under these conditions, the current account imbalances, quantity and quality of financial overlending, banking problems, and composition, maturity and size of capital inflows and reversals are the roots of the financial crisis.

\footnote{Corsetti, Pesenti, and Roubini, "What Caused ...: Part I ...," \textit{op. cit.}, n. 11.}
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(d) IMF Perspective

IMF analyses of the Asian financial crisis generally identified economic overheating, fixed exchange rates, financial weakness, lack of information and transparency, and loss of confidence as underpinnings of the crisis.36 According to the IMF,37 fast growth in domestic credit in the East Asian nations created overheated economies, which in turn generated large current account deficits and asset value inflation. The sustained maintenance of pegged exchange rate regimes encouraged large capital inflows that reversed themselves when the regime became unstable. Moreover, financial systems in the East Asian nations were systemically unsound, due to (1) weak management and poor control of risks, (2) lax enforcement of banking regulation and inadequate prudential supervision, and (3) governmental interference, directed credit policies, and lending to related parties. The absence of timely and accurate information and transparency in general were also pervasive in East Asian financial systems, which hindered market participants from maintaining realistic views of economic fundamentals. Finally, a lack of confidence unfolded in each nation just before the financial turmoil commenced, primarily resulting from political uncertainties regarding the authorities' commitment to maintaining pegged exchange rate regimes and implementing the necessary reforms and adjustments. This degeneration of confidence exacerbated the respective currency depreciation and declines in equity market indexes and other financial market asset prices. At the external dimension, large private capital flows were driven by an

37 IMF, World Economic Outlook (May 1998), p. 3.
underestimation of risks for higher yields. Thus, international investors contributed significantly to the downward pressure on the respective currency in crisis, especially the Thai baht in July 1997.

B. Origins of the Korean Financial Crisis

In looking specifically to the origins of the Korean financial crisis, the following specific observations can be made.

1. The Chaebol Structure

The Korean financial crisis stemmed in large part from the chaebol structure and its relationship to the failure of the financial system (especially as to the commercial banking and merchant banking sectors). With respect to the non-financial business aspects, several factors causing the economic crisis have been identified, including excess leverage (the ratio of debt to equity) and overly concentrated investments. The chaebols generally maintained high leverage given their easy access to credit from financial institutions. The average leverage ratio of the thirty largest chaebols was approximately five to one in 1996. At the same time, the chaebols' over-leveraged expansion caused excess industrial capacity. A statistical review of the financial practices and performance of corporates in East Asia reveals the trend of unsustainable rapid (and probably excessive) investment in fixed assets by excessive borrowing in Korea. The declining economic growth induced highly leveraged chaebols to prevail to overwhelmingly high debt burdens, and when the corporate sector could no longer service its debt obligations,

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38 See Pomerleano, op. cit., n. 9.
the financial sector was predictably burdened with massive nonperforming loans. The problems of excessive leverage and overcapacity led to the financial crisis, especially banking system failure, where the government intervened directly at the micro-level by controlling and manipulating the banking industry to carry out governmental economic policies.

2. Government Control over Banking Industry

As discussed in Chapter Two of this thesis, the Korean government controlled the banking industry in two ways. First, the government's control and intervention came from its legal and practical control over the regulatory and supervisory framework of the banking industry. Secondly, the Korean commercial banks were largely controlled and utilised for channelling funds to support the government's economic development plans. The government exerted direct control over bank regulators and supervisors such that the Korean commercial banks were relegated in essence to become "government agents."

Moreover, the government regarded the chaebols as pillars of the economy, and implicitly guaranteed that they would not fail. The Korean banks, therefore, would continue lending to them, regardless of the health of the underlying business, especially through loans secured with collateral, usually real property. As of June 1997, the ratio of collateralised commercial loans to total Korean loans dominated in won was approximately 50.6 per cent. Among the Korean nationwide commercial banks, the large commercial banks, which were controlled longer and more intensively by the

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39 See Chapter Two Section II C.
government on an aggregate basis, suffered more from non-performing loans than other newly established nationwide banks.

Under these circumstances, the Korean banking industry was thoroughly permeated with a culture of “moral hazard.” The Korean banks kept lending to chaebols which the government preferred or otherwise presented no objections thereto. Although government involvement in banking lending decisions gradually declined since banking industry liberalisation began in 1980s, Korean banks nonetheless developed few skills in credit analysis or risk management. Lending decisions were still largely based on the availability of collateral rather than on an assessment of risk or future repayment capacity. Reflecting the history of directed lending, banks generally did not insist on, or receive, full financial information from chaebols.

3. Lax Regulation and Supervision

As also discussed in Chapter Two in this thesis, the Korean government’s control over the domestic banking industry focused on the credit allocation among banks. Korea’s banking regulatory and supervisory framework was poorly implemented and the existing prudential regulations were not meaningfully enforced. The moral hazard problems created incentives for risky behaviour, but the lax prudential regulation and supervision did not allow the Korean banking regulatory and supervisory authorities to recognise and address these issues.

41 Unlike other Asian countries which experienced the financial crisis in 1997, in Korea, the quantity of lending growth was not significant during the 1990s, but many loans made by the banks and NBFIs were of low quality. See Corsetti, Pesenti, and Roubini, “What Caused …: Part I …,” op. cit., n. 11, pp.25-27 and Tables 18-20.
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The regulations concerning the Korean specialised banks and other non-bank financial institutions were more problematic. For specialised banks, only nominal regulation and supervision existed. Only single borrower lending limits and payment guarantee limits were enforced, but there were various exceptions, which subsumed the regulations themselves. For NBFIs, merchant banking corporations were prohibited from lending and discounting commercial bills\(^{44}\) or providing payment guarantees to any single individual or juridical person in excess of twenty-five per cent of its equity.\(^{45}\) The aggregate amount of borrowings, commercial paper issues, debt obligations, debentures, guarantees on commercial paper issues, and payment guarantees could not exceed twenty times the company’s equity.\(^{46}\) Merchant banking corporations could exceed these limitations when the MoFE authorised such activities, however. Under MoFE guidelines, the aggregate amount of commercial bill discounts, commercial bill brokerages, loans, and payment guarantees to the controlling shareholder was limited to 100 per cent of merchant banking corporation equity. The aggregate amount of commercial bill discounts, loans, and payment guarantees to a single affiliated business group was limited to 150 per cent of the equity.

The Office of Bank Supervision of the Bank of Korea (OBS) also permitted the banks to utilise lax and often unrealistic accounting standards. The commercial banks were required to reserve minimum 100 per cent loan loss provisions under OBS regulations. Under the OBS loan classification standards, banks were required to have on

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43 See Chapter Two Section II C.
44 Merchant Banking Act of 1995 art. 15, cl. 1.
45 Ibid. art. 15, cl. 2.
46 Ibid. art. 14.
reserve a total amount of 0.5 per cent of normal loans, one per cent of precautionary loans, twenty per cent of substandard loans, seventy-five per cent of doubtful loans, and 100 per cent of estimated loss loans. However, the OBS permitted banks' reserves to average ninety-four per cent of estimated loss loans as an interim target ratio in 1997.\(^{47}\)

The commercial banks were also required to have securities investment loss provisions of thirty and fifty per cent in 1996 and 1997 respectively.\(^{48}\) Even if the banks were required to meet the minimum eight per cent capital adequacy ratio on risk-weighted assets, the OBS provisioning ratios essentially limited the desired result. Under the OBS interim target ratios, only four commercial banks officially failed to meet the minimum capital adequacy ratio at the end of 1997. When the commercial banks were required to reserve 100 per cent loan loss provisions and securities investment loss provisions, however, only twelve of the twenty-six commercial banks could meet the minimum capital adequacy ratio.\(^{49}\)

Moreover, neither the regulatory nor supervisory authorities had implemented any measures to regulate and supervise Korean financial institutions in foreign currency denominated borrowings. Korea's total external liabilities were US$180.1 billion and US$158.1 billion as end of September and December 1997 respectively.\(^{50}\) The external liabilities had increased approximately 400 per cent over the last five years. Korean financial institutions, including commercial banks, were responsible for more than sixty-

\(^{47}\) The OBS set the interim target ratio on loan loss provisions between eighty-three and 100 per cent based on the bank's financial condition. See Office of Bank Supervision Press Release, "Regulatory Guidelines for Provisioning in Fiscal Year 1997 and Supervisory Measures to Problem Banks" (22 Dec. 1997).


\(^{50}\) See Table 4.
five per cent of total external liabilities as end of 1996. The structure of external liabilities revealed that short-term liabilities were more than sixty-three per cent of the total liabilities as end of 1996. More importantly, the financial institutions generally mismatched their foreign currency dominated lendings and borrowings by funding long-term lending facilities with short-term foreign currency denominated borrowings, which cost less than long-term borrowings. Under this mismatch problem, the commercial banks were not required to maintain adequate liquidity ratios on the foreign currency assets until June 1997. The OBS thereafter reviewed the ratios and, according to the audits of nationwide commercial banks, no nationwide commercial bank met the 100 per cent liquidity ratio as of end of the 1997; and only four banks maintained the minimum seventy per cent ratio (which the OBS required as an adequate level). Additionally, it is well recognised these banks also invested in foreign securities of nations such as Thailand, Indonesia, and Russia, and Latin America (Brady bonds) with about twenty per cent of their foreign borrowings. Thus, it is clear that insufficient capital adequacy ratios, inadequate legal lending limits on single borrowers or groups of related borrowers, inadequate asset classification systems and poor provisions for possible losses, and a general absence of meaningful disclosure and transparency of bank operations all contributed to banking fragility and the collapse of the Korean banking system.

