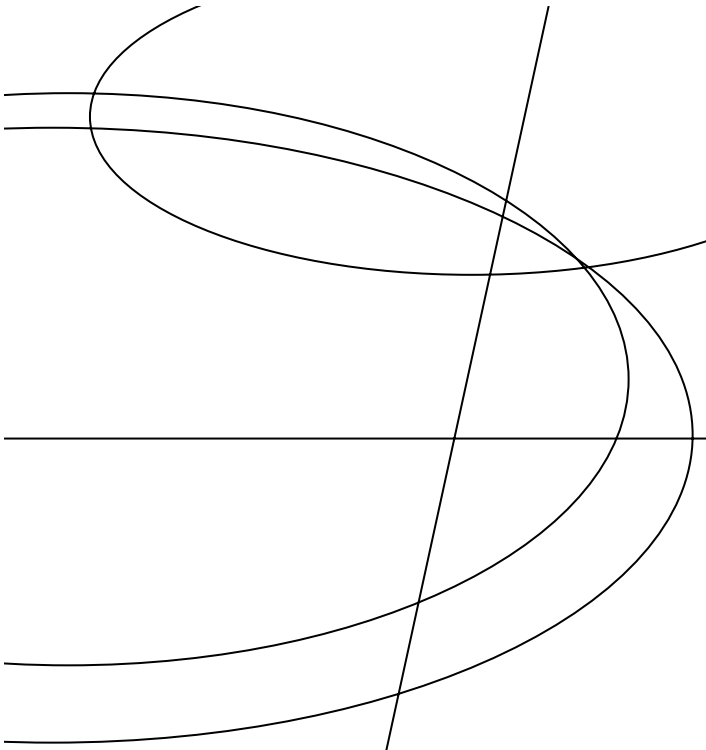

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Financial Liberalization and Regulatory Changes in Korea

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Financial Liberalization and Regulatory Changes in Korea

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1. Introduction

The Asian financial crisis of 1997 triggered a chain reaction of events in Korea's financial and corporate sector that culminated with a series of massive corporate bankruptcies of over leverage companies that sent Korea's economy into deep crisis. Leading up to the financial crisis, there was a proliferation of Non Bank Financial Institutions (NBFI), which were owned by *chaebols* and essentially used as their financing arms after the government siphoned off policy loans. Indeed, empirical analysis shows that total debt increased for *chaebols* which owned a NBFI while the profitability and balance sheets of *chaebol*-owned NBFI's deteriorated much more than those not owned by a *chaebol*. The analysis suggests that the expansion and unchecked lending of NBFIs to *chaebols* was a major cause of the financial crisis in Korea. But the ownership of NBFIs by *chaebols* explains how *chaebols* were able to over leverage themselves; but it does not explain why NBFIs were able to expand so quickly and were able to lend unchecked. The explanation may lie not in one but a series of factors that converged to facilitate their unabated expansion, namely haphazard deregulation, inadequate prudential supervision, and a change in policy direction that created a favorable environment for NBFIs.

In the wake of the crisis, Korea's corporate and financial sectors underwent massive reforms. Within the financial sector, the financial supervision system was specifically targeted for overhaul. Indeed, the system of supervision was consolidated and reorganized, and regulators were equipped with better tools for prudential supervision. Liberalization and opening of its financial market have left Korea seemingly more vulnerable to external shocks. At the same time, Korea has also experienced a higher frequency of home-grown financial crises albeit at a much smaller scale within a short amount of time since the 1997 crisis. Korea was hit with a credit card crisis came in 2003, which was followed by the mutual savings bank crisis in 2011. This begs the question what has really changed since 1997? To

be sure, financial liberalization in Korea has continued with varying effects on the financial sector, while an examination of the credit card and mutual savings bank crises seem to show a strikingly similar pattern of factors that led to the unchecked expansion of NBFIs can also be found in the recent crises. Other than the consideration of a favorable policy direction, the only other possible factor to consider in explaining the frequent crises would be that the reforms in financial supervision undertaken after the 1997 financial crisis were not deep enough or have not been implemented properly.

This paper first begins by examining the relationship between *chaebols* and NBFIs and presents empirical evidence showing their close linkage. Then it will try to explain factors that may have contributed to the expansion of NBFI's. Next, the paper discusses the financial supervisory landscape before the crisis and the subsequent the reforms carried out after the crisis. Lastly, the paper discusses the credit card and mutual savings bank crises and then tries to assess the nature and causes of the crises. To better understand the nature of the crises, the paper also provides the political context of policy changes and traces the development of Korea's financial system.

2. Proliferation of NBFIs: A Precursor to the 1997 Financial Crisis

Beginning in the 1980s, there was an explosive growth of NBFIs due to a combination of several factors. First, the entry barriers for NBFIs were deregulated in 1982 to formalize the curb market after the 1982 financial scandal. The scandal —which was basically a financial fraud in the informal curb market, involving relative of President Doo-Hwan Chun—revealed the urgency to formalize the curb market for improved transparency (See Box 1). Within one year, the number of NBFIs grew quickly as 12 new short-term finance companies (STFCs) and 57 mutual savings finance companies (MSFCs) were chartered.[1]

<Box 1> 1982 Financial Scandal

Starting early 1980s, the new government led by President Chun was committed to price stability thereby significantly reducing the money supply. This led firms to quickly turn to the informal credit market as a source of short-term funding. As such, the size of the informal curb market grew rapidly.

The scandal which involved family members with distant ties to President Chun would end up becoming the largest financial scandal in Korea at that time. The key figure involved in the scandal, Young-Ja Chang, was the sister of wife that was married to the uncle of the

[1] STFCs and MSFCs were essentially legacies of the 1972 August 3 Presidential Emergency Decree to formalize the curb markets. August 3 Emergency Decree contained three legislative measures to formalize the curb markets including the Short-term Financing Company (STFC) Act, the Mutual Savings and Finance Company (MSFC) Act, and the Credit Unions Act. MSFC Act sought to raise funds by mobilizing the financial resources of small money lenders in the curb market and then sought to provide small loans to small companies, self-employed people and low-income households with limited access to commercial banks. The MSFC were subject to a regulatory capital requirement in that the companies had to have at least 15 million won to 50 million won of capital, depending on the region. They were also subject to a lending limit of 10 times their capital. On the other hand, the STFC Act was targeted at large money lenders, which would be mobilized to create short-term investment finance companies (called *dan-ja-hoi-sa*) that specialized in commercial paper (CP) for large companies and call-market loans. Due to the large capital requirement (STFCs were subject to a regulatory capital of requirement of at least 500 million and a lending limit of 15 times of its capital base) for establishing STFB compared to MSFCs, many of these finance companies were inevitably established by large companies and *chaebols* which had the necessary financial resources.

First Lady. Furthermore, Chang's husband was former Deputy Chief of the Korea's Central Intelligence Agency (KCIA). Chang and her husband were major players, and were able to mobilize huge sums of money in the informal curb market due to their ties to President Chun. They would then purchase commercial papers that amounted to almost $1 billion (about 17% of South Korea's entire money supply) of large firms through financial intermediaries off the books. These transactions were conducted in the informal curb market due to the strict monetary policy at that time. When the scandal broke out, Chang was charged with defrauding the issuers of the commercial papers of about $250-300 million.

This scandal provided advocates of the reforms, Kim Jae-Ik and EPB officials, the political momentum to push ahead with financial reform considering the huge sum defrauded and the political nature.

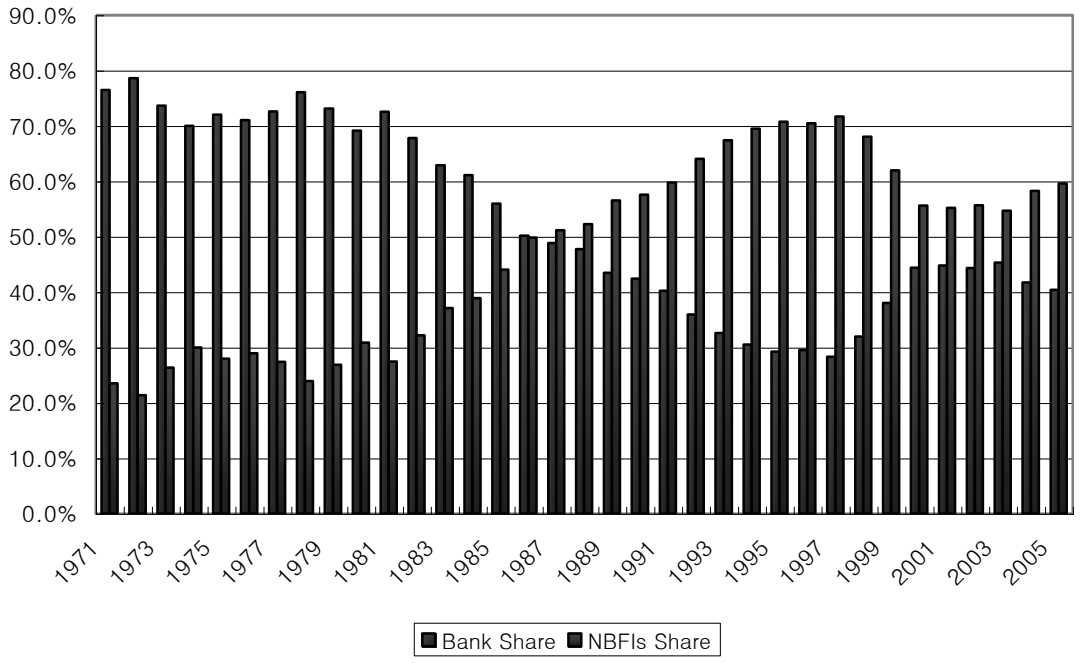
Second, interest rates for NBFIs were deregulated first before the commercial banks which were still regulated. As such, the difference between the interest rates offered by the NBFIs and those offered by commercial banks became wider in the 1990s. (Table 1) There are a couple of reasons why the interest rate deregulation for the banking sector happened much later than the deregulation for the NBFIs. First, the BOK was concerned with possible surge in M2 money supply when deposit rates are liberalized. As such it believed that, freeing NBFI deposit interest rates, which are not part of M2, while maintaining control over bank interest rates could prevent the rapid growth of money supply in M2. Second, more importantly, the government wanted to keep the cost of funds for policy loans low. (Y.J. Cho, 2003). As a result, uneven nature of interest rate liberalization led to the steady expansion of deposits at NBFIs. As Figure 1 shows, NBFIs' share in total deposits increased from less than 30 percent in the early 1980s to more than 60 percent in the 1990s. The total amount of deposits at NBFIs surpassed that of commercial banks in 1987.

