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Financial Sector Program (Loan 1601-KOR) and Institutional Strengthening of the Financial Sector Project (Loan 1602-KOR) to the Republic of Korea

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Performance Evaluation Report

PPE: KOR 31651

Financial Sector Program (Loan 1601-KOR) and Institutional Strengthening of the Financial Sector Project (Loan 1602-KOR) to the Republic of Korea

December 2005

Operations Evaluation Department
Asian Development Bank

CURRENCY EQUIVALENTS

Currency Unit – won (W)

		At Board Approval (19 December 1997)	At Program Completion (7 December 1999)	At Operations Evaluation (17 June 2005)
W1.00	=	$0.0006169	$0.0008636	$0.0009852
$1.00	=	W1,621	W1,158	W1,015

ABBREVIATIONS

ABS	–	asset-backed securities
ADB	–	Asian Development Bank
BIS	–	Bank for International Settlements
BOK	–	Bank of Korea
CAR	–	capital adequacy ratio
CB	–	commercial bank
DMC	–	developing member country
EA	–	executing agency
EMK	–	Extended Mission to Korea
FCRP	–	Financial Corporate Restructuring Project
FSC	–	Financial Supervisory Commission
FSPL	–	Financial Sector Program Loan
FSS	–	Financial Supervisory Service
GDP	–	gross domestic product
IA	–	implementing agency
IMF	–	International Monetary Fund
ITC	–	investment trust company
ITMC	–	investment trust management company
KAMCO	–	Korea Asset Management Corporation
KB	–	Kookmin Bank
KDB	–	Korea Development Bank
KDIC	–	Korea Deposit Insurance Corporation
KHCB	–	Korea Housing and Commercial Bank
KOSDAQ	–	over-the-counter market
KSE	–	Korea Stock Exchange
LIBOR	–	London interbank offered rate
M&A	–	merger and acquisition
MFI	–	multilateral financial institution
MOFE	–	Ministry of Finance and Economy
MOU	–	memorandum of understanding
MS&FC	–	mutual savings and finance company
NBFI	–	nonbank financial institution
NPF	–	National Pension Fund
NPL	–	nonperforming loan
OCR	–	ordinary capital resources
OEM	–	Operations Evaluation Mission
P&A	–	purchase and assumption
PCA	–	prompt corrective action
PCR	–	program completion report

PPER	–	program performance evaluation report
ROA	–	return on assets
RRP	–	report and recommendation of the President
SGI	–	Seoul Guarantee Insurance
SME	–	small- and medium-sized enterprise
TA	–	technical assistance
TOR	–	terms of reference
WB	–	World Bank
WrB	–	Woori Bank

NOTES

(i) In this report, "$" refers to US dollars.
(ii) The fiscal year (FY) of the Government ends on 31 December. "FY" before a calendar year denotes the year in which the fiscal year ends.

Director General	B. Murray, Operations Evaluation Department (OED)
Director	R.K. Leonard, Operations Evaluation Division 1, OED
Team Leader	H. Hettige, Principal Evaluation Specialist, Operations Evaluation Division 2, OED
Team Members	R. Lumain, Senior Evaluation Officer, Operations Evaluation Division 2, OED
	C. Roldan, Senior Operations Evaluation Assistant, Operations Evaluation Division 2, OED

Operations Evaluation Department, PE-672

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In accordance with the guidelines formally adopted by the Operations Evaluation Department (OED) on avoiding conflict of interest in its independent evaluations, the Director of Operations Evaluation Division 2 was recused because he served as a member of the Fact-Finding Mission, and the Director of Operations Evaluation Division 1 assumed responsibility for oversight of this report. C. Bender and S. Park were the consultants. T. Yoon (Advisor) joined the Mission. To the knowledge of the management of OED, there were no conflicts of interest of the persons preparing, reviewing, or approving this report.

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BASIC DATA
Loan 1601-KOR: Financial Sector Program
Loan 1602-KOR: Institutional Strengthening of the Financial Sector Project[1]

KEY PROGRAM/PROJECT DATA ($ million)	As per ADB Loan Documents		Actual	
	Loan 1601	Loan 1602	Loan 1601	Loan 1602
Total Program/Project Cost	4,000	22.7	3,700	13.6
ADB Loan Amount/Utilization	4,000	15.0	3,700	7.9
ADB Loan Amount/Cancellation	0	0.0	300	7.1

KEY DATES	Loan 1601		Loan 1602	
	Expected	Actual	Expected	Actual
Fact-Finding		29 Nov–9 Dec 1997		29 Nov–9 Dec 1997
Loan Negotiations		10–11 Dec 1997		10–11 Dec 1997
Board Approval		19 Dec 1997		19 Dec 1997
Loan Agreement		23 Dec 1997		23 Dec 1997
Loan Effectiveness	23 Dec 1997	23 Dec 1997	23 Dec 1997	23 Dec 1997
First Disbursement		24 Dec 1997		29 Jun 1999
First Tranche Release	Dec 1997	24 Dec 1997		
Second Tranche Release	Jan 1998	5 Jan 1998		
Third Tranche Release	Dec 1998	31 Dec 1998		
Fourth Tranche Release	Dec 1999	cancelled[2]		
Program/Project Completion	30 Jun 2000	7 Dec 1999	Dec 1999	May 2002
Loan Closing	30 Jun 2000	7 Dec 1999	31 Dec 2000	31 Oct 2002
Months (effectiveness to completion)	30	23	24	53

TRANCHE RELEASES	Loan 1601				
	Amount ($ million)	Number of Policy Conditions			
		Met[3]	Partly Met	Not Met	Waived
First	2,000	42	0	0	0
Second	1,000	11	0	0	0
Third	700	30	0	0	0
Fourth	300	10	0	1	0

BORROWER Republic of Korea
EXECUTING AGENCY Ministry of Finance and Economy

MISSION DATA[4]	Loan 1601		Loan 1602	
Type of Mission	No. of Missions	No. of Person-Days	No. of Missions	No. of Person-Days
Reconnaissance/Fact-Finding	1	121	1	121
Inception			1	34
Special Project Administration	2	27	4	29
Special Consultation			1	15
Review	3	118	2	10
Program/Project Completion Review	1	13	1	18
Operations Evaluation[5]	1	25		

ADB = Asian Development Bank.
1 Related technical assistance loan.
2 Final tranche of $300 million was cancelled in December 1999 at the request of the Borrower.
3 Fully or substantially complied with.
4 Some of the missions for Loan 1602-KOR were carried out in conjunction with missions for Loan 1601-KOR.
5 The Operations Evaluation Mission simultaneously evaluated Loans 1601-KOR and 1602-KOR.

EXECUTIVE SUMMARY

Since 1960, the Republic of Korea (henceforth Korea) achieved outstanding export-led growth fueled by high domestic savings and facilitated by sound fiscal and monetary policies. By 1996, its economy was the world's 11th largest, and it had been admitted as a member of the Organisation for Economic Co-operation and Development. With the liberalization and opening of its financial markets to foreign investors in the period leading up to the Asian financial crisis of 1997, many Korean industrial conglomerates had grown rapidly on borrowed capital and were highly leveraged. Interlocking relationships between the corporate and financial sectors, and the accommodative role of Government meant that financial institutions were not compelled to operate within prudent market-driven norms and some accumulated limited experience with pricing and managing commercial credit risk.

In mid-1997, the currencies, stock markets, and other asset prices of several Southeast and East Asian economies including Indonesia, Korea, Malaysia, and Thailand depreciated rapidly, causing a sense of panic among investors and concern among the multilateral financial institutions (MFIs). International investors lost confidence in securities in Southeast and East Asia and began to pull money out, creating a snowball effect. In Thailand, the baht dropped swiftly to half its value, from 25 to the dollar in July 1997 to 56 to the dollar in January 1998. The Indonesian rupiah, Malaysian ringgit, and Philippine peso also depreciated, gathering momentum in the second half of 1997. The financial crisis also affected asset markets—stock markets and real estate markets. The cumulative impact of these events affected the health of banks and nonbank financial institutions, and the speed and severity of the crisis took investors by surprise, driving the MFIs, led by the International Monetary Fund (IMF), to mount a rescue effort to stop the spread of contagion effects.

The Asian financial crises engulfed Korea in 1997, resulting in many economic management challenges for the Government. Early in the year, several smaller conglomerates declared bankruptcy, but they were not bailed out by the Government, as had been the practice. Subsequently, confidence in the resilience of Korea's financial sector eroded rapidly, leading foreign creditors to refuse to roll over short-term loans made directly and indirectly to the conglomerates. With the financial sector facing sudden demands for the repayment of foreign exchange-denominated claims from creditors, the Government intervened to prevent the implosion of the sector.

In November 1997, the Government approached IMF for emergency assistance to prevent the depletion of its currency reserves and economic collapse. By early December 1997, usable foreign exchange reserves were at a crises level, falling to a low of $6 billion (equivalent of 2 weeks of imports to Korea). Following difficult negotiations, IMF extended $21 billion under a 3-year standby arrangement. The World Bank (WB) and the Asian Development Bank (ADB) pledged $10 billion and $4 billion, respectively, to support this effort. Although there was no formal coordination among the MFIs, through the Government's efforts different MFIs took on different responsibilities. IMF addressed macroeconomic stabilization, monetary and exchange rate policy, financial sector restructuring, trade liberalization, capital account liberalization, corporate governance, and labor market reforms. WB addressed macroeconomic stabilization, banking sector restructuring, corporate governance, measures to promote competition and transparency, reforms to promote labor market flexibility, and social safety net concerns. ADB covered the restructuring of the entire financial sector. Since ADB had, at that time, no special program loan modality for crisis lending, it provided a Financial Sector Program Loan (FSPL) linked to the need for structural adjustments to enable Korea's financial sector to become market oriented.

Loan 1601-KOR: Financial Sector Program was unique in that (i) it was ADB's largest loan ever; (ii) it was processed in record time, given the urgency of the crisis, circumventing a number of ADB policies and procedures as disclosed in the report and recommendation of the President; and (iii) its design was not framed by a country strategy, because Korea had not borrowed from ADB for 9 years. The program framework originated from a Korean Presidential Commission that recommended introducing market forces to the financial sector. The FSPL broadened the Government's framework and deepened reforms in several areas, particularly with regard to the nonbank sector, thus making a clear contribution to the reform agenda. The FSPL was supported by Loan 1602-KOR: Institutional Strengthening of the Financial Sector Project, a technical assistance (TA) loan for $15 million. Both loans were provided from ordinary capital resources without a premium charge despite the fact that both IMF and WB had levied such a charge.

ADB concentrated on correcting weaknesses in the financial sector. The reforms were intended to (i) increase reliance on market forces and improve oversight (by facilitating the dissolution of nonviable institutions and by strengthening prudential norms and the regulatory framework), and (ii) improve the efficiency of markets (by loosening restrictions on the foreign ownership of securities and by strengthening corporate accounting and disclosure standards). Through its associated TA Loan, the FSPL was designed to support (i) capacity development for key players involved in the recovery, including a newly established market regulator and the institution responsible for the disposal of nonperforming loans acquired from restructured institutions; (ii) the upgrading of credit information and rating systems; and (iii) a review of impediments to the development of mortgage-backed securities.

The design of the FSPL had several positive features that enabled it to achieve many of its envisaged impacts. It was processed in a timely manner and had a very high level of government ownership of the reforms. It used the window of opportunity to address fundamental structural weaknesses in the financial sector. The coverage of the reforms and the sequencing were appropriate. With the benefit of hindsight, however, several weaknesses in the design were also apparent. Although the FSPL was compatible with the programs of IMF and WB, a unified policy matrix was not developed. Points of overlap emerged with regard to the TAs of ADB and WB, resulting in delayed implementation and change of scope. The Government ownership of the TA was not initially apparent, and the TA had to be restructured to avoid duplication. This is understandable, given the acute time pressures under which the Government, ADB, and other aid agencies were working. As ADB did not have a continuing program, the momentum of medium- and long-term reforms undertaken and sustained was not tracked.

Following the FSPL and the IMF-led international rescue effort, macroeconomic and financial sector indicators—in particular gross reserves and the exchange rate—improved rapidly in early 1998. Korea's financial sector is now healthier and less vulnerable to external shocks. Currency reserves are substantial. Reforms facilitated the elimination of nonviable institutions, opened the sector to competition, and improved the regulatory framework and market oversight. Subsequent but smaller crises involving credit card companies and investment trusts (areas not addressed by the FSPL) proved serious but ultimately not destabilizing. They do suggest, however, that some financial institutions may still lack prudence and may view growth as more important than profitability. The Government still plays a substantial role in the sector through (i) loan guarantee programs that lower the bar for small and medium-sized enterprises to obtain credit, (ii) at times, encouraging banks to rescue companies in distress, and (iii) its indirect control of the deposit insurance company and the National Pension Fund. The conglomerates themselves are more prudent, most are profitable, and many hold substantial liquid assets and are more cautious in their investments. However, the conglomerates are still subject to some pervasive regulations.

The FSPL is rated highly successful, bordering on successful. The Government demonstrated a strong commitment to the Program—it designed many of the key reforms; enacted some reforms before they were required for tranche release; and, in some cases, went beyond what was required. The FSPL reforms were appropriate and targeted toward addressing weaknesses in the financial sector that, at the time, were (correctly) thought to underlie the crisis. All but one of the FSPL conditions were met. The direction of subsequent policy initiatives has been broadly consistent with those supported by the FSPL. The Government's continued involvement in the financial and corporate sectors, however, has slowed the pace of market development and raise mild concern about the Government's commitment to allowing the financial sector to eventually function mostly on the basis of market forces. The FSPL's contribution to institutional development was substantial, although the TA loan did require restructuring.

Loan 1602-KOR, the TA loan, is rated successful. The original TA design was relevant, but there was lack of government ownership at the time of approval. At the time of loan processing, it was recognized that expert support would be needed, so funding was provided. However, there was insufficient time to develop detailed terms of reference. This weakness in design was rectified during implementation. The subsequent change in scope was relevant, and the revised TA had much better ownership by the institutions involved. The TA was efficacious, and the objectives of its revised design were achieved, but its implementation was delayed. The TA outcomes strengthened the efficiency and sustainability of the institutions that utilized the TA loan funds and enhanced their staff capacity. The training programs were successful, trainees have been absorbed into the institutions, and the knowledge acquired has been used and passed on in in-house training programs.

The following lessons emerge from the FSPL:

(i) Speed, client ownership, and the ability to leverage windows of opportunity to introduce politically contentious reforms are essential when responding to crisis situations.

(ii) Financial sector reforms are often crucially dependent on reforms in the real sector economy, such as in the corporate sector during the crisis in Korea.

(iii) In the face of financial market instability, temporary credit support may be needed to prevent viable enterprises from failing. However, such programs must eventually be eliminated, once the markets have stabilized, to prevent moral hazard.

(iv) The urgent nature of crisis lending may not address all weaknesses in a country's financial sector. Once a crisis has passed, attention must be given to further institutional strengthening to prevent future market failures.

(v) The complexity of large crisis situations is best addressed through effective coordination among MFIs to ensure that programs are consistent and comprehensive and do not overlap. Responsibilities should be allocated on the basis of core competencies.

(vi) Crisis lending to address financial sector instability should not ignore the human cost associated with displaced workers, particularly those from vulnerable groups. The adequacy of social safety nets must be considered when responding to large-scale external economic shocks.

Bruce Murray
Director General
Operations Evaluation Department

I. BACKGROUND

A. Rationale

1. Prior to the Asian financial crisis in late 1997, the Republic of Korea (hereafter Korea) embodied the Asian economic miracle. Gross domestic product (GDP) tripled every decade from 1962 onward, exports tripled from $41 million in 1961 to over $125 billion by 1995, and per capita income increased from less than $100 in 1961 to over $10,000 in 1996. High domestic savings rates, sound fiscal policies, and an export-oriented development strategy contributed to this success (Appendix 1). Because of this exceptional economic performance, Korea had not borrowed from the Asian Development Bank (ADB) in 9 years[1] and, in 1996, was admitted as a member of the Organisation for Economic Co-operation and Development.

2. The Asian crisis started in mid-1997 and affected currencies, stock markets, and other asset prices of several Southeast and East Asian economies including Indonesia, Korea, Malaysia, and Thailand. International investors lost confidence in securities in Southeast and East Asia and began to pull money out, creating a snowball effect. In Thailand, the baht dropped very swiftly to half its value, from 25 to the dollar in July 1997 to 56 to the dollar in January 1998. The Indonesian rupiah, Malaysian ringgit, and Philippine peso also depreciated, gathering momentum in the second half of 1997. The financial crisis also affected asset markets—stock markets and real estate markets. The cumulative impact of these events affected the health of the banks and nonbank financial institutions (NBFIs), creating a sense of panic in the region. The speed and the severity of the crisis took investors, financial institutions, and governments by surprise. The Asian financial crises was widely discussed in the media, corporate boardrooms, and international financial institutions, and resulted in calls for reform of the international financial architecture. There was a sense of panic and a strong consensus that action had to be taken rapidly to contain the Asian contagion.

3. With the liberalization and opening of Korea's financial markets to foreign investors in the period leading up to the crisis, many Korean industrial conglomerates (*chaebols*) had grown rapidly using capital obtained through the domestic financial sector. As a result, their gearing ratios were unsustainably high at up to 400%. Interlocking relationships between the corporate and financial sectors, and the accommodative role of Government meant that financial institutions were not compelled to operate within prudent market-driven norms and some accumulated limited experience with pricing and managing commercial credit risk.[2] In such circumstances, the Government stood ready to assist financial institutions that encountered difficulties.

4. In early 1997, several smaller chaebols declared bankruptcy, the cumulative result of several factors including reckless investments, labor market rigidities, increased competition from lower cost producers, and a cyclical downturn in export prices. These chaebols were not bailed out by government-led banks, as had been the previous practice.[3] Subsequently, as the foreign exchange crisis engulfed the rest of the region, confidence in the resilience of the Korean financial sector eroded rapidly, leading foreign creditors to refuse to roll over short-term loans made directly and indirectly to the chaebols. With the financial sector suddenly facing simultaneous demands for the repayment of hard currency-denominated claims from foreign

[1] ADB did not adopt a formal graduation policy until November 1998.

[2] The Banks' limited experience in managing commercial credit risks also stem from historically low rate of default that existed during the period of rapid economic growth, belated interest rate liberalization, and banks' excessive dependence on collateral due to the continuous rise in land prices at the time.

[3] These chaebols had unrevealed nonperforming loans in the banking sector, and the rescue operation would have been too big for the Government to finance by itself.

creditors—total external debt servicing in November and December 1997 alone was roughly $25 billion—the Government intervened to prevent the implosion of the financial sector.[4]

5. In November 1997, the Government approached the International Monetary Fund (IMF) to formulate a package of assistance to prevent the depletion of its hard currency reserves and avoid economic collapse. Usable foreign exchange reserves ultimately fell to a low of $6 billion (equivalent to 2 weeks imports to Korea) in early December 1997, roughly a third of their value at the end of October 1997 and down substantially from $28.4 billion in 1996. Following difficult negotiations, IMF agreed to extend $21 billion under a 3-year standby arrangement. In support of the crisis response effort, the World Bank (WB)[5] and ADB agreed to provide support of up to $10 billion and $4 billion, respectively.[6]

B. Formulation

6. The multilateral financial institutions' (MFI) rescue package providing emergency loans involved making policy reforms in various subsectors. Many of the reforms in the financial sector had been recommended by experts in Korea. Although there was no formal coordination, due to the efforts of the Government a division of labor emerged between the MFIs in terms of supporting various subsectors (Table 1). IMF addressed macroeconomic stabilization, monetary and exchange rate policy, financial sector restructuring, trade liberalization, capital account liberalization, corporate governance, and labor market reforms. WB addressed macroeconomic stabilization, banking sector restructuring, corporate governance, measures to promote competition and transparency, reforms to promote labor market flexibility, and social safety net concerns.[7] ADB covered the entire financial sector;[8] it was the only MFI addressing the nonbank financial sector and the capital market reforms in 1997. Appendix 2 shows the policy areas supported by the MFIs.

Table 1: Policy Areas Supported by Participating Multilateral Financial Institutions in 1997

Policy Conditions/Measures	IMF	WB	ADB
Capital Account Liberalization	√	—	—
Exchange Rate and Reserve Management Policy	√	—	—
Macroeconomic Framework	√	√	—
Monetary Policy	√	—	—
Banking Systems	√	√	√
Capital Markets and Funds	√	—	√
Nonbank Financial Institutions	—	—	√
Competition Policy	—	√	—
Corporate Governance and Restructuring	√	√	—
Trade Policy	√	—	—
Labor Market and Social Safety Net	√	—	—

√ = included in the initial policy matrix, — = excluded from the initial policy matrix.
ADB = Asian Development Bank, IMF = International Monetary Fund, WB = World Bank.
Source: Operations Evaluation Mission.

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[4] The Government's intervention was in line with the policy framework negotiated with the International Monetary Fund.
[5] Between December 1997 and December 1998, WB provided $7 billion in adjustment loans and $48 million in a technical assistance loan.
[6] These agreements were to be supplemented by a second line of defense equal to $23.4 billion in bilateral credits, which were never used.
[7] Some areas of reform were supported by revisions to the WB policy matrix in March 1998 and the subsequent loans given by WB and IMF.
[8] ADB conditionality included increasing foreign ownership in the entire financial sector.

7. Given the urgent need to restore confidence in Korea's financial sector and to help prevent its collapse, Loan 1601-KOR: Financial Sector Program was processed in record time. Approval of the loan by ADB's Board of Directors took place 9 days after the end of ADB's fact-finding mission. The fact that Korea had not borrowed from ADB for almost a decade forced the design of the Financial Sector Program Loan (FSPL) to deviate from normal processing practices because it was an emergency loan and there was no country operational strategy. Moreover, the haste with which the Program was processed compressed the normal design cycle and precluded a number of steps such as the management review meeting, appraisal mission, and staff review committee.[9]

8. The framework for the Program's design originated from the Government, specifically from the second report of the Presidential Commission for Financial Reform presented on 3 June 1997. This work provided a blueprint for reform based on the introduction of market forces to the financial sector. This framework was further defined as part of broader negotiations between the Government and IMF over the emergency standby arrangement that was approved by IMF's Board of Executive Directors a week before the negotiation of the FSPL. The FSPL broadened the scope of the Government's framework and deepened reforms in several areas, particularly with regard to NBFIs.

9. During the formulation of the FSPL, several questions were raised within ADB[10] on whether (i) the contribution of ADB to the recovery effort would be recognized by the wider public (para. 75), (ii) there was sufficient coordination and cooperation among the MFIs (para. 31), (iii) a larger spread than 40 basis points would have been more appropriate for the FSPL (para. 68), (iv) the release of the second tranche with only certification given by Korea (instead of verification by ADB) was appropriate (para. 34), and (v) implementation arrangements for the technical assistance (TA) were adequate (para.45).

10. Loan 1601-KOR for $4 billion from ordinary capital resources (OCR), the largest loan in ADB's history, was approved by the Board on 19 December 1997. A related TA loan, Loan 1602-KOR: Institutional Strengthening of the Financial Sector Project, for $15 million, from OCR was also approved to strengthen regulatory and other financial sector institutions. The ADB loans were provided at its standard OCR rate given to all borrowers. ADB elected not to charge a premium on the emergency loan (para. 68).[11]

C. Objectives and Outputs

11. The FSPL and its associated TA Loan supported a broad range of policy reforms across most segments of the financial sector, including commercial banks, merchant banks, insurance companies, the National Pension Fund (NPF), corporate pension schemes,[12] and others involved in the securities markets; and key institutions supporting the sector, including the Ministry of Finance and Economy (MOFE), Bank of Korea (BOK), Financial Supervisory Commission (FSC), Korea Asset Management Corporation (KAMCO), Korea Development Bank (KDB), Korea Deposit Insurance Corporation (KDIC), and Korea Stock Exchange (KSE).

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[9] These exemptions were described in the report and recommendation of the President and were approved by the Board.

[10] These questions are answered in the project performance evaluation report in the paragraphs indicated.

[11] Both IMF and WB charged premiums on their loans to Korea.

[12] Corporate pension schemes in Korea at the time of the crisis were legally distinct from those found in most of the other developed countries. Assets were not held in trust for pension plan participants in a fund distinct from the plan sponsor but were legally the property of the sponsor. As a result, pension assets were not protected from seizure and distribution in bankruptcy. This had a substantial adverse impact on persons who had accrued pension rights from bankrupt chaebols. Subsequent to the crisis, corporate savings schemes that made lump sum payments to employees at retirement were introduced. By end 2005, Korea will introduce corporate pension schemes following international best practice.

1. Loan 1601-KOR

12. The purpose of the FSPL was to support the Government in transforming the financial system by making it competitive and placing it on a sound basis by correcting policy and structural weaknesses. The policy reforms associated with the tranche releases of the FSPL were geared to increasing reliance on market forces and strengthening oversight of the financial sector in three primary areas:[13] (i) commercial banks (31 conditions), (ii) NBFIs (26 conditions), and (iii) financial markets (32 conditions). The FSPL also addressed corporate accounting and disclosure standards (5 conditions), but the associated conditions were modest in scope. The policy matrix for the FSPL is contained in Appendix 3.

13. Key reforms supported under the FSPL included the following:

(i) **Commercial Banks.** The FSPL facilitated the closure or merger of nonviable banks and strengthened prudential norms and the regulatory framework.

(ii) **Nonbank Financial Institutions.** The FSPL facilitated the closure or merger of nonviable merchant banks (which acted similarly to commercial banks but focused almost entirely on lending to the chaebols), securities companies, and life insurance companies. It also tightened supervisory, prudential, and accounting norms.

(iii) **Financial Markets.** The FSPL loosened restrictions on the foreign ownership of corporate bonds and the shares of companies listed on the KSE and the over-the-counter market to improve efficiency and price formation.

2. Loan 1602-KOR

14. The TA Loan had three primary objectives.[14] First, it was intended to strengthen several key players involved in the crisis recovery, including (i) FSC, a newly established unified market regulator, by supporting the establishment of a basic institutional framework, policies regarding the entry and exit of financial institutions, operational regulations and procedures, and supervisory measures and practices; and (ii) KAMCO, the public sector institution tasked with disposing of nonperforming loans (NPLs) acquired from restructured financial institutions by supporting the development of a financial plan and operational strategy. Second, the TA was intended to upgrade credit information and credit rating systems. Third, it was to support a review of institutional and other impediments to the development of a market for mortgage-backed securities. The TA was expected to cost $22.7 million, with ADB providing $15 million through the TA Loan. Although the scope of the TA was adequately described in the report and recommendation of the President (RRP), detailed terms of reference were not provided, given the time constraint and the lack of government ownership (para. 32).

