

# FINANCIAL SECTOR ASSESSMENT

## KOREA

JUNE 2003

EAST ASIA & PACIFIC REGION VICE PRESIDENCY  
FINANCIAL SECTOR VICE PRESIDENCY

BASED ON THE JOINT IMF-WORLD BANK FINANCIAL SECTOR ASSESSMENT  
PROGRAM

### I. INTRODUCTION AND KEY RECOMMENDATIONS

1. Joint IMF/World Bank missions visited Seoul in October 2001, April 2002 and October 2002 to conduct a financial sector assessment.<sup>1</sup> The missions met with Mr. Yun-Churl Jeon, Deputy Prime Minister and Minister of Finance and Economy (MOFE); Mr. Seung Park, Governor of the Bank of Korea (BOK); Keun-Young Lee, Chairman of the Financial Supervisory Commission (FSC); and senior officials of these and other government agencies. The mission also held extensive discussions with financial market participants, think tanks, and members of the academic community. The team thanks the authorities for their hospitality and warmth, and for the excellent cooperation and the frank and open discussions during the team's visits to Seoul and throughout the whole FSAP process.
2. Since the crisis in 1997–98, Korea has made major progress in financial and corporate sector reform: the supervisory and regulatory regime for the financial sector has been substantially strengthened, and recent reforms have helped achieve a high degree of observance of international standards and codes. The problem of non-performing assets and widespread insolvency of financial institutions has been addressed—especially for the banking sector. The banking sector underwent significant consolidation; banks have become more profit oriented, cutting costs, streamlining their operations, shedding staff, and

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<sup>1</sup> Mission members participating in one or more missions comprised Tomás J.T. Baliño (IMF—mission chief), Larry Promisel (World Bank—deputy mission chief); Anne-Marie Gulde (IMF); Oliver Fratzscher, Peter Kyle, William Mako, Behdad Nowroozi, Craig Thorburn (all World Bank); Magally Bernal, Greta Mitchell Casselle, Sonia Echeverri, Dong He, Matthew Jones, Kenneth Kang, Meral Karasulu, Thomas Laryea, Henry Ma, Stuart Yikona, and Jahanara Zaman (all IMF); Alan Ball (U.K. Financial Services Authority), Gregory Johnston (Reserve Bank of Australia); Jonathan Katz (U.S. Securities and Exchange Commission), Chu-Yun Pae (U.S. Federal Reserve Bank of San Francisco), Bengt Radstam, (Swedish National Debt Office); Pedro Teixeira (European Central Bank); and Fot Chyi Wong (Monetary Authority of Singapore). The mission benefited from the assistance of Mr. Paul Gruenwald (IMF Resident Representative in Korea) and his staff.

consolidating branches. In 2001 the sector as a whole registered a profit for the first time since the crisis. Foreign participation in the banking sector has tripled since 1996.

3. Korea's macroeconomic performance since the crisis has been impressive, with strong real growth, low inflation, and rapidly growing official foreign reserves. The overall favorable macroeconomic environment greatly facilitated the improvement of measured financial sector soundness. But these circumstances also permitted a delay in some important reform measures—including, for example, addressing issues in the area of insurance and securities, the adoption of the insolvency framework, and the completion of corporate restructuring—as the fast recovery made these steps appear less urgent and left the reform agenda unfinished. The completion of such reforms is crucial, since otherwise an economic downturn could unveil important weakness.

### **Key Recommendations**

4. Despite 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. Also, despite the important role of connected lending and cross ownership in the financial crisis, information and monitoring of these issues remains weak. Asset classification is, at times, not implemented properly, and provisioning rates are low, considering remaining weaknesses in the corporate sector. Off-site supervisory practices should be enhanced. The supervisory agency does not yet analyze the results of stress-tests of individual institutions in a systematic manner, which would allow a better assessment of individual and systemic risk. The introduction of bancassurance will pose even greater demands on both financial institutions and supervisors, including requiring more sophisticated systems to assess and price risks. The FSC and the Financial Supervisory Service (FSS) will need to evaluate the adequacy of its resources, especially staff, to deal with these issues.

5. The division of responsibilities between MOFE, FSC, and the FSS should be made more transparent. Steps should be taken to reassure markets that the independence of the regulator is important.

6. The banking sector has been recapitalized. Stress tests on its loan portfolio undertaken as a part of the FSAP process suggest that it can handle isolated shocks without compromising its soundness, although a combination of shocks could be problematic for at least some institutions. Banks are also increasingly exposed to potential adverse developments with respect to households, as lending to the household sector has been increasing rapidly. Recent measures to strengthen provisioning for household lending are welcome.

7. The rapid growth in off-balance sheet positions exposes banks and other financial institutions to significant counterparty risk. Remaining uncertainty about the legal enforceability of close-out netting in the event of counterparty bankruptcy under Korean law should be resolved. It would be good also to assess the adequacy of the safety cushions at the exchanges and the feasibility of developing a central clearinghouse to further reduce counterparty risk. Firms that engage in significant derivatives activity should be carefully

scrutinized. In particular, a full on-site examination should be conducted of Korea Development Bank (KDB), given its systemic importance, including a review of derivatives-related accounting systems and practices, and with particular attention to the net market and credit risks arising from the derivatives portfolio. In view of KDB's systemic importance, the on-site inspection should be complemented by a targeted external audit of the bank.