<Table 1> Average Interest Rates on Deposits (%)

	1991	1992	1993	1994	1995	1996	1997
Commercial bank time deposits (6-12 months) (A)	6.0	6.0	5.0	5.0	7.0-9.0	9.3	13.9
Investment finance co. cash management account (180 days) (B)	15.0	15.5	11.9	12.9	13.3	11.8	12.6
(B)-(A)	9.0	9.5	6.9	7.9	4.3-6.3	2.5	-1.3

Note: Investment finance companies were transformed to merchant banking corporations in July 1996.
Source: Bank of Korea, Monthly Bulletin. Recited from Joon-Ho Hahm (2003)

<Figure 1> Growth of Commercial banks and NBFIs: Shares in Deposits (%)



Third, there was a rapid increase in number of merchant banks in the NBFI sector, following a series of regulatory changes and deregulation. The government further deregulated the entry barriers for the merchant banking sector in the belief that greater competition would result in increased economic efficiency in financial markets. At that time, there were a couple of merchant banks operating that were established in the 1970s

which were allowed to conduct foreign exchange operations similar to commercial banks. With the deregulation of merchant banking sector, STFCs were able to obtain merchant banking licenses; in effect, STFCs had simply changed their names to merchant banks. Between 1994 and 1996, a total of 25 STFCs had been licensed as merchant banks.

The proliferation of merchant banks did not result in the hoped-for improvement in efficiency in financial markets but instead destabilized the financial sector, ultimately resulting in the 1997 financial crisis. Indeed, a lack of adequate prudential regulation of the NBFIs may not have necessarily prevented a crisis, however, had there been adequate supervision, the scale of crisis could have been much smaller as the alarms would have been sounded. Furthermore, the problem of inadequate supervision was much more serious for the merchant banks compared to commercial banks, in the sense that commercial banks at least subject to regular examinations by the BOK whereas the merchant banks were hardly supervised. Though formally a responsibility of the MFE, it would seem that merchant banks were not subject to adequate supervision. Consequently, only a few randomly selected merchant banks were examined each year. Even then, it is doubtful whether the examination was done properly, given that many of the retired bureaucrats from the MFE held positions in the merchant banks and were actively involved in lobbying on their behalf. Indeed, the rapid growth of the merchant banks driven by the deregulation and liberalization was not accompanied by stronger financial supervision.

3. Role of NBFIs in the 1997 Financial Crisis

In the years leading to financial crisis in 1997, NBFIs experienced a rapid increase in the amount of loans outstanding, most of which was funneled to *chaebols*, which had controlled the NBFIs and used them as their financing arm. By 1997, the 70 largest *chaebols* owned a total of 114 financial affiliates, mostly merchant banks, securities companies, non-life insurance companies, and installment credit companies. Unlike commercial banks, NBFIs other than life insurance companies and investment trust companies face no ownership restrictions.[2] Many NBFIs were owned and controlled by the *chaebols*.

Beginning in the mid 1980s, the government began to curb easy credit to the large business group. In response to increasing calls to support SMEs (See Box 2), the government introduced a credit control system to lower the concentration of bank loans to *chaebols*.

<Box 2> Democratization and SME Policy since the 1980s

After Chun Doo-Hwan seized power in 1980, the government sought to promote social equity and more balance between income distribution and growth. Korea's Constitution was immediately amended, constituting that the government directly support SMEs, stating that "the government must protect and nurture SMEs and their business activities." (Article 124 Clause 2)[3] The policy of supporting SMEs gained strength when the government pledged to pursue political democratization on June 29, 1987. Most crucial element underlying political democratization is in Article 119, Clause 2 of the Korean Constitution, which states:

[2] For life-insurance companies, the top 5 *chaebols* were prohibited from newly entering the market, and the top 6-10 *chaebols* were allowed to hold only less than 50% of the equity since 1996. The restrictions were repealed in February 1997, except the condition that the top 5 *chaebols* wishing to enter the market should acquire 1-2 unsound institutions. For investment trust companies, the 30 largest *chaebols* cannot own more than 15% (30% for local trust companies). But this ownership restriction was also lifted in 1998.

[3] Before this change in the constitution (Article 102 Clause 2), the government support was indirectly provided to farmers, fishermen, and SMEs through organizations and associations.

"[*T*]*he state may regulate and coordinate economic affairs in order to maintain the balanced growth and stability of the national economy, to ensure proper distribution of income, to prevent the domination of the market and the abuse of economic power and to democratize the economy through harmony among the economic agents.*" (Quoted from Jwa and Yoon, 2004)

Several major policy tools were used toward this end. First, commercial banks were required to increase the minimum ratio of loans provided to SMEs. Starting in 1985, the foreign bank branches and certain NBFIs were also subject to the requirement. (See Table B1) The BOK played a key role in subsidizing SMEs by using SME loans as the criterion for allocating the low rate BOK loans among commercial banks. The banks that meet the minimum required lending to SMEs were rewarded by receiving coveted BOK loans. In addition, the Bank set up rediscount ceilings of export bills and commercial bills associated with SME. The BOK also extended loans directly to SMEs for specific categories for investment, including that for R&D and pollution abatement. After 1983, the BOK also accepted bills payables for purchasing of SME products as collateral for the BOK loans.

<Table B1> Deposit Money Banks' Required Ratio of Financing SME (%)

	1965	1976	1980	1985	1986	1992
Nationwide commercial bank	30 (1)	30 (2)	35 (3)	35	35	45
Local bank	30 (1)	40 (2)	55 (3)	55	80	80
Foreign bank branches	-	-	-	25	25	25

Note: (1) Ratio in terms of total loans outstanding
(2) Ratio in terms of increase in total loans
(3) Ratio in terms of increase in total loans in won
Source: Cho and Kim (1995)

Together with this, the government introduced a credit control system to lower the concentration of bank loans to *chaebols*. Table B2 shows that bank loans to SMEs increased while those to *chaebols* declined, reflecting these policy changes. The share of bank loans to SMEs rose from 33.1 percent in 1983 to 56.8 percent in 1991. The share of bank loans to the 30 largest *chaebols* decreased from 24 percent in 1988 to 20 percent in 1991.

<Table B2> Share of loans to SMEs and the 30 largest *Chaebols* by domestic banks [(a)] (%)

	1988	1989	1990	1991

Loans to SME	48.1	50.1	55.5	56.8
Loans to the 30 largest *Chaebols*	23.7	20.7	19.8	20.4

(a) Domestic banks include deposit money banks only.
Source: Bank of Korea, and Office of Bank Supervision. Recited in Cho and Kim (1995)

The *chaebols* used NBFIs to borrow massively to finance their growing appetite for investment. To finance the loans, the NBFIs borrowed short-term loans at higher interest rates since they lacked international name and creditworthiness. Consequently, the balance sheet of NBFIs suffered mismatches as they borrowed short and lent long, resulting in high risk, high return business models. On top of this, the loan portfolios were prone to currency mismatches with high vulnerability to market and liquidity risks.

Moreover, NBFIs were not subject to the same lending restrictions as the commercial banks. This allowed NBFIs to make loans to *chaebol* affiliates. For instance, a merchant bank could lend as much as 150 percent of its equity capital to any single borrower whether an individual or *chaebol*, whereas the limit for a commercial bank was 45 percent. As of March 1997 the top 30 *chaebols* accounted for as much as 51 percent of the merchant banks' total outstanding loans. In early 1997, when Kia, an automobile manufacturer, was declared bankrupt, the non-performing loans (NPLs) of about 30 merchant banks amounted to 4 trillion Won, which exceeded their total equity of 3.9 trillion Won. The size of NPLs increased to 10 trillion won later in the year when several conglomerates (Jinro, Daenong, Sammi, and Woosung) joined Kia in bankruptcy.[4] A similar situation existed in the case of a number of the offshore funds established by Korean security or investment trust companies. Their number grew rapidly after 1994, reaching 166 in 1997. The total value of the 98

[4] Reported at various hearings at the National Assembly of the Republic of Korea.

offshore funds set up by 28 security companies reached US$2.6 billion, and in 1997 their loss was estimated to be about 11 trillion Korean won.