51 As of June 1997, the ratio was 67.9 per cent. The figures had gone down 61 per cent, 55 per cent, and 44.3 per cents of total liabilities as of September, November, and December 1997 respectively because of loan withdrawals by foreign banks.
52 The liquidity ratio on foreign currency asset = foreign currency assets with less than three month maturity foreign currency borrowings x 100.
4. *Increasing Financial Fragility*

The conditions of moral hazard and lax regulation and supervision rendered Korean banks and NBFIs more vulnerable to economic shocks in facilitating lending to economic sectors or firms whose debt service capacity was particularly susceptible to shocks and by reducing their own capacity to absorb negative shocks, especially by exacerbating currency and maturity mismatches and by under-provisioning for future potential losses. The general absence of meaningful regulation and supervision of financial institutions allowed poorly governed corporations to invest borrowed money in highly inflated or risky assets. The commercial bank trust businesses and merchant banking corporations were crucial for the buildup of the crisis due to weak and arbitrage regulation and supervision and the development of risky practices.\(^{55}\)

The general lack of transparency, in the form of unreported mutual guarantees, nondisclosure of corporate and bank net positions, and insider relations, masked the effect of poor investments and speculative lending activities, and prevented the market from recognising and correcting the problems through “market discipline” channels. These weaknesses were aggravated by undisciplined foreign lending. The problem was not so much overall indebtedness, but the composition of debt, with a buildup of short-term, unhedged foreign currency debt leaving the economies vulnerable to a sudden to a sudden loss of confidence.\(^{56}\) Further, the serious mismatch between foreign liabilities and foreign assets of Korean banks and NBFIs and growing corporate bankruptcies put the Korean financial institutions, especially several merchant banking corporations, under

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\(^{55}\) Baliano and Ubide, *op. cit.*, n. 42, p. 16.
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significant pressure since much of the foreign borrowing of these companies had been, in effect, channelled through (and in some cases guaranteed by) them.

III. RESPONSES TO THE CRISIS AND CRISIS MANAGEMENT

A. Dealing with Growing Corporate Bankruptcies Before the IMF Programme

The Hanbo Steel Co., Hanbo group's main company, defaulted on its debt obligations on 23 January 1997. The Hanbo "bribe-for-loan" scandal underscored that Korea needed sweeping financial reforms.57 The scandal forced the Korean government to decide against rescuing the Hanbo group from bankruptcy and insist on a more rigorous treatment based on market principles rather than the past policy of dealing with chaebol that bankruptcies of chaebol by takeovers from larger groups with government subsidised loans. Foreign investors perceived the Korean government policy in handling the Hanbo bankruptcy was regarded as a firm determination for market reforms toward a more independent and accountable banking system, even if Hanbo's collapse made foreign lenders suspend or limit financing to the overseas branches of Korean banks, given the continued widening of the so called "Korean Premium."58

After the Hanbo collapse, to promote corporate rehabilitation and restructuring, the Korean government introduced the Bankruptcy Deferment Accord (BDA) in April 1997. The BDA was intended to facilitate support to the troubled companies and prevent

56 Alba et al., op. cit., n. 4, p. 59.
their bankruptcies; the Jinro and Dainong groups were among those supported by the scheme. Notwithstanding the government's efforts towards rescuing troubled companies, on 15 July 1997 the Kia group became threatened with insolvency and was aided under the BDA. The government, dealing with the Kia collapse at the early stage, resisted widespread calls for a wholesale bailing out of Kia and other troubled chaebols.  

The MoFE, facing the difficulties in the financial industries, announced its package for financial assistance on 25 August 1997. The announcement was intended to help the banking sector following the string of chaebol collapses. The financial assistance would be channelled through the Korea Asset Management Corporation (KAMC) to take over non-performing assets. The announcement also offered emergency loans from the BOK to commercial banks and merchant bank corporations. On 22 October 1997, the Korean government decided to bail out the near-bankrupt Kia group. This was the turning point where Korea's private banking crisis officially became a sovereign crisis. On 24 October 1997, Standard & Poor's (S&P) promptly downgraded the credit ratings of Korea from AA- to A+ with the rating outlook remaining negative. The rating agency criticised the decision to bail out Kia by saying that 'the bailout might alleviate short-term pressures but the long run economic consequences are unambiguously negative.' On 28 October 1997, Moody's also downgraded Korea's short-term credit rating from Prime-1 to Prime-2. Under the Cooperative Financing System, the Korean government tried to revive Kia by forcing the banks to lend unlimited

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61 Park and Rhee, op. cit., n. 58, p. 15.
63 See Park and Rhee, op. cit., n. 58, p. 15.
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amounts until Kia's rehabilitation was secure. The government even suspended the lending limit guidelines against the new loans to Kia.

Moreover, in response to the growing foreign liability payment pressure, Korea pledged its foreign currency reserves to bail out banks and guarantee foreign loans to corporate borrowers that promoted its export policy. In August, the government decided to extend its foreign currency reserves to merchant banking corporations, and there was abundant speculation concerning the level of usable foreign currency reserves held by the Bank of Korea. In November 1997, the Korean press reported that Korean commercial banks were practically in default on their foreign liabilities and the Bank of Korea deposited its foreign currency reserves in the foreign branches or subsidiaries of Korean commercial banks in order to prevent the defaults. In October and November 1997, the Korean government announced fundamental restructuring packages to deal with the escalating financial crisis. The government announced policies for opening long-term bond markets and liberalising foreign borrowing to induce foreign capital. On 19 November 1997, two days before Korea officially requested monetary assistance from the IMF, the government also announced a set of financial support policies. These policies entailed: (1) enhancing the financial capacity of the KAMC to purchase distressed assets, which would then be purchased by the government within two years; (2) facilitating the restructuring of financial institutions through mergers and injections of new funds by domestic and foreign investment; (3) providing vastly increased deposit

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64 See "Is a Financial Panic Coming?" Korea Economic Daily (6 Nov. 1997).
insurance by raising the capital of the Deposit Insurance Corporation almost tenfold; (4) further liberalising the capital account by raising the limits on individual investments by foreigners and guaranteeing corporate bonds with maturities over three years; and (5) strengthening financial disclosure standards and loan classification requirements. This package was announced one month before the presidential election, however, and was generally viewed as neither credible nor tenable.

B. International Monetary Fund Programmes

After consistent denials, Korea’s new Minister of Finance and Economy announced on 21 November 1997 that Korea would seek a rescue package from the International Monetary Fund (IMF). After negotiations, the Korean government and IMF jointly announced a US$21 billion stand-by credit facility in support of the Korean economic adjustment programme. Some US$36 billion of additional financing from multilateral and bilateral sources were also announced in support of the programme. Under the IMF agreement, the Korean government agreed to undertake various measures. First, a strong macroeconomic framework designed to continue orderly reductions in the external current account deficit, build up international reserves, and contain inflationary pressures through tighter monetary policies and significant fiscal adjustment. Second, a comprehensive strategy to restructure and recapitalise the financial sector and improve transparency, market-oriented practices, and supervision. Third, measures to reduce the

70 See Adelman and Song, op. cit., n. 57.

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high degree of reliance by corporates and financial institutions on short-term debt obligations and facilitate improved diversification of risk in the economy.\footnote{International Monetary Fund Press Release, "IMF Approves SDR 15.5 Billion Stand-by Credit for Korea" (4 Dec. 1997). In summary, the IMF programmes have had nine main declared goals: (1) prevent outright default on foreign obligations; (2) limit the extent of currency depreciation; (3) preserve a fiscal balance; (4) limit the rise in inflation; (5) rebuild foreign exchange reserves; (6) restructure and reform the banking sector; (7) remove monopolies and otherwise reform the domestic non-financial economy; (8) preserve confidence and creditworthiness; and (9) limit the decline of output. See Radelet and Sachs, "The Onset...," op. cit., n. 5, p. 24.}

The programmes have been based on five key policy components: macroeconomic and fiscal policies, financial sector restructuring, capital account and trade liberalisation, corporate governance and corporate restructure, and labour market reform.\footnote{These included US$14 billion from the World Bank and the Asian Development Bank, and US$22 billion from a group of industrial countries.} First, in order to reduce the current account deficit and to contain inflation to five per cent, the Korean government pursued stringent fiscal and monetary policies by (1) tax increases and expenditure cuts, and (2) a substantial increase in interest rates. Second, to achieve a prudentially sound financial system, the programme planned to set up a strong, independent financial regulatory and supervisory authority; strengthen prudential regulations; close non-viable merchant banking corporations; and nationalise certain commercial financial institutions. Third, the further liberalisation of financial markets by proceeding to fully liberalise the use of money market instruments, allowance of foreign investment in domestic financial institutions, authorisation for foreign banks and brokerage houses to establish subsidiaries, and elimination of ceilings on foreign investment in Korea equities. The trade opening was to abolish trade-related subsidies and liberalise merchandise imports and foreign financial services. Fourth, in order to improve corporate governance and the corporate structure, the transparency of corporate balance sheets was to be improved by enforcing accounting standards and the
restructuring of corporate finances was to be encouraged by measures to reduce the high
debt-equity ratios, capital market development, and changes to the cross guarantee system with chaebols. Fifth, the labour market was to be made more flexible by clarifying the circumstances and procedures for layoffs. The subsequent IMF programmes relaxed monetary and fiscal targets. The second IMF programme adopted on 24 December 1997 allowed the Korean government to sterilise activated amounts from the 11.3 trillion won liquidity support package provided to the financial sector as necessary to keep overall liquidity sufficiently tight to maintain interest rates at adequate levels. The third IMF programme adopted on 7 January 1998 authorised the Korean government to expand the money supply by 14.9 per cent as of March 1998. The fourth IMF programme adopted on 7 February 1998, a fiscal deficit of about 0.8 per cent of GDP was projected. With the updated macroeconomic projections indicating weaker growth and ongoing structural adjustment in the economy, a larger fiscal deficit, 1.2 per cent of GDP, was permitted.