D. Financing Arrangements and External Agency Coordination

15. The interest rate for Loan 1601-KOR (para. 10) was the London interbank offered rate (LIBOR) plus ADB's standard (0.4%) per annum spread for public sector loans, including a per annum commitment charge of 0.75%. Four tranches for $2 billion, $1 billion, $700 million, and $300 million were to be released in December 1997 (upon loan effectiveness); January 1998; December 1998; and December 1999, respectively.[15] Bullet repayments were arranged such that each of the four tranches of the loan would be repaid in full 7 years after disbursement. Funds disbursed under the first and second tranches of the loan were onlent to KDB by the Government and were used to support KDB's foreign exchange obligations to BOK and to provide credit guarantees for small- and medium-sized enterprises (SMEs). An ADB review

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[13] Forty-two of the total 94 conditions were fully met by the Government before loan approval and the release of the first tranche.

[14] These objectives changed once the TA was restructured roughly a year following loan approval (para. 45).

[15] The fourth tranche was subsequently canceled at the request of the Borrower.

mission advised the Government that the third and fourth tranches should be included in the consolidated government budget in accordance with ADB's standard procedures. The TA Loan (1602-KOR) for $15 million from OCR was provided on standard terms for a TA loan (normal OCR financial terms; a grace period of 3 years; and amortization period of 15 years). It was designed to strengthen regulatory and other financial sector institutions to promote an efficient and healthy financial sector. The Executing Agency (EA) for both loans was MOFE. To ensure adequate support during program implementation, ADB established an Extended Mission to Korea (EMK) from September 1998 to January 2000. The FSPL was not counted toward the annual ADB-wide 15% limit for program lending.

E. Completion and Self-Evaluation

16. Loans 1601-KOR and 1602-KOR closed on different dates and were the subject of separate program and project completion reports (PCRs).

1. Loan 1601-KOR

17. The PCR for Loan 1601-KOR, dated 11 October 2001, rates the FSPL as highly successful. It assesses the FSPL to be highly relevant because it (i) demonstrated ADB's direct and timely response to the emerging financial crisis, and (ii) addressed structural weaknesses in the financial sector that magnified the impact of the crisis. The PCR states that the FSPL was implemented effectively and efficiently with strong government ownership for restoring financial stability. The first three tranches were released according to schedule. Compliance with the conditions of the FSPL was deemed satisfactory, and details are provided in the PCR. All of the conditions for the release of the second and third tranches are described as being either fully or substantially complied with. The first three tranches were used by the Government for general budgetary support, indirectly in support of financial sector restructuring to meet the conditions of the FSPL and those of the loans provided by IMF and WB. The PCR indicates that the Government elected not to draw the fourth and final tranche.

18. The PCR draws a few key lessons from the FSPL. It argues that crisis assistance should focus on restoring stability in the near term and that structural adjustment should be provided in the medium-term agenda to sustain economic stability. Longer term reforms should be addressed through advisory support, designed and implemented once a crisis has been contained and the markets stabilized (PCR para. 55). It also concludes that crisis assistance that provides only monetary support—without addressing underlying structural causes—might not succeed in restoring investor confidence and market stability. It acknowledges that policy dialogue and advice are an essential component of crisis assistance (PCR para. 58). The PCR's lessons imply that structural adjustments were a necessary part of the crisis assistance and the sequence of reforms was important (para. 28). The PCR further argues that the financial sector restructuring undertaken with the support of the FSPL would not be sustainable without also placing Korea's corporate sector on a healthier footing. In terms of broader issues, the PCR argues that ADB should conduct financial market surveillance in its developing member countries (DMCs), regardless of whether they are regular borrowers.[16] It indicates the need to develop a special program loan modality to respond to crisis situations in the future, something ADB has now done. The PCR does not discuss the impact of the FSPL on ADB operations in other countries.

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[16] Subsequent to the crisis, steps were taken by ADB to improve surveillance of nonborrowing member countries including, inter alia, (i) the semi-annual publication of the Asia Economic Monitor published by ADB's Office of Regional Economic Integration (OREI); (ii) the collection and publication of reports and data covering market indicators (currencies, stock indices, commodity prices, interest rates, credit spreads), macroeconomic indices, measures of financial and corporate soundness, and poverty and social indicators on the Asian Regional Information Center website (cofinanced by ADB and the Australian Agency for International Development); and (iii) the development by OREI of early warning software to detect economic and financial sector vulnerability (software which is currently being fielded). Available: <http://www.aric.adb.org>.

2. Loan 1602-KOR

19. The PCR for Loan 1602-KOR, dated 15 September 2003, rates the TA Loan as successful. The PCR notes that the design of the TA had to be substantially changed roughly a year after loan approval to maintain the relevance of the TA given (i) overlap between the original scope of the TA Loan and assistance subsequently provided by WB under its Financial and Corporate Restructuring Project, approved on 6 August 1998; and (ii) the refusal of the Korea Housing and Commercial Bank to participate in the TA once the bank had been privatized. This delayed implementation and, according to the PCR, reduced the efficiency of the TA. The PCR states that the implementing agencies (IAs) ultimately used the TA's inputs effectively, however, and that the TA helped to strengthen the capacity of those financial institutions supported by it.

20. The PCR drew four lessons from the TA Loan: (i) the success of the TA was, to a great extent, dependent on the Government's success in enacting structural reforms in the real sectors of the economy and on improvements in the broader economy; (ii) better policy dialogue and coordination with other MFIs would have helped prevent duplication in assistance programs; (iii) the Government found the costs for training and consultancy to be too expensive and, as a result, prepaid the TA Loan as soon as its balance of payments position improved; and (iv) ADB's lack of familiarity with Korea's financial sector made it difficult for ADB to design a TA without duplicating the efforts of others. The PCR recommended that ADB continue to field periodic consultation missions to monitor Korea's recovery and the status of reform efforts.

F. Operations Evaluation

21. This program performance evaluation report (PPER) covers both Loans 1601-KOR and 1602-KOR. Its primary purpose is to identify the strengths and weaknesses of the FSPL and its associated TA Loan and to extract lessons for future ADB operations in its other DMCs. The FSPL is assessed based on (i) the need for the Program and the effectiveness of its design (relevance), (ii) the achievement of its purpose and the production of its outputs (efficacy), (iii) the timeliness and the manner by which it was processed (efficiency), (iv) the durability of its outcomes (sustainability), and (v) its contribution to institutional strengthening and other developmental impacts. It was prepared on the basis of an Operations Evaluation Mission (OEM) fielded to Korea during 7–17 June 2005. Prior to visiting Korea, the OEM reviewed relevant documents and met with available ADB staff involved with the loans. To facilitate discussions, as well as collect and accurately interpret information from a large number of stakeholders, the OEM included the Director's Advisor for Korea. The OEM was led by an experienced evaluator with expertise in evaluating banking sector reforms, and included an international consultant with experience in the evaluation of capital market-related loans and a domestic consultant with direct knowledge of the Korean financial sector. A draft of this PPER was circulated to the relevant departments in ADB and to the Government and other stakeholders, and their comments were considered before it was finalized.

II. PLANNING AND IMPLEMENTATION PERFORMANCE

A. Formulation and Design

22. Much has been written about the appropriateness of the macroeconomic stabilization efforts mandated by IMF's standby arrangement,[17] including the merits of imposing tight fiscal policy and traditional prescriptions for interest rate and exchange rate management during a liquidity crises. ADB's involvement under the FSPL focused entirely on correcting structural weaknesses in the financial sector, which, at the time, were (correctly) thought to underlie the crisis. As such, ADB played no direct role in the approach taken by the Government to macroeconomic stabilization. The reforms supported under the FSPL could have been (and should have been) pursued regardless of the steps taken to respond to the crisis.[18]

23. **ADB's Incremental Contribution.** While the broad framework for the Program's design originated from the Government (to some extent negotiated as part of discussions between the Government and IMF over the emergency standby arrangement), ADB was the first of the three MFIs involved in the crisis response to develop a detailed policy matrix with the Government in support of its program. In negotiating the terms of the policy matrix with the Government, ADB played a constructive role in the formulation of the FSPL. In this way, ADB made an incremental contribution to restructuring the financial sector in the aftermath of the crisis. The specific differences in the FSPL resulting from ADB's involvement included

(i) broadening the scope of the framework to include components of the financial markets not initially addressed by the Government, including the insurance industry, the NPF, certain aspects of the equity and bond markets, and capacity building among domestic credit rating agencies;

(ii) deepening reforms in several areas, particularly with regard to promoting measures to strengthen prudential norms in financial sector oversight and regulation beyond what had been proposed under the Government's previous framework;[19] and

(iii) targeting reforms to address specific structural weaknesses in the financial sector that had not been explicitly identified in the initial framework agreements of either IMF or WB, particularly with regard to the nonbank financial sector.

24. The design of the FSPL and the TA Loan had several positive features that enabled it to rapidly achieve many of its envisaged impacts. With the benefit of hindsight, however, several weaknesses in the design were apparent to the OEM. Comments on the design and lessons learned that might be useful for future operations are discussed below.

25. **Timeliness of the Response.** ADB acted rapidly formulating, processing, and approving the FSPL in 3 weeks and circumventing some of its internal processing steps and disbursement

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[17] Critics of IMF's program argue that Korea's success in macroeconomic stabilization and structural reform came at a severe cost to its economy. They argue that IMF's traditional prescriptions (floating the currency, raising interest rates, tightening monetary and fiscal policies) were inappropriate, given that (i) the currency was only slightly overvalued (1.7%), (ii) the current account deficit was modest (3.8% of GDP), (iii) fiscal deficits did not exist, (iv) the inflation rate was moderate (8.7%), and (v) the stock of domestic savings was high. Supporters of IMF's program, on the other hand, argue that fiscal policies did not cause output to collapse (shrinking corporate balance sheets were to blame). They argue that the recession in early 1998 was driven by a contraction in credit flows following the restructuring of the banking sector, rather than by an increase in interest rates. They point out that the recession was short-lived and that macroeconomic reforms facilitated the rapid recovery of domestic demand. An assessment of the relative merits of opposing views of IMF's program is beyond the scope of this PPER.

[18] The appropriateness of imposing conditionality on DMCs is discussed in Quibria, M.G. 2004. *Development Effectiveness: What Does Recent Research Tell Us?*, OED Working Paper. Manila:ADB.

[19] The approach taken under the FSPL to increasing capital adequacy ratios is one such example. IMF's letter of intent of 1998 further strengthened these regulatory and supervisory aspects.

procedures. The Government enacted several of the most critical reforms supported by the FSPL and the programs of IMF and WB—such as the Financial Supervisory Institutions Act and BOK Act—almost immediately by December 1997. These actions and the timely injection of funds—$3 billion of ADB's total commitment of $4 billion was released under the first and second tranches of the FSPL by 5 January 1998—were essential to helping to restore market confidence and stem the outflow of foreign capital and the depreciation of the Korean won.

26. **Window of Opportunity.** ADB's involvement was initially sought by the Government largely to provide hard currency support to forestall a liquidity crisis and to calm international investors to prevent the collapse of the financial sector. ADB, through the FSPL, encouraged the Government to leverage the window of opportunity created by the crisis (because obtaining public consensus for much needed reforms was easier during a crisis) to address broader and more fundamental structural weaknesses in the financial sector. Such reforms included, for example, strengthening of financial market oversight and regulation, and enhancement of prudential norms. The FSPL also encouraged the Government to look more closely at some of the other players in the financial sector, such as insurance companies and the NPF, that had not contributed directly to the crisis but which were known to be structurally weak and, thus, could have threatened financial sector stability in the medium and long terms.[20]

27. **Coverage and Scope of the Program.** The FSPL focused primarily on those reforms needed to address known core weaknesses in the financial sector. The scope of the reforms was appropriate. Some issues that could not have been foreseen in 1999 were not addressed in the FSPL. As a result, the absence of fine-tuning in the aftermath of the crisis and the inability of ADB to follow up on the development of the financial sector contributed to other smaller crises in the sector in later years (paras. 63–64).

28. **Sequencing of Reforms**. Reforms for both the banking sector and the nonbank financial sector were generally appropriate, reasonable, and properly sequenced. The Government had taken some initial steps to restore the confidence of foreign investors that had claims on the Korean financial sector. However these were not sufficient as the investors realized the weaknesses in the enforcement of financial sector regulations and the vulnerability of the institutions. To restore the confidence of foreign creditors and using the window of opportunity available during the crisis, FSPL together with the other MFI formulated sequential reform conditions according to a time table that coincided with the tranche releases.[21] The tranches were expected in 1 month, 1 year, and 2 years later. The legal enactments allowed the establishment of the independence of the BOK for managing monetary policy and the supervisory responsibility was transferred to the FSC. A time table was then established to gradually adopt prudential regulations with full implementation in the medium term. Foreign banks were permitted to enter after a year and proportion allowed was increased gradually as the market matured.

29. **Absence of Medium-Term Monitoring.** Given the lack of an ongoing ADB program in Korea, the momentum with which these medium-term and longer term measures were operationalized or adapted could not be judged by ADB after program completion and closure of ADB's EMK. No one within ADB was specifically assigned responsibility for following up on Korea after both loans closed. Subsequent smaller crises (paras. 63–64) suggest that not all of the weaknesses in the financial sector were addressed. Subsequent market development also

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[20] The assets held by insurance companies constituted about 12% of total assets held by all the financial institutions in 1997, and 15% in 2004. Corresponding shares for the NPF amounted to 4% in 1997 and 11% in 2004.

[21] The relativity of appropriateness of reforms is a function of time and space. It is related to the social and economic systems in the DMCs. While strengthening prudential norms is a good measure to prevent a crisis, a strict prudential norm strictly enforced during a crisis could lead to even sharper decline in economic activities than need be.

suggests that, while the markets are reasonably robust, weaknesses in the underlying nature of the economy remain that prevent them from reaching their full potential.

30. **Ownership of Reforms.** At the time of the financial crises, Korea was not borrowing from ADB. Thus, the FSPL was not based on a country operational strategy. Much of the sector-specific analysis came from outside ADB. The macroeconomic crisis response framework was provided by IMF, and the financial sector reforms originated from the Government. Despite the fact that the FSPL broadened and deepened the reform program, ownership of it was generally strong. Indeed, in certain areas (such as the elimination of virtually all foreign ownership restrictions in the bond and equity markets), the Government went well beyond FSPL requirements.

31. **Coordination Among MFIs.** ADB's FSPL policy matrix was generally compatible with the programs of the other aid agencies. Points of overlap with IMF and WB programs later emerged, particularly with regard to the TA (para. 32). In an ideal world, a unified policy matrix would have been developed showing the allocation of responsibilities including monitoring to each of the three institutions on the basis of their core competencies. This approach to program design was not possible at the time due to a basic lack of transparency and coordination among the MFIs and the time pressures under which all parties were working.[22]

32. **TA Support to Operationalize Reforms.** The design of Loan 1602-KOR included TA to strengthen key institutions involved in the FSPL reform program. Given the time pressures, it was not possible to develop detailed terms of reference (TOR) to be included in the loan approval documents. A subsequent mission, 10 months after Board consideration, initiated the development of the TOR. Client ownership over the TA was not initially apparent. It only developed after the TA was restructured, about a year after the approval of the FSPL, leading to a delay in implementation and partial utilization. This, too, may have been partly attributable to the absence of transparency in the efforts of the MFIs.

B. Achievement of Outputs

33. The PCR's characterization of the status of reforms is accurate.[23] At the time of the PCR, 81 policy conditions were complied with, 12 were substantially complied with, and 1 was not complied with.[24] Many of the reforms that were substantially complied with at the time of the PCR have since been more fully implemented, including (i) liquidation of NPLs acquired by KAMCO from restructured banks during the crisis (90.5% of these assets have been sold or written-off), (ii) implementation of Basle Core Principles for Effective Banking Supervision,[25]

[22] IMF did not formally share its policy matrix with ADB during fact-finding and loan negotiations (when both MFIs had teams in Korea). IMF's policy of transparency, introduced in 2001, states that it will share policy matrixes and other documents after approval by its Board, if there is no objection from the borrowing country. While the introduction of public disclosure policies may facilitate access to the *outcomes* of lending negotiations, it does not address the need for a unified strategy during the process of loan processing and the formulation of reform agendas. For this to happen, the MFIs need to address institutional and other operational barriers that prevent aid coordination and cooperation.

[23] In numbering the conditions, the OEM adopted a detailed approach that took into account 94 conditions including the 42 fulfilled prior to loan approval and release of tranche 1.

[24] According to the RRP, BOK was to "place full reliance on open market operations for the implementation of monetary policy so that the reserve requirements for banks can be reduced from the current level of 3.3%." The PCR states that BOK "has been placing increasing emphasis on open market operations for monetary management. However, reserve requirements have not changed since February 1997, when the weighted average of reserve requirements was 3.1%. Reserve requirements are being retained to protect against risks associated with delays in settlements among banks. The Bank of Korea and MOFE contend that, in existing circumstances, lowering of reserve requirements would complicate monetary management and contribute to inflationary pressures."

[25] The supervisory authorities have reflected the Basle Core Principles to the concerned enactments and have inspected and guided the compliance of banks continuously. Items like approval; admission; minimum capital ratio; regulations; and detailed rules of supervisory toward banks, which enactments are needed, are specified in the Bank Law.

(iii) determination of ratings for insurance companies by the Financial Supervisory Service, and (iv) standardization of interest payments on government bonds. The policy matrix for the FSPL, along with information to describe the current status of compliance with each of the program conditions, is contained in Appendix 3.

C. Organization and Management

34. The urgency demanded by the crisis required flexibility in the organization and management of the FSPL. Disbursements were heavily frontloaded, with $3 billion of ADB's $4 billion commitment being released in two separate tranches within 17 days of Board approval. The first tranche for $2 billion was approved on 23 December 1997 upon loan effectiveness, by which point the Government had met all 42 conditions associated with the release. The second $1 billion tranche was released on 5 January 1998, by which point ADB had verified that the Government had met all 11 conditions associated with the release.[26] The third $700 million tranche was released on schedule on 31 December 1998, by which time the Government had met 29 of 30 conditions associated with the release (the last condition was partly met according to the PCR). The fourth tranche for $300 million was canceled at the request of the Government, although it did ultimately meet all but 1 of the 11 conditions associated with its release.

35. The frontloading of disbursements (and conditions) proceeded smoothly despite a change in government that took place in December 1997, in the middle of the crisis. While the new Government was reform minded, the turnover of senior officials required ADB to quickly develop relationships with new counterparts early during the administration of the FSPL. Initial reluctance on the part of the Government to embrace the TA Loan resulted in the TA funds being channeled to KDB, which effectively precluded several of the institutions targeted by the TA from borrowing against the loan. Roughly a year following approval of the TA Loan, the TA was restructured to prevent overlap with TA provided by WB in September 1998, and to eliminate the participation of the Korea Housing and Commercial Bank subsequent to its privatization. ADB established the EMK from September 1998 to January 2000 to support the implementation of both loans. The FSPL closed on 7 December 1999, 7 months ahead of schedule. The TA Loan closed on 31 October 2002, 29 months behind schedule, with a cost of $13.6 million (60% of its estimated cost) and a loan utilization rate of 53%. The loan covenants were fully complied with for both loans.

III. ACHIEVEMENT OF PROGRAM PURPOSE

A. Performance Indicators

36. Given the breadth of reforms supported under the FSPL and the fact that it was part of a broader crisis assistance package, specific performance indicators were not identified in the RRP, and none can reasonably be identified that separate the impact of the FSPL from the impact of the other external aid programs or the Government's own reform efforts. Macroeconomic and financial sector indicators—in particular the value of gross reserves (Figure 1) and the exchange rate of the won (Figure 2)—improved rapidly in the months following the processing of the FSPL, indicating that the crisis response contributed to significantly restoring investor confidence and discouraging capital flight.

[26] The Financial Reform Bill was passed by the National Assembly on 29 December 1997. A follow-up mission for the second tranche of the FSPL was fielded from 30 December 1997 to 5 January 1998. A certification, dated 31 December 1997, from the Deputy Minister for International Finance and Economy informed ADB about the fulfillment of all second tranche conditions. ADB's President approved the release of the tranche on 5 January 1998, and the Board was informed about the tranche release through a short progress report on the next day.

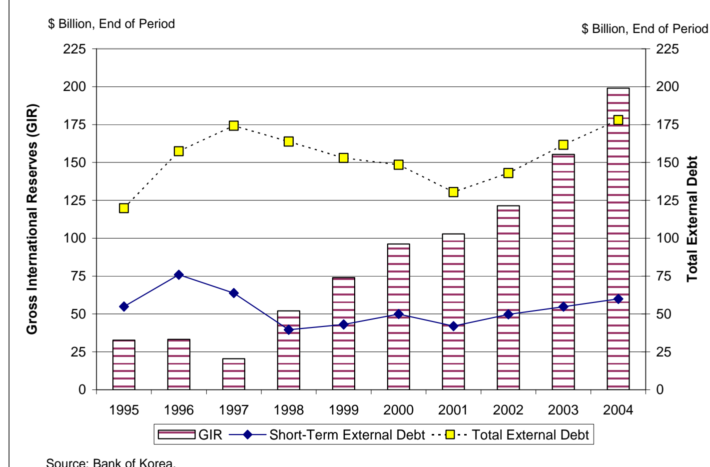


Figure 1: Gross International Reserves and Total External Debt, 1995–2004

Source: Bank of Korea.

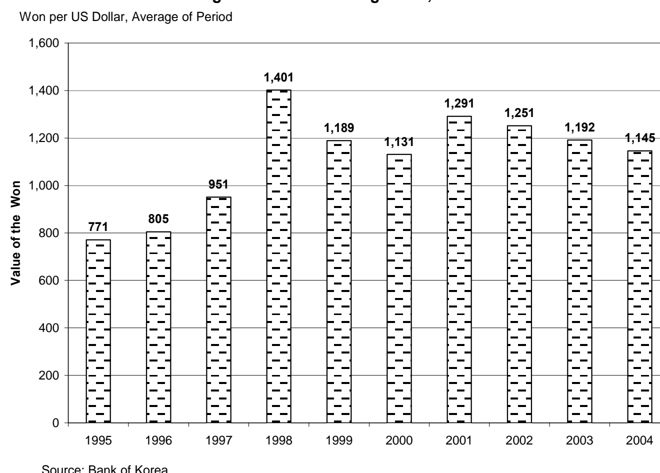


Figure 2: Won Exchange Rate, 1995–2004

Source: Bank of Korea.

37. Since the crisis, these same indicators suggest that the FSPL and other aid programs contributed to resolving the structural problems in the financial sector. The current account and net capital flows, for example, have remained positive (Figure 3), resulting in gross foreign reserves reaching $199 billion by 2004 compared with a low of $6 billion in early December 1997. This amount exceeds the level of Korea's gross external debt. In the real sector, GDP contracted by 6.9% in 1998 but rebounded sharply in 1999, with growth of 9.5%. From 2000 to 2004, GDP growth averaged over 5%, down from precrisis levels but still reasonably healthy (Figure 4).

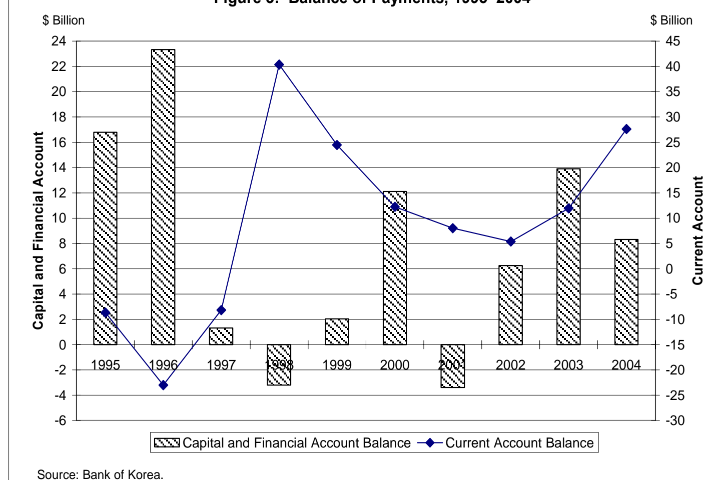


Figure 3: Balance of Payments, 1995–2004

Source: Bank of Korea.

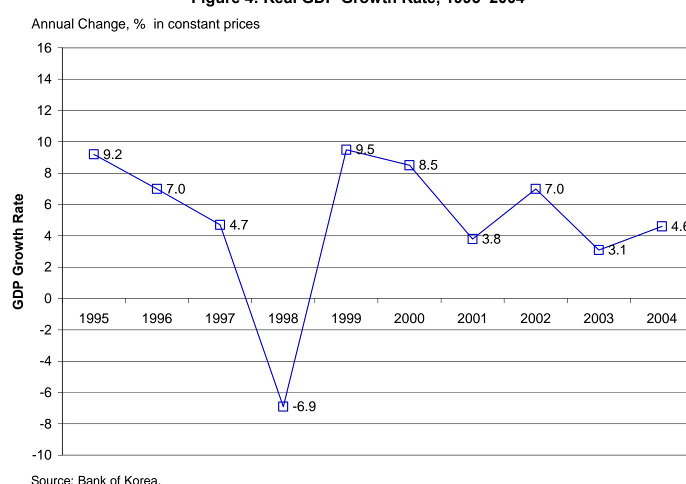


Figure 4: Real GDP Growth Rate, 1995–2004

Source: Bank of Korea.