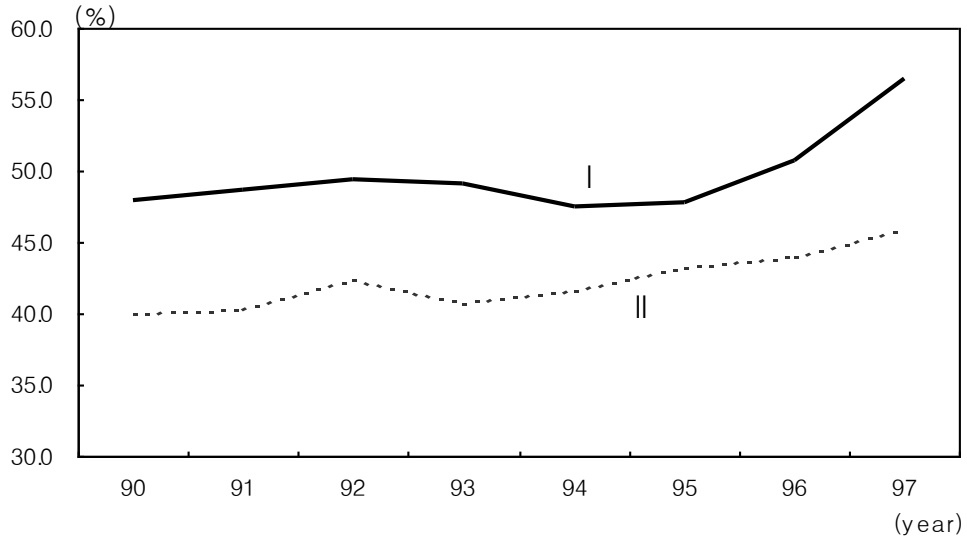
The close links between NBFIs and the *chaebols* created scope for conflict of interests. It appears that the *chaebols* exploited the affiliated NBFIs to finance the subsidiaries within their group in various ways: direct provision of funds, priority underwriting of securities issued by related subsidiaries, provision of preferential financial services and information on competing firms, management of related firms' shares and their prices, exercise of control of other firms via stock holdings, and other forms of unfair inter-group transactions. Ultimately, NBFIs, who were totally subordinated to the control by their *chaebol* owners, did not have incentive to monitor the loans. Strong belief of implicit government bailout of *chaebols* intensified this moral hazard.

Corporate Leverage and Ownership of NBFIs

In order to examine the linkage between the *chaebol's* debt leverage and its ownership of NBFIs, we analyze data from more than 5,000 externally audited firms. The sample is divided into two groups. Group I is a set of firms that own NBFIs. Group II is a set of firms without any ownership in NBFIs. If one or more subsidiary companies of a *chaebol* or the founding family own NBFIs, then all non-financial affiliated companies of the same *chaebol* are considered to belong to the first group. Various financial indicators are compared across different groups.

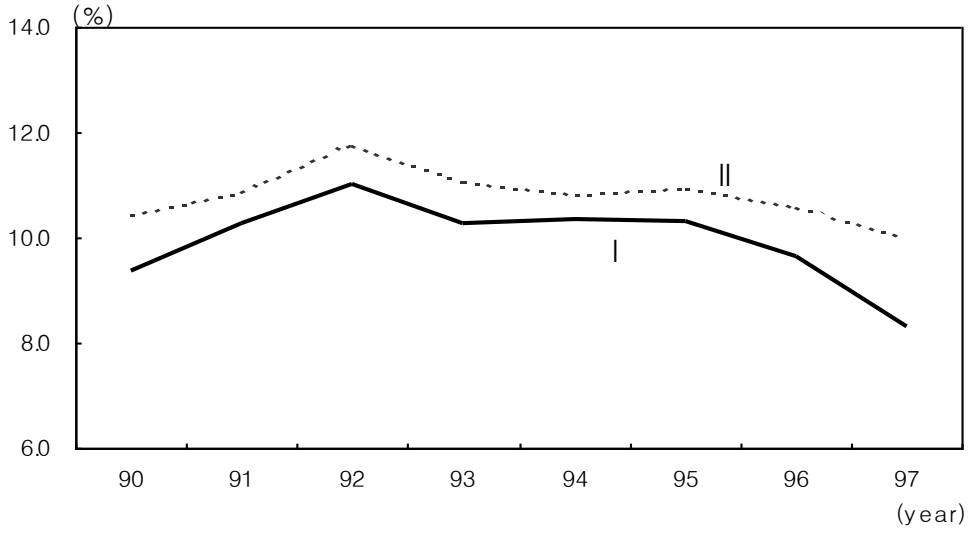
Figure 2 shows the ratio of total borrowings to total assets for each group. Group I shows consistently higher leverage than Group II, and the gap between the two groups became more pronounced right before the crisis in 1997. Figure 3 shows that Group I also faced lower interest rates, and the gap was also widened before the 1997 crisis.

<Figure 2> Total Borrowings to Total Assets for Non-Financial Firms



Note: 1) I: Non-financial firms that own NBFIs.
II: Non-financial firms without any ownership in NBFIs.
Source: National Information and Credit Evaluation Inc. Recited from JK Kim (1991)

<Figure 3> Interest Costs to Total Borrowings for Non-financial Firms



Note: 1) I: Non-financial firms that own NBFIs.
II: Non-financial firms without any ownership in NBFIs.
Source: National Information and Credit Evaluation Inc. Recited from JK Kim (1999)

The finding is consistent with the idea that NBFI ownership allowed *chaebols* to borrow more funds at favorable rates. The gap between the two groups in terms of leverage and interest costs became wider right before the crisis.

We have conducted regression analysis to examine the relationship between NBFI ownership and leverage. To control for the factors other than NBFI ownership that affect the leverage, the regression model includes firm size, the ratio of cash flow to total assets, the ratio of tangible fixed assets to total assets, and firm age as additional explanatory variables.[5]

We use the log of sales revenue as the measure of firm size. Large and diversified firms are likely to have small default risks, which allow them to have high leverage. High cash flow would reduce the need for external borrowing and should lead to low leverage. Firms with more tangible fixed assets could put up those assets as collateral for external financing, allowing them to have high leverage. Younger firms are likely to have hard time borrowing because of lack of credit histories (Demirguc-Kunt and Maksimovic, 1994). To control for this age effect, we construct a dummy variable that takes the value one if the firm was established within the last three years and zero otherwise. The regression model also includes industry dummies. The modeled is estimated by pooled ordinary least squares (OLS) over the sample period of 1990 to 1997.

The estimation results are reported in Table 2. We considered two alternative dependent variables: total debt to assets ratio and the share of long-term borrowing in total liabilities.

Model (I) uses a dummy variable that takes one when the firm owns NBFIs regardless of the type of NBFIs, as the NBFI ownership variable. The corporate leverage is positively and significantly correlated with the *chaebols'* ownership of NBFIs, while the other coefficient estimates have the expected signs and are statistically significant at 5% level.

[5] Some recent papers empirically examine the determination of corporate debt leverage in Korea (Lee, J. and Lee Y. 1999, and Hahm H., Ferri G., and Bongini P. 1998). As to the survey papers on the theory of determination of financial structure, see Harris and Raviv (1991) and Rajan and Zingales (1995).

<Table 2> Estimation of Corporate Debt Leverage

	Total borrowings/ Total assets	Long-term borrowings/ Total borrowings
	(I)	(II)
Log sales (firm size)	0.23 ** (2.0)	2.93 *** (26.3)
Cash flow/total assets	-0.91 *** (-78.6)	0.13 *** (11.4)
Fixed assets/total assets	0.21 *** (29.8)	0.34 *** (49.4)
Firm age	-3.24 *** (-4.9)	
Ownership of NBFIs	3.85 *** (6.4)	
Ownership of MBCs		-3.20 ** (-3.2)
Ownership of Security firms·ITCS		5.24 *** (5.5)
Ownership of Insurance firms		0.45 (0.5)
Constant	31.5 *** (15.8)	-26.5 *** (-13.5)
Adj. R^2	0.17	0.13
Number of samples	42,643	39,332

Note : 1) Estimation period : 1990~97 (annual period).
2) t-values are in parentheses. ***, ** and * indicate that the coefficient is significantly different from zero at 1, 5 and 10 percent levels respectively.
3) Firm age dummy: one if age is less than or equal to three years, and zero otherwise
4) Industrial dummy (manufacturing, construction and others) and year dummy variables are included.
Source: JK Kim (1999).

Model (II) examines how the proportion of short-term debt is influenced by the type of NBFIs that the firm owns. It is well known that merchant banks specialize in short-term financing such as CP discounting and securities companies and ITCs focus on long-term financing such as corporate bond underwriting. Such difference in business orientation of NBFIs may have an implication for the term structure of corporate debt. For example, *chaebols* that own merchant banks may have relatively high share of short-term loans. The model employs three separate ownership dummy variables for each non-bank financial sector, covering MBCs, securities companies and ITCs, and insurance companies.

The regression results of Model (II) shows that the coefficients of ownership dummy variables for MBCs and securities companies and ITCs have expected signs and are

statistically significant at the 5% level. This result implies that the ownership by the *chaebols* of NBFIs affected not only the overall leverage but also the maturity composition of corporate debt.

Profitability and Soundness of NBFIs

We also find differences among NBFIs depending on their *chaebol* affiliation. C*haebol*-affiliated NBFIs tend to be less profitable and less capitalized than independent NBFIs. (See Figure 4) Table 3 reports the average rate of return on asset (ROA) of NBFIs by *chaebol* affiliation for the years 1995 to 1997. The table shows that the ROA for *chaebol*-affiliated NBFIs was lower than that of independent NBFIs. The difference is significant at 5% level.

