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Post-Crisis Financial Reform in Korea:

A Critical Appraisal

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Abstract

In the aftermath of the economic crisis of 1997-98 South Korea has undertaken a number of financial reforms under IMF auspices. One of such reforms was in financial supervision, which created the Financial Supervisory Commission and the Financial Supervisory Service. In spite of these reforms Korea has recently experienced a costly financial instability relating to credit-card companies and household debts. Korea's success in bringing about rapid economic recovery from the crisis may have lessened, as suggested by the World Bank, the urgency for full financial reform. This paper, however, argues that the newly created supervisory agencies, although created as independent agencies, have not in fact functioned as such and thus failed to carry out proper supervision over credit-card companies. It is argued that those agencies have not been able to function independently due to institutional constraints imposed on them by other extant, formal as well as informal, institutions in Korea.

JEL Classification: G2
Keywords: Financial reform, financial supervision, institutions

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1. Introduction

In the aftermath of the economic crisis of 1997-98 South Korea (henceforth Korea) has undertaken a number of reforms in its financial system under IMF auspices. The Bank of Korea Act was revised to provide for central bank independence with price stability as the Bank's main mandate, and two state-owned corporations, the Korea Asset Management Corporation (KAMCO) and the Korea Deposit Insurance Corporation (KDIC), were reorganized to clean up the non-performing loans and strengthen the capital base of banks.

Major changes also took place in financial supervision with the creation of the Financial Supervisory Commission (FSC) in April 1998 and the establishment of the Financial Supervisory Service (FSS) in January 1999. FSC was created to act as the integrated supervisor of all types of financial institutions and markets while FSS was established to function as the executive arm of FSC. FSC is a government agency whereas FSS is a private corporation in the form of a special legal entity operating in the public sector, and the two are formally separate and independent agencies. In their operation, however, they are supposed and expected to function as a single supervisory authority.

Under the new system of integrated financial supervision the bank supervisory function was transferred from the Bank of Korea (BOK) to FSC/FSS while monetary and credit policy functions, over which the Ministry of Finance and Economy (MOFE) had had a considerable leverage, became wholly vested in BOK with the autonomy to pursue the goal of monetary stability strengthened.[i] Non-bank supervisory function was transferred from MOFE to FCC/FSC. KDIC, which first began its deposit insurance operation for insured banks in January 1997, became an integrated deposit insurance agency in April 1998, taking in as its charge not only insured banks but also insured non-bank financial institutions (NBFIs). Now, with these changes MOFE, FSC/FSS, BOK, and KDIC have become the agencies responsible for Korea's financial system (Kim 2004c).

All these changes clearly attest to the fact that Korea has undertaken a number of major institutional reforms in its financial system in the few years following the financial crisis of 1997-98. In spite of these reforms, however, there still remain doubts as to whether Korea has succeeded in creating an efficient and stable financial system. In fact, a World Bank report on Korea's financial sector reform, which seemingly commends Korea for having made major progress in reforming its financial sector, notes that "[d]espite notable progress in prudential supervision, concerns remain about the regulator's ability to supervise certain risks in an integrated, coherent manner and to

respond to new challenges" (World Bank 2003, p.2). Korea's recent costly experience with financial instability relating to credit-card companies and household debts is a case in point that renders support to the concerns raised by the World Bank about the state of financial supervision in Korea.

One of the reasons offered by the World Bank for Korea's less than fully adequate progress in financial sector reform is its success in bringing about rapid economic recovery from the crisis; the success has made further reforms appear less urgent or even unnecessary. In this paper we argue that there is a reason much more fundamental than that, and it is that the reforms that have been undertaken are mostly in formal institutions of financial supervision with necessary reforms in informal institutions yet to be undertaken. The latter are more difficult to execute than reforms in formal institutions.

Numerous studies on institutional reform have shown that countries installing new formal institutions may fail to reap the expected positive effects if these institutions are not compatible with the countries' informal institutions (e.g., Lin and Nugent 1995, Ruis and van de Walle 2003). In other words, institutional reform is a path-dependent process with initial conditions—the existing formal as well as informal institutions—limiting the type of new formal institutions that can be introduced with success.

In this paper we argue that the formal institutions for financial supervision that were introduced in Korea following the crisis have been less than fully successful in carrying out their statutory responsibilities because of their incompatibility with other extant, formal as well as informal, institutions in Korea. More specifically, we argue that FSC/FSS and BOK, which were created or reorganized as *independent* agencies after the crisis, have not in fact functioned as such and, consequently, failed to prevent the recent financial instability involving credit-card companies and household debts. In fact, this is a point alluded to by the World Bank (2003) when it recommends that "[t]he division of responsibilities between MOFE, FSC, and the FSS should be made more transparent **…** [and] … [s]teps should be taken to reassure markets that the independence of the regulator is important" (p.2).

Our view is that the reforms that have been carried out in Korea since the crisis were a continuation and culmination of the reform process that began with a change in political leadership in 1980. In the early 1980s the new government launched a major paradigmatic shift in political economy from state-led developmentalism that guided economic policies during the 1960s and the 1970s to a liberal market economy at the behest of liberal reform-minded economists. This shift did not, however, mean that actual reforms strictly followed the prescription of the new paradigm, as interest politics

played an increasingly influential role in shaping the reform process and its outcome. The actual reforms were thus far from being guided by theoretically correct reform agenda, and their cumulative effect was the economic crisis of 1997-98.

The crisis nevertheless had the immediate effect of galvanizing political support for reform, strengthening the state capability to undertake reform, but in 1998, unlike in 1980, there was no paradigmatic shift in political economy. In fact, the post-crisis reforms were an extension of the pre-crisis reform process that began in the early 1980s and had continued to the eve of the crisis. The institutional forces that had made the pre-crisis reforms half-done and incomplete prevailed even after the crisis, restraining the scope of reform and its effectiveness, as will be demonstrated in our discussion of supervisory failures in both the pre- and post-crisis periods. Thus, understanding the post-crisis financial reform requires understanding the pre-crisis financial reform as well.

The plan of the paper is as follows. In section 2 we discuss the political economy of the major reform attempts that began in the early 1980s, the pre-crisis financial reform during the 1980s and 1990s, and the supervisory failure relating to merchant banks that led to the crisis of 1997-98 as a way of providing a benchmark for comparison with financial supervision in the post-crisis era. In section 3 we discuss the financial reform in the immediate aftermath of the crisis and examine the supervisory failure with respect to credit-card companies and household debts. Section 4 presents a summary and conclusions.

