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THE SEQUENCE AND CONSEQUENCES OF BANK RESTRUCTURING IN SOUTH KOREA, 1998–2006

Too Fast to Adjust

Myung-koo Kang

Abstract

This paper explores the sequence, pace, and emerging outcomes of bank restructuring in South Korea since the financial crisis in late 1997, paying special attention to the state intervention pattern in regard to resolving non-performing loans and privatizing temporarily nationalized banks by foreign selling.

Keywords: financial restructuring, bank recapitalization, non-performing loan (NPL), state intervention, Asian financial crisis

Introduction

Since the outbreak of the Asian financial crisis in late 1997, a total of 913 financial institutions (43.4%) out of 2,103 disappeared in South Korea [hereafter Korea]. In the case of banks, 16 out of 33 underwent the resolution process, and 29 out of 30 merchant banks and 138 out of 231 mutual banks were forced to shut down their operations.[1] The Korean government succeeded in rapidly resolving the problem

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1. Public Fund Oversight Committee (PFOC), <http://www.publicfund.go.kr/kor_pf/org/data_funds.html>, accessed July 17, 2007.

Asian Survey, Vol. 49, Issue 2, pp. 243–267, ISSN 0004-4687, electronic ISSN 1533-838X. © 2009 by The Regents of the University of California. All rights reserved. Please direct all requests for permission to photocopy or reproduce article content through the University of California Press's Rights and Permissions website, at http://www.ucpressjournals.com/reprintInfo.asp. DOI: AS.2009.49.2.243.

of non-performing loans (NPLs) in the banking sector.[2] In March 1998, NPLs in Korea amounted to 19.4% of gross domestic product (GDP), and the NPL proportion of total bank loans was 16.8%. Thereafter, however, the government reduced the NPL ratio quickly, and it fell to 3.4% by the end of 2001.[3] Considering the scale of NPLs, this rapid resolution was remarkable.[4] This outcome raises a critical question regarding the role of government in financial restructuring: how did the government resolve Korea's systemwide banking problem so swiftly?

A prevalent view emphasizes the external pressure or conditionality agreements imposed by the International Monetary Fund (IMF) in return for providing $57 billion in emergency funds.[5] The IMF demanded that Korean officials strictly monitor the government's financial restructuring measures by applying structural performance criteria. The three-year IMF program had a total of 21 structural performance criteria—an average of seven per year—and these had to be observed as the time frame specified. However, we can spot variations in the speed of NPL resolution and recovery of bank performance among those crisis-hit Asian countries that adopted similar conditionality agreements with the IMF.[6] Therefore, to understand the variations in the speed of NPL resolution in the banking sectors, we need to focus more on the domestic institutional dynamics that determined the different types of state intervention for bank restructuring. The Korean authorities were able to respond in a more decisive and centralized fashion because the financial sector was organized into a hierarchical policy network with the regulator at the apex.

Despite its speed, we should be cautious in evaluating the success of the Korean financial restructuring. The primary problem is that financial re-

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2. A nonperforming loan is a loan that is in default or close to being in default. Standards of defining loans as nonperforming have varied: Before the financial crisis in 1997, loans in default more than six months were classified as nonperforming loans, but after the crisis, loans in default more than three months are now classified as nonperforming loans.

3. Financial Supervisory Service (FSS), *Monthly Financial Statistics Bulletin*, various issues.

4. For example, Japan's NPL ratio to GDP was less than 6%, and the NPL ratio to total bank loans was 6.3% in March 1998, after the successive banking crises in 1997–98. But it took more than seven years to reduce the NPL ratio below 4% of total loans.

5. See Stanley Fischer, *IMF Essays from a Time of Crisis: The International Financial System, Stabilization, and Development* (Cambridge, Mass.: MIT Press, 2004). For critiques on the contractionary policy prescriptions by the IMF, see Martin Feldstein, "Refocusing the IMF," *Foreign Affairs* 77:3 (March/April 1998), pp. 20–33; and Joseph E. Stiglitz, *Globalization and Its Discontents* (New York: W. W. Norton, 2002), especially ch. 4.

6. See Timothy Lane et al., "IMF-Supported Programs in Indonesia, Korea, and Thailand: A Preliminary Assessment," IMF Occasional Paper 178 (1999); Asia Development Bank (ADB), *Asian Development Outlook, 2004* (New York: Oxford University Press, 2004), pp. 31–38.

sources have not been channeled into more-productive economic sectors than before. Banks and non-banking financial institutions have reduced loans to the corporate sector and increased loans to households. The total amount of loans to households by commercial banks increased more than four times between 1999 and 2006, surpassing the total loans extended to corporate sectors. Moreover, in the commercial banking sector, foreign ownership rose from 12.3% in 1998 to approximately 70% by the end of 2006. These foreign-owned banks have engaged in more retail banking; this competitive pressure, in turn, has forced domestic banks to follow suit. How, then, did these outcomes emerge?

The Korean government has been mostly concerned with the speed of financial restructuring, while neglecting to consider the complementary nature of the relationship between the banking and non-banking sectors, and between the financial and corporate sectors. The government has driven an asymmetric restructuring focusing on banking, and this has resulted in an institutional mismatch among the economic sectors. As a result, and contrary to the conventional view that stresses how foreign banks' entry helps upgrade the domestic banking system,[7] the rapid foreign selling has not substantially contributed to such an upgrade. Meanwhile, the Korean government recklessly sold nationalized banks, initially to foreign equity funds and later to foreign financial institutions. This trend occurred in part because of the legacy of a strong presidency in which the supremacy of the president and the economic bureaucracy dependent on him were not appropriately checked and balanced by the legislature.

In the following sections, this article explores the intervention pattern of the Korean government to recapitalize failed banks and to resolve NPLs in the banking sector. First, I analyze the specific process of injecting public funds for bank recapitalization, discussing the role of the Korea Deposit Insurance Corporation (KDIC). Second, I explore the role of the Korea Asset Management Corporation (KAMCO) in the resolution of NPLs, and how KAMCO helped create a model of foreign selling in the course of bank privatization since late 1999. Finally, the emerging consequences

7. Central Europe displays the largest growth of foreign ownership in the banking sector during the 1990s, from less than 10% to over 50% between 1994 and 1999. Likewise, foreign ownership rapidly increased in Latin American countries during the 1990s. In regard to the economic analysis on the positive impacts of foreign entry in the banking sector, see Asli Demirguc-Kunt, Stijn Claessens, and Harry P. Huizinga, "How Does Foreign Entry Affect Domestic Banking Markets?" *Journal of Banking and Finance* 25:5 (May 2001), pp. 891–911; James R. Barth, Gerard Caprio, Jr., and Ross Levine, "Bank Regulation and Supervision: What Works Best?" NBER Working Paper Series 9323 (November 2002); Heather Montgomery, "The Role of Foreign Banks in Post-Crisis Asia: The Importance of Method of Entry," ADB Institute Research Paper Series 51 (January 2003).

of these financial restructuring efforts are discussed, focusing on the change in financial intermediation.