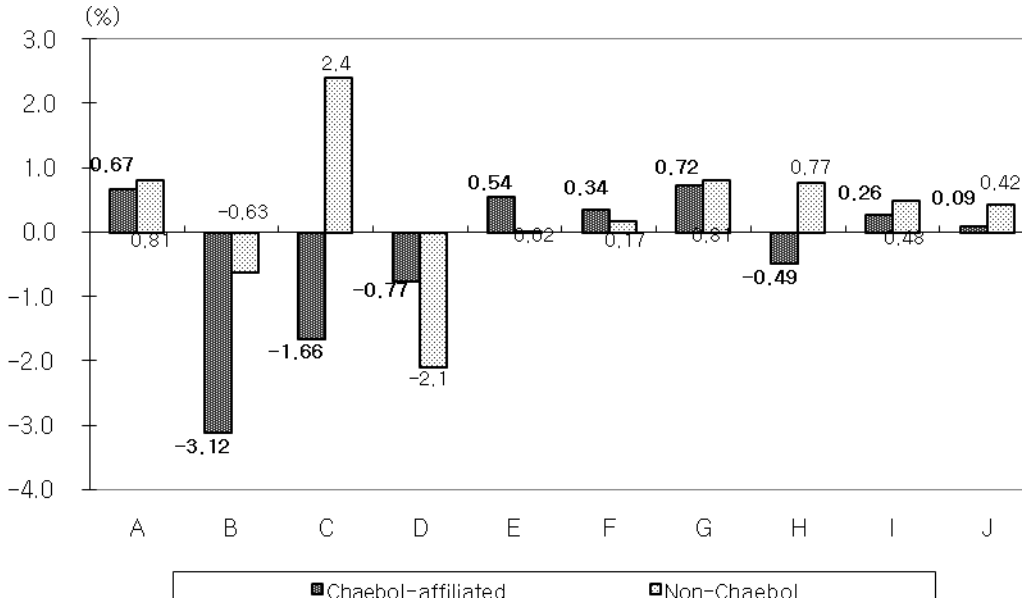
<Table 3> ROAs of NBFIs

(Weighted average)

	Chaebol-affiliated	Non-*Chaebol*
1995	0.27%	1.00%
1996	-0.68%	-0.10%
1997	-0.47%	-0.37%

Source: National Information and Credit Evaluation Inc. Recited from JK Kim(1999).

<Figure 4> ROAs of NBFIs by Sector (Average for 1995-97)



A : Merchant Bank	B : Securities	C : Investment Trust Company
D : Life Insurance	E : Fire & Marine Insurance	F : Installment Credit
G : Mutual Saving & Finance	H : Venture Capital	I : Credit Card
J: Finance & Factoring		

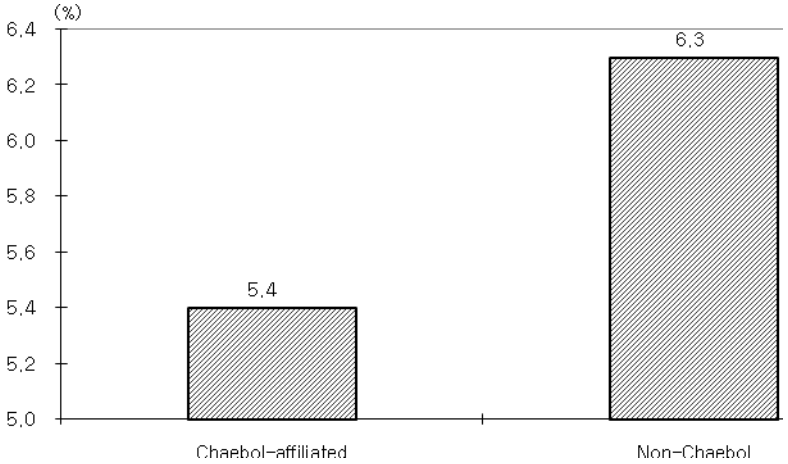
Source: National Information and Credit Evaluation Inc. Recited from JK Kim (1999)

C*haebol*-affiliated NBFIs also have lower capital ratios compared with independent NBFIs. Figures 5 and 6 compares the capital adequacy of merchant banks and securities houses respectively at the end of March 1998. The average BIS ratio for *chaebol*-affiliated merchant banks was 5.4% while that for independent institutions was 6.3% . The net operating capital ratio of *chaebol*-affiliated securities companies was 165% while that for independent institutions was 234%.

Although the result is consistent with the idea that *chaebol*-owned NBFIs suffers from conflict of interest, we need to be cautious in interpreting these differences. Simple comparison of averages can be misleading. For example, if *chaebol* firms tend to be safer than independent firms, the NBFIs that lent to those safer firms may experience lower ROAs. Similarly, *chaebol*-affiliated NBFIs may decide to have lower capital ratios because they deal with safer borrowers.

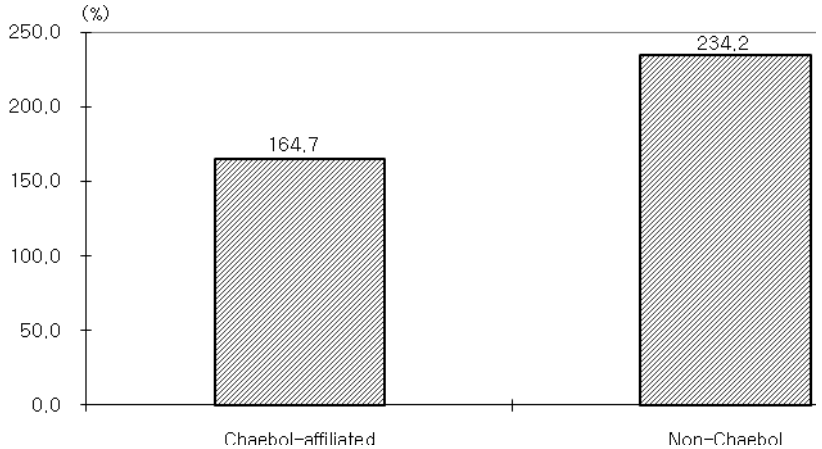
<Figure 5> BIS Ratio of Merchant Banking Companies

(Weighted average, as of March 1998)



<Figure 6> Net Operating Capital Ratio of Securities Companies

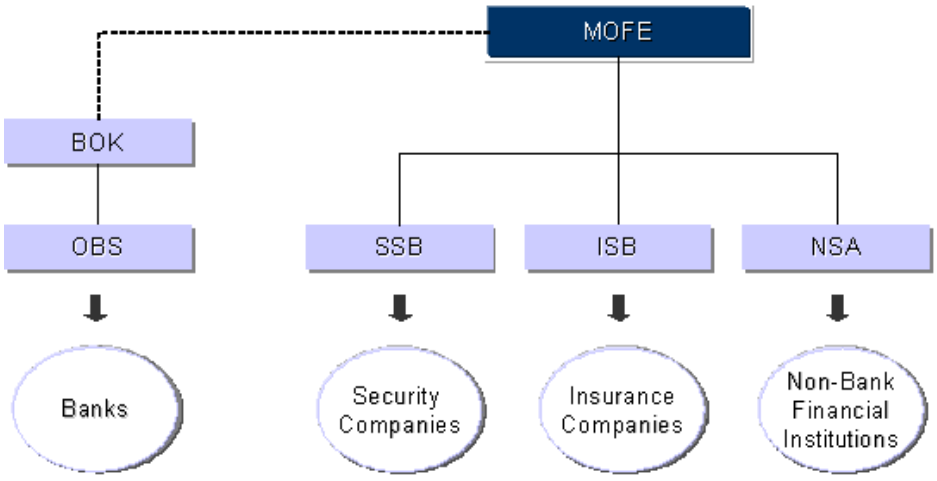
(Weighted average, as of March 1998)



4. Financial Supervision: Before and After the Crisis

Before the crisis in 1997, the Korean financial supervisory system was highly fragmented, spread out among many individual agencies based on type of financial institutions. Banks were supervised by the Bank of Korea (BOK) while NBFIs including security companies, insurance companies, merchant banks, mutual savings and finance companies (MSFCs), credit unions and other non-banking institution, were under the responsibility of the Ministry of Finance and Economy (MFE, a super-ministry created by merging the Economic Planning Board and the Ministry of Finance). As seen in Figure 7, there were four separate public agencies including the Office of Bank Supervision (OBS) under the Bank of Korea, and the Securities Supervisory Board (SSB), the Insurance Supervisory Board (ISB), and Non-Bank Supervisory Authority (NSA) under the MOFE.

<Figure 7> Pre-Crisis Financial Supervisory Structure



Moreover, supervisory responsibility over foreign currency based operations in commercial banks was shared between the MFE and the BOK. Specifically, the MFE oversaw long-term foreign capital transactions and outgoing foreign direct investment while

the BOK had responsibility over short-term foreign capital inflows. Also the MFE set policies on foreign exchange management while the BOK carried out those policies. Indeed, the MFE could influence monetary policy as the Minister of Finance and Economy was also the chair of the BOK monetary board before the crisis.

Before the outbreak of the 1997 financial crisis, it just happened that a group of experts from the private sector and academia had formed the Presidential Committee for Financial Reform in January in 1997 to recommend the policy directions and reforms for Korea's financial system, driven by concerns that Korea's financial system may have been underdeveloped due to past prolonged government intervention. The Committee sought to strengthen the competitiveness of Korea's financial industry through deregulation by expanding the scope of businesses of financial institutions, such as universal banking, and by opening access to foreign capital markets. To promote a more efficient financial market, the Committee also recommended liberalization of interest rates and deregulation of restriction on fees. The Committee also sought to promote a sound financial system by insuring independence of the central bank and building a supervisory system that was in line with the financial reform recommendation. Indeed, the recommendation to consolidate the financial supervisory system was driven by the belief that the financial sector would have to adopt universal banking to be competitive. The most critical set of recommendations to reform the financial supervisory system was to strengthen the independence of the central bank and consolidate the fragmented system of financial supervision through the amendment of the Bank of Korea Act and the new act on Establishment of Financial Supervisory Organizations. However, the recommendations, that were legislated and submitted to the National Assembly on August 23 1997, were not ratified until December 1997, about a month after the crisis.

