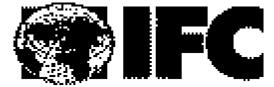

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"THE FINANCIAL CRISES IN MEXICO AND KOREA – RESOLUTION STRATEGIES, WHAT WORKED AND WHAT DIDN'T"

(Session 5)

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MEXICO

1. **Salient Pre-Crisis Events**

a. Many Structural and Trade Policy Reforms implemented in 1980s to reduce the role of the State in the economy, and shift to market based incentives. 58 private commercial banks nationalized in 1982, followed by major consolidation, leaving18 nationalized commercial banks (other than Citibank) which were sold in 1991/2 to Mexican financial holding companies (*Grupos Financieros),* for multiples of book value (2-4 times), becoming subsidiaries of the *Grupos.*

b. Joined OECD, and NAFTA in 1994

c. Sluggish GDP growth even after reforms (between 2% and 4.5% pa since 1991), continuing fiscal deficit along with low savings rates, with persisting high inflation, and high real interest rates. 1994 GDP per capita US $ xxxx.

d. 1994 - Recurring current account deficit, high levels of public foreign borrowings through NAFIN (*Tesobonos*) to finance deficit spending in run up to 1994 Presidential elections, tarnished by assassination of leading candidate.

e. End 1991-1994 - Reckless expansion by privatized banks, 143% nominal, 89% in real terms, eight times real GDP growth rate in the period, in pursuit of expansion of loan book/asset base and profits/dividends; declining deposits/loans ratio 106% end 1991 to 80% end 1994. deteriorating portfolio composition (5.4% NPLs end 1991 to 8.8% end 1994) understated by Mexican GAAP rules; inadequate loan loss provisions with unprovisioned past dues at 22.7% end 1991 and 50.8% end 1994. Meanwhile regulatory framework for banking system was inadequate, and supervision capacity weak. Poor management (insider lending) inadequate supervision and economic slowdown in 1994. Implicit guarantee of all deposits by FOBAPROA was disincentive for markets monitoring and source of moral hazard. Still banking system assets relatively small--zz% of 1994 GDP.

f. Newly created regulatory and supervisory body, *La Comision Nacional Bancaria*, CNB aimed at improving banking supervision; scope expanded in early 1995 to integrate supervision of securities markets(*Valores*) forming CNBV. Two banks (Union and Cremi) intervened in late 1994 due to fraudulent activities.

g. Precarious decline in foreign exchange reserves in second half of 1994, while exchange rate remained fixed to US$.

2. **The “Peso” Crisis**

a. Depletion of reserves, flight of foreign capital in December 1994, (New)Peso was floated from late December 1994, its value dropping from NP 4.4/US$ to some NP 9.5 /US$. Foreign lines of credit suspended. Collapse of domestic demand, spike in domestic prices and interest rates. Banks faced with defaults across the board, except by exporters. Loss of US$ deposits.

b. Immediate effects on banks -- foreign exchange losses on open short positions limited by restrictive regulation, but about 10% of total equity (NP 4.6 billion); interest rate exposure affecting fixed income securities, due to spike in domestic interest rates (NP 56 billion); accelerated decline in portfolio quality with interest rates at 70%pa. Past due/gross loan ratio doubled from 9% to 18% by December 1995, despite many govt. supported restructuring programs (ADE, UDI etc). Sharp decline in capital ratios due to rise in peso value of US$ denominated assets and liabilities. Also, liquidity pressures raising funding costs. Government feared collapse of banking system, leading to a Government led strategy for resolution, supported by the World Bank.