8. The insurance sector still seems financially weak and the capital adequacy requirement needs to be redefined. Some life insurance companies are undercapitalized compared to the eventually fully phased in requirements. Subsequent to the assessment, capital was added, but the authorities should continue to monitor the situation. Greater transparency of the 'quasi-insurance' sector would enhance competition. Continued pension reform is urgent in light of Korea's rapidly aging population, since under current policies Korea's partially funded public pension system will not be able to deliver the promised benefits.

9. Non-bank deposit taking institutions face soundness problems and some parts seem inadequately supervised. This is particularly worrisome given the sector's size and the reputational consequences should there be runs on these institutions. The FSC/FSS should continue to strengthen the oversight of these institutions and resolve promptly any that are insolvent. Securities markets are highly volatile. Tighter supervision of the securities houses—particularly to curb excessive risk-taking by weakly capitalized institutions—seems warranted. Several investment trust companies (ITCs) are financially weak.

10. Special privileges and constraints relating to some specialized and development banks have different effects across financial institutions and distort market competition. It would be appropriate to level the playing field by phasing out such privileges and constraints.

11. Money, bond, and foreign exchange markets are still less developed than is warranted in a market of Korea's size and income level. The observed lack of depth is, in part, related to segmentation in the government debt market and a lack of key maturities. Consolidation of government and government-guaranteed debt will help to enhance transparency and reduce market segmentation. Further steps would include the introduction of short-term securities—to provide a benchmark to the market and to allow the use of Monetary Stabilization Bonds (MSBs) solely for liquidity management—and removal of some remaining impediments to participation by foreigners. Measures to increase institutional investor participation and more regular and larger issues of long-term bonds would foster market development.

12. Corporate governance and disclosure have improved but further steps are needed. Accounting and auditing reform should continue, to align Korea with evolving international best practice.<sup>2</sup> Audit committees need to become more effective. The challenge is to close the gap between standards and actual practice. Other reform areas include improved corporate

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<sup>2</sup> An accounting and auditing ROSC is currently underway.

disclosure, particularly with regard to related-party transactions, strengthening of shareholder rights, and a clearer role for and professional training of outside directors.

13. Corporate restructuring has made significant progress, but a quarter of Korean corporations are increasingly unprofitable and highly leveraged. Exposure of banks to such companies remains a concern. Current proposals to modernize the insolvency regime go in the right direction; a draft Consolidated Insolvency Law was submitted to the National Assembly in February 2003. Passage of the draft law is of key importance, to give Korea an appropriate framework to deal with corporate distress (including a legal basis for close-out netting).

14. Korea has made considerable strides in achieving observance of the Financial Action Task Force's (FATF) recommendations on combating money laundering and the financing of terrorism, but some measures remain to be taken to achieve full observance of the applicable international guidelines.

15. Korea broadly observes other key international standards and codes but full implementation is still in progress. The main findings of the standards assessments are summarized in Box 1, at the end of this report.

## II. SHORT-TERM VULNERABILITIES

16. **Stress tests suggest that Korea's banking sector is broadly resilient to isolated macroeconomic shocks of a plausible size based on the experience over the last five years, although a combination of shocks could be problematic to at least some institutions.** At the time of the assessment, stress tests for the insurance sector yielded more worrisome results, showing that some companies could suffer unsustainable losses even from moderate changes in interest rates and stock prices, although the authorities recently have provided information indicating that the situation with respect to insurance companies had improved by end-2002. The exposure of banks to off-balance sheet risks, weaknesses in the securities and ITCs, and recent capital losses in non-bank financial institutions deserve careful monitoring, as they could cause serious problems in the financial sector, even in the short-run. Exposure to interest rate risk and earnings risk is the main source of vulnerabilities for the corporate sector, despite historically low interest rates and strong growth in the economy. Given the reduced direct foreign borrowing of corporations and the increase in hedging, the corporate sector appears less sensitive to foreign exchange rate risk than at the time of the crisis. However, it appears that many companies do not hedge consistently. Moreover, given the differences in the quality of hedges available in the Korean market, even those that do hedge may face risks.

17. **The following short-term vulnerabilities should be highlighted:**

- **Derivatives and associated supervisory challenges.** The Korean derivatives market was established only in 1996 but has since grown to become one of the largest in the world. There are potentially important benefits: they allow domestic investors and end-users to manage their financial risks better. Use of over-the-counter (OTC) derivative markets reflects the growing participation of increasingly sophisticated

domestic investors and issuers in international markets and their use for trading purposes. The growth of the exchange-traded derivatives market has been fueled by the availability of a technically sophisticated trading platform, the presence of eager retail investors, and strong proprietary interest in equity derivatives trading by some securities companies.

The rapid growth in the overall market size for derivatives calls for supervisory vigilance to prevent financial institutions from taking on excessive risks and to adequately protect retail investors. Some progress had been achieved prior to the FSAP missions. Subsequently, in February 2003, the FSS established a special team within its Supervision Coordination and Planning Department to make supervision of derivatives activities more effective in a number of ways. Also, the authorities have rightly chosen to “go slow” in the liberalization of securities firms’ access to the OTC market, requiring significant capital and adequate risk management systems.

One specific area in which supervision has not kept track of developments relates to KDB, which is a major player and a key market maker in OTC derivatives. KDB has not been subjected to a targeted FSS audit of its derivative activities, and there has not been a general on-site examination, which also would have looked at the bank’s derivative activities, in more than two years.