76 The first IMF programme was designed to yield 1.5 per cent of GDP.
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IV. REFORMING THE FINANCIAL SYSTEM

A. New Financial Regulatory and Supervisory System

The Korean government introduced a plan to reform the central banking and financial supervisory systems in July 1997 and further submitted thirteen financial reform bills, including a Revised Bank of Korea Act and an Act Concerning Establishment of Financial Supervisory Organisations. The proposed legislation received substantial objections from financial supervisory organisations, those Bills were not enacted until the IMF intervened. On 29 December 1997, in a special session of the National Assembly following the Stand-By Arrangement between the Korean government and the IMF that required financial sector restructuring, the Bills were enacted. The General Banking Act was also amended on 13 January 1998 and came into effect on 1 April 1998.

1. Bank of Korea

The Revised Bank of Korea Act 1997 designates the Bank of Korea (BOK) as the monetary authority. It also mandates price stability as the sole objective of the BOK. The Act also changes the composition of the Monetary Policy Committee (MPC), which replaced the Monetary Board. The MPC consists of seven members, including the Governor of the Bank of Korea (Governor). The Governor is nominated by the President

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and approved by the State Council. Three of the seven members are recommended respectively by the MoFE, the Governor, and the Chairman of the Financial Supervisory Commission; and the remaining three are recommended by the President of the Korea Chamber of Commerce and Industry, the Chairman of the Korea Federation of Banks, and the Chairman of the Korea Securities Dealers’ Association, respectively. The Governor is designated as Chairman of the MPC. Under the revised Act, the BOK implements monetary policy based on market principles and harmonises its policies with the government’s economic policies, but only insofar as it does not conflict with the BOK’s main objective of maintaining price stability. The revised Act significantly repudiates government control over the BOK by removing the chairmanship position and the membership from the MoFE to the MPC. The revised Act further reduces the power of the Minister of MoFE to appoint the Auditor of the BOK and to administer the appointment process for MPC members. Thus, the MoFE no longer has the right to review the business activities of the BOK, but on the other hand it retains the power to request reconsideration of MPC decisions (but only when the resolution is in conflict with the government’s economic policies). In such cases, the MoFE should immediately announce its request publicly.

Under the Revised Bank of Korea Act, the banking regulatory and supervisory responsibilities are transferred from the BOK to the Financial Supervisory Commission (FSC). However, the BOK retains limited supervisory roles as the de jure lender of last

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80 Revised Bank of Korea Act art. 1.
81 Ibid. art. 13, cl. 1.
82 Ibid. art. 13, cl. 2.
83 Ibid. art. 4.
84 The Auditor shall be appointed by the President on the recommendation of the Minister of MoFE.
85 Revised Bank of Korea Act art. 92.
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resort. The BOK retains the right to request financial institutions and the financial supervisory authorities to submit information necessary to implement monetary policy.\textsuperscript{86} The BOK further retains the right to request financial supervisory authorities to inspect commercial banks and implement corrective measures.\textsuperscript{87} If necessary, the BOK may request a joint inspection.\textsuperscript{88} Finally, the BOK maintains the right to inspect operations and assets of financial institutions when it extends liquidity support to them.\textsuperscript{89}

2. Financial Supervisory Commission, Securities and Futures Commission, and Financial Supervisory Board

The Act Concerning Establishment of Financial Supervisory Organisations establishes a new financial regulatory and supervisory system. The Financial Supervisory Commission (FSC) under the jurisdiction of the Prime Minister is responsible for promulgating and amending supervisory rules and authorising business activities and operations of the financial institutions.\textsuperscript{90} The FSC consists of seven members: the chairman, the vice-chairman, the vice-Minister of MoFE, the Deputy Governor of the BOK, the head of the consolidated Korea Deposit Insurance Corporation, a financial expert nominated by the chairman of the Commission, an accounting specialist nominated by the Minister of MoFE, a legal expert nominated by the Minister of Justice, and a representative of the business sector nominated by the President of the Korea

\textsuperscript{86} Ibid. art. 87.
\textsuperscript{87} Ibid. art. 88, cls. 1 and 2.
\textsuperscript{88} Ibid. art. 88, cl. 1.
\textsuperscript{89} Ibid. art. 65, cl. 3.
\textsuperscript{90} Act Concerning Establishment of Financial Supervisory Organisations art. 3; Act Concerning Establishment of Financial Supervisory Organisations art. 17. Even if placed under the Prime Minister, the FSC shall operate its functions independently from the Prime Minister under the article 3 of the Act.
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Chamber of Commerce and Industry. The chairman, the vice-chairman, and the financial expert are to serve on a full-time basis for a renewable three year term. The Securities and Futures Commission (SFC) is responsible for overseeing the securities and futures markets under the guidance of the FSC. The FSC vice-chairman is designated to hold the position of the SFC chairman.

Under the Act, the Financial Supervisory Service (FSS) was established as a special juridical person on January 1, 1999 as prescribed by subsequent Presidential Decree. The FSS is responsible for inspecting, auditing, and sanctioning financial institutions under the direction of the FSC and the SFC. The FSC chairman is also designated as FSS. From April 1, 1998 until the FSS was established, financial institutions were essentially supervised by several institutions. The OBS, which was separate from the BOK, was responsible for supervising commercial banks, long-term credit banks, the NACF, the NFFC and its member cooperatives, the NLCF, trust companies, and other institutions as FSC sees fit. The Securities Supervisory Board was responsible for supervising securities companies, securities finance corporations, investment advisory companies, securities investment trust companies, and futures trading companies. The Insurance Supervisory Board as its name implies was responsible for supervising insurance companies. Finally, the Credit Management Fund supervised merchant banking corporations, mutual savings and finance companies,

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91 Act Concerning Establishment of Financial Supervisory Organisations art. 4, cl. 1.
92 Ibid. art. 6, cl. 1.
93 Ibid. art. 19.
94 Ibid. art. 20, cl. 2.
95 Ibid. art. 24; Ibid. Addenda art. 1.
96 Act Concerning Establishment of Financial Supervisory Organisations art. 37.
97 Ibid. art. 29, cl. 2.
98 Ibid. Addenda art. 2, cl. 2, no. 1.
99 Ibid. Addenda art. 2, cl. 2, no. 2.
financial companies specialising in loan business, and credit unions.\textsuperscript{101} The Korea Development Bank, the Export-Import Bank, and the Industrial Bank of Korea had been regulated and supervised by the MoFE.

Although the FSC and FSS are authorised financial regulatory and supervisory entities, the BOK retains the right to request that FSS conduct on-site or, in conjunction with the Bank, joint examinations of specific banks.\textsuperscript{102} Furthermore, the BOK may request the FSS for its findings from the examinations and, on the basis of these findings, may request that FSS order banking institutions to implement corrective measures.\textsuperscript{103} In the above situations, the FSS must accept and act on BOK requests.\textsuperscript{104} The Korea Deposit Insurance Corporation (KDIC) may also request the FSC and the FSS to conduct on-site or joint examination of insured financial institutions.\textsuperscript{105} Additionally, the MPC of the BOK may request the FSC to reconsider a previously adopted resolution provided that the resolution has direct relation to and impact on monetary and credit policies.\textsuperscript{106} When the request for reconsideration is made, the final decision requires a 2/3 majority vote of the FSC membership.\textsuperscript{107} The MoFE, the MPC, and the FSC may, when any one of them deems it necessary for the conduct of its policies, request information and data from each other.\textsuperscript{108} In those cases, each of them must comply with the request unless a feasible reason can be given for not doing so.\textsuperscript{109}

\textsuperscript{100} Ibid. Addenda art. 2, cl. 2, no. 3.
\textsuperscript{101} Ibid. Addenda art. 2, cl. 2, no. 4.
\textsuperscript{102} Ibid. art. 62, cl. 1.
\textsuperscript{103} Ibid. art. 62, cl. 2.
\textsuperscript{104} Ibid. art. 62, cl. 4.
\textsuperscript{105} Ibid. art. 66.
\textsuperscript{106} Ibid. art. 63, cl. 1.
\textsuperscript{107} Ibid. art. 63, cl. 2.
\textsuperscript{108} Ibid. art. 65.
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3. New Role of the MoFE

The MoFE retains authority over financial policies at the macroeconomic level, foreign exchange policies, and preparation of financial-related legislation. The licensing authority for banking institutions was initially transferred to the MoFE from the Monetary Board. In May 1999, the authority over licensing financial institutions and prudential supervision of specialised banks was transferred to the FSC.

4. Depoliticalisation

The Korean reforms regarding central banking and financial regulatory and supervisory systems are necessary steps towards establishing a new banking system which is structurally independent from other government departments (especially the MoFE). However, the reformed banking regulatory and supervisory structure does not entirely remove the possibility of undue government agency and other political interference over the Korean banking system. As part of the executive branch, the FSC can still exert significant control over the Korean banking system to pursue the government's objectives. Moreover, the reformed system does not provide any practical means to prevent or substantially limit political interference.

B. Financial Sector Restructuring Programmes

Under the IMF agreement, the Korean government agreed to make its financial system more transparent, market-oriented, competitive, and well regulated and supervised with

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109 Ibid. art. 65.
clear and firm exit policies.\textsuperscript{112} The reforms implemented in the financial sector may be divided into three components: restructuring troubled financial institutions, disposing of non-performing loans and improving prudential supervision.

\textit{1. Restructuring Financial Institutions}

\textit{(a) Merchant Banking Corporations}

Prior to the financial crisis, there were thirty merchant banking corporations operating in Korea. As providers of short-term financing,\textsuperscript{113} the merchant banking corporations were capitalised with public deposits, and also borrowed in domestic and foreign currency from the Korean commercial banks and foreign financial institutions. However, the merchant banking corporations had significant "mismatch" problems. In November 1997, approximately eighty-four per cent of their assets had longer maturities than the sources of capital.\textsuperscript{114} As the Korean economic and financial conditions deteriorated, their non-performing assets increased. According to the FSC, the ratios of non-performing assets to total assets of the merchant banking corporations were 1.55 per cent, 1.76 per cent and 4.49 per cent as at the end of December 1996, June 1997 and December 1997, respectively.\textsuperscript{115} Further, the pressures of foreign currency withdrawals from international institutions increased and several merchant banking corporations faced defaults. Thus, on 25 November 1997, the MoFE suspended foreign currency operations of eight

\begin{footnotesize}
\begin{enumerate}
\item Revised General Banking Act of 1998 art. 28, cl. 1.
\item See Revised General Banking Act of 1999 art. 8, cl. 1.
\item See IMF Press Release, \textquotedblleft IMF Approves SDR 15.5 Billion Stand-by Credit for Korea,	extquotedblright\ Press Release No. 97 55 (4 Dec. 1997).
\item See Chapter One Section I.
\item See E. A. Lee, \textquotedblleft Conditions of Merchant Banks,	extquotedblright\ \textit{Maeil Business Newspaper} (19 Nov. 1997).
\end{enumerate}
\end{footnotesize}
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merchant banking corporations and ordered them to transfer their foreign currency assets and liabilities to designated commercial banks.