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3. **Mexican Government Response in the Financial Sector**

a. Established US$ liquidity window through bank support fund (FOBAPROA), while lender of last resort, Banco de Mexico provided short term peso credit.
b. Required all banks to increase provisions to higher of 4% of loan portfolio, or 60% of past dues (under Mexican GAAP), with the latter being binding. This was later reduced to 45% after accounting rules changed in January 1997.
c. Temporary recapitalization scheme (PROCAPTE) with FOBAPROA purchasing subordinated convertible debentures from undercapitalized banks, with proceeds deposited in Banco de Mexico. This program was wound up in a year as banks recapitalized from other sources or were intervened.
d. Inflation indexed (UDI) funding to banks to permit them to carry troubled commercial, mortgage, agricultural, state and municipal, and consumer loans that had been restructured into long term UDI obligations. Later augmented by direct subsidies to some classes of borrowers that remained current.
e. Debtor support program(ADE) to certain classes of borrowers (mortgages, consumer loans and SMEs) with direct interest rate subsidy for a year.

f. Loan purchase program by FOBAPROA in return for a commitment by bank to raise additional capital usually from existing shareholders, with bank receiving 10 year non transferable bullet zero coupon government bonds. First begun with Probursa and Serfin, eventually extended to all banks. Three waves of purchases involving all surviving privatized banks, led to some US$ 20 billion of purchases. "Mexican" ownership of 3 largest banks considered non negotiable!

g. Intervention of seriously decapitalized banks, starting with Banpais in March 1995, followed by seven others. Assistance to stronger banks willing to merge with weaker banks.
h. Framework (UCABE) for voluntary out of court restructuring of largest corporate loans agreed by banks with CNBV suasion.

4. **Principal Governance Reforms**

a. Upgrading of accounting and disclosure standards for all banks – introduction of USGAAP, proposed for 1996, but actually started from January 1997, to tighten definitions for loan classification and provisioning; quarterly publication of portfolio quality by CNBV to enable market monitoring.
b Revision of Prudential Regulations – higher levels of core capital and requirement for larger levels of cash capital rather than subordinated loans, over time—to reduce moral hazard.
c. Strengthened supervision of all banks, beginning with an independent audit of all banks' portfolios in 1995 to improve confidence.
d. Attempts to revise the hitherto unlimited deposit protection guarantee implicitly provided by FOBAPROA to all banks, by instituting limits on guarantee comparable to those in most other countries- incentive for depositors/markets to monitor banks' "quality", and reduce moral hazard.

5. **What worked Well**

a. Collapse of banking system avoided.

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b. Legal and regulatory regime upgraded, notably on prudential regulations.
c. Supervisory capacity rapidly became vastly better, as did CNBV's ability to deal with complex crisis issues – top quality senior staff learned fast on the job and from lessons of other crises.
d. Revised accounting rules markedly eased Mexican firms' access to US capital markets (explanatory notes to convert accounts no longer needed).
e. Foreign bank (Santander) acquired majority position in an undercapitalized bank (Probursa) in June 1995, making it the second majority owned foreign bank in Mexico (besides Citibank, never nationalized). During three years following onset of crisis, over 25% of banking assets were in majority foreign-owned banks (compared with 6.5% in end 1995). By August 1997, some 89 "large" corporate loans presented for restructuring to UCABE, of which 30 restructured ($ 2.76 billion), 18 turned down, 11 signed MOUs, 4 in process, 6 came out of bankruptcy, and 20 turned over to other agencies.
f. Economic Outcomes: Recovery started in 1996, although exports grew rapidly from 1995. (To be expanded later.)

