FINANCIAL SYSTEM
IN KOREA

December 2006

THE BANK OF KOREA

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Part I Overview

The foundations of the modern financial system in Korea were laid during the early 1950s when the central and commercial banking systems were realigned under the new institutional bases provided by the Bank of Korea Act and the Banking Act. Specialized banks were established during the 1960s, in order to increase capital mobilization and to strengthen financial support for underdeveloped or strategically important sectors.

Most non-bank financial institutions were introduced during the 1970s in order to diversify financing sources, to promote the development of the money market, and to attract funds into the organized market.

From the early 1980s, several commercial banks and non-bank financial institutions were added as part of a series of broad measures to spur financial liberalization and internationalization. This coincided with a shift from a government-orientated stance on economic policy towards a market-orientated stance.

Since the currency crisis broke out around the end of 1997, the Korean financial system has been undergoing substantial changes in the course of the implementation of a comprehensive financial reform program.

The financial institutions in Korea may be divided into seven categories by substance and function: (i) a central bank, that is the Bank of Korea, (ii) banking institutions including commercial and specialized banks, (iii) non-bank depository institutions including merchant banking corporations, mutual savings banks, credit institutions etc., (iv) securities related companies, (v) insurance institutions, (vi) other financial institutions, and (vii) financial auxiliary institutions.

Financial Institutions

Central Bank	The Bank of Korea
Banking institutions	Commercial banks
	Specialized banks
Non-bank depository institutions*	Merchant banking corporations
	Mutual savings banks
	Credit institutions, etc.
Securities related companies*	Securities companies
	Asset management companies
	Futures companies
	Securities finance companies, etc.
Insurance institutions*	Life insurance companies
	Non-life insurance companies
	Postal insurance, etc.
Other financial institutions*	Credit specialized financial companies
	Venture capital companies, etc.
Financial auxiliary institutions*	Financial supervisory service
	Deposit insurance institutions
	Financial telecommunications & clearings institute, etc.

* Non-bank financial institutions

Part Ⅱ The Bank of Korea

General Features

The Bank of Korea was founded on June 12, 1950 under the Bank of Korea Act. The Bank of Korea was originally established with a capital of 1.5 billion won, all of which was subscribed by the Government, but the revision of the Bank of Korea Act in 1962 made the Bank a special juridical person having no capital.

The primary purpose of the Bank, as prescribed by the Act, is the pursuit of price stability. The Bank sets an inflation target in consultation with the Government and draws up and publishes an operational plan for monetary policy.

In line with the shift in the financial supervision system on April 1, 1998 toward the integrated supervision of the banking, securities and insurance industries, the bank supervisory function was separated from the Bank and it now has only indirect and limited supervisory powers.

The Bank performs the typical functions of a central bank, issuing banknotes and coins, formulating and implementing monetary and credit policy, serving as the banker's bank and the Government's bank. In addition, the Bank of Korea undertakes the functions of overall management and surveillance of the payment and settlement systems, and manages the nation's foreign exchange reserves. It also exercises the limited bank supervisory functions stipulated in the Bank of Korea Act.

Organization

The Bank of Korea's organization consists of the Monetary Policy Committee, the supreme policy-making body; the executive, which carries out the policies formulated by the Monetary Policy Committee; and the Auditor.

The Monetary Policy Committee as the policy decision-making body, has the right to deliberate and resolve on major matters concerning monetary and credit policy and the operations of the Bank of Korea.

The Committee is composed of seven members appointed by the President and the term of all members except the Senior Deputy Governor is four years. All members of it are full-time members and no member may be discharged from office against his will. The Governor of the Bank serves concurrently as the Chairman of the Monetary Policy Committee.

The Committee has regular meetings on the Thursdays of the second and fourth weeks each month and extraordinary meetings as frequently as needed. Monetary policy is resolved and announced on the Thursday of the second week of every month. The minutes of each Committee meeting are announced in the Bank's web-site on the first Tuesday after six weeks have passed from a meeting.

Resolutions at a Monetary Policy Committee meeting are adopted by simple majority when there are at least five members present. Any member may submit a proposal with the concurrence of at least one other member. The Chairman, however, can submit a proposal on his own motion.

