2012 Modularization of Korea's Development Experience:

Deposit Insurance System in Korea

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Deposit Insurance System in Korea

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Knowledge Sharing Program

2012 Modularization of Korea's Development Experience

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Preface

The study of Korea's economic and social transformation offers a unique opportunity to better understand the factors that drive development. Within one generation, Korea has transformed itself from a poor agrarian society to a modern industrial nation, a feat never seen before. What makes Korea's experience so unique is that its rapid economic development was relatively broad-based, meaning that the fruits of Korea's rapid growth were shared by many. The challenge of course is unlocking the secrets behind Korea's rapid and broad-based development, which can offer invaluable insights and lessons and knowledge that can be shared with the rest of the international community.

Recognizing this, the Korean Ministry of Strategy and Finance (MOSF) and the Korea Development Institute (KDI) launched the Knowledge Sharing Program (KSP) in 2004 to share Korea's development experience and to assist its developing country partners. The body of work presented in this volume is part of a greater initiative launched in 2010 to systematically research and document Korea's development experience and to deliver standardized content as case studies. The goal of this undertaking is to offer a deeper and wider understanding of Korea's development experience with the hope that Korea's past can offer lessons for developing countries in search of sustainable and broad-based development. This is a continuation of a multi-year undertaking to study and document Korea's development experience, and it builds on the 40 case studies completed in 2011. Here, we present 41 new studies that explore various development-oriented themes such as industrialization, energy, human resource development, government administration, Information and Communication Technology (ICT), agricultural development, land development, and environment.

In presenting these new studies, I would like to take this opportunity to express my gratitude to all those involved in this great undertaking. It was through their hard work and commitment that made this possible. Foremost, I would like to thank the Ministry of Strategy and Finance for their encouragement and full support of this project. I especially would like to thank the KSP Executive Committee, composed of related ministries/departments, and the various Korean research institutes, for their involvement and the invaluable role they played in bringing this project together. I would also like to thank all the former public officials and senior practitioners for lending their time, keen insights and expertise in preparation of the case studies.

Indeed, the successful completion of the case studies was made possible by the dedication of the researchers from the public sector and academia involved in conducting the studies, which I believe will go a long way in advancing knowledge on not only Korea's own development but also development in general. Lastly, I would like to express my gratitude to Professor Joon-Kyung Kim and Professor Dong-Young Kim for his stewardship of this enterprise, and to the Development Research Team for their hard work and dedication in successfully managing and completing this project.

As always, the views and opinions expressed by the authors in the body of work presented here do not necessary represent those of the KDI School of Public Policy and Management.

May 2013

Joohoon Kim

Acting President

KDI School of Public Policy and Management

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Summary

This report studies the deposit insurance system that Korea established at the end of 1995 and has operated since then. Events during the Asian financial crisis of 1997 and the global financial crisis of 2007-2008 have demonstrated the importance of effective depositor protection schemes.

This report attempts to extract lessons and suggestions that would prove beneficial to policymakers in developing countries where the adoption of an explicit deposit insurance system is considered a way of either containing financial crises, or creating one of the important pillars of modern financial safety nets in the liberalized and globalized financial system.

It is an enormous challenge for developing countries to design and operate an efficient deposit insurance system. One of challenges is to strike an optimal balance between the benefits of preventing crises in advance, and the cost of controlling insured financial institutions and customer risk-taking. There are various designs for deposit insurance arrangements that may meet the objectives of deposit insurance systems. Deposit insurance arrangements should be adaptable to different countries' environments and circumstances.

The global financial crisis of 2007-2008 provided lessons for countries that operate deposit insurance systems. The effectiveness of their deposit insurance systems in protecting depositors and maintaining financial stability was put to the test. The prompt adoption of extraordinary arrangements to improve depositors' confidence reveals the importance and necessity of operating an effective deposit insurance system.

The explicit limited deposit insurance system has been chosen by many Financial Stability Board member countries including Korea.

Korea's deposit insurance system came into existence on June 1, 1996, with the establishment of the Korea Deposit Insurance Corporation (KDIC). Korea's deposit insurance scheme adopted the limited coverage scheme in 1996. The deposit protection limit of Korea's deposit insurance scheme was initially 20 million won per depositor in 1996.

In the beginning, the Korean deposit insurance system was classified as a "pay-box system" in view of its role and responsibilities defined by its law and actual business activities. The Korean deposit insurance system was not intended to deal with systemic crises like the 1997 financial crisis. However, the outbreak of the financial crisis caused many decisions and events that had a huge impact on the deposit insurance system. Limited coverage was changed to blanket coverage to stabilize the financial system during the crisis and to protect depositors. As a result, the deposit insurance scheme in Korea has become considerably exposed to moral hazards. The government reintroduced a limited coverage system in January 2001 to deal with the moral hazard problem and to strengthen market discipline after the second round of restructuring was finished. The KDIC raised the coverage limit from 20 million won to 50 million won in order to prevent withdrawals by large depositors and to maintain financial stability.

Insurance premium rates for insured financial institutions were raised several times after the financial crisis of 1997 to strengthen and reinstate the financial health of the Deposit Insurance Fund. Insurance premium rates for banks and mutual savings banks reached 0.08% and 0.40%, respectively.

The role and function of the KDIC were enlarged in several ways in order to support and facilitate the process of financial restructuring after the financial crisis of 1997. The Korean deposit insurance system has developed an advanced administrative process for resolving failures of financial institutions and has been, in general, effective in protecting small savers. Now the KDIC is classified by the Financial Stability Board as a deposit insurer with a "risk minimizer" mandate.

Korea's experiences in implementing and operating the explicit prefunded deposit insurance system during the financial crisis of 1997 and thereafter provide the following policy implications to developing countries.

Events during the financial crisis of 1997 revealed the importance of effective and explicit prefunded depositor protection systems. Korea's experiences in adopting and operating the explicit prefunded deposit insurance system demonstrate that the explicit prefunded deposit insurance scheme is a better choice than reliance on implicit deposit protection.

The KDIC was established in June 1996 and embarked on the task of deposit insurance protection as an ex-ante prefunded system for banks. In addition, each non-bank financial

sector had its own method of depositor protection, usually in the form of a fund. When the financial crisis occurred in late 1997, the government was able to immediately use the KDIC as an instrument of public policy. The government and the KDIC could implement faster and smoother failure resolutions of insolvent financial institutions because they could operate on the basis of established rules and procedures set in the Depositor Protection Act. The KDIC acted as agent of the government to issue Deposit Insurance Fund bonds guaranteed by the government, executed resolution methods determined by the Financial Supervisory Commission (FSC), and fulfilled recovery functions. The functions of KDIC were expanded in several ways to support and facilitate the process of financial restructuring after the financial crisis.

The explicit prefunded deposit insurance scheme in Korea has been a part of a well-designed financial safety net, supported by strong prudential regulation and supervision of financial institutions conducted by the Financial Services Commission (FSC) and the Financial Supervisory Service (FSS), effective laws that are established and enforced by the Ministry of Strategy and Finance (MOSF) and the government, and an adequate amount of deposit insurance funds and public funds mobilized by the government and the KDIC.

One lesson of the 1997 financial crisis with regard to the deposit insurance system in Korea is the importance of speedy and decisive reaction of authorities, including the government, financial regulatory and supervisory authorities, and deposit insurers, to restructure failing financial institutions, contain losses, and eliminate the underlying causes that triggered the crisis. Swift, effective resolution mechanisms orchestrated by the Financial Supervisory Commission (FSC) with the help of the Ministry of Finance and Economy (MOFE) and implemented by the Financial Supervisory Services (FSS), the Korea Deposit Insurance Corporation (KDIC) and the Korea Asset Management Company (KAMCO) have been crucial for constraining losses and for preventing prolongation of harmful effects of the crisis on the financial system as well as the real economy in Korea.

A greater emphasis should be placed on early detection and warning of potential problems, timely identification of risks, and intervention in failing financial institutions. The Financial Supervisory Commission (FSC) and the Financial Supervisory Services (FSS) adopted and implemented the prompt corrective action (PCA) system to deal with problem financial institutions. The KDIC has endeavored to improve risk surveillance of insured financial institutions to facilitate the early detection of risks and prevent those risks from leading to failures of financial institutions. However, since the Depositor Protection Act (DPA) that defines the scope of duties of the KDIC does not include a provision for proactive risk surveillance, the KDIC's risk surveillance activities have been constrained.

The deposit insurer should adopt a blanket insurance coverage system during a financial crisis in order to improve and maintain depositors' confidence and to stabilize the financial system, and then reintroduce a limited coverage system when deemed appropriate. In Korea, limited coverage was changed to blanket coverage to stabilize the financial system and to protect depositors during the financial crisis of 1997. The Korean government reintroduced a limited coverage system in January 2001.

The single integrated deposit insurance system in Korea provides a protection for up to 50 million won to deposits held by not only banks, but also finance investment companies, insurance companies, merchant banks and mutual savings banks. However, in order to deal with the shortcomings of the single integrated deposit insurance system, the deposit insurer should differentiate the size of the deposit protection for each financial sector based on idiosyncratic features and varying degrees of risk in each financial sector. Coverage limits are especially important in controlling moral hazards.

Prompt resolution of failing insured financial institutions can save many depositors and much financial resources of the deposit insurance fund. Forbearance of failing financial institutions would result in a huge increase in the cost of resolving insolvent financial institutions. The deposit insurance agency should be proactive in its resolution planning process to minimize the loss in resolving insolvent financial institutions. In the late 2000s, the KDIC began to participate in the decision process of the resolution method when the FSC decided the resolution method of failed mutual savings banks.

The deposit insurance agency should endeavor to use the least- cost resolution method to minimize the losses on the deposit insurance fund and thus, the burden on depositors and taxpayers. The Financial Services Commission (FSC) and the Korea Deposit Insurance Corporation (KDIC) have been responsible for conducting the least- cost resolution method in the resolution of failing financial institutions.

The deposit insurance system should ensure that adequate deposit insurance funds are available to deal with problems as they occur. Adequate deposit insurance funds and public funds, as well as timely funding, are necessary to implement the financial restructuring of the insolvent financial institutions and to protect depositors. A deposit insurance system with a large deficit or insufficient insurance funds would not be able to implement the financial restructuring and to protect depositors. Inadequate funding may lead to a delay in resolving insolvent financial institutions and considerable increase in resolution costs. In Korea, the KDIC did not have adequate resources to cover the costs of implementing the financial restructuring and to protect depositors. Therefore, the government had to draw from public funds. The KDIC mobilized 81.6 trillion won of public funds during the period from November 1997 to June 2011 by issuing Deposit Insurance Fund (DIF) bonds guaranteed by the government.

The government and the KDIC suffered from the shortfall of public funds in late 1999. However, timely funding had been postponed due to political and bureaucratic interests and consideration in mobilizing the second-round public funds. Belatedly, the second-round public funds were mobilized by issuing 40 trillion won of DIF bonds during the period from December 2000 to December 2001.

Insufficient funds in the MSB account of the Deposit Insurance Fund (DIF) may have been one of the factors that led to forbearance of failing mutual savings banks and then resulted in a huge increase in the cost of resolving insolvent mutual savings banks in the 2010s in Korea. The government and the KDIC had to create a special account for restructuring mutual savings banks (MSBs) as a part of measures to reinstate the financial health of the MSB sector account and the Deposit Insurance Fund (DIF), because the MSB sector account of the DIF recorded large deficits due to continuous failures of the MSBs.

The deposit insurer should set the target amount of the deposit insurance fund. In Korea, the KDIC implemented a Target Fund System and set target fund levels for five financial sectors, including the banking sector, in September 2009. The target size of the deposit insurance fund per financial sector should be set at an amount sufficient to cover future losses. The deposit insurance fund per financial sector should be independently managed and should not duplicate the Korean DIFs' unpleasant experiences in the 2000s. In principle, the reserve deposit insurance fund of different financial sector should not be mobilized to cover losses of the deposit insurance fund of a particular financial sector.

A deposit insurance agency should have powers to implement its mandate efficiently and these powers should be formally specified. In the beginning, the Korean deposit insurance system was a "pay-box system" in view if its role and responsibilities; the KDIC could not implement its responsibilities effectively during the financial restructuring of insolvent financial institutions after the financial crisis.

The Deposit Protection Act had to be revised several times to support the expanding mandates of the KDIC in order to facilitate the financial restructuring of insolvent financial institutions and to strengthen the financial health of the Deposit Insurance Fund (DIF) after the financial crisis in Korea.

The deposit insurance agency should be made financially and operationally independent and accountable, and shielded from inappropriate political and industry influence. The Korean government and the KDIC have been under heavy political pressure to expand the deposit insurance coverage to deposits of more than 50 million won at several insolvent mutual savings banks (MSBs) under the limited deposit protection system in the 2000s.

The deposit insurer should implement a risk-based deposit insurance system to mitigate the problem of moral hazard. The risk-based insurance premium system can play a significant

role in disciplining the risk-taking behavior of insured financial institutions. It can thereby reduce the burdens which the deposit insurer should bear in lessening the potential losses to the deposit insurance fund. The KDIC is expected to implement a risk-based insurance premium system in 2014.

The deposit insurer should be given certain instruments that would be available to a private insurer to constrain costs. These include: 1) the ability to promptly stop insurance coverage when a financial institution is operating in a precarious manner, and 2) the authority to examine and assess risk at all insured financial institutions. Since the Depositor Protection Act (DPA) does not give the KDIC such tools, the capabilities to control the KDIC's costs have been constrained.

In order to effectively and efficiently conduct the technical matters related with responsibilities of the deposit insurer, in particular during a financial crisis, the deposit insurance agency should endeavor to strengthen its capacities in core financial areas, such as operation of the deposit insurance fund, risk management, resolution and recovery, and supporting management information systems. Furthermore, the deposit insurance agency needs to design and implement a comprehensive human resource development program to improve staff skills. The KDIC had recruited many experts and lawyers to conduct its business efficiently and effectively during the financial restructuring of insolvent financial institutions.

Chapter 1

Introduction

1. Financial Deregulation and Financial Opening
2. Deposit Insurance System
3. Financial Safety Net and Deposit Insurance

Introduction

In the liberalized and globalized financial system, where competition between financial institutions has increased both domestically and across national borders, a deposit insurance system is essential for protecting depositors and maintaining the stability of the financial system.

Events during the Asian financial crisis of 1997 and the global financial crisis of 2007-2008 demonstrated the importance of effective depositor protection schemes. In both advanced countries and developing countries, the effectiveness of their deposit insurance systems (DISs) in protecting depositors and maintaining financial stability was tested, and several reforms were subsequently implemented to improve the deposit insurance systems where appropriate. The swift adoption by many countries of special arrangements to improve depositors' confidence reveals the importance and necessity of adopting an effective deposit insurance system.

This report consists of five chapters. Chapter 1 describes the background of establishing the deposit insurance system as an important pillar of the financial safety net in the midst of implementing financial deregulation and financial reform during the 1990s in Korea.