6. **What didn't work**

a. Restructuring of banks was far too slow-- banks were slow to reveal extent of impaired loans to supervisors and seek clean out; banks had to return to CNBV for second and third wave of clean out of non performing portfolio (most egregious case was Serfin) prolonging moral hazard problem of undercapitalized weak banks keeping insolvent clients afloat, inefficient allocation of scarce resources; therefore, Mexican banks were unable to expand credit to private sector, becoming a brake on economy. Meanwhile, larger export oriented firms were able to tap US capital markets.
b. Bonds that replaced non performing portfolio purchased by FOBAPROA did not pay current interest, thus providing no additional liquidity to banks. Since banks suffer from non repayment during crisis, their liquidity situation worsened.
c. Acceptance of subordinated loans as new Tier I "equity capital infusion" meant a further squeeze on liquidity, since banks had to pay interest to shareholders on this so called "new equity capital".
d. The CNBV staff responsible for supervising the banking system were also responsible for negotiations with banks on their recapitalization/restructuring. The World Bank had recommended at the outset an exclusive crisis management team to resolve undercapitalized banks.
e. Legal framework did not allow asset backed securitization (ABS), which may have enabled more quick disposal of large volume of consumer and mortgage loans. Similarly, inability to place liens on movable property (secured lending) prevented viable SMEs from taking off more quickly.
f. Resolution of problem loans took years, and is still ongoing. World Bank counseled that sale of first batch of non performing loan portfolio take place in early 1996, but sale was delayed for a variety of reasons, including poor quality of original loan agreements. As time passed the value of the loans purchased with public funds declined, raising the cost of the resolution to tax payers.
g. Underlying all the delays seems to have been a political reluctance to deal boldly with major problems a few months into the crisis. The "*El Barzon*" movement led to the debt forgiveness through ADE, with the middle classes mainly benefiting on mortgage loans. However, it appears that the significant beneficiaries of bail outs were corporate borrowers, while households and workers in informal and smaller enterprises bore a large share of the adverse impact of the crisis.

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h. The fiscal cost of the crisis is estimated at around 7 to 8% of 1996 GDP, but will only be known with precision after all the NPLs with IPAB are sold or resolved. The slow implementation imposed a cost in terms of much slower economic growth than might otherwise have been possible.

7. A GOVERNANCE PERSPECTIVE

a. Corporate governance reforms are easier to put in place than changing the pre existing corporate opacity "culture", which takes much time. Mexican banking crisis essentially due to insider abuses- to put it bluntly, corruption and mismanagement. The focus therefore was on improving transparency and disclosure, putting in place better regulations as a basis to track performance of shareholders and management.
b. Arguably the most important reform in accounting standards to USGAAP was delayed from January 1996 to 1997, not because CNBV and banks believed the change was not the right thing to do, but because it would reveal the extent of the real losses. In the end the crisis ended up costing more because of delays.
c. Quality of Capital- The World Bank insisted on raising the share of cash in Tier I capital, but CNBV delayed this. Part of the reason was political, to preserve "Mexican" ownership of top 3 banks at least - a relic of the NAFTA agreement!
d. Strengthened supervision of banks from 1995 - more frequent on site inspections, with focus on internal risk management systems - improved banks' management culture.
e. Transparency of portfolio clean outs was less than desirable, resulting in 3 to 4 clean outs in weak banks. The remnant non performing portfolio became a drag on banks and increased losses, while conditions for moral hazard were left in place.
f. In the battle for survival, corporate governance appears to have been traded off by the authorities during the Mexican financial crisis. This is partly explained by lack of financing, and partly by the lack of political will to deal with large corporate groups— the IMF and World Bank underestimated the financing required for banks' resolution. World Bank and IDB loans provided US$ 1.75 billion for bank restructuring, while the estimate of losses in 1995 was US$ 6 – 16 billion, a figure that was raised later. In Mexico, tax payer households, and SMEs bore a large cost, but large corporate groups benefited most from tax payer bail outs. Not one major corporate group came under serious threat.

KOREA

1. Recent Economic Performance

a. Korea experienced over 3 decades of outstanding economic growth and social development, among the highest growth performances in the world. This was due to physical capital accumulation with emphasis on exports, aided by strong domestic savings, and human capital development. By the late 1990s its workforce's education profile was akin to that of the UK or Canada, and quite unlike other countries in East Asia (ex Japan). The Government had always maintained a conservative fiscal tradition, and limited public borrowing.
b. Joined OECD in 1994, graduated from World Bank borrowing in 1995, and by 1997 boasted a GDP per capita of over US$ 10,000.