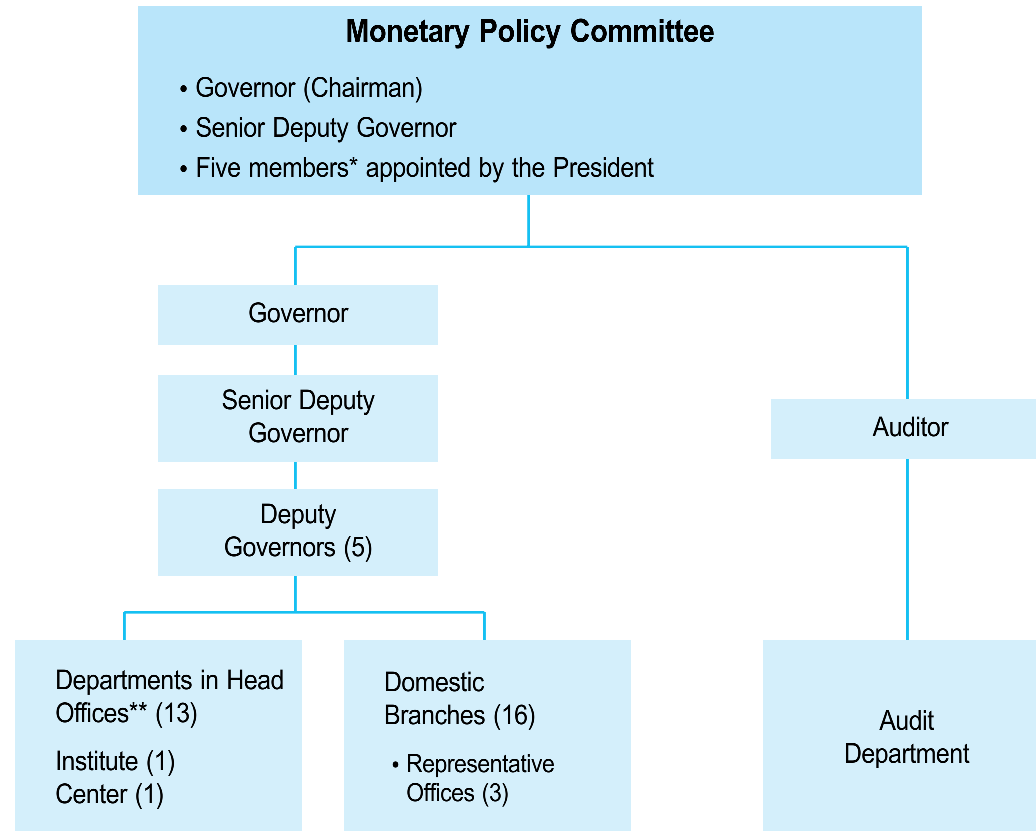
The Bank's executive officers are the Governor, the Senior Deputy Governor, and five Deputy Governors. The Governor, appointed by the President following the deliberation of the State Council, administers and directs the operations of the Bank, and conducts monetary policies as formulated by the Monetary Policy Committee. The term of the Governor is four years and he may be reappointed only once. The Senior Deputy Governor and Deputy Governors assist the Governor. The Senior Deputy Governor, an ex-officio member of the Monetary Policy Committee, is appointed by the President on the recommendation of the Governor and the Deputy Governors are appointed by the Governor. The Senior Deputy Governor and Deputy Governors have three-year terms.

As for its executive body, the Bank has 13 departments, one center (Economic Education Center) and one institute (Institute for Monetary & Economic Research) in its head office in Seoul. The Bank also has 16 branches (3 representative offices) in major cities throughout the country. In addition, the Bank has 6 overseas representative offices in principal international financial centers. The total number of employees was 2,226 as of June 2006.

The Auditor is appointed by the President on the recommendation of the Minister of Finance and Economy for a three-year term. The Auditor inspects the operations of the Bank of Korea and reports the results to the Monetary Policy Committee and the Government.

Organization of the Bank of Korea

(As of the end of June 2006)



* Recommended by
  ① The Minister of Finance and Economy
  ② The Governor of the Bank of Korea
  ③ The Chairman of the Financial Supervisory Commission
  ④ The President of the Korea Chamber of Commerce and Industry
  ⑤ The Chairman of the Korea Federation of Banks

** International Department includes six overseas representative offices.

Functions

1. Issuing Banknotes and Coins

The Bank of Korea has the exclusive right to issue banknotes and coins in the Republic of Korea. It may, with the approval of the government, issue them in any size, shape and denomination as determined by the Monetary Policy Committee.

The Bank is not required to maintain any prescribed minimum ratio of gold or foreign exchange against its banknotes and coins issue, nor is any maximum limit imposed on the issue. The issue of banknotes and coins relies ultimately on decisions made by the Bank of Korea in line with its monetary policy.

Currently, the Bank issues banknotes in three denominations: ₩1,000, ₩5,000, ₩10,000; and coins in six: ₩1, ₩5, ₩10, ₩50, ₩100, ₩500.

2. Formulating and Implementing Monetary and Credit Policy

The Bank of Korea formulates and implements monetary and credit policy in pursuit of its objective of price stability.

The Bank's monetary and credit policy is exercised principally through three orthodox instruments which affect the availability and cost of banking institutions' reserves, and thereby influence overall monetary and credit conditions. These are changes in the terms and conditions of loans (rediscounts), open market operations, and changes in reserve requirement ratios.

In addition to these instruments, the Bank has the authority to set maximum interest rates on deposits and loans of banking institutions and to control the volume of bank credit directly in periods of pronounced monetary expansion.