The Bank Recapitalization Process: Nationalization

An Abrupt Rule Change: "Shock Therapy"

A critical task the Korean government undertook immediately after the financial crisis was to recapitalize failing or failed financial institutions. To recapitalize banks, the government requested that they observe the 8% capital adequacy ratio, the so-called BIS (Bank for International Settlements) ratio.[8] The government requested that all banks submit to diagnostic reviews by internationally recognized accounting firms. Officials then organized an appraisal committee of 12 private experts in April 1998 to distinguish between viable and nonviable banks. Given such an abrupt rule change, many banks failed to meet these requirements and became subject to financial assistance from the government. The government, then, injected a huge amount of public funds to all commercial banks and nationalized them temporarily.

Specifically, by the end of 1997, the BIS ratios of 12 banks were below 8%. Of these, five banks were resolved through purchase and assumption (P&A);[9] the other seven banks merged.[10] Twelve viable banks also merged with other viable banks and two banks were auctioned off to the New Bridge Capital Consortium in December 1998.[11] The two worst cases were Korea First Bank and Seoul Bank. Korea First's capital was in fact negative, while Seoul Bank's capital ratio was less than 1%. Thus, the banking system faced a situation in which the majority of banks were seriously undercapitalized. Consequently, the government injected public funds into all banks to facilitate rapid P&A and improve the banks' capital base.

The government also introduced new standards to reinforce the prudential regulations governing the banking sector and declared that it would adopt the best international practices. These new standards covered a wide range, including loan classification and provisioning, capital adequacy,

8. The BIS ratio originates from the agreement among the governors of the Group of 10 central banks in July 1988 in Basel, Switzerland, where the headquarters of the Bank of International Settlements is located, to apply a common minimum level of capital standards for regulatory supervision of internationally active banks.

9. Daedong Bank, Dongnam Bank, Dongwha Bank, Choongchung Bank, and Kyunggi Bank.

10. Cho Hung Bank, Hanil Bank, Commercial Bank of Korea, Korea Exchange Bank, Peace Bank, Kangwon Bank, and Chungbuk Bank.

11. Korea First Bank and Seoul Bank.

and accounting and disclosure. The loan classification of NPLs became tougher. In the past, NPLs were those loans in arrears for more than six months. This definition was changed to debts delinquent for more than three months, and three different classifications of NPLs were applied: loans collectible through disposal of collateral (substandard); doubtful for collection because of no collateral (doubtful); or estimated to be a complete loss (estimated loss). These classification criteria were strengthened in 1998 and became even more strict in 1999. At the end of the year, new methods of loan classification and provisioning were introduced based on forward-looking criteria that considered the capacity of borrowers to service all obligations, rather than focusing on delinquency criteria.

Because of the change in loan classification standards, total NPLs in Korea increased by about W 45 trillion ($48.7 billion). In addition, because of economic contractions stemming from the crisis and the subsequent tightening of monetary and fiscal policy (in compliance with the IMF program), more than W 93 trillion ($100.7 billion) of NPLs newly accumulated in the banking sector. Under these circumstances, the government injected more public funds to recapitalize insolvent and failing banks.

Injecting Public Funds

Regarding the use of public funds, one of the critical tasks the government faced was the need to assess the funds needed for bank recapitalization. Injecting too much could worsen the moral hazard in the banking sector, while injecting too little might prolong instability in the banking system.

For speedy bank recapitalization, the government expanded the functions of the KDIC. Before 1996, there was no deposit insurance system in Korea because no banks had failed while under government protection. The government established the KDIC on June 1, 1996, to strengthen institutional foundations to prepare for potential bank failures. Initially, the KDIC's functions were limited to providing an effective deposit insurance system exclusively for the banking sector. After the crisis, however, the government expanded the functions of the KDIC; it was empowered to protect depositors in both banking and non-banking institutions as of April 1, 1998.

Based on an initial appraisal in April, the government announced a comprehensive plan for financial restructuring in May. This plan projected an increase in core NPLs of all financial institutions from about W 68 trillion ($73.7 billion) at the end of March to a peak of W 100 trillion ($108.3 billion), almost one-quarter of GDP that year.[12] The initial resources earmarked for financial restructuring were estimated at W 50 trillion ($54.2

12. OECD, *OECD Economic Surveys: Korea, 1998* (Paris: OECD, 1999).

billion, 12% of GDP), to be obtained by bond issues in 1998 and 1999.[13] According to this plan, the government made public funds available by issuing Deposit Insurance Fund bonds ("DIF bonds") through the KDIC.

The Financial Supervisory Commission (FSC)[14] determined whether certain financial institutions were insolvent or not, and then requested the KDIC to inject funds through equity participation, contributions, deposit payoff payments, and other routes. The KDIC then entered into memoranda of understanding (MOU) with the insolvent financial institutions on reorganizing their management structure and injecting funds. The KDIC monitored on a monthly basis through an MOU compliance council.

The KDIC utilized three primary methods for the normalization and resolution of insolvent banks: (1) directly providing financial support via capital injection; (2) helping fund the purchase of insolvent accounts by acquiring entities involved in merger and acquisition (M&A) transactions; and (3) purchasing assets from insolvent institutions to prevent further deterioration. The total amount of public funds disbursed for restructuring stood at W 168 trillion ($181.9 billion) by the end of 2005. Specifically, W 87 trillion ($94.2 billion) was disbursed to the banking sector and W 79 trillion ($85.5 billion) to the non-banking sector. This included W 63.5 trillion ($68.7 billion, 37.8%) as equity participation; W 18.1 trillion ($19.6 billion, 10.8%) for contributions; W 30.3 trillion ($32.8 billion, 18%) for repayments of deposits; W 17.1 trillion ($18.5 billion, 10.2%) for purchasing assets; and W 39.0 trillion ($42.2 billion, 23.2%) for purchasing NPLs. In terms of the source of the provisions, the KDIC provided public funds worth W 110 trillion ($119 billion, 65.5%) for banking recapitalization through DIF bonds by the end of 2005 (see Table 1).

After the injection of public funds, their management and recovery came to be a politically sensitive issue because their ultimate source was public taxes. Politicians of the opposition Grand National Party demanded transparency. In fact, making an issue out of the misuse and relatively low recovery rates was a useful political strategy for opposition parties attacking the government during elections, given the public's strongly negative perceptions about the injection of taxpayer money to rescue essentially private financial institutions.

The government tried to divert criticism by creating a new organization that oversaw the management of public funds. The Public Fund Oversight

13. Ibid., p. 77.

14. The FSC was established in April 1998, and it serves as a consolidated policymaking body for all matters pertaining to supervision of the financial industry as a whole. The primary function of the FSC is deliberating and resolution of important financial issues concerning the advancement of financial industry, the stability of financial markets, and the promotion of a sound credit system and fair trading practices.