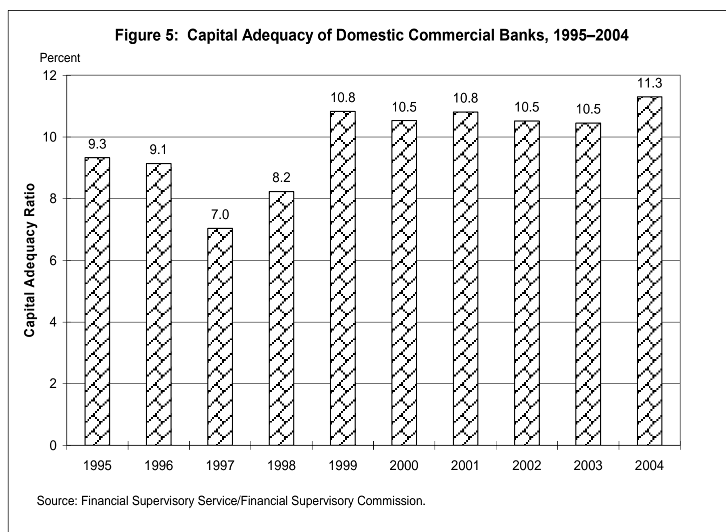
38. Appendix 1 contains key macroeconomic indicators before and after the crisis. The evolution of performance indicators for individual components of the financial sector is discussed in the following section.

B. Program Outcomes

39. **Commercial Banks.** A total of W165 trillion in public funds ($163 billion) was spent on financial sector restructuring as of late 2004 (Appendix 4). Of this total, 56% was spent prior to 1999; 78% was spent prior to 2000. About half (53%) went toward commercial bank

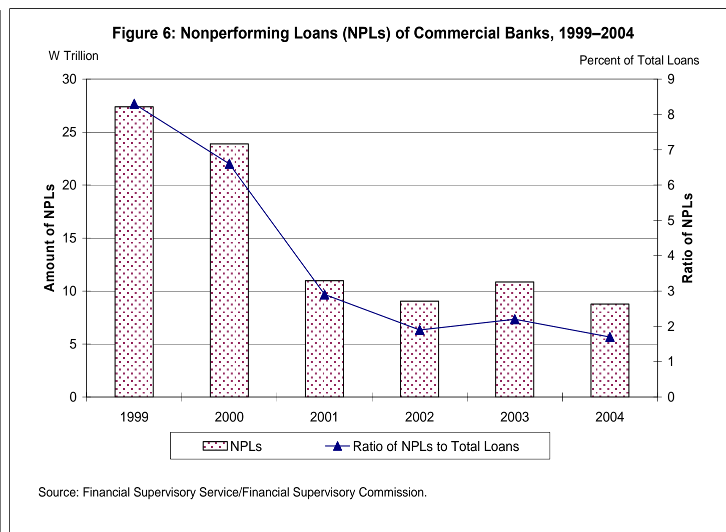
restructuring.[27] The outcome of this restructuring was the marked consolidation of the financial sector. The impacts of the FSPL and the other MFI programs are described in Appendix 5 and are supported by the data in Appendix 4. The number of commercial banks decreased from 33 at the end of 1997 to 19 by the end of 2004. Capital adequacy ratios (CARs) increased rapidly from 7% in 1997 to about 11% in 1999, given the injection of capital from the Government and other investors (Figure 5). The current level compares well to the 8% CAR minimum required by the Basle Capital Accord. The value of NPLs gradually recovered from a peak of 10% of total bank lending in mid-1998 to 8.3% of gross loans in 1999, reaching a low of 1.7% in 2004 (Figure 6). Bank profitability also increased substantially, with the average return on assets (ROA) increasing from a negative 3.25% in 1998 to a positive 0.89% in 2004.[28]

Figure 5: Capital Adequacy of Domestic Commercial Banks, 1995–2004



Source: Financial Supervisory Service/Financial Supervisory Commission.

Figure 6: Nonperforming Loans (NPLs) of Commercial Banks, 1999–2004



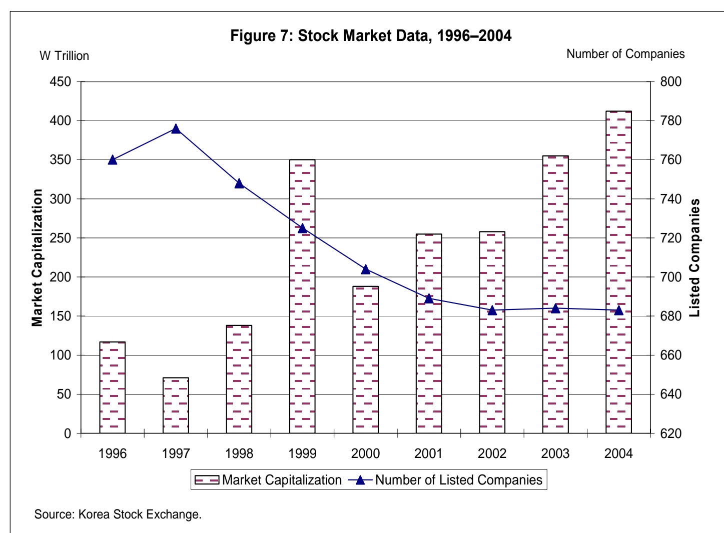
Source: Financial Supervisory Service/Financial Supervisory Commission.

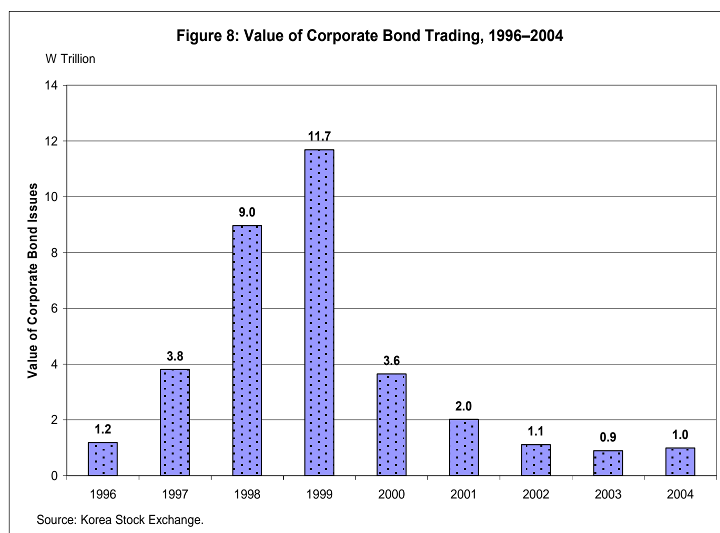
40. **Nonbank Financial Institutions.** The FSPL strengthened the nonbank financial sector in two ways. First, the FSPL facilitated the merger or exit of nonviable companies. Of 30 merchant banks existing in 1997, only six were still in existence by the end of 2000, and only two were in operation in 2004. There were 36 securities companies existing in 1997. Six were closed in 1998, and 57 were in operation by 2004. Second, the FSPL tightened supervisory, prudential, and accounting norms for merchant banks and securities companies. Merchant banks were required to meet a capital asset ratio of 8% by June 1999 or face penalties culminating in closure. Securities companies were forbidden from issuing guarantees and have been subjected to stricter regulatory guidelines. The minimum solvency margin in the insurance industry gradually increased to 4% as of March 2004. Despite these improvements, some weaknesses remain in the securities industry. Reforms regarding the NPF were more modest and included only increasing the contribution rate and discussing with ADB the final report of the Government's Pension Review Committee. Further more substantive reforms are required to restore long-term financial balance to the scheme and address the gradual problem of an aging population in Korea.

41. **Financial Markets.** The FSPL strengthened the financial markets by (i) introducing modest changes in the government bond market, including the standardization of interest payment mechanisms; (ii) loosening restrictions on the foreign ownership of corporate bonds and the shares of companies listed on the KSE and the over-the-counter market; (iii) encouraging the institutional strengthening of credit rating agencies; (iv) promoting the development of a secondary mortgage market; and (v) establishing an exchange for futures and

[27] This total group is defined to include designated "special" banks.
[28] Outcomes dipped during this period as banks absorbed losses resulting from the credit card crisis in 2003.

options. Most outputs expected from the FSPL were achieved and, in some cases, exceeded. Ownership restrictions on corporate bonds and stocks, for example, were removed almost entirely.[29] This improved market efficiency by improving price formation and allowing the markets to better allocate capital among competing opportunities. Despite these achievements, the potential of the financial markets to support economic growth has not been fully realized. The Government's continued involvement in the financial sector, including for example its loan guarantee program for SMEs, and pervasive regulations governing the activities of the corporate sector, such as the restriction on chaebols investing outside their existing business sectors, are issues of concern.[30] While market capitalization (Figure 7) continues to rise (growing from W255 trillion in 2001 to W412 trillion in 2004), the number of listed companies (Figure 8) has remained constant over the past few years. Also, the corporate bond market lacks liquidity and maturities are relatively short.





C. Sustainability

42. Overall, Korea's financial sector is far healthier now than it was at the time of the crisis and is less vulnerable to external shocks. Foreign exchange reserves are substantial and are more than adequate to support the stock of Korea's short-term foreign debt. Reforms facilitated the exit of nonviable institutions, opened the sector to greater competition, and improved the regulatory framework and market oversight. There is no evidence to suggest that market regulation is lax or corrupt.[31] The direction of the Government's subsequent policy initiatives has been broadly consistent with those supported by the FSPL.

43. Subsequent smaller crises in the financial sector (areas not covered by the FSPL) proved to be serious but ultimately did not destabilize the sector. Having absorbed the losses of the credit card crisis in 2003, banks emerged profitable in 2004. Problems in the financial sector involving investment trust companies (ITCs) and credit card issuers suggest, however, that

[29] Restrictions still apply to certain industries, such as the power industry, for strategic or national security reasons.
[30] Immediately after the Asian financial crises, the Government sharply expanded its credit guarantees to SMEs to contain the decline in loans to this sector. These emergency guarantees, however, have not been wound down over time. Instead, they have been repeatedly rolled over, contributing to a boom in bank lending to SMEs in 2001–2003. As a result, this vital sector—which accounts for 85% of employment—is now plagued by over capacity and poor profitability. In 2004, the SME guarantees accounted for more than 40% of banks credit portfolio, and 6% of GDP. A wave of SME defaults would put pressure on the financial system (IMF. 2004. *Staff Report for the 2004 Article IV Consultation*. Korea).
[31] Korea's ranking in terms of the corruption perception index has improved over the years. In 1997, it was ranked 34/52, in 2000 48/90, and in 2004 47/146 (the lower the ranking, the better).

some financial sector institutions may lack a culture of prudence and may still view growth as being more important than profitability. The Government still plays a substantial role in the sector (i) by continuing to provide guarantee programs that lowers the bar for SMEs to obtain credit (para. 64); (ii) at times, encouraging banks to rescue companies in distress, and (iii) through its indirect ownership of KDIC and the NPF.[32]

44. The chaebols have more prudent strategies now than at the time of the crisis. Most are profitable; many are holding substantial liquid assets and are cautious in their investments,[33] but they are still subject to pervasive regulation by the Government, which prevents them from making investments outside their existing business sectors. The Government's continued involvement in the financial and the corporate sectors in combination with the rigidity of Korea's labor market laws could influence the longer term sustainability of the market-oriented reforms pursued under the FSPL.

D. Institutional Development

45. Once extensive changes were made to the design of the TA (para. 19), it achieved a number of significant and sustainable outcomes in each of the IAs. In the Kookmin Bank (KB) and Woori Bank (WrB), for example, the TA helped improve risk management strategies and generate new business plans for the consolidated institutions created after the crisis. Financial statements of both banks reflect prudent management and greater financial soundness. While the profitability of WrB has increased moderately, that of KB has risen only marginally as a result of credit card losses. The CAR for KB improved from 10% in 1998 to 11% in 2004. The ROA improved from 0.16% in 1998 to 0.30% in 2004. NPLs declined from 5.9% in 1999 to 2.9% in 2002 and to 2.3% in 2004. Its ratings are satisfactory according to the Standard & Poor rating of BBB+ stable in 2005. WrB has also achieved satisfactory performance, with a Standard & Poor A- rating in 2005. Its CAR improved progressively from 8.7% in 1999 to 11.6% in 2002 and further to 12.2% in 2004. The ROA improved from -4.36% in 2000 to 1.06% in 2001, and declined to 0.28% in 2004 due to higher loan loss provisions. NPLs fell from 14.04% in 2000 to 2.06% in 2001 and to 2% in 2004.

46. The other two institutions—KAMCO and KDIC—also benefited from the TA, which funded specialized capacity building necessary for each organization. The IA supported training, most of the trainees being mid-level managers, who were provided with domestic and/or international training. Those interviewed by the OEM confirmed their appreciation of the training and its usefulness in their day-to-day activities. Most have stayed in their institutions long enough to pass on the benefits of their training. Some have taken responsibility for running training programs on behalf of their respective organizations. The history of the TA Loan and its impact on the development of the institutions it supported is discussed in Appendix 6.

IV. ACHIEVEMENT OF OTHER DEVELOPMENT IMPACTS

A. Socioeconomic Impact

47. The financial crisis in Korea had a substantial human cost. The WB estimated that the rate of absolute poverty more than doubled, from 9% in 1997 to 23% in 1998, in part because the social safety net in place prior to the crisis was quite limited. Only 41% of wage earners were eligible for unemployment insurance in January 1998. The collapse of the chaebols and the subsequent restructuring of the financial sector resulted in higher levels of poverty, higher levels of unemployment (Figure 9), and lower levels of personal income (particularly for workers in the bottom of the income distribution). Unemployment rates more than doubled, from an

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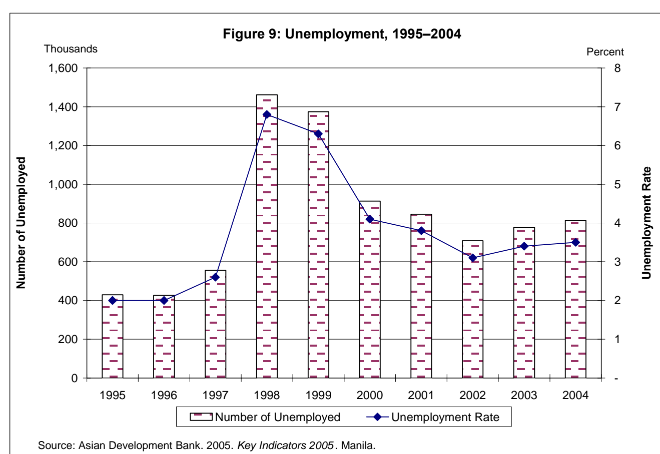
[32] It is not unusual for some governments to have part ownership of deposit insurance companies.

[33] As a result, however, they have not relied recently on the financial sector for substantial new investment capital, which has slowed the pace of market development.

average of 2.3% during 1990–1996 (roughly half a million persons) to 5.3% from 1997 to 1999 (roughly 1.1 million persons). Unemployment was concentrated in the construction, trade, and manufacturing sectors, and disproportionately impacted unskilled laborers and persons employed in service and sales positions (i.e., nonprofessional workers).



48. Higher levels of unemployment and wage reductions for existing workers contributed to a reduction in average household consumption by about 15%. Many families adjusted to the crisis by drawing on their savings and relying on intrafamily transfers. Wage reductions depressed the average monthly income of urban workers by an estimated 6.7%, with persons in the lowest quintile suffering a drop of more than 17% (Table 2).

Table 2: Reduction in Average Monthly Income of Urban Workers in 1998

Income Group	**Real Income** (Won)	**Change in Income** (%)
Highest Quintile (81–100%)	4, 244,000	(0.3)
Upper Middle Quintile (61–80%)	2,440,200	(8.0)
Middle Quintile (41–60%)	1,827,000	(9.9)
Lower Middle Quintile (21–40%)	1,368,000	(11.8)
Lowest Quintile (0–20%)	784,000	(17.2)
Average	**2,133,100**	**(6.7)**

Note: Numbers in parentheses means negative.
Source: National Statistics Office, Korea.

49. The impact of the crisis was felt disproportionately by the less educated, young workers and women, which resulted in deterioration in the distribution of income. Between April 1997 and April 1998, employment fell by 3.8% among men compared with 7.1% among women. Employment of those without a high school diploma fell by 14% in 1998, compared with 9.4% for college graduates.[34] The proportion of temporary and daily workers—who received less total compensation on average and have no assurance of job security—increased by 29% and 18%, respectively, between 1995 and 1999.

50. The socioeconomic impact of the crisis, however, was reasonably short-lived. For the most part, key indicators improved markedly, albeit not entirely to precrisis levels. Unemployment rates, for example, improved to an average of 3.6% per year (0.8 million persons annually) during 2000–2002. Had the Government not implemented a massive stabilization program with the support of ADB, IMF, and WB, the impact of the crisis would have been worse, because the spillover from the failure of the chaebols could have wiped out

[34] Lee, Jong-Wha, and Changyong Rhee. 2000. *Macroeconomic Impacts of the Korean Financial Crisis: Comparison with the Cross-Country Patterns*. Korea.

household bank deposits, threatened otherwise healthy chaebols (which could have starved for capital if foreign investors had completely exited from the market), and resulted in higher rates of unemployment in the financial sector. The quick return of stability to the financial sector supported rapid recovery in the corporate sector.

B. Environmental Impact

51. The Program had no discernible environmental impacts.

V. OVERALL ASSESSMENT

52. This PPER assesses[35] the FSPL and its associated TA against their objectives as described in the RRP. While supporting Korea's balance of payments position was implicit in the formulation of the Program, the FSPL was explicitly geared toward correcting structural weaknesses in the financial sector.

A. Relevance

53. The Program was highly relevant given (i) evidence of strong ownership by the Government of the reforms supported under the FSPL; (ii) the validity of the diagnosis of the underlying causes of the financial crisis and the weaknesses within the financial sector; and (iii) the appropriateness of the Program's essential formulation and design, which gave priority to those objectives that addressed the most critical development constraints.

B. Efficacy

54. As a component of a broader package of reforms that restored macroeconomic stability while addressing underlying weaknesses in the financial sector, the Program was efficacious. The political economic and macroeconomic contexts were conducive to the achievement of program objectives. The program objectives were achieved because they were consistent with reforms the Government was making across the broader political economy. As a result, Korea's financial sector indicators are better now than at the time of the crisis. Although subsequent but smaller crises suggest a lack of market orientation in some parts of the financial sector, Korea's vulnerability to financial contagion is now quite low.

C. Efficiency

55. The Program was highly efficient. It was processed, and funds were disbursed, at record speed. The rapid processing of the loan was essential if funds were to become available to the Government before its hard currency reserves were exhausted and to reassure foreign investors that the commitments of the international aid community would be met. Policy reforms were implemented rapidly and achieved the desired development results. Adequate public expenditures were made available to meet the Government's portion of adjustment costs.

D. Sustainability

56. The sustainability of the Program is likely, given the general consistency of subsequent reforms with those supported by the Program, the absence of evidence suggesting backtracking on enacted reforms, and the comparatively strong institutional capacity of both public and private sector institutions in Korea. The continued influence of the Government over the financial sector, however, has slowed the pace of progress in market development and raises

[35] The assessment criterion was guided by Curry, S., and S. Tabor. 2005. *Good Practices for the Evaluation of Policy-Based Lending by Multilateral Development Banks*. Manila:ADB.

mild concerns about the Government's commitment to allowing the financial sector to eventually function mostly on the basis of market forces.

E. Institutional Development

57. Institutional development resulting from the FSPL was substantial. The Program resulted in sweeping changes in the regulatory framework and dramatic consolidation in the banking and nonbanking financial sectors. Through the TA Loan, the FSPL supported training for a core group of market participants. Government capacity and financial sector agency capacity to manage financial sector activities have improved, and the necessary management information systems are in place.

F. Overall Program Rating

58. The overall assessment of Loan 1601-KOR is highly successful, bordering on successful, based on the above evaluation criteria (paras. 53–57). Loan 1602-KOR was relevant and efficacious after the change in scope. Implementation was less than efficient, given that the TA funds were unutilized for 18 months and the ultimate utilization rate was 53%. The institutional strengthening has been sustainable. Overall, Loan 1602-KOR is rated successful (Appendix 6).

G. Performance of the Executing Agency and ADB

59. The EA's performance with respect to the FSPL was highly satisfactory. The Government demonstrated strong commitment to the challenging Program. The Government enacted some reforms before they were required for tranche release and, in some cases, enacted reforms that went well beyond what was stipulated in the Loan Agreement. MOFE (i) implemented the FSPL effectively in close consultation with BOK and FSC, and (ii) cooperated fully with ADB's program review missions.

60. The performance of the EA with respect to the TA Loan was initially less satisfactory. Reluctance on the part of the Government to embrace the TA Loan resulted in the TA funds being diverted to KDB. This effectively precluded several of the institutions targeted by the TA from borrowing against the loan. After about a year of inactivity, the TA was restructured in part to preclude overlap with TA being provided by the WB. Once extensive changes were made to the design of the TA, it was better utilized and achieved a number of significant and sustainable outcomes in each of the IAs.

61. ADB's performance with respect to the FSPL was highly satisfactory, and its performance associated with the TA Loan was satisfactory. Faced with a crisis that pushed the economy to the brink of collapse, ADB responded rapidly to its client's needs and demonstrated flexibility in deviating from its normal lending practices to provide support when that support was most urgently needed. ADB monitored the implementation of the FSPL closely (i) through its Seoul-based EMK (staffed by a senior economic advisor and a long-term consultant); and (ii) by fielding 1 inception mission (34 person-days), 6 special project administration missions (56 person-days), 1 special consultation mission (15 person-days), 5 review missions (128 person-days), and 2 completion review missions (31 person-days). Learning from the experience of the FSPL and other crisis lending programs, ADB established a regional surveillance unit—the Regional Economic Monitoring Unit—in 1999 and created a new program lending instrument for crisis lending, albeit 5 years after the crisis (para . 74).

VI. ISSUES, LESSONS, AND FOLLOW-UP ACTIONS

A. Issues

62. The following describes the evolution of Korea's financial sector in the aftermath of the crisis. This discussion is meant to identify lessons of experience that might be relevant for future lending operations in other DMCs.

63. **Credit Card Crisis.** The credit card industry in Korea boomed from 1999 to 2002 following aggressive marketing and the reckless issuance of cards to a population generally inexperienced with household credit. Tax incentives initiated by the Government to discourage informal economic activity and, indirectly, to promote consumption, especially among lower income groups, also played a role in creating the boom. Encouraged by the success of early entrants into the market, most commercial banks eventually joined the boom. Cards were often issued without adequate credit analysis. In the absence of credit bureaus to track consumer credit,[36] the number of issued cards soared to 100 million (for a total population of 48 million persons), and the annual value of transactions reached 114% of GDP. By December 2002, the value of accounts in arrears reached 11.2% of total card balances, tripling to 34.2% by November 2003. The largest card company faced a liquidity crisis in December 2003. The Government-owned KDB, with the support of other commercial banks, arranged a rescue. Other banks merged their subsidiaries into their own operations, which averted an implosion of the industry, albeit at substantial cost to the banks. Since 2003, the majority of indebted households have cut spending and readjusted their balance sheets. While the financial sector has overcome the crisis, the credit bureaus require strengthening, and more stringent bankruptcy code provisions merit consideration.

64. **Weaknesses in the SME Sector.** As lending to chaebols slowed in the wake of the crisis, banks looked for new business opportunities. The Government, through expansion of the existing SME credit guarantee funds, encouraged SME lending. These funds, financed by the Government and by commercial banks, distorted lending decisions in the banking sector.[37] SME sector which account for 85% of employment is an important sector in the Korean economy. While increasing the scope of credit guarantee programs was appropriate at the time of the crisis, no exit strategy was put in place to curtail these programs once the crisis had passed.[38] Although a number of banks have improved their credit analysis and are not relying entirely on credit guarantees, guarantee programs create an incentive to extend credit also to SMEs that are not fundamentally creditworthy, thus creating moral hazard. While loss provisions are adequate, over 70% of SME loans are backed by real estate collateral or credit guarantees. Credit guarantees have the potential to generate fiscal risk[39] to the Government and losses by the banks. The strength of the unionized labor market has also reduced the competitiveness of the corporate sector, especially vis-à-vis low-cost producers. Operating profits of SMEs as a percentage of total assets remained at 5–6% for the last 10 years, while those of large enterprises fell following the crisis but increased

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[36] Many cardholders held multiple cards and used new cards to withdraw cash to pay the balances on their existing accounts.

[37] "Bank lending to SMEs has risen at time when large firms have been de-leveraging, which has lifted their debt-equity ratio above that for large companies, limiting their ability to invest and upgrade. The OECD suggest that government support measures, such as debt guarantees, are contributing to the problem of SMEs. These have sheltered the companies from the need to overhaul their operations in parallel with the larger enterprises (OECD, 2005).

[38] "Korea's long-term economic growth fundamentals will be restrained without significant improvement among the SMEs. Behind the lagging performance of SMEs has been the reluctance of both SMEs and the Government to push forward with forceful operational and financial restructuring. Not only were SMEs largely sheltered during the Asian financial crises, but government support, including guarantees for SME credit, has also prevented the emergence of an effective market mechanism to force the exit of failing firms" (ADB. 2005. *Asian Development Outlook 2005: Promoting Competition for Long-Term Development*. Manila).

[39] Commercial banks contribute about 25% of the annual funds raised by the credit guarantee funds. However, the Government is responsible for meeting any shortfall in the funds as the final guarantor.

substantially since 2002. While labor market rigidities can be eliminated only with political consensus, nonviable SMEs must not be kept alive on the basis of rigid labor laws that also discourage the creation of new and dynamic ventures offering the potential to create new jobs and increase economic growth.[40] During the transition, social safety nets must be strengthened to protect workers displaced by the closure of nonviable firms.

65. **Pace of Capital Market Development.** While substantial progress was made in terms of eliminating nonviable participants in the capital market and strengthening market regulation and oversight, the capital market still plays a relatively small role in mobilizing investment capital in the economy. The volume of initial public offerings has been low (the total number of companies listed on the KSE has remained almost constant for the past 5 years). Although the absolute volume of corporate bond issues is large by comparison with other developing countries in the region, it is modest relative to Korea's sizeable economy. The secondary market is largely illiquid. Foreign participation in the bond market is low, constituting less than 1% of market turnover as compared with over 40% in the equity markets. Explanations for this weak domestic bond market include (i) the profitability of larger companies and their reluctance to invest domestically; (ii) the difficulties faced by SMEs attempting to graduate to the capital markets; (iii) the absence of longer term sovereign bonds, which discourages the issuance of long-term corporate debt; and (iv) structural issues in the operation of the market that discourage participation. Examples of such factors include poor pricing by securities issuers; high tax withholding on investment returns; and a history of government bailouts of bond issues such as Daewoo, Hyundai, and, more recently, LG Card, which distorts the market's ability to price investment risk. While securities are being issued with increasingly longer maturities, particularly in the case of mortgage-backed securities and other collateralized bond issues, the duration of assets issued in the capital markets remains short relative to what is needed by holders of long-term liabilities, such as insurance companies and pension funds. This creates an asset-liability term mismatch problem and provides incentives for these companies to look abroad for long-term instruments, thereby encouraging investments abroad.