■ Issuing Banknotes and Coins

- ○ Banknotes in three denominations : ₩1,000, ₩5,000, ₩10,000
- ○ Coins in six denominations : ₩1, ₩5, ₩10, ₩50, ₩100, ₩500

■ Formulating and Implementing Monetary and Credit Policy

- ○ Pursuit of the objective of price stability
  - Sets an inflation target in consultation with the government
  - Formulates and promulgates an operational plan for monetary and credit policies
- ○ Indirect instruments
  - Loans and rediscounts
  - Open market operations
  - Changes in reserve requirement ratios
- ○ Other instruments
  - Changes in the maximum interest rates on deposits and loans of banks
  - Imposing ceilings on bank credits in periods of pronounced monetary expansion

3. Acting as the Banker's Bank

The Bank of Korea makes loans to and receives deposits from banks, thus serving as the banker to the banking sector.

It maintains checking accounts for banking institutions. Reserve deposits kept in these checking accounts are used to clear checks and settle inter-bank balances, including those arising from the use of BOK-Wire, the Bank's real-time gross-settlement system.

The Bank conducts credit operations with banks by rediscounting commercial bills or by extending loans against eligible collateral with maturities of up to one year.

As the lender of last resort, the Bank may extend exceptional loans to banking institutions, in periods of serious emergency when monetary and banking stability is directly threatened.

4. Serving as the Government's Bank

As the fiscal agent of the Government of the Republic of Korea, the Bank of Korea carries out various kinds of business for the Government in accordance with the Bank of Korea Act and other relevant laws.

The Bank handles the receipt of national revenues and the disbursement of national expenditures as the depository of the Government.

The Bank may extend loans to the Government, and may directly subscribe to Government bond issues. It may also grant loans to Government agencies which carry out projects or functions of a public character and handle business related to the issue, sale, or redemption of securities representing obligations of the Government.

■ Acting as the Banker's Bank

- ○ Extending loans and rediscounts to banks
- ○ Receiving deposits from banks
- ○ Conducting temporary credit operations in periods of serious emergency as the lender of last resort

■ Serving as the Government's Bank

- ○ Receipt and disbursement of Treasury funds
- ○ Loans to government
- ○ Issue, sale, or redemption of securities representing government obligations

5. Developing and Managing Payment Systems

The Bank of Korea has responsibility for the operation and management of the nation's payment systems.

It provides settlement facilities to financial intermediaries by use of their checking accounts with the Bank for final settlement purposes. Net settlement arising from bill clearing, giro, the interbank funds transfer system, and the interbank CD/ATM network is made through these checking accounts with the Bank.

To ensure safe and efficient settlement for large-value interbank fund transfers, the Bank operates a real-time gross-settlement system, termed BOK-Wire, which was launched in mid-December 1994.

The Bank of Korea has constantly promoted electronic banking in order to enhance the efficiency of the banking industry. To this end, it has guided and encouraged financial institutions to accelerate the provision of electronic banking services.

6. Managing Official Foreign Exchange Reserves

The Bank holds and manages Korea's official foreign exchange reserves. Its principal objectives in their management are to safeguard the value of the reserves and to meet the nation's demand for foreign exchange. The size of the reserves is tending to increase as the scale of trade and the economy grows larger.

The Bank conducts certain foreign currency operations in the foreign exchange market. Their main aim is generally to counter disorderly market conditions. The exchange rate of the Korean won against U.S. dollar is determined by market forces, namely foreign exchange demand and supply in the domestic market. Exceptionally, however, if there is a large discrepancy between demand and supply that disrupts the regular operation of the foreign exchange market, the Bank participates in it as a buyer or seller.

In addition, the Bank acts as an agent for the Government in managing the Foreign Exchange Equalization Fund, which was founded in 1967 with the object of stabilizing the foreign exchange market.

The Bank represents the government in all dealings and transactions with international financial institutions of which the Republic of Korea is a member.

7. Exercising Certain Bank Supervisory Functions

The Bank of Korea exercises certain bank supervisory functions as stipulated in the Bank of Korea Act.

The Bank may request materials from banks, and from non-bank financial institutions which enter into agreements to hold checking account with it, when the Bank deems this desirable for the implementation of monetary policy.

The Bank may also require the Financial Supervisory Board to examine banking institutions within a determined specific range. It may also require the Financial Supervisory Board to have staff of the Bank of Korea participate on a joint basis in the examination of banking institutions.

The Bank may require the Financial Supervisory Board to submit to it the findings of examinations and on the basis of these findings to order corrective action to the banking institutions concerned.

In addition, the Bank may, at its own initiative, check and confirm the operation and status of the assets of banks and those for-profit enterprises to which the Bank extends emergency loans.

8. Compilation of Statistics and Economic Research

The Bank of Korea collects and compiles statistics, and conducts economic research.