Under the IMF programme, the Korean government demonstrated its intention to close troubled financial institutions. The MoFE suspended operations of nine insolvent merchant banking corporations on 2 December 1997 and five additional merchant banking corporations on 10 December 1997, respectively. The MoFE then required all thirty merchant banking corporations to submit preliminary rehabilitation plans. The Evaluation Committee for Merchant Banking Corporations, established on 29 December 1997, completed its assessment of plans submitted by the merchant banking corporations based on their ability to achieve Basle Committee capital adequacy ratios of four per cent by 31 March 1998 and six per cent by 30 June 1998. The ten merchant banking corporations that were suspended after the Evaluation Committee's first assessment were closed by revocation of their respective licenses on 27 February 1998. The remaining twenty merchant banking corporations were required to submit revised rehabilitation plans for a second round of evaluations by the Evaluation Committee.

The second round of evaluations were premised on liquidity, asset quality, and management capability.\textsuperscript{116} The Evaluation Committee recommended the closure of two additional merchant banking corporations and revaluation of three other merchant banking corporations. Of those five merchant banking corporations, three were ultimately closed. The remaining fifteen merchant banking corporations, whose rehabilitation plans were approved, were required to enter into managerial contracts with

\textsuperscript{115} See Financial Supervisory Commission, "Financial and Corporate Restructuring: Progress and Future Tasks" (March 1999), p. 29.  
the supervisory authorities. These contracts included timetables for achieving and maintaining operations in compliance with the capital adequacy ratios of four per cent by 31 March 1998, six per cent by 30 June 1998, and eight per cent by 30 June 1999, respectively. If rehabilitation plans were not implemented to the satisfaction of supervisory authorities, the merchant banking corporation(s) in question would have its (their) licenses revoked.\footnote{See Republic of Korea, “Letter of Intent Sent to IMF and Memorandum on the Economic Reform” (18 Feb. 1998); Ministry of Finance and Economy Press Release, “Merchant Banking Corporation Evaluation”} As a result of end-June 1997 evaluation, which required the merchant banking corporations to meet capital adequacy ratio of six per cent, two additional merchant banking corporations were ultimately closed. In January and February 1999, two other merchant banking corporations were merged with commercial banks. Thus, at present eleven merchant banking corporations are operating, and one merchant bank corporation is suspended.

In response to the suspension and closures of merchant banking corporations, a “bridge” merchant banking corporations, called Hanaerum Merchant Bank, was established in December 1997 to assume control over and liquidate their assets. This institution also assumed control over the deposits of suspended or closed merchant banking corporations, along with most of their performing assets.

\subsection*{(b) Commercial Banks}

\subsubsection*{(1) Initial Measures}

The Korean government employed a different approach in the commercial banking sector. One of the ten Korean local commercial banks had a 21.4 per cent ratio of non-
performing loans to total loans as at the end of 1997, while four other such banks had 18.3 per cent, 14.9 per cent, 12.5 per cent, and 11.3 per cent non-performing loans to total loan ratios, respectively. Two nationwide commercial banks, the Korea First Bank and Seoul Bank, had 11.4 per cent and 10.3 per cent non-performing loans.\textsuperscript{118} Thus, upon full disclosure of loan losses and securities investment losses, these banks had -2.70 per cent and 0.97 per cent of capital ratios to risk-weight assets as of end of 1997.\textsuperscript{119} Unlike the merchant banking corporations, the Korean government initially neither suspended nor closed the troubled commercial banks. Instead, the government unilaterally reduced the existing shareholders equity of the Korea First Bank and Seoul Bank, which were both technically insolvent, from 820 billion won to 100 billion won each (the minimum amount of equity required for a nationwide commercial bank under the General Banking Act), and provided capital injections in January 1998.\textsuperscript{120} After recapitalisation, the capital adequacy requirement ratios for these institutions improved dramatically, to 7.15 per cent and 11.63 per cent, respectively.\textsuperscript{121} The government and KDIC effectively acquired an ownership stake of ninety-four per cent in each bank, effectively nationalising them, and appointed outside experts to assist the Privatisation Committee in developing privatisation strategies and select lead managers for privatising these


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banks. The government planned to sell at least one of these banks to foreign financial institution to normalise the operations.

In addition, the OBS ordered measures designed to improve management for six commercial banks whose capital adequacy ratios based on full provisioning fell below six per cent, and management improvement recommendations for six commercial banks whose ratios fell between six and eight per cent, as of year end 1997. Under the management improvement recommendations, the commercial banks must meet the minimum eight per cent capital adequacy ratio within six months to two years. The respective banks must formulate clear plans for utilising new capital sources and reducing the amount of risk assets to meet the minimum ratios. Until the respective banks meet the minimum ratio, dividend payouts are suspended, unprofitable branches must be closed, and authorisation must be obtained to conduct new activities or considerably expand existing operations. Thus, such banks are required to:

(1) establish measures to reduce costs and improve internal governance;
(2) establish and carry out measures to reduce non-performing loans and improve risk assessment, pricing, and loan recovery;
(3) replace management;
(4) improve internal audit and control functions and develop risk management systems with appropriate risk levels; and

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(5) present business plans and expected financial statements for the next three years.

Under the management improvement measures, the banks must meet all requirements of the management improvement recommendations. Beyond the above referenced requirements, banks are obliged to establish measures for restructuring; replace external auditors; analyse internal governance systems and submit plans to improve them; and present business plans and expected financial statements for the next five years. In addition, the banks are prohibited from new investments and expanding operations. The twelve banks, under the management improvement measures or recommendations, were required to submit its recapitalisation plans to the OBS by 30 April 1998. If the plans were approved by 30 June 1998, the bank in question would enter into a managerial contract with the OBS to implement the plans, which would include a schedule for achieving specified goals. If the plans were rejected or otherwise not implemented as agreed, the OBS would adopt appropriate measures to the full extent of its powers. The government further established a special task force for the MoFE to coordinate, monitor and assess rehabilitation plans, bank restructurings, and use of public funds. The Task Force functions were transferred to a bank restructuring unit under the Financial Supervisory Commission in April 1998.

ordered the management improvement recommendations on September 5, 1997 and the management improvement measures on December 22, 1997.


Ibid.

The Task Force was established under the IMF programme. The members of the Task Force, chaired by a Director General level staff at the MoFE, include two or three staff of director level members from the MoFE, the OBS, the Korea Asset Management Corporation, and the Korea Deposit Insurance Corporation. The Director of Supervision Policy of the OBS, the Executive Director of the KAMC, the Director of Management of KDIC, and non-government specialists such as financial researchers, lawyers, and accountants participate in the ordinary meetings.
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The twelve commercial banks whose capital ratios fell below eight per cent as of December 1997 submitted their rehabilitation plans by 30 April 1998. After evaluations by external auditors based on capital adequacy, the recapitalisation plan, assets quality classification, the reduction plan for risky assets, cost reduction measures, and the management improvement plan, a Bank Management Evaluation Committee (or Bank Appraisal Committee)\textsuperscript{128} evaluated the rehabilitation plans as to whether the banks could meet the revised capital adequacy ratios of either eight per cent (or six per cent if a bank would not engaged in the international operations) by June 2000.\textsuperscript{129} On 28 June 1998, the Committee reported its final assessment results to the FSC, wherein five banks' plans were approved, two banks received conditional approvals, and six banks' plans were rejected.\textsuperscript{130}

(2) Bank Closures

On 29 June 1998, following review of the Bank Management Evaluation Committee report, the FSC conditionally approved seven banks' plans and disapproved of five banks' plans, respectively. The FSC considered the Bank Management Evaluation Committee's recommended approvals of four banks' plans with some reservations, and decided that such plans were evaluated as being vulnerable to external macroeconomic

\textsuperscript{128} The Committee was established on 20 June 1998. It consisted of twelve members from the private sectors. The chairman was the representative of the lead accounting firm from the group of accounting firms that had conducted evaluations on rehabilitation plans. The other members were selected from accounting firms (five members), law firms (two members), university professors (one member), research institutions (one member), consulting firms (one member), and international experts (one member).


\textsuperscript{130} Ibid.
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conditions and relied on internal sources of funds rather than external funds. 131 The FSC also decided that one bank’s plan, despite receiving disapproval by the Bank Management Evaluation Committee, should be approved with conditions because the bank’s total assets exceeded its total liabilities. The Financial Industry Restructuring Act did not allow for the closure of a bank with positive net worth. Therefore, the bank legally could not be classified as a non-viable financial institution under the Financial Industry Restructuring Act,132 as amended in September 1998.133

With its rehabilitation plan decisions, the FSC decided to close five small to medium-sized banks, three nationwide banks and two local commercial banks, and transfer their assets and liabilities to five stronger banks in so-called purchase and assumption ("P&A") operations.134 Under the P&A formula, the five acquiring banks purchased the sound assets and assumed the liabilities of each closed bank. The acquiring banks were selected based on their (1) capital adequacy ratios of nine per cent or more at the end of 1997; (2) capabilities to stabilise in a timely manner after acquiring the failed bank and to recapitalise through rights issues or foreign capital injections; and (3) synergy effects considering competitive edge and branch distribution.135 To prevent the deterioration of acquiring banks’ financial conditions, the FSC provided fiscal support measures,136 which included:

132 Ibid.
133 See Financial Industry Restructuring Act art. 2 cl. 3.
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(1) the acquiring banks were granted put-back options to sell back to the KAMC any assets that turned became nonperforming within six months after acquisition; and

(2) capital was to be injected, in the form of government securities, to the acquiring banks to the extent necessary to prevent deterioration of the acquiring banks' capital adequacy ratios due to their P&A of the failed banks' assets, while the KAMC was to purchase some of the bad loans on their own books at standard discounts to book value.