66. The Government is cognizant of these issues and has taken some steps to promote further development of Korea's capital markets. In 2004, it sold Hyundai ITC, the largest of the state-owned or -controlled ITCs, to Prudential, and it has plans to auction off the remaining two (Daehan and Korea ITC). Returning these companies to the private sector should help restore confidence in the industry and may encourage a shift in savings away from bank deposits and real estate into ITCs, and thus into riskier equities and bonds. The Government also has plans to (i) promote the introduction of corporate-sponsored pension plans; (ii) give greater autonomy to the NPF to invest in corporate bonds and equity, which should substantially increase the demand for longer term domestic corporate bonds and new share issuances; and (iii) extend the maturities of its sovereign debt. The recent presence of foreign asset management companies, such as Fidelity, bodes well for market development. Finally, the Government, as part of its strategy to position Korea as a regional financial hub, recently announced a plan to move from a civil law to a common law approach to market legislation, which may help facilitate innovation in the delivery of financial products.

67. **Impact on ADB Lending in Other Member Countries.** The OEM did not find evidence that the exceptionally large FSPL, and the cumulative impact of ADB's other $4 billion emergency lending during the Asian financial crises, crowded out OCR lending to other DMCs in the period following the crisis. The FSPL represented about half of the total value of emergency loans approved between October 1997 and March 1999 (for programs in Indonesia,

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[40] Although a guarantee system for SMEs may sometimes delay the demise of nonviable SMEs, nevertheless, they play an important role for the development of new and dynamic ventures. Because they lack track record, they are most likely to face difficulties in accessing financial services without such a guarantee system.

Korea, and Thailand). OCR lending excluding emergency loans averaged $3.9 billion during the period prior to the crisis (1995–1997), and $3.4 billion in the period immediately following the crisis (1998–1999). This suggests that there was little impact on the overall lending amount, and the absence of crowding out following the crisis.

68. ADB did not charge a lending premium on its loans to Korea. IMF and WB charged premiums on their loans. It would have been more prudent for ADB also to charge a premium, given that the large volume of lending affected ADB's financial ratios[41] and because Korea had already graduated from ADB's lending program. Bail-out loans in principle should be more costly to the Borrower to prevent moral hazard. At the time of the crisis according to documents prepared at approval in 1997, ADB recognized that to maintain its financial ratios, ADB would have to have its fifth general capital increase in 2002 instead of in 2003 because of the substantial volume of quick disbursing loans made during the Asian financial crises. At the end of 1999, ADB reviewed the OCR loan charges and decided to increase the cost of its OCR funds to borrowers to maintain its financial soundness and to address concerns of increased risk to its loan portfolio. Thus, although there is no evidence of crowding out, it can be argued that the sharp increase in quick-disbursing lending to Korea and other affected DMCs resulted in a surcharge on all OCR borrowers. Changes to the borrowing rate included a front-end fee of 1% on all new loans and an increase in the lending spread from 40 basis points to 60 basis points on all OCR loans. Commitment fees for new program loans were changed to a flat rate of 75 basis points instead of the progressive rate that existed. ADB lending rate has subsequently been lowered effectively to LIBOR plus 40 basis points, and the entire 1% up-front fee is also currently waived. The OCR charge in June 2005 was 4% (including the 40 basis points after the waiver of 20 basis points in effect until June 2006).

B. Lessons

69. The following lessons emerge from the FSPL.

70. Speed, client ownership, and the ability to leverage windows of opportunity to introduce otherwise politically contentious reforms are essential when responding to crisis situations. These were all present for the FSPL and contributed to its success.

71. The success of financial sector reforms is often dependent on reforms elsewhere in the economy, such as in the corporate sector during the crisis in Korea. The Government's willingness to allow ailing chaebols to fail, and its commitment to tackling weaknesses in the corporate sector were essential for the success of the financial sector reforms supported under the FSPL.

72. During periods of severe financial market instability, temporary credit support may be necessary to prevent viable enterprises from failing for lack of capital. Such programs must be eliminated once the financial markets have stabilized to prevent moral hazard and to enable the efficient allocation of investment capital on the basis of market forces.

73. In crisis situations, it may not be possible to address all weaknesses in a financial sector. Once a crisis has passed, attention should be given to further institutional strengthening to prevent future market failures. This suggests that periodic surveillance is needed to track developments, provide early interdiction when problems emerge, and facilitate learning across DMCs. ADB established a surveillance unit in 1999 (footnote 16).

74. At the time of the Asian financial crisis, ADB did not have an appropriate lending instrument for crisis support and had to resort to traditional program lending with accompanying

[41] The FSPL affected ADB's financial indicators, i.e., interest coverage ratio and reserve loan ratio.

conditionalities to help its clients in a time of financial crisis. Given the flexibility and the responsiveness of ADB and the Government's high ownership of the reforms, the absence of such an instrument was not problematic in this case. In 2003, ADB established a special program loan modality[42] to address crisis situations. It enables the provision of large-scale loans as part of an international rescue effort without associated conditionalities. If the new lending instrument had been available at the time of the financial crisis, it is not clear that ADB would have had the opportunity to support the financial sector restructuring in Korea and whether the reforms would have been as extensive.

75. During crisis situations, effective coordination among MFIs and sharing of information in a transparent manner are needed to insure that external aid programs are consistent and comprehensive and do not overlap or work at cross purposes. Responsibilities should be allocated on the basis of core competencies. ADB's involvement as one of the three MFIs responding to the crisis was essential to address a number of key weaknesses in the financial sector (particularly the nonbank financial sector) that may not have been addressed at the time without ADB's involvement.[43]

76. Crisis lending to address financial sector instability must not neglect the human cost that such crises exact from displaced workers, particularly from low-income workers and other vulnerable groups. The adequacy of social safety nets should be reviewed in the face of large-scale external economic shocks.

C. Follow-Up Actions

77. Given the absence of an ongoing program in Korea and the good performance of the FSPL, no follow-up actions were identified.

[42] See Section D4/BP, paras. 18–19 of the Operations Manual, issued on 29 October 2003.
[43] While ADB's role as a MFI contributing to the rescue package has been recognized, its unique contribution in terms of supporting the strengthening of NBFIs may not have been adequately recognized in the literature.

KEY FINANCIAL SECTOR INDICATORS BEFORE AND AFTER THE CRISIS

Table A1.1: Macroeconomic Indicators, 1995–2004

Indicator	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004
National Accounts										
GDP per Capita (current, ‘000 won, EOP)	8,845	9,854	10,688	10,459	11,359	12,310	13,141	14,370	15,145	16,190
Real GDP Growth (%)	9.2	7.0	4.7	(6.9)	9.5	8.5	3.8	7.0	3.1	4.6
Growth by Sector (%)										
Industry	9.8	7.3	4.5	(8.2)	12.2	11.7	3.1	6.4	6.1	9.0
Services	9.1	7.2	4.8	(6.1)	8.3	7.2	4.5	8.0	1.9	1.8
Growth by Expenditure (%)										
Private Consumption	9.9	6.7	3.3	(13.4)	11.5	8.4	4.9	7.9	(1.2)	(0.5)
Govt Consumption	5.0	8.0	2.6	2.3	2.9	1.6	4.9	6.0	3.8	3.0
GDCF	10.1	10.5	(5.3)	(30.6)	24.1	10.7	(0.0)	5.9	2.5	4.9
Nominal GDP (trillion won)	398.8	448.6	491.1	484.1	529.5	578.7	622.1	684.3	724.7	778.4
By Sector (%)										
Industry	37.7	37.0	36.7	36.9	35.9	36.2	34.7	33.8	34.6	36.3
Services	56.5	57.7	58.4	58.5	59.4	59.5	61.4	62.6	62.2	60.4
Share by Expenditure (%)										
Private Consumption	52.3	52.7	52.7	49.3	51.9	54.0	55.2	55.7	53.7	51.5
Govt Consumption	11.2	11.6	11.6	12.8	12.3	12.1	12.9	12.9	13.3	13.5
GDCF	37.7	38.9	36.0	25.0	29.1	31.0	29.3	29.1	30.0	30.2
XGS	28.8	27.9	32.4	46.2	39.1	40.8	37.8	35.3	37.9	44.1
MGS	29.9	31.3	33.0	33.3	32.4	37.7	35.5	33.9	35.6	39.7
Savings and Investment (% of GDP)										
Gross Domestic Savings	36.5	35.7	35.8	37.9	35.8	33.9	31.9	31.4	32.8	35.0
Gross National Savings	36.8	35.3	35.2	36.2	34.6	33.5	31.7	31.5	33.0	35.2
Gross Domestic Investment	38.5	39.5	36.8	24.5	29.1	31.1	30.0	30.5	31.0	31.1
Current Account Balance	(1.7)	(4.1)	(1.6)	11.5	5.5	2.4	1.7	1.0	2.0	4.1
Government Finance (% of GDP)										
Central Govt Revenue	18.3	19.1	19.0	20.0	20.4	23.5	23.2	23.2	24.0	—
Central Govt Expenditure	15.8	16.3	16.6	18.8	19.1	18.9	20.4	19.8	22.9	—
Fiscal Balance	0.3	0.2	(1.4)	(3.9)	(2.5)	1.1	1.2	3.3	1.1	0.7
Trade and Current Accounts (% of GDP)										
Exports	24.2	23.3	26.9	38.3	32.6	34.4	31.4	29.9	32.4	37.9
Imports	25.0	26.0	27.5	26.2	26.3	31.1	28.6	27.2	28.8	32.3
Trade balance	(0.8)	(2.7)	(0.6)	12.1	6.4	3.3	2.8	2.7	3.6	5.6
Current Account Balance	(1.7)	(4.2)	(1.6)	11.7	5.5	2.4	1.7	1.0	2.0	4.1
Export Growth (% change)	30.3	3.7	5.0	(2.8)	8.6	19.9	(12.7)	8.0	19.3	31.0
Imports CIF (% change)	32.0	11.3	(3.8)	(35.5)	28.4	34.0	(12.1)	7.8	17.6	25.5
Terms of Trade	138.5	125.4	122.2	116.7	114.1	100.0	95.5	95.0	89.0	85.3
Foreign Equity Investment										
FDI, Net ($ billion)	(1.8)	(2.3)	(1.6)	0.7	5.1	4.3	1.1	(0.2)	0.1	3.4
FPI, Net ($ billion)	11.6	15.2	14.3	(1.9)	8.7	12.0	6.6	0.7	17.9	9.3
FDI as percent of GDI	(0.9)	(1.1)	(0.9)	0.8	4.0	2.7	0.8	(0.1)	0.1	1.7
Inflation and Unemployment										
CPI (1996 = 100, annual average)	4.5	4.9	4.4	7.5	0.8	2.3	4.1	2.7	3.6	3.6
GDP Deflator (annual)	7.4	5.2	4.6	5.9	(0.1)	0.7	3.5	2.8	2.7	2.7
Unemployment Rate (%)	2.0	2.0	2.6	6.8	6.3	4.1	3.8	3.1	3.4	3.5
Money and Credit (% change, year on year)										
Growth Rate of Narrow Money	20.0	3.5	(7.0)	1.9	23.5	4.8	15.1	16.9	3.9	8.3
Growth Rate of Broad Money	23.3	16.7	19.7	23.7	5.1	5.2	8.1	14.0	3.0	5.2
Average Ratio of Broad Money to GIR	14.7	14.7	17.2	11.1	9.1	7.0	5.9	5.9	5.6	4.7
Average CB Discount Rate	5.0	5.0	5.0	4.3	3.0	3.0	2.8	2.5	2.5	2.5

Indicator	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004
Average 3-Month Interbank Lending Rate	14.0	12.8	14.1	14.6	6.8	7.1	5.2	4.8	4.3	3.8
Average 3-Month Interbank Real Interest Rate	9.5	7.9	9.6	7.1	6.0	4.8	1.2	2.0	0.8	0.2
External Payments										
GIR ($ billion, EOP)	32.7	33.2	20.4	52.0	74.1	96.2	102.8	121.4	155.4	199.1
Months of Imports	2.9	2.7	1.7	6.7	7.4	7.2	8.7	9.6	10.4	10.6
% of STED	59.6	43.8	32.0	131.5	172.0	192.4	244.7	244.2	283.3	331.9
Total External Debt ($ billion, EOP)	119.8	157.4	174.2	163.8	152.9	148.5	130.4	143.0	161.6	178.0
% of GDP	23.1	28.2	33.5	46.8	34.3	29.0	27.0	26.0	26.6	26.1
Short-Term External Debt ($ billion, EOP)	54.9	75.9	63.8	39.6	43.1	50.0	42.0	49.7	54.8	60.0
% of GIR	167.7	228.3	312.5	76.1	58.1	52.0	40.9	41.0	35.3	30.1
% of XTD	45.8	48.2	36.6	24.2	28.2	33.7	32.2	34.8	33.9	33.7
Debt-Service Ratio (% of XGS)	7.9	—	—	13.1	25.0	12.6	13.7	10.0	8.1	—
Official Exchange Rate (won per $, Average)	771	805	951	1,401	1,189	1,131	1,291	1,251	1,192	1,145
Real Effective Exchange Rate (1996 = 100)	95.7	100.0	96.0	79.5	86.9	90.0	87.6	93.7	95.5	97.1
Financial Assets Market										
Average Stock Price Index, in Local Currency (1996=100)	—	100.0	75.0	51.7	106.1	102.0	78.7	105.1	96.3	—
Average Stock Price Index, in US$ (1996=100)	—	100.0	63.4	29.7	71.6	72.3	48.9	67.4	64.8	—
Foreign Currency Debt Rating										
Moody	—	—	—	—	Baa2	Baa2	Baa2	A3	A3	—
Standard and Poor	—	—	—	—	BBB	BBB	BBB+	A-	A-	—
Global Bond Spread	—	—	—	—	157	241	197	135	36	—

— = data not available; CB = central bank; CIF = cost, insurance, and freight; CPI = consumer price index; EOP = end of period; FDI = foreign direct investment; FPI = foreign portfolio investment; GDCF = gross domestic capital formation; GDI = gross domestic investment; GDP = gross domestic product; GIR = gross international reserves; Govt = government; MGS = imports of goods and services; OER = official exchange rate; STED = short-term external debt; XGS= exports of goods and services; XTD = external debt.

Sources: Asian Development Bank (ADB) Key Indicators 2005; ADB Statistical Database System/Asian Regional Information Center online query; and the International Monetary Fund, 2004 Article IV Consultation-Staff Report, February 2005.

Table A1.2: Financial Soundness Indicators, 1997–2004

Financial Sector	**1997**	**1998**	**1999**	**2000**	**2001**	**2002**	**2003**	**2004**
Gross Foreign Liabilities of the Banking Sector as % of Total Liabilities, EOP	14.3	9.6	7.6	6.3	5.1	6.8	7.5	7.5
Loans-to-Deposits Ratio	1.6	1.6	1.4	1.3	1.3	1.3	1.4	1.4
Real Bank Credit Growth Rate (%)	14.4	4.3	18.9	15.9	10.4	16.3	5.3	(1.7)
Real Bank Credit Index (1996 = 100)	114.4	119.4	141.9	164.4	181.5	211.1	222.3	218.6
Ratio of Gross Foreign Liabilities of the Banking Sector to Gross Foreign Assets, EOP	0.9	0.9	0.8	0.7	0.8	1.4	1.4	1.3
Total Loans/GDP (%)	—	—	111.6	107.4	103.6	119.5	—	—
Commercial Banks (%)	—	—	62.0	62.5	60.9	67.9	69.2	—
Other Financial Institutions (%)	—	—	49.6	44.9	42.6	51.6	—	—
Return on Assets of Commercial Banks	(0.9)	(3.3)	(1.3)	(0.6)	0.8	0.6	0.1	0.9
Net Interest Margin	—	—	2.9	2.7	3.0	2.9	2.8	—
Capital Adequacy Ratios of Commercial Banks, EOP	6.7	8.2	10.8	10.5	10.8	10.5	10.4	11.3
Tier 1 Capital Ratio	4.7	—	—	6.3	6.7	5.7	6.2	—
Precautionary/Below Loans, Share	—	—	21.2	14.0	7.9	5.7	6.0	—
Substandard/Below Loans, Share	—	—	13.6	8.9	3.3	2.4	2.8	—
NPLs including Net Transfers to AMCs as % of Total Loans, EOP	—	—	—	13.9	9.9	—	—	—
NPLs Disposals by AMCs, as % of NPLs Acquired, EOP	—	—	52.2	48.0	57.8	57.2	—	71.6
NPLs Purchases by AMCs, as % of Total NPLs, EOP	—	—	52.2	65.5	76.4	79.3	—	—
Corporate Sector	**1997**	**1998**	**1999**	**2000**	**2001**	**2002**	**2003**	**2004**
Corporate Debt/GDP	140.0	143.9	123.9	118.0	114.2	107.2	105.8	—
Enterprise Delinquency Ratio to Banks	—	8.9	4.4	3.4	2.1	2.0	2.1	—
								—
Debt Ratio to Equity	396.3	303.0	214.7	210.6	182.2	135.4	123.4	—
Debt Ratio to Total Assets	54.2	50.8	42.8	41.2	39.8	31.7	28.3	—
Debt Ratio to Sales	66.4	62.7	52.8	42.7	40.1	29.8	26.6	—
								—
Interest Coverage Ratio[a]	129.1	68.3	96.1	157.2	132.6	260.3	367.1	—
% of Companies < 100	41.4	45.8	32.6	26.3	28.6	23.5	26.2	—
Current Assets/Current Liabilities	91.8	89.8	92.0	83.2	97.9	106.1	109.8	—
								—
Operating Income/Sales	8.3	6.1	6.6	7.4	5.5	6.7	6.9	—
Financial Expenses/Sales	(6.4)	(9.0)	(6.9)	(4.7)	(4.2)	(2.6)	(1.9)	—
Ordinary Income/Sales	(0.3)	(1.9)	1.7	1.3	0.4	4.7	4.7	—
Household Sector	**1997**	**1998**	**1999**	**2000**	**2001**	**2002**	**2003**	**2004**
Household Credit (% of GDP)	41.1	37.9	38.6	45.3	54.3	62.5	59.9	
of which: Commercial Bank	10.8	10.9	13.8	18.2	24.9	31.6	34.0	
Delinquency Ratio (%)								
Bank Loan	—	—	2.4	2.5	1.3	1.5	1.8	—
Credit Card Debt	—	—	—	—	—	6.0	14.1	—
Including Re-aged Loans	—	—	—	—	—	5.2	21.5	—
Delinquent Individuals (million persons)	—	—	—	2.08	2.45	2.63	3.72	—
of whom: Credit Card Related	—	—	—	0.80	1.04	1.51	2.40	—
Housing Prices (% change)	2.0	(12.3)	3.4	0.4	9.9	16.4	5.7	—
of which: Seoul	2.0	(13.2)	5.5	3.0	13.0	22.5	6.8	—
Ratio of Housing Price to Rent	100	108	95	86	81	86	92	—
of which: Seoul Apartment	100	110	93	87	84	99	112	—

— = data not available, AMC = asset management company, EOP = end of period, GDP = gross domestic product, NPL = nonperforming loan.

[a] Operating income to gross interest payments.

Sources: International Monetary Fund and Asian Development Bank Asian Regional Information Center online query.

Table A1.3: Social and Poverty Indicators, 1997–2003

Indicator	1997	1998	1999	2000	2001	2002	2003
Poverty, Income, and Human Development							
Income Per Capita Index (1996 = 100)	103.8	95.6	103.7	111.5	114.8	121.8	126.0
Poverty Incidence, % of Total Population Below Official Poverty Line	—	19.2	—	—	—	—	—
Per Capita Real Private Consumption Expenditure Index	102.5	87.7	96.9	104.2	108.4	115.9	114.7
HDI Value	0.85	0.85	0.88	0.88	—	0.89	0.90
HDI Rank	30	31	27	27	—	28	28
GDP per Capita (PPP US$)	13,590	13,478	15,712	17,380	—	16,590	17,971
Social Safety Nets							
Central Government Expenditure on Social Safety nets as % of Total Expenditure	11.8	13.5	14.5	6.5	—	—	—
Government Social Expenditure Index (1996=100)	107.0	108.8	116.2	130.3	170.0	171.1	184.5
Government Social Expenditures as % of Total Government Expenditure	28.1	26.4	25.6	26.6	31.9	29.9	30.8

GDP = gross domestic product, HDI = human development index, PPP = purchasing power parity.
Sources: ADB Asian Regional Information Center online query; and United Nations Development Programme (UNDP) Human Development Report, various issues.

POLICY AREAS SUPPORTED BY MULTILATERAL FINANCIAL INSTITUTIONS

Policy Conditions/Policy Measures	IMF MEP	WB ERL[a]	ADB FSP
A. Capital Account Liberalization			
1. Equity market	Dec 97		
2. Bond market	Dec 97		
3. Money market	Dec 97/Feb 98		
4. Corporate borrowings	Dec 97/Feb98		
5. Financial sector	Dec 97		Dec 97
a. Passage of Banking Act			
b. Foreign banks and brokerage houses to establish subsidiaries	Dec 97		Dec 97
6. Foreign borrowing	Dec 97		
B. Exchange Rate and Reserve Management Policy	Dec 97/Feb 98		
C. External Debt Monitoring	Feb 98		
D. Fiscal Policy	Feb 98		
E. Macroeconomic Framework	Dec 97	Dec 97	
F. Monetary Policy	Dec 97/Feb 98		
1. Reliance on open market operations─reduce reserve requirements of banks to 3.3%			Dec 97
G. Banking Systems			
1. Strengthening the regulatory and institutional framework			
a. Financial sector restructuring	Dec 97	Dec 97/Mar 98	
b. Deposit insurance scheme	Dec 97	Dec 97	
c. Prudential supervision and regulation	Feb 98	Dec 97/Mar 98	
d. Amend Bank of Korea Act	Dec 97		Dec 97
e. Legislation in closure of financial institutions, allocation of losses, and equity write-down	Dec 97		
f. Legislation to allow full write-down of existing shareholders' equity	Feb 98		
g. Foreign participation in banks	Dec 97	Dec 97/Mar 98	
2. Resolution of merchant banks	Dec 97/Feb 98	Dec 97/Mar 98	Dec 97
3. Resolution of Korea First Bank and Seoul Bank	Dec 97/Feb 98	Mar 98	Dec 97
4. Commercial banks			
a. Data quality on portfolios and capital adequacy	Feb 98	Mar 98	Dec 97
b. Viability of banks (meet BIS capital adequacy standards)	Dec 97/Feb 98	Mar 98	Dec 97
c. Verify viability and enforcement action	Feb 98	Mar 98	Dec 97
d. Profitability in CAMEL ratings			Dec 97
e. Loan loss provisioning and mark-to-market accounting			Dec 97
f. Current ratio of FX assets and liabilities to 70%			Dec 97
g. Current ratio to FX assets and liabilities raised to normal banking standard			Dec 97
5. KAMCO and bridge bank operations	Dec 97/Feb 98	Mar 98	Dec 97
6. Transparency of government support	Dec 97/Feb 98	Mar 98	Dec 97
a. Information	Feb 98	Mar 98	
H. Capital Markets and Funds			
1. Promote competition between financial service providers		Mar 98	
2. Debt market reforms		Mar 98	
3. Strengthening the regulatory and institutional framework			
a. Prudential supervision and regulation		Mar 98	Dec 97
b. Foreign participation in capital markets	Dec 97	Dec 97	Dec 97
4. Government bonds			Dec 97
5. Corporate bonds	Dec 97		Dec 97
6. Credit rating agencies			Dec 97
7. Equity market	Dec 97		Dec 97
8. Mortgage-backed securities			Dec 97
9. Insurance			Dec 97
10. Pensions			Dec 97
11. Derivatives market			Dec 97
I. Nonbanking Financial Institutions			
1. Strengthening prudential supervision and regulation			Dec 97

Policy Conditions/Policy Measures	IMF MEP	WB ERL[a]	ADB FSP
2. Insurance companies			
a. Permit entry of five largest chaebols to the insurance market			Dec 97
b. Solvency regulations			Dec 97
c. Review insurance companies' 1997 performance			Dec 97
d. Annual ratings of insurance firms by ISB			Dec 97
e. Liberalize nonlife insurance premiums			Dec 97
3. Securities companies			
a. Prudential supervision and regulations		Mar 98	Dec 97
b. Corporate bond guarantees not > 10% of equity			Dec 97
4. Pension funds			
a. Prudential supervision and regulations		Mar 98	
b. Pension Review Committee report			Dec 97
c. Mandatory contribution rate up to 9% for industrial workers in 1998			Dec 97
J. Assistance to Small and Medium Enterprises	Feb 98		
K. Competition Policies			
1. Competition and efficiency in financial and industry sectors		Dec 97/Mar 98	
2. Operational capacity of KFTC		Dec 97/Mar 98	
L. Corporate Governance and Restructuring			
1. Transparency: Corporate accounting and disclosure standards	Dec 97/Feb 98	Dec 97/Mar 98	Dec 97
2. Accountability to shareholders	Feb 98	Dec 97/Mar 98	Dec 97
3. Corporate restructuring	Feb 98		
4. Bankruptcy procedures	Dec 97	Mar 98	
M. Trade Policy			
1. Trade-related subsidies	Dec 97		
2. Import liberalization	Dec 97		
3. Financial services liberalization	Dec 97		
N. Labor Market and Social Safety Net			
1. Labor market			
a. Labor market flexibility	Dec 97	Mar 98	
b. Functioning of labor market	Feb 98	Mar 98	
c. Worker protection	Feb 98	Mar 98	
d. Gender equality		Mar 98	
2. Protecting the poor			
a. Poverty monitoring		Mar 98	
b. Targeting of public antipoverty programs		Mar 98	
3. Pension system			
a. Income support for elderly		Mar 98	
b. Transparency and efficiency of pension fund management		Mar 98	
c. Long-term financially sustainable pension system		Mar 98	
O. Economic Management and Public Policy			
1. Economic policy making		Mar 98	
2. Debt and asset liability management		Mar 98	
3. Streamline public administration		Mar 98	

ADB = Asian Development Bank; BIS = Bank for International Settlements; CAMEL = capital adequacy, asset quality, management, earnings, and liquidity; ERL = Economic Reconstruction Loan; FSP = Financial Sector Program; FX = foreign exchange; IMF = International Monetary Fund; ISB = Insurance Supervisory Board; KAMCO = Korea Asset Management Corporation; KFTC = Korean Fair Trade Commission; MEP = Memorandum on Economic Program; WB = World Bank.
[a] Policy matrix of the ERL was revised on March 1998.
Source: Operations Evaluation Mission.