The Bank compiles statistics which are essential to developing the appropriate economic policies. They include money and banking statistics, GDP statistics, the producer price index, the balance of payments, the flow of funds account, input-output tables, etc.

The Bank carries out research on national and world-wide economic activities in order to formulate monetary policy effectively, enabling it to advise the Government on various economic policy options.

It also publishes various periodicals, such as the Annual Report and the monthly Bulletin, to provide accurate and up-to-date information to the public on the economy.

Developing and Managing Payment Systems

- Operating a real-time gross-settlement system (BOK-Wire)

Managing Official Foreign Exchange Reserves

- Conducting certain foreign currency operations to counter disorderly market conditions

Exercising Certain Bank Supervisory Functions

- Request for on-site examination of banking institutions by Financial Supervisory Service(FSS) or joint examination with FSS

Compilation of Statistics and Economic Research

- Compilation of statistics such as money and banking statistics, GDP statistics, the producer price index, the balance of payments, etc.
- Research on national and world-wide economic activities

Commercial Banks

1. General Features

As of the end of June 2006, commercial banks consisted of seven nationwide commercial banks, six local banks, and thirty-six foreign bank branches. Commercial banks have adopted the branch banking system with a nationwide or province-wide network. The total number of domestic branches of commercial banks amounted to about 4,760 as of the end of June 2006.

Since business demarcation is still quite strict, commercial banks can engage in very limited securities business, and had not been allowed to engage in insurance business until August 2003. However, since then, bancassurance has been introduced to permit commercial banks to sell insurance products.

The ownership of a commercial bank's stocks by a single holder has been restricted since 1982, except in the case of a joint bank, a local bank, or where they are held by the government. This limit was set at 8 percent in 1982 and was tightened to 4 percent in 1994. In 2002, the single shareholder ceiling was raised to 10 percent.

Foreign bank branches carry on their business under almost identical conditions to Korean banks nowadays as preferential treatment has been reduced and discriminatory business regulations lightened.

2. Sources and Uses of Funds

Nationwide commercial banks held total assets amounting to about 767.0 trillion won as of the end of June 2006, representing a 80.3 percent share in the total assets of commercial banks.

Their principal sources of funds are deposits in domestic currency. At the end of June 2006, deposits in domestic currency and foreign currencies accounted for

Commercial Banks

(As of the end of June 2006)

Nationwide Commercial Banks (7)*	○ Branch banking system throughout the country ○ Handling of long-term financing in addition to short-term financing
Local Banks (6)**	○ Branch banking system within a province ○ Business oriented to regional small and medium enterprises
Foreign Bank Branches (36)	○ Wholesale banking ○ Retail banking recently strengthened

* Woori Bank, SC First Bank, Hana Bank, Korea Exchange Bank, Shinhan Bank, Citi Bank Korea, Kookmin Bank

** Daegu Bank, Pusan Bank, Kwangju Bank, Jeju Bank, Jeonbuk Bank, Kyongnam Bank

52.1 percent and 1.9 percent of total sources, respectively. As for uses of funds, nationwide commercial banks operated the largest proportion of their funds, 55.9 percent, as loans and discounts. The share of securities investment in total assets was 20.2 percent.

The financial structure of local banks is largely similar to that of the nationwide commercial banks, but their reliance on domestic currency deposits and securities investment is higher. At the end of June 2006, deposits in domestic currency accounted for 63.7 percent of total sources. And the share of securities investment in their total assets was 26.6 percent.

Foreign bank branches' most important source of funds is, typically, the inter-office account which, as of the end of June 2006, represented 22.4 percent of their total sources while deposits in domestic currency constituted only 4.0 percent. As to uses of funds, securities investment accounted for the largest proportion, at 36.1 percent. Loans to Korean banks in foreign currencies accounted for 4.5 percent and loans in domestic currency represented 5.2 percent.

Specialized Banks

As of the end of June 2006, there were five specialized banks: the Korea Development Bank for the financing of key industries for the development of industries and national economy; the Export-Import Bank of Korea for financial support for export and import transactions, overseas investment projects, and the development of natural resource abroad; the Industrial Bank of Korea for the financing of small and medium-sized firms; the credit and banking sector of the National Agricultural Cooperative Federation for agricultural, forestry, and livestock loans; and that of the National Federation of Fisheries Cooperatives for fishery loans.