- **Other supervisory challenges.** A significant amount of non-performing loans (NPLs) in Korean banks’ balance sheets have been securitized. Some of these asset-backed securities (ABS) have included credit enhancements provided by banks. Appropriate disclosure and supervisory vigilance on the valuation and provisioning practices in the ABS market are needed to monitor remaining bank exposure. Insufficient information is available on connected lending and related-party transactions, which was a major problem at the time of the crisis. Finally, the technical capacity of supervisors to stress-test banks’ balance sheets in order to assess their resilience to possible shocks is unclear.
- **Weaknesses in the non-bank deposit institutions.** While these institutions are neither individually nor as a group systemically important, a crisis in that sector might nevertheless tarnish the reputation of the Korean financial system.
- **Weak ITCs.** Public awareness of the financial difficulties and the negative capital ratios of three large ITC companies are increasing. As in the case of non-bank deposit institutions, the main danger could lie in the loss of market confidence and, additionally, possible contagion to other segments of the financial market, in particular since the securities sector as a whole remains weak.
- **Delays in completing corporate restructuring.** Despite the progress made, corporate restructuring has failed to address the problems of about a quarter of the corporations, many of which have negative cash flow, are unprofitable, are excessively leverage, and are likely to fail. While those potential failures are probably smaller than the Daewoo and Hynix cases, they could be substantial in the aggregate and would increase credit losses in financial institutions. (See Box 2, at the end of this report.)

### III. MEDIUM-TERM AND STRUCTURAL ISSUES

18. **The medium-term challenge for Korea's financial sector is to deepen markets, while ensuring that the supervisory and regulatory framework is capable of addressing any associated risks.** This chapter highlights the main areas that might need attention. In the legal and regulatory area there are important challenges, such as ensuring the full independence of the regulator and providing a workable framework for insolvency. Medium-term financial stability will also require addressing structural soundness problems especially in the insurance and securities sectors. Furthermore, impediments to market development are an issue of concern. The further deepening of money, foreign exchange and bond markets all appear closely linked to adequate government debt management practices. Finally, improving corporate governance practices will enhance investor confidence—critical to all other areas discussed.

#### A. Financial Sector Supervision and Regulation

19. **To improve financial supervision and regulation, the authorities reorganized the sector's regulatory agencies in 1998.** The FSC was created to oversee regulation of Korean financial institutions and markets. It is a statutorily independent government agency under the general authority of the President, who appoints its nine-member Board.

20. **The FSC is responsible for policy formulation for the financial markets and is the supervisory and regulatory authority for all banks and non-bank financial institutions.** The powers of the FSC include the authority to issue and revoke licenses for financial institutions. It is responsible for coordinating the activities of and setting policy for the FSS and the Securities and Futures Commission (SFC). The FSS is the executive arm of the FSC. MOFE is to consult with FSC on all proposed legislation pertaining to financial markets that it submits to Parliament. MOFE, the BOK, and the Korea Deposit Insurance Corporation (KDIC) continue to have some involvement in the policymaking, examination, and supervisory process for the financial sector. As a result of the crisis, FSC was also given some responsibilities for corporate sector restructuring.

21. **The FSC, FSS, and SFC have an impressive record of issuing rules and regulations, but concerns remain about some aspects of the regulatory process.** In particular, market participants have questioned the quantity and quality of such regulations, the opaque way in which some of them have been introduced, their interpretation, and the fact that such authorities lack the unfettered right to issue new regulations when they perceive a need to do so. There is also a perception in the market that violations of applicable regulations are often overlooked or weakly sanctioned. Weak implementation of regulations or inadequate sanctions for violations undermine the integrity of the regulatory process and encourage inefficient and inappropriate market behavior.

22. **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.

23. **Supervisory effectiveness may also be hampered by the insufficient legal protection for FSC, FSS, and SFC staff against lawsuits for supervisory actions carried out in good faith.** While there are to date no reported difficulties, this could become an issue as Korea becomes increasingly integrated into the global financial system and participants become less bound by traditional Korean legal customs and procedures. Appropriate legal protection for supervisory staff would help to ensure that fear of retribution does not constrain supervisors when exercising their professional responsibilities.

24. **The FSC was also given, in addition to its role as regulator, responsibility for overseeing the restructuring in the corporate and financial sectors in the wake of the financial crisis.** As a result, it has been put in a position of having to compromise on occasion with what might be appropriate from a purely prudential perspective. Whatever the merits of this assignment of responsibility at the time, corporate and financial restructuring should now be carried forward by the private sector or, in the case of government-owned entities, by the agency holding the shares.

25. **The FSC, FSS, and SFC have a well-trained staff to carry out their responsibilities, but there are indications of shortages of expertise in a few key areas.** Additionally, there are some concerns about the ability of the supervisor to maintain the technical capacity of staff through ongoing recruitment and training in an increasingly complex and competitive financial system. This situation also reflects a national shortage of key professionals. Efforts are under way to reduce these shortages over time, and other efforts might be considered.

26. **Some market participants have voiced concern that prudential supervision is not applied equally, and that there is excessive intervention of the supervisor in day-to-day management.** Market participants also note that the complex regulatory framework makes full compliance with all requirements impossible, leaving them exposed to inconsistent application of fines and retribution. The authorities seem mindful of the need to avoid perceptions of unequal treatment and of unjustified retribution. They are making efforts to make the sanctions process more open and transparent and to allow opportunities for appeal.

## B. Legal Infrastructure

27. **Korea is to be commended for establishing a sound and respected judiciary and judicial system.** Judges are well regarded and considered competent and impartial. In the area of commercial disputes including insolvency, the authorities have strengthened the ability of the courts to respond to the needs of the financial and corporate sectors. Court procedures have been streamlined, although further reforms would help to overcome some concerns regarding perceived delays in the court system, the ability of a creditor to issue attachment proceedings on an *ex parte* basis, and the relatively unfettered right of any party to appeal or to seek adjournments.