POLICY MATRIX AND STATUS OF COMPLIANCE WITH REFORMS

Program Components and Conditions	Status of Compliance at Evaluation
I. Banking: Ensure resilience of the banking system through increased reliance on market forces with independent regulatory oversight.	
A. Restructure viable financial institutions to restore stability and ensure capital adequacy of banking institutions.	
1. The Government announced in August 1997 that KAMCO would buy nonperforming assets from banks. The initial fund was set at W3.5 trillion and was increased to W10 trillion as of 19 November 1997. (tranche 1)	1. **Complied with** before loan approval.
2. Review funding requirements for KAMCO relative to conglomerate bankruptcies since 19 November 1997 and make necessary arrangements for the additional financing required. (tranche 2)	2. **Complied with.** Following a review of KAMCO's funding requirements, the Government arranged W39.0 trillion for the NPAMF. Of the funding mobilized, W20.5 trillion was by way of NPAMF bonds, W0.6 trillion from financial institutions, W0.5 trillion from KDB, and W17.4.trillion from recovered funds.
3. Fully implement business plan of KAMCO. Complete arrangements for acquisition of bank's NPLs to reduce NPLs by one half of their end-September 1997 level of W21.5 trillion. (tranche 3)	3. **Complied with.** As of April 2005, KAMCO purchased W39.0 trillion worth of NPLs. Of the total NPLs, 63.1% (W24.6 trillion) was from commercial banks, 21.8% (W8.5 trillion) from securities and investment trust companies, 4.6% (W1.8 trillion) from surety insurance companies, and 0.5% from merchant banks.
4.Finalize acquisition and pricing of NPLs. (tranche 3)	4. **Complied with.** For this, KAMCO used the following pricing methods: • **Secured Loans:** the recent average foreclosure auction rate of comparable collateral assets, adjusted by price fluctuations; • **Unsecured Loans:** 3% of the face value. By mid-2000, more than 50% of the NPLs had been purchased by KAMCO. The ratio of NPLs in the banking system had declined to 1.90% at the end of 2004.
5. KAMCO will seek to maximize recovery from purchased loans. (tranche 4)	5. **Complied with.** KAMCO recovered 90.5% of funds injected by the end of April 2005. Of the recovered funds which amounted to W35.3 trillion, W1.6 trillion was through international auction; W6.8 through other issues and sales; W11.8 trillion by individual sale, court auction, and direct recovery; and W4.8 trillion from Daewoo bond redemption. However, W10.3 trillion consisted of "reverse and cancellation" operations under which an asset required by KAMCO is returned to the originating institution, at the original purchase price, net of interest. Recovery techniques have included foreclosure auctions, packaged loan sales, collections, and voluntary repayment.
B. Reestablish confidence in financial sector institutions through initial government protection augmented by full reliance on credit analysis for future back lending with increased management accountability to shareholders for profitability.	
6. The Government provided broad protection to depositors, investors, and the creditors of financial institutions against potential losses for 3 years, effective 18 November 1997. At the end of 3 years, the Government's broad protection will be replaced by a limited deposit insurance scheme. (tranche 1)	6. **Complied with** before loan approval.

Program Components and Conditions	Status of Compliance at Evaluation
7. In 1997, a Loan Committee system was introduced in commercial banks for collective decision making relative to proposed credits. (tranche 1)	7. **Complied with** before loan approval.
8. Eliminate formal and informal government approval, permission, and control over managerial decisions of banks. (tranche 2)	8. **Complied with.** Prime Minister's Decree 408, issued 13 November 2000, eliminated formal and informal government control over the managerial decisions of banks.
9. Encourage stock options (approved in April 1997) for bank management by increasing understanding of the role of such systems as managerial incentive schemes to encourage bank profitability. (tranche 3)	9. **Complied with.** To encourage stock options for bank management, the Government introduced tax exemptions on capital gains from exercising options in August 1997. Since the Housing and Commercial Bank Corp introduced a stock option scheme for its chair in October 1998, several commercial banks have followed this approach. Stock option schemes in some less sound banks are structured so that capital gains depend not just on stock price performance relative to the industry average but also on the capital adequacy ratio (CAR) or the level of NPLs. In 2000, a standard model of management stock option was established to help more firms introduce such system. In 2003, the Financial Supervisory Commission (FSC) introduced several measures to promote a performance-related stock option, transparent and fair option award, option award within total compensation, transparent disclosure of option award, and proper accounting of stock options.
10. Apply stringent standards with respect to profitability in CAMEL ratings.[a] (tranche 3)	10. **Complied with.** In June 1998, the Bank Supervisory Authority (BSA)[b] adopted the "operational expense/revenues ratio" as one of the indices of earnings in the CAMEL ratings. Due consideration is given to profitability when the Financial Supervisory Service (FSS) determines management scores of individual banks.
C. Enhance regulatory measures with independent oversight. Amendment of the Bank of Korea (BOK) Act to provide for BOK independence and autonomy 11. Annual inflation target to be set in consultation with the Government minister concerned, 12. Operational independence granted to BOK, and 13. Restructuring of the Monetary Board to give effect to operational independence. (tranche 2)	 11–13. **Complied with.** The National Assembly approved amendment of the BOK Act to guarantee BOK's operational independence and autonomy at its 186th session on 29 December 1997. Under the amended Act (Act 5491), the governor of BOK chairs the Monetary Board, a decision-making body for monetary and credit policies; and BOK sets the annual inflation target in consultation with the Ministry of Finance.
14. Enactment of a bill (expected by December 1997) to consolidate supervision of all commercial banks, specialized banks, merchant banks, securities firms, and insurance corporations in a body with operational and financial autonomy and with the powers needed to restructure and exit ailing institutions. (tranche 2)	14. **Complied with.** The National Assembly passed the act for the Establishment of the Financial Supervisory Institutions (Act 5490) on 29 December 1997. Under this act, supervision of all commercial banks, specialized banks, merchant banks, securities firms, and insurance corporations is consolidated in a body with operational and financial autonomy and with the powers needed to restructure and resolve ailing institutions.
15. Review prudential standards with approval of an action plan to meet the Basle Core Principles. (tranche 3)	15. **Complied with.** In August 1998, the Bank Supervisory Authority (BSA) introduced a program for meeting the Basle Core Principles. The major tightening of prudential regulations included • Deduction from Tier 2 capital all provisioning of assets except those classified as "normal" and "precautionary" (1 January 1999); • Assets in trust accounts with guarantees to be weighted at 50% from 1 January 1999 and 100% from 1 January 2000;

Program Components and Conditions	Status of Compliance at Evaluation
	• Rules to be applied to all trust accounts ensuring segregation for management as well as accounting purposes (1 January 2000); and • Revising loan classification criteria to reflect capacity to repay in addition to past performances (December 1999). In addition, prudential regulations were introduced so that loans of more than 90 days past due would be classified as "substandard" or lower (1 July 1998), and the provisioning rate for "precautionary" assets was increased from 1% to 2% (1 July 1998). **Loan Classification** — **Provisioning Rate** (%) Normal — 0.5 Precautionary — 2.0 Substandard — 20.0 Doubtful — 50.0 Estimated loss — 100.0
16. Fully implement the Basle Core Principles. (tranche 4)	16. **Complied with.** Forward-looking criteria (FLC) were introduced on a trial basis on 30 June 1999, and took effect in January 2000. Under FLC, banks are required to use loan classification standards based upon the prospects of debtors to generate sufficient future cash flow, instead of standards based entirely on delinquency criteria. The Korean Banking Institute offered training courses to bankers on how to assess the health of banks based on FLC. The supervisory authorities have reflected the Basle Core Principles to the concerned enactments and have inspected and guided the compliance of banks continuously. The items like approval, admission, minimum capital ratio, regulations and detailed rules of supervision *of* banks, which enactments are needed, are specified in the Bank Law. For the items to inspect and to guide, such as risk management system and operational controls, the authorities evaluate the whole concerned systems and compliance of banks by inspection visits, continuous watch and evaluation of management, and demand of necessary measures to fix if needed. Most of the 25 Basle Core Principles are applied substantially to the supervision of banks. However, the international mutual assistance systems with foreign supervisory authorities are not sufficient. At present, channels for information exchange and cooperation like the conference call with Federal Reserve Board of America, yearly conference with Financial Supervisory Authority of England have been constructed and make great efforts for extension to Japan, People's Republic of China, and some other nations.
17. Basle capital adequacy standard of 8% in place with scheduled implementation of loan loss provisions. (tranche 1)	17. **Complied with.**
18. Establish a timetable for all banks to meet or exceed the Basle capital adequacy standards. (tranche 3)	18. **Complied with.** Table A4.3 in Appendix 4 summarizes the status of the 17 commercial banks' compliance with these standards. As of December 2004, there were no banks that could not meet the Basle capital adequacy standard of 8%.The average capital adequacy standard of the 17 commercial banks was 11.30. It was 10.53 in 2001, 10.81 in 2002, 10.52 in 2003, and 10.45 in 2004.

Program Components and Conditions	Status of Compliance at Evaluation
19. Fully implement loan loss provisioning and mark-to-market accounting. (tranche 3)	19. **Complied with.** The FSS required banks to make provisions of 100% of actual loan losses and valuation losses on marketable securities investments. Mark-to-market accounting for won-denominated bonds is required from 1 January 1999.
20. Completed review of accounting and disclosure practices for all off-balance sheet items with the January 1996 Bank Supervisory Board regulation on derivatives. (tranche 1)	20. **Complied with** before loan approval.
21. Raise the current ratio of banks' foreign exchange assets and liabilities to 70% (from 60% in August 1997). (tranche 3)	21. **Complied with.** Previously, BOK raised the required current ratio of banks' foreign exchange assets and liabilities to 70%.
22. The current ratio of banks' foreign exchange assets and liabilities will be raised to normal banking standards. (tranche 4)	22. **Complied with.** The FSS now uses the "maturity ladder" approach, under which banks are required to have (i) foreign assets with a maturity of 3 months or less equal to no less than 80% of foreign currency liabilities of 3 months or less, (ii) a positive mismatch in the 7-day period, and (iii) a negative mismatch of no more than 10% in the 1-month period. Observance of these limits is monitored on a monthly basis. In addition, the short-hand position (i.e., the greater between the sum of overbought positions and the sum of oversold positions) of any bank may not exceed 20% of the bank's capital.
D. Improve competitiveness in the banking system by opening access for new entrants and reducing costs of operating a bank.	
23. No limitation on entry to the banking and nonbanking industries by domestic financial entrepreneurs, except for prudential considerations. (tranche 1)	23. **Complied with** before loan approval.
24. Permit foreign banks to establish bank subsidiaries. (tranche 3)	24. **Complied with.** The General Banking Act (December 1997) was revised to allow foreign banks to establish bank subsidiaries with permission from the Ministry of Finance and Economy (MOFE).
25. To allow banks to be competitive with nonblank financial institutions, the Monetary Board intends to reduce reserve requirements, commensurate with monetary policy needs, as reliance on open market operations in increased. (tranche 1)	25. **Complied with** before loan approval.
26. Reserve requirement was reduced from 9.4% in 1995 to 3.3% in February 1997. (tranche 1)	26. **Complied with** before loan approval.
27. BOK will place full reliance on open market operations for the implementation of monetary policy so that the reserve requirements for banks will be reduced from the current level of 3.3%.[c] (tranche 4)	27. **Not complied with.** Reserve requirements were being retained to protect against risks associated with delays in settlements among banks.[d] BOK and MOFE contend that, under existing circumstances, lowering of reserve requirements would complicate monetary management and contribute to inflationary pressures. BOK has been placing increasing emphasis on open market operations for monetary management. However, reserve requirements have not changed since February 1997. The requirement is 1.0% for labor wealth-forming deposit, labor long-term deposit, labor house provision deposit, long-term house provision deposit, household long-term deposit, and labor preference

Program Components and Conditions	Status of Compliance at Evaluation
	deposit, etc.; 2.0% for term deposit, term installment deposit, mutual savings, housing savings, and deliverable Certificates of Deposits; and 5.0% for other deposits. The weighted average of reserve requirements was 3.03% in June 2005.
E. Exit of nonviable banking institutions	
28. Financially distressed banks are encouraged to implement rehabilitation plans. (tranche 1)	28. **Complied with** before loan approval.
29. Exits through mergers and acquisitions and, if necessary, through closures could be final measures to deal with troubled banks. (tranche 1)	29. **Complied with** before loan approval.
30. Develop rehabilitation plans for the two distressed banks. (tranche 3)	30. **Complied with.** Initial rehabilitation plans of the two banks, Seoul Bank and Korea First Bank, were approved by BSA in February 1998. The plans covered aspects such as lay-offs, disposal of subsidiaries, and closure of branches.
31. Explore mergers with another financial institution or disposal of some or all of their banking business to restore profitability to an acceptable level and meet minimum solvency requirements. (tranche 3)	31. **Complied with.** In January 2005, Standard Chartered Bank purchased a 48.56% stake of Korea First Bank and a 51.44% (KDIC 48.49%, MOFE 2.95%) for W3.4 trillion. Seoul Bank, wholly owned by the Government (KDIC) since 1998, was merged with Hana Bank in 2002 for a 30.9% stake in the merged bank. KDIC planned to sell 60% of its stake within a year.
II. Nonbank Financial Institutions: Improve access and provide financial services on a competitive basis.	
A. Merchant Banks: Improve exit policies.	
32. Foreign participation of 100% in existing merchant banks was allowed from 1 January 1997. (tranche 1)	32. **Complied with** before loan approval.
33. The Government suspended nine merchant banks effective 2 December 1997, and a further five effective 10 December 1997. (tranche 1)	33. **Complied with** before loan approval.
34. Agree on recovery/rehabilitation program for suspended merchant banks or closure within 4 months from the date of official suspension. (tranche 3)	34. **Complied with.** In February 1998, rehabilitation plans for troubled merchant banks were submitted to the Merchant Banks' Rehabilitation Evaluation Committee. On the basis of these plans, licenses of 22 (of 30) merchant banks were revoked by January 2005; these banks were closed. The assets and liabilities of the closed merchant banks were taken over by a bridge bank. Between 1999 and 2003, seven merchant banks were merged into banks or securities firms.
35. Full implementation of merchant bank restructuring program. (tranche 4)	35. **Complied with.** Of 30 merchant banks in operation at the end of 1997, only 2, Hanbul and Kumho, remained in operation in June 2005. Hanaro, a merchant bank established by KDIC to help restructure four merchant banks (Hankook, Hans, Joong-ahng, and Youngnam) in 2000, was merged into Woori Finance Group in 2003. Regulations for merchant banks are now similar to those for commercial banks and include limits on connected lending and large exposures. Merchant banks were required to meet a minimum risk-adjusted CAR of 6% by June 1998 and 8% by June 1999. Currently, Hanbul and Kumho maintain CARs well over the minimum requirement (39.3 and 11.3, respectively). Loan classification and provisioning norms for merchant banks were also gradually made comparable with those imposed on commercial banks.

Program Components and Conditions	Status of Compliance at Evaluation
36. The Government announced in August 1997 that KAMCO would buy nonperforming assets, including those of the suspended merchant banks referred to above. (tranche 1)	Merchant banks that failed to meet the performance criteria were subject to strict penalties culminating in closure. At the end of 1997, 30 merchant banks were in operation in Korea, but only 2 remained in June 2005. 36. **Complied with** before loan approval.
B. Securities Companies: Enhance investor protection.	
37. The ceiling on the amount of guarantees of corporate bonds that can be issued by securities companies was reduced from 200% of their equity capital to 100% in July 1997. (tranche 1)	37. **Complied with** before loan approval.
38. The government-mandated ceiling on brokerage commissions was abolished on 1 September 1997. (tranche 1)	38. **Complied with** before loan approval.
39. Fully implement the requirement that the amount of corporate bonds that can be guaranteed by a securities company should be no more than 100% of its equity capital. (tranche 3)	39. **Complied with.** Effective June 2005, securities companies were no longer allowed to provide guarantees for corporate bonds as had been the case since 1998.
40. Review the regulatory framework for securities companies to enhance investor confidence. (tranche 3)	40. **Complied with.** A review of the supervisory regulations for securities companies was undertaken.
41. Issue revised supervisory guidelines, if necessary, following consultations with the Asian Development Bank (ADB). (tranche 3)	41. **Complied with.** New regulations were issued in April 1998. While ADB was not consulted, subsequent review indicates that the supervisory guidelines are appropriate.
C. Insurance: Improve insurance services by increasing competitiveness within the industry.	
42. The economic needs test for new entrants to the insurance industry, as determined by the Government, was eliminated in January 1997. (tranche 1)	42. **Complied with** before loan approval.
43. The restriction on the five largest chaebols that prevented their entrance into the insurance industry was eliminated in August 1997 and will be effective upon the issuance of the implementing guidelines. (tranche 1)	43. **Complied with** before loan approval.
44. Issue guidelines that permit entrance of the five largest chaebols to the insurance market. (tranche 3)	44. **Complied with.** Notifications issued in February 1998 provide opportunities for the five largest chaebols to gain access to the insurance market by rescuing insolvent insurance companies. However, no chaebols have entered the insurance market so far. After SK Group sold SK Life Insurance to Mirae Asset Finance Group in 2005, only Samsung group holds Samsung Life Insurance and Samsung Fire Insurance. Moreover, they have not acquired any insolvent insurance companies so far.
45. A prudential solvency ratio (capital to total liabilities) of 1% was imposed in 1994. Some of the newly established insurance companies are facing difficulties in meeting the solvency ratio, and 7 of the total of 50 insurance companies are under sanction as a result of their failure to meet this ratio in the fiscal year ending 31 March 1996. (tranche 1)	45. **Complied with** before loan approval.
46. Fully implement solvency standards and provide ADB with a complete review of individual insurance companies' 1997	46. **Complied with.** The existing prudential ratio 1% (capital to liabilities) imposed in 1994 was substituted by minimum solvency standards whereby

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performance. (tranche 3)	assets were required to exceed liabilities. All 23 life insurance companies and the 27 nonlife insurance companies met the minimum solvency standards as of December 2004. However, in April 2004, Noksipja Life Insurance Company was warned by the FSS to improve its solvency standard, which it did by the end of 2004.
47. Discuss with ADB measures to be taken according to solvency regulations for ailing insurance companies and enforce exits as necessary for nonviable insurance companies. (tranche 3)	47. **Complied with.** In 1998, the Appraisal Committee for the Rehabilitation Plan evaluated the rehabilitation plans of 22 insurance companies that failed to meet solvency margin standards or had liabilities in excess of assets. On the basis of this evaluation: • seven life insurance companies and two nonlife insurance companies were given notice to take steps to meet minimum solvency margin requirements by the end of FY1998; • seven life insurance companies were given execution plans requiring that they reduce their solvency margin shortage to 10% by March 1999, to 5% by March 2000, and to minimum solvency margin requirements by September 2000; • four life insurance companies were closed by the FSC and their business transferred to four healthier companies; and • the FSC forced the merger of two nonlife surety insurance companies. As was described above, all insurance companies meet minimum solvency margin requirements as of June 2004.
48. Require annual ratings of all insurance firms by the Insurance Supervisory Board, and the posting of these ratings in all their offices, with full reports available to customers on request. The regulatory agency will periodically publish a complete set of ratings with public explanations. (tranche 3)	48. **Complied with.** The FSS amended the management practice evaluation of insurance companies in April 2003 to enable them to determine ratings for life and nonlife insurance companies. These ratings take into consideration various financial and nonfinancial factors. Based on capital adequacy, asset quality, management, earnings, liquidity (CAMEL), ratings for all life insurance companies and nonlife insurance companies including Korean branches of foreign companies and foreign branches of Korean companies were given by the FSS as one of five grades: 1 (excellent), 2 (good), 3 (average), 4 (weak), 5 (risky). The only exceptions are insurance companies established within 2 years. The ratings of life and nonlife companies were disclosed by the agency.
49. Continue implementation of actions required under the solvency regulations. (tranche 4)	49. **Complied with.** The FSS lowered the standard interest rate applied to reserve requirements from 4.75% to 4.25% so that nonlife insurance companies build up more reserved capital. The government authorities have tried to help restructuring of the life and nonlife insurance industry since 1997. Although 20 of 50 insurance companies were closed, merged, or acquired since 1997, as the same number of newcomers started their businesses in the market, so there are still 50 insurance companies operating in the saturated market (22 life insurance and 28 nonlife insurance companies). Moreover, bank assurance orchestrated by commercial banks and securities companies triggered cut throat competition in the market. To enhance the financial soundness of insurance companies in reference to the current inefficient but highly saturated market, the FSC will introduce the risk assessment and application system (RAAS) in 2006, which systematically

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	evaluates the risk status of an insurance company such as risk exposure and risk management capacity so that the agency can focus its monitoring resources on the weakest area. The FSC will also introduce the risk-based capital (RBC) regulation system in 2007, which estimates all the potential risk of the insurance company and demands that the company maintain sufficient solvency by requesting to provide equity enough to match fully the perceived risk.
50. Premiums were uniformly subject to prior approval of Government, but since 1993, liberalization has gradually been adopted. (tranche 1)	50. **Complied with** before loan approval.
51. Liberalize completely nonlife insurance premiums. (tranche 3)	51. **Complied with.** Following the deregulation of rates for auto insurance in August 1998, nonlife insurance premiums have all been deregulated.
D. Pensions: Introduce more market-determined asset management.	
52. In May 1997, a pension review committee was established to develop measures to reform the national pension scheme. (tranche 1)	52. **Complied with** before loan approval.
53. Final report of the pension review committee to be issued. (tranche 2)	53. **Complied with.** Final report of the Pension Review Committee was issued on 27 December 1997. The report recommended (i) division of the pension formula into a basic and earnings-related portion, (ii) distinction between the management of the basic fund component and the earnings-related component, (iii) reduction of the benefit formula, (iv) gradual increase of the retirement age from 60 to 65, (v) revision of actuarial estimates every 5 years with an adjustment to the premium level as necessary (after 2009), and (vi) extension of coverage to the urban self-employed.
54. Raise the mandatory contribution rate to 9% for industrial workers in 1998. (tranche 3)	54. **Complied with.** In 1998, the mandatory contribution rate for industrial workers was raised from 6% to 9% with employers, employees, and the retirement pension reserve each required to contribute 3%. Since 1999, employers and employees are each required to contribute 4.5% for an aggregate contribution of 9% under the National Pension Act.
55. Discuss with ADB recommendations of the Pension Review Committee, including the implementation schedule, and implement recommendations acceptable to the Government. (tranche 3)	55. **Complied with.** The final report of the Pension Review Committee was provided to ADB, and its recommendations were reviewed and discussed with the Government. Based on the discussions, the Government revised the National Pension Act in December 1998. Among the revisions, self-employed workers, including farmers and fishermen, will be covered by the Plan. Their initial contribution rate was 3% in 1999 but increased by 1% every year to 9% in 2005.
E. Enhance independent regulations and strengthen prudential and supervisory functions.	
56. Deficiencies in the regulation of nonblank financial institutions are fully recognized. (tranche 1)	56. **Complied with** before loan approval.
57. Enactment of a bill to ensure independent regulation as noted above under the banking section. Amendment of the regulatory framework for nonbank financial institutions to	57. **Complied with.** The regulatory framework for nonbank financial institutions has been revised to undertake needed improvements and to develop effective enforcement mechanisms through the passage of the

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undertake any needed improvements and to develop effective enforcement mechanisms. (tranche 2)	following legislation on 19 December 1997: • The Act for Establishment of the Financial Supervisory Institutions • Financial Industry Restructuring Act • Merchant Bank Act • Trust Business Act • Credit Union Law • Insurance Business Law • Mutual Savings and Finance Companies Act
III. Financial Markets: Improve the range of financial services and efficiency of these markets through enhanced competition and an independent regulatory framework.	
A. Government Bonds	
58. Government bonds outstanding at end-August 1997 amounted to W27 trillion. There are 5 different types of active government securities. While normally competitive, the present government auction procedures result in lower than market interest rates with negative impacts on the development of capital markets.[e] (tranche 1)	58. **Complied with** before loan approval.
59. The National Debt Management Fund Bond consolidated four public sector issues in 1994. There is a need to further consolidate the remaining issues to provide uniform government bonds with standard interest rate mechanisms. (tranche 1)	59. **Complied with** before loan approval.
60. The internal preset rate in the auctioning of government securities is to fully reflect the market rate in the secondary market. (tranche 2)	60. **Complied with.** MOFE eliminated the preset mechanism effective July 1999.
61. Delete the preset rate mechanism in auctioning of government securities to ensure that the system is fully market determined. (tranche 3)	61.**Complied with.**
62. Consolidate grain security bonds with National Debt Management Fund bonds. (tranche 3)	62. **Complied with.** In 1999, the Government revised the relevant law to consolidate grain security bonds with Treasury bonds (formerly known as National Debt Management Fund bonds). Since 2003, foreign exchange destabilization bonds were issued as converted to Treasury bonds, and government loans are also expected to be converted to Treasury bonds.
63. Standardize the interest payment mechanisms of the government bonds issued via auction to simplify trading and pricing in the secondary market. (tranche 4)	63. **Complied with.** As of March 2001, there are four categories of government bonds: Treasury bonds, foreign exchange destabilization bonds, national housing bonds, and compensation bonds. Of these, Treasury bonds and foreign exchange stabilization bonds are issued at auction, and their interest payment mechanisms are standardized as follows: • Maturity of 1 year or less: payment at maturity date; and • Maturity of more than 1 year: payment every 3 months. In April 2005, MOFE announced a new plan to issue STRIPS (Separate Trading of Registered Interest and Principal of Securities), inflation-linked bonds, and treasury bonds with maturity longer than 10 years to enhance the liquidity of the government bond market.