Specialized banks share the following main characteristics. First, they were established to provide funds to particular sectors whose supply of funds through

Sources and Uses of Funds

(As of the end of June 2006)

		Nationwide Commercial Banks	Local Banks	Foreign Bank Branches
Total Assets*		767,004.1 (80.3)**	76,799.4 (8.0)**	112,089.3 (11.7)**
Major Sources (%)	• Deposits in domestic currency	52.1	63.7	4.0
	• CDs	6.5	5.4	1.5
	• Deposits in foreign currencies	1.9	0.6	1.1
	• Borrowing in foreign currencies	1.7	1.7	5.3
	• Inter-office	0.2	0	22.4
Major Uses (%)	• Loans & discounts in domestic currency	55.9	55.7	5.2
	• Securities	20.2	26.6	36.1
	• Loans in foreign currencies	3.6	2.6	3.8
	• Inter-office	0.2	0	1.6
	• Loans to Korean banks in foreign currencies	-	-	4.5

* Unit : billion won

** Figures in parentheses are percentages of total figures for all commercial banks.

commercial banks was insufficient due to limited availability or low profitability. With subsequent changes in the financial environment, however, they have expanded their business into commercial banking areas, although their share of funds allocation to their relevant sectors is still relatively high. Now most specialized banks have, by and large, the same pattern of business as commercial banks.

Second, they rely heavily on deposits from the public for their sources of funds in addition to the issue of debentures and borrowing from the government. Therefore, they compete with commercial banks in acquiring deposits.

Specialized Banks

- ○ The Korea Development Bank
- ○ The Export-import Bank of Korea
- ○ The Industrial Bank of Korea
- ○ The National Agricultural Cooperative Federation*
- ○ The National Federation of Fisheries Cooperatives*

* Credit and Banking Sector

Main Characteristics

- ○ Funds allocation to particular sectors specifically defined by the relevant legislation
- ○ Heavy reliance on deposits as a source of funds

Part Ⅳ Non-Bank Financial Institutions

Non-bank financial institutions can be broadly classified into five categories according to their business activities: that is non-bank depository institutions, securities related companies, insurance institutions, other financial institutions, and financial auxiliary institutions.

Non-bank depository institutions consist of merchant banking corporations, mutual savings banks, credit institutions, and the postal savings system. Merchant banking corporations can engage in almost all financial businesses except insurance business. Mutual savings banks specialize in taking deposits and lending for populace and small enterprises. Credit institutions such as credit unions, mutual credit facilities, and community credit cooperatives operate for mutual aid between members by taking deposits and lending. The postal savings system, which operates through post offices nationwide, is a public financial institution.

Insurance institutions consist of life insurance companies, non-life insurance companies, postal life insurance, and pensions.

The Act on Business of Operating Indirect Investment and Assets entered into force from January 5, 2004; under its provisions both securities investment trust companies and asset management companies, which had been regulated respectively by the Securities Investment Trust Companies Act and the Securities Investment Company Act, were converted into asset management companies. The main business of such asset management companies is investing capital raised from investors in stocks and bonds and distributing the earnings on such investments. Securities companies engage in the stock and bond markets either as dealers or brokers. There are futures companies, securities finance company (the Korea Securities Finance Corporation), investment advisory companies which also operate as securities related companies.

In addition to the financial institutions just mentioned, there are other financial institutions such as credit specialized financial companies, venture capital companies, and trust companies. Also there are financial auxiliary institutions including, financial supervisory service, deposit insurance institution (the Korea Deposit Insurance

Corporation), financial telecommunications & clearings institute, credit guarantee institutions, credit rating companies, etc.

These non-bank financial institutions, unlike banks, have no special limits on ownership, and some are affiliated companies of other financial institutions such as banks and securities companies.

Non-Bank Financial Institutions*

(As of the end of June 2006)

Non-bank depository institutions	○ Merchant banking corporations	(2)
	○ Mutual savings banks	(110)
	○ Credit institutions	(4,111)
	○ Postal savings	(1)
Securities related companies	○ Securities companies	(54)**
	○ Asset management companies	(48)
	○ Futures companies	(14)**
	○ Securities finance companies	(1)
	○ Investment advisory companies	(62)
Insurance institutions	○ Life insurance companies	(22)**
	○ Non-life insurance companies	(29)**
	○ Postal life insurance	(1)
Other financial institutions	○ Credit specialized financial companies ***	(49)
	○ Venture capital companies	(125)
	○ Trust companies****	(24)**
Financial auxiliary institutions	○ Financial supervisory service	(1)
	○ Deposit insurance institutions	(1)
	○ Financial telecommunications & clearings institute	(1)
	○ Credit guarantee institutions	(2)
	○ Credit rating companies	(4)
	○ Korea asset management corporation	(1)
	○ Korea housing finance corporation	(1)
	○ Korea securities & futures exchange	(1)
	○ Money broker companies	(5)

* Figures in parentheses are numbers of institutions.
** Foreign companies' branches are included.
*** Credit specialized financial companies consist of credit card companies, leasing companies, installment financing companies, and new technology venture capital companies.
**** The figures of trust companies are based on the bank trust.

Part Ⅴ Market Share of Financial Institutions

There have been large structural changes in the financial system in the last few years and these are reflected in the market shares of different institutions.

In terms of total assets, the market share of banking institutions including their trust accounts decreased from 66.6 percent as of the end of 1995 to 60.1 percent as of the end of June 2006.