Chapter 2 explains how the Korea Deposit Insurance Corporation (KDIC) was established via legislation, and then goes on to depict the consolidation of deposit insurance institutions and the evolution process of the deposit insurance system. It also describes the major business areas of the KDIC and assessment of the Korean deposit insurance system using June 2009 BCBS-IADI Core Principles for Effective Deposit Insurance Systems as a benchmark.

Chapter 3 reviews the resolution of the financial crisis of 1997 and financial restructuring. It then describes the expanded mandates and functions of the KDIC during the financial restructuring after the financial crisis occurred.

Chapter 4 reviews in detail the management of the deposit insurance funds, which include original (old) Deposit Insurance Fund, Deposit Insurance Fund Bond Redemption Fund, and new Deposit Insurance Fund. It reviews recent issues with regard to the Deposit Insurance Fund in the 2000s in Korea.

Chapter 5 briefly suggests policy implications to policymakers and deposit insurers in developing countries who are keen on enhancing the effectiveness of their deposit insurance systems in protecting depositors and maintaining financial stability.

1. Financial Deregulation and Financial Opening

1.1. Financial Liberalization in the Early 1990s

From the 1960s and through the 1980s, capital account transactions had been strictly regulated. A gradual opening of financial markets in Korea, implying a move towards deregulation of interest rates and limited liberalization of capital movement, began from the early 1980s.

The early 1990s witnessed major changes in scope and orientation of financial regulation. The government engaged in a comprehensive reform of regulatory framework that governs the operations of financial institutions and markets. The financial market deregulation and market opening gathered speed in 1993 with the introduction of plans to further liberalize domestic and external financial transactions. It was accelerated by Korea's accession to the OECD as its 29th member. By the end of 1995, the gradual deregulation program had led to a domestic financial system that had comprehensive freedom to decide its lending and borrowing rates.

In 1995, a new program, lasting until 1999, was introduced to accelerate the liberalization of capital flows. During this period, the government planned to reduce its influence over the direction of bank lending by privatizing some state-owned banks and diminishing controls over credit allocation in the economy. These financial deregulation measures were expected to be beneficial to the economy in the long run. However, there was a risk that they might cause problems in the short run as augmented capital inflows could bring about a substantial rise in the exchange rate and an increase in the current account deficit.

The government also endeavored to establish prudential regulation and a depositor protection safety net that aimed at safeguarding the soundness of the financial system and protecting the interest of users of financial services, including small depositors. Regulatory reform was prompted by structural changes and innovations in financial markets.

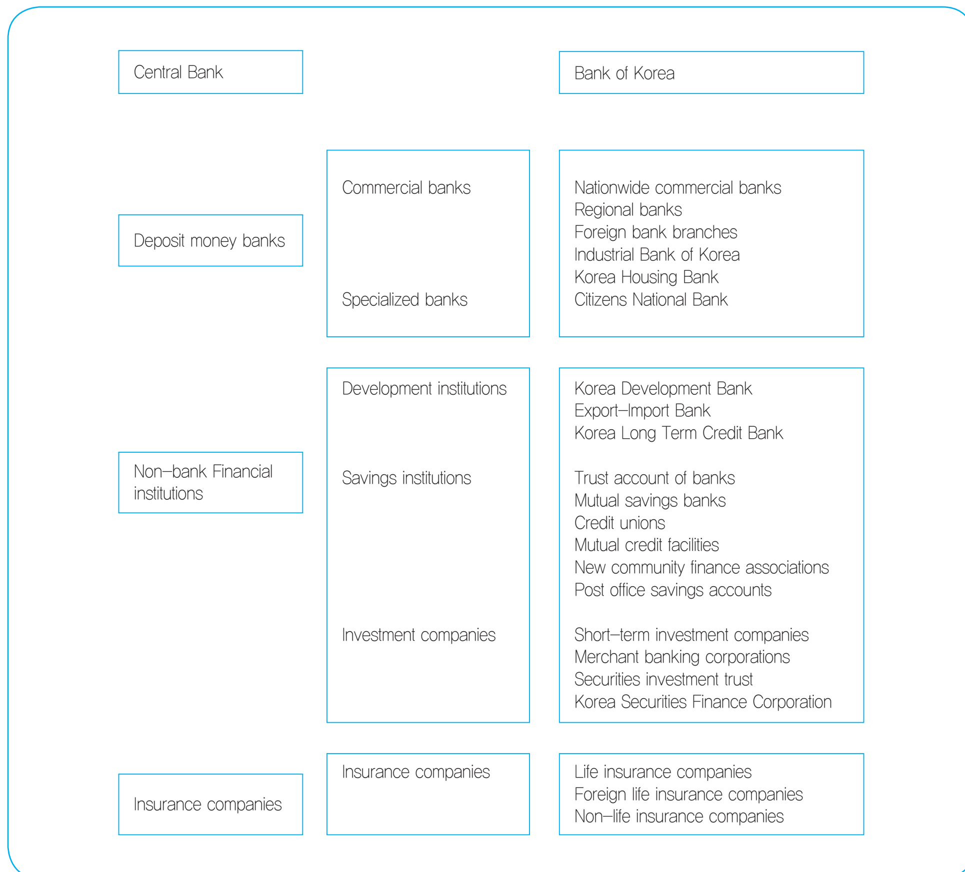
1.1.1. Changes in the Structure of the Financial System

In 1993, deposit-taking financial institutions in Korea were of two types: deposit money banks (DMBs) and non-bank financial institutions (NBFIs). The deposit money banks, with 49 percent of deposits, were divided into commercial banks (36 percent) and various specialized banks that were nearly all state-owned (13 percent). The non-bank financial institutions (51 percent of deposits) consisted of state-owned development institutions, savings institutions and investment companies that extend money market finances to the public and act as financial intermediaries.

Competition among financial institutions had gradually intensified over the preceding fifteen years by the decrease of administrative entry barriers. The establishment of new banks was permitted in 1982 and again at the end of the 1980s and in the early 1990s. As a result, between 1982 and 1992, the number of commercial banks increased to fourteen from six. Simultaneously, the requirements for establishing NBFIs were significantly eased, resulting in the establishment of 44 mutual savings companies and ten investment and finance companies.

In the banking sector, five of six commercial banks were privatized in the early 1980s, and the business scope of commercial banks was expanded in response to intensifying competition from the NBFIs. In 1984, commercial banks were permitted to operate trust businesses. From the mid-1980s, commercial banks were permitted to issue certificates of deposits (CDs) that were not subject to reserve requirements.

Figure 1-1 | Structure of the Korean Financial System, 1995



By 1995, a number of the measures in the 1993-1997 Blueprint for Financial Reform, which aimed to diminish the role of the government in the allocation of obligations between industries and companies, had been implemented.[1] The government has lessened the obligation of banks to provide credit to the manufacturing industry and to small and medium-sized enterprises (SMEs). However, the nationwide commercial banks still had to lend 30 percent of their loan portfolio to the manufacturing industry, down from 55 percent in 1993. The minimum share of loans extended to SMEs remained at 45 percent for nationwide commercial banks. The minimum share of loans extended by provincial banks to SMEs was decreased to 70 percent in 1994 from 80 percent in 1995. In Korea, the dominant position of commercial banks has been challenged by the creation and advancement of non-bank financial institutions.

1. OECD, Economic Surveys Korea 1995-1996, 1996.

1.1.2. Interest Rate Deregulation

The deregulation of domestic interest rates proceeded in accordance with the 1993 Blueprint for Financial Reform. In November 1993, the interest rates charged on all lending, except for policy loans, were liberalized and, in July 1995, those on the policy loans funded by rediscounts at the Bank of Korea were deregulated.

The liberalization of interest rates on deposits was limited to those with maturity of more than two years in order to maintain the profitability of banks during the period of intensified interest rate competition. In November 1995, all interest rates, excluding short-term demand deposits, were liberalized. As a result, the interest rates on only 17 percent of bank deposits and 3 percent of domestic loans remained regulated as of the end of 1995.[2] The final stage of interest rate liberalization, initiated in July 1997, was completed in February 2004, when all lending rates and deposit rates, including the interest rates on demand deposits and short-term savings deposits, were liberalized.

Table 1-1 | Stages in the 1993 Blueprint for Financial Reform

Interest Rate Deregulation		
1993	• Loans	• Only policy loans to remain regulated.
	• Deposits • Bonds	• Time deposits greater than two years. • Corporate bonds less than two years. All financial debentures, MSBs and government and public bonds.
1994-1995	• Loans • Deposits • Money market	• Policy loans eligible for BOK discount deregulated. • Short-term deposits deregulated. • Restrictions on types and quantities of large denomination short-term marketable products eased. • MSB backing for trust deposits lowered. • Short-term instruments diversified.
1996	• Loans • Deposits • Money market	• Policy loans eligible for interest subsidies deregulated. • All remaining deposits including low denomination CDs with maturities less than two years, except demand deposits, are deregulated. Market-related instrument to be introduced. • MSB backing for trust deposits abolished. • New short-term instruments studied.
1997	• Deposits	• Study and plan for liberalization of demand deposit rates and restriction on instruments.

Source: *Ministry of Finance and Economy*

2. OECD, Economic Surveys Korea 1995-1996, 1996.

1.1.3. Deregulation of International Capital Movement

Deregulation of international capital flow proceeded gradually, in a manner closely associated with macroeconomic development. The first medium-term plan for the partial liberalization of capital movements was introduced in 1993 simultaneously with the Blueprint for Financial Reform. The reform program for capital movements was extended over a longer period of time, with three stages scheduled to be accomplished by end-1993, end-1995, and end-1997. This deregulation process was superseded by the December 1994 Foreign Exchange Reform Plan. At the end of 1995, the government introduced a new four-year program, the "Revision to the Foreign Exchange Reform Plan," to liberalize capital flow. This new plan covered not only long-term capital flow, but also extended the liberalization of short-term capital transactions.

1.1.4. Maintaining Financial Stability

Financial opening, however, was expected to raise numerous challenges that would have to be met, including the risk of higher inflation, the possibility of an unwarranted short-term appreciation of the exchange rate and the risk that the banking structure would be too fragile to withstand such adverse developments.[3]

The importance of maintaining macroeconomic and financial stability while implementing financial reform had been recognized by policymakers. However, questions regarding the pace and sequencing of financial reforms were difficult to answer. The establishment of an effective, efficient, and robust financial safety net was an urgent task of the government at the time.

2. Deposit Insurance System

2.1. Adoption of Deposit Insurance System

Instability in the banking system can have serious effects on a nation's economy. It can disrupt a nation's payments mechanism, decrease the nation's savings rate, reduce financial intermediation, and cause serious damage to small depositors. To avert such adverse effects, many governments have intervened in financial markets with various institutional arrangements designed to preserve stability in the banking system. Such arrangements include 1) banking laws and regulations that lay down the rules for bank operations and try to restrain banks' improper risk-taking, 2) the supervision and examination of banks to ensure bank compliance with laws and regulations and to prevent banks from taking

3. OECD, Economic Surveys Korea 1995-1996, 1996.

on unsafe and unsound banking practices, and 3) lender-of-last-resort facilities that aim to prevent bank illiquidity problems from developing into insolvencies.[4]

Many countries also established deposit insurance systems during the 1970s and 1980s. As of March 31, 2011, 111 countries have established some form of explicit deposit insurance system (up from 12 in 1974). Another 41 countries are studying or considering the implementation of an explicit deposit insurance system.[5]

Deposit insurance systems have been set up to maintain public confidence in the banking system, offer to the government a formal mechanism for dealing with problem banks, and ensure that small depositors are protected in the event of failures of insolvent banks. An effective deposit insurance system is an essential pillar of the financial safety net and performs an important role in contributing to the stability of the financial system and the protection of depositors. Moreover, by boosting depositors' confidence in the stability of the financial system, deposit insurance is generally thought to contribute in the long run to a deeper financial system, which could lead to higher economic growth.[6] Deposit insurance is an important and potentially beneficial component of a country's financial safety net.

At present, most OECD members have deposit insurance systems (DISs). Some developing countries also have deposit insurance systems, and other developing countries are contemplating the establishment of a deposit insurance system or improvement of the current system. In many countries, the creation of a deposit insurance system has been as a result of a financial crisis.

In a complete market environment, where all agents in the economy have perfect information and there is no asymmetry-of-information problem, bank deposit insurance is superfluous and offers no social benefit. However, banking systems are not perfect, and thus there is widespread support for establishing a deposit insurance system in the economy.

The purpose of most deposit insurance systems is as follows. First, the deposit insurance system attempts to make small depositor savings de facto risk-free, since it is irrational to urge small depositors to assess the riskiness of their deposits because of the large information-processing capability and surveillance costs needed to do so.[7] Extending deposit protection to small depositors is fair because the cost of acquiring information about the solvency of a financial institution is larger for small depositors than for a deposit insurer. Second, the role of deposit insurance is to protect the financial industry from bank runs and financial

4. Talley, Samuel H. and Ignacio Mas, "The Role of Deposit Insurance," Dimitri Vittas (ed.), Financial Regulation, EDI of the World Bank, 1992, p.321-351.

5. International Association of Deposit Insurers, www.iadi.org, 2011.

6. Levine, 1997.

7. Merton, 1977.

panic and help stabilize the financial system[8]. A deposit insurance system elucidates the government authority's obligation to depositors, limits the range of discretionary decisions, can prop up public confidence, assists to contain the costs of resolving insolvent financial institutions and can offer an orderly process for dealing with the failures of financial institutions and a mechanism for financial institutions to fund the cost of failures.[9]

A bank run breaks out when depositors rush to withdraw their deposits because they expect the bank may fail. Depositors, because they do not have enough relevant information, may have an incentive to join bank runs whether the bank is actually solvent or not. Another type of bank run occurs when bank investors decline to roll over their claims on the bank, and concurrently access to alternative sources of funding is impeded. Banks inherently face exposure to the threat of bank runs because it is their nature of business to provide short-term and demandable credits, which are invested into longer-term assets.

Diamond and Dybvig[10] (1983) study the economics of banking and related policy issues, including deposit insurance. Their study shows that without a deposit insurance contract to prevent bank runs, there always is a point at which a bank run is triggered. Once the bank run begins, all depositors panic and try to withdraw their assets. In a world of many banks, even sound banks are forced to fail as a result of a bank run. As banks become unable to supply credit for transactions and investment, almost every agent in the economy becomes unable to transact and operate effectively.