28. **The scope and pace of legislative reform following the 1997–98 financial crisis have been extraordinary.** New laws dealing with particular aspects of financial and corporate restructuring and other specialized areas of financial sector reform have been introduced and new institutions were created. Several of these laws have been amended, reflecting the authorities' readiness to fill identified gaps in the legislative and regulatory framework. However, the framework in place is, in certain areas, complex and has resulted in some overlapping responsibility and uncertainty as to lines of authority—particularly in relation to regulatory supervision—and in some tension between regulatory bodies.

29. **The legal framework for secured transactions is generally sound, and a preliminary assessment of the proposals for insolvency reform confirms that the authorities are moving in the right direction.** Company, movable and immovable property registers work well and debt enforcement mechanisms are relatively straightforward. However, there is no provision for non-possessory pledges such as the right to secure inventory and accounts receivable. The introduction of such a form of pledge should be considered, together with a comprehensive review of the secured transactions regime. The adoption of a single unitary law that also addresses consumer rehabilitation and cross border insolvency would be a welcome development. However, an improved legal framework, while desirable, is not sufficient. Of perhaps even greater importance will be the attitude that creditors take to the new regime and whether they will act reasonably to promote solid corporate recovery.

### C. Sectoral Issues

30. **Korea's financial sector is large and diversified, including banks, various non-bank deposit institutions, securities firms and insurance companies, as well as active markets for equities and bonds.** Pension schemes are still in their infancy. In international comparison, given Korea's size and level of development, the sector seems heavily focused on bank intermediation, with securities and equities markets playing a comparatively smaller role.

#### **Banks and non-bank financial institutions**

31. **The restructured banking sector showed profits in 2001 for the first time since the crisis.** Aggregate risk-weighted capital ratios are close to 11 percent even though shareholders' equity capital remains relatively low compared to total (non-risk weighted) capital. Assets amounted to about 180 percent of GDP. Commercial banks primarily engage in traditional financing of the corporate and the household sectors, but they also have limited activities in securities business and factoring, and in derivatives—an area of recent rapid growth. Most banks have leasing and credit card operations. It is expected that bancassurance will become permissible in 2003. Commercial banks are banned from owning real estate other than for business purposes.

32. **Key characteristics of the Korean banking sector are a high share of government ownership and increasing concentration.** Eight out of 15 commercial banks are either majority government owned or co-owned by the government and private owners. When combined with government ownership in specialized and development banks, in mid-2002

nearly 60 percent of the Korean banking sector was government controlled. Foreign ownership increased from about 10 percent in 1998 to more than 30 percent in 2002. Concentration has increased considerably with the consolidation in the sector; following the merger of Hana Bank and Seoul Bank in 2002, three large banks now dominate the market, increasing concentration ratios.

33. **The government has made encouraging strides to return banks under its control to private ownership.** It has found creative ways to place parts of Woori and Chohung in the market and make a number of contingent sales. However, the process remains to be completed. The merger of Hana Bank with Seoul Bank leaves the government with a 30 percent equity stake in the merged bank, which accounted for about 9 percent of banking sector assets in June 2002.<sup>3</sup> In addition to selling this stake, the sales of Woori, Chohung and minority stakes in KEB, KFB, and Kookmin Bank are still pending. Full divestiture would eliminate potential conflicts of interest arising from the government's role as both regulator and owner of banks.

34. **Increased bank concentration has been consistent with the restructuring policy pursued by the government since 2000, and the number of non-viable banks in the system has been reduced.** However, the market, rather than the government, seems better placed to determine over time the structure of the banking system. Despite the increased concentration in the sector, competition in both deposit and loan markets remains healthy. Consumer protection and competition policy should remain important concerns for the authorities, but they should be implemented in a way that allows for innovation.

35. **Special privileges and constraints relating to some specialized and development banks were designed to achieve government objectives but they distort market competition.** For instance KDB, Industrial Bank of Korea (IBK), and the banking sections of the National Agriculture Credit Federation (NACF) and the National Forestry and Fisheries Corporation (NFFC) carry out operations typical of commercial banks, such as deposit taking, lending, trust business, and credit card operations; the IBK is a main competitor of many mid-sized commercial banks in its SME lending business. They enjoy benefits that include some combination of low cost funding through government guarantees, borrowings from the government, as well as preferential treatment regarding some prudential ratios, such as liquidity. It would be appropriate to level the playing field by phasing out any privileges and constraints that have different effects across financial institutions.

36. **Non-bank deposit taking institutions hold more than one quarter of the assets of the total deposit taking system, or about 15 percent of total financial sector assets.** The sector is diverse, including merchant banking corporations, mutual savings banks, a postal savings bank, credit unions, mutual credit facilities and community credit cooperatives. Each type of institution is specialized, and all have important limitations on their business activities.

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<sup>3</sup> The merged bank guarantees the sell-off of the remaining government stake within a year and a half from the time of the merger.

37. **Strength varies across types of institutions, but there have been concerns about weaknesses in the sector.** Most notable are credit unions, which, as a group, have sustained losses for three consecutive years; provisioning is low and 22 percent of these institutions have been closed since 1999. The FSC/FSS recently announced a further round of restructuring or liquidation for about 10 percent of these institutions along with other improvements in its supervision over the sector.