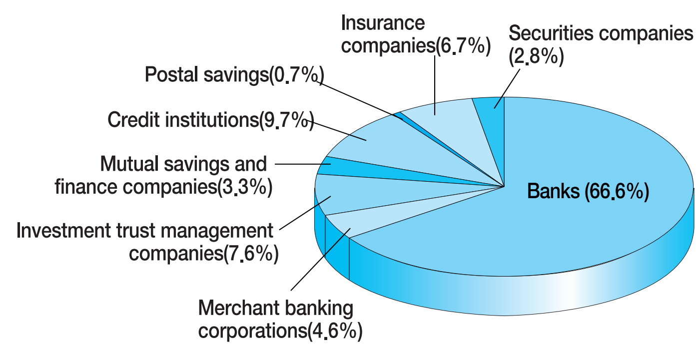
The share of merchant banking corporations dropped sharply from 4.6 percent to 0.7 percent, as 29 companies closed down during the period of financial restructuring. The share of insurance companies, in contrast, increased over the same period.

The share of investment trust management companies, (now; asset management companies), rose from 7.6 percent to 9.5 percent.

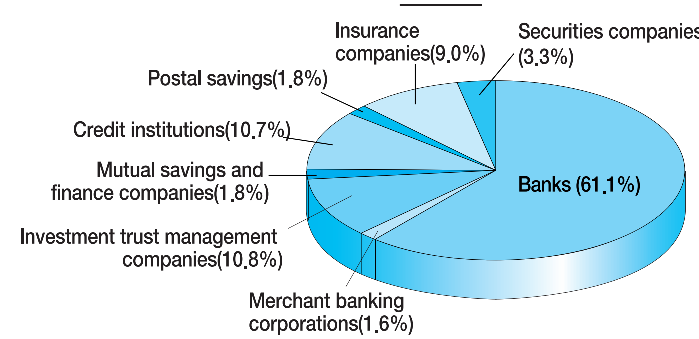
The share of credit institutions, such as credit unions, mutual credit facilities, and community credit cooperatives, decreased slightly from 9.7 percent to 9.5 percent. Mutual savings banks, meanwhile, have been suffering from a dwindling of their market share, as more than 110 companies closed down or merged after the crisis.

Market Shares of Financial Institutions*

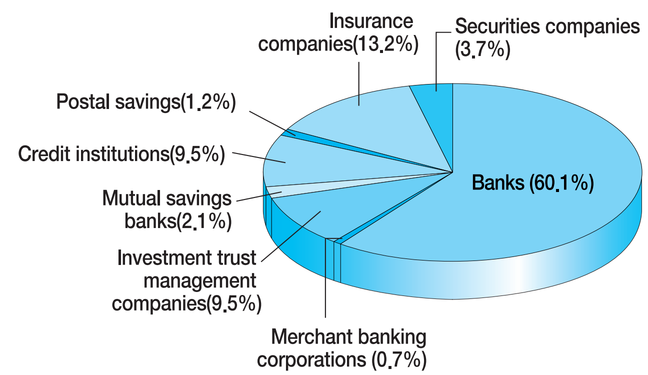
1995



2000



2006.6



* Market shares are in terms of total assets.
** The designation of mutual savings and finance companies was changed to mutual savings banks in March 2002.

Money Market

The money market in Korea embraces the call market and a wide range of other financial markets including those for Monetary Stabilization Bonds (MSB), negotiable certificates of deposit (CD), repurchase agreements (RP), commercial paper (CP), and cover bills (CB).

Since 1985, there has been a sharp increase in the outstanding balance of money market instruments. This has been chiefly prompted by product innovation and the expansion in the number of financial institutions handling such instruments.

However, the scale of the money markets contracted except for the MSB and call markets in the course of financial and corporate restructuring. Most notably, the CP market shrank dramatically in the three years after the crisis. As the financial market stabilized as a result of financial and corporate restructuring, the markets for CD and CP rebounded from 2001 as did the RP market from 2000.

Securities Markets

The growth of the securities markets in Korea has been substantial. Encouraged by government efforts and an improved investment climate with rapid economic growth and the opening of the stock market, the role of the securities markets in mobilizing funds continued to strengthen. The monthly traded value of stocks in the exchange swelled from 4.5 trillion won as of the end of 1990 to 84.1 trillion won as of the end of June 2006 and that of bonds also burgeoned from 3.2 trillion won to 324.0 trillion won. The market value of listed stocks increased from 79.1 trillion won as of the end of 1990 to 633.2 trillion won as of the end of June 2006.

However these trends were weakened due to worries about economic downturn and the increase of the geopolitical risk around Korean Peninsula as of the end of June 2006.