2. Pre-Crisis Reform of the Financial System and Supervisory Failure

2.1. Political Economy of Major Reforms in the early 1980s

Korea began its march toward establishing a liberal market economy in the early 1980s although the reform that began then was largely in the area of macroeconomic policies. It was nevertheless a success in that it helped Korea gain rapid economic growth throughout the 1980s. Macroeconomic stability was achieved with moderate budget deficits and a manageable external debt, low or moderate inflation, and a stable exchange rate (World Bank 1993). This success came, however, at a cost as it dulled the urgency for solving structural or microeconomic problems such as the power of *chaebols* and their opaque corporate governance that were becoming increasingly evident to knowledgeable observers of the Korean economy.

The reform that began in the early 1980s left largely intact many of the economic institutions such as the basic economic structure that relied heavily on *chaebol*s, their relationship with the state, corporate governance, and industrial relations (up to the mid-1980s). Although changing macroeconomic policies is a politically

challenging task as it inevitably impacts adversely some powerful interest groups in society**,** it is not as difficult as disbanding or downsizing *chaebols* and changing corporate governance and labor-management relations.[ii] The latter requires changing formal institutions such as laws and property rights as well as informal institutions such as sanctions, taboos, customs, traditions, and the codes of conduct, which govern the way that individuals in society interact with each other. These are local-specific conditions that any attempt to reform the country's formal institutions must take into account, as they are slow to change and may not be compatible with newly introduced formal institutions.

One of the difficulties in changing institutions is that the durability of informal institutions constrains the type and speed of change that may be made in formal institutions since the newly introduced formal institutions will have to be compatible with informal institutions if they are to be effective.[iii] This is a conclusion that Lin and Nugent (1995, p.2362) reach, as in the following quote, after an extensive survey of the literature:

> **"**[M]ere transplantations of successful institutions from DCs to LDCs [are], at best, unlikely to have the expected positive effects on performance, and, at worst, may have rather disastrous effects. Where to start and how to bring about the reforms in a country are questions that can be answered only with serious consideration of the country's existing institutional structure and human and physical endowments.**"**

The privatization of banks in Korea, which was carried out in the early 1980s, is an exemplary case that clearly demonstrates how informal institutions may limit the effectiveness of formal institutions. In spite of their privatization in terms of law and official policy, the government continued to interfere with the banks by appointing bank directors and officials and by maintaining an "overly cozy" relationship with them (Emery 2001). It should be pointed out, however, that although such relationship is obviously abnormal seen from an Anglo-American perspective there is nothing extraordinary about it in the Korean context where in the tradition of Confucianism the government staffed by educated mandarins is expected to take an active role in promoting economic development (Cho 1994). It was such a culturally deep-rooted attitude toward government that gave legitimacy to the extra-legal influence that the government exercised over the banks that had been legally privatized.

The reform that began in the early 1980s brought about a radical change in Korea's political economy. This did not mean, however, that there was a wholesale transition from a state-led system, where economic policy decisions were made by "state elites (leaders of the military, senior civilian bureaucrats, top policy specialists) in

close collaboration with the top business leaders," to a liberal market order (Kong 2000, pp. 130-1). It was only the beginning of a new political economy where policy-making became subject to the pressures from big business firms that were becoming increasingly independent of the state as well as the pressures from the entrenched power of the bureaucracy and the previously excluded forces and short-term electoral considerations (Moon 1994).

The new paradigm, by prescribing in principle state intervention in the market at most to *functional* intervention,[iv] led to the diminution of the power of the state relative to society and the weakening of state autonomy in policy formulation and implementation. That is, with the new paradigm in place that constrained the power of the state it became easier for vested interests to become organized and actively pursue their parochial interests at the expense of the developmental objectives of the state. Such interest groups, becoming more active after the mid-1980s, were labor unions, consumer organizations, taxpayers, intellectuals, and the media. They began to make their voices heard in policy making, thus weakening the autonomy that the policy elites had enjoyed until then.

The voices of those interest groups had a significant effect on the actual course of reforms undertaken in Korea. The policy elites, who were used to the practice of command and discretion but now began to be increasingly co-opted by interest groups, and the vested interests of domestic producers, who benefited from those practices, fought their rear-guard action against the forces of change, blocking or distorting the reform efforts in many sectors of the economy. The reforms actually implemented in Korea in the 1980s and 1990s were, consequently, an outcome of "conflict and contradiction between these traditional and new forces" (Yoo 2001, p.370).

Of course, interest politics itself does not necessarily lead to the failure in economic reform if the country has a political system that can effectively mediate the claims of competing interest groups for reasonable compromise solutions. When Korea was *democratized* in the mid-1980s it was nevertheless far from having such a system in place. It lacked strong democratic institutions such as a firmly established system of legislative bargaining necessary for disputing parties to negotiate (Mo 2001). Even in the areas where formal democratic institutions existed they were not very effective as they were not compatible with the country's traditional political culture. For example, in the National Assembly of the Republic of Korea informal rules such as constraints on majority rule often took precedence over formal rules; people were lukewarm in supporting democracy in action although they expressed their support for it in principle; and they lacked the fundamental democratic values and attitudes such as pragmatism,

trust and tolerance, and the belief in equality and rights (Mo 2001).

2.2. Pre-Crisis Financial Reform

Financial markets are one sector in the Korean economy where substantial, yet partial reforms were undertaken through the 1980s and 1990s, which we argue planted the seeds for the crisis of 1997-98. The reforms were undertaken as a matter of removing state intervention from markets: financial markets were deregulated without first putting in place appropriate supervisory institutions to keep them efficient and stable.

The fact that the policymakers in Korea accepted the principle of financial liberalization, even if they understood it correctly,[v] does not mean that they were successful in carrying out the reform in strict accordance with the principle. Powerful interest groups influenced the way that financial reform was carried out. In what follows we discuss in greater detail how some of the deregulatory policy initiatives were undertaken.

In the early 1990s, the government deregulated the entry and business scope of financial institutions in order to promote competition in financial markets and increase market efficiency. As a result, a number of merchant banks were created; some were newly created but many of them were former investment finance companies that had been owned and controlled by *chaebols* and have remained so although the names changed.

Another important deregulation in domestic financial markets was a significant loosening of restrictions on *chaebols'* ownership of other NBFIs such as life insurance companies and investment trust companies. Before deregulation, the top 15 *chaebols* were not allowed to own and control life insurance companies while the next top 15 *chaebols* were allowed to have only up to a 50 percent ownership of life insurance companies. But, in May 1996, many of these restrictions were relaxed allowing most of *chaebols* to own and control life insurance as well as investment trust companies.