The eventual ratification of the reform legislations strengthened the independence of the BOK to carry out monetary policy while the BOK relinquished its responsibility of

supervising banks. Almost five months later as Korea struggled to overcome the crisis, the Financial Supervisory Commission (FSC) was established as integrated financial supervisory body,[6] to act as an independent government agency. The Securities and Exchange Commission (SEC) was also reorganized into the FSC, and became the Securities and Futures Commission (SFC). Then on January 1, 1999, the four separate supervisory agencies - the OBS, SSB, ISB, and NSA – were consolidated into one single entity named as the Financial Supervision Service (FSS). The FSC became the principal supervisory authority with the responsibilities of formulating financial policies, and overseeing financial institutions and markets. The FSC has nine commissioners led by the chairman who is appointed by the President with recommendation of the prime minister. All commissioners are appointed for a term of three years. The actual tasks of carrying out prudential supervision and examinations of financial institutions have been delegated to the FSS, which is a private organization.

The consolidation of supervisory function into one independent agency was expected to improve the efficiency and stability of the financial system. Despite the formal changes to the supervisory system, the expected gains in efficiency and stability have not materialized. In fact, Korea has also experienced a higher frequency of home-grown financial crises albeit at a much smaller scale within a short amount of time since the 1997 crisis. Korea was hit with a credit card crisis came in 2003, which was followed by the mutual savings bank crisis in 2011.These frequent crises suggest that the reforms in the financial supervision were either not deep enough or not implemented properly.

[6] Soon after its establishment on April 1, 1998, the FSC was mandated with the job of restructuring corporate and financial sectors in the wake of the crisis.

4.1 **Credit Card Crisis: Haphazard Deregulation and Weak Financial Supervision**

The signs of credit card crisis began to emerge in early 2003 when the financial markets began to show concerns of the credit card company insolvency, as many of them had difficulties raising capital. Indeed, the credit card bubble had been burst, and the government was forced to intervene by rescuing credit card companies to prevent a major crisis. Almost a year later in January 2004, the government bailed out LG Card, the largest credit card company at that time and was a *chaebol* affiliate, could not roll over the debt and subsequently failed.

In the years preceding the crisis, the rapid expansion of credit card industry can be seen in the sharp increase of the number of credit card issued and total credit card loans which were 105 million cards (about 4.6 cards per consumer) and 51 trillion won, respectively, at the peak of crisis in 2002. The subsequent fallout of the crisis led to a sharp rise in the number of credit card defaulters, which increased to 2.5 million credit card users by 2004.

<Table 4> Credit Card Market in Korea

	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
Number of credit cards issued	39.0 (1.8)[1)]	57.7 (2.6)	89.3 (4.0)	104.8 (4.6)	95.5 (4.1)	83.5 (3.6)	82.9 (3.5)	91.1 (3.8)	88.8 (3.7)	96.2 (4.0)	107.0 (4.4)	116.6 (4.7)
Credit card loans and cash services[2]	13,761.53 (55.1%)[3)]	29,516.62 (69.2%)	36,896.51 (51.4%)	50,890.36 (44.3%)	27,295.53 (17.5%)	15,415.80 (18.5%)	15,677.22 (25.8%)	17,489.33 (35.0%)	18,425.60 (38.8%)	23,954.09 (33.0%)	29,888.51 (35.8%)	37,605.66 (34.8%)
Credit card purchases as a % of private consumption	15.5%[4)]	24.9%	39.1%	45.7%	43.9%	41.7%	44.8%	47.3%				
Total credit card assets as a % of household credit	6.4%	11.1%	10.8%	11.6%	6.1%	3.2%	3.0%	3.0%	2.9%	3.5%	4.1%	4.7%
Cash payment fees and revenues on credit card loans as a % of credit card revenues	79.9%	62.5%	53.8%	44.3%	57.5%	32.1%	28.0%	18.2%	19.9%	18.7%	17.6%	18.9%

Note: 1. Number of credit cards issued per person,
2. Billion won
3. % of total assets
4. Kang and Ma (2007)

Source: Financial Supervisory Service

A combination of several factors can be considered in explaining the causes of the credit card crisis. First, the government carried out a round of deregulation, easing regulatory restrictions in the credit card industry. In fact, the objectives of the deregulation were well intentioned as the government sought to reduce the number of cash-based transactions by providing tax benefits to increase the usage of credit cards. The goal of the credit card policy was to reduce unreported income and tax evasion since credit card transactions leaves a record. During 1997-99, the government undertook a series of deregulatory measures for credit card companies including: expanding the scope of financial products by permitting cash advance and card loans; lifting the limit on the issuance of debentures by credit card companies; and lifting the limit restricting the credit card companies from expanding non-traditional credit card activities (i.e., cash advance and card loans). Essentially, these deregulations allowed credit card companies to offer more different products with no limits and to borrow more to finance these activities. This was followed by anther round of deregulation that sought to promote the use of credit cards including: offering tax benefits for credit card purchases; lifting monthly credit limit on cash advance; requiring corporate credit cards to be used for expenses related to entertainment; and offering lotteries using credit card receipts. During this time, the government was pursuing a policy of boosting domestic consumption. Expansionary monetary policy together with the government promotion of the credit card usage set off a large increase in credit card purchases: between 1999 and 2002 the amount of credit card billings almost tripled to 46 percent of private consumption (See Table 4).

Following the liberalization of interest rates, the credit card industry experienced a period of rapid and aggressive expansion with the entry of *chaebol* affiliated credit card companies that saw the credit card industry highly lucrative business. In addition to being relatively less regulated than other financial industries, the consumer credit market offered

high returns on their assets as they are allowed to charge high interest rates over 20 percent or more on their cash advance services and loans.[7] Consequently, the credit card industries experienced increased competition as commercial bank affiliated credit card companies expanded their operations. By 2000, there were 25 credit card companies. Practically all commercial banks offered credit card services directly or indirectly by setting up credit card subsidiaries. By then, the *chaebols* had also moved into the credit card business by establishing credit card companies. Among the 25 issuers, only the largest four – Samsung, LG, KB, and BC cards mattered as they held together a 90% market share.[8]

As a consequence, credit card companies became engaged in intense competition for a large market share. Indeed, the increased competition had led credit card companies to lower credit lending standard, and engaged in aggressive often predatory practices in soliciting new credit card customers. Indeed, at the peak of the credit card crisis in 2002, average number of credit card owned by one customer was estimated to be 4.6 cards. It was reported by FSS in 2002 that minors were solicited without parental consent, high rebates were offered to attract new customers, credit limits went well beyond creditworthiness of the cardholders who often were not subject to credit evaluation. Most of these aggressive marketing practices became widespread by 2001 when many credit card companies had employed the practice of soliciting customers on the street. There were 31,000 solicitors at the end of 2000 that solicited 58% of 18.3 million newly issued credit cards. Solicitors were $10 for each customer signing up for a new card without scrutinizing their creditworthiness.

As Kang and Ma (2007) point out, the competition for a larger market share contributed in part to lowering the industry wide screening and underwriting standards. More

[7] At the early stage of business, credit card issuers earn high rates of return on their assets as the loan delinquency rate is relatively low and hence they do not set aside large amounts of provisions for future losses

[8] Some of the *chaebol* with limited banking experience succeeded in capturing as much as 76 percent of domestic credit card transactions by 2002

importantly, the competition led the credit card issuers to lend a disproportionately large share of their loanable funds to least creditworthy borrowers - households, self-owned and other small sized businesses denied access at banks, thereby causing mounting credit risk in their loan portfolios. Inevitably, the credit quality of their loan portfolios deteriorated sharply. Since they did not know or did not pay much attention to creditworthiness of new card holders, they also had to charge higher interest rates on their loans and fees for cash services. This increased the share of unpaid loans, later on.

On the funding side, moral hazard for institutional investors came into play in amplifying the credit card lending boom-bust cycle. In raising funds, credit card firms borrowed from banks, issued debentures, commercial paper, and ABS. Compared to other types of financial assets including corporate bonds, they carried higher interest rates. Although the high yields reflected a premium for the default risk credit card firms were exposed to, institutional investors including investment trust companies (ITCs), pension funds, and insurance companies, which were the largest investors for these assets, ignored the riskiness of their investments. The institutional investors behaved as if the repayment of debts of the credit card companies would ultimately be ensured by their parent companies such as commercial banks and industrial groups.

This moral hazard syndrome reduced further the incentives for credit card issuers to compromise on screening their borrowers, causing the transfer of much of their credit risk to the institutional investors. This implicit and explicit transfer of risk allowed credit card issuers to borrow and lend much more than they should have and subsequently exacerbated the boom-bust cycle[9]. During the credit card lending boom from 2000 to 2002, the share of cash services and loans in total credit card assets rose to more than 55 percent on average. In

[9] In some respects the unfolding of the boom-bust cycle in Korea reveals similar problems associated with "the originate-to-distribute" model of mortgage lending that triggered the sub-prime crisis in the US

2001, the estimated return on the credit card companies' assets were six times as much as the average returns of Korean commercial banks (Yun 2004).

However, the credit card loan boom could last only so long. Given the high cost of loans and cash services, many of the borrowers at credit card companies could not service their debts at a time when the economy was slowing down. Credit card debts snowballed as many of these borrowers had several credit cards, using them to borrow from one credit card company to repay their loans to other firms. The number of delinquent accounts started to soar and so did the volume of bad loans to squeeze profits of the credit card issuers

In early 2001, financial supervisors began to raise red flag witnessing the explosive growth of credit card industry. The FSS conveyed concerns of the widespread use of aggressive marketing practices by credit card companies, which created excessive competition. In fact, the financial supervisors attempted to address the problem. In April 2001, the FSC sought to reintroduce the limit restricting non-traditional credit card activities (i.e., cash advance and card loans). However, the FSC did not have the legal authority to make regulatory changes. Moreover, the government opposed re-regulation of the credit card industry, fearing that it would have a negative impact on the economy's growth.