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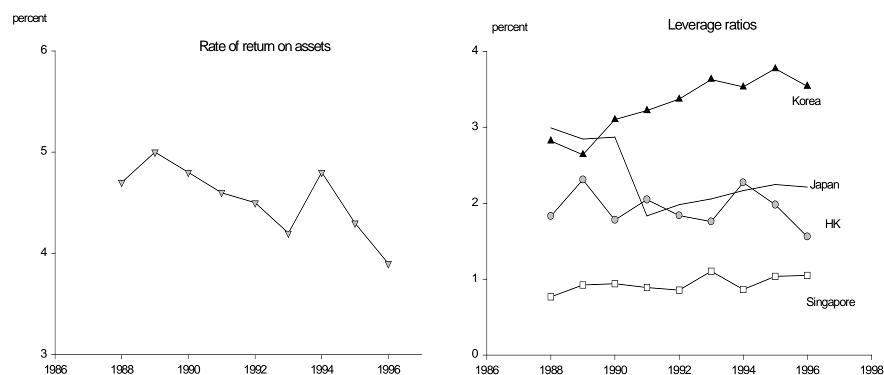
c. However, underlying problems began building up in the 1990s. The financial system was weak with poor supervision, split among two main agencies. Corporate leverage was extremely high compared with other OECD countries, and rising. This was coupled with very weak governance systems. Corporations pursued growth at the expense of profitability and efficiency. The economy was essentially closed, with limited domestic competition. For example, FDI in 1997 was 3.8% of GDP in Malaysia, but only 0.5% of GDP in Korea. The labor market was rigid with layoffs being almost impossible, and wages rising faster than productivity, thus eroding competitiveness. Meanwhile Japan and China became increasingly competitive in the same product lines as Korea. The current account deficit widened, but the exchange rate remained fixed to the US$. (See Chart I, and Fig 1).

Figure 1

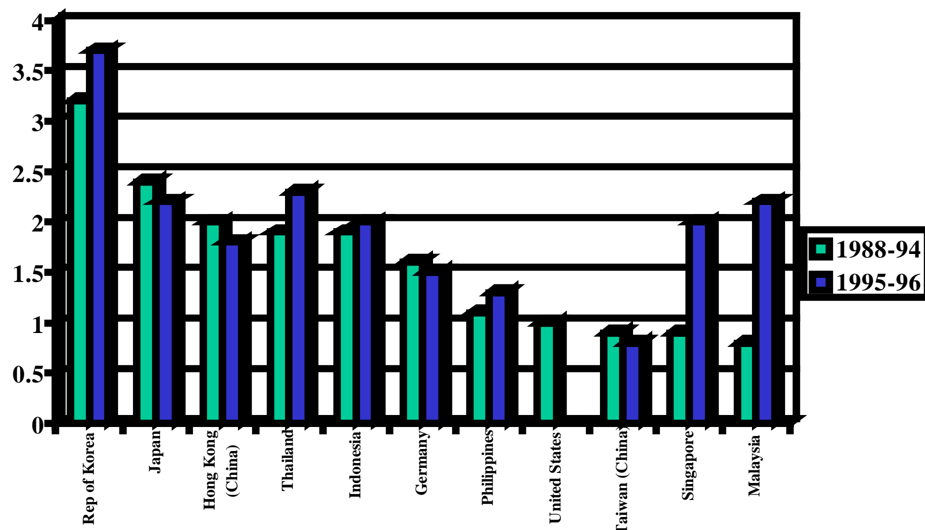
Low profitability and high leverage led to increased vulnerability of corporates



Bangkok, May 25, 2000.

Corporate debt was excessive in the crisis countries but Korea was an outlier

Debt to common equity ratios of nonfinancial corporations, 1988 - 96



London, Dec. 21, 1999

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d. Financial market liberalization initiated as part of entry into OECD was poorly sequenced. The capital account was liberalized in 1995, with incentives for short term capital flows, which took place as private debt contracted by merchant banks on behalf of their *chaebol* (corporate conglomerates) borrowers.
e. The Government led economic development strategy had outlived its time, but intervention was dominant. At Government behest banks were frequently used to sustain corporate inefficiency and opacity.

e. Prior to the crisis the Korean financial system passively accommodated corporate credit demand, supplying debt financing without any discipline on corporations, with poor governance within financial institutions as well. Chaebols acquired controlling stakes in non bank financial institutions (NBFIs) including stock market intermediaries (see Table I).