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B. Corporate bonds	
64. Foreign investors are permitted to invest in corporate bonds issued beginning 15 December 1997 up to 30% (50% for nonguaranteed convertible bonds issued by large companies) of each corporate bond offering, with individuals able to hold up to 10%. With respect to nonguaranteed SME bonds, the ceiling has been abolished. (tranche 1)	64. **Complied with** before loan approval.
65. Increase the percentage limits of corporate bonds that may be held by foreign investors in consultation with ADB. (tranche 3)	65. **Complied with.** The ceiling on foreign ownership of all KSE-listed bonds was abolished in December 1997. Effective July 1998, foreign investors are allowed to hold unlisted bonds and engage in repurchase transactions.
C. Credit-Rating Agencies	
66. The capability of rating agencies is limited. Due to a default of a highly rated bond, a rating agency was suspended for a month by SMC. (tranche 1)	66. **Complied with** before loan approval.
67. Encourage domestic CRAs to undertake institutional strengthening programs to increase financial analysis capability. (tranche 3)	67. **Complied with.** New standards on licensing for nonguaranteed bonds came into effect in 1999. These standards are intended to prevent moral hazard and enhance institutional strengthening and reporting requirements. Measures to prevent moral hazard include prohibitions on the issuance of rating on companies with which the CRA has close ownership relations. The CRAs are also required to report default ratios on companies they have rated. Further measures to strengthen the bonds institutionally include a paid-in capital of W5 billion and the employment of at least 30 qualified analysts. As of June 2005, Moody's holds a 50% + 1 share in one domestic agency and Fitch holds about 7.41% stake in another agency (Korea ratings).
68. Each time a company issued a nonguaranteed bond, ratings above investment grade (BBB) from two rating agencies were previously required. As of June 1997, a company's rating is valid for 6 months, the company may issue bonds during the period based upon the rating, and the minimum BBB rating has been waived. From 27 September 1997, the Government has opened the domestic market to international rating agencies and allowed them to establish subsidiaries and joint ventures. (tranche 1)	68. **Complied with** before loan approval.
D. Equity market	
69. KSE. The KSE has a substantial history of success. However, the stock market capitalization stood at 30% of GDP in 1996, well below its potential. (tranche 1)	69. **Complied with** before loan approval.
70. In May 1996, the Stock Market Stabilization Fund was eliminated. (tranche 1)	70. **Complied with** before loan approval.
71. In September 1996, stock supply coordination was abolished and public offerings were liberalized. (tranche 1)	71. **Complied with** before loan approval.
72. On 25 November 1996, the daily price change limit to prevent excessive short-term price fluctuations was increased from 6% to 8% of the previous day's closing price. (tranche 1)	72. **Complied with** before loan approval

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73. On 1 September 1997, manual trading was abolished. All orders are handled by a computerized trading system, the Stock Market Automated Trading System (SMATS), while transaction results are automatically transmitted to securities firms. Competitive price discovery occurs at the point of sale (i.e., a fully competitive interaction between buyers and sellers determines the price). (tranche 1)	. 73. **Complied with** before loan approval.
74. The limit on foreign investors' shareholding in a KSE-listed company was raised on 1 May 1997 to 235 and on 3 November 1997 to 26%, while individual investors will be able to increase their stake in listed companies from 6% to 7%. (tranche 1)	74. **Complied with** before loan approval.
75. The limit on foreign ownership in a KSE-listed company is raised to 50% by December 1997. (tranche 2)	75. **Substantially complied with.** The limit on foreign ownership in a KSE-listed company was raised to 50% on 11 December 1997, and restrictions were abolished in May 1998.
76. Limit foreign ownership in KSE-listed companies to 55% by December 1998. (tranche 3)	76. **Substantially complied with.** Since March 2001, however, the foreign ownership limits remain on seven companies operating in strategic industries such as telecommunications and airlines.
77. Over-the-counter market (KOSDAQ). The KOSDAQ, established in July 1996 to raise capital for small and medium-sized companies (now lists 364 companies), was opened to foreign investment on 1 December 1997 to provide increased assistance to small and medium industries (up to 15% in a company listed on the KOSDAQ, while the limit on a single foreign investor is set at 5%). (tranche 1)	77. **Complied with** before loan approval.
78. Permit foreign investment up to 25% in a KOSDAQ-listed company and raise the limit on a single foreign investor to 10% by December 1998. (tranche 3)	78. **Substantially complied with.** The limit on foreign ownership was abolished on 25 May 1998. Since March 2001, however, foreign ownership limits remain on 14 companies operating in strategic industries such as telecommunications, broadcasting, and airlines.
79. Raise the limit on foreign ownership to 55% by December 1999. (tranche 4)	79. **Substantially complied with.** The KOSDAQ increased the daily trading band for stock price fluctuation to 15% in March 2005 from 12%, which had been increased from 8% in 1998.
80. Foreign investors are allowed to invest up to 100% in venture capital companies listed on the KOSDAQ effective 1 December 1997. (tranche 1)	80. **Complied with** before loan approval.
81. Companies listed on the KOSDAQ are allowed to issue overseas bonds, convertible bonds, and depository receipts to bring them in line with those companies listed on the KSE effective 1 December 1997. (tranche 1)	81. **Complied with** before loan approval.
E. Mortgage-Backed Securities 82. Housing loans are increasing rapidly. The outstanding housing loans of the Housing and Commercial bank amounted to W16.1 trillion at the end of October 1997. It is important for commercial banks to augment the supply of housing loans to meet the high level of demand. In this regard, it is necessary to	82. **Complied with** before loan approval.

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create mortgage-backed securities to ease the maturity mismatches and the liquidity problems experienced by commercial banks. (tranche 1)	
83. Take necessary measures, including creation of a legal framework, for establishment of a financial institution that will secure mortgage-backed loans. (tranche 3)	83. **Complied with.** A law concerning asset-backed securitization came into effect on 16 September 1998. This law deals with all asset-backed securitization. To establish an institution that issues mortgage-backed securities, the Mortgage-Backed Securities Company Act was enacted in January 1999.
84. Establish a financial institution to issue mortgage-backed securities for purchases of mortgage-backed loans. (tranche 4)	84. **Complied with.** Following the enactment of the Mortgage-Backed Securities Company Act in January 1999 and approval by the FSC, the Korea Mortgage Corporation (KOMOCO) opened for business in October 1999. In 2000, KOMOCO issued mortgage bonds of W1.28 trillion, using mortgages originated by the National Housing Fund. Ever since, KOMOCO has shifted operations to mortgages originated by other financial institutions. In March 2004, KOMOCO and the Credit Guarantee Department for Housing Finance of the Credit Guarantee Fund were merged to form the Korea Housing Finance Corporation to issue mortgage-backed securities and credit guarantees for housing finance more stably in the long run.
F. Derivatives Market	
85. The floating exchange rate and the domestic market-based interest rates result in the need for business and institutional investors to increasingly hedge their exposures arising from the increased volatility in these markets. All exchange-traded derivatives are covered by the Futures Trading Law of 1 July 1996. (tranche 1)	85. **Complied with** before loan approval.
86. KOSPI 200 options (European-type) were initiated on 7 July 1997. Six delivery month contracts covering both call and puts are now traded with up to 1 year maturity. About 55,000 contracts are traded each day. KOSPI 200 options are open to foreign participation. (tranche 1)	86. **Complied with** before loan approval.
87. Establish the Korea Futures and Options Exchange (KOFEX) to offer foreign exchange and interest rate futures and options with foreign participation allowed with respect to the underlying assets open to foreign investment. (tranche 4)	87. **Complied with.** KOFEX opened in April 1999 in Pusan. As of June 2005, futures contracts on KOSPI 200, Korea Treasury bonds, certificates of deposit, US dollars, gold, and KOSDAQ index (KOSDAQ 50), and options on KOSPI 200, KTB futures, US dollars, Kookmin Bank, Samsung Electronics, SK Telecom, POSCO, KT, Korea Electric, and Hyundae Motors are traded. However, except the future contracts and options on KOSPI 200, which account for 97% of all transactions at the market, other derivatives are not actively traded. This exchange is open to foreign participation. The foreign investors account for 26.5% of the total trading at the market in April 2005. KOFEX was the number one exchange in the world in terms of number of derivative contracts with 2, 913 million contracts in 2004. The options on KOSPI 200 were also the world's largest, with 2,522 million transacted. The futures contracts on KOSPI 200 were 55.6 million in 2004, which was the fourth largest after E-mini S&P 500, DJ Euro STOXX 50, and E-Mini NASDAQ 100. Incidentally, there is a good chance of shrinkage in futures trading, because the futures index grew too fast, mostly due to individual investors with

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	speculative motives, until 2003 at an amazing 136% growth rate, after which the market turned around to shrink throughout 2004 and 2005 as individual investors quit the market after they lost huge amounts of money. Their transactions account for 46.7% of all in April 2005. In January 2005, the Korea Securities and Futures Exchange (KRX) was established out of the mergers of KSE, KOFEX, and KOSDAQ Securities Exchange to enhance the competitiveness of the securities market.
IV. Corporate Accounting and Disclosure Standards: Improve the accuracy and timely disclosure of financial and accounting information.	
88. Accounting and disclosure rules are generally in line with international accounting standards. (tranche 1)	88. **Complied with** before loan approval.
89. Enactment of a bill (an act concerning external audit of joint stock corporations) requiring corporate financial statements to be prepared on a consolidated basis and certified by external auditors. (tranche 2)	89. **Complied with.** A bill was enacted in December 1997 requiring combined financial statements for the corporate sector from 1999. In 1999, the Government announced that the 30 of the largest business groups are required to prepare financial statements on a consolidated basis from 2000. Combined financial statements are required for the parent company and its subsidiaries to report their economic performances and status as a whole. By contrast, consolidated financial statements are required for a group with total assets size of all companies in the group larger than W2 trillion, and they are made out of the financial statements of all member companies in the group.
90. The SMC issued guidelines for disclosure and reporting of derivatives on 30 March 1996. (tranche 1)	90. **Complied with** before loan approval.
91. A real name system was adopted in 1993 to promote transparency and equity in taxation. (tranche 1)	91. **Complied with** before loan approval.
92. Maintain the real name system, with some possible revisions. (tranche 4)	92. **Complied with.** The Real Name Financial Transactions and Guarantee of Secrecy Act was passed at the end of 1997. According to this act, financial transactions, both with and through financial institutions, must be conducted under a customer's real name.
93. Increase the daily price change limit to 10%. (tranche 3)	93. **Complied with.** The daily trading band for stock price fluctuation was increased to 12% in March 1998, and then to 15% in December 1998. For the futures market, the band was increased from 7% to 10% in December 1998.
94. Stock borrowing is particularly important in hedging operations. Stock borrowing has been introduced among the financial institutions, and a standardized contract was introduced on 1 September 1996. (tranche 1)	94. **Complied with** before loan approval.

ABS = asset-backed securities, CRA = credit-rating agency, KAMCO = Korea Asset Management Corporation, KDB = Korea Development Bank, KDIC = Korea Deposit Insurance Corporation,, KSE = Korea Stock Exchange, NPAMF = Nonperforming Asset Management Fund, NPL = nonperforming loan,

[a] CAMEL ratings encompass capital adequacy, asset quality, management earnings, and liquidity scores for banks.

[b] The current consolidated supervisory body, the Financial Supervisory Service, was established on 29 January 1999.

[c] The level prevailing in December 1997.

[d] BOK has been seeking ways to reduce the risk associated with settlement delays. For example, it introduced the Daylight Overdraft Facility in September 2000.

[e] While not important relative to government financing, the system of managing government bond issuance has several shortcomings that impact on the development of capital markets. Government bonds are issued using a competitive bidding method. The bid is awarded in the order of the lowest rate of return to the highest rate of return; however, the highest rate of return must be lower than the rate set by the Government. If the total award is lower than the total planned, the syndicate is obliged to buy the rest at an interest rate 0.1% lower than the average bid-awarded rate. As the preset rate is lower than the market interest rate, the issuing rate does not reflect the real market rate.

Source: Asian Development Bank.

FINANCIAL SECTOR DATA

Table A4.1: Public Funds Utilized for Financial Sector Restructuring
(November 1997–December 2004)
(W billion)

Type of Institution	Korea Deposit Insurance Corporation	Korea Asset Management Corporation	Government	Total
Commercial Banks	44,102	24,559	18,092	86,753
Merchant Banks	21,398	1,541		22,939
Securities Companies	14	76		90
Insurance Companies	19,382	1,813		21,195
Investment Trust Companies	9,293	8,390	900	18,583
Mutual Savings Banks	8,092	209		8,301
Credit Unions	4,756			4,756
Others		2421		2,421
Total	**107,037**	**39,009**	**18,992**	**165,038**

Source: Bank of Korea.

Table A4.2: Closure and Establishment of Financial Institutions

Item	Banks[a]	Merchant Banks	Leasing Companies	Securities Companies	Insurance Companies	Investment Trusts	Mutual Savings/ Finance Companies	Credit Unions	Total
Number of Institutions (Dec 1997)	33	30	25	36	50	31	231	1,666	2,102
Number of Institutions (Dec 2000)	22	6	19	63	40	40	146	1,317	1,653
Number of Institutions (Mar 2001)	22	5	19	43	40	29	146	1,311	1,615
Number of Institutions (Dec 2004)	19	2	18	57	50	47	113	1,066	1,372
Revocation of License/Liquidation (1998–2000)	5	23	8	6	7	9	72	258	388
Revocation of License/Liquidation (2001–2004)	0	0	5	7	7	1	31	244	295
Mergers (1998–2000)	6	3	1	1	6	1	25	101	144
Mergers (2001–2004)	3	4	0	6	0	1	2	7	23
Newly Created Institutions (1998–2000)	0	1	3	14	3	8	12	4	45
Newly Created Institutions (2001–2004)	0	0	4	7	17	9	0	0	37

[a] Including specialized banks.

Source: Financial Supervisory Commission/Financial Supervisory Service.

Table A4.3: Capital Adequacy Ratio of Commercial Banks (%)
(1995–2004)

Bank	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004
Cho-Hung Bank	9.01	8.48	6.50	0.93	9.80	9.78	10.43	8.66	8.87	9.40
Hanvit Bank				12.05	8.67	10.26				
Woori Bank						10.26	11.28	11.59	11.23	12.20
Commercial Bank of Korea	9.64	9.25	7.62							
Hanil Bank	9.72	8.89	6.90							
Korea First Bank	8.71	9.14	(2.70)	(1.47)	11.44	13.40	13.26	11.55	12.00	11.90
Seoul Bank	8.97	8.56	0.97	(0.88)	10.41	10.08	9.22			
Korea Exchange Bank	8.66	9.16	6.79	8.06	9.76	9.19	10.96	9.31	9.32	9.50
Kookmin Bank	6.06	8.46	9.78	10.09	11.38	11.18	10.23	10.41	9.80	11.10
Korea Housing and Commercial Bank			10.29	10.79	11.74	9.92				
Shinhan Bank	11.77	10.03	10.29	14.69	13.85	12.30	12.02	10.92	10.49	11.90
KorAm Bank	8.57	8.80	8.57	15.21	12.14	8.67	11.18	12.11	10.98	
Hana Bank	8.35	8.71	9.29	13.10	12.33	10.45	10.29	10.30	11.17	11.80
Peace Bank	9.49	8.92	5.45	(1.79)	5.15	10.09				
Nationwide Commercial Banks	8.97	8.97	6.66	8.22	10.79	10.52	10.81	10.46	10.40	11.30
Daegu Bank	11.12	9.93	11.25	11.42	12.12	11.69	11.01	10.85	10.58	10.66
Pusan Bank	8.61	8.58	9.66	9.25	11.45	10.53	10.26	11.69	11.66	10.84
Kwangju Bank	12.96	11.27	10.65	10.12	8.63	10.12	11.15	11.03	10.72	11.81
Bank of Cheju	24.32	14.95	12.13	9.65	7.85	10.14	9.71	11.71	10.96	10.91
Jeonbuk Bank	16.43	15.13	13.27	12.94	13.36	10.87	10.30	11.35	10.79	10.79
Kyongnam Bank	10.03	9.41	12.27	11.87	12.39	10.06	11.08	11.34	11.69	11.34
Regional Banks	11.44	10.15	9.60	8.31	11.36	10.77	10.75	11.26	11.13	11.01
Domestic Commercial Banks	9.33	9.14	7.04	8.23	10.83	10.53	10.81	10.52	10.45	11.30

Notes: 1. Based on Basle Capital Accord.
2. Calculated on the condition that allowance for valuation of securities and credit losses is no less than 100% from 1997.

Source: Financial Supervisory Service.

Table A4.4: Return on Assets of Commercial Banks (1995–2004)

(%)

Bank	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004
Cho-Hung Bank	0.39	0.34	(0.72)	(4.80)	(1.69)	0.21	1.01	(0.97)	(1.48)	0.42
Hanvit Bank					(2.82)	(4.36)				
Woori Bank						(4.36)	1.06	0.99	1.42	1.92
Commercial Bank of Korea	0.34	0.35	(0.45)	(4.46)	0.00	0.00				
Hanil Bank	0.31	0.19	(0.73)	(4.24)	0.00	0.00				
Korea First Bank	0.06	0.02	(4.61)	(7.94)	(3.21)	1.13	0.86	0.35	(0.04)	0.28
Seoul Bank	0.02	(0.67)	(3.25)	(8.03)	(9.59)	(2.53)	0.51			
Korea Exchange Bank	0.35	0.29	(0.15)	(1.85)	(1.80)	(0.90)	0.48	0.22	(0.36)	0.81
Kookmin Bank	0.41	0.56	0.31	0.16	0.16	0.97	0.76	0.81	(0.52)	0.30
Korea Housing and Commercial Bank	0.00	0.00	0.36	(0.68)	1.02	0.94				
Shinhan Bank	0.70	0.63	0.19	0.18	0.30	0.85	0.70	1.05	0.71	1.15
KorAm Bank	0.28	0.40	(0.38)	0.33	0.24	(1.59)	0.69	0.79	0.11	0.55
Hana Bank	0.55	0.55	0.39	0.69	0.47	0.05	0.80	0.65	0.68	1.66
Peace Bank	(0.63)	0.16	(0.88)	(6.54)	(1.13)	(1.40)				
Nationwide Commercial Banks	0.28	0.23	(0.90)	(2.99)	(1.42)	(0.53)	0.79	0.56	0.04	0.90
Daegu Bank	0.84	0.73	0.17	(4.85)	0.29	0.13	0.23	0.88	0.67	0.70
Pusan Bank	0.50	0.58	0.23	(4.61)	0.05	0.09	0.42	1.09	0.79	0.81
Kwangju Bank	0.53	0.22	(1.00)	(5.16)	(1.41)	(2.18)	1.07	1.00	0.67	0.81
Bank of Cheju	0.40	(0.36)	(3.05)	(8.71)	0.45	(1.59)	0.09	0.81	0.28	0.37
Jeonbuk Bank	0.29	0.30	(2.35)	(6.03)	(0.02)	0.20	(1.15)	0.17	1.14	0.83
Kyongnam Bank	0.79	1.02	0.05	(5.41)	0.12	(4.05)	0.88	0.89	0.80	0.98
Regional Banks	0.56	0.47	(1.17)	(5.83)	(0.11)	(1.07)	0.41	0.90	0.75	0.80
Domestic Commercial Banks	0.32	0.26	(0.93)	(3.25)	(1.31)	(0.57)	0.76	0.59	0.13	0.89

Note: Including trust accounts.
Source: Financial Supervisory Service.

Table A4.5: Nonperforming Loans of Commercial Banks (1999–2004)
(W billion)

Year	Total Loans	Nonperforming Loans[a]	Nonperforming Loans: Loans Overdue for More than 3 Months	Nonperforming Loans: Total Nonaccrual Loans	Nonaccrual Loans: Bankrupt Loans	Nonaccrual Loans: Loans to Borrowers Whose Capacity to Repay is Weakened	Nonaccrual Loans: Nonperforming Restructured Loans	Ratio of Nonperforming Loans to Total Loans (%)
1999	328,294.5	27,393.8	6,113.3	21,280.5	4,842.1	7,299.2	9,139.2	8.3
2000	361,608.6	23,891.2	3,801.2	20,090.0	3,334.3	3,896.1	12,859.6	6.6
2001	379,092.4	10,976.0	2,536.3	8,439.7	1,936.3	1,701.4	4,802.0	2.9
2002	464,577.4	9,040.7	4,388.0	4,652.7	1,170.0	1,960.4	1,522.3	1.9
2003	499,532.8	10,851.3	7,287.9	3,563.4	1,528.9	1,334.7	699.8	2.2
2004	512,253.0	8,761.9	6,211.5	2,550.3	854.1	1,176.5	519.7	1.7

[a] Nonperforming loans by forward-looking criteria from 1999.
Source: Bank of Korea.

Table A4.6: Foreign Investors (1995–2004)
(number and percent)

Year	United States		United Kingdom		Japan		Others		Total	
	no.	%	no.	%	no.	%	no.	%	no.	%
1995	1,553	36.2	682	16.5	365	8.5	1,686	39.4	4,286	100.6
1996	1,930	36.5	781	14.8	441	8.3	2,142	40.5	5,294	100.1
1997	2,369	36.3	806	13.8	528	7.9	2,811	42.0	6,514	100.0
1998	3,225	38.0	859	10.1	677	8.0	3,719	43.9	8,480	100.0
1999	3,900	39.2	963	9.7	803	8.1	4,287	43.1	9,953	100.1
2000	4,602	39.2	1,057	9.0	942	8.0	5,147	43.8	11,748	100.0
2001	5,001	38.9	1,130	8.8	1,066	8.3	5,663	44.0	12,860	100.0
2002	5,430	38.4	1,228	8.7	1,151	8.1	6,319	44.7	14,128	100.0
2003	5,814	37.9	1,320	8.6	1,243	8.1	6,958	45.4	15,335	100.0
2004	6,394	37.8	1,424	8.4	1,323	7.8	7,758	45.9	16,899	100.0

Source: Financial Supervisory Service.

Table A4.7: Types and Foreign Investors (1995–2004)
(number)

End of	Institutional Investors					Individuals	Total
	Funds	Pensions	Securities	Others	Subtotal		
1995	1,864	351	153	398	2,766	1,520	4,286
1996	2,412	432	191	477	3,512	1,782	5,294
1997	3,198	476	250	595	4,519	1,995	6,514
1998	3,763	522	285	759	5,329	3,151	8,480
1999	4,239	598	310	938	6,085	3,869	9,954
2000	4,966	686	336	1,225	7,213	4,535	11,748
2001	5,503	766	361	1,436	8,066	4,794	12,860
2002	6,190	874	388	1,652	9,104	5,024	14,128
2003	6,752	990	422	1,929	10,093	5,242	15,335
2004	7,464	1,131	449	2,317	11,361	5,538	16,899

Source: Financial Supervisory Service.

Table A4.8: Foreign Capital Movement (1995–2004)
($ million)

Year	Inflow	Outflow	Balance
1995	10,184	7,754	2,430
1996	12,464	7,977	4,487
1997	12,649	11,795	854
1998	16,480	11,699	4,781
1999	41,744	36,247	5,496
2000	60,150	48,841	11,309
2001	43,984	36,476	7,508
2002	65,383	66,210	(827)
2003	81,568	68,046	13,522
2004	116,166	106,742	9,424
Total	**460,772**	**401,787**	**58,984**

Notes: 1. Figures for 2004 are preliminary.
2. Figures include only portfolio investments such as stocks, bonds, beneficiary certificates, and derivatives.

Source: Bank of Korea.

Table A4.9: Trading Activities of Foreign Investors (1995–2004)
(W billion)

Year	Purchase	Sale	Balance
1995	7,602.1	6,284.1	1,318.0
1996	10,123.5	7,049.7	3,073.8
1997	11,061.1	10,637.1	424.0
1998	17,269.6	11,546.2	5,723.4
1999	45,465.1	43,948.9	1,516.2
2000	63,179.6	51,668.6	11,511.0
2001	55,106.5	47,474.8	7,731.7
2002	83,313.9	85,866.8	(2,552.9)
2003	91,181.1	77,414.0	13,767.1
2004	132,214.1	121,234.8	10,979.4

Source: Financial Supervisory Service.

Table A4.10: Shareholding by Foreign Investors (1995–2004)

Year	Institutional Investors			Market Value				
	Total Number of Listed Shares (millions)	**Shares Held by Foreigners** (W billion)	**Share** (%)	**Total Market Value** (W billion)	**Direct Investment by Foreigners** (W billion)	**Portfolio Investment by Foreigners** (W billion)	**Total Investment by Foreigners** (W billion)	**Share** (%)
1995	7,609.4	762.3	10.0	144,151.4	2,659.5	14,063.4	16,722.9	11.8
1996	8,598.4	989.3	11.5	117,370.0	2,953.4	12,268.6	15,222.0	13.0
1997	9,030.8	819.8	9.1	70,988.9	1,623.3	8,734.7	10,358.0	14.6
1998	11,443.7	1,204.1	10.5	137,798.5	3,103.2	22,530.2	25,633.4	18.6
1999	17,325.8	2,136.9	12.3	349,504.0	5,936.2	70,654.3	76,590.5	21.9
2000	19,639.0	2,731.0	13.9	188,041.0	6,567.0	49,992.0	56,559.0	30.1
2001	19,578.0	2,869.0	14.7	255,850.0	5,408.0	88,291.0	93,698.0	36.6
2002	26,463.0	3,055.0	11.5	258,681.0	5,112.0	88,049.0	93,161.0	36.0
2003	23,662.0	4,259.0	18.0	355,363.0	6,170.0	136,364.0	142,534.0	40.1
2004	23,427.0	5,154.0	22.0	412,588.0	13,438.0	159,720.0	173,158.0	42.0
Total	**166,777.1**	**23,980.4**	**133.5**	**2,290,335.8**	**52,970.6**	**650,667.2**	**703,636.8**	**264.7**

Source: Financial Supervisory Service.