Nearly a year later, the Financial Policy Coordination Committee, comprised of the vice-minister of MOFE, the vice-chairman of FSC, and the vice-governor of the BOK, convened in February 2002 to address the credit card problems and subsequently agreed on a set of policies response measures to curb the rising consumer debt levels. However, a month later, the government reversed its position on taking policy action to curb the excessive borrowing of households driven by credit card related loans, believing it would hurt domestic consumption and thus weaken the economic recovery.

Meanwhile, the amount of consumer debts and the number of defaults continued to grow, worsening to a point it had become a social and political issue. Weighed by concerns of

a political backlash, the ruling party sought to quickly address the credit card problems. In May 2002, the policy chair of the ruling party convened a meeting with the Minister of MOFE and the chairman of FSC which agreed to take policy measures to contain the fallout stemming from excessive consumer debts. In June 2002, a set of restrictions such as credit limit were reintroduced to tighten the regulation of credit card companies. In addition, tools for prudential supervision were introduced for the credit card companies, including PCAs (prompt corrective actions), financial disclosure requirement and on-site and off-site examinations.

In response to tightening regulations on credit card companies, tighter screening standards were applied for new card and loan applicants and for renewing the existing loans. This tightening created a liquidity crunch, sending more accounts into arrears. Realizing these financial difficulties, institutional investors holding large amounts of financial instruments issued by credit card firms were waiting for the right moment to unload their investments.

An accounting scandal at a subsidiary of a large *chaebol* – SK group- together with the Moody's down grading of Korea's sovereign rating coupled with the growing concern about North Korea's nuclear weapons program disrupted money and capital markets to cause a sharp fall. Fearing losses investors began cashing in their holdings at ITCs on which credit card companies heavily relied for their funding. Because of the restrictions on borrowing, ITCs had to liquidate their assets to meet redemption, causing further increases in interest rates. Since the ITCs could no longer invest in debentures and ABS issued by credit card companies as much as they did before, their withdrawal from the market created a severe liquidity crunch in the credit card industry, which in turn pushed up the delinquency rate and funding cost. By the early months of 2003, many of the credit card companies brought to the edge of insolvency.

To avert the impending crisis, the Bank of Korea injected 4 trillion won, or $4 billion, into the banking system and the state owned Korea Development Bank bailed out the LG card by lending almost 1.5 trillion won, more than a quarter of creditor claims. The government also pressed *chaebols,* such as Samsung, LG, and Hyundai to recapitalize their credit card subsidiaries. The government was also leaning hard on banks with card units, such as Kookmin Bank, Woori Bank, and Shinhan Bank, to inject funds into their credit-card arms. Under the emergency package announced on April 3 2003, banks and *chaebols* with card businesses were required to put up an additional $3.8 billion to boost the capital of their credit-card affiliates. The plan also mandated that banks, brokerage firms, and insurance companies arrange bridge loans amounting to $4.2 billion to rescue the troubled investment-trust industry. At the same time, institutional investors holding credit-card debts are required to roll it over indefinitely to give bond issuers more time to pay.

The event of the credit card crisis begs the question of what has really changed in financial supervision since the 1997 post-crisis reforms? Indeed, had the supervisory taken action when the problems in the credit card industries were raised, the magnitude of the crisis may have been minimized if not prevented. It would seem that the supervisors failed to act after detecting the problems in the credit card industry, and did not utilize their new tools of prudential regulations that were introduced in 2002. This would lead to the conclusion that financial supervisory system had not changed much after the reforms. Specifically, this would imply that the FSC and FSS lack independence and autonomy even though it is ensured by the statue. This impedes its ability to act independently and carry out their statutory responsibility, clearly demonstrated by the way the policy priorities of the government came into conflict with the responsibility of the supervisors. In the end, the aim of sustaining economic growth overrode the supervisory function of maintaining financial stability and ensuring financial consumer protection. Although the financial supervisors detected

problems in the credit card industry, they were not allowed to take corrective actions, which most likely aggravated the crisis.

Indeed, the assessment of Korea's financial supervisory system by the World Bank questioned the independence of the FSC/FSS and ability regulators to supervise.

"*Given the scope and power of the FSC, FSS, and SFC, their independence is a matter of great importance. Although embodied in the law, in practice their operational independence has been called into question. Concerns arise because of the role taken by MOFE in interpreting laws and supervisory regulations, giving the FSC, FSS and SFC only limited freedom in implementing supervision. In addition, the rapid turnover of the FSC chairmanship and the policy whereby FSC staff sometimes move to and from MOFE have the potential to detract from the credibility of supervisory independence.*"[10]

The high turnover of the chairmanship, where the chairman has yet to serve out one term of three years, has led to a lack of continuity and stability. Also the fact that all of the chairmen up to that point were from MOFE, and many of the top leadership at FSC are filled by employees from MOFE, who use it as a ladder for promotion, has undermined independence.

[10] World Bank (2003), "Financial Sector Assessment Korea," pp 6-7.

4.2 Mutual Savings Bank Crisis in 2011: A Replay of Previous Crises

In examining the recent mutual savings bank crisis, the causes of the crisis seems to follow a similar pattern found in previous crises. Aside the effects from the liberalization of interest rates, all of the crises seem to share common features when examining their causes. Foremost, the merchant banks, credit card companies, and mutual savings banks can all be grouped as NBFIs. In addition, all of these industries underwent a series of the deregulation that in retrospect seems to have been done haphazardly, resulting in rapid expansion of industry based on the amount of assets and thus excessive competition. Moreover, weak or the absence of prudential supervision allowed the rapid expansion of mutual savings banks to go unchecked; in that prudential supervisors may have failed to take appropriate actions in a timely manner.

The financial difficulties of mutual savings banks began to surface in January 2011 when Financial Supervisory Commission (FSC) suspended the operation of Samhwa Mutual Savings Bank, the fourth largest in terms of assets at the end of June 2010, when the bank's BIS ratio fell below zero. The country's 105 savings banks, which had combined assets of 87 trillion won at the end of 2009 swung to a loss of 472.6 billion won in the fiscal year ended June 30, 2010. Because the savings bank industry was small, accounting for about 5 percent of total assets and capital of the entire banking system and they were not engaged in foreign currency borrowing and lending, they essentially remained below the radar of the financial supervision system.

A chain of events led to what could have initially been a minor problem snowballing into something much bigger. Indeed, mounting losses and non-performing loans (NPLs) at Busan Savings Bank first erupted as an insolvency problem. It turned into a criminal case involving the bank's senior managers who were engaged in illegal lending to its owners and

building projects and bribing regulators and powerful politicians to avoid the penalties and suspension. It escalated into a corruption scandal and a political crisis that has yet to be addressed sufficiently. Although the national assembly initiated its own investigation of the crisis, no tenable solution has been reached.

Causes of the Mutual Savings Bank Crisis

Several factors can be considered as causes of the mutual savings bank crisis, including 1) weak and opaque internal governance at the savings banks, 2) changes in the business environment that led to the demise of the business model, 3) haphazard deregulation and regulatory changes and 4) weak or absent financial supervision system.

1) Weak and opaque internal governance at the savings banks

The mutual savings banks suffered from poor governance due to a lack of checks and balances. Indeed, governance suffered because major shareholders also held top management position at the savings bank, and some of the major shareholders were found to have a history of illegal dealings. Between 2003 and 2010, the major shareholders of 12 savings banks were found to have engaged in illegal lending activities, out of 16 total banks that were shut down. Despite having an independent board of directors with larger savings banks having outside directors, and even internal auditor per regulatory requirement, these mechanisms did not function properly. Indeed, some retired savings bank examiners from the FSS held positions at the savings banks and were actively involved in lobbying on their behalf. On top of this, the external accounting firms did not properly conduct audits of the savings banks. The accounting firms, that audited the banks were not independently selected as many of the accounting firms, had a prior relationship with the banks. Changes to regulation on external auditors allowed banks to select the same accounting firms for

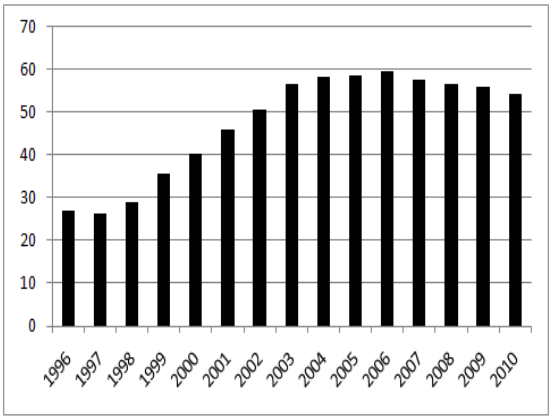
consecutive number of years. Initially, the regulation reform of 1997 post crisis reforms required that accounting firms be randomly selected and only allowed to audit a certain amount of years continuously. As such, mutual savings banks were able to receive favorable audit opinion from the accounting firms.