Upon completion of due diligence analysis of the assets and liabilities of the resolved banks, the KAMC purchased bad loans with a book value of 4.16 trillion won on 28 September 1998. On 29 September 1998, the KDIC injected 5.78 trillion won by which the liabilities of the resolved banks exceeded their assets. Finally, the licenses of the resolved banks were revoked on 30 September 1998.

(3) Viable Bank Restructuring

The remaining seven banks that were deemed able to carry out rehabilitation plans were required to submit implementation plans (memoranda of understanding) by 31 July 1998. The MOUs between a bank and the FSC generally included:

(1) measures for changing management (including large scale replacement of management, recruitment of new management from outside, and recruitment of foreign experts);

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(2) measures for recapitalisation or mergers, if the recapitalisation is difficult, with clear timetables for implementation;

(3) capital reduction plans to write down the equity of existing shareholders, equivalent to the difference between the net asset value and paid-in capital;\footnote{The assets value was calculated based on the assessment results at the end of March 1998. If the net asset value was negative, a full write-off was required.} (4) measures for management improvement, including downsizing and earning improvement; and

(5) measures for preventing any further deterioration of asset quality.

The process induced voluntary mergers and foreign investments with government contributions. Two large nationwide banks announced their merger on 31 July 1998, and registered their merger on 6 January 1999. The government announced a contribution of 5.5 trillion won to purchase their non-performing loans and recapitalise these banks, which would own ninety-five per cent of the merged bank.\footnote{See Financial Supervisory Commission, “Financial & Corporate Restructuring” (March 1999), p. 8.} On 17 December 1998, one large nationwide bank, a local bank and a merchant bank corporation announced their merger to create a unified commercial bank.\footnote{Ibid.} On 12 February 1999, one additional local bank, which was categorised as non-viable and ordered to merge by the FSC. The government also contributed 7.75 trillion won to purchase their non-performing loans and recapitalise the institution, which would own ninety per cent of the merged bank.\footnote{Ibid.}

One nationwide bank, formally a specialised bank, recapitalised through foreign investment and government capital injections.\footnote{See Ministry of Finance and Economy Press Release, “Korea’s Economy Reinvented: Strategy Details and Progress” (12 June 1998).} A German bank invested 350 billion
won by converting existing debt to equity, which acquired an ownership stake of thirty per cent. The Bank of Korea, the existing shareholder, injected 336 billion won through the Korea Ex-Im Bank. One remaining small nationwide bank wrote off its paid-in capital and recapitalised on 29 October 1998.

(4) Sound Bank Restructuring

The remaining twelve banks, whose capital adequacy ratios were eight per cent or more, were reviewed by the FSC in August 1998. One local bank, which was ordered to comply with the management improvement measures before the evaluation, increased its paid-in capital, and two more local banks were ordered to comply with the management improvement recommendations following the evaluations. The FSC conditionally approved their rehabilitation plans. In addition, two medium sized nationwide banks voluntarily merged in January 1999, followed by the merger between one large nationwide bank, formally a specialised bank, and the Korea Long-Term Credit Bank. Foreign investment also contributed the restructuring, as the International Finance Corporation invested US$152 million in Hana Bank and US$25 million in the Korea Long-Term Credit Bank.

145 See ibid., p. 10.
(c) Other Financial Institutions

According to the FSC, the Korean NBFIs had approximately 30 trillion won in non-performing loans as of March 1998, nearly seven per cent of NBFI total assets. In June 1998, the FSC announced a restructuring plan for insurance companies, investment trust companies, leasing companies and securities companies, based on the measures that non-viable institutions would be closed and distressed NBFIs subject to prompt corrective actions. Of twenty-five existing leasing companies, twenty-one companies had negative assets. The restructurings were generally conducted by the parent company(ies) (banks) on a voluntary basis, because the Lending Act prohibited the application of prompt corrective action measures against leasing companies under the Financial Industry Restructuring Act. As a result, five companies are currently under liquidation procedures and five additional companies transferred their businesses to a bridge leasing company. The remaining eleven companies, which had negative assets, are undergoing management normalisation.

In May 1998, the FSC announced the standards for "prompt corrective actions" against securities companies, based on their respective operational net capital ratios. Two securities companies were closed and three additional securities companies were suspended between May-August 1998. In August 1998, four securities companies whose operational net capital ratio or asset/liability ratio fell short of 100 per cent at the end of June 1998 were ordered to submit rehabilitation plans. The FSC approved two

149 See ibid., pp. 13-14.
companies’ plans with conditions and disapproved the other two, which the FSC decided to close. As for the fifty existing insurance companies, the FSC adopted prompt corrective action standards in June 1998 based on their respective reserve ratios. The FSC required eighteen life insurance companies and four non-life insurance companies, which had insolvent utilising reserves at the end of March 1998, to submit rehabilitation plans. As a result of evaluation, the FSC closed four life insurance companies. Thus, seven life insurance companies have submitted their implementation plans and seven other life insurance companies and two non-life insurance companies have submitted their performance undertaking letters. Finally, the FSC closed two investment trust companies and five other of such companies are liquidating voluntarily. Thus, among 230 mutual credit facilities companies, twenty-six companies were closed and seventeen companies are currently under restructuring.

2. Public Support for Disposing of Non-performing Loans and Financial Sector Restructuring

At the end of 1997, the Korean commercial banks had bad loans (loans classified as either doubtful or estimated loss) in excess of 10 trillion won and approximately 22.6 trillion won in non-performing loans (loans classified as either substandard, doubtful or estimated loss), after 7.1 trillion won worth of bad loans were sold to the KAMC in November-December 1997. The bad loans and non-performing loans represented approximately 2.7 per cent and 6 per cent of their total outstanding loans, respectively. If the 7.1 trillion won worth of bad loans sold to the KAMC were taken into account, the non-performing loans of Korean commercial banks would be approximately 10.7 per cent
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of total outstanding loans. As Korea's economic conditions deteriorated, the total non-performing loans of commercial banks increased to 29 trillion won, which was approximately 8.6 per cent of total loans. At the end of 1998, the Korean commercial banks held approximately 22.2 trillion won in non-performing loans, which was nearly 7.4 per cent of total outstanding loans. The specialised banks held approximately 11.4 trillion won in non-performing loans, which was 8 per cent of total loans at the end of 1998. The Korean NBFIs non-performing loans were approximately 26.6 trillion won, or 20 per cent of total loans at the end of 1998. Finally, the Korean financial institutions held precautionary loans in excess of 50 trillion won as of March 1998.

The Korea Asset Management Corporation (KAMC) was established to reduce the problems faced by banks and merchant banking corporations from non-performing loans. The KAMC began purchasing non-performing assets from financial institutions in November 1997. On 20 May 1998, the Korean government released a progress report and future plans for economic restructuring, wherein it estimated the total amount of troubled loans (loans classified as precautionary or worse) of all Korean financial institutions was approximately 118 trillion won, or 28 per cent of GDP, and that the total amount of non-performing loans was approximately 68 trillion won as of March 1998. The government targeted 100 trillion won worth of troubled loans for immediate disposition at an estimated market value of 50 per cent of their book value. Therefore,

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151 The KAMC was originally established in 1962 to collect non-performing loans for banks. In November 1997, a legislation was passed to dissolve the old KAMC and create a new entity with increased capital.
152 The KAMC's Non-performing Asset Management Fund has ten trillion won. 2.5 trillion won from the budget account, two trillion won loan from the Bank of Korea, an estimated five trillion won from the proceeds from bonds by the Fund itself, and 0.5 trillion won in contributions from financial institutions make up the ten trillion won. All losses will be covered using fiscal resources. See Ministry of Finance and Economy Press Release, "Financial Market Stabilisation Package" (19 Nov. 1997).
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under this scenario the losses incurred by financial institutions would be 50 trillion won. The government planned the disposal of troubled loans through two channels: (1) half of the loans would be disposed of by financial institutions themselves by selling off collateral or calling in loans, and (2) the KAMC would purchase the remaining half at the estimated market price of 50 per cent of book value. The KAMC would issue 25 trillion won in bonds to meet the funding requirement for the disposal of non-performing loans, and the government would provide a guarantee on the bonds and bear the interest expense.

Thus, the KAMC purchased non-performing loans with a purported face value of 44.1 trillion won from Korean financial institutions for 19.9 trillion won, from the period of November 1997-December 1998. The Korea First Bank and the Seoul Bank sold 6.6 trillion won worth of non-performing loans, and other commercial banks sold 23.2 trillion won worth of non-performing loans. The KAMC purchased 2.7 trillion won worth of the merchant banking corporations’ non-performing loans. The KAMC also purchased 5.8 trillion won worth of non-performing loans from fidelity and surety insurance companies. The life insurance companies and the securities companies sold 0.1 trillion worth of their non-performing loans, and specialised banks also sold 5.7 trillion worth of non-performing loans, to KAMC. In addition, the Korean government planned to purchase about 32 to 42 trillion won worth of non-performing loans at 12.5 trillion won.