In the 1980s the government was not successful in deregulating interest rates because of the opposition by *chaebols* that feared a heavier interest burden that higher market-determined interest rates would impose on them (Choi 1993). In the 1990s, however, much progress was made in interest-rate deregulation because they now saw an advantage in having NBFIs freed from government control and thus having freer access to credit. Thus, in 1993 restrictions were lifted on all lending interest rates (except for those on policy loans) as well as many deposit interest rates, including those on long-term savings, corporate bonds, certificates of deposits, and checking accounts. The actual implementation of this deregulation policy took, however, a bizarre course.

As originally planned, long-term interest rates were to be deregulated before short-term interest rates. In the event, however, short-term interest rates such as the rates on the certificates of deposits and commercial papers of NBFIs were deregulated first in a speedy manner while the time deposit rates of commercial banks remained under government control. Likewise, all restrictions were removed from interest rates on NBFIs' commercial papers and the amount that they could issue while restrictions remained on the interest rates on commercial bank loans and corporate bonds.

A consequence of this "short term commodities first, long term commodities later" deregulation was a rapid increase of the share of commercial papers in corporate external financing from 7.6 percent in 1992 to 16.1 percent in 1995 (Cho 1999). High-yield commercial papers and other short-term instruments became an important segment of the financial market with NBFIs becoming major players. The market also turned into a dualistic structure consisting of tightly controlled commercial banks lending at low controlled interest rates and rapidly growing and relatively free NBFIs headed by merchant banks, many of them owned by *chaebols*, lending at higher market-determined interest rates.

There was a confluence of three forces that made the post-1993 financial opening of Korea one of the most rapid and comprehensive openings in the developing world. First, since there was a ceiling on the aggregate amount of bank credit that the 30 largest *chaebols* could obtain they looked for alternative sources of finance. They turned to NBFIs for additional financing but they also sought financing from offshore banking and began pressuring the government to liberalize international financial transactions.

Second, the external pressure to open the financial markets increased starting in the mid-1980s. Korea decided to open the markets to foreign competition in the early 1980s, but its implementation was very slow until the mid-1980s when Korea experienced its first ever current account surplus and the opening of the capital market became a serious trade issue between Korea and the United States. The pressure to open the markets increased greatly in 1989 when the U.S. government made it a policy goal to open the Korean financial markets and improve the treatment of U.S. financial institutions in Korea (Frankel 1992).

Third, the Korean government had its own reason for pushing for financial market opening, as it was keenly interested in joining the OECD and capital-account opening was a condition required for Korea's membership in the OECD.

The measures taken to open the capital account included removing regulations on the issuance of foreign currency-denominated bonds by domestic firms and financial institutions, export-related foreign borrowing and general commercial borrowing, and

abolishing the annual ceiling on foreign currency loans by financial institutions. These measures did not, however, apply equally to both long-term and short-term transactions: short-term transactions were fully deregulated while long-term transactions were either partially deregulated or not at all.

What accounts for the unbalanced financial opening in Korea? Although the Korean government was fully committed to the principle of financial liberalization it nonetheless regarded it necessary to use the commercial banks as a vehicle for achieving policy objectives such as promoting small and medium-sized enterprises and establishing strategic industries.[vi] The pressure for financial liberalization was increasing, however, from both *chaebols* that saw the advantage of having freer access to the global capital market through their NBFIs and the foreign financial interests that saw profitable opportunities in investing in the then booming Korean economy. Under such unyielding pressures the government undertook financial reform, giving in where the pressure was strong and holding back where it was not (Cho 2003). Given that NBFIs' activities were mainly in short-term transactions whereas those of the commercial banks were in longer-term maturities, the unbalanced financial opening was an inevitable outcome of the interest politics playing on financial reform.

While financial liberalization—both external and internal—gave more freedom to *chaebols* in their search for financing, the government's ability to control them and curb their highly concentrated economic power was significantly reduced since 1993. For instance, in 1993 the credit-ceiling scheme—the last stick that the government had over *chaebols*—was modified, exempting from the ceiling the *chaebol*-affiliated companies that were in *chaebols'* chosen areas of specialization. Furthermore, the number of *chaebols* to which the ceiling applied was reduced from the top 50 to the top 30 in 1993 and was further reduced to the top 10 in 1996. Restrictions on the holdings of non-business related land and the debt structure were also abolished. The ceiling on the ownership of bank shares was also raised in 1994, allowing more shares to be purchased by *chaebols*, and in 1996 they were given more freedom with respect to the ownership of NBFIs. Although the government also made effort to introduce stricter rules regarding cross-debt guarantees, cross-shareholdings, insider trading, the role of the board of directors, and the rights of minority shareholders it failed to translate its effort into laws.

2.3. Supervisory Failure Relating to Merchant Banks

In the mid-1990s when capital-account liberalization was under way external financing was permitted to merchant banks but not to investment finance companies. This

imbalance created an incentive for the latter to become merchant banks, and that led to an increasing political pressure to allow their conversion. MOFE responded, perhaps too readily, to the pressure and allowed nine conversions in 1994 and 15 in 1996 (Choi 2001). It was lax as well in issuing foreign branching licenses to merchant banks, thus causing excessive competition among them and encouraging excessive risk-taking on their part (Choi 2001).

To make the situation worse, the merchant banks were subject to very weak prudential regulations (Choi 2001). For example, in computing the capital adequacy ratio for merchant banks their asset values were simply added. This was an inappropriate measure of the ratio, as the merchant banks had begun extensive external financing in 1994 and the commercial banks were already subject to the BIS capital adequacy ratios. Regulations regarding loan concentrations and connected lending were also very weak (Choi 2001).

In addition, the merchant banks faced a serious maturity mismatch between their foreign currency-denominated assets and liabilities, a consequence of the unbalanced deregulation undertaken in the early 1990s that encouraged short-term borrowing (Cho 2003, Choi 2001). They had also made excessive investments in junk bonds of Southeast Asia, a consequence of MOFE's exclusion of investments in foreign currency-denominated securities from the regulatory limits on the total amount invested in securities (Choi 2001).

What accounted for the failure of MOFE to properly supervise NBFIs? First of all, we find that the regulatory jurisdiction relating to NBFIs was divided among various laws and regulations and supervisory tasks also were dispersed widely among different departments and bureaus within the ministry. This dispersion made it difficult, if not impossible, to carry out coordinated supervision and, consequently, there was a virtual supervisory vacuum in 1994-96. In fact, although MOFE (or BOK at the request of MOFE) was supposed to undertake on-site examinations of NBFIs' foreign exchange transactions no such examinations were actually carried out during that period (Choi 2001).