Table 1

Chaebols' ownership of NBFIs is high in Korea

(as of September 1999)

	Non-life Insurance	Securities	Credit Card	Life-Insurance	ITCs	Avg. Mkt. Share (Mar-1999)	Avg. Mkt. Share (Mar-1997)
Top five chaebols (Percentage Share)	47.3	54.6	52.2	40.3	30.2	34.7	22.5

Source) Korea Institute of Finance

London, Dec. 21, 1999

The accounting and disclosure standards required under Korean GAAP was limited, and market participants' failed to provide oversight of corporations. Regulation and supervision of financial institutions was weak, financial market infrastructure was underdeveloped compared with countries with similar per capita incomes, and capital market development was hampered. The financial sector was politicized with an active Government/business/banks nexus- invariably favoring bail outs of failing chaebols- and hence fraught with moral hazard.

3. The 1997 Financial Crisis

a. In December 1997, following the crises in Indonesia and Thailand, there was a loss of confidence in Korea leading to flight of capital and a collapse of the currency. The usable foreign exchange reserves were around US$ 4 billion while short term debt stood at US$ 64 billion, with total debt at US$ 158 billion.
b. The Won was floated and fell from 850 to over 1700/$. Consumer confidence collapsed and GDP shrank in 1998 by 6.7%, the worst since the Korean war. The unemployment rate which had been around 2 – 3% for most of the decade spiked to 8.8% by February 1999. Real wages fell by some 20%.

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c. Given underlying weaknesses in the corporate sector, with the rise in interest rates from 12 to around 30% at the peak of the crisis, leverage ratios of the top 30 chaebol averaged about 520% by end 1997. Corporations which could not cover interest payments with cash flow more than doubled from 20% at end 1996 to over 46% by end 1998 for the top 6-64 chaebols. The worsening of the corporate sector's balance sheets and incomes intensified problems for the financial system. NPLs in the banking system which were 5.8% at end 1997 rose to 8.6% by June 1998, based on backward looking provisioning criteria in force. Applying forward looking criteria (adopted in end 1999) the NPLs would be twice as high. Bankruptcies among SMEs was very high. The number of urban poor rose sharply from some 9% (based on consumption expenditures) in the last quarter of 1997 to 23% in the 3rd quarter of 1998.

4. The Government's Policy Response

a. Quick macroeconomic policy response adopted with help of IMF, with priority to restore external stability. Monetary policy was tightened sharply, with call rates rising to 30% pa by December 1997 compared with 13% in October, and fiscal policy also tightened(erroneously) but relaxed later. Voluntary rescheduling of short term debt was negotiated successfully with commercial creditors by end January 1998, and implemented in April. As the exchange rate stabilized, monetary policy was loosened to respond to the recession with rates falling to 12% by July 1998.
b. Two supplementary budgets were approved during 1998, the second envisaging a deficit of 5% of GDP to provide a stimulus of about 2.5% of GDP. Recognizing that SMEs were hardest hit, several schemes were put in place to facilitate their access to credit, including credit guarantees that reduced default risk on banks' books and loan rollovers in response to systemic distress. Responding to the unprecedented social distress, the unemployment insurance, livelihood protection, and public works schemes were expanded, so that by end 1998 social protection expenditures were tripled to reach 1.6% of GDP, later expanded to 25 of GDP in the March1999 supplementary budget.
c. The crisis highlighted to the new Government of President Kim Dae jung the need for structural reforms and a new development paradigm. The main elements of the reform program were i. The establishment of a sound market based financial system(revise prudential regulations and strengthen supervision under newly created- April 1998- Financial Supervisory Commission); ii. Corporate sector reform to restructure corporate finances(e.g., D/E ratios of chaebols to be below 200% by end 1999), improve corporate governance(e.g.,cross guarantees to be eliminated by March 1999, consolidated financial statements required by end 1999 etc.); corporate restructuring program, voluntary, out of court, adopted in July 1998; and enhance competition through policy reform and opening to FDI; iii. Reorienting the role of Government from "dirigisme" to support private activity; iv. Improve labor market flexibility and strengthen social safety nets.
d. A large number of laws were enacted on February 14, 1998 to launch the reforms, including opening of Korean firms to 100% foreign ownership, through friendly or hostile takeovers, corporate governance reforms (minority shareholders' rights, outside directors etc.), expansion of unemployment insurance, strengthen competition policy and anti trust enforcement by the Fair Trade Commission.