Demirguc-Kunt and Detragiache (2002) revealed that depositors are able to firmly entrust a bank with their money and it helps if there was a certain kind of guarantee that, regardless of what might take place, they would get their money back.[11]

Disastrous experiences during banking crises have lead many advanced countries to establish deposit insurance systems. Some deposit insurance systems date back to the early 1800s.[12] Demirguc-Kunt, Kane and Laeven (2008) indicated that high-income, advanced countries and those that have experienced a financial crisis are more likely to adopt the EDIS. External influences prove particularly crucial in the adoption decision, especially during periods of crisis.[13]

The goals of implicit deposit protection systems (IDPSs) and explicit (formal) deposit insurance systems (EDISs) are fundamentally the same – to promote financial stability

8. Hein, Eelis, "Deposit Insurance: Pricing and Incentives," Bank of Finland Studies E: 6, 1996.

9. BCBS and IADI (March 2009).

10. Diamond and Dybvig, 1983.

11. Demirgue-Kunt and Detragiache (2002).

12. See Calomiris (1990) and Mas and Talley (1993).

13. Demirguc-Kunt,A., E. Kane and L. Laeven (2008).

and to protect small depositors from losses when financial institutions fail. However, there are some differences in the features of IDPSs and EDISs. The EDIS results in faster and smoother failure resolutions because it operates on the basis of established rules and procedures set in deposit insurance law. In contrast, the whole process of dealing with failing financial institutions and protecting depositors of an IDPS is discretionary and ad hoc. The government will have to decide a source of funding. Moreover, an IDPS is liable to be subject to substantial political pressures, thereby producing less foreseeable and mores inconsistent results over time.[14]

A study by Reint Gropp and Jukka Vesala (2001) demonstrates that in Europe implicit insurance system has meant a larger potential for moral hazard than explicit insurance systems. This is because the coverage of implicit insurance may extend to a larger set of bank stakeholders compared to the case of explicit deposit insurance laws protecting only depositors.[15]

The EDIS was rapidly proliferated in the developing countries in the 1990s. In January 1995, 49 countries adopted the EDIS. By the end of 2003, 87 countries adopted the EDIS.[16] Beginning in the 1990s, IMF crisis-management advice recommended establishing an EDIS as a way either of containing crisis or of formally winding down crisis-generated blanket guarantees of deposits.[17] A reliable EDIS builds and maintains depositor confidence even in perilously fragile and ailing banks.

Events during the Asian financial crisis of 1997 and the global financial crisis of 2007-2208 demonstrated the importance of effective depositor protection schemes in giving depositors confidence, thereby lessening the likelihood of a bank run, and in maintaining confidence in the financial system as a whole.

It is an enormous challenge for the developing countries to design and operate an efficient deposit insurance system. One of challenges is to strike an optimal balance between the benefits of preventing crises in advance and the cost of controlling insured financial institutions and customer risk-taking.

There are various different designs for deposit insurance arrangements that may meet the objectives of deposit insurance systems. Deposit insurance arrangements should be adaptable to country environments and circumstances.

14. Talley and Mas (1992).

15. Reint Gropp and Jukka Vesala (2001).

16. Asli Demirguc-Kunt, Edwaed J. Kane and Luc Laeven (2008).

17. Folkerts-Landau and Lindgren (1998), Garcia (1999).

Demirguc-Kunt and Detragiache (2002) demonstrated that, based on evidence for 61 countries between 1980 and 1997, variations in coverage, funding or management of deposit insurance schemes are important determinants of probability of banking crisis, particularly across countries where interest rates have been liberalized and the overall institutional framework is fragile.[18]

Cull, Senbet and Sorge (2004) argued that, under "generous" deposit insurance scheme, if a depository institution fails, the government takes in almost all of the depositors' losses. This might abate market discipline and generate a moral hazard problem, since there is an incentive for depository institutions to engage in unduly high-risk activities, relative to socially optimal results. Particularly, in loose regulatory environments, these incentives would lead to larger systemic instability.[19]

Global financial crisis of 2007-2008 provided lessons for countries that operate the deposit insurance system. The effectiveness of their deposit insurance systems in protecting depositors and maintaining financial stability was put to the test. The prompt adoption by many countries with deposit insurance systems of extraordinary arrangements to improve depositors' confidence reveals the importance and necessity of operating an effective deposit insurance system.

The global financial crisis prompted changes in the prevailing views about the role of the deposit insurance system. The crisis brought about convergence in practices and provided the momentum for consensus about the proper design features to come out. The emerging majority views about appropriate design characteristics include higher deposit coverage levels; the elimination of co-insurance; improvement in payout process; better depositor awareness of deposit insurance; the adoption of ex-ante funding; and better information sharing and coordination with other safety net participants.

An explicit and limited-coverage deposit insurance system elucidates the deposit insurer's obligations to depositors, can support public confidence, contributes to containment of the costs of resolving failed financial institutions and can offer an orderly process for dealing with failures of financial institutions. To be credible and minimize moral hazard, the deposit insurance system must be appropriately designed, well-operated and understood by the public.[20]

Prudential regulations set up the outside limits and constraints imposed on financial institutions to ensure the safety and soundness of the financial system. Prudential regulations

18. Deminguc-Kunt and Detragiache (2002).

19. Cull, Senbet and Sorge (2004).

20. Financial Stability Forum, Report of the Financial Stability Forum on Enhancing Market and Institutional Resilience, April 2008.

are essential elements to prevent and limit the losses caused by poor management of financial institutions. The absence or weakness of prudential regulations in important areas could result in failure of financial institutions and systemic instability. Regulation and supervision can contribute to minimizing the adverse effects of moral hazards and relative price shocks on the financial system, thus reducing the likelihood of failures of financial institutions and financial system distress. In countries with inadequate and ineffective supervision and regulation, deposit insurance may offer a false sense of security and result in the taking of reckless and undesirable risks.[21]

An article by Cull, Senbet and Sorge (2004) indicates that the effects of the explicit deposit insurance are strongly dependent on the quality of banking regulation and supervision.[22] Regulatory and supervisory systems are requested to set up and enforce effective standards for financial institutions' behavior.

2.2. Introduction of Deposit Insurance System in Korea

Deposit-taking institutions in Korea are of two types: deposit money banks and non-bank financial institutions (NBFIs). In Korea, banks have been the most important financial institutions for intermediating between savers and borrowers, executing monetary policy and offering payment services. At the same time, banks are vulnerable to illiquidity and insolvency due to pattern of their asset portfolios.

Competition among banks and non-bank financial institutions has been strengthened by the reduction of administrative entry barriers, the gradual liberalization of interest rates, and adjustment of the business scope of banks and NBFIs in the 1980s and 1990s.

RMS accelerated in 1993 with the introduction of multi-year plans to liberalize further domestic and external financial transactions. By the end of 1995, the financial deregulation program had led to a financial system that had considerable freedom to determine its lending and borrowing interest rates. In 1995, a new multi-year plan, lasting until 1999, was announced to speed up the liberalization of capital flows.

There has been a concern that the failure of one bank, if dealt with inappropriately, can spill over to other banks and non-bank financial intermediaries, thus generating negative externalities and giving rise to more problems for other banks and financial institutions in the financial system.[23]

21. Polizatto (1992).

22. Cull, Senbet and Sorge (2004).

23. See Garcia (1999).

However, prior to June 1996, Korea did not have an explicit formal deposit insurance system for banks. Instead, considering the serious repercussions that can result from the bankruptcy of a financial institution, the Korean government took on the role of implicitly protecting depositors in the event of failure or insolvency. The Korean government provided implicit deposit insurance partly because the political pressure on policymakers to rescue depositors could become difficult to resist during banking crises.

Protection of non-bank financial institutions existed for each financial sector and in the case of a failure or insolvency, the government intervened to resolve the problem and protect depositors. These non-bank financial institutions had their own depositor protection scheme, usually in the form of a fund.

In the liberalized and globalized financial system, where competition between financial institutions has increased both domestically and across national borders, the deposit insurance system is essential for protecting depositors and the stability of the financial system. The abundant crises during the 1980s and 1990s and the failure of the Barings Bank in 1995 led the Korean government and policymakers to consider introducing an explicit system of deposit insurance.

During the period of accelerating financial liberalization and globalization in the mid-1990s, the government also envisaged instituting an explicit deposit insurance system to protect depositors and to maintain the stability of the financial system in Korea.

Deposit insurance for commercial banks was introduced in 1996. It was generally presumed that the government would never permit bank depositors to lose money. Concerning non-bank financial intermediaries (NBFIs), a variety of non-bank deposit insurance institutions have provided insurance since 1981, in exchange for fees, on deposits at investment and finance companies, merchant banks and mutual savings up to 20 million won per depositor.

The Korean government enacted the Depositor Protection Act (DPA) in December 1995 to protect depositors and to ensure the stability of the financial system during the financial liberalization process that had started in the early 1990s.

A deposit insurance system can take various forms with regards to sponsorship, administration and financing. It may be purely public, purely private, or a public-private sector mix.

Korea's deposit insurance system came into existence on June 1, 1996, with the establishment of the Korea Deposit Insurance Corporation (KDIC). Korea's deposit insurance system belongs to the American model of deposit insurance, whereby a deposit insurance corporation periodically collects an insurance premium from insured member

banks. The deposit insurance system of the United States, Canada and Korea apply such a system.

In 1996, Korea's deposit insurance scheme adopted the limited coverage scheme, which is designed principally to protect small depositors when banks fail. The deposit protection limit of Korea's deposit insurance scheme was initially 20 million won per depositor in 1996. All deposit accounts are insured up to a maximum amount (20 million won), so that when an insured bank fails, the insurer, KDIC, is authorized to pay off insured depositors up to the maximum amount, 20 million won, or arrange for all the failed bank's insured deposits to be transferred to another insured bank.

3. Financial Safety Net and Deposit Insurance

3.1. Financial Safety Net and KDIC

In the wake of the financial crisis of late 1997, the public sector of the Korean financial system was rearranged. Currently, the financial system safety net in Korea consists of the Ministry of Strategy and Finance (MOSF), Financial Services Commission (FSC), Financial Supervisory Services (FSS), the Bank of Korea (BOK) and the KDIC. The financial system safety net includes the functions of prudential regulator and supervisor, resolution authority, a lender of last resort and deposit insurer.

(1) The Ministry of Strategy and Finance (MOSF) is in charge of overall policy coordination and, if deemed necessary, provides fiscal support to facilitate financial restructuring and to maintain the financial safety net.

(2) The Financial Services Commission (FSC) is in charge of financial policy-making. The FSC and the Financial Supervisory Services (FSS) have the right to enforce financial policies, supervise the operation of financial institutions, and issue and revoke licenses to financial institutions. They conduct on- and off-site examinations of financial institutions in each industry and take prompt corrective action (PCA) measures against substandard financial institutions.

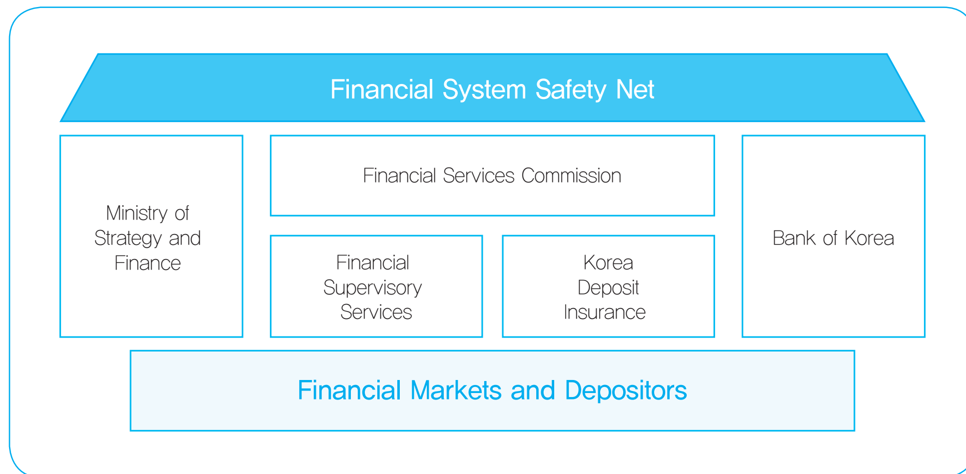
(3) The Bank of Korea (BOK) takes charge of monetary policy and managing the settlement system. As the lender of last resort, the BOK provides liquidity to failing financial institutions, if deemed necessary to maintain the financial stability and can minimize system risk.

(4) The KDIC provides deposit protection that reduces the risk that one institution's failure may trigger a bank run and lead to a systemic crisis. The KDIC is also an important public institution for the stability of the financial system.

Each of these institutions plays its own role in stabilizing the financial market and system. The Korean financial safety net includes all these public institutions and the KDIC. As an element of the financial system safety net, the deposit insurance system complements the functions of prudential regulator and lender of last resort.

During periods of financial normalcy, each of the Financial Safety Net participants performs their own role and function to maintain the stability of the financial system. However, when financial stability is at risk, all of them pool their resources and cooperate with each other to reestablish stability in the financial system and markets.

Figure 1-2 | Structure of Financial System Safety Net in Korea



To ensure effective cooperation among the Financial Safety Net participants, several measures are introduced. For example, there are MOUs signed by the KDIC, Financial Supervisory Authorities, and the Bank of Korea that declare joint examination and sharing of financial information. The MOUs are very useful in facilitating balanced financial supervision and exchange of financial information between the Financial Safety Net participants. When deemed necessary, the KDIC can request insured financial institutions and the Financial Supervisory Services (FSS) to provide data. The KDIC can also either request the FSS to examine a particular insured financial institution and inform the KDIC of the examination result, or request that the FSS perform a joint examination.

Chapter 2

Korea Deposit Insurance Corporation (KDIC)

1. Background Establishment of KDIC
2. Establishment of Korea Deposit Insurance Corporation (KDIC)
3. Consolidation of Deposit Insurance Institutions
4. Major Business Areas of KDIC
5. Evolution of Deposit Insurance System
6. Assessment of Korean Deposit Insurance System

Korea Deposit Insurance Corporation (KDIC)

1. Background Establishment of KDIC

In the liberalized and globalized financial system, where competition between financial institutions has increased both domestically and across national borders, the deposit insurance system is essential for protecting depositors and the stability of the financial system. Financial liberalization and globalization have led to intensified competition among financial institutions in Korea. To effectively meet these challenges and to strengthen the financial safety net in a rapidly changing environment, the government enacted the Depositor Protection Act in 1995 and established the Korea Deposit Insurance Corporation in 1996 with a vision to create a formal deposit protection system in Korea.

The deposit insurance for commercial banks was introduced in 1996. The Korean government enacted the Depositor Protection Act (DPA) in December 1995 to protect depositors and to ensure the stability of the financial system during the financial liberalization process that started in the early 1990s.

The KDIC was established on June 1, 1996, as a non-capital special corporation to provide a deposit insurance system for the public, based on the Deposit Protection Act (DPA).

In the wake of the financial crisis of 1997, the Korean financial system has gone through various changes and significant measures have been implemented to strengthen prudential regulation and improve governance in order to restore market discipline and guarantee the proper functioning of market mechanisms.

2. Establishment of Korea Deposit Insurance Corporation (KDIC)

The KDIC was established on June 1, 1996, as a non-capital special corporation to provide a deposit insurance system for the public based on the Deposit Protection Act (DPA).

The KDIC embarked upon the task of deposit insurance protection as an ex-ante system for banks in 1996. In addition, each non-bank financial sector had its own method of depositor protection, usually in the form of a fund.

KDIC acts as the guarantor of deposits in case financial institutions become insolvent and unable to pay back depositors. By protecting depositors, it endeavors to promote savings, enhance the development of financial operations, and thereby maintain the stability of the financial system in Korea.