Wide dispersion of financial supervision, which is aptly referred to as "supervisory fragmentation" (Lindgren *et al.*, 1999), was an inevitable consequence of the then prevailing institutional structure of MOFE (Kim, 2004d). Since the Economic Planning Board (EPB) and the Ministry of Finance (MOF) were merged into MOFE in December 1994, the formulation and implementation of the nation's economic policies has been one of MOFE's primary tasks.[vii] In contrast, supervising NBFIs, which became MOFE's charge, was regarded to be of secondary importance.[viii] It is thus likely

that MOFE did not give due attention to its supervisory task or, if it did, subordinated it to the pursuit of short-term objectives such as economic recovery and rapid financial liberalization, including relaxing control over foreign exchange transactions, required for joining the OECD. What made this tendency more likely is that MOFE lacked the expertise as well as human and physical resources for carrying out its supervisory task (Choi 2001, Kim 2004a).

The second reason is that the time horizon of supervisory bureaucrats tended to be short (Kim 2004a). This tendency is basically due to the policy of rotating appointments of bureaucrats to supervisory positions with no fixed tenure in the office. It thus has encouraged supervisory officials to take a myopic view of events and stick to their bureaucratic routine as much as possible. A consequence of such behavior was the customary sweeping of problems under the rug, which in fact resulted in regulatory forbearance. In addition, as noted in the World Bank report (2003), this policy of staff rotation between FSC and MOFE has undermined the credibility of supervisory independence and led to shortages of expertise in some key areas of supervision.

The third reason is that MOFE lacked a basic understanding of the supervisory process. In undertaking financial deregulation and capital-account liberalization it did not make certain that the merchant banks developed the capability for risk management necessary for operation in a deregulated environment. Given that most of the merchant banks had been investment finance companies only a few years back they had had yet to acquire the expertise for risk management *qua* merchant banks. In other words, the merchant banks were ill prepared for successful operation in a business environment that had been newly created by financial deregulation and capital-account liberalization (Choi, 2001).

Finally, it is possible that regulatory *capture* took place since, as noted by Kong (2000) and Moon (1994), interest politics began to play an important role in policy formulation and implementation in Korea. It is well known in economic literature that supervisory agencies are apt to be captured by those who they are supposed to supervise.[ix] In the case of Korea, the fact that the National Assembly held a public hearing in early February 1999 on MOFE's handling of conversion licenses for investment finance companies in the years preceding the crisis suggests that many of its members suspected regulatory capture in the conversion cases (Choi, 2001). Adding to this suspicion is a report that many MOFE officials moved to high positions at merchant banks upon retirement, serving as their advocates in dealing with MOFE (Lee, Lee and Lee 2002).

3. Post-Crisis Reforms and Supervisory Failure

3.1 Financial Reform in 1997-98

As part of the post-crisis reform in financial policy and supervision the government undertook a major structural change in its main economic ministry, MOFE. With the newly amended Government Organization Act promulgated early in 1998, MOFE was reorganized with some of its functions transferred to other public agencies. For instance, its non-bank supervisory function was transferred to FSC while its monetary and credit policy functions were transferred to BOK. In addition, the budgetary functions were taken away from MOFE. This reorganization of MOFE was prompted by the realization that its "policy decision-making had become overly concentrated, thereby undermining the checks and balances required for effective government"(MOFE, 2002) and the criticism that those weaknesses had contributed much to Korea's financial crisis of 1997-98.

The reform of MOFE and in financial supervision led to the division of responsibilities and powers that had been concentrated in MOFE among a number of public agencies. MOFE was assigned the task of developing the legal framework for the nation's financial system and using public funds in a crisis; FSC/FSS that of supervising financial institutions; BOK that of maintaining monetary stability and keeping an oversight of the financial system; and KDIC that of protecting depositors. In other words the new regulatory regime's defining characteristic was the division of responsibilities among a number of public agencies with each of them given its own policy mandate and responsibilities while at the same time sharing a common objective of securing financial stability. The new regime, however, was not successful in achieving this objective as it failed to bring about interagency cooperation necessary for policy coordination and to maintain checks and balances among them (Kim, 2004e).

In spite of the appearance of being based on the division of responsibilities among specialized and separate agencies, it was not long before the new regulatory regime in effect turned into a hierarchical system (Kim *et al.*, 2002). With the power to initiate legislation MOFE has become the most powerful agency dominating other agencies[x] although the system is supposed to work on the basis of the division of responsibilities and powers. Thus FSC/FSS and BOK have come under the direct influence of MOFE and there has been very little of either functional cooperation or horizontal checks and balances among the public agencies. Appearances to the contrary, the *modus operandi* of the new regulatory regime remains the same as that of the old one in which all the powers and policy functions were in the hands of MOFE. In short, the post-crisis reforms in financial supervision have had very little effect on the way that

financial supervision is carried out in Korea (Kim 2004c). In this regard it is worth quoting fully a passage from the World Bank report on Korea's financial sector reform (2003, p.6-7):[xi]

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

Below we discuss supervisory failures relating to credit-card companies as a case study that demonstrates the failure of reforms in formal institutions in changing the way financial supervision is carried out in Korea. The failures resulted in "the first large-scale, post-crisis instability in the financial markets" (BOK 2004a).

3.2. Supervisory Failure Relating to Credit-Card Companies

Recently, the financial markets in Korea suffered instability with serious prudential problems relating to credit-card companies and huge household indebtedness.[xii] In March 2003 the solvency of those companies began to be widely questioned and soon the financial markets became rocked with instability. To prevent an impending crisis MOFE, FSC/FSS, and BOK intervened, taking the lead in arranging rescue plans and forcing the credit-card companies to abide by hastily drawn-up restructuring packages. Soon afterwards the markets returned to what appeared to be a stable situation.

The basic underlying problem, however, persisted, threatening market stability. For instance, the LG Card, the biggest credit-card company in Korea, became illiquid in November 2003, then subsequently became insolvent and had to be bailed out in January 2004. The seriousness of the problem can be seen in the fact that as of June 2004 there were up to 3.7 million[xiii] credit delinquents[xiv] (one sixth of Korea's economically active population) with total credit to household amounting to US $377 billion (over three fifths of Korea's GDP for 2003) (KFB 2004, BOK 2004b).