### **Insurance and pensions**

38. **Korea's insurance market is large in world and regional terms**, ranking seventh by premium behind the United States, Japan, the United Kingdom, Germany, France, and Italy. Gross premiums as a percentage of GDP, commonly referred to as "insurance penetration," stood at about 13 percent, the third highest in the world after South Africa and the United Kingdom. Life insurance makes up the largest segment of the market, with 22 companies in operation at the time of the assessment. The sector was particularly affected by the crisis and the subsequent economic conditions, which exposed past product weaknesses, poor quality assets, and a management focus largely on growth.

39. **The principal concern for the insurance sector is the capitalization of the life insurance companies.** The industry is, at best, marginally capable of meeting the current minimum capital requirements once they are fully phased in. A more robust valuation of liabilities, exclusion of double counting of regulatory capital in subsidiaries, and an additional margin for the substantial market risk arising from the asset liability mismatch and exposure to equities would place many companies in a marginal situation. Many of them will have access to capital from their parent, and the regulatory and supervisory regime should require the allocation of this capital to the life insurance business. Others may need closer supervisory intervention. The prudential status of companies would also be enhanced if the impediments to listing were overcome.

40. **The non-life insurance sector has been stable over the last 15 years.** The combined ratios for the companies in the sector indicate marginal but improving profitability. Non-life insurance companies have faced less serious asset liability mismatch issues than the life insurance companies.

41. **The role of the Korean Insurance Development Institute (KIDI) raises some concerns.** While useful in the ongoing development of the sector, the extent of KIDI's continuing role, for example in product development and approval, may discourage individual company innovation and company development of in-house technical expertise, with companies instead continuing to rely on the expertise of KIDI. The procedures and basis for decisions within KIDI are not transparent to industry participants, who were unable to elaborate with confidence on the way their own issues were considered within KIDI. The functions and operations of KIDI should be refined and refocused to enhance their transparency and flexibility, in concert with a system that further encourages companies to develop their own advanced risk management systems.

42. **The government is involved in the insurance sector through its continuing part ownership of Korea Life via the KDIC<sup>4</sup>, and the operations of the ‘quasi-insurance’ sector.**<sup>5</sup> The marked lack of transparency in the “quasi-insurance” sector operations contributes to suspicion from the commercial sector. More transparency would be consistent with the stated public benefit objectives of the “quasi-insurance sector” and facilitate a more soundly based consideration of the merits of its continued operation in its present form.

43. **Regulators should devote close attention to the introduction of bancassurance.** Early attention will need to be given to the potential existence of capital and other regulatory arbitrage and differential taxation treatment of product providers. This would ensure that any refinements can be made while transitional issues are at a minimum.

44. **Pension reform is recognized as necessary given the aging of Korea’s population and the general level of funding of the current arrangements.** Occupational pension schemes are expected to emerge through reform of the current retirement allowance system, although the precise form of the new arrangements is undecided. The current National Pension Scheme, which holds assets amounting to 15 percent of GDP, is facing its own challenges as it attempts to achieve actuarial balance. These pressures arise from benefits accruing at a rate and value in excess of current contributions and an imperative to recover much of the intergenerational subsidy built into the scheme owing to lower past contributions. A small but growing tax-favored voluntary pension sector has emerged over the last five years. The authorities are to be commended for the priority they have attached to these initiatives to date and should continue these efforts, both in terms of the proposals for an occupational pension system in the private sector and for the continued careful consideration of the role and sustainability of the national pension system. The introduction of an occupational pension system will require the establishment of a well considered regulatory and supervisory regime; the effort needed to achieve such a regime should not be underestimated.

### **Fund management and securities**

45. **Korea’s securities and collective investment sector represents about 70 percent of GDP.** Collective investment schemes include more than 260 institutions but are dominated by the ITC sector, which manages assets equal to almost 60 percent of GDP. Forty-four securities firms manage assets equal to about 11 percent of GDP. Some corporate-style investment funds were introduced in 1998, but have not been very successful. Foreign participation in 10 investment trust companies, mostly through minority shares, gradually increased to 19 percent of assets. Given concerns about the soundness of the fund management industry, investors prefer to establish their own funds and roll over investments annually.

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<sup>4</sup> Subsequent to the assessment, Korea Life was privatized.

<sup>5</sup> The Agricultural Cooperative Life Insurance and the Postal Life Insurance operations together account for one-sixth of new business by policies and premium, a quarter of in force premium income, and almost 20 percent of total sector assets.

46. **Securities markets are characterized by high retail participation and significant trading by securities firms on their own account. In contrast, sizeable institutional investors are virtually absent.** This market structure has contributed to high volatility in equity markets and rapid growth in speculative derivatives trading. There are also weaknesses in the investment trust industry, where some companies have negative capital.

47. **Higher participation of institutional investors in Korea's securities markets would greatly benefit the stability and development of that market.** Such investors promote long-term savings, enhance productivity and innovation, emphasize trust and corporate governance, and often become strategic investors. Although Korea has introduced a variety of collective investment vehicles, the fund management industry has not yet been able to rebuild investor trust. Industry experts suggest that corporate governance must be enhanced emphasizing independence, both from government and corporate or sell-side pressures. Moreover, the market requires substantial consolidation. In addition, new legislation on fund management should emphasize market principles and provide safeguards for independence, such as mandatory monthly disclosure of assets, and strict separation between managers and trustees.