Table 2-1 | Outline of the KDIC's History

Date	Major Events
December 29, 1995	Enactment of the Depositor Protection Act
June 1, 1996	Establishment of the KDIC
January 1, 1997	Launching of Deposit Insurance Operations
December 31, 1997	Revision of the Depositor Protection Act
April 1, 1998	Integration of Deposit Insurance Funds Launch of an Integrated Deposit Insurance Fund
1998-2002	Restructuring of 655 Financial Institutions with 159 trillion won of Public Funds
December 26, 2002	Revision of the Depositor Protection Act
January 1, 2003	Launch of the New Deposit Insurance Fund
July 2005	Establishment of Legal Framework for the Differential Premium System and the Target Fund System
September 2009	Launch of the Target Fund System
June 2010	Plan for the Launch of the Differential Premium System in 2014
April 2011	Creation of Special Account for Restructuring of MSBs

Source: KDIC

2.1. The Legal Basis for the KDIC's Mandates and Powers

2.1.1. The Depositor Protection Act of 1995

The KDIC's mandates and powers come from the Depositor Protection Act (DPA). As the likelihood of bank failures increased through the financial liberalization in the 1990s, the government enacted the Depositor Protection Act in December 1995, and the KDIC was established in June 1996. The purpose of the DPA is to contribute to the protection of depositors and maintenance of the stability of the financial system by efficiently operating a deposit insurance system in order to prevent a situation in which a failed financial institution is unable to reimburse its depositors.

The DPA has an Enforcement Decree as supporting legislation. The Decree is designed to provide for matters delegated by the DPA and those necessary for its enforcement.

The Depositor Protection Act of 1995 and the Financial Industry Structural Improvement Act (FISIA) provided the legal regime for the government's approach to depositor protection before the 1997 financial crisis.

2.1.2. The Amended Depositor Protection Act of 2002

The Depositor Protection Act (DPA) was amended on December 26, 2002 to facilitate the recovery of public funds and to improve on deficiencies in the original deposit insurance system identified during the resolution of the financial crisis of 1997. The amended DPA also aimed to properly position the KDIC to appropriately serve its missions and objectives in the ensuing financial framework in Korea.

The Deposit Insurance Fund (DIF) Bond Repayment Fund was created within the KDIC to repay debts incurred by the Deposit Insurance Fund in the course of supporting the restructuring of failed financial institutions after the financial crisis of 1997. The amended DPA also required insured financial institutions to pay the Special Assessment for Repayment of DIF Bonds.

2.1.3. The Special Act on the Management of Public Funds

To ensure efficient use of public funds as well as to minimize the financial burden on taxpayers, the Special Act on the Management of Public Funds was enacted in December 2000. The Act lays out how to enhance the objectivity, fairness and transparency of fund raising and management.

2.1.4. The Public Fund Redemption Fund Act

The Public Fund Redemption Fund Act was enacted on December 26, 2002 to facilitate the repayment of the debt principal by the "DIF Bond Repayment Fund," and the "Non-Performing Claim Resolution Fund," pursuant to the "Depositor Protection Act" and the "Act on Efficient Disposal of Non-Performing Assets of Financial Institutions and Establishment of the Korea Asset Management Corporation."

In compliance with the Act, the "Public Fund Redemption Fund" was created. The Public Fund Redemption Fund mobilized needed capital primarily through the issuance of government bonds. The Public Fund Redemption Fund made financial contributions to the DIF Bond Repayment Fund and the Non-Performing Claim Resolution Fund.

2.1.5. Other Act

Other laws that provide the legal basis for the KDIC's mandates include the Financial Industry Structural Improvement Act (FISIA).

2.2. KDIC after 1997 Financial Crisis

Initially, the KDIC had limited risk management capability and resolution functions. The KDIC was regarded as a government agency reacting to public policy initiatives and decisions made by the regulatory and supervisory authorities such as the Financial Services Commission (FSC) and Financial Supervisory Services (FSS). The number of KDIC staff in 1996 was only thirty-four.

2.2.1. Expanded Mandates of the KDIC

As it had promised the IMF, Korea had to enact reform legislation by the end of 1997. The National Assembly passed about twenty-three key measures in special legislative sessions from December 22-30, 1997. Among the key measures passed, there were a couple of measures that expanded the coverage of the deposit insurance system, and mandate and powers of the KDIC:[24]

(1) Amendment of the Depositor Protection Act: the KDIC was to assume full authority for deposit insurance; financial institutions to be covered under the deposit insurance program were to be expanded to include securities companies, insurance providers, merchant banks, mutual savings and finance companies, and credit unions.

24. Kyu-Sung Lee (2011), p.104-106.

(2) Amendment of the Act on the Structural Improvement of the Financial Industry: the authority for mergers and acquisitions and the clean-up of distressed financial institutions was to be shared and rearranged among the MOFE, the FSC, and the KDIC.

(3) A consent bill for the government guarantee on the repayment of the principal and the interest of the Korea deposit insurance fund bond to be issued in 1997 and 1998; the total amount of the deposit insurance bond was 12 trillion won.

After the 1997 financial crisis, the government used the KDIC as an instrument of public policy and KDIC has implemented its role successfully with limited resources and expertise. During the period of overcoming the 1997 financial crisis, the KDIC acted as a pay-box-style deposit insurance organization and agent of the government to issue bonds guaranteed by the government, executed resolution methods determined by the FSC, and fulfilled recovery functions.

The occurrence of the 1997 financial crisis caused many decisions and events that had a significant impact on the KDIC. Limited deposit insurance coverage was changed to a temporary blanket deposit insurance coverage to stabilize the financial system during the financial crisis. The separate deposit insurance agencies were unified under the KDIC to establish a comprehensive and systemic operation of the depositor insurance mechanism; accordingly, the number of KDIC staff increased to 755 to conduct the expanded scope of business in 2002.

In addition, the functions of the KDIC were expanded in several ways during the process of financial restructuring after the financial crisis.

First, for risk management, the KDIC can investigate and call for insured financial institutions to provide the information necessary to receive premiums and liquidate insolvent financial institutions. The KDIC can also request that the Financial Supervisory Services (FSS) examine a particular insured financial institution and inform the KDIC of the result, or request that the FSS perform a joint examination.

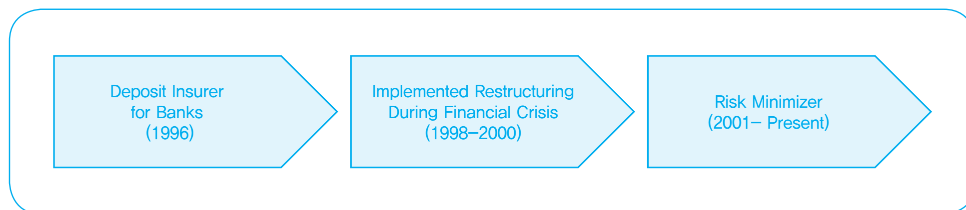
Second, for speedy resolutions, the KDIC may decide that an insured financial institution with high probability of becoming insolvent is an ‘insolvency-threatened financial institution’ and invest in or contribute to improvement in the financial institution’s financial status.

Third, for efficient recovery, the KDIC may permit its officers to carry out the duties of managers, liquidators, and bankruptcy administrators of insolvent financial institutions, and can be assigned the right to file for liability litigation. The Resolution and Finance Corporation (RFC) was also established to maximize the value and liquidity of the undertaken assets.

The mandates of the KDIC expanded following the 1997 financial crisis. As a result, the KDIC is now classified by the Financial Stability Board, with the FDIC of the United States, as a deposit insurer having a "risk minimizer" mandate, where the insurer has comprehensive risk minimization functions that include a full suite of resolution powers as well as prudential oversight responsibilities.[25] Only two member countries (Korea and the United States) have a deposit insurer with a "risk minimizer" mandate among 24 FSB member countries.

On the other hand, nine FSB member countries (Canada, France, Indonesia, Italy, Japan, Mexico, Russia, Spain, Turkey) have deposit insurance systems with a "loss minimizer" mandate where the insurer actively engages in the selection from a full suite of appropriate least-cost resolution strategies.

Figure 2-1 | Changes in the Role of KDIC



2.3. Governance Structure of KDIC

The governance structure of KDIC is carried out by a dual system consisted of the Deposit Insurance Committee and the Board of Directors. KDIC's supreme decision-making body is the Deposit Insurance Committee.

2.3.1. Deposit Insurance Committee

The Deposit Insurance Committee is composed of seven members including the President of the KDIC, who serves as committee chairman, the Vice Minister of the Financial Services Commission (FSC), the Vice Minister of the Ministry of Strategy and Finance (MOSF) and the Deputy Governor of the Bank of Korea (BOK). The three remaining committee members are appointees commissioned by the Financial Services Commission (FSC). Of the three members, one committee member is commissioned directly by the FSC and the

25. Financial Stability Board, "Thematic Review on deposit Insurance Systems: Peer Review Report, February, 2012.

other two members are recommended by the Minister of Strategy and Finance and the Governor of the BOK and commissioned by the FSC.

The Deposit Insurance Committee deliberates and makes decisions on important matters including the following:

(1) Establishment of basic guidelines for KDIC's operations and review of fund management plan;

(2) Amendments to the Articles of Incorporation;

(3) Enactment, amendment and nullification of rules and regulations related to the KDIC's fund management;

(4) Issuance of Deposit Insurance Fund Bonds (DIF Bonds) and DIF Bond Redemption Fund Bonds;

(5) Payment of (advance) deposit payouts;

(6) Financial assistance for the failed financial institutions and insured financial institutions;

(7) Between-account transactions of the KDIC's funds; and

(8) Management of surplus funds.

2.3.2. The Board of Directors

The Board of Directors is the executive body of the KDIC and is composed of the President, Executive Vice President, four internal Executive Directors, and seven non-executive Directors. The Auditor may express opinions at Board meetings, but cannot participate in the Board's voting process. In addition to its duty to support the Deposit Insurance Committee, the Board makes executive decisions on the operation of the KDIC.

The President of the KDIC is appointed by the President of the Republic of Korea on recommendation of the Executive Director Recommendation Committee and in agreement with the recommendation of the Chairman of the Financial Services Commission (FSC).

2.3.3. Organization

As of December 31, 2010, the KDIC is composed of 10 departments, 5 offices and I division: Department of Risk Management 1, Department of Risk Management 2, Department of Savings Bank Support, Department of Deposit Insurance Policy, Department of Research and Analysis, Department of Fund Management, Department of Resolution, Department of Receivership and Collection, Office of Information Technology, Department of Planning and Coordination, Office of Management Innovation, Department of Human

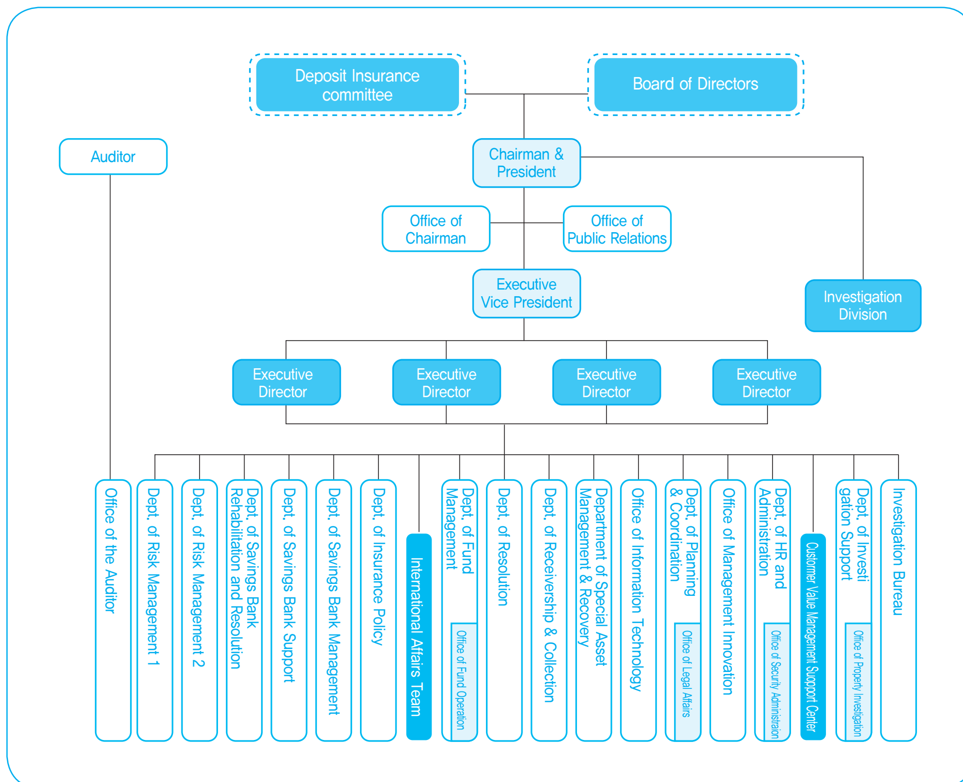
Resources and Administration, Office of Public Relations, Office of the Chairman, Office of the Auditor, and Insolvency Investigation Division.

Table 2-2 | Designated Number of Staff of KDIC (As of the end of 2010)

Type	Executive Directors	Employees		
		Regular	Special	Total
Number	14	399	162	561

Source: KDIC (2011)

Figure 2-2 | KDIC Organization Chart

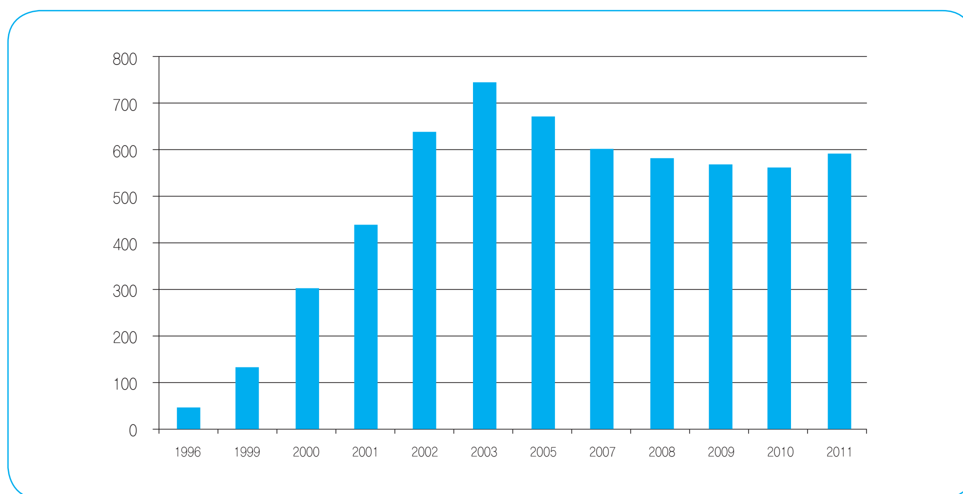


Source: KDIC (2011)

The organization of the KDIC has been significantly changed as its role and function was broadened after the financial crisis of 1997. The number of KDIC employees has increased considerably in the course of supporting and implementing the financial restructuring,

and reached 745 in 2003. Among the employees of the KDIC, there have been special employees, including experts such as attorneys, management specialists, bankruptcy estate support personnel, examiners. The number of special employees recorded 439 at the end of December 2002.[26]

Figure 2-3 | Number of KDIC Employees by Year



Source: KDIC (2011)

3. Consolidation of Deposit Insurance Institutions

Only banks were covered when the deposit insurance system was first implemented in 1997. The deposit insurance system was later expanded on April 1, 1998 - after the Asian financial crisis - to cover securities firms, insurers, merchant banks, savings banks and credit unions as well as banks.