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5. **Governance Reforms** (see Annex for specific details)

   a. The reforms in the area of governance touch on shareholders, Boards of Directors, audit systems, monitoring of management and market oversight. Specialized insolvency courts were recommended and adopted with delay. Also laws were enacted on ABS, and CRVs to resolve NPLS and reallocate assets.
   b. The reformed accounting and disclosure standards required were consistent with IAS, or USGAAP where IAS does not have a provision. Also, responsibility for setting standards was shifted from Government to the professional association.
   c. Stronger rights for minority shareholders, institutional and strategic investors, and external financiers in general; progress in improving creditors' rights, improving the functioning and accountability of company boards and directors, improving the legal system in terms of better insolvency procedures, and better transparency and financial accountability.
   d. Strengthening enforcement.
   e. Regulation on adoption by banks of forward looking criteria (future ability to repay) for loan classification in end 1999 puts borrowers on notice about their future performance.

6. **What Worked Well**

   a. **Economic Outcomes**: Rapid V shaped turnaround in economic activity, faster and stronger recovery than in any other similar crisis affected country. Sharp drop in inflation and unemployment rates, gradual reversal of adverse social consequences including poverty, strengthened external payments position and investor confidence. Recovery driven by private investment and consumption, and strong export growth.
   b. GDP growth: –6.7% (1998), 10.7% (1999), highest in the world, 8.8% (2000); 3.7% (2001), highest after 9/11 except for China.
   c. Inflation rate: 10% in Feb 1998, averaged 7.5% for 1998, below 1% for1999, 2% in 2000.
   d. Unemployment: Peaked at 8.8% in Feb 1999, dropped to below 4% in 2000.
   e. Poverty: Dropped close to pre crisis level (11.4%) in 2001 from peak of 23.2% in 1998.
   f. FDI: Rose sharply to $8.8 billion in 1998, $15 billion(1999), $ 13 billion (2000)
   g. External Position: BOP Current Account Balance- Deficit of $8 billion (2% of GDP) in 1998, turned to consistent surplus every month since then, even after 9/11/2001. Gross FEX Reserves $8.9 billion in Dec. 1997, turned to surplus of over $ 45 billion at end 1998, while short term external debt was reduced to $ 30.7 billion, and total debt to $148.7 billion. By end 1999 short term external debt stood at $35 billion, with total debt at $ 136 billion Korea's FEX reserves now stand at over $ 105 billion, the fifth largest in the world, while it also reached net creditor status since end 2000 at 4.5% of GDP. Sovereign credit rating continuously upgraded.
   h. The total financing offered by the IMF, World Bank and ADB was equivalent to $ 35 billion. A "second line of defense" of $ 23 billion was pledged by bilaterals in case the crisis was prolonged, and IFI commitments were exhausted. In the event, Korea only drew $ 29.5 billion equivalent by 1999, and in August 2001 fully prepaid the $19.5 billion drawn from the IMF, reducing total external liabilities to $121 billion by October 2001.