TABLE 1 *Provision and Recovery Status of Public Funds, November 1997–May 2007* (in trillion won)

	KDIC and Others												
	Equity Participation[1]		*Contributions*[2]		*Deposit Payoffs*[3]		*Asset Purchase*[4]		*KAMCO NPL Purchase*[5]		*Total*		
Financial Sector	*In*	*Out*	*In*	*Out*	*In*	*Out*	*In*	*Out*	*In*	*Out*	*In (a)*	*Out (b)*	*(b)*[6]*/(a), %*
Banks	34.0	14.0	13.9	1.7	—	—	14.4	11.3	24.6	28.0	86.9	55.0	63
Non-banking sector	29.5	2.6	4.6	1.3	30.3	13.9	2.9	1.2	11.8	10.5	79.0	29.3	37
Foreign institutions	—	—	—	—	—	—	—	—	2.4	2.8	2.4	2.8	117
Total	63.5	16.5	18.5	3.0	30.3	13.9	17.3	12.5	38.7	41.2	168.3	87.1	52

SOURCE: Public Fund Oversight Committee, <http://www.publicfund.go.kr/kor_pf/org/data_funds.html>, accessed July 17, 2007.

[1] Equity participation refers to the public funds utilized to increase equity for cases where rehabilitation of an insolvent financial institution through restructuring is deemed necessary.

[2] Contribution refers to the public funds used to generally supplement a capital deficit when an insolvent financial institution is merged or acquired by a third party.

[3] Deposit payoff refers to the public funds used to repay the depositors of bankrupt financial institutions.

[4] Asset purchase refers to the public funds used to purchase properties such as real estate from insolvent financial institutions.

[5] NPL purchase refers to the case where the public funds were used by the KAMCO to purchase NPLs from financial institutions.

[6] Redemption ratio of public funds.

Special Act was passed at the end of 2000, creating the PFOC. However, this occurred after much of the funding had already been injected. The PFOC's role is to decide whether to sell certain funds-injected financial institutions in consultation with the Ministry of Finance and Economy (MOFE) and the FSC.[15]

We can observe three notable aspects of the process of public funds injection. First, the Korean government applied new rules that had the effect of declaring nearly all banks undercapitalized; officials then virtually nationalized all commercial banks by injecting more public funds. The high proportion of equity participation in public funds injection, amounting to about 10% of GDP, highlights this nationalization process in the course of financial recapitalization.

Second, the total amount of injected public funds was almost 1.7 times larger than planned. Initially, the government had stressed that fiscal support would only be provided to supplement institutions' own restructuring and financing plans. Under the scheme, the government expected that the peak of the fiscal cost for financial restructuring would be less than W 100 trillion ($108.3 billion). The government planned that only W 4 trillion ($4.2 billion) would be necessary for the improvement of the capital bases of banks.[16] However, as can be seen from Table 1, the government injected more than W 63 trillion ($66.2 billion) for equity participation alone. This huge gap between the initial amount planned for financial restructuring and the actual amount of public funds expended underscores the high degree of regulatory forbearance of the Korean government. It also indicates that the government chose a policy option in order to restore stability as soon as possible, at the cost of failing to reduce moral hazard in the financial sector.

Third, the ability to recover public funds has varied according to their use. W 87.1 trillion ($94.3 billion, 52%) was recovered out of the total injected funds (W 168.3 trillion, $182.3 billion). The irretrievable amount was estimated at more than 10% of GDP and is still a very large fiscal cost compared to the cases of other financial crises.[17] Notably, however, the injected public funds for NPL purchases were fully recovered (see Table 1).

15. The staff of the PFOC were mostly recruited from the MOFE, and they thought of the MOFE as their home organization to which they would return at some later time. Therefore, in practice, the MOFE makes decisions regarding the sale of public funds-injected financial institutions. Interview by author with a staff member of PFOC, tape recording, November 20, 2002.

16. OECD, *OECD Economic Surveys: Korea, 1998*, p. 78.

17. In the case of Finland (1991–93), the fiscal cost share of the GDP was 8%; in Norway (1987–89), 3%–4%; in the United States (1984–91), 2%–5%; and in Mexico (1995–97), 14%. For more detail, see OECD, *OECD Economic Outlook 63* (Paris, June 1998), Box 1.7.

This success is closely linked to the performance of KAMCO and the rapid foreign selling in the course of privatizing nationalized banks.

NPL Resolution: The Initiative Role of KAMCO

For speedy NPL resolution, the government expanded KAMCO's functions. KAMCO was established in April 1962 as a subsidiary of the Korea Development Bank to dispose of distressed assets of financial institutions, but in the wake of the financial crisis of 1997, the government mandated KAMCO to acquire and dispose of the NPLs of the financial sector. KAMCO's role was broadened when a bill was passed on April 30, 1999, to allow it to function as a corporate restructuring agent for non-performing assets.[18]

The Korean government forced all banks to sell their nonperforming assets to KAMCO, which made the purchases by issuing non-performing asset bonds ("NPA bonds").[19] KAMCO used W 39 trillion ($42.2 billion, 23.2%) to purchase NPLs from financial institutions between 1998 and May 2007 (see Table 1). In particular, from 1998 to 2000, KAMCO purchased W 95.1 trillion ($103 billion) of NPLs (book value) from financial institutions, about 62% of which came from the banking sector, and resolved about W 45.7 trillion ($49.5 billion) of NPLs using various methods (see Table 2). During those three years, KAMCO resolved more than 45% of the total NPLs in the banking sector.[20] Accordingly, banks' NPL ratios have sharply declined since 2001. Moreover, KAMCO repaid W 40.8 trillion ($44.2 billion) of public funds by the end of 2006. In short, the W 38.7 trillion ($41.9 billion) in public funds used by KAMCO for the purchase of NPL were fully redeemed (see Table 2).

From November 1997 to February 2007, KAMCO acquired $111 billion of NPLs with NPA bonds and resolved $76.6 billion of them.[21] This performance is remarkable because no banks had failed before the crisis, and therefore the distressed-debt markets for failed or failing financial institutions did not exist in Korea. KAMCO had no prior experience or know-how in NPL resolution, so how could it perform so well?

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18. For detail, see KAMCO's *Annual Reports*, <http://www.kdic.or.kr/english/publication/annualreport.jsp>.

19. The funding sources of NPA bonds were composed of contributions from financial institutions, borrowed funds from the Korea Development Bank, and the issuance of KAMCO bonds.

20. KAMCO, *Annual Report, 2002*, p. 17.

21. Changyong Rhee, *Corporate Restructuring Market in Korea: Past, Present, and Future*, paper presented at the international forum on the Non-Performing Asset Fund, April 3, 2007, Seoul, Korea.