When the KDIC was established in 1996, the separate funds for each respective non-bank financial institution (NBFI) remained in place. The separate deposit insurance agencies were unified under the KDIC to establish comprehensive and systemic operation of the depositor insurance mechanism. The Depositor Protection Act (DPA) was revised on December 31, 1997 to unify the separate deposit insurance agencies under the KDIC by April 1998.

The deposit insurance funds that had existed for each type of financial institution prior to the consolidation were all integrated into one and are now managed as separate accounts of a single fund.

26. KDIC, Annual Report 2002.

The Deposit Insurance Fund thereby assumed the assets and liabilities of the Insurance Guarantee Fund, Korea Non-Deposit Insurance Fund, and Credit Union's Security Fund.

Thus, deposits subject to protection now include not only those of banks, but also those held by financial investment companies, insurance companies, merchant banks, mutual savings banks (MSBs), and credit unions (Credit unions had been excluded from the coverage since 1994). This established a single, comprehensive, and integrated deposit insurance system which aims to enhance financial stability and to ensure public confidence in the financial system.

<Table 2-4> shows the deposit insurance system at the end of 1997 before the adoption of an integrated system.

Table 2-3 | Deposit Insurance System in Korea (As of the end of 1997)

	Korea Deposit Insurance Corporation	Securities Investor Protection Fund	Insurance Guarantee Fund	Credit Management Fund	Credit Union Guarantee Fund
Establishment Date	June 1996	April 1997	April 1989	May 1983	July 1983
Legal Basis	Depositor Protection Act	Securities and Exchange Act	Insurance Business Act	Credit Management Fund Act	Credit Union Cooperation Act
Insured Institutions	Domestic and Foreign Banks	Securities Firms	Life and Non-Life Insurers	Merchant Banks, Mutual Savings Banks	Credit Unions
Function	Deposit Insurance and Financial Assistance	Payment Guarantees for Customer Deposits for Securities trading	Guarantees for Insurance Payout	Deposit Insurance, Financial Assistance, Resolution, and Savings Bank Inspection	Deposit Insurance, and Financial Assistance
Membership	Compulsory	Compulsory	Compulsory	Compulsory	Compulsory
Coverage Limit	20 million won	20 million won	50 million won	20 million won	10 million won

Note: Blanket guarantee was provided from November 19, 1997 – December 31, 2000

Source: Jae-Youn Lee and Seungkon Oh (2011)

4. Major Business Areas of KDIC

The major functions of the KDIC are as follows:

(1) Funding and management of deposit insurance funds;

(2) Risk management to prevent insolvency of insured financial institutions;

(3) Depositor reimbursement and resolution of failed financial institutions;

(4) Recovery of assistance through sale of assets and bankruptcy dividends.

4.1. Management of the Deposit Insurance Fund

Based upon the amended Depositor Protection Act (DPA) on Public Fund Repayment Measures approved in 2002, the funds in the KDIC have been divided into the Deposit Insurance Fund Bond Repayment Fund and the (New) Deposit Insurance Fund.

The Deposit Insurance Fund Bond Redemption Fund and the (New) Deposit Insurance Fund are primarily invested in bonds, such as government and public bonds within the scope where stability, profitability, and liquidity are guaranteed. The purchased bonds are, in principle, held to maturities of the bonds. In order to maintain the stability of the funds, the investment in performance-based products, with no protection of the principal, is forbidden. However, the investment in MMF beneficiary certificates of investment pools for public funds is permitted.

4.1.1. Financial Support of the DIF Bond Redemption Fund

From the 1997 financial crisis until the end of August 2009, a total of 112.5 trillion won of public funds was injected into 517 failed financial institutions. Of this financial support, 44.3 trillion won was recovered by disposing of equity stocks and receiving dividends.

Table 2-4 | Financial Support and Recovery of the DIF Bond Redemption Fund (As of August, 2009)

(Unit: trillion won)

	Equity Participation	Contribution	Deposit Payoffs	Asset Purchases	Loans	Total
Financial Support Provided (A)	48.9	18.9	30.3	12.5	2.2	112.5
Recovery (B)	17.5	3.2	15.0	6.7	1.9	44.3
Recovery Ratio (B/A)	35.8	17.3	49.4	54.0	86.8	39.4

Source: KDIC

Table 2-5 | Income and Expense of the Deposit Insurance Fund (As of August, 2009)

(Unit: billion won)

	Banks	Financial Investment Companies	Life Investment Companies	Non-Life Investment Companies	Merchant Banks	MSBs	Credit Unions	Total
Income	3,877	256	2,678	582	23	1,196	180	8,792
Expense	146	21	73	31	4	3,505	250	4,030

Source: KDIC

4.2. Resolution of Insolvent Financial Institutions

The Financial Services Commission and the Deposit Insurance Committee of the KDIC have the authority to declare a financial institution to be insolvent or insolvency-threatened when its financial status is so unsound that its operation is unlikely to get normalized.

4.2.1. Principles of Support

The principles of support are set up in compliance with international standards in reference to the experiences of advanced countries and through consultation with the IMF. The specific principles of support are as follows:

a. Least Cost Principle

Financial institutions subject to public fund injection are selected according to strict criteria. The scope of support is determined after due diligence by competent experts from the private sector, including accountants, so that insolvent financial institutions are resolved at minimum cost.

b. Loss-sharing Principle

Funds are extended based upon the fair sharing of losses through capital decrease (shareholders), change of management and downsizing. Senior managers and employees of failed financial institutions, who are responsible for insolvency, are subject to civil and criminal liabilities even after funds are injected into the failed financial institutions.

c. Self-Help Efforts Principle

Financial support is provided on the premise of rigorous self-help efforts through a Memorandum of Understanding (MOU). For financial institutions that have signed MOUs with the KDIC to get public funds, the KDIC has the right to review and assess their management performance and take corrective actions, if deemed necessary.

d. Transparency and Objectivity Principle.

Transparency is ensured by applying Prompt Corrective Action (PCA) in compliance with standards announced in advance, and public funds are provided from a structural management specialty organization such as the KDIC.

4.2.2. Methods of Support

The KDIC supports an insolvent financial institution largely using two methods: deposit payoffs and liquidity support. For the insolvent financial institution that has stopped repaying deposits to its depositors, the KDIC pays out insurance money to the institution's depositors. Otherwise, the KDIC provides funds to a party who endeavors to protect depositors of failed institutions through self-improvement of an insolvent (concerned) financial institution, or through takeover and merger.

There are four methods of support: loan and deposit of funds, purchase of assets and liabilities, takeover of loans, and investment or contribution.

4.2.3. Resolution Methods

In order to resolve a failed financial institution in the least costly way, the KDIC selects the most appropriate method among the following:

(1) Deposit Payoff

Deposit payoff is a resolution method that is used when liquidation of the financial institution is decided to be the least costly resolution or when there is no institution that tries to assume the failed financial institution.

(2) Purchase and Assumption (P&A)

A sound and healthy insured institution purchases some or all of the assets and assumes the deposit liabilities of a failed financial institution.

(3) Bridge Bank

A temporary financial institution is created and operated by the deposit insurer on an interim basis to obtain the assets and assume the liabilities of a failed financial institution until the final resolution is completed.

(4) Open Bank Assistance

The deposit insurer extends financial assistance to a failing insured financial institution through equity participation, contribution or purchase of assets, and obtains its shares in return.

Figure 2-4 | Resolution Method Determination

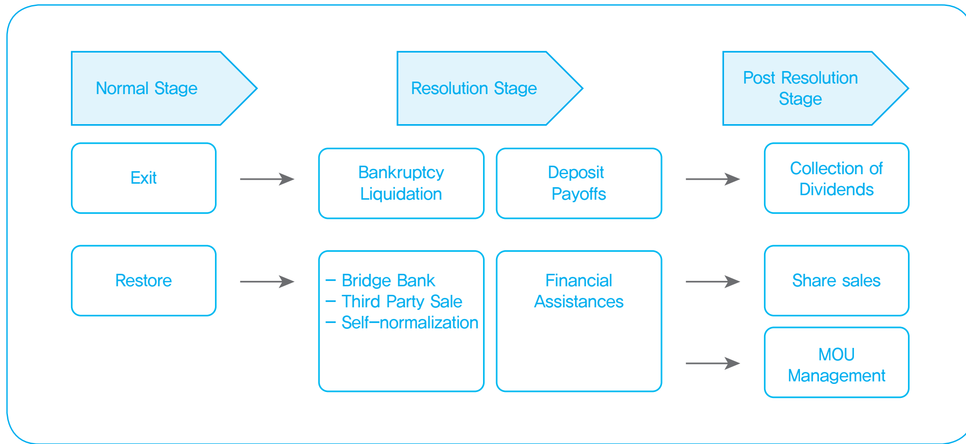


Figure 2-5 | Resolution Process and Method

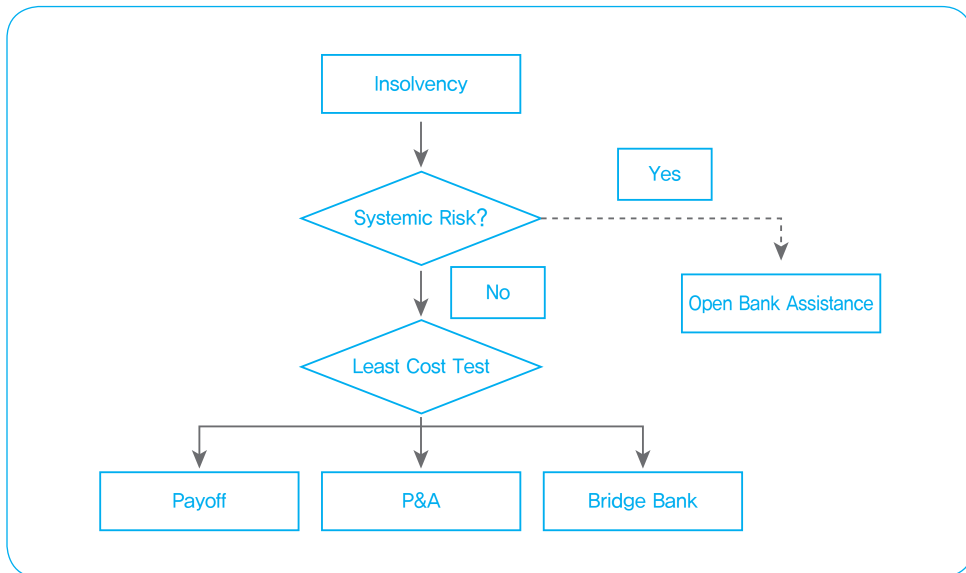


Figure 2-6 | Resolution through Contract Transfer to Third-Party

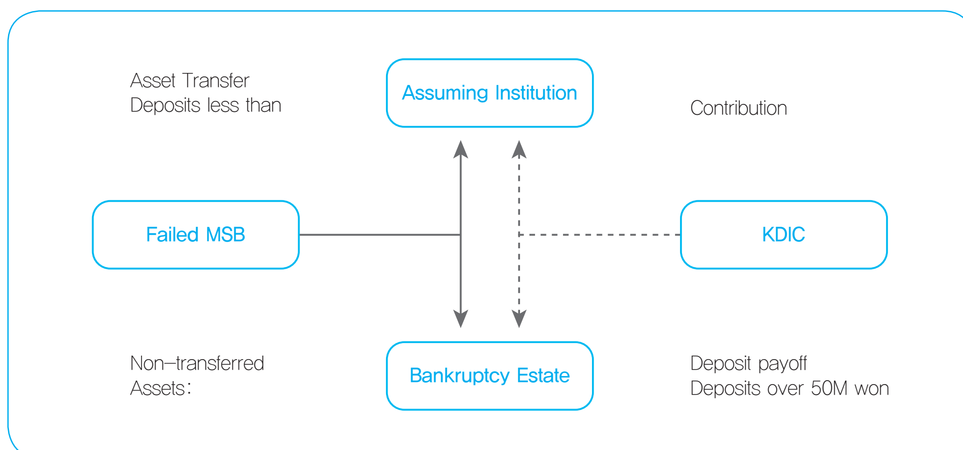
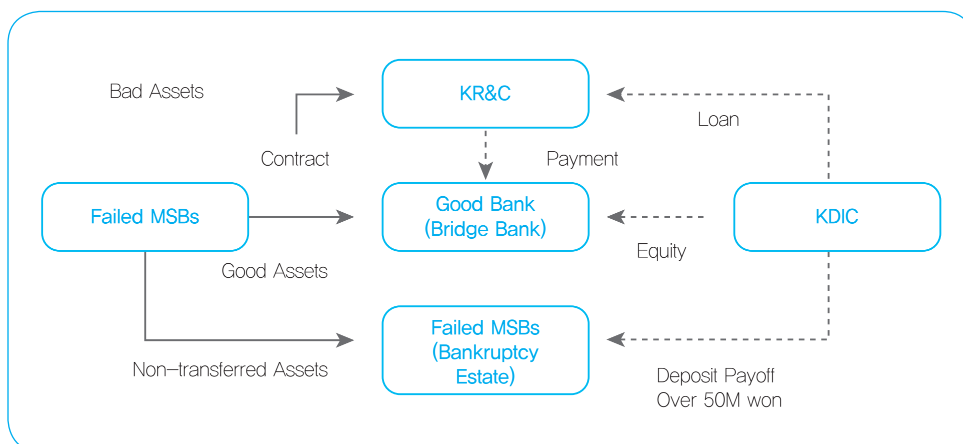


Figure 2-7 | Resolution Using Bridge Bank



4.3. Risk Surveillance of Insured Financial Institutions

The KDIC performs systematic ongoing risk surveillance to stave off insolvency of insured financial institutions in advance. The KDIC has endeavored to improve risk surveillance of insured financial institutions to facilitate the early detection of risks and prevent those risks from leading to failures of financial institutions. However, since Article 18 of the DPA, which defines the scope of duties of the KDIC, does not include a provision for proactive risk surveillance, the KDIC's risk surveillance activities have been constrained.

4.3.1. Improvement of Differential Premium Assessment Model

The KDIC has also made efforts regarding the model for differential premium assessment. The KDIC has been accumulating financial data and statistics on banks, securities companies, insurance companies, merchant banks and mutual savings banks.