2) Structural Changes in the Financial Sector

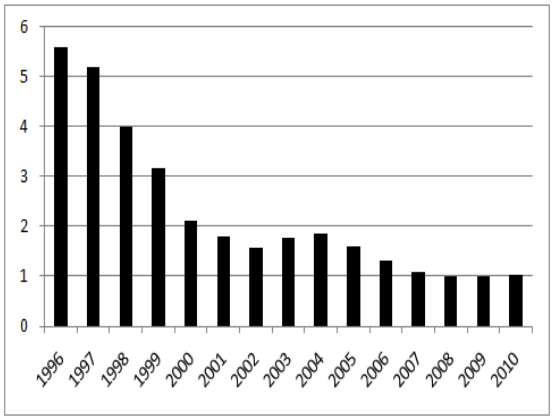
In the wake of the 1997 financial crisis, the once fragmented financial sector underwent structural changes as commercial banks sought to expand in new market segments, from their traditional business of lending to large corporation into the consumer and small business markets, which were the strongholds of the mutual savings banks. Moreover, regulatory change allowed the commercial banks to lend to service oriented businesses such as golf courses, condos, bars, etc, previously prohibited which were largely customers of the mutual savings banks. As commercial banks began to lend to these businesses, and consumer households and small businesses, the share of total credits extended by commercial banks increased from 40.3% in 1995 to 70.1% in 2010, while the share of total credits extended by mutual savings banks decreased from 6.8% in 1995 to 4.6% in 2010. The same pattern can be seen for consumer loans, as commercial banks increased their shares of consumer loans. (See Figure 8) This implies that savings banks were losing consumer loan business mostly to commercial banks.

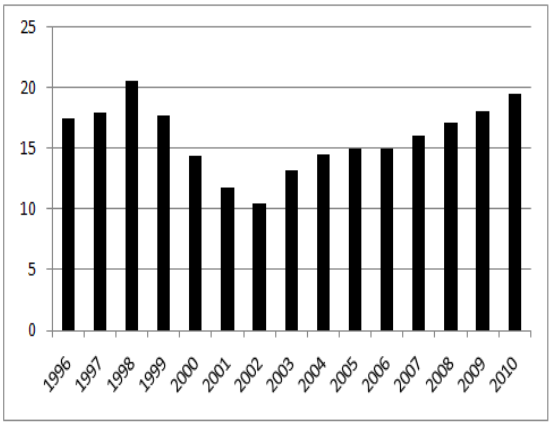
<Figure 8> The Consumer Loans Markets by Sector (%)

<Commercial Banks>

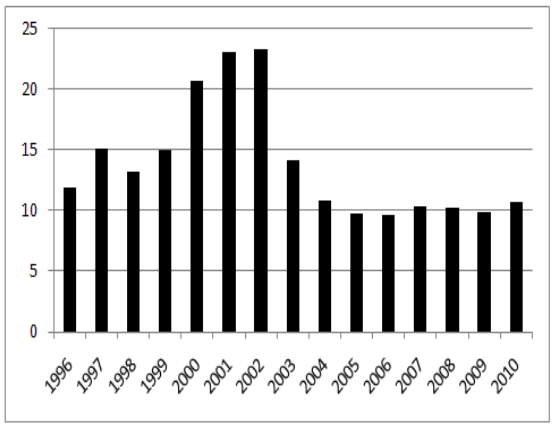


<Mutual Savings Banks>





<Credit Cooperatives>

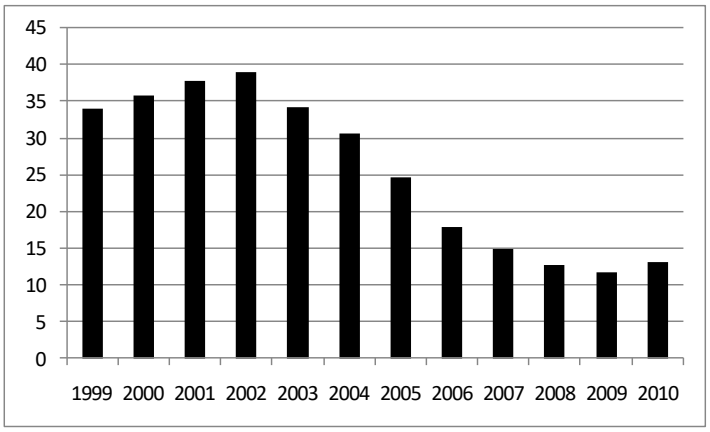


<Credit Card/Installment Finance Companies>

Source: Bank of Korea

With the loss of their traditional niche customer segments, savings banks were forced to seek out new and risky business by placing a large share of their total loans in real estate investments and project financing. The share of project financing out of total loans extended by savings banks increased from 16% in 2005 to 29% in 2007, while the share of consumer loans fell from 34% in 1999 to 13% in 2010. (Figure 9)

<Figure 9> The Share of Consumer Loans of Total Loans by Savings Banks (%)



Source: Financial Supervisory Service

3) Haphazard Deregulation and Regulatory Changes

As mutual savings banks continued to lose market share due to increased competition from the commercial banks, many became troubled, resulting in the closure or restructuring of the savings banks in the years after the 1997 financial crisis. In 1997, there were 237 savings banks. By the end 2002, many of them were closed, acquired by and merged with others to reduce the number to 116. For the next 8 years, 18 more banks were merged with others or shut down. Indeed, the mutual savings bank industry had undergone massive restructuring. However, the remaining savings banks that were left over from the restructuring continued to have difficulties in coping with the increased competition.

A series of regulatory changes in the overall financial sector in the wake of the 1997 financial crisis and active lobbying by the mutual savings bank industry resulted in creating a favorable environment for mutual savings banks to attract the deposits. In response to the financial crisis, the deposit insurance for all deposit-taking financial institutions, which was set at 20 million won before the crisis, was given carte blanch between 1997 and 2000, and then subsequently reduced to 50 million won once the crisis had subsided. Then, the mutual savings banks were allowed to change their name from finance companies to banks in 2002 after lobbying for change.

Renamed as savings banks and now able to insure more deposits, the mutual savings banks experienced a continuous and rapid expansion of deposits. Indeed, the savings banks arbitrarily offered higher rates on deposits to attract more depositors since by now interest rates had been liberalized. But the savings banks found themselves with growing deposits with no one to lend to due to increased competition from commercial banks. Unable to deploy their deposits, the savings banks lobbied for deregulation of the lending limit that was set at 8 billion won (approximately $8 million) per single borrower. The lending limit was increased in 2006 by allowing banks that had BIS ratio above 8% and the share of substandard loans below 8% to lend up to 20% of capital for a single borrower, which opened the door for the savings banks to diversify their lending from household borrowers to property developers.[11] Freed from the 8 billion won lending limit, savings banks began making large loans via special purpose companies (SPCs) they had set up. Since their main funding source was savings deposits, they were borrowing short and lending long, creating maturity mismatches in their balance sheets. The savings banks had adopted a high risk and

[11] These conditions proved to be difficult to enforce because of unreliability of balance sheets and income statements, many of them being falsified.

high return model. Indeed, loans to fund project financing increased by 87% in one year alone in 2006.

By 2010, the share of corporate loans accounted for almost 90 percent of saving banks' total lending, and more than 50 percent of their total loans were extended to construction firms, real estate, project financing, and real estate renting firms. However, the loans to finance some of the projects began to sour, leaving the savings banks with mounting non-performing assets as the real estate markets declined (Table 5). Despite this, savings banks continued to attract more deposits by offering higher interest rates and make risky loans to offset the growing share of non-performing assets, essentially disguising the severity of the troubled assets by growing total assets.

<Table 5> Outstanding Project Finance Loans made by Savings Banks and Ratio of Unpaid Loans (Trillion won, %)

	2005	2006	2007	2008	2009	2010
PF Loans	6.3	11.8	12.1	11.5	11.8	12.2
Share of PF Loans	16.2	26.7	28.9	20.9	18.5	18.9
Ratio of Unpaid PF Loans	9.1	9.6	11.6	13.0	10.6	25.1

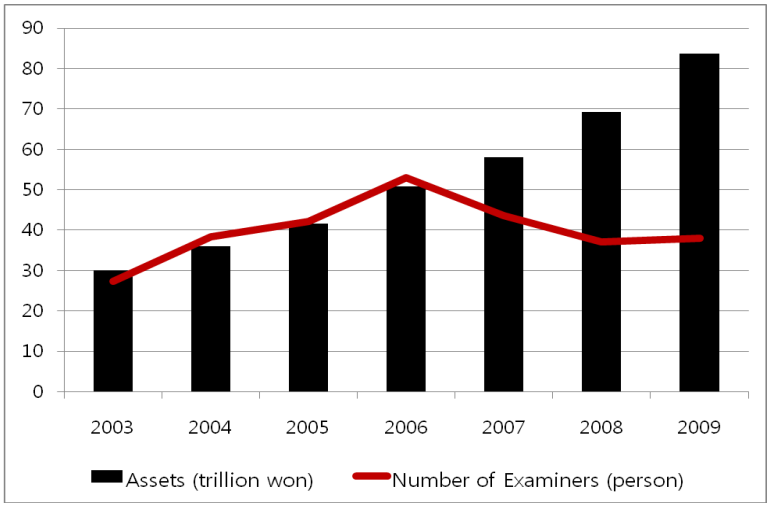
Source: Financial Supervisory Service

4) Weak or Absent Financial Supervision

The situation was made worse by a weak or absent financial supervision that had also failed to take appropriate action in a timely manner, leaving troubled savings banks to go unresolved. In general, mutual savings banks were subject to looser standards of supervision; they were subject to a lower BIS capital adequacy requirement ratio of 5%, compared to 8% of commercial banks and to less stringent standards in the classification of NPLs and requirements on loan loss provisions. Most importantly, there was a large reduction of in the

number of on-site examinations conducted by the regulators. The number of on-site examinations for whole financial sector fell from 1,479 cases in 2004 to 1,111 cases in 2007. On the other hand, the number of off-site examinations increased from 55 cases in 2006 to 95 cases in 2007 and 214 cases (planned in 2008). At the time, the government sought to lessen the regulatory burden in the financial sector as part of efforts to make Korea a Northeast Asian financial hub. There were calls from the financial sector to lower the number of examinations. The same pattern can be seen in the number of examinations for mutual savings banks, in that the number of examiners that conducted examinations fell from 5,291 in 2006 to 3,713 in 2009. As can be seen in Figure 10, total assets of the mutual savings banks continued to experience rapid increase since 2003 following the introduction of the deposit insurance; at the same time, the number of on-site examiners decreased sharply starting in 2007.[12]