Korea’s financial restructuring requires not only the disposition of non-performing loans but also recapitalisation of viable financial institutions. In May 1998, the government estimated that Korean financial institutions had to realise 50 trillion won of losses, which would eventually result in the erosion of their capital bases. The
financial institutions had set provisions for 9 trillion won, and were expected to provide an additional 6 trillion won during 1998. Therefore, the estimated provisioning shortfall of financial institutions would be approximately 35 trillion won. The government also estimated that financial institutions would need at least 4 trillion won to reach the minimum 8 per cent capital adequacy ratio. Thus, the total capital shortfall of financial institutions would be approximately 39 trillion won. Under the government plan, to cover the 39 trillion won recapitalisation funding, the KDIC would issue 16 trillion won in bonds to inject capital in financial institutions. The government would also provide a guarantee on the bonds issued by the KDIC and bear the interest cost. The financial institutions would raise 20 trillion won in the market, and the remaining 3 trillion won corresponded to capital injections into the Korea First Bank and Seoul Bank, already disbursed in January 1998. In addition, the KDIC would issue an additional 9 trillion won in bonds to meet the expected demand for depositor protection.

Thus, under these measures, the government injected a total of 21 trillion won into commercial banks for recapitalisation and loss compensation for depositor protection, and into NBFIs for loss compensation. The five commercial banks, which acquired five other closed banks, received 5.8 trillion won for loss compensation to cover for negative net worth registered as a result of the acquisitions and an additional 1.2 trillion won for recapitalisation necessary to elevate their capital adequacy ratios to pre-acquisition levels. The merged banks received 3.6 trillion won to elevate capital adequacy ratios to the sound bank’s pre-merger ratios (in case of merger between the sound bank and the troubled bank, or up to 10 per cent, in case of merger between the troubled banks). The NBFIs also received 7.8 trillion won for loss compensation.
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3. **Strengthening Banking Environment and Prudential Supervision**

After the Hanbo scandal, the OBS introduced the credit committee system to improve loan evaluations in commercial banking, in particular to prevent bank presidents from deciding on large loans, thus eliminating politically connected lending schemes. The FSC introduced a lending evaluation system for interlinked business groups (chaebols),\(^\text{154}\) which focuses on the interlinked business group as a whole rather than on individual companies in the group. Under this programme, the interlinked business group is required to enter into a financial agreement with its main creditor bank. The agreement contains regularly scheduled evaluations of the group's financial conditions, leverage reduction plans, and mandatory discussions with the bank on any new projects that the group may desire to undertake. The agreement also places the true owner as the executive director to be legally responsible for the management of the group.

The FSC further requires commercial banks to maintain diversified loan portfolios and avoid concentration on a specific industry. Thus, when commercial banks finance large investment projects, they need to use project financing structures and techniques to ensure that the project company is independent from the parent company and the account is supervised in an escrow account of the main creditor bank. As part of improving loan evaluations, the FSC requires commercial banks to review borrower financial statements with all available information rather than simply on the basis of ordinary balance sheets and profit and loss accounts generated during the loan evaluation period.\(^\text{155}\)

\(^{154}\) See Detailed Enforcement Regulations for the Credit Management of Banking Institutions art. 14.

The Korean government introduced the prohibition of mutual payment guarantees within the fifty largest interlinked business groups to be implemented by March 2000. The thirty largest groups must reduce mutual payment guarantees to 100 per cent of their equity by March 1998 and otherwise clear all mutual payment guarantees by March 1999. The thirty largest chaebols are required to produce combined financial statements beginning in fiscal year 1999 to increase the transparency of corporate accounts. The new system is based on a broad definition of what constitutes an “affiliated company,” which makes the statements very comprehensive. The combined financial statements include combined balance sheets, income and cash-flow statements, as well as footnote reporting of intra-group loans, loan guarantees and other major transactions. In addition, accounting standards were tightened in December 1998. To enhance the independence of external auditors responsible for verifying company accounts, auditor selection committees are now required in Korean stock market listed companies and chaebol affiliated firms that are required to otherwise prepare combined financial statements.

The Korean government also established a plan to strengthen the regulatory and supervisory framework, in particular the prudential regulations implemented during 1998. In April 1998, the evaluation standard for marketable and investment securities, held by the banks in their trust accounts, was changed to reflect the mark-to-market method. At the end of June 1998, a full 100 per cent provisioning for loan losses, retirements and valuation losses on securities investment must be set aside. On 30 June

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157 See ibid.
1998, the FSC introduced additional prudential regulations, most importantly the new classification standards and provisioning rules. Loans more than 3 months overdue are to be classified as "substandard," and loans in arrears by 1 month to less than 3 months are to be classified as "precautionary." The provisioning requirement for precautionary assets was increased from 1 per cent to 2 per cent. The FSC also introduced regulations to require provisions for securities losses against non-tradable securities in trust accounts, and to deduct from Tier 2 capital all provisions for non-performing loans (effective January 1999). The FSC further required that the mark-to-market evaluation standard for marketable and investment securities be applied to securities in banking accounts.

The FSC also announced the strengthening of prudential regulations and supervision with respect to foreign exchange operations of commercial banks. The FSC recognised that foreign exchange operations under the Foreign Exchange Act had been enforced mainly through focusing on aspects of management of external assets and liabilities. Thus, the supervision of foreign exchange operations was tailored towards the stability of foreign exchange and monetary policies rather than towards assuring the soundness of commercial banks. The principal area of strengthening in this respect is that of liquidity management. The foreign currency liquidity regulations include the Market Mismatches (GAP) Regulation and the Foreign Currency Liquidity Ratio Regulation. Under the GAP Regulation, banks are required to divide their assets and liabilities into seven "buckets" based on residual maturities: 0 to 7 days, 8 days to 1 month, 1 month to 3 months, 3 months to 6 months, 6 months to 1 year, 1 to 3 years and above 3 years. Then the banks have to maintain minimum ratios of cumulative GAP

amounts to total foreign currency assets.\textsuperscript{160} The ratio must be positive mismatches for the first bucket of no more than 7 days, -10 per cent for the period of no more than 1 month, and -20 per cent for the period of no more than 3 months. This regulation is enforced on a consolidated basis, encompassing the accounts of banks’ headquarters, domestic branches, overseas branches, overseas subsidiaries and offshore accounts. The Foreign Currency Liquidity Ratio Regulation requires that banks have short-term assets (less than 3 months) to cover at least seventy per cent of short-term liabilities. The ratio must be calculated based on foreign currency assets and liabilities of banks’ headquarters, domestic branches, overseas branches, overseas subsidiaries and their off-shore accounts. Those regulations came to effect 1 January 1999. The FSC also introduced overall foreign currency exposure limits on a per counterparty basis, including foreign currency loans, guarantees, securities investments and off-shore financings. Finally, the FSC required that banks establish risk management systems for country risk, derivatives and foreign currency asset-liability-management, and further strengthened its off-site surveillance by improving banks’ reporting systems.

V. CONCLUDING OBSERVATION

Korea’s financial crisis in 1997 illustrates that a government-controlled banking system, coupled with lax regulation and supervision, facilitates inevitable problems for banks even if macroeconomic conditions appear to be sound and even robust. Moreover, without appropriate diagnosis of and policy responses to crisis, with appropriate sequencing thereof, measures to protect the economy and financial system cannot

\textsuperscript{160} GAP ratio in each period = (accumulated foreign currency liquid assets – accumulated foreign currency
succeed. Korea’s Bankruptcy Deferment Accord, which intended to support troubled companies, and its liquidity support for commercial banks are good examples of such failures.

Korea’s reform of the regulatory and supervisory framework represents a significant step towards establishing a “safe and sound” banking system, but clearly further steps are necessary to establish the longevity of appropriate reforms. First, the new banking regulatory and supervisory bodies (i.e., FSC and FSS) should not control the Korean banking sector, but rather provide an environment in which the Korean banking system operates according to appropriate international prudential standards. In order to restructure corporate sector (especially chaebols), the Korean government facilitates banks with “work-out” programmes as well as directs the restructuring with enforced swaps (“big deals”). These practices might produce a situation in which the government controls financial and corporate sectors. Furthermore, the Korean government owns a very large share of the banking system once the recapitalisation of banks is completed and hence the Korean government needs to denationalise banks for creating a privately owned banking system. Second, Korea needs to establish a reformed banking system which systematically precludes or mitigates opportunities for undue political interference. An important focus is to provide a high degree of transparency in the FSC decision-making processes, which can help the FSC to protect its decision making from undue political interference. Korea’s financial restructuring programmes illustrate that, during the crisis, restructuring programmes should provide certainty of process and transparency

liquid liabilities) / total foreign currency assets.
161 See Chapter Two Section VI and Chapter Three Section II.
163 See Chapter Two Section VI.
with clear, realistic timetables. Clear exit policies and rules should be implemented for removing explicit or implicit guarantees against failure for troubled financial institutions. There are concerns that the improving economy (in Korea industrial output and the stock market are close to pre-crisis levels in 1999) may evaporate the restructuring progress. By providing clear and realistic timetables for the NBFIs restructuring (e.g., life insurance companies) and the corporate sector reform, Korea should implement and apply real reforms. Finally, public support for financial restructuring, including the use of public sector funds, is necessary. The Korean government firmly established the principle that in cases of bank insolvency some of the cost would be borne by shareholders by reducing paid-in capital of the troubled banks. Nonetheless, the Korean government (eventually taxpayers) must bear most the financial sector restructuring costs, although the government may be able to recoup part of costs from future bank earnings and sales of its equity positions in banks.

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CHAPTER FIVE

CONCLUDING OBSERVATIONS AND RECOMMENDATIONS
FOR THE REFORM OF KOREAN BANKING REGULATION
AND SUPERVISION

I. THE NEED FOR REFORM OF KOREAN BANKING
REGULATION AND SUPERVISION

The recent Korean financial crisis illustrates that a government-controlled banking system
with lax prudential regulation and supervision inevitably creates significant problems for
banking institutions. A government-controlled banking system, where both the regulators
and the banks are subject to governmental guidance for purposes such as the channelling
of funds to preferred uses, as a means of supporting the national economic development
plans, as in Korea, can be the source of problems such as moral hazard. In turn, these
problems threaten the stability of the banking system. As a result of such distortions,
banks in Korea kept on lending to the chaebols; as the latter were regarded by the Korean
government as pillars of the economy, they received preferential treatment and there was
no objection to banks building large credit exposures to them. The moral hazard
problems also impeded the development of the right set of institutional incentives and
tools for the analysis of credit allocation, the management of risks and the efficient
operation of Korean banks.
The lack of adequate prudential regulations and supervisory processes aggravated the risks inherent in the governmental control of the banking system. It is clear that, without an appropriate framework of prudential regulation and supervision, consistent with evolving international standards, banking regulatory authorities cannot recognise and adequately address banking problems. Rapid growth and prudent macroeconomic policies cannot by themselves guarantee sound economic performance, if a well-functioning and robust financial system is not in place.  