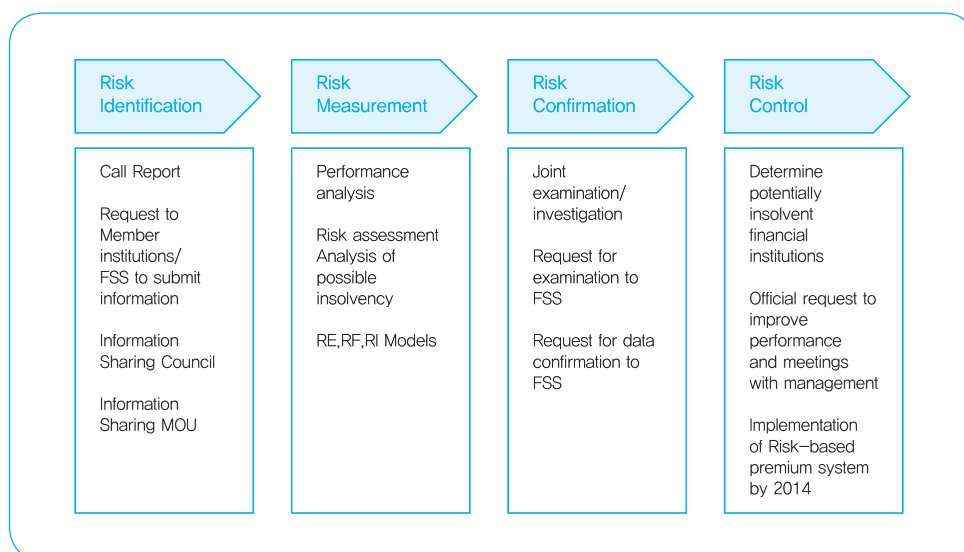
4.3.2. Ongoing Risk Surveillance

The KDIC set up the Ongoing Surveillance Council, which is responsible for overseeing, coordinating, and assessing risk monitoring activities. It required the use of a newly developed risk indicator (RI) model in the ongoing surveillance, and adopted the same reporting frequency for risk evaluation (RE) reports and risk forecast (RF) analysis reports. The KDIC defined the risk grading system in each stage of risk surveillance.

4.3.3. Data Submission and Investigation

The KDIC may request insured financial institutions and financial holding companies that have insured financial institutions as affiliates to submit data on the business operation and assets within the scope deemed necessary for deciding whether the insured financial institution is insolvent or potentially insolvent. If the insured financial institution is found to be on the edge of insolvency, based upon the preliminary review of the data, the KDIC may execute a more comprehensive investigation including a review of the institution's operation and asset management (Article 21 of the Depositor Protection Act (DPA)).

Figure 2-8 | Risk Surveillance



4.3.4. Joint Examination with the FSS

If deemed necessary, the KDIC may request the Financial Supervisory Services (FSS) to perform an official examination into specific areas of the insured financial institution's operations and to inform the KDIC of the outcomes of the examination. The KDIC may also ask the FSS to perform a joint examination through the decision of the Deposit Insurance Committee. The FSS is obligated to comply with such requests from the KDIC (Article 21(3) of the DPA).

To strengthen cooperation with relevant agencies, the KDIC signed a revised Memorandum of Understanding (MOU) on the Sharing of Financial Information among five agencies - the Ministry of Strategy and Finance (MOSF), the Financial Services Commission (FSC), the Bank of Korea (BOK), the Financial Supervisory Service (FSS), the KDIC - in September 2009. To facilitate more efficient joint examinations of insured financial institutions, the KDIC signed a Memorandum of Understanding (MOU) on Joint Examinations of Financial Institutions with the FSS in September 2003. In 2010, the KDIC participated in joint examinations of 24 insured financial institutions with the FSS. In 2011, the KDIC considerably increased the number of financial institutions subject to joint examinations from 24 to 31 in 2011. The KDIC strengthened its risk surveillance activities by expanding on-site examinations of MSBs whose financial soundness was weak.

Table 2-6 | Joint Examination with the FSS

Year	Number of Joint Examinations
2008	9
2009	15
2010	24
2011	31

Source: KDIC (2012)

4.4. Recovery of Injected Funds

4.4.1. Collection of Dividends: Management of Bankrupt Estates

To facilitate efficient recovery of public funds injected into insolvent financial institutions, the KDIC can arrange it for its staff to execute the duties of managers and bankruptcy administrators of the insolvent institutions.

If an insured financial institution cannot meet deposit obligations because of insolvency, the KDIC pays the depositors on the institution's behalf and takes over the claims against the financial institution. Based upon the claims, the KDIC participates in the bankruptcy process and collects bankruptcy dividends.

The KDIC can also be assigned the right to file for liability or damage claim litigation in subrogation of insolvent financial institutions.

The KDIC has also the authority to participate in receivership activities such as sales of assets of failed financial institutions or settlement of claims. Upon declaring bankruptcy, the court appoints a receiver who will oversee the bankruptcy process. A KDIC employee, instead of a lawyer, is appointed as receiver because of his/her financial expertise and experiences.

4.4.2. Method of Recovery

In order to recover injected public funds, the KDIC uses various methods, including but not limited to 1) sales of non-performing loans (NPLs), 2) sales of equity through privatization and issuance of exchangeable bonds, 3) block sales, 4) securitization through issuance of asset-backed-securities, 5) M&As.

4.4.3. Current Share Sales Procedure

The Public Fund Oversight Committee acts as the highest advisory authority on the KDIC's share sales. The KDIC has a Subcommittee for the Review of Share Sales to ensure that the sales are performed appropriately.

4.4.4. Management of MOUs for Business Normalization

The KDIC signs a memorandum of understanding (MOU) with a financial institution that gets public funds. The KDIC periodically reviews the progress in the implementation of the MOU to improve the company's corporate value.

As of the end of 2010, six financial institutions - Woori Financial Holding, Woori Bank, Kwangju Bank, Kyongnam Bank, Credit Business Part of the National Federation of Fisheries Cooperatives, and Seoul Guarantee Insurance Corporation – have MOUs signed with the KDIC.

Both financial and non-financial targets are set in the MOUs and financial institutions are reviewed each quarter for goal accomplishment.

4.5. Investigation

Pursuant to Article 21-2 of the Depositor Protection Act, the KDIC performs liability claims against former/incumbent management, employees, and majority shareholders of insolvent financial institutions who are accountable for the insolvency of financial institutions injected with public funds. The KDIC also investigates the management, owners and employees of default debtor companies and default debtors who are responsible for the insolvency of financial institutions for failing to pay back their borrowings.

In addition, the KDIC executes comprehensive investigations of concealed properties of insolvency-implicated persons to secure the assets for damage claims against them. Based upon such investigations, appropriate legal measures, such as damage suits, provisional attachments and provisional dispositions, are taken through relevant financial institutions.

Through such comprehensive liability claims against insolvency-related parties, the KDIC endeavors to lessen the burden on taxpayers by recovering public funds injected into failed financial institutions as much as possible.

The KDIC established the “Insolvency Investigation Division” consisting of prosecutors and KDIC employees to conduct organically-linked investigations in March 2008.

5. Evolution of Deposit Insurance System

5.1. Insured Financial Institutions

All financial institutions operating in Korea under the licenses of the Financial Supervisory Service (FSS) and special banks are required to be insured by the KDIC. This includes the branches of foreign banks and the national federations of Agricultural and Fisheries cooperatives. The total number of insured financial institutions increased to 324 in 2011 (55 banks, 117 financial investment companies, 44 insurance companies, 1 merchant bank and 107 mutual savings banks (MSBs)) from 322 in 2010.

Table 2-7 | Number of Insured Financial Institutions

Financial Sector	End of 2004	End of 2005	End of 2006	End of 2007	End of 2008	End of 2009	End of 2010	End of 2011
Banks	55	56	53	53	55	54	54	55
Domestic	18	18	17	17	17	17	17	17
Foreign	40	37	38	36	38	37	37	38

Financial Sector	End of 2004	End of 2005	End of 2006	End of 2007	End of 2008	End of 2009	End of 2010	End of 2011
Financial Investment Companies	56	53	53	53	60	115	118	117
Insurance Companies	43	42	43	44	43	43	44	44
Life	23	22	22	22	22	22	23	23
Non-Life	20	20	21	22	21	21	21	21
Merchant Banks	2	2	2	2	2	2	1	1
Mutual Savings Banks(MSBs)	113	111	110	109	106	106	105	107
Total	269	264	261	261	266	320	322	324

Note: 1) Identified from date of opening business to date of dissolution, liquidation or withdrawal/cancellation of license

2) As the Capital Market Consolidation Act came into force as of February 2009, Financial Investment Companies now include not only securities companies, but also investment dealing and brokerage companies (Prior to February 2009, it included only securities companies.)

3) Credit Unions were excluded from the deposit insurance scheme as of January 1, 2004

Source: KDIC, Annual Report 2011

5.2. Insurable Deposits

Insurable deposits are depository products sold by insured financial institutions under Article 2 of the DPA and exclude deposits made by the government, local governments, and other insured institutions as determined under Article 3 of the DPA's Enforcement Decree. The total amount of insurable deposits reached 1,161 trillion (1.16 quadrillion) won at the end of 2010, rising 13.8 percent compared with the end of previous year. By financial sector, banks accounted for 738 trillion won, financial investment companies for 22 trillion won, insurance companies for 323 trillion won, merchant banks for 1 trillion won, and MSBs for 77 trillion won.

Table 2-8 | Insurable Deposits by Financial Sector (As of the end of 2011)

(Unit: billion won)

Financial Sector	Balance of Deposits (2010)	Balance of Deposits (2011)
Banks	738,224	850,117
Financial Investment Companies	22,207	20,476
Insurance Companies	322,521	357,921
Life	26,954	289,364
Non-Life	53,567	63,557
Merchant Banks	1,226	1,046
Mutual Savings Banks (MSBs)	76,602	51,499
Total	1,160,779	1,281,059

Source: KDIC (2012)

5.3. Adoption of Blanket Guarantee System

The Korea Deposit Insurance Corporation (KDIC) was established in June 1996 and started to provide protection for bank depositors up to 20 million won in January 1997. The 20-million-won limit of the deposit insurance coverage was 2.8 times the per capita GDP in 1994. The limit of 20 million won was enough to provide protection to 97 percent of all bank depositors and 22-50 percent of deposits at individual banks. However, as the financial crisis occurred in late 1997, the Korean government had to adopt a blanket guarantee in November 1997 that would cover not only banks, but also insurers, securities firms, merchant banks, savings banks and credit unions. It was designed as a temporary measure to prevent a collapse of confidence and a run on deposits. The blanket guarantee system was to be maintained until the end of 2000. After that date, the system was expected to return to a partial deposit insurance system. It was intended to constrain moral hazard problems of financial institutions and their clients.

5.4. Deposit Insurance Premiums

The KDIC receives insurance premiums from insured financial institutions, in accordance with Article 30 of the Depositor Protection Act (DPA) and Article 16 of the DPA's Enforcement Decree. Banks are required to pay these insurance premiums within one month of the end of each quarter. Other insured financial institutions are required to pay their insurance premiums within three months of the end of each business year.

The KDIC also receives special assessments for repayment of deposit insurance fund bonds (hereinafter "special assessment") in accordance with Article 30-3 of the Depositor Protection Act and Article 16-2 of the DPA's Enforcement Decree. Special assessments refers to the statutory allotments that insured financial institutions must pay for 25 years from 2003 to 2027, according to the Public Fund Recovery Measures established in 2002 to recover the public funds injected during financial restructuring in the past.

Newly-established insured financial institutions are required to pay a one-time contribution to the Deposit Insurance Fund pursuant to Article 24 of the Depositor Protection Act and Article 14 of the DPA's Enforcement Decree. However, when an insured financial institution receives a license of business or establishment after a merger or divestiture, it does not pay contributions.

The insurance premiums that the KDIC got from the insured financial institutions in 2010 recorded 1.160 trillion won, decreasing 6.8 percent as the insurance premium rates for financial investment companies and insurance companies were lowered by 0.05 percent point and 0.15 percent point, respectively, in July 2009.

Table 2-9 | Rates Applied to Insured Financial Institutions

	Banks	Financial Investment Companies	Insurance Companies	Merchant Banks	MSBs	Credit Unions
Premium Rate[1]	8/10,000	15/10,000	15/10,000	15/10,000	40/10,000	-
Special assessment Rate[2]	1/1,000	1/1,000	1/1,000	1/1,000	1/1,000	5/1,000
Contributions[3]	1/100	1/100	1/100	5/100	5/100	-

Note: 1) The rates are multiplied by the balance of deposits, etc

2) The rates are multiplied by paid-in-capital or equity participation

3) Article 24 of the DPA and Article 14 of the DPA Enforcement Decree require that a newly insured financial institution should contribute a proportion of its paid-in-capital or equity capital to receive insurance coverage within one month of starting business operations

Source: KDIC (2011)

Table 2-10 | Insurance Premium Revenues of KDIC 1997-2002

(Unit: billion won, %)

Year	Banks	Securities Companies	Life Insurance Companies	Non-life Insurance Companies	Merchant Banks	MSBs	Credit Unions	Total
Amount Remitted[1]	-	-	141.4	37.9	84.8	201.7	40.2	506.0
1997	32.1	-	-	-	-	-	-	32.1
1998	129.2	-	38.6	14.3	13.2	39.0	-	234.3
1999	197.5	5.1	101.1	24.9	33.6	37.7	16.2	416.1
2000	263.0	15.6	140.2	37.9	23.3	32.3	28.1	540.4
2001	413.9	21.8	193.8	47.8	13.9	52.9	40.7	784.8
2002	436.1	26.2	229.5	48.5	13.0	60.4	64.1	877.8
Total	1,471.8 (43.4%)	68.7 (2.0%)	844.6 (24.9%)	211.3 (6.2%)	181.8 (5.7%)	424.0 (12.5%)	189.3 (5.6%)	3,391.5 (100.0%)

Note: 1) includes the amount transferred from the Credit Management Fund when it was consolidated with the Deposit Insurance Fund in April 1998

Source: KDIC (2011)

5.4.1. Target Size of Deposit Insurance Fund

Since the Target Fund System was been adopted in January 2009, the KDIC set a target size of deposit insurance fund per sector at an amount sufficient enough to cover future losses. When the target size of deposit insurance fund per specific sector is achieved, financial institutions in that sector are exempted from paying premiums.

As of September 2009, a Target Fund System was implemented for five sectors including the banking sector.

Table 2-11 | Target Fund Size per Financial Sector

Target Fund Size	Banks	Financial Investment Companies	Life Insurance Companies	Non-Life Insurance Companies	Merchant Banks	MSBs
Minimum	1.5%	1.5%	1.2%	1.5%	n.a.	3.0%
Maximum	2.0%	2.0%	1.7%	2.0%	n.a.	3.5%

Note: 1) The target fund size is a percentage of insurable deposits as of the last day of the previous calendar year

2) As only two merchant banks are in operation in the market, an adequate target fund size cannot be appropriately estimated

Source: KDIC

5.4.2. Risk –based Premium System

For deposit insurance contracts, risk rating is very important. If the insurance premium does not properly reflect the risk, problems of moral hazard and adverse selection bias may become acute. The deposit insurance agency has two important instruments to control its loss within adequate limits: 1) risk premiums and 2) direct monitoring and supervision. However, the KDIC has only a limited function and power with regard to supervision of insured financial institutions.