#### **D. Market Development and Debt Management Issues**

48. **Three modern exchanges operate in Korea, trading equities and a wide range of securities and derivative instruments.** Foreign and individual retail investors participate heavily in these markets, which exhibit comparatively high volatilities in returns. Institutional investors are not a significant force, as private pension plans are still rare. Derivatives have grown the fastest.

49. **Money and bond markets remain partially fragmented and, at least in certain maturities and instruments, insufficiently deep.** Unlike comparable markets, there is no core "interbank" market. Instead, the call money market encompasses more than 600 financial and non-financial institutions that can also participate in the repo market. While the market is liquid for maturities below 90 days, liquidity dries up quickly beyond that maturity given the difficulties of pricing such deals in the absence of a suitable yield curve.

50. **The bond market encompasses corporate and government bonds of different maturities.** The government bond sector includes a range of different instruments, including bonds issued in the restructuring process (by the Korea Asset Management Company (KAMCO) and KDIC), Exchange Stabilization Bonds, National Housing Bonds and MSBs. There have also been small issuances of 10-year treasury bonds. The multiplicity of instruments, the absence of a short-term benchmark government bond (issued at regular intervals), and an insufficient volume of ten-year government bonds all constrain the market's ability to price risk and the further development of money and bond markets. The market for corporate bonds is not particularly active, especially relative to its potential.

51. **The trading volume in Korea's foreign exchange market has grown significantly since the crisis, when shallowness was a concern.**<sup>6</sup> The expansion in trading is due to the foreign exchange liberalization program that started in April 1999 and the accompanying increase in inflows of foreign direct investment and portfolio investments, as well as to an increase in trade. Also notable is the jump in foreign exchange forward and swap transaction volumes since 1999 following the removal of the *bona fide* (real demand) principle in the use of foreign exchange forward and derivative transactions, and the authorization for onshore financial institutions to transact in offshore non-deliverable forward contracts.

52. **Notwithstanding the sharper increase in foreign exchange forward and swap transactions, spot trading still dominates.**<sup>7</sup> In addition, Korea's foreign exchange market is more end-user and domestically oriented, with cross-border transactions accounting for about a quarter of total foreign exchange volume in 2001, compared with about 70 percent in the comparator countries. The authorities plan to liberalize the capital account further in three phases over the period 2002–2011 and to implement measures to broaden and deepen the foreign exchange market; there may be scope for accelerating some of these measures.

53. **Korea has active money, bond and foreign exchange markets, but further market development hinges upon overcoming some structural problems.** These include insufficient ability to build a yield curve in won assets, which reduces the liquidity of money markets, with possible effects also on investors' ability to hedge activities in the foreign exchange market. In addition, the insufficient volume of longer term government bonds constrains the deepening of the corporate bond market. Government debt management practices, including the choice of types and maturities of instrument offered, can play a critical role in market development.

54. **Korea's short-term money market suffers from some shortcomings.** A lack of instruments prevents the determination of the short-term end of the risk-free yield curve between the overnight and 1-year maturities. This complicates the determination of a prime rate used for pricing of loan contracts and forward foreign exchange transactions. In addition, it impedes the effective transmission of monetary policy to the longer end of the yield curve. Regular issuance of 3-month Treasury bills would help to meet these needs without constraining the use of MSBs for monetary purposes.

55. **On the whole, public debt management conforms to the Guidelines for Public Debt Management.** The risk management framework has been strengthened with the implementation of a simple, yet powerful system. The authorities may now wish to consider broadening the risk management framework towards an asset-liability management (ALM) approach.

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<sup>6</sup> Turnover compares favorably with that in many Asian emerging market economies, although it still lags behind that of most industrialized countries, Hong Kong SAR, and Singapore.

<sup>7</sup> Close to two-thirds of total trade volumes are spot, compared with less than one-third in most industrialized countries, Hong Kong SAR, and Singapore.

56. **The government bond market modernization plan launched two years ago has had important results.** The introduction of a fungible issuance system and the buy-back operations have increased the average issue size and liquidity. The government has also launched a new 10-year Korean Treasury Bond (KTB). Furthermore, interest rate swaps and a futures contract based on the 3-year KTB have been introduced as hedging instruments for KTBs.

57. **The government should develop the long end of the government bond market.** In the long run, such lengthening can lower the government's borrowing costs and, more importantly, facilitate the emergence of a fully developed and liquid corporate bond market. Consolidating Foreign Exchange Stabilization Bonds and National Housing Bonds with KTBs would help in reducing market fragmentation, as is already under way with KDIC and KAMCO bonds.

58. **On the demand side, there is a clear need for more heterogeneous investors with different investment horizons and risk preferences.** The National Pension Fund with its growing demand for assets could be a major force in the market. In addition, more active participation of foreign investors would also be helpful. This would have two main benefits: higher long-term demand for Korean government bonds and enhanced market liquidity from more active trading. The fact that foreign investors presently hold only 1 percent of the outstanding stock of government bonds suggests the existence of impediments to foreign investor participation in the market. Such impediments include the withholding tax on interest income and the restrictions a foreign investor meets when trying to hedge foreign exchange exposure. Constraints related to the still relatively shallow secondary market may, however, be the most important disincentive.

## **E. Financial Safety Nets and Crisis Management Capabilities**

### **Emergency liquidity support**

59. **The BOK Act provides sufficient flexibility for the BOK to provide emergency liquidity assistance (ELA) to financial institutions in periods of instability. The BOK provided extensive ELA during the financial crisis but operations in the post-crisis framework remain untested.** During the crisis, ELA assistance proved critical in containing the systemic liquidity crisis. However, the BOK's ELA operations at that time were conducted when the government blanket guarantee on bank liabilities was still in effect, which is no longer the case. Looking forward, therefore, there could be new challenges for the BOK's ELA operations, should a need for such lending arise again. The BOK has developed an ELA instrument (Liquidity Adjustment Loans) and prepared operational guidelines on the decision process, eligibility criteria, terms and conditions, and disclosure.