TABLE 2 *Performance of KAMCO in NPL Resolution, 1998–2006* (in trillion won)

	1998	*1999*	*2000*	*2001*	*2002*	*2003*	*2004*	*2005*	*2006*
Total NPLs in all financial institutions	102.7	82.1	56.4	32.1	28.1	32.2	24.7	21.7	17.8
Banking sector									
Total NPLs	86.0	61.0	42.1	18.8	15.1	18.7	13.9	9.7	7.8
NPL ratio, %	16.8	12.9	8.0	3.4	2.3	2.6	1.9	1.2	0.8
Non-banking sector									
Total NPLs	—	21.1	14.3	13.3	13	13.5	10.8	12	10
NPL ratio, %	—	23.2	10.6	12.2	7.7	9.0	7.5	7.3	5.3
Purchase of NPL by KAMCO (accumulated)	44	62.2	95.1	101.2	110.8	110.8	110.8	110.8	110.8
Accumulated NPL resolution by KAMCO	5	20.8	45.7	56.7	64.6	68.6	69.7	71.7	76.6
KAMCO's repayment of public funds	2.4	9.7	8.9	5.3	3.8	2.4	1.4	2.1	4.8

SOURCES: FSS, *Monthly Financial Statistics Bulletin* (June 2007), p. 22, and other issues; KAMCO, *Annual Report*, various issues.
NOTE: All figures are book values except the NPL ratio.

Purchasing Process: Pricing of Nonperforming Assets

When KAMCO undertook the function of purchasing NPLs from financial institutions in November 1997, it lacked the organizational strength to carry out the complex tasks involved. For instance, there was no systematic computerized information database on the current situation of the transferred NPLs from financial institutions, as of 1997.[22] To make matters worse, neither FSC nor MOFE officials had any specific experience or expertise in NPL resolution.

In June 1998, the FSC ordered KAMCO to finish transferring the nonperforming assets from the five license-revoked banks within 20 days. However, those banks had 180 branches, and their NPLs were not systematically classified. Workers at the five banks strongly resisted license cancellation; they even blocked KAMCO staff from entering their branches. Under the circumstances, it was impossible to finish the transfer of NPLs

22. Jae-Ryong Chung and Eun-Joo Hong, *Busil Chaekwon Jungli* [Resolution of nonperforming loans] (Seoul: Samsung Economic Research Institute, 2003).

in 20 days; the transfers ended up taking more than six months.[23] The former CEO of KAMCO described the process as a "war" between KAMCO and those banks required to transfer their NPLs to KAMCO.[24]

In the transfer process, the most sensitive issue between KAMCO and the financial institutions was determining the "proper" price of nonperforming assets: KAMCO tried to minimize the cost to public funds, while financial institutions wanted to maximize their asset prices. Purchase prices varied according to the type of loan. In the beginning, for loans with collateral, KAMCO's purchase price was generally equal to 75% of book value, while loans without collateral were purchased at very deep discounts. However, to expedite the speed of purchase, KAMCO paid relatively high prices, on average about 39% of book value.[25]

It was controversial whether the elevated prices were proper or represented an immoral benefit to the financial institutions. High prices meant that more public funds had to be used to purchase the nonperforming assets. This could weaken the principle of self-responsibility of financial institutions. KAMCO's purchase prices were very high compared to those offered by the Resolution and Collection Corporation of Japan (RCC), which averaged less than 13% of book value.[26] In short, the Korean government chose speed of NPL resolution over minimizing the moral hazard for financial institutions.

Liquidation Methods of NPLs

Once nonperforming assets were transferred to KAMCO, its next crucial task was to rapidly resolve NPLs while maximizing the resolution value. KAMCO employed diverse disposal methods, which can be roughly divided into three types: (1) resolving assets in bulk sales; (2) resolving assets individually; and (3) establishing joint ventures.

First, bulk sales typically included the issuance of asset backed securities (ABS)[27] and international bidding. KAMCO used these two methods to pool assets or to form an asset portfolio. The process of issuing ABS was conducted as follows: KAMCO transferred assets to a Special Purpose

23. Ibid., pp. 99–102.
24. Ibid., pp. 91–98.
25. KAMCO, *Annual Report, 2005*, p. 12.
26. Considering the fact that KAMCO recovered more value with those purchased assets, it seems fair to say that KAMCO's rapid purchasing strategy was rational, even at high prices.
27. Asset-backed securities is a method of liquidating assets by issuing securities based on the future cash flow of underlying assets, and securitization is the process by which loans or other credit exposures are pooled and reconstituted into securities, with one or more classes or positions that may be sold.

Company (SPC); the SPC evaluated the assets and after credit enhancement, issued the ABS. The advantage of this method was that it was convenient to secure liquidity by pooling similar NPLs. In particular, when employing the international bidding method, KAMCO tried to pool NPLs purchased from financial institutions to form the best possible asset portfolio.[28] By February 2007, KAMCO had disposed of about 15.6% of NPLs, $6.5 billion out of a total recovered value of $41.6 billion, through issuing ABS and international bidding.[29]

Second, in contrast to bulk sales, individual sales focus on discovering the market value of each individual asset. Bulk sale aims for early resolution of NPLs and quick cash flows, but individual sales are used to maximize recovery by selling loans at the fairest price possible after accurate valuations of assets. KAMCO usually used this method for corporate restructuring. In particular, large loans or loans largely influenced by creditors were resolved through the individual loan sales method.[30] KAMCO recovered about 11.5% of purchased NPLs through individual loan sales and public auctions; the amount reached about $4.8 billion.

Third, KAMCO set up various joint venture firms with qualified foreign investment companies. For instance, it established asset management companies (AMCs), corporate restructuring companies (CRCs),[31] and corporate restructuring vehicles (CRVs)[32] to resolve NPLs. When KAMCO tried to sell NPLs beginning in late 1998, no domestic demand existed because of the devastating impact of the crisis. The only demand was from American distressed-debt investors.[33] However, KAMCO did not have specific experience or expertise in international bidding. Its former CEO Jae-Ryong Chung described the situation: "We were trying to resolve NPLs, nobody had the right answers; we felt like we were shooting our guns in a thick fog during combat, not knowing our enemy from our troops."[34] Under the circumstances, KAMCO tried to utilize specialized know-how and expertise

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28. Chung and Hong, *Busil Chaekwon Jungli*, pp. 219–56.

29. Rhee, *Corporate Restructuring Market in Korea*, p. 18.

30. KAMCO, *Annual Report, 2002,* pp. 18–19.

31. CRCs play a role like vulture funds, and KAMCO established three CRCs: KAMCO SG Investor Inc., KAMCO-LB Investor, and KAMCO-MS Investor. In 1999, only 16 CRCs existed, and KAMCO's CRCs made up more than 90% of the total investments of CRCs. However, the number of CRCs rapidly increased; 90 existed in 2001, and 103 in 2002. For details, see Chung and Hong, *Busil Chaekwon Jungli*, pp. 280–84.

32. A CRV is a paper company that collects NPLs held by creditor banks and workout companies, and normalizes the operations of companies subject to reorganization by entrusting the management of assets to a professional asset management company. The first joint venture CRV was established in July 2001.