Table A4.11: Korea Stock Exchange Data
(1996–2004)

Item	1996	1997	1998	1999	2000	2001	2002	2003	2004
KOSPI[a] (closing)	651.2	376.3	562.5	1,028.1	504.6	693.7	627.6	810.7	895.9
(average)	833.4	654.5	406.1	806.8	734.2	572.8	757.0	679.8	832.9
Trading Volume (Daily Average, million shares)	26.6	41.5	97.7	278.6	306.2	473.2	857.2	542.0	372.9
Trading Value (Daily Average, W billion)	486.8	555.8	660.4	3,481.6	2,602.2	1,997.4	3,041.6	2,216.6	2,232.1
Stock Issue (W billion)	5,042.9	3,155.6	13,488.9	35,147.0	5,788.8	5,315.5	7,438.7	7,726.5	5,167.5
Initial Public Offerings	1,391.4	479.3	36.8	1,720.1		217.8	1,227.3	560.2	641.3
Seasoned Equity Offerings	3,651.5	2,676.3	13,452.1	33,426.9	5,788.8	5,097.7	6,211.4	7,166.3	4,526.2
Number of Listed Companies	760	776	748	725	704	689	683	684	683
Market Capitalization (W trillion)	117	71	138	350	188	255	258	355	412

KOSPI = Korea Composite Stock Price Index.
Source: Korea Stock Exchange.

Table A4.12: Listed Bonds (1996–2004)
(W trillion)

Year	Public Bonds			Corporate Bonds			Total
	Number of Issuers	Number of Listed Issues	Amount Listed	Number of Issuers	Number of Listed Issues	Amount Listed	Amount Listed
1996	129	5,808	102.4	1,977	8,762	73.1	175.5
1997	160	7,717	138.1	1,827	8,170	86.0	224.1
1998	140	7,090	214.6	1,512	6,500	119.4	334.0
1999	139	5,701	253.3	1,078	4,054	111.1	364.4
2000	111	5,030	296.8	727	2,436	127.9	424.7
2001	90	5,585	363.5	742	2,306	141.2	504.7
2002	77	6,303	422.6	682	2,260	141.3	563.9
2003	75	6,528	471.2	662	2,422	136.1	607.3
2004	70	6,273	545.9	652	2,441	115.5	661.4

Sources: Korea Stock Exchange and Korea Stock and Futures Exchange.

Table A4.13: Bond Trading (1996–2004)
(W billion)

Year	Korea Stock Exchange Market			Over-the-Counter Market
	Public Bonds	Corporate Bonds	Total	
1996	192	1,186	1,378	114,484
1997	237	3,807	4,044	139,451
1998	6,519	8,968	15,487	431,898
1999	281,921	11,685	293,606	745,740
2000	23,521	3,648	27,169	1,144,840
2001	12,214	2,013	14,227	1,397,654
2002	46,063	1,111	47,174	1,078,349
2003	214,010	892	214,902	1,236,447
2004	383,122	987	384,109	1,428,218

Sources: Korea Exchange for KRX market figures and Koscom Corporation for over-the-counter market figures.

FINANCIAL SECTOR CHANGES BEFORE AND AFTER THE FINANCIAL SECTOR PROGRAM LOAN (FSPL)

A. Restructuring and Consolidation of the Banking System

1. Before FSPL

1. At the end of 1997, 26 domestic commercial banks (CBs) held 51% of total financial sector assets. These include 17 large CBs with over two thirds of total CB assets. In the banking sector, the share of 52 foreign banks was relatively minor at 9%. The foreign banks concentrated mainly on wholesale banking. Prior to the financial crisis, government intervention in the banking system and this dependence constrained local banks from developing strong credit-risk management practices. Lending decisions relied on collateral and intercompany guarantees and not on projected cash flows. Loan review processes were inadequate, while management information systems were rudimentary. Prudential regulation was lax and fell short of international best practice. The loan classification and provisioning rules were based on a loan's servicing record and the availability of collateral, without due regard to borrower repayment capacity. Accounting and disclosure standards were also weak.

2. After FSPL

2. At the onset, the FSPL sought to maintain public confidence in the banking system and, in November 1997, the Government announced that it would guarantee all deposits of financial institutions until the end of 2000.[1] Two large distressed CBs were later taken over by the Government on 31 January 1998.[2] Progress made to restructure and reconsolidate the banking system during 1998–2000 was substantial.

a. Capital Adequacy

3. The FSPL supported the full implementation of the Basle Core Principles of Banking Supervision. At the end of 2000, the restructured CBs individually exceeded the minimum risk-adjusted capital adequacy ratio (CAR) of 8% based on the estimates of the Financial Supervisory Commission (FSC).[3] Forward-looking criteria were introduced to fully implement the Basle Core Principles.

b. Bank Restructuring and Consolidation

4. The full-scale restructuring of the banking system began in June 1998. This included the identification, development, and implementation of exit strategies for nonviable banks. Rehabilitation plans specifying measures to achieve the minimum risk-adjusted CAR of 8% and to restructure operations were required for viable banks. The banks' balance sheets were strengthened by taking out nonperforming loans (NPLs) and infusing additional capital. This process was supported by the Korea Deposit Insurance Corporation (KDIC), which guaranteed deposits in failed financial institutions and provided recapitalization funds, and the Korea Asset Management Corporation (KAMCO), which acquired the NPLs at a discount. Both troubled and

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[1] Effective January 2001, the Government reduced coverage of the deposit insurance scheme (but the upper limit was increased to W50 million from the prescribed limit of W20 million due to apprehensions about financial stability).

[2] The Korea First Bank was sold to New Bridge Capital in December 1998, while the Seoul Bank remained a state-owned bank until it merged with Hana Bank in 2002.

[3] However, when compared with precrisis levels, these CARs are credible, as they are based on enhanced accounting standards (closer to international best practice) and tighter loan classification and provision rules.

healthy banks were also encouraged to consolidate and develop universal banking services to become leaders in the banking sector.[4]

5. Between April and June 1998, six reputable international accounting firms carried out objective evaluations of capital adequacy, asset quality, recapitalization plans, cost reduction plans, management reengineering plans, and replacement plans of 12 CBs that had a Bank for International Settlements (BIS) ratio of 8% or below at the end of 1997. Following this review, five smaller banks with negative CARs were closed in July 1998 and their operations transferred to five stronger banks under purchase and assumption (P&A) agreements.[5] The remaining seven undercapitalized banks were required to take remedial action under approved rehabilitation plans.[6] Thirteen healthy banks with BIS CARs of over 8% as of end 1997 were also reviewed for financial soundness and long-term viability in August 1998. Subsequently, FSC mandated prompt corrective actions (PCAs) for four of these banks. Amid drastic changes in the banking sector, two mergers and acquisitions (M&As), i.e., Kookmin Bank with Long-Term Credit Bank, and Hana Bank with Boram Bank, were carried out voluntarily, which led to the creation of Korea's two largest banks in early 1999.

6. Full-scale restructuring of the banking sector resumed in September 2000 when FSC called on six CBs deemed unsustainable in the long run to submit rehabilitation plans. Based on independent reviews, FSC disapproved the rehabilitation plans of four banks (Hanvit, Peace, Kwangju, and Cheju) and requested amended plans, which entailed each bank being placed under a bank holding company. FSC approved the amended rehabilitation plans of the four banks, but disapproved the rehabilitation plan of Kyongnam Bank, which was not viable. Consequently, FSC issued an order to place these five banks as subsidiaries under a bank holding company. To facilitate the new scheme, KDIC injected W4.1 trillion in public funds into six banks—five subsidiary banks and Seoul Bank. In November 2000, the Government allowed Chohung and Korea Exchange Bank to pursue their own rehabilitation plans including raising capital and removing NPLs. The Government decided to inject additional public funds into Hanvit, Kwangju, Kyongnam, and Peace, and then to merge them in a government-owned financial holding company.[7] In 2000, the financial restructuring process was supported by public funds of W127 trillion ($112 billion), or about 25% of the gross domestic product. About half of the amount went to the banking system. The restructuring process resulted in the consolidation of the banking sector, and the number of CBs fell from 26 to 17.

c. Nonperforming Loans

7. Under the FSPL, the problem of NPLs in the banking system was addressed through KAMCO. The ratio of NPLs in the banking system declined to 8.3% at the end of 1999, and

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[4] Kookmin Bank and Korea Housing Bank announced their merger in December 2000 and launched a consolidated bank—new Kookmin Bank—in November 2001. Shinhan Bank established a bank holding company in September 2001, took control of Cheju Bank in 2002, and put Chohung Bank under control as well in 2003. Seoul Bank was merged into Hana Bank in November 2002.

[5] FSC organized the "Bank Evaluation Committee" of 12 specialists from the private sector to independently review the evaluations of the accounting firms. Based on the committee's reviews, FSC decided not to approve the rehabilitation plans of five local banks (Dongnam, Dongwha, Chungchong, Kyunggi, and Daedong) and to revoke their business licenses. It merged them with five healthy nationwide banks (Korea Housing, Shinhan, Hana, KorAm, and Kookmin) through the P&As.

[6] Seven banks were approved to continue operations under the condition that they make full efforts to restructure or undergo M&As before a strict deadline.

[7] In April 2001, Hanvit and Peace were merged and then became a subsidiary of a bank holding company. In 2002, the bank and the Financial Holding Company changed their names to Woori Bank and Woori Financial Holding Company, which holds Kwangju Bank and Kyongnam Bank as well.

further to 6.6% at the end of 2000.[8] FSC/Financial Supervisory Service (FSS) requested all banks to submit plans to reduce their NPLs and monitored monthly progress towards achieving a goal of 5% NPL ratios by the end of 2001. It encouraged banks with a target of 5% NPL ratios to actively dispose of their NPLs (through write-offs, securitization, and direct sales) and streamlined applicable regulations to facilitate write-offs of NPLs. As a result, the ratio of NPLs to total loans of banks progressively declined from 6.6% in 2000 to 1.7% in 2004. While lending levels, which contracted in 1998 following the crisis, grew at a slow pace, bank deposits continued to grow strongly after the crisis (34% annually) in line with the FSP objective of restoring public confidence in the banking system.

B. Restructuring of Nonbank Financial Institutions

1. Before FSPL

8. The majority of the country's nonbank financial institutions (NBFIs) were insolvent after the 1997 financial crisis.

a. Merchant Banks

9. The merchant banking subsector, which was a major source of instability leading to the crisis, contracted significantly.[9] Merchant banks were able to borrow in foreign exchange while lending in won. This led to currency mismatches and excessive foreign exchange exposure in 1997, which resulted in heavy losses from a series of large-scale corporate bankruptcies during the crisis. This also led analysts to believe that the drastic change in the corporate sector would bring down the entire financial market.

b. Securities Companies

10. Prior to the 1997 financial crisis, securities companies were already suffering cumulative losses from sagging trading fees and huge losses from bond guarantees.[10] Despite the growing uncertainties from losses in management and operations, the financial supervisory authorities did not impose the net capital rule and early warning system that was introduced in April 1997. Severe imbalances stalked the asset-liability structures of securities companies, whose assets were mainly composed of stocks and bonds, which could not be disposed of in a plunging market, while liabilities were mostly short-term including deposits, short-term borrowings, and call money. These shortcomings led to doubts among investors and debtors on the soundness of securities companies, thus generating a systemic crisis in the securities industry. When the financial crisis erupted in December 1997, some securities companies closed. Of the 36 securities companies operating at the end of 1997, two went bankrupt in December, and their business licenses were revoked in June 1998.

11. Like the securities companies, the investment trust industry already stood on weak financial footing even before the 1997 crisis, and after the crisis the investment trust management companies (ITMCs) went bankrupt. In 1995, the Government had restructured the

[8] With the tightening of loan classification standards in 1999, NPLs now provide a more realistic assessment of the financial health of banks.

[9] In December 1997, there were 30 merchant banks, which were mostly investment finance companies transformed in the mid-1990s.

[10] Most securities companies had negative earnings at the time of the crisis, as brokerage and underwriting commissions failed to generate sufficient revenue. To boost revenue, most of the securities companies had turned to proprietary trading and provision of guarantees for bond issues, but ended up incurring large losses from these sources.

industry to reduce the financial distress of ITMCs and break their oligopolistic structure. These efforts led to the establishment of 16 new ITMCs between June 1996 and December 1997, which led to much greater competition and squeezed profit margins. The ITMCs were also hurt by an extremely overbearing regulatory regime and by their own unsound business practices. These included implicit guarantees on the returns of investment trust funds, manipulation of returns by shifting gains among funds, asset valuation based on book value rather than market value, etc. The unsound practices eventually caused most ITMCs to become seriously undercapitalized, and they could not expect to survive without drastic action on their part. To prevent the distress from spilling over into the rest of the financial industry, FSC strongly encouraged companies to recapitalize, sell securities holdings, downsize their organizations, and reduce overhead costs.

c. Insurance Companies

12. Since 1988, the number of life insurance companies rose from 6 to 33 just before the financial crisis. Over the years, newly established life insurance companies that were less competitive than existing ones faced cumulative losses due to the excessive operating costs that they incurred as they attempted to win larger market shares. Prudential standards that were below international norms and a lack of prompt action by insurance supervisors also contributed to the steady erosion of the financials of insurance companies. Many companies had negative solvency margins despite a required solvency margin in 1997 of 1%, which by itself was much below international standards. Prior to the crisis, life insurance companies acted like quasi banks, carrying short-term savings products on the liability side and commercial loans on the asset side. Industry profitability was restrained by the combined effects of high NPL levels, high policy lapse rates, high administrative costs, and unproductive distribution channels. Future profitability was, therefore, dependent on improvements in these areas, as well as on the adoption of sound policies in investment and risk management and related parties' transactions.

d. Mutual Savings and Finance Companies and Credit Unions

13. The financial soundness of mutual savings and finance companies and credit unions eroded due to consecutive bankruptcies of large corporations, declining real estate prices, and fierce competition with other financial institutions after the economic crisis. Assets declined and the volume of NPLs grew.

e. Pension Funds

14. The pension scheme was underfunded and did not assure full funding of pension liabilities. At the time of the crisis, the National Pension System was projected to face a rapid increase in pension disbursements from 2008 and to generate fiscal deficits by 2020 that would deplete the reserve fund by 2031.

2. After FSPL

15. The rehabilitation of NBFIs involved weeding out weaker institutions and strengthening the balance sheets of remaining institutions through reductions in NPLs and the provision of additional capital from the Government.

a. Merchant Banks

16. In December 1997, the Government organized the Evaluation Committee for Merchant Bank Corporations to study the conditions of 30 merchant bank corporations based on several

criteria such as the BIS CAR and composite rating index, which comprehensively addressed capital adequacy, asset quality, liquidity, management strategy, and compliance with applicable laws.

17. During the restructuring process, a bridge merchant bank called Hanareum Merchant Bank Corporation was founded by the Nonbank Supervisory Authority to (i) redeem deposits for the closed merchant banks; (ii) acquire, manage, and sell liabilities or assets of closed merchant banks; and (iii) borrow funds from the Nonbank Supervisory Authority and other financial institutions, etc. In line with structural market changes, the bulk of commercial paper discounting, which was one of the main and exclusive businesses of merchant banks, shifted to the bank trust account and securities companies, which were then permitted to engage in the business. To prevent restructured merchant banks from engaging in unsound activities, the financial supervisory authorities sought to strengthen prudential regulations and the management evaluation system and to introduce prompt corrective action. The Government imposed tighter supervisory (minimum capital requirements), prudential, and accounting norms, and closed institutions that could not meet the tougher standards.[11] Loan classification and provisioning norms for merchant banks were gradually made comparable with those imposed on CBs. Merchant banks that failed to meet the performance criteria were subject to strict penalties, culminating in closure. By June 1999, only 11 merchant bank corporations remained in operation, and all met the 8% BIS CAR.[12] FSC attempted to complete the restructuring of merchant banks based on the Restructuring Scheme of Merchant Banks drafted in October 2000.[13] Of 30 merchant banks in operation at the end of 1997, only 5 remained by the end of 2000.

18. Together with the restructuring of ailing merchant banks, FSC also built a platform for merchant banks to develop as investment banks. Merchant banks were allowed to offer wrap accounts in June 2001 and to expand into up to seven businesses if they transformed themselves into securities companies through mergers. In the end, the number of merchant banks still in operation was only two in 2004, which implies that the merchant banking sector is gone.

b. Securities Companies

19. Responsibility for the restructuring of securities companies was left to its majority shareholders even as companies that were deemed nonviable were first completely swept out of the market. Consistent with the FSPL, the Government tightened prudential standards leading to the closure of 6 of the 36 securities companies in 1998. The Government also introduced regulations that limited the risk exposure of securities companies and forbade them from issuing guarantees, e.g., corporate bonds. Similarly, changes in legislation reduced the capability of securities companies to assume risk that might destabilize markets.

20. FSC introduced PCAs to accelerate the restructuring of securities companies. After the introduction of PCAs, three companies were suspended in July and August 1998, and four companies were ordered to submit rehabilitation plans in August 1998. The FSC revoked the

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[11] Merchant banks were required to meet a minimum CAR of 6% effective June 1998 and 8% effective June 1999, and to adopt internationally accepted accounting principles by April 1999.

[12] Through August 1998, the licenses of 16 corporations were revoked. Two other merchant bank corporations (Hanwae, Hyundai) were merged into banks (Kwangwon, KEB) in January and February 1999, respectively, and one corporation (Daehan) was closed in April 1999.

[13] Dongyang and Woolsan-Hyundai Merchant banks merged in March 2001; Kumho Merchant Bank and Kumho Capital merged in April 2001; Dongyang-Hyundai Merchant Bank and Regent Merchant Bank merged in June 2001; and Dongyang-Hyundai Merchant Bank was taken over by Dongyang Security Company in November 2001.

licenses of two companies and announced quarterly monitoring of two conditionally approved companies in October 1998. Since then, all the remaining securities companies have performed well largely due to the rise in stock prices that began in the fourth quarter of 1998.

21. Investment trust companies (ITCs) were restructured, and the asset management business was separated from the beneficiary certificate sales operations. Three ITMCs were closed as a result of the default of their parent securities companies. By 1998, some majority stockholders returned their licenses as management continued to deteriorate. FSC strongly encouraged ITCs to improve corporate governance systems and permit outside directors to play more important roles. It also improved the disclosure system to encourage more detailed announcement of management to investors, and tightened the regulations on ITC sales and marketing.

22. During the restructuring process, the number of securities companies, especially ITCs, increased. The rise in the number of industry players had been encouraged by the Government, which was eager to promote the securities market to facilitate corporate financing. As the stock market boomed, there was growing demand for equity investment in the market. Moreover, entry barriers to ITCs were low, considering the fact that these companies do not run risks directly in the process of managing customer funds.

23. The securities industry's soundness was severely compromised by the losses borne in the process of restructuring the Daewoo group. It was agreed that losses from unsecured corporate bonds issued by the Daewoo group would be shared among ITCs, securities companies, and investors. While most ITCs were capable of absorbing the losses to some extent, the Government needed to pour W3 trillion of quasi-public funds in 1999 to rehabilitate Korea ITC and Daehan ITC, which were not able to withstand cumulative losses, and to restore investor confidence in the two once dominant trust companies.[14]

24. Despite the injection of a large amount of new funds, the two companies could not recover within a short period due to losses from their stock investments and as the collapse of the Daewoo group weighed more heavily over time. Consequently, the Government needed to inject a further W4.9 trillion in public funds into the two companies and asked them to submit memoranda of understanding (MOUs) of rehabilitation plans and make strong efforts to turn around and achieve the goals specified in the plans. Hyundai Investment Trust Management and Securities Company, which faced capital depletion because of the loss sharing process of Daewoo group restructuring, also attempted at rehabilitation through recapitalization. It was scheduled to dispose of W1.7 trillion in secured stocks by February 2001 if MOU conditions were not met. Prudential Financial, USA acquired the company in April 2004. Other ITCs were due to be restructured through cleanup and disclosure of trust assets and recapitalization.

25. Together with the measures taken by individual companies, efforts were also made to boost the transparency of the investment trust system. The marked-to-market pricing system took effect in the bond market. The new system purportedly activated the secondary bond market by ensuring fair pricing to reflect gains and losses arising from interest rate changes. The marked-to-market pricing system was applied only to funds that had been established since 15 November 1998 to avoid any irregularities.

26. All ITCs were permitted to establish mutual funds, and nontaxable or semi-open mutual funds were introduced in July 2000. The criteria for write-offs were tightened to facilitate the

[14] Both ITCs were then transformed into securities companies in June 2000 and renamed Korea Investment Trust Management and Securities and Daehan Investment Trust Management and Securities.

swift write-off of bad assets. The internal control systems of ITCs were strengthened through introduction of audit committees and compliance officers. Uses of trust assets became more visible through outside auditing of funds.[15] PCAs were issued to ITMCs starting in April 2001, providing further incentive for companies to press on with their restructuring. The FSC/FSS checked the financial soundness of ITMCs on a quarterly basis and took appropriate measures for companies that did not meet the guidelines.

27. In December 2004, the Government announced deregulation of the securities industry. Major contents are expanding business lines and trimming government regulations to provide better opportunity for investment banking business. According to the new policy, securities firms can do trust business and trade derivatives related to credit and general commodities; and are allowed to underwrite, trade, or intermediate securitized derivatives. Securities firms are also allowed to do consulting and the brokerage of real estate related to restructuring; and to arrange, intermediate, or represent a loan from affiliated financial institutions.

c. Insurance Companies

28. Insurance companies found themselves under a crushing burden of nonperforming assets following the numerous defaults of corporations after the financial crisis. Some of the latecomers were unable to operate normally. The Government had no choice but to force nonviable insurance companies out of the market. There were several means available for their restructuring, including sell-offs through competitive bidding, P&As, nationalization, and enforced M&As. These were accompanied by administrative measures meant to ensure that the majority shareholders and managers were held accountable for any wrongdoing that they may have committed.

29. In June 1998, FSC required 18 life insurance companies and 4 casualty insurance companies to submit rehabilitation plans. Based on due diligence by accounting firms and an assessment report by the Evaluation Committee, FSC issued PCAs to 20 corporations in August 1998. Four companies were suspended and absorbed by large, healthy companies; seven were required to submit management improvement plans; and nine were required to submit memoranda. Among 14 life insurance companies under the rehabilitation plan, 6 were later deemed unable to pursue their plans further, and an announcement was made concerning the sale of the severely undercapitalized Korea Life Insurance Company to any domestic or foreign investors through an M&A in order to reduce its fiscal burden and downsize.

30. In September 1998, two seriously troubled guarantee insurance companies were required to submit stringent rehabilitation plans under which they would merge and downsize. In November 1988, after the merger, they were renamed Seoul Guarantee Insurance (SGI). However, SGI experienced financial distress again and received an injection of public funds of W1.25 trillion in June 1999. From late 1999 to early 2000, five ailing life insurance companies were sold to another four insurance companies, and another insurance company was taken over through a P&A. The Government engineered the entire sales procedure as the primary shareholder. Existing stocks were completely written off, and W30 billion was poured into each institution as a legal minimum capital requirement.

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[15] Korea and Daehan Investment Trust Management and Securities Companies tried to turn themselves around on their own. Among the many steps taken were the disposal of bad assets and strategic alliances with foreign asset management companies. The MOU for rehabilitation was checked quarterly by KDIC, the majority shareholder, to encourage speedy recovery. In 2005, Daehan Investment Trust Management and Securities Company was taken over by Hana Financial Holding Company, and Korea Investment Trust Management and Securities Company was merged with Donwon Securities Company, a subsidiary of Dongwon Financial Holding Company, which changed its own name to Korea (Hankook) Financial Holding Company.

31. By late 1999, the life insurance industry continued to show negative net worth and operated at a loss. Nonetheless, after the crisis, the portion of loans in total assets had sharply decreased, and the industry showed some signs of improvement in management efficiency and distribution productivity. Life insurance companies were gradually required to meet a 4% solvency margin (plus 0.3% of the sum at risk) by March 2004. The gradual introduction of the risk-based solvency standard was to avoid major disruptions to the subsector, given the difficult financial situation of the insurance companies. Of 22 (18 life and 4 nonlife) distressed insurance companies that were evaluated, 4 were closed and their businesses transferred to sounder companies. Meanwhile, other companies were required to improve their solvency margins to prescribed higher levels over a period of time. FSC required that all life insurance companies should attain positive solvency margins by September 1999 and 4% solvency margins by March 2004. Under the FSPL, insurance companies were also required to disclose, among other things, their ratings determined by the Insurance Supervisory Board and to make the ratings available at their headquarters and at all branch offices. In addition, all nonlife insurance premiums have been fully deregulated in line with the FSPL since August 1998, when auto premium rates were deregulated.

32. Korea Life Insurance Company, which had failed to seek an appropriate buyer, was in urgent need of recapitalization. It received W2.5 trillion in public funds from October to November 1999. The Government entered an MOU with the company in April 2000 according to which it would later ascertain whether predetermined managerial targets were achieved. SGI was suffering as a result of its W6 trillion substitute payments on Daewoo corporate bonds. The Government gradually injected W6 trillion in public funds into SGI until 2001. A total of W10.25 trillion in public funds was injected into SGI to minimize the possible adverse effects on the economy as a whole. Hyundai Insurance Company and Samshin Insurance Company were taken over by Daehan Insurance Company through a P&A on April 2001. However, Daehan Insurance Company was designated to be sold in May 2001 and received W1.5 trillion in public money in September 2001. Daeshin Insurance Company underwent due diligence before being put up for sale. Three fire insurance companies were also being prepared for sale in the market.

33. In 2005, FSS announced a restructuring plan for future insurance companies. The plan encouraged insurance companies to manage their affairs with the clear objective of value maximization instead of size maximization. Along this line, large insurance companies should grow and evolve into universal financial groups or insurance groups. Small and medium-sized firms should voluntarily merge into bigger companies or be transformed as boutiques pursuing clients, localities, or unique products. It is not determined yet whether industrial groups other than Samsung will be allowed to own insurance companies, or if insurance companies can do banking business.

d. Mutual Savings and Finance Companies and Credit Unions

34. In answer to the problems of mutual savings and finance companies (MS&FCs) and credit unions, the financial supervisory authorities responded in 1998 by applying PCAs to MS&FCs and providing management consultation to credit unions. They also took steps to reinforce prudential regulation including the raising of loan provision requirements.