60. **On-going market consolidation will produce large financial institutions with complex organizational structures, where banks and non-bank financial institutions have inter-linkages and share common reputational risks. Given the separation of banking supervision from the BOK, assessing the systemic implications of, and providing liquidity support to, such large and complex financial institutions will be more difficult.** There is a need for the BOK and the FSS to strengthen their information

sharing arrangements. The recent memorandum of understanding (MOU) between the BOK and the FSS is a useful step in that direction.

### **Deposit insurance and resolution of financial institutions**

61. **The Korea Deposit Insurance Corporation (KDIC) in cooperation with the Korea Asset Management Company (KAMCO) has been instrumental in resolving distressed financial institutions and in paying depositor claims.** This was done under the blanket Deposit Protection System that was put temporarily in place during the crisis. With the reinstatement of the Partial Deposit Protection System, from January 1, 2001, KDIC's role has broadened from *ex post facto* deposit insurance provider to include expanding responsibilities in monitoring and safeguarding the financial stability of insured deposits and the Deposit Insurance Fund.<sup>8</sup>

62. **The KDIC already has significantly improved its organizational structure to address its changing role.** To safeguard the insurance fund it is considering the introduction of risk-based premiums and the development of risk assessment models to detect potential problems at individual institutions and the system as a whole. While in principle welcome—once preconditions have been met—the introduction of risk-based premiums is a demanding exercise and should be approached with caution, since inadequate implementation could have serious consequences.

63. **The existing safety net and resolution arrangements date from the 1997–98 crisis.** In light of the changed environment, the roles of the different institutions concerned may now need to be reviewed, to set clear responsibilities to all those institutions and establish contingency planning for crisis management. The Financial Policy Coordination Committee could serve to identify priorities and establish guidelines for such planning. In assessing the respective roles of FSC, FSS, BOK, MOFE, and KDIC, arrangements for crisis management, coordination, and information sharing between these institutions should take precedence, perhaps through committees that establish guidelines and procedures for early action and meet regularly should symptoms of a systemic crisis emerge.

### **F. Corporate Governance**

64. **In the past few years, Korea has laid a solid foundation for good corporate governance.** However, while formal corporate governance rules may now be substantially similar to those in other OECD countries, practices often fall short of the spirit, if not the letter, of the OECD principles. The challenge now lies in implementation and effective enforcement of legislative changes to improve the corporate culture and practices. The government and the business community should take additional steps to change incentives and promote transparency of business practices, particularly among chaebol groups; to strengthen competition policies, in order to subject chaebol and firms to stricter market

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<sup>8</sup> In December 2002, the Depositor Protection Act was revised to cease insuring credit unions and 122 distressed credit unions were ordered to cease their operations. The National Credit Union Federation of Korea plans to establish a private deposit insurance system for its members.

discipline; to enhance and enforce shareholder rights; and to improve disclosure and monitoring of related-party transactions.

65. **While there has been good progress in upgrading accounting and auditing standards, efforts should continue to improve accounting standards and their implementation to make them fully consistent with evolving international practices.**<sup>9</sup> In addition, Korea should also continue to improve the effectiveness of audit committees, including measures to clarify and strengthen the role and function of such committees; replace statutory auditors with audit committees for smaller companies over time; and upgrade the skills of audit committee members.

66. **Shareholder rights have been improved significantly to allow reduced levels of shareholding for assertion of certain rights, but further improvements are required.** While derivative actions are allowed, these are costly and therefore have been limited so far to only a few. Shareholders lack a cost-effective way to seek redress. There is an urgent need to introduce class action lawsuits by shareholders and investors against directors, managers, and auditors for breaches of duty and violations of the law. The draft law submitted to the National Assembly to allow class action lawsuits should be enacted as soon as possible.

67. **The concept of independent (outside) directors is new and still not well rooted in Korea.** An institute of directors has been established to train directors, which will help them to know what is expected of them and how they should exercise their duties. Additional efforts could include measures to expand the fiduciary duty of directors to shareholders and make it explicit under the law; further expand and clarify the right of directors to access all corporate information necessary to perform their duties; and limit liability of independent directors in cases in which they have acted in good faith.

#### **G. Anti-Money Laundering and Combating the Financing of Terrorism**

68. **Korea has made considerable strides in achieving observance of the Financial Action Task Force's (FATF) recommendations on combating money laundering and the financing of terrorism.** Korea's Financial Intelligence Unit (KoFIU) joined the Egmont Group in June 2002, and its computer database recently became operational. A system for the strategic analysis of suspicious transactions will also become operational this year. Underscoring Korea's commitment to AML/CFT, it submitted in August 2002 to an on-site examination by the Asia Pacific Group of the framework it has set in place to combat these activities. Nonetheless, further efforts are warranted, including expediting the enactment of the Anti Terrorism Bill, consistent with the United Nations International Convention for the Suppression of the Financing of Terrorism of 1999, and addressing the limitations of the Real Names Act on access to customer information, to facilitate international cooperation in the investigation of money laundering and financing of terrorism cases.

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<sup>9</sup> The recent problems with the stated earnings of SK Global are illustrative of the need for further efforts.