<Figure 10> Number of On-site Examiners and Total Assets in the Mutual Savings Bank



Source: Financial Supervisory Service

[12] In the U.S., entering the 1980s the government implemented a program to cut budget spending and reduced the size of the government. As a result, examination budget was reduced as part of spending cuts. However, it was evident that the reduction of examination led to bank failures with 3-year time lag in the U.S., particularly with S&L Debacle in the last 1980s. Since then, the U.S. government reinforced on-site examination for financial institutions

Before the financial crisis of 1997, the Korean financial supervision was highly fragmented in that there were four independent groups that oversaw the commercial banking, insurance, securities, and other financial institutions including savings banks and credit unions. After the crisis, the four supervisory groups were integrated as part of restructuring efforts. Despite consolidating all the groups under the FSS, they effectively remained isolated and operated as silos with little or no interaction with each other. The situation was much worse at the group that oversaw the mutual savings banks industry. The group suffered from lack of qualified staffs which often worked in the same position for many years and did not have opportunities to advance their careers within or outside FSS. Indeed, many of the examiners of savings banks were offered jobs at the very same savings banks they examined after retirement from FSS. The lack of career opportunities for savings banking examiner and their close ties with the savings banks created environment that was ripe for corruption. Indeed, several examiners were found to have taken bribes to look the other way when a bank was found to have problems.

Amid the deficiencies in financial supervision and environment ripe for corruption, it is not surprising to see how the mutual savings bank crisis was largely caused by weak or absent financial supervision. The use of regulatory forbearance instead of taking corrective action to resolve the troubled savings banks allowed the problem to mushroom into a crisis. This can be clearly seen in the inappropriate application of prompt corrective actions (PCAs) which had been introduced for the entire financial sector in the post-financial crisis reforms. The remedies under the system of PCAs consist of three sets of progressively more stringent corrective procedures: management improvement recommendations, management improvement requirements, and management improvement orders. The type of PCA a bank must implement depends on the capital adequacy requirement ratios and the composite grade of CAMELS (Capital, Asset quality, Management, Earnings, Liquidity, Sensitivity of Market

Risk). In the US, PCAs are automatically triggered based on an assessment of the bank but the Korean system allows for the option of deferring any action.

With the option to defer any PCAs, the regulators deferred taking PCAs on some of the troubled savings banks which should have been subject to corrective actions, instead inducing the merger of troubled banks, for fear of triggering a bank run among savings banks. But regulators had initially failed to induce a merger of the troubled savings banks with commercial banks, and resorted to inducing larger savings banks to acquire the troubled banks by allowing them to open branch offices outside of their designated region.[13] In addition, the savings banks that had acquired troubled banks were not subject to regular on-site examinations by FSS for three years.

To illustrate this point, Busan Savings Bank which ultimately was suspended after its survival became questionable had in fact acquired two troubled savings banks in 2008 in exchange for five branches for each bank. As a result, Busan Savings Bank experienced a sharp increase in its deposits and at the same time substantially increased project financing. Indeed, there are several other troubled savings banks that engaged in similar lending practices that should have taken PCAs but instead pursued regulatory forbearance.

[13] To induce merger of the troubled savings banks, the larger savings banks were given permission to open branch offices outside of the region of up to 5. Initially, FSS proposed the idea of allowing savings banks to open one branch for every troubled bank purchased at 200 billion won with maximum five branches. However, the amount per branch was lowered to 12 billion won.

5. Financial Development and Inadequate Financial Supervision

The study of merchant banks in determining the causes of the 1997 financial crisis suggests that the unchecked expansion of NBFIs was elemental in triggering the crisis. It has also proved useful in explaining the causes of the recent credit card and mutual savings bank crisis. In some form of another, the root causes of the troubles of the merchant banks, credit card companies and mutual savings banks that eventually imploded into a financial crisis of varying scale can be traced back to the effects of financial liberalization, haphazard deregulation, rapid expansion and excessive competition in each industry, and finally, a weak or absent financial supervision. In the case of merchant banks, we find that empirical evidence suggests merchant banks were merely used as the financing vehicles by *chaebols* to fund their investments. The close linkage between *chaebols* and their affiliates may have also contributed to partially causing the credit card crisis; in that the rapid expansion of credit card affiliates of *chaebols* was made possible by investors and creditors who relied on the parent's implicit support.

In the wake of financial liberalization and capital market opening, Korea's financial system has become less stable, and more susceptible to external shocks, based on the high frequency of financial crises since the 1997 financial crisis. It is becoming increasingly apparent that the development of the financial supervision system has not nearly kept pace with the development of the financial system, which has put a heavy burden on prudential regulators. The recent credit card and mutual savings crises suggest that the reforms and changes to financial supervision carried out after the 1997 financial crisis were not deep enough or properly implemented, even though new tools of prudential regulation have been instituted.

As the credit card and mutual savings bank crises have shown, once any trouble is detected albeit belatedly prudential regulators delayed action often due to political pressure or conflicts before finally resorting to regulatory forbearance; instead of taking prompt corrective action (PCAs) once a problem was detected to minimize costs and instill market discipline. In the case of the credit card crisis, the government was forced to intervene by rescuing the credit card companies due to the systemic nature of the crisis. This same pattern of inaction on part of supervisors and regulatory forbearance can be seen as the mutual savings crisis has unfolded. To be fair, the financial supervisors did take corrective actions during 2003-05, however, many of the savings banks were relatively very small in scale and resolved by the deposit insurance system, KDIC. It was not until later on, when much bigger savings banks began to show problems and the KDIC ran out of money, effectively, becoming insolvent[14] that financial regulators again resorted to regulatory forbearance. In the Savings and Loans Association (S&Ls) crisis in the US during the 1980s and 1990s, the cost and time of resolving the crisis ended up being much more and taking longer due to regulatory forbearance or mismanagement of the crisis by policy makers who failed to act promptly. It was only after the S&L crisis had dragged on for over 10 years that the government was forced to intervene by resolving the distressed financial institutions with taxpayers' money, and that PCA was instituted in the US to minimize resolution costs.

As Korea's financial development continues and the benefits of financial liberalization and opening are to be realized, then the financial supervisory system must be strengthened to ensure a sound and stable financial system. To this end, the independence and autonomy of the financial supervisory authority must be secured. The inaction of the prudential regulators in the credit card and mutual savings bank crises are in large part due to the lack of

[14] Between 2003 and 2010, KDIC's deposit insurance fund for mutual savings banks suffered deficits every year of 353 billion won on average.

independence of supervisory authority. The fact that most of the management at the FSC are from MOFE and that the position of chairman has become a revolving door and promotional ladder show how the independence of the FSC is undermined. Indeed, nearly every chairman since the establishment of FSC has not served a full term of three years before getting promoted (See Table 6). Moreover, the FSC suffers from high turnover at the director level which results in lack of continuity and experienced regulators with necessary expertise. Indeed, most directors end up serving less than one year at FSC, while the average tenure was even lower for directors in the department of non-bank institutions, serving for only 10 months (See Table 7). Besides the lack of competent supervisors, the short tenure and high turnover of FSC's commissioners and employees does not allow for regulators to take a long-term horizon, further undermining the importance of accountability. In addition, the fact that the PCAs is not automatic, but can be deferred by the statue creates environment where prudential supervisors can engage in regulatory gambling by resorting to regulatory forbearance and passing off responsibility. The pattern in which Korea's mutual savings bank crisis has unfolded so far closely resembles the pattern of the S&L crisis in the US.

To strengthen prudential supervision, the accountability, transparency and independence of supervisors must be strengthened by requiring commissioners to serve the full-term and to lengthen the term of office beyond 3 years. Also, the system of selecting FSC commissioners from MOFE should be re-evaluated. Lastly, PCAs should be made to trigger automatically without the option to delay actions. This could help to further mitigate the abuse of regulatory forbearance and minimize the resolution costs.

<Table 6> Commissioners of FSC: Past Position and Average Term in Office

(As of May 31, 2011)

	Past position held	Number of changes within the position	Average term in office (months)
Chairman	MOFE/MOSF	7	20
	Private sector	1	11
Vice-chairman	MOFE/MOSF	9	12
	Private sector	3	18
Standing Commissioner	MOFE/MOSF	12	13
	Private sector	1	36
Non-standing commission (automatically appointed)	Vice Minister, MOFE/MOSF Deputy Governor, BOK President, KDIC President, FSS	11 4 6 1	12 34 22 36
Non-standing commissioner (recommended)	Private (MOFE) Private (Minister of Justice) Private (Korea Chamber of Commerce & Industry)	4 4 5	30 29 31

Source: FSC

<Table 7> Director-level Officers at FSCs and MOFE/MOSF: Average Term in Office

(2000.01.01～08.02.28)

	Department	Number of Turnover for same position	Average term in office (months)
FSC	Bank	10	9
	Securities	8	11
	Insurance	7	14
	Non-bank institute	**10**	**10**
MOFE/MOSF	Bank	6	15
	Securities	4	24
	Insurance	6	17
	Non-bank Institute	7	14

Source: FSC and MOSF

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