What has brought about such huge credit delinquency and household indebtedness? The following quote from FSS (2002) points to a proximate cause for the problem—a misconduct by the credit card companies:

> "[G]ranting cards to minors without parental consent, renewal or re-issuance of cards after expiration without the consent of the member even though no transaction took place in the

> member account, … attempts to attract new members with offer of high-priced giveaways, … setting credit limits well beyond the card members' income or ability to pay only after perfunctory or negligent verification process, and using the offer of high credit limit as a marketing tool to attract new members … ."[xv]

Such misconduct could not have been carried out if the credit-card companies had been proper supervised. Consequently, the ultimate responsibility for their misconduct lies with the supervisory agencies. The following, which is based largely on Kim's investigation (2004d, 2004e) of the relevant documents and data published by MOFE, FSC/FSS, and BOK during the 1999-2003, shows that the post-crisis supervisory failures relating to the credit card companies shares a close structural similarity with the pre-crisis supervisory failures relating to the merchant banks.

3.2.1. MOFE

MOFE began undertaking a series of deregulatory measures for credit-card companies in 1997-99. It included expanding the scope of financial activities permitted (e.g., cash advances and card loans), removing the corporate borrowing limit (20 times the stockholders' equity), and also removing the ceiling ratio (60 percent) of account balances of non-core credit-card businesses (e.g., cash advances and card loans) to account balances of both core (i.e., settlement of credit-card payment) and non-core credit-card businesses (FSS 2003).[xvi] These were soon followed in 1999-2001 with another series of deregulatory measures, which aimed at popularizing a wide use of credit cards by the general public. It included removing the monthly credit limit (a little over $600) on cash advances, offering tax breaks for credit-card purchases, awarding lottery money for the receipts of credit-card payments, requiring corporate entertainment expenses to be paid with corporate credit cards, and offering further tax breaks for credit-card purchases (FSS 2003).[xvii]

These deregulatory measures were undertaken as part of government policies aimed at boosting the domestic demand in the post-crisis economy.[xviii] These, plus MOFE's actions to stimulate real estate investment in the middle of 1998, might have been warranted then as the Korean economy was experiencing a credit crunch and high unemployment as a result of post-crisis restructuring in both real and financial sectors. MOFE, however, continued with its policy of promoting the use of credit cards well beyond those years.

As early as early 2001 there began to appear signs of excessive competition among credit-card companies, as evidenced in widespread practices such as "indiscriminate granting of credit cards – often to unqualified or ineligible applicants"

and "street solicitation" for membership (FSS, 2002). Household debts (including credit-card debts) were snowballing and the number of credit defaulters was increasing at a rapid rate. MOFE nevertheless stuck to its credit-card promotion policy through the first half of 2002 apparently because it was intent on boosting the domestic demand and making a rapid recovery from the crisis of 1997-98.[xix]

In February 2002, the Financial Policy Coordination Committee,[xx] which consisted of the MOFE Vice Minister, FSC Vice Chairman, and the BOK Vice Governor, agreed to pursue a broad set of policy measures to limit the surge of household debts. As it turned out, however, the public agencies did not regard it as a top priority issue as what concerned them the most was economic recovery from the crisis. In fact, at a meeting held in March 2002 the Council expressed its reservation at taking *excessive* measures against household indebtedness, as it feared they would suppress consumption and thus delay economic recovery. It is thus likely that the task of properly supervising credit card companies was subordinated to the goal of bringing about rapid economic recovery.[xxi] A consequence of this policy stance was an increase in overdue credits, credit default, and household indebtedness.

In May 2002, the MOFE Minister, the FSC Chairman, and the Policy Committee Chair of the Millennium Democratic Party (then the incumbent party) got together in the Ruling Party-Administration Consultation Meeting[xxii] and agreed to make an all-out effort to combat the prudential problems relating to credit-card companies and household debts. Finally, faced with the aggravating signs of the problem, MOFE decided to give up its policy of boosting the domestic demand that it had maintained for four years since the middle of 1998. In July 2002 policy measures were introduced to deal with the problem, but because of their belated introduction they only had the effect of putting a heavier regulatory burden on the credit card companies instead of mitigating the severity of the problem. The financial markets suffered a very serious, albeit temporary, instability in the middle of March 2003 when it was discovered that the SK Global committed accounting frauds.

3.2.2. FSC/FSS

In February 2001, FSC/FSS first recognized signs of excessive competition among credit-card companies and decided subsequently to carry out a comprehensive set of measures to deal with the prudential problems relating to credit cards. They wanted to reintroduce, for instance, the ceiling ratio of account balances of non-core credit-card business to account balances of both core and non-core credit-card businesses. FSC/FSS

were, however, unable to put such measures into practice because of MOFE's opposition to revising the relevant laws and regulations.

As noted earlier, the ceiling ratio, which had been set at 60 percent, was removed in 1999 in the hope of advancing economic recovery in the aftermath of the financial crisis. In April 2001, FSC, being concerned with the rapid increase in non-core credit-card businesses such as cash advances and card loans, requested that MOFE provide a legal basis for FSC to reintroduce the ceiling ratio (BAI 2004b). Faced with MOFE's opposition, FSC attempted on its own in May 2001 to re-impose the ceiling ratio at 50 percent (FSS 2001b), taking the position that the re-imposition is a matter of regulatory discretion and is within their jurisdiction.[xxiii] MOFE, however, took issue with FSC, insisting that the re-imposition of the ceiling ratio required a revision in law and was not a matter of regulatory discretion. MOFE was probably opposed to the reintroduction because it feared that such a measure would have a negative effect on the domestic demand and slow the pace of economic recovery. Then, in May 2002, when the problems became worse and urgently demanded a solution MOFE finally revised the law, thus delaying the re-imposition of the ceiling ratio one whole year from the time when FSC/FSS thought it appropriate and necessary.

The inability of FSC/FSS to reintroduce the ceiling ratio clearly demonstrates their lack of autonomy in carrying out their supervisory task alluded to in the World Bank report (2003). The cause for this lack of autonomy lies, we argue, in the hierarchical relationship that MOFE maintains with other public agencies. By being at the top of this hierarchy and by turning discretionary regulatory issues into legislative matters MOFE dominates other agencies in policy matters, turning them practically impotent in carrying out their statutory responsibilities (FSS, 1999). In fact, IMF (2003**,** p.24) also noted in its report on Korea that "prudential regulators lack the unfettered right to issue new regulations which they perceive a need to do so." In this regard it is notable that the Board of Audit and Inspection (2004a, 2004b) provides delineations of several specific incidents in which MOFE has dominated FSC/FSS in supervisory issues on prudential problems of credit-card companies.[xxiv]

Until May 2002, FSC/FSS sent out mixed signals regarding the problem of household debts. Just one month before they had announced plans to strengthen prudential supervision of credit-card companies, but soon after that FSC Chairman stated in a public lecture that prudential policy measures would be pursued carefully so that economic recovery would not be deterred. Such inconsistent signals coming from the supervisory authorities probably created confusion in the financial markets while damaging credibility in supervisory policy. When MOFE took the occasion of the

Ruling Party–Administration Consultation Meeting in May 2002 to announce a change in its policy stance of boosting private consumption, FSC/FSS quickly became decisive in their view on the prudential problems and started taking strict supervisory actions. These actions by FSC/FSS demonstrate that they lacked autonomy and were simply following the policies set by MOFE.