7. **Structural Changes in Financial/Corporate Sectors**

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a. Of 30 merchant banks operating in 1997, 17 insolvent banks closed by April 1998, and number reduced to 9 by end 2000, and 5 now.
b. Korea First Bank a large commercial bank intervened along with Seoul bank in December 1997 due to insolvency, sold to Newbridge capital, a US strategic investor in early 1999- first foreign majority bank in Korea (other than Citi). Other Korean banks also attracted equity participation by major foreign banks.
c. Commercial banks audit completed by end June 1998, 5 insolvent commercial banks closed and merged by September 1998 with stronger banks through Purchase and Assumption (P&A).
d. Ratio of NPLs dropped from about 20% in end 1998 to 10% by end 2000, and below 4% by end 2001under forward looking criteria for classification adopted in end 1999. Capital adequacy of banks below 8% in Dec. 1999, rose to over 11% by Oct 2001, and even higher now.
e. Debt/Equity ratios of chaebol reduced; for top 4 chaebol from 400% in 1997 to below 200% by end 2000, based on consolidated financial statements. Cross guarantees eliminated and interlocking nature of financial structures somewhat clarified.

8. Weak Spots

a. Corporate reform was resisted and slowed by fast recovery in 1999. Weak corporations did nothing to improve financial structure. Liquidation of chaebol affiliates, however inefficient, was avoided. Weak affiliates continued to receive access to financial resources, with banks unwilling to shut off credit. Specialized insolvency courts were set up at WB recommendation, but the aversion to exit of large firms prevailed. Pre packaged bankruptcies were agreed with the authorities, but never practiced for large chaebol affiliates, only for SMEs. This slowed the corporate restructuring program, allowing many weak firms to continue. Banks were unwilling to recognize losses, or to stand up to large chaebols. Bank managements continued to look to FSC for guidance on many issues within their control- a legacy from past practice. Even in mid 2001, some 20% of listed large companies were estimated by the Bank of Korea to be unable to cover interest payments with operating income, living on continuous borrowing. Only in March 2001 was the need to speed up corporate reform revisited, and a new Corporate Restructuring Promotion Law enacted in September 2001, calling on banks to review the financial situation of weak borrowers, and push for their exit through courts if necessary.
b. FSC, which was responsible for supervision and regulation of the financial system became the overseer of the voluntary bank-led corporate restructuring program, but as the financial system had to bear the burden of strict and disciplined workouts, there was an apparent conflict of interest for FSC whose dominant interest was in systemic stability in the financial sector.
c. While banks were restructured with speed, investment trust company (ITC) reform was not addressed until late 1999, after largest ITC(Hyundai) faced liquidity problems and two others became insolvent, leading to their sale with Government absorbing losses. Since ITCs were a sizeable part of the financial system, with many under chaebol ownership, this was a regulatory oversight.
d. With surprise disclosure of financial problems at large chaebol in April/May 1999, markets lost confidence in financial statements of listed banks and corporations, quickly bringing stock indices down.

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e. Behavioral change in banks' management was slow but even slower in chaebol. The new economy managers of high tech firms however, showed much more flexibility.

9. Factors Contributing to Korea's Success

a. Foremost, were the bold and determined actions by the Government to address the underlying causes of the December 1997 Financial Crisis. Examples include the seizure of 2 large insolvent commercial banks in December 1997, raft of laws enacted on February 14,1998; the speedy audits of merchant and commercial banks and their resolution, with the majority of merchant banks closed by April 1998, and 5 commercial banks in September.
b. Strong public support for the reforms, evidenced by a steep drop in domestic consumption in 1998 while savings rose to a record of almost 40% of GDP.
c. The legal reforms aided confidence, and the opening to foreign investment led to a large inflow of FDI which has been sustained.
d. The Government led strategy of financial sector restructuring was adequately funded, and when additional funds were required the Government sought more resources from the Assembly, even in 2000 to complete the clean out.
e. The Government did not hesitate to dissolve the second largest corporate group Daewoo in late 1999 when it became insolvent. Later the Hyundai group also broke up.
f. By mid 2000 over 50% of NPLs were purchased by KAMCO, and 35 % of them sold. This was aided by speedy legal reforms to permit Asset Backed Securitization (ABS), establishment of Corporate Restructuring Vehicles (CRV), Vulture Funds etc- even though Korea has a civil law system like Mexico.
g. The legal, regulatory and institutional framework were put in place very quickly, although behavioral change came more slowly, but is being seen in many banks and firms.
h. One expert's opinion of why Korea emerged out of the crisis faster than other countries:

High level of literacy –even school children know the BIS capital adequacy ratio.
Developed sense of community, nation and equity—ashamed of crisis, supported reforms actively from early on, with cuts in consumption and increase in savings.