33. Chung and Hong, *Busil Chaekwon Jungli*, p. 83.

34. Ibid., p. 128.

in asset management from foreign investment companies by establishing joint venture partnerships.[35] By the end of 2002, just over $1.3 billion and 6.9% of NPLs were resolved through these partnerships.

Such joint ventures were helpful in taking advantage of foreign expertise and capital. Moreover, joint ventures with foreign investment companies were useful in blocking political intervention in purchase and sale of bad assets by politically well-connected companies. For example, KAMCO established a joint venture with 50/50 ownership with foreign investment banks, but the ultimate decision on management was left to the foreign institutions. Therefore, KAMCO staff could block domestic pressure over NPL resolution.[36]

Through these various disposal methods, KAMCO resolved the purchased NPLs very quickly. In every case, the goal was to dispose of the asset as quickly as possible in order to avoid further deterioration in value and to minimize the carrying cost of the bad assets, known as "snowball effects." Accordingly, the NPL ratio in the banking sector declined rapidly. In 2001, it fell below 4%. More importantly, however, KAMCO's foreign sale methods provided a model for the privatization of Korean banks beginning in 2000.

Emerging Outcomes

Bank-centered Financial System

The role of banks in financial intermediation grew as the Korean government set bank recapitalization as a top policy priority to restore financial stability swiftly by injecting public funds. As Figure 1 shows, the size of bank assets[37] quickly increased, while the asset size of other financial institutions[38] sharply decreased. The relative ownership of assets between the non-banking and the banking sector has reversed since 1999. Meanwhile, stock market capitalization[39] and private bond market capitalization[40] gradually progressed (see Figure 1). In other words, capital markets have not

35. For more detail on NPL resolution methods adopted by KAMCO, see KAMCO's *Annual Reports*, <http://kamco.or.kr/eng.html>; He Dong "The Role of KAMCO in Resolving Nonperforming Loans in the Republic of Korea," IMF Working Paper, Wp04/172 (Washington, D.C., 2004); Chung and Hong, *Busil Chaekwon Jungli*, especially pp. 106–15.

36. Chung & Hong, *Busil Chaekwon Jungli*, p. 276.

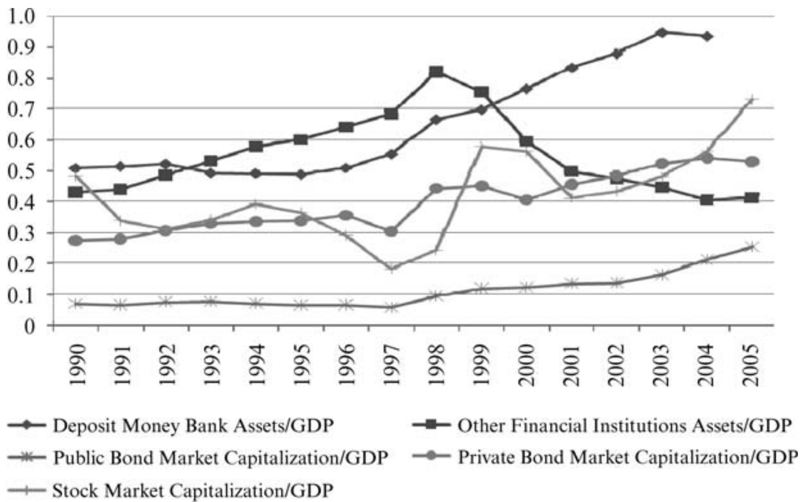
37. Claims on the domestic real nonfinancial sector by monetary deposit banks as a share of GDP.

38. Claims on the domestic real nonfinancial sector by other financial institutions as a share of GDP.

39. Value of shares listed to the GDP.

40. Private domestic debt securities issued by financial institutions and corporations as a share of GDP.

FIGURE 1 *Trends in Financial Market Size, 1990–2005*



SOURCE: World Bank (2007), *Financial Structure Database*, <http://siteresources.worldbank.org/INTRES/Resources/FinStructure_60_05_final>, accessed July 17, 2007.

developed as quickly as banks' roles in financial intermediation. Over the past decade, the bank-centered financial system in Korea was strengthened. This consequence contradicts the conventional wisdom that more market-oriented financial reforms will lead to a decreasing role for banks. Much literature on financial liberalization has compared the bank-centered system to the market-based system, focusing on their relative merits and demerits. Proponents of the bank-based view emphasize the positive role of banks in providing external financing to existing firms and to new firms that require staged financing; they also emphasize the ways in which banks can mitigate information and transaction costs. In contrast, proponents of the market-based view emphasize the disadvantages of bank-based financial systems in promoting innovation and "creative destruction" in markets, particularly in funneling external financing to new firms. However, considering the emerging outcomes in Korea, this simple dichotomy and the implicit assumption that a bank-centered system will converge into a more market-based system are both misleading. In Korea, the role of banks in financial intermediation has greatly increased, contradicting a conventional view that a more market-oriented financial system will decrease the importance of banks in financial intermediation. This outcome

results from an asymmetric government intervention in the course of financial restructuring in which the Korean government put a policy priority on restoring the banking sector first. To date, Korean government efforts to consolidate a more market-oriented financial system has rather increased the role of banks in overall financial intermediation.

This consequence contradicts the conventional wisdom that more market-oriented financial reforms will lead to a decreasing role for banks. Much literature on financial liberalization has compared the bank-centered system to the market-based system, focusing on their relative merits and demerits.[41] Proponents of the bank-based view emphasize the positive role of banks in providing external financing to existing firms and to new firms that require staged financing; they also emphasize the ways in which banks can mitigate information and transaction costs.[42] In contrast, proponents of the market-based view emphasize the disadvantages of bank-based financial systems in promoting innovation and "creative destruction"[43] in markets, particularly in funneling external financing to new firms.[44] However, considering the emerging outcomes in Korea, this simple dichotomy and the implicit assumption that a bank-centered system will converge into a more market-based system are both misleading. In Korea, the role of banks in financial intermediation has greatly increased as a result of government efforts to consolidate a more market-oriented financial system.

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41. See Franklin Allen and Douglas Gale, *Comparing Financial Systems* (Cambridge, Mass.: MIT Press, 2000). For a cross-country empirical comparison, see Asl Demirgèuðc-Kunt and Ross Levine, *Bank-based and Market-based Financial Systems: Cross-country Comparisons* (Washington, D.C.: World Bank Development Research Group Finance, 1999).

42. See Masahiko Aoki and Hugh T. Patrick, *The Japanese Main Bank System: Its Relevance for Developing and Transforming Economies* (New York: Oxford University Press, 1994); Takeo Hoshi, Anil Kashyap, and David Scharfstein, "Corporate Structure, Liquidity, and Investment: Evidence from Japanese Industrial Groups," *Quarterly Journal of Economics* 106:1 (1991), pp. 33–60; Joseph E. Stiglitz, "Credit Markets and the Control of Capital," *Journal of Money, Credit, and Banking* 17:2 (1985), pp. 133–52.