It is well known that risk-based insurance premiums are difficult to implement because risk assessment is complex and demands a large information collection system. In the United States, the risk-based deposit insurance premium system was adopted in 1991, when the FDICIA was enacted. Canada implemented the risk–based premium system in 1999. According to Garcia (1999), 21 countries out of 68 had adopted the risk-based premium system as of 1999.[27]

The KDIC has made efforts regarding the model for differential premium assessment. The KDIC has been accumulating financial data and statistics on banks, securities companies, insurance companies, merchant banks and mutual savings banks. In June 2010, the KDIC announced the "Plan for the Launch of the Differential Premium System in 2014". Thus, the KDIC is expected to implement a risk-based insurance premium system in 2014.

The risk-based insurance premium system can play a significant role in disciplining the risk-taking behavior of senior managers of insured financial institutions by directly affecting their incentive structures. It can thereby reduce the burdens which the limited supervisory function of the KDIC should bear in lessening the potential losses to the deposit insurance fund.

5.5. Reintroduction of the Limited Insurance Coverage System

The adoption of a blanket guarantee system led to a moral hazard problem. Some depositors shifted their money to high-return products and financial institutions took on added risks in pursuit of high returns. The cost of the blanket guarantee system could be enormous. On top of the explicit expenditure of deposit insurance funds to pay out depositors, an acute moral hazard has arisen with the financial institutions and depositors.

Thus, the government revised the Enforcement Decree of the Deposit Protection Act in July 1998, providing protection for up to 20 million won in principal and interest for deposits made after October 1, 1998 to strengthen market discipline after the second round of restructuring finished.

27. DTT,KDI,KIF Consortium (2000).

Prior to the shift from a blanket guarantee system to a limited coverage system in 2001, the government and the KDIC began a comprehensive review of macroeconomic and financial markets conditions in mid-1999.[28]

First, the Korean economy has recovered based on strong growth in exports after the financial crisis. The Korean economy recorded a double digit growth rate in the first half of 2000. However, uncertainties continued to prevail in financial markets due to the Korean economy's susceptibility to overseas market volatilities, the credit crunch triggered by the meltdown of the Daewoo business group in July 1999 and the continued restructuring of corporate and financial sectors after the currency crisis. In response, the Korean government continued to make efforts to resolve the credit crunch and remove uncertainties by carrying out corporate and financial restructuring, introducing new financial instruments such as bond funds and tax-free funds, and promoting the issuance of primary CBOs.

Second, the strenuous restructuring efforts that began in the wake of the 1997 financial crisis brought some stability to the financial market. Numerous problem financial institutions were closed down by March 2001. The non-performing loans (NPLs) held by financial institutions were estimated to total 112 trillion won at the end of March 1998. By the end of 2001, 176.5 trillion won of NPLs were resolved through restructuring and financial assistance. Thanks to the comprehensive financial restructuring, most financial institutions got back on a sounder footing. The BIS capital adequacy ratio of commercial banks that once dropped to 7.04 percent during the 1997 financial crisis rose to 10.81 percent at the end of 2001 and stability returned to the financial market.

Third, financial regulation and supervision have been reorganized and strengthened in order to ensure market discipline in the financial system. The government upgraded the disclosure regime in October 1998 to meet the requirements of international accounting standards. In addition, to provide consumers with accurate information about the soundness of financial institutions, the government adopted the new BIS capital adequacy requirements and the forward-looking criteria (FLC), and strengthened loan loss provision requirements and prompt correction actions (PCA).

Fourth, in order to deal effectively with the movement of funds that may occur after the shift to a limited coverage system, as well as uncertainties in the financial market, the government and the KDIC closely monitored capital movements in each institution, sector and region, and drafted four scenarios to respond to various anticipated situations. The scenarios and corresponding policy measures were as follows:

28. Jae-Youn Lee and Seungkon Oh (2011), "A Study on the Foundation for Introducing Limited Deposit Protection Scheme in Mongolia," Kang-Soo Kim (eds.), Public-Private Infrastructure Investment and Deposit Insurance in Mongolia, Ministry of Strategy and KDI, 2011.

(1) To support liquidity (by the Bank of Korea) or to resolve failure (by the KDIC) to eliminate liquidity concerns for regional banks experiencing bank runs;

(2) To announce measures to stabilize the financial market, in case deposit movements in some sectors reach a critical level;

(3) To expand coverage or to adopt a blanket guarantee for existing deposits if all financial sectors begin to face bank runs; and

(4) To postpone the shift to a limited coverage for a certain period of time in the event of a depositor stampede in all financial sectors.

However, when they monitored deposit movements prior to the shift to limited coverage, the government and the KDIC discovered that the financial market remained rather stable even though 33.4 percent and 4.9 percent of total deposits withdrew from merchant banks and savings banks, respectively <Table 2-12>. Thus, the government reintroduced a limited coverage system in January 2001 as planned when the blanket coverage system was adopted during the financial crisis of 1997.

The KDIC raised the coverage limit from 20 million won to 50 million won in order to prevent withdrawals by large depositors and to maintain financial stability. The 50-million won limit was deemed sufficient to preclude uneasiness among depositors since it covered 99.3 percent of all bank depositors, 97.4 percent of savings bank depositors and 99.7 percent of credit union depositors as of the end of June 2000 as is shown in <Table 2-12>.

Figure 2-9 | Deposit Insurance Coverage 1997- Present

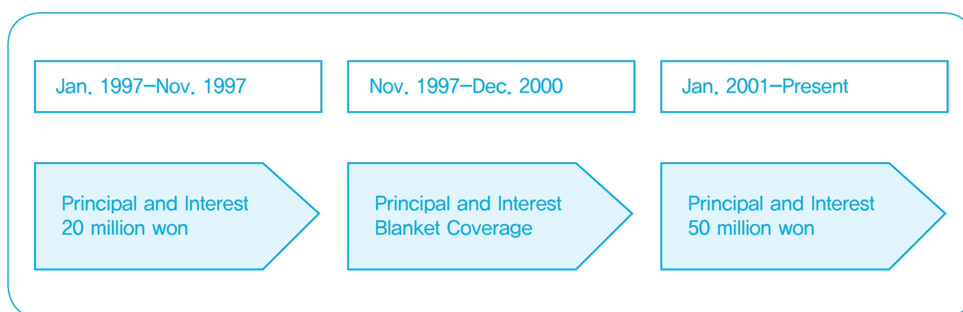


Table 2-12 | Changes in Total Deposits by Financial Sector (1999-June 2000)

(Unit: hundred million won, %)

	Banks	Commercial Banks	Merchant Banks	Mutual Savings Banks	Credit Unions
End of 1999 (A)	5,349,486	3,747,875	142,750	226,352	184,760
June 2000	5,728,903	4,031,675	95,056	215,257	192,480
Change (B)	379,417	283,800	-47,694	-11,095	7,720
B/A (%)	7.1	7.5	-33.4	-4.9	4.2

Source: Financial Supervisory Services

Table 2-13 | Deposits by Accounts (As of June 2000)

(Unit: %)

		Less than 20 million won	20-30 million won	30-50 million won	Over 50 million won
Banks	Depositors	96.6	2.2	0.6	0.7
	Amount of Deposits	24.2	9.4	5.7	60.7
Merchant Banks	Depositors	39.7	27.6	7.7	25.0
	Amount of Deposits	1.5	7.4	3.0	88.1
Mutual Savings Banks	Depositors	91.2	3.9	2.3	2.6
	Amount of Deposits	37.5	5.9	6.5	50.1
Credit Unions	Depositors	91.3	7.8	0.6	0.3
	Amount of Deposits	53.8	34.5	4.8	6.9

Source: Korea Deposit Insurance Corporation (2000)

The deposit insurance system returned to a limited protection scheme in 2001 with a protection limit of 50 million won. The higher protection limit was set to ensure sustainable stability in the financial market.

On the other hand, products that received temporary protection such as foreign currency deposits, CDs and bank bonds were excluded from coverage with the shift to a limited coverage. <Table 2-14> shows how the scope of insured products changed after the shift to the limited coverage system.

Compared with countries such as Sweden and Finland that returned to a limited coverage scheme after a rather long period of full coverage following a financial crisis, Korea reintroduced the limited coverage system in a relatively short period.

Table 2-14 | Insured Financial Products in Korea (As of the end of 2000)

Type of company	Insured Financial Products		Uninsured Financial Products
	Permanently Covered	Insured until Dec.31, 2000	
All	Individual/Corporate Deposits	Deposits of the Government/Regional Authorities/The Bank of Korea/Financial Supervisory Commission	Loans (including Call Loans)
Banks	Deposits, Savings, Installments, Secondary Bills, Principal-covered Trusts	Foreign Currency Denominated Deposits, CDs, Development Bank Trusts, Bonds Issued by Banks	Performance-based Trusts, RPs
Securities Companies	Customers Deposits, Securities Savings	Subscriber Deposits, Collateral for Loaned Securities	Tax Liability Withholdings, Beneficiary Certificates, RPs, Bonds Issued by Stock Companies
Insurance Companies	Individual Polices, Severance Benefits Policies	Corporate Insurance Polices	Surety Policies, Reinsurance Policies, Variable Benefit Contracts
Merchant Banks	Notes Payable, Issued Notes, CMAs		Bills Sold, Foreign Currency Borrowings, Beneficiary Certificates, RPs, Bonds Issues by Merchant Banks
MSBs	Installments, Deposits, Savings, Issued Notes		
Credit Unions	Share Subscriptions, Deposits, savings		Insurance related Financial products

Source: KDIC Annual Report (2002)

6. Assessment of Korean Deposit Insurance System

6.1. Core Principles and Assessment Methodology for Effective Deposit Insurance Systems

In 2008, in the midst of the global financial crisis, the International Association of Deposit Insurers (IADI) and the Basel Committee on Banking Supervision (BCBS) decided to collaborate to develop a global standard for deposit insurance systems at the request of the G20 Summit leaders and the Financial Stability Board (FSB). They used the IADI Core Principles for Effective Deposit Insurance Systems[29] as a basis. The Consultative Document, entitled "Core Principles for Effective Deposit Insurance Systems," was finished in March 2009 and was reported to the Financial Stability Board (FSB) in June 2009.

Then in December 2010 they issued the Core Principles for Effective Deposit Insurance Systems-Methodology for Compliance Assessment (together with the International Monetary Fund (IMF), the World Bank, The European Commission, and the European Forum of Deposit Insurers)to enable assessments of compliance with these core principles. In February 2011, the Financial Stability Board agreed to include the Core Principles in the FSB's list of 12 Key Standards for sound financial systems that deserve priority implementation depending on country circumstances. It will be recommended that deposit insurers around the world formally adopt the Core Principles and will be reviewed according to the Assessment Methodology.[30]

The document presents 18 Core Principles and an accompanying set of Preconditions that addresses mainly external elements necessary to support effective deposit insurance systems.

6.1.1. Preconditions

A deposit insurance system will be most effective if a number of preconditions are in place:

(1) Assessment of the economy and banking system;

(2) Macroeconomic stability;

(3) Sound banking system;

(4) Sound governance of agencies comprising the financial safety net;

29. The International Association of Deposit Insurers, February 2008.

30. Lee, Jae-Youn and Seungkon Oh (2011).

(5) Strong prudential regulation and supervision;

(6) Well-developed legal framework; and

(7) Sound accounting and disclosure regime.

6.1.2. Core Principles and Assessment Methodology

The main part of the Assessment Methodology consists of 18 principles including setting objectives, mandates and powers, governance, relationship with other safety-net participants and cross-border issues, membership and coverage, funding, public awareness, selected legal issues, and failure resolution.

Table 2-15 | Core Principles and Assessment Methodology

Principles	Essential Assessment Criteria	Korean DIS
1. Public Policy Objectives	The public policy objectives of the deposit insurance system are clearly defined and formally specified through legislation, etc. There is a review of the extent to which a deposit insurance system is meeting its public policy objectives on a regular basis (e.g. every five years).	Compliant
2. Mitigating Moral hazard	The design of the deposit insurance system mitigates moral hazard as much as possible by limiting deposit insurance coverage and scope; charging deposit insurance premiums that are assessed on a differential or risk-adjusted basis; and minimizing the risk of loss through timely intervention and resolution.	Largely Compliant
3. Mandate	The deposit insurer has a mandate that is clearly defined and formally specified, for example, through legislation. The mandate clarifies the role and responsibilities of the deposit insurer within the financial safety net.	Compliant
4. Powers	The deposit insurer has the following minimum powers to: - compel member banks to comply with their obligations to the deposit insurer; - have the legal authority and capability to reimburse depositors; - enter into contracts; - set internal operating budgets and internal policies and procedures; - access timely and accurate information; - share information with other safety-net participants; and - engage in information-sharing and coordination agreements with deposit insurers in other jurisdictions	Compliant

Principles	Essential Assessment Criteria	Korean DIS
5. Governance	The deposit insurer is able to use the powers and means assigned to it without undue influence from external parties. There is in practice no significant evidence of government or industry interference in the operational independence of the deposit insurer and its ability to obtain and deploy the resources needed to carry out its mandate. The operational funding of the deposit insurer is provided in a manner that does not undermine its autonomy or independence and permits it to fulfill its mandate. The members of the governing body (e.g., directors or officers) and management of the deposit insurer are held accountable to a higher authority through a transparent framework for the discharge of the system's duties in relation to its objectives and mandate. The deposit insurer operates in a transparent and responsible manner. It discloses and publishes on regular basis appropriate information on its activities, governance practices, structure and financial results. The deposit insurer is structured such that the potential for conflict of interest for or between members of the governing body and management is minimized. Members of the governing body can be removed from office during their term only for reasons specified or defined in law.	Compliant
6. Relationships with other safety-net participants	A framework for information-sharing and the coordination of actions among the safety-net participants is explicit and formalized through legislation, memoranda of understanding, legal agreements or a combination of these instruments. The safety-net participants make information on banks that are in financial difficulty or are expected to be in financial difficulty available to the deposit insurer in advance. Additionally, where confidentiality requirements prevent this, or where the information is not available from other safety-net participants, the deposit insurer has the power to collect information directly from such banks.	Compliant
7. Cross-border Issues	Appropriate cross-border bilateral/multilateral agreements are in place in circumstances where coverage for deposits in foreign branches is provided by the deposit insurer in another jurisdiction or by a combination of deposit insurers in different jurisdictions. Depositors in the jurisdictions affected by cross-border banking arrangements are provided with information on the existence and identification of the deposit insurance system legally responsible for reimbursement and the limits and scope of coverage.	Largely Compliant