### Box 1. Main Findings of the Assessment of Observance of Key International Standards and Codes

- The review of the **Basel Core Principles (BCP)**, **IAIS**, and **IOSCO** shows that the FSC/FSS, the unified supervisory agency, is a competent regulator. Assessors felt though that the supervisory framework and implementation should be reviewed to strengthen the supervisor's independence, including its ability to provide authoritative guidance and interpretation. Legal protection of supervisors should be strengthened.
- **Basel Core Principles**. There is a high degree of compliance with best international supervisory practices in banking supervision. Measures needed to further strengthen compliance with the BCP would include: (i) increasing staffing in key areas: this will also help to address the challenges of new supervisory tasks related to off-balance sheet activities, Basel II, and AML; (ii) paying greater attention to differing risk levels when setting minimum capital levels; (iii) broadening the coverage of fit and proper criteria; and (iv) giving more attention to qualitative criteria in supervision.
- **IAIS**. There is also a high degree of compliance with the IAIS. Measures initiated to strengthen the insurance sector go in the right direction but may need to go further. In particular the new capital requirements for life insurance companies, even when fully phased-in, may not be adequate given Korea's structural and financial framework. In addition, a withdrawal of government from direct insurance business, facilitating the listing of insurance companies on the stock exchange, further price and product liberalization and further deepening of the capital markets would all help to further strengthen the insurance sector.
- **IOSCO**. Korea has achieved significant observance of the IOSCO principles, but some critical issues remain. They include: (i) the need to improve regulatory transparency, (ii) in the volatile market framework, regulators should require more frequent calculation and reporting of capital requirements, and (iii) extended enforcement of prudential rules could increase market confidence.
- **CPSIPS**. BOK-Wire, Korea's RTGS payment system, is efficient and compliant with all CPSIPS principles, but the BOK's role in the payments system should be explicitly set out in the legislation, and accompanying legislative powers should also be introduced. In addition, the check system remains important, including in OTC settlement. The BOK is aware of the systemic risks implied in the use of checks for large value payments. However, there are efforts to encourage a broadening of the use of BOK-Wire for large transfers, especially for payments related to OTC trades. It appears though that there are some significant obstacles, including the (t+0) settlement practice in debt securities trade. Other important obstacles to reducing the role of checks are related to the widespread use of cashiers' checks as a substitute for cash, encouraged further by the low value of the largest denomination bill.
- **Code of Good Practices in the Transparency of Monetary and Financial Policies**. All assessed financial institutions in Korea practice a high degree of transparency. The practice could be improved through better information sharing arrangements, wider consultation on technical changes to regulations and better disclosure of internal governance procedures.
- **OECD Principles of Corporate Governance**. Corporate governance rules are close to those in other OECD countries, but actual practice remains an issue. Efforts will be needed to improve the transparency of business practices and ensure adequate disclosure for chaebols.
- **AML/CFT**. Korea has put in place the legal and institutional framework necessary for an effective framework for anti-money laundering and combating the financing of terrorism but more focus needs to be given to implementation. To make the framework operational, more staff resources should be devoted to the Korea Financial Intelligence Unit (KoFIU). The FSS/FSC should fully exercise its mandate in this area, avoiding the need to build up a parallel structure within the KoFIU.

## Box 2. Completing Corporate Restructuring and Financial Sector Stability

The 1997–98 crisis included a series of corporate failures and prompted several waves of corporate restructuring. Korea has succeeded in increasing overall profitability of the corporate sector, in addressing long-term moral hazard issues, financially stabilizing distressed companies, in initiating follow-on operational restructuring, and in improving transparency in financial disclosure and corporate governance. However, three main risks remain:

- In 2001, the bottom quartile of Korean companies showed very high leverage ratios, large net losses, and negative interest coverage. The viability of Hynix and other large companies remains problematic.
- The prospects for many of the smaller companies emerging from workouts are uncertain. Almost half of the smaller public companies remain unprofitable and most are still highly leveraged.
- Weaknesses in financial disclosure and corporate governance may permit insiders in Korea’s largest chaebols to channel financial support from strong to weak affiliates, at the expense of the stronger affiliates (and outside shareholders).

Given the risks associated with corporate restructuring, the following measures could help minimize possible spillover effects on the financial sector:

- Encourage financial institutions to identify emerging cases of corporate distress and initiate needed financial and operational restructuring in a timely manner: Apply forward-looking criteria for the classification, move forward aggressively with restructuring of distressed-but-viable companies, and pursue prompt sale or liquidation of non-viable companies.
- Address concerns that weak corporations are sometimes propped up by financial institutions, especially state-owned banks, perhaps in order to avoid recognizing losses on over-valued assets. The FSC/FSS should ensure that financial institutions value workout companies at market value. It would also be useful for state-owned financial institutions to divest their holdings of distressed corporate debt and converted corporate equity.
- Enhance market-based monitoring and discipline of large chaebols, and replace direct regulations with more market-based mechanisms, especially to control the risk that companies exploit deregulation and engage in renewed over-expansion without regard to profitability. Apply adequate “fit-and-proper” rules to prevent financially less-than-robust chaebols from acquiring financial institutions.
- Continue to improve financial disclosure, especially of related-party transactions, which even under the newly improved accounting standards are not fully adequate. In addition, there should be prompt and full disclosure of all foreign and domestic cross-debt and cross-payment guarantees among related companies and parties.
- Reform further Korea’s insolvency system in order to promote the orderly exit of non-viable companies and the rehabilitation of distressed-but-viable companies.
- Continue to improve corporate government standards and practices.