1. Money Market Trends (Balance as of the end of period)

(billion won)

	1990	1998	2000	2001	2003	2004	2005	2006.6
Call*	3,650.5	15,955.8	12,916.0	18,179.4	24,773.8	27,481.5	34,608.2	30,354.2
MSB**	15,240.5	45,673.3	66,377.7	79,121.3	105,496.7	142,773.0	155,235.0	157,468.7
CD	6,803.5	15,742.6	14,217.8	16,002.3	36,827.6	43,544.9	63,877.1	66,851.6
RP	3,357.1	17,543.4	26,308.7	32,147.3	38,703.1	34,574.9	42,932.7	52,189.1
CP	22,686.6	19,872.1	9,113.5	21,921.1	16,214.3	15,898.2	20,043.0	22,981.0
CB	276.8	4,092.9	11,201.4	3,703.8	4,305.1	3,906.0	4,031.4	3,924.8

* Daily average transactions during the last month in the period
** Monetary Stabilization Bonds issued by the Bank of Korea
Source : Money and Banking Statistics, The Bank of Korea

2. Securities Market Trends (As of the end of period)

	1990	2000	2001	2003	2004	2005	2006.6
Stocks							
Number of listed companies	669	704	689	684	683	702	718
Composite stock price index (KOSPI)*	696.1	504.6	693.7	810.7	895.9	1,379.4	1,295.2
Traded value** (bil. won)	4,454.5	52,261.1	40,947.1	45,625.70	46,316.3	65,521.5	84,071.9
Market value (bil. won)	79,109.7	188,041.5	255,850.1	355,362.6	412,588.1	655,074.6	633,158.2
Bonds							
Traded value*** (bil. won)	3,213.1 (284.2)	178,559.6 (2,264.1)	243,698.3 (1,185.5)	235,503.1 (17,908.6)	293,613.9 (32,009.3)	332,695.3 (30,230.0)	323,971.4 (26,094.1)

* The Korea Composite Stock Price Index (4. Jan. 1980 = 100)
** Monthly average during the period
*** Monthly average during the period and figures in parentheses represent values traded on the stock exchange
Source : Money and Banking Statistics, The Bank of Korea

Part Ⅶ Recent Financial Restructuring

Korea undertook a strong drive for financial liberalization and market opening from the early nineties. But the structural weaknesses brought about by high costs and low efficiency in its thirty-year process of concentrated growth meant that its financial and economic system had become destabilized and unable to stand the associated strains.

Most notably, in 1997, a string of large corporate insolvencies and the consequent rapid build-up of financial institutions' bad loans undermined their soundness and threatened the systemic health of the financial system. Furthermore, the negative effects of the Southeast Asian currency crisis deepened foreign investors' misgivings about the health of the Korean economy. Accordingly, there was a large net outflow of foreign portfolio capital. Korea found itself in crisis, lacking sufficient foreign currency liquidity to meet its maturing liabilities following the draining of its foreign exchange reserves from early November, 1997.

This left the government no option but to turn to the IMF for stand-by credit. An emergency package was agreed on December 3 under the conditionalities attached to which Korea began an economic reform program focused on macroeconomic stability and restructuring of the financial and corporate sectors, and the labor market. The drive for financial sector restructuring focused on a shake-out among financial institutions, the clearing-off of bad loans, the tightening of prudential regulation, the heightening of transparency of financial information, and the reorganization of the corporate governance of financial institutions.

Economic Reforms

Implementation of comprehensive economic reform program agreed with IMF

- Macroeconomic stability
- Financial sector restructuring
- Corporate sector restructuring
- Labor market restructuring

Resolution of Unsound Financial Institutions

The top priority in financial sector restructuring was given to the earliest possible resolution of unsound financial institutions. In 1998, five banks whose capital adequacy ratios were below the 8% BIS guideline were forced to exit the market. Nine banks merged to form four successor banks in 1999, and two merged to form one successor bank in 2000. In the meanwhile, eight banks were nationalized through recapitalization by the government. Among them, Korea First Bank was subsequently sold to Newbridge Capital in December 1999 and in March 2001 Hanvit, Peace, Kwangju, and Kyongnam Banks were consolidated into Woori Finance Holdings Company, all of whose equity is held by Korea Deposit Insurance Corporation.

In addition, among healthy banks, Kookmin Bank and Housing & Commercial Bank merged as 'Kookmin Bank' and Shinhan Bank and its affiliates established Shinhan Financial Group in 2001. In 2002, the Government arranged for Cheju Bank to be brought under the umbrella of Shinhan Financial Group and sold Seoul Bank to Hana Bank. In 2003, the Government sold its controlling stake in Chohung Bank to Shinhan Financial Group and that in Korea Exchange Bank to Lone Star Fund. In 2004, Hyundai Investment & Securities Co. was sold to Prudential Financial Inc. In 2005, Korea Investment & Securities Co. was sold to Dongwon Financial Holdings, Daehan Investment & Securities Co. was sold to Hana Bank, and Korea First Bank was sold to U.K.-based Standard Chartered Bank. In 2006, Shinhan Bank and Chohung Bank merged as 'Shinhan Bank'.