In order to establish such a banking system, Korea needs to implement reforms in the areas of:

(1) the institutional structure of banking regulation and supervision; and

(2) the applicable substantive standards of prudential regulation and supervision, as well as the monitoring and enforcement processes.

II. STRUCTURAL REFORM OF BANKING REGULATION AND SUPERVISION

A. Structural Arrangements for Banking Regulation and Supervision

In general, four types of institutional arrangements for the banking regulatory and supervisory functions can be distinguished, depending on whether these functions are carried on by the central bank, the executive branch, an independent agency or a self-regulatory body.

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A central bank can be granted authority both for national monetary management and for banking regulatory and supervisory issues. Even if the goals of monetary policy and banking regulation and supervision are different, they are closely related to each other. The two sets of goals cannot be attained independently. The moral hazard and information problems arising in the context of the lender of last resort function lead central banks to become involved in the regulation and supervision of banking systems. On the other hand, conflict of interest problems may arise, where the monetary authorities also exercise banking regulatory and supervisory powers. For example, in Korea during the deregulation period (1982-1997), the Bank of Korea pursued, in its capacity as banking regulatory and supervisory authority, a policy of interest rate deregulation directed at abolishing policy loans and credit controls over the banking sector. However, as monetary authority, the Bank of Korea was forced to re-impose interest rate controls, fearing that higher interest rates might affect the performance of the real economy. Moreover, in the context of banking crisis management, the central bank’s performance of the function of lender of last resort is limited by the size of available funds, while taxpayers must eventually pay the final costs of the relevant operations.

Alternatively, the regulation and supervision of banks and other financial institutions can be delegated to an executive department of government. This can be done directly through the finance ministry or through a separate department, established either within or outside the finance ministry. The institutional arrangement of banking regulation and supervision by the executive, however, may not preclude governmental

2 Chapter Two Section II.
3 See Chapter Two Section II B 2.
4 Chapter Two Section III.
interference with the regulatory process for general economic policy purposes. Indeed, this form of institutional arrangement may involve a greater potential for direct or indirect government intervention in major regulatory policy decisions.

An independent agency can also be established to conduct banking regulation and supervision. The institutional features of such an agency are usually intended to ensure a neutral environment for regulatory and supervisory activities. Decision making in the agency could be entrusted to qualified experts, who are non-partisan and know well the banking area. The structure of an independent agency can maximise the degree of independence of regulatory and supervisory functions. However, with regard to the performance of regulatory functions, reliance to the expertness of an independent agency has its limits. Expertness is more appropriate for the achievement of specific, narrow objectives than for basic policy formation, which requires long-term planning and the balancing of various social interests. In addition, the institutional structure of an independent agency cannot always guarantee its independence. In some cases, a head of the government concerned with the activities of independent agency may be able to exercise more influence over the agency than he would over an executive department.

Self-regulation can be an alternative for banking regulation and supervision. Self-regulation can allow banks more freedom to run their own affairs as they think fit; it can transfer the costs of regulation to the regulated banks; it can give banks the ability to decide the rules of the game; it can utilise industry experts, who know how the regulated activity works and what types of control are most feasible and appropriate; it can ensure

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5 Chapter Two Section IV.
6 See Chapter Two Section IV B 1.
7 See Chapter Two Section IV B 2.
faster regulatory and supervisory decision making than is possible in the case of governmental bodies; and it can produce greater flexibility in the creation, interpretation and application of regulatory rules. However, self-regulation has its own limitations. “Free rider” problems make it difficult for an industry to create an effective self-regulatory organisation. Antitrust problems also need to be overcome, in order to avoid sanctions and restrictions by antitrust laws, which are intended to control monopoly power and anti-competitive activities.

B. Structural Reform of the Korean Banking Regulatory System

Until 1997, the Korean banking system was regulated and supervised by the Monetary Board and the Office of Bank Supervision of the Bank of Korea (BOK), Korea’s central bank. However, the banking regulatory and supervisory authorities were effectively controlled by the Ministry of Finance and Economy (MoFE), through legal and practical means. Therefore, the first step in reforming Korean banking regulation and supervision is to establish a new institutional structure for the performance of banking regulatory and supervisory functions. The banking regulatory and supervisory authorities should be structurally independent from governmental and political interference, that is, sufficiently independent from government’s objectives that are inconsistent with prudential regulatory objectives, aimed at ensuring that banks are “safe and sound”. To balance such structural independence, a reformed and restructured system should include a high degree of transparency and accountability.

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8 Chapter Two Section V.
9 Chapter Two Section III C.
Chapter Five

Korea must choose between the various possible institutional arrangements (executive branch, central bank, independent agency and self-regulation), and even develop its own institutional structure, because in this area there is no theoretically ideal framework of general application and a lot depends on the practical detail.

First, in the Korean situation, the removal of governmental control over the banking system can be achieved by making regulatory and supervisory authorities independent from the government – especially the MoFE – and the politicians.10 Establishing new financial regulatory and supervisory authorities, e.g. the Financial Supervisory Commission and the Financial Supervisory Service, is a move towards creating a market oriented banking system. However, the regulatory and supervisory authorities do not yet have full legal independence, but only operational independence under the Establishing Act, since they remain under the jurisdiction of the Prime Minister. Even statutory operational independence cannot ensure their actual and practical independence. Therefore, it is necessary for Korea to formulate further practical and legal measures that would ensure that the new regulatory and supervisory authorities are truly independent.

Secondly, the new Korean banking regulatory and supervisory authorities should not be forced to take into account governmental objectives that are inconsistent with sound prudential regulatory objectives. Structural independence does not guarantee that the banking regulatory and supervisory authorities actually perform their responsibilities in pursuance of the appropriate objectives. Therefore, the FSC, as part of the executive

10 To achieve credibility and stability of the banking system, it is essential for the regulatory and supervisory authorities to be independent from the political process. See Rosa Maria Lastra, Central Banking and Banking Regulation (1996), pp. 151-52.
branch, should not become a second MoFE, pursuing the government's economic objectives and exercising a tight control over the banking industry.

Thirdly, independence does not mean that the banking regulatory and supervisory authorities should be accountable to no one: it is essential to provide for suitable mechanisms of accountability. However, these should not open the way to governmental intervention or control under the guise of accountability. Formally, the Act Concerning the Establishment of Financial Supervisory Organisations places the FSC under the jurisdiction of the Prime Minister. However, the Act does not provide for any mechanism of accountability to the Prime Minister. Therefore, Korea needs to provide for a degree of accountability of the FSC. One possible step is to require a high degree of transparency with regard to the actions of the regulators.

Transparency can support and foster the independence and accountability of the FSC. Transparency in decision making processes and supervision processes should improve their independence. For example, reporting and publishing the minutes of the meetings of the decision making bodies would increase the transparency of the procedures and reduce the possibility of interventions on the part of the government and politicians. Moreover, the FSC and the FSS need to publish their regulatory and supervisory decisions, with reasons. Certain types of decisions can be published immediately or regularly, while others can be published after a specified time lag. This would increase the accountability of the FSC and the FSS to the public.

11 The Monetary Board of the Bank of Korea is required to publish its minutes. See Revised Bank of Korean Act art. 24, cl. 2.
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III. REFORM OF THE SUBSTANTIVE REGULATORY STANDARDS AND THE MONITORING AND ENFORCEMENT PROCESSES

A. The Appropriate Objective for Korean Banking Regulation and Supervision

In order to create an adequate banking regulatory and supervisory system, it is essential to establish an appropriate overall statutory objective for the banking authorities. Financial institutions over the world have been experiencing extensive deregulation. Deregulation, particularly in the banking sector, has been linked to increased instability. Furthermore, financial globalisation and integration have cause a sharp expansion of international flows (both inward and outward) of funds. Under these circumstances, Korea needs a new set of objectives for its banking regulation and supervision. Among the current objectives, “national economic progress” cannot serve as a suitable banking regulatory and supervisory objective, but can only be employed as a plausible excuse for controlling the banking industry. Other objectives, e.g., the sound operation of banking institutions, depositor protection and the maintenance of the order of credit system, can contribute to the establishment of a safe, sound and effective banking system in Korea. However, those objectives should be harmonised.

As the Korean banking regulatory and supervisory system relaxes the economic controls over the banking sector and gives the banks more incentives to act independently in their market operations, the new approach may cause - at least in the short run - increased instability in the banking system. Therefore, “financial stability” should be the primary objective of Korea’s banking regulation and supervision. Under the financial
stability objective, the FSC would pursue the goals of sound operation of banks, depositor protection and maintenance of the order of the credit system. Furthermore, clear and objective criteria of regulation and supervision would also reduce the potential for political interference.

B. Substantive Regulatory Standards

Korean banking regulations can be classified under three headings, i.e., as structural, conduct and consumer protection regulations. Structural regulations include entry controls, branching restrictions, restrictions in the scope of banking activities and ownership restrictions. Conduct regulations include economic, allocative and prudential regulations. In order to achieve financial stability, Korea needs, in particular, to review the current banking regulations in the area of prudential regulation, with a view to establishing an adequate set of regulatory and supervisory standards. Reforms should seek to achieve two main aims:

1. to establish appropriate standards, which would ensure the safety and soundness of the banking system and prevent regulatory and supervisory forbearance; and

2. to ensure that banks carry on their commercial activities in a market, yet prudent, manner.