3.2.3. BOK

BOK itself took note of marked increases in cash advances of credit-card companies and household debts as early as September 1999 but did not regard them as a major threat to financial stability. In the first half of 2002, however, BOK began to express in various public statements its concern about the ever-increasing household debts although, like MOFE, it appeared to be torn between two conflicting objectives—boosting the domestic demand for economic recovery and maintaining financial stability. It nevertheless announced in February 2002 the need for strengthening private consumption, thus indicating it was not too concerned with the household debt problems.

In May 2002 the Monetary Policy Committee of BOK made a decision to move the target level of the call rate slightly upward by 0.25 percentage points. The decision was made with the problems of household indebtedness and financial instability in mind. A couple of weeks or so later, MOFE made a complete and sudden turnaround in its policy stance, giving up its long-maintained policy for boosting private consumption. BOK itself then suddenly became expressly concerned with the prudential problems of credit-card companies and household debts.

BOK is *not* a part of the government unlike FSC, which is a government agency of a lower rank than MOFE. But, its passive, inconsistent patterns of behavior towards prudential problems relating to credit-card companies and household debts strongly suggests that in spite of the statutory independence it has gained with the post-crisis financial reform BOK has been subject to influence from MOFE.[xxv] It is likely that MOFE has been able to exert its influence on BOK through its authority to appoint the members of the BOK Monetary Policy Committee and a weakened legal basis of BOK involvement in the matters of financial stability, a consequence of the 1997 revision of the Bank of Korea Act.

3.2.4. Synopsis

The Ruling Party-Administration Consultation Meeting held in May 2002 marked the watershed at which MOFE basically abandoned its policy of boosting the domestic demand in an attempt to rapidly bring about post-crisis economic recovery. It now

began to tackle the prudential problems relating to credit-card companies that had been festering unattended for years. With this change in policy stance by MOFE all other public agencies, including FSC/FSS and BOK, followed suit and became outspoken and decisive in their views and actions regarding the prudential problems. This new public policy stance was in stark contrast with the inconsistent and ambiguous attitudes they had adopted before in public and a clear manifestation of their closely following the dictates of MOFE in all matters relating to the economy.

What FSC/FSS and BOK had done before was to toe, at the expense of carrying out their statutory responsibilities, the policy line dictated by MOFE that was more concerned with achieving macroeconomic policy objectives than financial supervision. But, as soon as MOFE made a complete and sudden turnaround in its policy stance in May 2002, FSC/FSS and BOK likewise made its policy turnaround.

In short, the prudential problems relating to the credit-card companies and household debts were a failure of a system in which MOFE, given its primary mission of achieving economic policy objectives, dominated other public agencies in a wide range of policies. In such a system the task of financial supervision and the necessary interagency supervisory coordination that are necessary for solving the credit card and household debt problems were simply relegated to the back burner until the problems reached crisis proportions.

4. Summary and Conclusions

We have argued in this paper that although Korea has undertaken a number of reforms in its formal regulatory institutions since the crisis of 1997-98 little has changed in the way financial supervision is actually carried out. We explain this failure of reforms to change the *modus operandi* of financial supervision in terms of the proposition we noted at the beginning of the paper: that is, a new formal institution will not be effective unless it is compatible with the country's other extant, formal as well as informal, institutions. In spite of their statutory independence, public agencies such as FSC/FSS and BOK have not operated as truly independent agencies because of the limits imposed on their action by other more powerful institutional constraints. In sum, we identify the following structural causes for the failure of the reform to bring about effective financial supervision in Korea.

The first is the practice of rotating appointments of government officials,[xxvi] which we argue has hampered FSC from acting as an independent agency and from developing technical expertise. This practice is not conducive to supervisory bureaucrats becoming experienced and skillful experts in financial supervision. It has

also given birth to supervisory myopia and regulatory forbearance as, being appointed with no fixed tenure of office, the supervisory bureaucrats tend to be shortsighted and are apt to allow regulatory forbearance through inaction. When there are signs of an emerging problem they are inclined not to take action, hoping that the problem would go away. Such inaction results in *de facto* regulatory forbearance. That all the public agencies had suffered from this "disaster myopia"[xxvii] until the first half of 2002 when the problems relating to the credit card companies reached crisis proportions is an example of such regulatory forbearance. Note that this inclination of supervisory bureaucrats towards regulatory forbearance, which would be encouraged by powerful political/industrial interests, would in itself open the back door for their capture by them.

The second is the opaqueness and the lack of openness in decision-making of the Korean government. We noted earlier that MOFE (2002) itself admitted that its policy decision-making before the 1997 financial crisis had been too concentrated for effective checks and balances. MOFE had kept vital economic information to itself, thus limiting the scope of informed debate on policy matters. We now know, for example, that on the eve of the financial crisis of 1997 only a handful of highest-ranking MOFE officials had access to information on the nation's foreign exchange holdings (BOK 1999). The opaqueness and lack of openness in decision-making in government may lead to a purposeful cover-up of the supervisory problems, thus re-enforcing the tendency towards regulatory forbearance and political/industrial capture. Also, as noted by the IMF (2003) and the World Bank (2003), the opaque way in which some of the regulatory rules and regulations were introduced has undermined their effectiveness.

The third is the hierarchical structure of the Korean government that puts MOFE above other public agencies such as FSC/FSS and BOK. This organizational structure has enabled MOFE to dominate them in policy matters and, specifically, to subordinate their supervisory task to achieving MOFE's macroeconomic objectives. Its dominance in policy matters is further strengthened by the practice of routinely rotating bureaucrats frequently between MOFE and FSC, as it has created incentives for them to be more loyal to MOFE than to FSC to which they are temporarily assigned. In this circumstance, FSC bureaucrats may develop a mistaken notion about their mandate, identifying themselves as economic policymakers rather than supervisors and regarding economic policymaking to be more important than supervisory task. Such attitudes have led their supervisory role to be downgraded and become subordinate to MOFE's economic policies.