43. Joseph A. Schumpeter's term. Schumpeter used the term to describe the dynamic nature of the industrial mutation process in capitalism in which new consumers, new goods, new markets, and new forms of industrial organization "incessantly revolutionize the economic structure *from within*, incessantly destroying the old one, incessantly creating a new one." Joseph A. Schumpeter, *Capitalism, Socialism, and Democracy*, 3rd ed. (New York: Harper Perennial, 1962), p. 83.

44. See Ekkehard Wegner and Christoph Kaserer, "The German System of Corporate Governance: A Model which Should Not Be Imitated," in Stanley W. Black and Mathias Moersch, eds., *Competition and Convergence in Financial Markets: The German and Anglo-American Models* (New York: Elsevier Science & Techno, 1998); David E. Weinstein and Yishay Yafeh, "On the Costs of a Bank-Centered Financial System: Evidence from the Changing Main Bank Relations in Japan," *Journal of Finance* 53:2 (1998), pp. 635–72.

Sharp Increase of Household Loans

Meanwhile, the profitability and capital adequacy ratios of banks have greatly improved since 2001 (see Table 3). Nonetheless, we should be cautious in evaluating this ostensible success. For instance, the average spread margin (loan interest rate minus deposit interest rate) increased from 0.42% in 1996 to 2.23% in 2004 and then decreased a bit to 1.63 by the end of 2006.[45] Moreover, according to data from the FSS,[46] between 2001 and 2004, 18 banks created 233 new commission fees while increasing fees on 755 items. About 25% of profits were acquired via these non-interest-related commission fees.[47] This indicates that the increasing profitability of banks does not necessarily correspond with an improvement in overall credit rating or risk-management skills in the banking sector.

A more important point, however, is that traditional bank-firm relationships have drastically changed under pressure for rapid restructuring; banks have reduced loans toward the corporate sector and rapidly increased loans to households. The total amount of loans to households by commercial banks increased more than four times between 1999 and 2006, from W 63.3 trillion ($68.5 billion) to W 248.0 trillion ($268.6 billion). Since 2001, the share of household loans in commercial banks has exceeded the total loans extended to corporate sectors (see Table 3). According to a survey by the Bank of Korea on the usage of household loans, more than 50% were used for purchasing houses in 2002, and the 88% of total borrowers who already owned homes borrowed more money from banks using their houses as collateral.[48]

This trend clearly shows that more funds were channeled into the noncorporate sector. Small- and medium-sized firms, which rely more on bank loans than do chaebols, have suffered when attempting to secure funds from financial institutions. This pattern of capital flow becomes more serious when we examine the sources of funds for facilities investment in the manufacturing sector. In 1996, before the crisis, manufacturers raised more than 75% of funds for facilities investment through external financing such as bank borrowings and stocks, but this ratio has declined sharply since 1999. In 2004, only 15.6% of funds for facilities investment was mobilized

45. The Bank of Korea home page of statistics, <http://ecos.bok.or.kr/EIndex.jsp>, accessed July 18, 2007.

46. The FSS was established as an executive arm of the FSC in January 1999. The primary function of the FSS is examination and supervision of financial institutions, but it can extend to other oversight and enforcement functions as charged by the FSC.

47. The FSS home page is <http://www.fss.or.kr>.

48. The Bank of Korea, *Sample Survey on Household Loans* (in Korean), April 2002, <http://www.bok.or.kr>.

TABLE 3 *Loans by Type and Profitability in the Commercial Banking Sector, 1999–2006* (in trillion won)

	1999	*2000*	*2001*	*2002*	*2003*	*2004*	*2005*	*2006*
Total loans	184.3	231.9	270.6	357.4	405.0	421.8	446.8	508.6
Household loans (%)	63.3 (34.3)	90.3 (39.0)	133.0 (49.1)	189.2 (52.9)	214.8 (53.0)	232.2 (55.0)	251.7 (56.3)	284.0 (55.8)
Corporate loans (%)	114.0 (61.9)	131.0 (56.5)	132.2 (48.9)	162.8 (45.5)	184.8 (45.6)	183.4 (43.5)	188.2 (42.1)	216.0 (42.5)
Operation funds	101.8	116.8	117.9	142.5	161.3	156.0	163.4	183.0
Facilities funds	12.2	14.2	14.4	20.3	23.5	23.7	24.8	32.9
Special funds	3.4	3.4	0	0	0	0	0	0
Others	7.0	10.6	5.4	5.4	5.5	5.9	7.0	8.6
ROE (Return of equity) (%)	–23.13	–11.9	15.88	11.67	2.16	17.96	20.33	15.64
ROA (Return of asset) (%)	–1.31	–0.57	0.76	0.59	0.1	0.89	1.23	1.05
BIS ratio (%)	11.75	10.58	11.67	11.33	11.16	12.06	13	12.75

SOURCE: FSS, *Financial Statistics Information System*, <http://fisis.fss.or.kr/>, accessed July 15, 2007.

through external funding, while more than 84% was raised through internal funding sources. Funding through stocks accounted for only 0.2% of facilities investment.[49]

One of the critical reasons for this sharp decline in external funding was the drastic change in bank loan portfolios from corporate to individual or household lending. This emerging trend highlights the fact that rapid financial restructuring in Korea has not produced more-efficient capital allocation for industrial sectors. This trend has been reinforced by increasing foreign ownership in the banking sector.

Rampant Increase in Foreign Ownership

Foreign ownership in the commercial banking sector has increased at a remarkable speed. Before the crisis, foreign banks advanced into the domestic Korean market mainly by establishing regional offices or branches. However, this pattern changed drastically after the crisis, particularly since late 1999 when the government started to sell nationalized banks to foreign buyers. Foreign banks were initially hesitant to buy because they were concerned about the soundness of Korean banks and were waiting for more favorable prices relative to the latter's financial assets. Under the circumstances, without screening foreign capital, the government simply tried to sell nationalized banks to foreign buyers.[50]

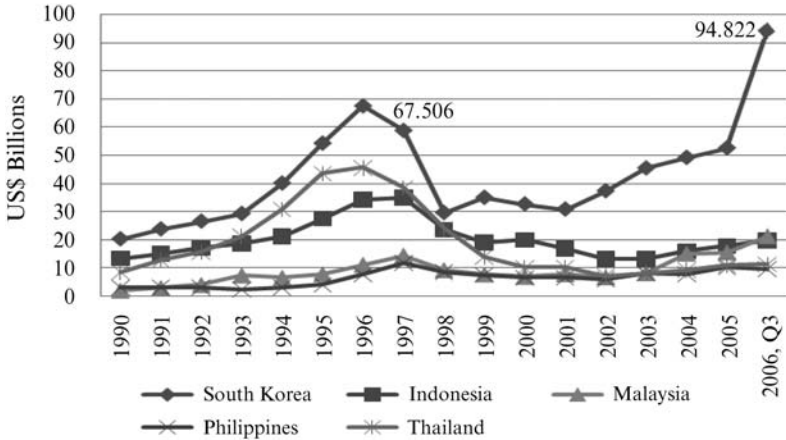
The first foreign buyers were investment funds, more interested in reselling purchased Korean banks to other buyers. As a case in point, Newbridge Capital took over Korea First Bank in January 2000, and other foreign investment funds purchased other banks. After that, foreign banks increased their bid to purchase domestic commercial banks from the government and investment funds. As a result of the full liberalization of foreign ownership[51] and the consequent M&A-related deregulation, it became easier for foreign financial institutions to buy domestic banks rather than establish their own branches and regional offices first. The combined foreign ownership share in the commercial bank sector rose from 12.3% in