Areas that would benefit from new and improved regulatory standards include: capital adequacy; loan classification; loan loss provisioning; and internal control systems.

12 Chapter One Section IV.
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1. Capital Adequacy Requirements

Although Korea has already introduced capital adequacy requirements for commercial banks that are broadly in line with the Basle Committee's international standards, their concrete implementation has been inadequate.\(^{13}\) Initially, capital adequacy requirements were introduced to raise Korean banks' credit standing in the international finance markets, not to improve the prudential standing of their operations. In cases of deterioration of the balance sheet position of Korean banks, this approach often resulted in supervisory forbearance.

Inadequate implementation distorted the real status of Korean banks' capital ratios especially in the context of supplementary capital, leading to bank financial positions inconsistent with the Basle standards. In particular, Korean banks were allowed to include in their calculation of supplementary capital general provisions for loan losses, up to a limit of 1.25 per cent of risk-weighted assets. However, for the most part, Korean banks' general provisions for loan losses were reserved for their non-performing loans (loans classified as substandard or worse) and, accordingly, were not available to be used freely to cover unidentified future losses. The FSC corrected this problem by excluding loan loss provisions for non-performing loans as supplementary capital in January 1999.

In addition, the Korean capital adequacy standards allow the Korean banks to count up to 45 per cent of their latent gains on securities holdings as supplementary capital. Under this standard, banks can utilise securities revaluation gains to adjust their

\(^{13}\) Chapter Three Section II A.
capital ratios while refusing or delaying to recognise reductions. Therefore, the FSC needs to either abolish this standard or closely monitor and examine banks’ accounting practices for securities revaluation.

In order to achieve adequate supervisory and examination standards in Korea, the capital adequacy requirements should employ objective, rule-based criteria. Generally, the capital adequacy requirements can serve as:

1. standards for the supervisory enforcement measures, such as prompt corrective actions,
2. tools of bank management discipline; and
3. a means of transparency for Korean banking operations.

2. Loan Classification Standards and Loan Loss Provision Requirements

Complementing the need for more effective capital adequacy standards, Korea needs to strengthen its loan classification and loan loss provision requirements.

The FSC has enhanced its loan classification and loan loss reserve requirements. Under the new regulations, Korean banks are required to classify loans which are in arrears for three months or more as substandard (as distinct from normal) loans, and to make provisions of two per cent (up from one per cent) against precautionary assets. However, the current loan classification standards are arbitrarily formulated, based on the borrower’s past or current financial performance, and do not take into account the expected future performance of borrowers, their projects and prospects for collection of loans. The FSC plans to implement a forward-looking loan classification scheme. For an
appropriate loan classification system, the FSC needs to consider whether individual banks have established their own loan classification standards which reflects the borrower’s past financial performance, its current financial condition and reasonably-based projections of future performance.

Furthermore, the current loan loss provision requirements are based on default ratios derived from historical averages ("rule of thumb" approach). This approach can be misleading as to the true condition of banks regarding credit risk, because differences in individual banks' loan portfolio characteristics and financial conditions are not considered. Like in the case of loan loss classification standards, the FSC needs to take into account individual circumstances by placing the primary responsibility for establishing and maintaining adequate loan loss reserve methodologies on individual banks. The FSS should then assess the reasonableness and validity of the methodologies used.

3. Internal Control Systems

The Korean financial system also requires specific measures for the improvement of internal control systems. The current regulatory programmes implemented or proposed focus on financial requirements for lending activities, portfolio constraints and public disclosures, using satisfactory accounting standards. The one exception is the requirement to set up a financial agreement between the interlinked business group (chaebol) and the main creditor banks to resolve large loans and political loans that have been made to chaebols and to monitor the credit worthiness of borrowers.
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To maintain the soundness and safety of the financial system, the regulatory and supervisory authorities should further require commercial banks to develop a system of prudent lending policies, set out in writing, specified procedures for loan approval and administration and appropriate loan documentation practices in their lending functions.14

To achieve these objectives, Korea's commercial banks need to establish adequate internal control systems.15 In particular, this requires the establishment of: (1) adequate organisational structures; (2) lending standards; (3) risk management standards; and (4) adequate administration procedures.

The organisational structures, composed of the board of directors, bank management and internal auditor, need to ensure the autonomous operation of banks and to provide an environments where banks can establish their own prudential standards for their operations.

For sound bank management, banks need to establish and implement internal policies and measures governing lending standards and other financial decisions. Such policies should be explicit and transparent and should be disseminated throughout the banking organisation.

In the past, Korean banks' risk management practices have been particularly weak. The effectiveness of internal control systems requires that banks have their own adequate risk management standards, by means of which they identify and continually assess all material risks.

14 Basle Committee on Banking Supervision, Core Principles for Effective Banking Supervision (1997), pp. 24-25.
15 Chapter Three Section II C.
Additionally, appropriate administration procedures are necessary to ensure that the established policies and measures are followed and that special interests are not allowed to influence decisions.

C. Monitoring Measures and Prompt Regulatory Action

1. Public Disclosure Requirements, Supervisory Reporting and Off-site Surveillance

The supervisory authorities cannot identify potential problems only by means of on-site examinations. Accordingly, they need to improve off-site surveillance.\(^{16}\) Off-site monitoring makes possible the early detection of problems, and enables the authorities to undertake prompt corrective actions, before these become too serious.\(^{17}\)

Off-site monitoring requires appropriate disclosure and accounting standards. Public disclosure requirements utilise market discipline as a complement to banking regulation and supervision. Timely, accurate, relevant and sufficient disclosure of qualitative and quantitative information enables the market to reach a proper assessment of a bank’s activities and risk profile.

Of course, the banking supervisory authorities cannot rely only on publicly disclosed information, but need also additional supervisory information. However, to avoid imposing substantial costs on banks by requiring the reporting of irrelevant data, the FSS should consider carefully, whether the supervisory reporting information is necessary in order to: (1) focus management’s attention on its responsibilities for

\(^{16}\) Chapter Three Section III A

\(^{17}\) Basle Committee on Banking Supervision, op. cit., n. 14, pp. 32-33.
maintaining adequate internal controls and ensuring compliance with laws and regulations; (2) enable the detection of unsafe and unsound conditions at an early stage; and (3) facilitate prompt corrective actions.

2. **Accounting Standards**

It is essential that the information disclosed and reported by banks is based on sound accounting standards and that these standards are properly applied. Information based on weak accounting standards may provide a distorted view of a bank's true financial condition. Thus, weak accounting standards allow bank managers to mislead the users, for example, by delaying loss recognition for as long as possible.

Applicable accounting standards should be sufficient for reflecting the true financial situation of banks and providing an early warning sign in the case of troubled banks. In this context, Korea's enhancement of financial statement accounting standards is a significant move towards establishing safe and sound banking.

3. **On-site Examinations**

On-site bank examinations are one of the major supervisory instruments used for reviewing and assessing the prudential condition of banks. In Korea, however, bank examinations have become tools for determining whether banks comply with non-prudential laws, regulations, and other regulatory and supervisory guidelines or directions. In order to ensure financial stability in the banking sector, the bank examiners should, instead, concentrate on risk-related issues.
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4. Prompt Regulatory Action

Even with adequate sets of prudential regulations in place, banks are prone to trouble. Korea’s experience demonstrates that, when faced with banks in difficulties, the banking regulatory and supervisory authorities tend to employ forbearance policies, in the hope that the situation will eventually improve. However, the recent Korean financial crisis illustrates that forbearance policies do not succeed and may even aggravate the underlying problems. A policy of prompt corrective action should therefore be adopted, aimed at limiting the number and costs of bank failures and reducing the possibilities of regulatory and supervisory forbearance. Implementing such a policy in Korea would also increase the transparency of the regulatory and supervisory decisions, by setting criteria for non-discretionary enforcement actions.

5. Effective Enforcement

In addition to their direct enforcement powers, the Korean banking regulatory and supervisory authorities have powers: to suspend all or part of a bank’s operations; to suspend a bank’s officers from carrying on their duties and to recommend that the general shareholders’ meeting dismiss such officers; and to request bank presidents to launch disciplinary actions.

In the past, these powers have been exercised for the purpose of ensuring that banks follow the directions of the authorities. Therefore, the enforcement powers were
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utilised for controlling the operations of the banking sector, rather than preventing future bank safety problems.

In order to ensure that banks operate in a prudent manner, the exercise of enforcement powers should be directed at effectively contributing to enhancing bank safety and soundness. This does not mean that the banking supervisory authorities should overlook other irregularities, but that they should primarily focus on whether banks operate consistently with prudential requirements.

IV. LESSONS FROM THE KOREAN FINANCIAL CRISIS

The Korean financial crisis stemmed from the prevalence of the *chaebol* structure and the weaknesses of the financial system. The *chaebols'* highly leveraged financial positions, with easy credit coming from the financial institutions, and their business overexpansion resulted in massive non-performing loans. The government's exercise of control over the banking system and the lack of adequate structures of prudential regulation and supervision enabled Korean banks and the *chaebols* to further increase the financial fragility, which was at the root of the crisis.

Korea's early responses and, in particular, its failure to deal with growing corporate bankruptcies and financial problems prior to the IMF programme, indicate that bailing out troubled corporations and financial institutions, without simultaneously undertaking substantive reforms, is not conducive to resolving the underlying problems or preventing the continuing deterioration of the overall economic conditions.

Korea's crisis resolution programme provides three lessons:
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(1) The restructuring programmes should provide certainty of process and be transparent. Without commitment to process, the programmes will eventually fail. The process needs to be transparent in order to restore international investors' confidence in the financial market.

(2) The restructuring programmes should provide a clear, realistic timetable for restructuring.

(3) Finally, the government or the regulatory and supervisory authorities must refrain from assuring, whether explicitly or implicitly, that the commercial banks cannot fail. Instead, clear exit policy and rules need to be adopted, with a view to minimising moral hazard.

18 Ibid., p. 9.
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