Policy implications of the above discussion are rather clear: Korea needs to develop truly independent regulatory agencies that are subject to public scrutiny and

held accountable for their action. How to do so remains a challenging question yet to be fully answered, but one thing that is certain is that as long as the present hierarchical relationship between MOFE and the other public agencies persists there is always the possibility that financial supervision will be subordinated to MOFE's other policy objectives. Severing that relationship is thus *sine qua non* for creating truly independent supervisory agencies in Korea.[xxviii]

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Endnotes

[i] Evaluating the degree to which BOK independence was enhanced with the 1997 revision of the BOK Act, Cargill (2001) argues that central bank independence is neither necessary nor sufficient for price stability.

[ii] There are at least two other reasons for lack of reform in the basic economic structure. The first is that the Washington consensus, the guiding principle of the reform in Korea, focused largely, if not entirely, on establishing "correct" macroeconomic policies and removing government intervention from the market. The second reason is that by the time the reform began in the early 1980s *chaebols* had become a powerful political force that was able to influence the formulation and implementation of specific reform agenda to protect their own parochial interests.

[iii] Roland (2004) also points out that "slow-moving" institutions such as culture constrain the transplantation of "fast-moving institutions" such laws and regulations.

[iv] Government intervention was focused on three *functional* areas—restructuring of distressed industries, support for the development of technology, and promotion of competition (World Bank, 1987).

[v] On policymakers seeing financial liberalization simply as a matter of deregulation and how such policies implemented in some of the countries in Asia led to the Asian crisis of 1997-98, see C. Lee (2003).

[vi] MOFE supervised long-term foreign capital transactions while BOK had jurisdiction over short-term foreign capital inflows. The latter reportedly had a greater predilection toward financial liberalization than the former.

[vii] The Economic Planning Board and the Ministry of Finance were merged to become MOFE on December 23, 1994. The background reasons for the merge are stated as follows (MOFE 2002): "Since its inception on July 23, 1961[,] the Economic Planning Board was responsible for formulating comprehensive economic development plans, including 5-year economic and social development plans, drawing up the national budget, and establishing fair trade practices. Since the Ministry of Finance was established [on] July 17, 1948[,] along with the Korean government itself, it formulated national taxation polices, managed the national treasury and accounts, and implemented financial and foreign exchange policies. … MOFE was originally founded to integrate public finance-sector operations, including the budget, national treasury and taxation, to improve policy consistency and effectiveness."

[viii] This perception traced back to the Korean government's practices of financial repression that had begun with the idea of formulating and implanting a series of 5-year economic development plans since the early 1960s, persisting for about thirty years thereafter. Under financial repression, financial resources were seen merely as a strategic instrument of achieving high economic growth and thus they were naturally at the mercy of the government. The governmental policy of financial repression during that period has much to do with the fact that the Ministry of Finance (MOF) took upon itself to supervise both specialized banks and NBFIs, which came into being since the early 1960s. MOF also exerted influences on BOK that was responsible for bank supervision as well as monetary and credit policy. From MOF's point of view, supervising financial institutions was not a matter of supervision *per se*. Instead, supervision by MOF was in a sense constituted part of financial repression and deemed a leverage that the Korean government needed in order to have influence on channeling financial resources strategically into specific industries and firms at very favorable terms (Kim 1996). When MOF was absorbed into MOFE in 1994, this kind of atmosphere may well have been passed on to the latter, which took over the task of supervising specialized banks and NBFIs from MOF. Although financial deregulation had been already under way at that time, laws and institutions were lagging far behind, slow to change. For example, it was not until the economic crisis hit Korea in December 1997 that the BOK Governor replaced the Minister of Finance and Economy in his role as the Chairman of the Monetary Policy Committee of BOK.

[ix] In economic literature this phenomenon is described in phrases such as "politically motivated forbearance" (Das, Quintyn and Taylor 2002) and "political interference" (Das, Quintyn and Taylor 2002, Quintyn and Taylor, 2004), and it has been offered as a cause for the 1997 Asian crisis.
[x] Some critics may take issue with this view on the grounds that FSC organizationally belongs to the Office of the Prime Minister (OPM) but not to MOFE and that in many advanced countries the competent ministry within the government has, like MOFE, the power to develop financial laws, being accompanied nevertheless by no such hierarchical problems as we observe in Korea.
Regarding the first point, it is true that FSC formally belongs to OPM in terms of government organization. FSC, as a public sector agency, was originally so designed at the time of its creation that it could hopefully keep MOFE at an arm's length. However, our experience for the last seven years has clearly proven that such an intentional institutional design was meaningless at all, in the sense that MOFE in fact has dominated FSC all along in policy matters. This is perhaps attributed in part to the fact that the Prime Minister has traditionally been regarded as quite a symbolic, rather than functional, position in Korea.
Regarding the second point, Kim (2004d, p.95) offers the following explanations: "The deep-rooted

Confucianist cultural tradition seems to have provided rich soil that grew the vertical relationships between the public agencies in Korea. In addition, there has been something peculiar about Korean government bureaucrats in general and MOFE bureaucrats in particular that enables the latter, given the power to develop laws, to exercise policy dominance over FSC/FSS and BOK. Related, several features stand out. First, government bureaucrats are accustomed internally to an army-like atmosphere in which any orders from supervisors are deemed authoritative and thus have to be absolutely obeyed by their subordinates in any circumstances. Second, government bureaucrats are accustomed externally to exclusive cohesion in which they act as a clique and protect themselves in unison. These two factors are certainly the core part of the general features that shape the bureaucratic culture in Korea. Third, MOFE bureaucrats have had deep-rooted elitism of their own that was naturally formed in the process of government-driven condensed economic growth for several decades in the latter part of the 20th century. To wit, with Confucianism as a backdrop, MOFE has easily extended its powers, both developing and interpreting laws. These strong powers of MOFE, intertwined with strict order-obedience and exclusive cohesion as a couple of general features of the bureaucratic culture and with deep-rooted elitism of MOFE's own, have worked together to establish and preserve the institutional vertical hierarchy, on top of which MOFE is situated."

[xi] The Securities and Futures Commission (SFC), which appears in the quotation from the World Bank report (2004), is a subcommittee of FSC and has five members. FSC vice chairman chairs SFC, which is responsible for oversight of securities and futures markets. Here we make no distinction between FSC and SFC since the former includes the latter organizationally.

[xii] Household debts expanded greatly after the crisis of 1997 as the banks switched the composition of their assets in favor of public bonds and household loans while significantly reducing corporate loans (Choi 2003).