35. **Mutual Savings and Finance Companies.** The restructuring of MS&FCs entailed mainly the introduction of advanced management evaluation systems and PCAs. Once determined to be nonviable, a company was immediately put up for sale to a third party or assumed by a bridge company. Of the 43 financially distressed companies that underwent restructuring, 7 were sold to third parties, 10 were merged, and 26 were assumed by a bridge

company as of September 1999. However, once deemed to be viable, a company was strongly encouraged to rehabilitate itself through recapitalization or an M&A.

36. From December 1997 to August 2000, the business licenses of 42 MS&FCs were revoked, 19 companies were merged, and 15 companies were sold by P&A. After the first stage of restructuring, 31 more companies either had their licenses revoked or were merged or sold. The MS&FCs faced severe competition from banks, which were struggling to expand their market bases after the crisis by targeting low-income consumers and moving away from corporate loans. The MS&FCs were also not ready to manage credit risks arising from lending, though lending is a major part of their operations. Many companies exacerbated the market difficulties by their own illegal activities, further reducing market confidence. Partial depositor protection was scheduled to become effective in 2001, and it also prevented MS&FCs from restoring customer confidence in the market. To mitigate market disturbances as a result of the sharply declining market base, the Government drafted its policies to promote the function of MS&FCs in May 2000. These policies aimed to strengthen their competitiveness.

37. The business licenses of 20 MS&FCs already closed were revoked in June 2001, and companies that were at high risk of engaging in illegal activities were put under close surveillance. To revitalize the operations of MS&FCs, the Government not only attempted to encourage M&As and to recapitalize financially depressed companies, it also lifted regulations to increase the competitiveness of the industry and provided incentives for issuance of small unsecured loans.

38. **Credit Unions.** Financially distressed credit unions also attempted rehabilitation with the assistance of management consultants or through mergers. In cases where rehabilitation was not possible, the companies underwent bankruptcy procedures or liquidation. From December 1997 to August 2000, the business licenses of 2 credit unions were revoked, 101 credit unions merged, and 237 credit unions were liquidated for a total of 340 credit unions exiting the market.

39. Credit unions had long been vulnerable to changes in the external environment, since these are small in size; handle risk management and corporate governance poorly; and are constrained in their scope of business. Credit unions were characterized by mutual and circular finance, and prospered within traditional Confucian society, where group activity was emphasized; but they could not be sustained in a modern society characterized by individualism. Faced with such environmental changes, credit unions began to lose competitiveness in the market and had no choice but to pursue restructuring. Between 2000 and 2004, after 251 fragile credit unions were wiped out through bankruptcies, liquidations, and mergers, 1,372 were still in operation.

e. Pension Funds

40. Lastly, the Government established a pension review committee to examine the pension system. Both the committee and the Asian Development Bank (ADB) provided a set of suggestions for reforms of the Korean pension system. To assist the Government with pension reform, ADB prepared a report recommending that consideration be given to moving to a fully funded pension scheme. The Government tightened benefits, improved pension fund management, and revised the National Pension Act to allow for pension funds to invest in the over-the-counter market (KOSDAQ) and overseas markets beginning in July 2001.

C. Efficiency of Financial Market Infrastructures

1. Before FSPL

41. The stock market played a relatively small role in corporate finance despite a broadening and deepening of the Korean capital market over the years. The bond market remained small and illiquid. Prior to the implementation of FSPL, trading in government bonds was insignificant. Due to Korea's strong fiscal position, issuance of government securities was limited, and the policies adopted inhibited the development of a government debt market.[16] Under the FSPL, capital market reforms highlighted the need to enhance the range of financial services, introduce greater competition, improve the supervisory framework, and build institutional capacity.

42. While ITCs were not covered by the FSPL, these have emerged as a key systemic weakness aggravating financial market instability and undermining the development of a dynamic capital market. The industry holds about 40% of the total listed bond issues, while their trading activities account for about 30% of the average stock market trading volume. The industry's large exposure to Daewoo triggered early redemption of the beneficial certificate issued by ITCs and ITMCs in July 1999. The redemption pressure forced ITCs and ITMCs to sell their assets to satisfy investor demands, which in turn paralyzed the corporate bond market.

2. After FSPL

43. Foreign participation in the Korean capital market increased substantially, measured in terms of the number of foreign investors, foreign portfolio investment flows, trading activities of foreign investors in the stock market, and shareholdings by foreign investors. In 2000, 704 companies were listed on the Korea Stock Exchange (KSE), with total market capitalization of W188 trillion ($166 billion).

a. Bond Markets

44. The Government took steps to improve bond market operations after the crisis. Among other things, it opened the bond market, established benchmark interest rates, and introduced marked-to-market pricing and real-time settlement. However, many issues remained unresolved. The market was still very thin and restricted to ITCs, the dealer function was very weak, and the market infrastructure was woefully inadequate. Moreover, the bankruptcy of the Daewoo group and the resulting liquidity crunch in ITCs served to exacerbate both the primary and secondary bond market functions.

45. The Government responded by introducing loan transactions to the bond market in September 1998. To improve disclosure in the bond market, the Government mandated reporting of bond yields twice each trading day in June 1998. A system of prompt assessment was introduced in January 1999 to upgrade credit risk assessment, and the effective duration of credit risk assessment was reduced to 3 months from 6 months in December 1999. High-yield bonds for high-risk corporations such as new ventures and distressed companies with credit ratings below BBB facilitated the fund raising and restructuring of these companies through M&As. The Government prepared a plan to establish the market for high-yield bonds in May 1999, and launched high-yield funds to spur fund flows into ITCs in October 1999. These funds

[16] The Government predetermined the price at which debt would be issued. This prevented effective competitive bidding for government debt and resulted in mandatory allocations of government debt to institutions.

targeted mainly collateralized bond obligations, a type of asset-backed securities (ABS) issued on the basis of speculative grade bonds.

46. ABS emerged as a new instrument for corporations and financial institutions. Financial institutions could maintain a certain level of capital adequacy and higher liquidity by issuing ABS in the process of disposal of bad assets or long-term assets. KDIC could raise more money for restructuring by issuing ABS based on collected bad assets and collateral real estate. A massive supply of highly ranked ABS did a great deal to activate the bond market at a time of severe recession after the crisis and provided liquidity. To expedite the ABS market, the Government enacted legislation and issued regulations on ABS at the end of 1998, thereby accelerating ABS issues based on installment finance assets, loan assets, or real estate.

47. To secure transparency in the bond market, a new bond pricing system using marked-to-market pricing was put in place in July 2000, and the Secondary Bond Market Promotion Plan was launched in August 2000. Government policies to reduce the credit crunch in corporate financing promoted bond funds and primary collateralized bond obligations by expanding the market base for corporate bonds and commercial papers. Competitive bidding procedures were introduced along with larger size of issues and consolidation of types to gain transparency and liquidity in the government bond market. The interdealer market for government securities was set up inside the KSE with the introduction of a primary dealer system in April 1999.[17]

48. The KSE also has a general bond market—a retail market where investors trade various fixed income securities including corporate bonds, government bonds, and municipal bonds. The general bond market is a typical order-driven market, and all trades are settled on a netting basis on the contract day. The opportunities for risk pricing and management have been expanded with the introduction of newer financial instruments such as ABS, futures, and options. Despite the Government's efforts to stabilize the corporate bond market including the creation of the Bond Market Stabilization Fund in September 1999 and the Korea Development Bank Quick Underwriting Program in January 2001, the corporate bond market has since been chronically weak.

b. Mortgage-Backed Securities

49. Mortgage-backed securities have been encouraged in several emerging market economies to ease the maturity mismatches and liquidity problems experienced by CBs. Accordingly, the Financial Sector Program envisaged setting up an institution to issue mortgage-backed securities. Following the enactment of the Mortgage-Backed Securities Company Act in January 1999, the Korea Mortgage Corporation was set up in October 1999. The Government also set up the Korea Futures and Options Exchange in April 1999. The exchange is open to foreign participation. Futures contracts on certificates of deposit, US dollars, gold, treasury bonds, and KOSDAQ index (KOSDAQ 50), and options on US dollars are traded in this market. The exchange's trading volume reached 4 million contracts in January 2001. Equity index (Korea Composite Stock Price Index 200) futures and options have been traded on the KSE since 1996 and 1997, respectively.

[17] The interdealer market is a wholesale government bond market equipped with an electronic trading system called KTS (KSE trading system for government securities). Treasury bonds and foreign exchange stabilization bonds dominate trading. All trades conducted on the interdealer market are settled on the contract day (T+0), on a netting basis, under the book-entry system of the Korea Securities.

c. Stock Markets

50. The Government laid the groundwork for development of KOSDAQ, which had long been neglected due to the thin market base and trading volume. In 1999, the Government pursued in earnest the creation of KOSDAQ. In May, it provided strong incentives to attract market participants to KOSDAQ by easing requirements for registration in the market and granting tax deductions for registered corporations. The Government also took action in December 1999 to ensure the soundness of KOSDAQ, including making improvements to the entry and exit system, and strengthening the disclosure standard and monitoring system to detect unfair trading. KOSDAQ proved to be a remarkable success. Trading volume and value were at record levels for a stock market in Korea, so it was indeed efficient in channeling funds to small and medium-sized enterprises and venture businesses.

51. In 2005, the KSE, KOSDAQ, and the Korea Futures Exchange were merged to the unified Korea Securities and Futures Exchange, which had been proposed by many professionals to enhance the competitiveness of the financial market. The headquarters of the Korea Securities and Futures Exchange is located in Pusan, a southern port and the second largest city in Korea.

D. Improving Corporate Accounting and Disclosure Standards

1. Before FSPL

52. Before the 1997 crisis, accounting standards were well below international standards, given that arbitrary adjustments of profits and losses were implicitly permitted and different accounting standards were applied in different subsectors of the financial sector. Window dressing was especially widespread across industries, motivated by the incentive of managers to realize short-term profits on the one hand, and facilitated by the lack of proper checks and balances against managerial abuses on the other. There was no effective auditing, as punishments for fraudulent auditing were absent. This situation implied that the financial statements of domestic firms were extremely unreliable, and this impacted the whole economy. Confidence in the market was severely tested as the full truth of the shortcomings of the accounting system and practices came to light. The FSC acted to counter the situation, taking series of measures to upgrade the old system.

2. After FSPL

53. In line with the conditions of the FSPL, a law was enacted in 1998 requiring combined financial statements for the corporate sector starting in 1999. Listed companies are required to prepare and disclose their financial statements quarterly, and to establish audit committees with at least two thirds of their membership from outside independent directors. The FSPL also called on the Government to maintain the real name system, with some possible revisions. According to the Act on Real Name Financial Transactions and Guarantee of Secrecy, which was passed at the end of 1997, financial transactions both with and through financial institutions must be conducted under a customer's real name.

a. Corporate Governance

54. To improve management transparency of listed and registered companies, a person employed at a corporation within the past 2 years was restricted to take the role of the standing auditor of the same corporation starting May 1999. Likewise from December 1999, at least one

quarter of the board of directors was to be nonstanding directors, and recommendation committees for nonstanding directors were to be established. The membership of the board of directors in a listed company with total assets of more than W2 trillion was required to more than half nonstanding directors and no fewer than four nonstanding directors. Majority shareholders, their proxies, major shareholders of affiliated companies, or subsidiaries were permitted to serve only as nonstanding director in order to ensure neutrality. Firms with assets of more than W2 trillion were also required to set up audit committees. Each committee was to have at least four directors, and at least two-thirds of the directors had to be nonstanding.

55. To encourage their participation in corporate management, minority shareholders rights were strengthened by easing required conditions for derivative suits by shareholders of listed and registered companies. Furthermore, the practice of majority shareholders' selecting the board of directors has been discouraged by permitting concentrated votes on the basis of the corporate memorandum of association. The exercise of voting rights in writing reinforced the voting rights of shareholders who do not attend the general meeting of shareholders.

b. Accounting System

56. Proper corporate accounting principles were put into effect in April 1998, and necessary revisions were made in the ensuing months until these reached international standards by December 1998. Accounting rules across financial industries were set up with several objectives including (i) establishing compatibility with the corporate accounting principles, (ii) establishing uniformity across financial industries, (iii) reflecting industry-specific characteristics, and (iv) providing convenience for providers and users of the information.

57. Since 1999, the 30 largest industrial groups (as designated by the Fair Trade Commission) and companies belonging to these groups have been required to prepare consolidated financial statements and receive external auditing. The rules for consolidated financial statements were revised in 1999 to further enhance the transparency of corporate management. In December 1998, outside auditing was made mandatory for quarterly reviews in addition to semiannual reviews of financial statements. Aside from improvements in the accounting systems, measures relating to accounting firms and public reviews by the financial supervisor were taken to improve accounting practices. In December 1998, domestic accounting firms affiliated with highly regarded foreign accounting firms in the international market were allowed to provide auditing services for large financial institutions with total assets of more than W800 billion. With the intent of making transparent the accounting practices of companies and accounting firms, FSC imposed a new regulation to widen public review of financial statements and strengthen its enforcement.

TECHNICAL ASSISTANCE

A. Purpose and Objectives

1. The objective of the technical assistance (TA) loan was to assist the Korean Government in addressing key institutional constraints restricting sound development of the financial sector and to supplement sector reforms under the Asian Development Bank (ADB) Financial Sector Program Loan (FSPL). The TA loan objective was to finance the training and consulting services for institutional strengthening necessary to realize the objectives of the FSPL. The original scope of the TA loan comprised four components: (i) part A—strengthening the Financial Supervisory Commission (FSC); (ii) part B─strengthening the Korea Asset Management Corporation (KAMCO); (iii) part C─upgrading the credit information and rating systems; and (iv) part D─assisting the Korea Housing and Commercial Bank (KHCB) in reviewing problems and constraints associated with the introduction of mortgage-backed securities. The Ministry of Finance and Economy (MOFE) was the Executing Agency for the TA loan. FSC was to be the implementing agency (IA) for part A, KAMCO for part B, the Securities Market Committee for part C, and KHCB for part D. The project completion report for the TA loan described in detail the outputs achieved under each component. This appendix summarizes the key outputs and outcomes and assesses the TA according to standard evaluation criteria.

B. Design and Implementation

2. **Rationale and Design.** The TA outputs envisaged during appraisal had to be reformulated during implementation. The major changes in design and implementation were necessary to be responsive to the client's needs. While the design of the TA loan was relevant to the ADB strategy for financial sector reform at the time of approval, the loan was processed rapidly (and simultaneously with the FSPL), resulting in a lack of policy dialogue and agreement with the Government and other development partners on the type of TA needed in the Korean financial system. As a result, the TA funds were not utilized for about a year. Parts A and C were covered by the Financial Corporate Restructuring Project (FCRP) of the World Bank approved in August 1998. To avoid duplication, ADB and the Government designed new components with new IAs. KHCB, the proposed IA for part D, was privatized after the crisis and rejected participation in the TA program. The Securities Market Committee (the proposed IA for part C) was absorbed into FSC in April 1998.

3. Accordingly, the Government and ADB agreed to a change in the scope of the TA loan that replaced its original four components with three new ones: (i) restructuring of financial institutions, (ii) strengthening of KAMCO, and (iii) strengthening of the Korea Deposit Insurance Corporation (KDIC). These revisions concentrated on assisting in (i) the creation of two restructured banks, and (ii) improving KDIC's and KAMCO's recovery of funds spent for bailing out troubled banks. These changes benefited reform of the Korean banking sector restructuring and demonstrated ADB's support for efficient bank restructuring, consolidation, and enhancement of public confidence in the banking system without creating a moral hazard.

4. The major change in scope enhanced its development objectives, broadened its coverage, and resulted in cost reductions and time overruns during implementation. The revised TA loan design supported its development objectives of strengthening both participants in the financial sector market and their regulators to develop a sound and efficient financial sector, while complementing (but not duplicating) the FCRP's efforts. The introduction of the component for restructuring of the financial institutions—Kookmin Bank (KB) and Woori Bank

(WrB)—facilitated the necessary inputs for their successful financial operations and provided them with sustainable opportunities for broader based ownership structures. The component for institutional strengthening of KDIC facilitated its enhanced role in restoring public confidence in the banking system.

5. **Cost, Financing, and Executing Arrangements.** MOFE was the Executing Agency and was responsible for the overall coordination during implementation. The new IAs were KB, WrB, KAMCO, and KDIC. Although in the TA Loan Agreement the Government was to borrow the TA loan, it was not able to make this line item provision in its budget. As such, the Government entered into a subsidiary loan agreement to relend ADB loan funds to the Korea Development Bank (KDB), which onlent the funds to the new IAs. ADB approved this change in implementation arrangements retrospectively in December 1998. KDB paid MOFE a management fee (0.5%) for principal and interest installments. It also bore the credit risk for the onlending arrangements to the IAs and charged a margin of 40 basis points from KB and WrB and 50 basis points from KDIC and KAMCO. The lower margin was applied to KB and WrB because they were commercial banks.

6. The major change in scope brought the TA cost down considerably to $13.6 million (including $7.9 million from the ADB TA loan) from the appraisal estimate of $22.7 million (including $15.0 million from the ADB loan). The cost underrun was due to not financing domestic consultancies from the loan, lower cost of domestic training and workshops, and cancellation of the unallocated amount in the TA's budget. The four IAs borrowed the loan funds from KDB with interest and were diligent in using their resources efficiently. The first disbursement was made in June 1999, 18 months after TA approval, and the final disbursement was in October 2002. There was no disbursement schedule in the report and recommendation of the President or the Loan Agreement. Loan covenants did not need revision due to the change in TA scope. All covenants of the Loan Agreement were complied with satisfactorily.

7. **Procurement and Scheduling.** Project implementation was initially envisaged over a 2-year period beginning in January 1998. Due to the revisions in the project scope, the TA loan was unutilized for over a year. Implementation of the revised Project started in June 1999 and ended in May 2002. The implementation period was extended to 31 December 2002. After completion of all activities under the revised project scope, the TA loan was closed on 31 October 2002. At appraisal, the TA loan envisaged 312 person-months of consultancy spread over 2 years, but the actual implementation extended to 2-and-a-half years. All consultants were selected in accordance with ADB's *Guidelines on the Use of Consultants*.

C. Outputs and Outcomes

8. **Kookmin Bank.** The KB and the Korea Long-Term Credit Bank (KLCB) was merged in January 1999 aiming to benefit from combining the retail clients of KB with the KLCB's corporate clients. The TA aimed to (i) develop a new risk management strategy; (ii) establish a new core business plan and a marketing strategy; (iii) establish measurable performance targets for the merged bank and a system of data collection to measure performance; (iv) estimate the merged bank's capital requirements in accordance with the Basle Committee of Banking Supervision's benchmarks and provide guidelines and a road map for achieving it; (v) plan the human resources and information technology requirements of the merged bank; and (vi) design strategies for recovery of the merged bank's nonperforming loans (NPLs).

9. The KB consultants (Anderson Consulting Company) were fielded from October 1998 to March 1999. Consultants' output was satisfactory and complied with their terms of reference.

Their work was carried out in a participatory manner, maintaining cordial relations with KB staff and seeking feedback on the efficacy of their recommendations in Korea's context. The success of the consultants' output is borne out by KB's operational and financial performance result since 1999.[1] The performance of KB has improved since the TA was provided. The capital adequacy ratio improved from 10% in 1998 to 11% in 2004. The return on assets improved from 0.16 in 1998 to 0.30 in 2004. The NPLs declined from 5.9% in 1999 to 2.9% in 2002 and was 2.3% in 2004.

10. The bank successfully completed unification of brand, information technology upgrading, personnel, organization, and operation according to the unification master plan detailed by the consulting firm. information technology system is mainstreamed into KB system. Corporate lending and process is merged with KLCB. Although business strategy has changed significantly due to business environment changes and mergers with Housing Bank after consulting services, core process has been maintained and developed. Following the consultant recommendations, the bank has also developed the following areas: (i) transformation of seniority personnel system to job competence/performance-oriented personnel system; (ii) establishing marketing strategy according to customer segmentation of retail financing; and (iii) adopting credit evaluation system of lending, collateral evaluation system, and post-event management system.

11. **Woori Bank.** The TA loan provided consulting support for WrB to (i) initiate short-term profit improvement, (ii) establish post-merger integration plans for WrB's different constituents and a road map for its implementation, (iii) prepare an action plan for recapitalization of the bank, (iv) develop a strategy for management and recovery of WrB's NPLs not transferred to KAMCO, (v) create a corporate governance plan, (vi) begin a risk management strategy for WrB, and (vii) establish strategies and action plans for the integration of WrB's human resources and information technology policies.

12. The WrB consultants (Price Waterhouse Coopers) carried out their assignments satisfactorily and within their original time frame from September to December 1998. Although the consultants' suggestions caused some disagreement within WrB, the bank's improved operational and financial performance since 1999 confirms the efficacy of their outputs: (i) improvement of governance system; (ii) introduction of divisional system and customer classification; and (iii) branch offices restructuring, implementing employee harmony program. The improvement were evident in various ways including the stipulation that outside directors to the board be a majority, separation of the board of directors—the decision-making body from the executive board. A management structure was established focusing on shareholder value. Independent profit and loss accounting was introduced with profit responsibilities to each unit and providing them with control over human and physical resources. Customers were classified according to markets. Professional marketing training was provided according to customer classes.

13. Outcome of these changes were that the WrB branch network reduced to a third of its 1997 size closing unprofitable branches. Since 1999, WrB has maintained a satisfactory level of solvency, a comfortable level of liquidity, and an improving trend of profitability. WrB's capital adequacy ratio progressively improved from 8.7% in 1999 to 11.6% in 2002 and further to 12.2% in 2004. The return on assets improved from -4.36% in 2000 to 1.06% in 2001, and declined to 0.28% in 2004 due to increased loan loss provisions. The NPL reduced from 14.04% in 2000 to 2.06% in 2001 to 2%in 2004.

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[1] The project completion report for Loan 1602-KOR provides a detailed description of the outputs.

14. **KAMCO.** The TA loan was designed to give KAMCO the consulting and training services needed to estimate bailout requirements and understand standard methodologies as well as to carry out innovative methodologies, taking into consideration experiences of the Resolution Trust Corporation of the United States and the Institute for the Protection of Bank Savings (IPAB) of Mexico.

15. The consulting firm provided services from July 1998 to April 1999. The consultants worked efficaciously, efficiently, and in a participatory manner, to KAMCO's satisfaction. KAMCO endorsed their recommendations, which provide direction for KAMCO's future operations. In particular, the consultants covered procedures and advanced techniques for financial and corporate restructuring of companies, recovery of public funds used for purchasing and deposition of NPLs. They also made recommendations regarding KAMCO organizational structure and its management information system. Training was provided domestically at the Korea Development Institute for about 1,400 KAMCO staff in 2000 and 2001; on NPL workouts, asset securitization, corporate restructuring, etc., followed by a Diploma examination. Out of the country training was provided to 59 mid-level, KAMCO staff in Dallas Texas with Price Waterhouse Coopers and in Baruch College in New York familiarizing them with techniques adopted by Resolution Trust Corporation of the United States and IPAB of Mexico. One of the key outcomes following the training was the 79% recovery of the bailout funds amounting to W31 million.

16. **KDIC.** In 1997, KDIC issued special bonds guaranteed by the Government to raise additional resources to rescue troubled financial institutions. Its mission during the Korean financial crisis was to restore public confidence in the banking system without creating a moral hazard. The TA loan was intended to strengthen KDIC strategy and staff capability to improve public confidence in KDIC, improve risk management capabilities, strengthen autonomous resolution and recovery function, develop a management information system, and establish a formal training function in KDIC. It used the TA loan for consulting services and for external staff training. The services of a consortium of consultants were used to over 10 months from June 2000 to April 2001. Consultants' performance was relevant to KDIC's needs and KDIC was fully satisfied with the TA. The consortium of consultants was: Deloitte Touche Tohmatus Emerging Markets, Korea Development Institute, and Korea Institute of Finance. The international consultants teamed up with two local consulting firms and tailored their services to suit the KDIC needs.

17. The overseas training programs were held at the City University of New York (Baruch College) for 17 participants from November to December 2000, the program was halted in 2001 due to the terrorist attacks in New York. The training focused on-site training included visiting the US supervisory authorities such as FDIC, FRB, OCC, as well as private sector entities. Based on the consultant recommendations, each department promoted the management strategy with the plan for strengthening implementation process and capabilities in KDIC's core business. KDIC also expanded Risk Management Department and investment on Information Technology Department. The least cost principle and equitable loss sharing principle has been adopted minimizing the resolution cost of failed financial institution. Enactment of Public Fund Oversight Special Act helped KDIC take strong responsibility and right as an executive organization of public fund. Enactment of Depositor Protection Act enabled the KDIC avoid conflicts of interests by replacing seven delegates from insured institutions to four civilian delegates.

D. Overall Assessment

18. **Relevance.** The original TA design was relevant. However, a change in scope was needed due to the lack of ownership. The subsequent change in scope was also relevant and had much better ownership from the institutions involved.

19. **Efficacy.** The TA was efficacious and the objectives of its revised design were achieved contributing to strengthen the financial sector reforms by restructuring two major commercial banks. The training programs conducted for KDIC and KAMCO enabled them to support the recovery efforts. The consultant performed well and their recommendations were adopted by the IAs and the Government as envisaged.

20. **Efficiency.** The TA was less than efficient taking into account the delays in redesign, implementation arrangements, and disbursement. The closing date was extended by nearly 2 years. The counterpart funding was available without delay.

21. **Sustainability.** The TA outcomes strengthened the efficiency of the four institutions involved and enhanced their staff capacity. The trainees have been absorbed to the institutions and the knowledge acquired has been used and passed on in in-house training programs. About half of the public funds spent by KAMCO and KDIC in the bail outs have been recovered by 2004. The performance of the KB and WrB has improved and they are also sustainable. Overall, the sustainability of the TA outcomes has been likely.

22. **Institutional Development.** The TA recommendations provided key inputs to strengthen the legislation (i.e., Public Fund Oversight Special Act and amendments to Depositor Protection Act) and regulations relating to KDIC and KAMCO and enabled them to avoid moral hazard. Based on TA inputs, the Public Fund Oversight Special Act endorsed the need for transparency and cost-effectiveness in the resolution of banks. The Depositor Protection Act endorsed the autonomy of KDIC. The TA institutional development and other impacts are assessed as significant.

23. Based on the above criteria, the TA loan is rated as successful.