In the case of non-bank financial institutions, twenty-nine merchant banking corporations, fifteen securities companies, eleven asset management companies, and seventeen insurance companies were closed down following exits or mergers in the period between 1998 and June 2006.

Changes in the Number of Financial Institutions

(As of the end of June 2006)

	Institutions as at the end of 1997 (A)	Type of resolution			Institutions newly established (C)	Institutions in operation (A-B+C)
		Exit	Merger	Total(B)		
Banks	33	5	10	15	-	18
Merchant banking corporations	30	22	7	29	1	2
Securities companies*	36	8	7	15	19	40
Investment trust management companies	31	6	5	11	28	48
Insurance companies**	45	11	6	17	9	37

* Foreign companies' branches are excluded
** Prior to 2003, the figures were compiled on the basis of investment trust management companies, but those after 2004 include the former asset management companies(13 companies as of the end of 2003)
*** Life and non-life insurance companies(Foreign companies' branches and the postal life insurance system are excluded)

Injection of Public Funds

The government raised 102.1 trillion won in public funds by issuing Deposit Insurance Fund Bonds and Non-performing Loans Management Fund Bonds for financial restructuring and recycled funds to the value of 42.0 trillion won through new issues of such bonds up until June 2006. Also it pumped in an additional 24.2 trillion won by June 2006 raised from various other sources including Public Capital Management Fund and loans from the World Bank. As a result, the total amount of financial support devoted to financial restructuring stood at 168.3 trillion won at the end of June 2006. Out of the total amount, 63.5 trillion won was used for recapitalization, 39.0 trillion won for the purchase of non-performing loans, and 30.3 trillion won for the payment of deposit insurance claims.

Public Funds Injected

(November 1997 ~ June 2006)

(trillion won)

Source	Support type	Total
Korea Deposit Insurance Corporation	Recapitalization	50.8
	Compensation for losses	18.4
	Purchase of assets	10.8
	Repayment of deposits	30.3
	Subtotal	110.3
Korea Asset Management Corporation	Purchase of NPLs	39.0
Fiscal resources	Recapitalization	11.8
	Purchase of subordinated debentures	6.3
	Subtotal	18.1
Bank of Korea	Recapitalization	0.9
	Total	168.3

Heightening Prudential Regulation

In order to tighten the prudential regulation of financial institutions, a prompt corrective action framework was introduced so that regulatory authorities could order financial institutions that failed to meet certain criteria to replace their management, reduce capital, merge, or dispose of certain businesses. And the asset quality classification standards of banks, merchant banking corporations, securities companies, asset management companies and insurance companies were strengthened in order to take into consideration the future repayment capacity of borrowers. To reduce the risk resulting from large credit exposures to a single entity, the ceilings on credit to a single individual or juridical person, as well as to a single large business group, were lowered. Also criteria for internal controls and a compliance system were introduced for banks, merchant banking corporations, securities companies, asset management companies, insurance companies, etc.

Improving Corporate Governance of Financial Institutions

An outside director system and an audit committee system were introduced to improve corporate governance in 1999. At least three outside directors must be appointed to make up over half of total board membership and an audit committee must be set up with outside directors forming at least two-thirds of its membership. These two systems were put in place for all commercial banks and merchant banking corporations, and for some securities companies, insurance companies, asset management companies, and other financial institutions whose assets are above a specific level.

To attract foreign investment, the restriction on the nomination of foreigners as directors of banks was lifted and ceilings on the foreign ownership of domestic banks were eased in 1998.

In 2002, to encourage the emergence of sound financial capital and promote accountability in the management of financial institutions, the single shareholder ceiling restriction on the holding of stocks issued by a bank or a bank holding company was raised from 4 percent to 10 percent.

Heightening Transparency of Financial Institutions

At the same time, efforts have been made to strengthen market discipline and to enhance the transparency of financial information. Standards for accounting and public disclosure were heightened to enable shareholders, creditors, and others to gauge a financial institution's management performance accurately from its financial statements. For example, a mark-to-market system for marketable securities was introduced and a financial institution's financial statements should now be drawn up according to accepted corporate accounting standards.

Other Steps

In addition, the government has improved various financial systems to facilitate financial restructuring. Financial institutions' fund-raising capacity has been expanded through the introduction of asset-backed securitization and mortgage-backed securitization companies. Legislative provision for financial holding companies was also introduced not only to strengthen financial institutions' competitiveness through enlargement of their scale but to help restructuring of the financial sector.

The blanket guarantee deposit insurance system that was brought in to mitigate financial market instability after the financial crisis was converted back to a partial guarantee system in 2001 to avoid moral hazard on the part of financial institutions and their depositors.

Besides the matters just mentioned, the legal rights of minority shareholders of banks, merchant banking corporations, securities companies, insurance companies, and other financial institutions have been strengthened by lowering the holding threshold for the exercise of certain rights.

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