49. See Bank of Korea statistics homepage (<http://ecos.bok.or.kr/EIndex.jsp>), accessed July 18, 2007.

50. It remains controversial in Korea whether it was a wise choice to sell those nationalized banks to foreign vulture funds. In fact, many initial buyers of Korean banks who purchased them at discounted prices sold them to other foreign financial institutions within three years, after management was normalized.

51. The ceiling on shareholding by foreign investors was fully liberalized in May 1998, only after several months of the crisis. In May 1997, the ceiling was 6% for individual foreign investors, and total foreign investment could not exceed 23%.

FIGURE 2 *Loans from Foreign Controlled and Foreign Located Banks, 1990–2006*



SOURCE: Joint BIS-IMF-OECD-World Bank statistics on external debt, <http://www.jedh.org>, accessed July 15, 2007.

1998 to more than 70% in 2006.[52] Except for the Woori financial holding group in which the KDIC's ownership share was 78% as of the end of 2005, the ownership of major commercial banks was largely transferred to foreign financial institutions.

This trend is particular to Korea, in contrast with the other countries hit by the crisis in 1997. As Figure 2 shows, loans borrowed from foreign controlled and foreign located banks sharply increased and decreased before and after the crisis. These loans to all four relevant other Asian countries continuously declined and then started to recover in 2004. In the Korean case, however, after a short contraction, those loans have continuously increased and have exceeded the pre-crisis level since 2006. On the one hand, this indicates that foreign banks assess positively the structural reforms initiated in the financial and corporate sectors, and that the Korean economy is becoming more globally engaged. On the other hand, this trend reflects the increasing foreign ownership in the domestic banking

52. As of December 2006, the share of foreign investors in major commercial banks are as follows: Kookmin bank (82.7%), Shinhan financial holding company (58.9%), Hana financing holdings (80.2%), Woori financial holdings (9.5%), Korea Foreign Exchange (76.9%), Korea Citi (Hanmi) bank (99.9%), SC Jeil bank (100%).

sector and the reality that the Korean style of rapid foreign selling is not a general pattern, even among crisis-hit Asian countries.

This increasing foreign ownership had significant impact on the pattern of financial intermediation. Before the crisis, foreign financial institutions could not help focusing on wholesale banking because it was difficult to establish networks wide enough to compete with domestic banks. In retail banking, however, the opening up of the industry has made it easier for foreign purchasers to take over domestic financial institutions with extensive networks. Such domestic firms often have competitive advantage in retail banking, coupled with experience, including the know-how to properly assess individual customer credit.

As banks taken over by foreign financial institutions have engaged more in retail banking than domestic banks have, this competitive pressure has forced domestic banks to engage more and more in retail banking. This, in turn, has accelerated loans to households (versus those to the corporate sector). Consequently, all banks have been increasingly engaged in less risky and more profitable retail banking. Indeed, those banks taken over by foreign banks have engaged in retail banking even more than domestic banks have.[53] According to the Bank of Korea, the total amount of loans to the corporate sector by foreign banks decreased by 33.3% between 1998 and 2003. Of course, the corporate lending rates of mixed and domestic banks have also declined, but those rates are 10.4% and 24.8%, respectively, less than that of foreign banks (see Table 4). This rapid increase in foreign ownership raises a puzzling question: Why did the Korean government sell nationalized banks so hastily to foreign buyers?

Reasons for Rapid Foreign Selling

Economic and political factors contributed to this rapid sale. First of all, the ceiling on foreign ownership was lifted quickly, immediately after the crisis. Within a month from November to December 1997, the ceiling on foreign ownership increased from 7% to 50% for individual investors, and it was fully lifted in May 1998, only six months after the crisis, without introducing any restrictions on foreign ownership. This measure contributed to the rapid increase of foreign ownership, not only in the banking sector but also in the corporate sector, drawing much speculative foreign investment. Given the fact that domestic asset prices were highly devalued because of the depreciated Korean currency—at that time the exchange rate

53. Bank of Korea, *Foreign Participation in Domestic Banking Industry and Policy Implications* (in Korean) (2004), <http://www.bok.or.kr/content/old/attach/00000109/200312220942370.hwp>.

TABLE 4 *Lending Patterns of Banks (Domestic and Foreign), 1998–2003* (%)

	(A) 1998	*1999*	*2000*	*2001*	*2002*	*(B) 2003*	*(B) – (A)*
Corporate loans							
Foreign	82.9	73.4	63.5	54.8	50.1	49.6	–33.3
Mixed	47.6	47.0	42.8	38.1	37.4	37.2	–10.4
Domestic	80.6	75.0	69.9	58.2	54.2	55.8	–24.8
Household loans							
Foreign	10.4	17.9	26.1	38.6	44.0	45.6	35.2
Mixed	48.8	46.2	48.1	56.2	59.9	59.4	10.6
Domestic	14.3	19.3	23.6	35.7	42.1	40.7	26.4

SOURCE: Bank of Korea, *Press Report*, no. 2003–12–24, p. 12.

was almost doubled—such a rapid lifting of the ceiling opened the door to foreign vulture funds to buy Korean assets on the cheap.

Second, the Korean bureaucracy wanted to escape from political responsibility in regard to the use of large amounts of public funds. The government was under continuing political pressure to redeem public funds rapidly, because that burden ultimately is borne by the taxpayer. In fact, the fiscal burden resulting from interest payments for the injected public funds quickly piled up.

Third, there was no viable option in selling to the domestic market. Because of underdeveloped capital markets, there were no competitive, private equity funds or other types of large, domestic investment funds to purchase distressed banks. One option that the government had was to sell banks to domestic buyers, but there were no economically viable domestic business actors except for chaebols, which were prohibited from acquiring banks. Moreover, it was too politically risky to sell to domestic business actors because this would be perceived as unfairly transferring nationalized assets to the private sector.

Despite these economic factors, it is nonetheless puzzling why the Korean government opted for so rapid a sale to foreign markets. There was strong resistance from opposition parties as well as the public. Many accused the government of diverting national wealth in a cheap sale to foreign buyers. This large foreign presence ensured a definitive end to the role of banks in the pre-crisis era as key instruments for implementing government policies. Furthermore, the ruling party was not the majority party in the National Assembly. How, then, could the Korean government promote so rapid a sale to foreign buyers?