10. A GOVERNANCE PERSPECTIVE

a. The World Bank emphasized reforms in corporate governance standards and competition policy from the outset, and provided specific advice drawing on OECD principles- to enhance the role of regulators and improve incentives to reduce pervasive moral hazard, and to enable markets to function. The reforms were focused on transparency, the role of boards in providing arms length oversight and openings for stakeholders to participate. (see Annex I for specific reforms)
b. The Kim Dae jung Government recognized the need for modern corporate governance systems and stronger enforcement powers of regulatory agencies including the FSC, KFTC and others. This is evidenced by the speed with which the Banking Act, Securities and Exchange Act, Commercial Code and other laws were amended from February 1998 onwards thru end 1999 to set in place a completely new legal framework and incentive structure needed for a shift to an open, market

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oriented economy. Even though at end 1999 they declared they were out of the crisis, mainly because of the early remarkable recovery, and reform fatigue, the reform process has been internalized and is now seen as an ongoing process, as shown by laws enacted in 2001recognizing the need to speed up corporate reform and restructuring, following the adoption of the Continuous Corporate Credit Risk Assessment System by banks at FSC´s urging. Markets responded with more investment capital both domestic and foreign.

c. It became clear from early 1999 that following the reform of the foreign investment laws, Korean firms with institutional investment from abroad saw share prices appreciate faster, and, measured on the basis of book value etc were better valued by the markets. This was attributed to the perception of reliable (external) monitoring of transparency in disclosure, and of management practices. This process continued and more firms sought and benefited from foreign institutional investor participation.
d. The early significant fines in millions of dollars levied by the new Fair Trade Commission on large conglomerates for violating anti trust laws was well regarded as a sign of change. The FTC also regularly published data on inter affiliate transactions, thus playing a positive role in disclosure, and continuing to sanction violations.
e. In March 1998, the laws on minority shareholders to examine the books in detail was tested by a public interest group at Samsung’s Annual Meeting. This process continued and still does, including through law suits by these groups of stakeholders. The open press is another key stakeholder.
f. The seizure of the second largest conglomerate Daewoo and its dissolution in the summer of 1999 was seen by the markets as a clear sign that the “too big to fail” line had been broken. The intervention thereafter of two large ITCs was also regarded as proof of decisive enforcement. The exposure by the press of outdated autocratic practices by the founder Chairman in Hyundai, the largest chaebol and its “voluntary” break up in 2000, was seen as another sign that the large chaebol were paying attention to the new environment for governance. The market economy framework was still only about two years old in Korea.

11. SOME BROADER POINTS FOR CONSIDERATION

a. Globalization is being led by technological advances rather than by politics. Spread of consumer society values even in remote areas is due to speed of progress in information and communication technologies, travel and transport, along with integration of markets. [1]Convergence is a logical outcome: process by which rules, regulations or political institutions governing economic activity in different countries are becoming more and more similar. [2]
b. Given integration of financial markets, and the speed of innovation in their products and services, these markets are also becoming more similar. Banking laws and regulations across the world increasingly resemble each other. Improving and optimizing prudential regulation of financial institutions(FI) is likely to improve not only the governance of FIs but also their borrowers, i.e., corporations in general. Such positive externalities argue for international institutions such as OECD, BIS, IMF, the World Bank and Regional Banks to continue to review and update the principles for such regulation for the ultimate benefit of end users.

[1] Hwa-Jin Kim, Journal of Korean Law, 2001
[2] Laurence, H. Indiana Journal of Global Legal Studies, 1999

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c. Convergence of securities laws through uniform rules and standards for disclosure would also achieve the same ends, but these markets are harder to monitor because of their dispersion and heterogeneity.
d. Securities markets growth depends on reducing information asymmetries—it appears that civil law societies implicitly are less inclined towards greater disclosure to markets.

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