[xiii] According to the Korea Federation of Banks (KFB), which is the central credit information aggregation agency in Korea, individual consumers that were on the list of credit defaulters totaled 3,693,643 as of the end of June 2004. Over two thirds (68%) of these credit defaulters were related to credit card uses. See KFB (2004) for details. Since Korea had about 23.6 million economically active people as of the end of June 2004 (BOK 2004b), roughly one out of six of them turned out to be a credit defaulter while one out of nine was a credit-card related credit defaulter.

[xiv] As regards individual consumers, a credit defaulter is by definition a person who has loans in arrears in excess of KRW 300,000 (approximately US $270) for over three consecutive months.

[xv] According to FSS (2001), most of these practices became widely used by early 2001, rapidly popularized by street solicitors under contract with credit-card companies. As of the yearend of 2000 there were 31 thousand credit-card solicitors nationwide and they contributed to 58 percent of the total of 18.3 million credit cards newly issued during 2000.

[xvi] Of the three deregulatory measures, the first two were based on the Credit-Specialized Financial Business Act initiated by MOFE and introduced in July 1997, four months before the financial crisis broke out in November 1997. The last measure was introduced by MOFE revising the enforcement ordinances in April 1999. This revision provided MOFE with the regulatory basis for the ensuing revision in the enforcement rules in May 1999 – i.e., removal of the monthly credit limit on cash advances. See FSS (2003).

[xvii] Of the five deregulatory measures, the first one was introduced by MOFE revising the enforcement rules in May 1999. This single measure, among others, proved to have had explosive impacts on credit-card holders' use of cash advances for years. Cash advances in 2002 amounted to about US $28 billion, more than eleven times of those in 1998, which were about $318 billion. The second measure, a tax break offer, was introduced in August 1999, the third in January 2000, and the fourth in October 2000, and the fifth in August 2001.

[xviii] Although no documentary evidence such as public document from MOFE in support of this proposition is available, indirect evidence is readily available. An example is an article written by Mr. Byong Won Bahk in his capacity as the Director of the Economic Policy Bureau of MOFE for the *JoongAng Ilbo* on November 11, 2002 and posted on a MOFE website. As its title "[t]he policy of boosting domestic demand was the unavoidable option that was chosen to stimulate the economy" clearly reveals, his writing attempts to justify MOFE's policy stance of boosting domestic demand that was strongly maintained in 2001 and up until the end of the first half of 2002. Considering Mr. Bahk's own admission, together with the fact that all those deregulatory measures that had been introduced in the aftermath of the 1997 economic crisis were kept unblemished all along during that period, we should be able to arrive at a conclusion that those deregulatory measures including credit-card promotion policy measures were *actively exploited*, not to say they were *introduced at the outset*, as a means of boosting domestic demand during that period. In addition, the recent audit report from the Board of Audit and Inspection (BAI) makes the point very clearly by beginning its general comments as follows (BAI 2004a, p.2): "In response to the occurrence of the 1997 economic crisis, the government removed, in its pursuit of the credit-card promotion policy, part of the existing limits and regulations that related to credit-card companies and credit-card uses. The policy was intended to revive the economy through boosting domestic demand and to secure the tax base through enhancing transparency in commercial transactions." Further, in his interview with the *Chosun Ilbo* (2004b), Mr. Jeung-Hyun Yoon, current FSC Chairman who took office in August 2004, commented that "prudential problems of credit-card companies originated in the process of boosting private consumption that had been undertaken during the previous administration [i.e., the Kim Dae Jung Administration]." Lastly, see also the footnote xx for Mr. Andy Xie's view of this issue.

[xix] According to an article published in the *Chosun Ilbo* (2004a), MOFE was attempting to influence the outcome of the general election in the spring of 2000 and the presidential election in December 2002 by pushing the credit-card promotion policy measures in 1999 –2001.

[xx] The Financial Policy Coordination Committee, an *ad hoc* organization without any legal basis, usually meets eight times a year to discuss financial and/or macroeconomic policies. For years the Council has been the only channel of communication among the public agencies concerned. According Kim (2004d), the Financial Policy Coordination Committee served not as a channel for interagency cooperation and coordination but as a means for justifying MOFE's policy dominance over FSC/FSS and BOK.

[xxi] In his interview with the *Chosun Ilbo* (2004c)**,** Mr. Andy Xie, chief economist for Asia at Morgan Stanley, also notes that the Korean government concentrated solely on stimulating domestic demand by encouraging credit card use and lowering interest rates while putting off fundamental economic reforms. As he sees it, Korea's economic woes are accelerating because growth, unaccompanied by reforms, has reached a limit.

[xxii] The Ruling Party-Administration Consultation Meeting is held two or three times a year on an irregular basis. It is likely that at such meetings political influence, if not political pressure, is transmitted to supervisory agencies, thus compromising their operational independence.

[xxiii] The ceiling ratio is correctly regarded as one of the most powerful direct measures with a great impact on profitability and business patterns of credit-card companies.

[xxiv] The incidents reported in BAI (2004a, 2004b) include those in which MOFE has turned down or delayed a request made by FSC for revision of relevant legislation, and those in which the line of demarcation between laws and regulations has been drawn arbitrarily by MOFE with the result that the competent authorities that are responsible for applying the same rules (e.g., capital adequacy ratios) or the same procedures (e.g., licensing) may often differ – either MOFE or FSC in this matter - across sectors and types of financial institutions such as banking, securities, merchant banks, insurance, credit-card companies, and savings banks.

[xxv] This lack of independence of BOK from MOFE in spite of its statutory independence is similar to

government intervention with banks after bank privatization in the early 1980s discussed earlier in the text.

[xxvi] Consider, for example, the turnover rate of the FSC Chairman. The Act for the Establishment of Financial Supervisory Organizations, enacted on December 31, 1997, explicitly states that the term of office of the FSC Chairman is three years. However, the reality is that no chairman has ever completed his legal term of office and that the 5th chairman has recently taken office since FSC began to operate in April 1998. According to the authors' own computation, the term of office for the four ex-chairmen averages only 19 months or so, i.e., slightly over half of the legal term of office. In addition, those four ex-chairmen as well as the present chairman have all come from MOFE.

[xxvii] According to BIS (2001), "disaster myopia" is "[t]he tendency for investors, entrepreneurs and financial institutions to become overly optimistic in booms … placing too little weight on low-probability adverse events." The recent Korean experience with financial supervision or lack of it that led to the 2003 credit-card fiasco reveals that the public agencies responsible for maintaining financial stability may have suffered the disaster myopia for some years.

[xxviii] For further details in this direction, see Kim (2004a, 2004b).