We should note, in this regard, the peculiar characteristics of the policy-making structure in Korea, especially in terms of policy agenda-setting. In particular, we should note the legacy of the strong presidency institutionalized during the period of developmental dictatorship (1961–92) in which the power of the president—as well as his ideological orientation on market reform—could not be appropriately checked and balanced by the National Assembly.

First, the Korean president could dominate the legislative process in the National Assembly. He was not only executive leader of the government but also chaired the ruling party. As such, the president wielded almost absolute power over the nomination of district representatives, and personal loyalty to him was crucial to being nominated. This institutional framework reinforced a boss-centered, highly personalized, and centralized party structure and enabled the president to dominate the legislative process.

Second, under the strong presidency the government enjoyed supremacy over political parties in national agenda-setting. For example, the majority of parliamentary statues originated with the bureaucracy and not the lawmakers, and such tendencies only accelerated over time. Even after democratization during the late 1980s, this practice has not changed in its content, form, and frequency. Moreover, nominally, through the ruling party-government consultation meetings, the ruling party could control or check the government in advance before a certain bill was proposed by the government. Yet in reality, the consultation had already been carried out between top-ranked bureaucrats and ex-high-ranked bureaucrats who resigned their official positions only to be temporarily assigned to the ruling party. After a certain length of service, the ex-high-ranked bureaucrats were re-employed by the government in higher positions such as vice minister. Under the circumstances, major economic decisions drafted by the government—and the pre-fixed decisions within the government—were automatically approved by the National Assembly.

Third, Korean parties did not have institutional capacity or expertise over the government in agenda-setting for major economic policies. The high turnover rate of National Assembly members reveals this weakness. In the National Assembly, politicians usually change their membership on standing committees in turns every two years. Especially with the Standing Committee for Finance and Economy, widely regarded by politicians as a prize committee, members are normally reshuffled every two years. It is also a rule to replace the supporting secretariats of each committee yearly in order to treat fairly the National Assembly staff. Therefore, National Assembly members often lack expertise on special issues such as

financial policy and are weak in checking or controlling the dominance of the economic bureaucracy in setting policy agendas.

Under this institutional setting of national-agenda setting, the president's ideological orientation had a huge impact on policymaking and implementation. President Kim Dae-jung (1998–2002) pointed to the declining sovereign credit rating as a major indication that Korea needed to attract more foreign inward investment. He justified rapid foreign sales as a necessary step to improve the competitiveness of the financial sector. Kim equated democracy with a more liberalized economy, and with this in mind, he drove the economic bureaucracy to sell nationalized banks to foreign investors.[54] Under his strong presidency, neither bureaucrats nor political parties could effectively check and balance the president's will to liberalize the financial sector by attracting more foreign capital.[55]

Meanwhile, the government could easily justify rapid foreign selling, attributing the blame to the IMF's structural adjustment program. The government was able to attribute political responsibility for economic turmoil after the crisis to the former government, or to the opposition Grand National Party, which was the ruling party when the financial crisis hit.

Concluding Remarks

Liberal economists claim that the withdrawal of the state from markets will *ultimately* increase market efficiency. However, in reality, the *pattern* of retreat matters more. The financial restructuring process and its emerging consequences in Korea highlight the importance of the pattern of state intervention. Simply emphasizing the degree of deregulation or highlighting a retreat from bureaucratic control is a misleading mode of analysis and policy prescription.

The Korean government took a "shock therapy" approach in restructuring the financial sector after the outbreak of the financial crisis. This process can be summarized as centralization, nationalization, and rapid privatization. First, the government centralized the process of NPL resolution and financial restructuring. The FSC came to have de jure as well as de facto authority for restructuring. Second, while recapitalizing banks, the government abruptly introduced various new standards to determine viable and non-viable banks, and then nationalized all commercial banks by injecting public funds through the KDIC. The government subsequently forced all banks to transfer their NPLs to KAMCO. For speedy transfer,

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54. He expressed that the crisis could be a "disguised blessing" for the Korean economy. See the speech delivered by President Kim at the International Conference on Democracy, Market Economy, and Development, February 26, 1999, Seoul, Korea.

55. This requires further future research.

KAMCO purchased NPLs at relatively high prices. Third, the process of NPL resolution was centralized by KAMCO, which adopted liquidation-oriented disposal methods for the sake of speedy resolution. In particular, KAMCO's foreign-sale methods have provided a model for Korean banks in the process of privatization beginning in 2000.

Despite this rapid restructuring, however, financial resources have not been channeled into more-productive economic sectors. Contrary to the conventional wisdom that more market-oriented financial reforms will lead to a decreasing role for banks, in the Korean case, the bank-centered financial structure was strengthened. Banks have reduced their loans to the corporate sector while rapidly increasing household loans. The total amount of loans to households provided by commercial banks increased more than four times between 1998 and 2006; it now exceeds the total amount of loans to corporate sectors. The majority of those household loans were used for purchasing houses, and those who already own homes borrowed more money from banks by using their houses as collateral. This outcome convincingly indicates that rapid financial restructuring has inequitably shifted costs to economically and politically underrepresented social groups, in particular, non-homeowners and small firms.

Moreover, foreign ownership in the commercial banking sector has sharply increased, and these foreign-owned banks have engaged in more retail banking than domestic banks because they hold a competitive advantage in this area. This pressure has forced domestic banks to increase their retail banking activity, highlighting the fact that increasing foreign ownership matters not only in terms of size but of the business patterns of foreign banks. It has yet to be seen whether increasing foreign ownership will upgrade the competitiveness and efficiency of the financial sector or will instead prove to provide "long-run pain" rather than "short-run pain but long-run gain." One thing remains clear for now: increasing foreign ownership has not necessarily contributed to the efficient financial intermediation of domestic financial resources, and this pattern cannot be easily reversed. Nonetheless, it may trigger a nationalistic reaction against increasing foreign ownership in the banking sector as well as in other financial and corporate sectors. As an alternative solution to defend the domestic financial sector, the Korean government may allow chaebols to own banks.

This process of financial restructuring demonstrates the vulnerability of the Korean financial policy network to external pressures. The strong presidency has produced an institutional framework in which the domineering power of the president and a president-dependent bureaucracy has gone unchecked by political parties or any other social group in regard to agenda-setting in financial reforms. Under the circumstances, both the

president and the Korean economic bureaucracy have utilized the crisis to reactivate failed reform agendas. They have diverted political responsibility for financial disruptions and social dislocation resulting from rapid financial restructuring and foreign sales, attributing the blame to external pressures. The swift financial restructuring after the crisis in Korea does not indicate the integrity or the strength of the Korean economic bureaucracy but rather the hierarchical and personalized governance pattern, which is potentially vulnerable when exposed to external pressures.

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