Principles	Essential Assessment Criteria	Korean DIS
8. Compulsory Membership	Membership in a deposit insurance system is compulsory for all financial institutions accepting deposits. Criteria for membership are explicitly stated and transparent. If the deposit insurer does not control membership (i.e., cannot refuse membership), the law or administrative procedures describe a clear time frame in which the deposit insurer is consulted about or informed in advance of "newly-licensed" banks.	Compliant
9. Coverage	Insured deposits are clearly and publicly defined. The level of coverage is credible. There are rules about coverage in the event of a merger between financial institutions.	Compliant
10. Transitioning from a blanket Guarantee to a Limited overage Deposit insurance System	A situational analysis of the economic environment and the banking system is conducted before a country begins a transition from a blanket guarantee to limited coverage. Policymakers are aware of the tradeoff between the length of time it takes for the transition to the limited coverage system and the degree of moral hazard in the system, and have planned the transition accordingly.	Compliant
11. Funding	Funding arrangements for the deposit insurance system ensure the prompt reimbursement of depositors' claims. The deposit insurer has a pre-arranged and assured source(s) of back-up funding for liquidity purposes like a funding agreement with the central bank, a line of credit with the government treasury, or market borrowing. Primary responsibility for funding the deposit insurance system is borne by member banks. If an ex-ante deposit insurance fund is established, the size of the fund is defined in order to meet the public policy objectives. For deposit insurers that use risk-adjusted differential premium systems, the system for calculating premiums is transparent to all participants. Additionally, policymakers ensure that the deposit insurer has the necessary authority, resources and information in place to carry out its responsibilities with regard to the operation of such systems.	Compliant
12. Public awareness	The deposit insurer is responsible for promoting public awareness of the deposit insurance system and how the system works, including its benefits and limitations, on an on-going basis. The public awareness program or activities convey information about which financial institutions offer insured deposits, and how they can be identified, as well as the reimbursement process.	Compliant

Principles	Essential Assessment Criteria	Korean DIS
13. Legal Protection	The deposit insurer and individuals working for the deposit insurer are protected against lawsuits for their decisions and actions taken in "good faith" while discharging their mandates. Individuals are required to follow appropriate conflict-of-interest rules and codes of conduct to ensure they remain accountable. Legal protection is defined in legislation and administrative procedures, and under appropriate circumstances, cover legal costs for those indemnified.	Largely Compliant
14. Dealing with Parties at fault in a bank failure	The conduct of parties responsible for or who contributed to the failure of a bank is subject to investigation by the deposit insurer. If identified as culpable for the failure of a bank, such parties are subject to sanction and/or redress.	Compliant
15. Early detection and timely Intervention and Resolution	There is an effective failure resolution framework within the financial safety net. The safety-net participants have the operational independence and power to perform their respective roles in the failure resolution framework and there exist clearly defined procedures for information sharing among them. A clearly-defined early intervention mechanism exists to ensure that appropriate action is taken (to allow the orderly resolution of a troubled bank) by the responsible party without delay.	Largely Compliant
16. Effective Resolution process	Bank resolution and depositor protection procedures are not limited to depositor reimbursement. Resolution procedures clearly ensure that bank shareholders take first losses.	Compliant
17. Reimbursing depositors	The deposit insurer is able to reimburse depositors promptly. In order to promptly reimburse depositors, the deposit insurer has a range of payment methods for reimbursing depositors. The deposit insurer has the capacity to carry out the reimbursement process in a timely manner, including: Adequate computer capabilities; and adequate personnel.	Compliant
18. Recoveries	If the deposit insurer plays a role in the recovery process, its role is clearly defined in law or regulation. The deposit insurer shares in the proceeds of the recoveries arising from the failure of its member banks. The deposit insurer has at least the same or comparable creditor rights or status as a depositor in the conduct of the estate of the failed bank. The deposit insurer has access to information to make and pursue its recovery claim against the estate.	Compliant

Source: IADI and BCBS (2011)

6.1.3. Assessment

An assessment of a country's compliance with the Core Principles can be a valuable tool for countries that are implementing or reforming their deposit insurance systems. The Assessment Methodology adopted by the FSB as one of 12 key standards for sound financial systems would be used in:

(1) Self-assessment performed by the deposit insurer;

(2) Financial Sector Assessment Program (FSAP) by the IMF and World Bank;

(3) Reviews conducted by private third parties such as consulting firms; and

(4) Peer reviews.

Assessment results by external parties follow a five-grade scale such as ① compliant, ② largely compliant, ③ materially non-compliant, ④ non-compliant and ⑤ not applicable.

We have attempted to apply the Assessment Methodology developed jointly by the IADI and the BCBS to the Korean deposit insurance system (DIS). The provisional assessment results are provided only as an outsider's review. The provisional assessment results reveal that the Korean deposit insurance scheme is "compliant" with regard to 14 Core Principles and "largely compliant" with regard to 4 Core Principles. Generally speaking, the Korean deposit insurance scheme is broadly consistent with the Core Principles for Effective Deposit Insurance Systems issued by the International Association of Deposit Insurers (IADI) and the Basel Committee on Banking Supervision (BCBS).

6.2. International Comparison with FSB Member Countries

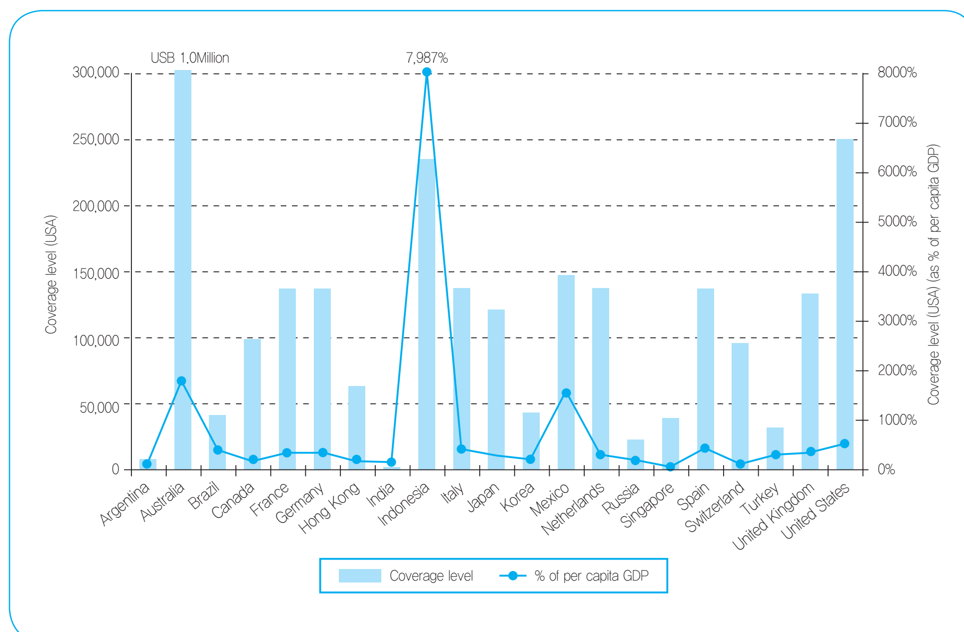
6.2.1. Coverage Level of Deposit Insurance

The level of coverage in the Financial Stability Board (FSB) member countries with an explicit DIS covers a large majority of depositors. The coverage limit on a per-depositor-per- institution basis of the Korean deposit insurance system is US$43,902 (50 million won); less than the simple average of around US$145,000. Those coverage levels have increased considerably as a result of the global financial crisis. When converted into a percentage of the country's per capita GDP, the coverage limit of the KDIC is 214%, which is less than the coverage limit of the FDIC (535%) but is similar to that of CDIC (216%).

The adequacy of coverage is principally a function of the proportion of covered deposits and depositors rather than of the absolute coverage level. In the Korean DIS, 95.4% of total eligible depositors were fully covered; while an average of 84% of total eligible depositors were fully covered in those FSB member countries where such data are available. The value

of deposits covered as a percentage of total deposits in the Korean DIS is 27%, which is less than the average of 42% in the FSB member countries.[31]

Figure 2-10 | International Comparison of Coverage Levels at end-2010 (Absolute level and % of per capita GDP)



Source: FSB (2012)

Table 2-16 | International Comparison of Coverage Levels at end-2010

(Unit: USD, %)

	Korea	U.S.A.	Canada	U.K.	France	Germany	Japan
Deposit Coverage Level (A)	43,902	250,000	100,000	133,068	136,920	136,920	122,775
Per capita GDP (B)	20,540	46,702	46,212	36,186	39,170	39,852	43,063
(A/B)	214%	535%	216%	368%	350%	344%	285%

Source: Financial Stability Board (2012), World Bank, KDIC (2012)

31. Financial Stability Board (2012).

Table 2-17 | International Comparison of Deposit Insurance Coverage (Year-end-2010)

Country	Deposit Coverage Level			Provision of Coverage	Total Domestic Deposit Base (US$ billions)	Deposit Value (%of total)		No. of Fully Covered Eligible Depositors/ Accounts (% of total)	
	US$	Set-off	Indexed	By Depositor and institution		Eligible	Covered	Depositors	Deposit Accounts
Korea	43,902	Yes	No	Yes	951	68	27	95.4	N/A
United States	250,000	Yes	Yes	Yes	7,888	100	79	N/A	99.7
Canada	100,000	No	No	Yes	1,803	64	35	N/A	97
United Kingdom	133,068	No	No	Yes	N/A	N/A	N/A	N/A	98
France	136,920	No	No	Yes	1,742	92	67	N/A	N/A
Germany	136,920	Yes	No	Yes	3,395	-40	N/A	N/A	N/A
Japan	122,775	Yes	No	Yes	11,101	90	71	N/A	98.9

Note: N/A = not available

Source: Financial Stability Board (2012)

6.2.2. Funding Structure

The global financial crisis of 2007-2008 revealed that depositor confidence relied partially on knowing that adequate funds would always be available to guarantee the speedy reimbursement of their claims. A considerable number of FSB member countries with an explicit DIS, which includes Korea, the United States, Canada, France, Germany and Japan, have created an ex-ante fund. On the other hand, the United Kingdom, Australia, Italy and Netherlands are presently supported only by an ex-post funding system.[32]

32. Financial Stability Board (2012).

Table 2-18 | International Comparison of Funding Structure (Year-end 2010)[1)]

Country	Type of Financing	Size of Fund		Target Size[2)]
		In US$ Million	% of Covered Deposits	
Korea	Ex-ante	4,141[3)]	1.61	0.825-1.1% of insured deposits
U.S.A.	Ex-ante	-7,350	-0.12	1.35% of insured deposits
Canada	Ex-ante	2,100	0.32	40-50 basis points of insured Deposits
U.K.	Ex-post			
France	Ex-ante	2,519	0.21	None
Germany	Ex-ante	Confidential	0.15	None
Japan	Ex-ante	1,600	0.04	None

Note: 1) In countries with multiple DISs, the figures include only the fund of main statutory DIS unless otherwise noted

2) Target size of ex-ante fund

3) The figures concern the bank account of the Deposit Insurance Fund only. In total, the Fund has assets of US$5.9 billion with a coverage ratio of 1.04%. The target size differs from account to accounts within the limit of 0.660% to 1.925% of insured deposits

Source: Financial Stability Board (2012)

6.2.3. Funding Sources

Most FSB member countries' DISs are supported by explicit emergency back-up funding arrangements. It is regarded as good practice to guarantee immediate access to emergency back-up funding to support the speedy reimbursement of depositors' funds and to assist bolster the credibility of the deposit insurance agency. Examples of countries with such arrangements include Korea, the United States, Canada, and Japan.

Table 2-19 | International Comparison of Funding Sources (Year-end 2010)

Country	Premiums		Assessment Basis	Back-up Funding
	Risk-Based	Rate		
Korea	No		Eligible deposits	Borrowing from the market, or issuing bonds, borrowings from the government or the central bank
U.S.A.	Yes	2.5-45 basis points	Average consolidated total assets minus average tangible equity	$100 billion line of credit from Treasury. Authority to borrow from Federal Financing Bank., Federal Home Loan Banks and insured depository institutions
Canada	Yes	2.8. 5.6, 11.1, and 22.2 basis points	Covered deposits	It can borrow CAD 17 billion from the Government or markets. Additional borrowing requires a special Act.
U.K.	N/A	N/A	N/A	The initial primary source of funding for the FSCS is levies on other deposit takers.
France	Yes		Eligible deposits	Borrowing in market and additional premiums
Germany	Yes	0.016%	Liabilities of protected deposits	Extraordinary contributions from institutions; borrowing in market
Japan	No		Eligible deposits	Borrowing from central bank, in market, or issuing bonds

Note: N/A = Not applicable

Source: Financial Stability Board (2012)

Chapter 3

Financial Crisis and the Role of Deposit Insurance System

1. Financial Crisis of 1997
2. Resolution of the Financial Crisis and Financial Restructuring
3. Financial Crisis and the KDIC

Financial Crisis and the Role of Deposit Insurance System

1. Financial Crisis of 1997

Korea's international competitiveness began to deteriorate in the early 1990s due to the amassed structural deficiencies within the Korean economy. A major shock to the Korean economy occurred as a result of terms- of -trade shock in 1996. The terms of trade deteriorated by approximately 20 percent in the 1996-97 period, the largest drop since the first oil shock of 1974-75. The terms of trade shock put extremely heavy pressure on the thin profit margins of firms.

Another big shock to the Korean economy occurred with the bankruptcy of Hanbo Group in January 1997. Four others of the thirty largest *chaebol* (conglomerates) also went bankrupt in 1997: Sammi, Jinro, Haitai and New-Core Groups. The failure of these *chaebol* revealed problems with low profitability and excessive leverage ratios in the corporate sector, and faulty corporate governance in Korea.

Foreign investors had already become increasingly skeptical of the government's willingness and ability to implement economic reforms and serious structural adjustment. In addition, the unanticipated intensity and power of contagion, first from Thailand and then Indonesia, came to bear its effects on Korea. This contagion coincided with a period of structural adjustments as well as a cyclical downturn in the Korean economy.

In November 1997, less than a year after its accession to the OECD, Korea experienced a severe financial crisis. With its useable foreign exchange reserves nearly exhausted, the Korean government formally requested assistance from the International Monetary Fund to mitigate the external liquidity shortage and regain the confidence of international investors.

A complicated and often opaque combination of macroeconomic distortions and financial fragility were at the core of the economic crisis in Korea. These include an inefficient and distorted financial sector, weak supervision and prudential regulation, and a corporate sector burdened with high levels of short-term debt.

In the financial sector, structural defects were deeply rooted and endemic as a result of the extensive use of credit restrictions as a primary tool of economic development in the past. Protracted periods of interest rate control and selective credit allocations gave rise to an inefficient distribution of funds. Short-term foreign debt of financial institutions increased significantly to finance the strong investment demand of the corporate sector as the economy entered a boom in 1994.

Since December 1997, the nation has embarked on a comprehensive program for economic reform and recovery, which has produced fruitful results in terms of rectifying the causes of the crisis.

Due to high interest rates and the severe recession, about 2,700 firms filed for bankruptcy every month in the first half of 1998. As a result, the flow of bank credit came to a virtual stop. The dishonored bills ratio jumped to 1.49% in December 1997. The dishonored bills ratio declined to around the 0.4% to 0.6% level during the first half of 1998, and then tapered off to 0.20% in November 1998.

Table 3-1 | Number of Bankrupt Companies and Dishonored Bills

(Unit: %, billion won)

	1990	1993	1995	1996	1997	1998	1999	2000
Number of bankruptcies	4,107 (-)	9,502 (6)	13,992 (5)	11,589 (7)	17,168 (58)	22,828 (39)	6,718 (··)	6,693 (··)
Dishonored bills ratio	0.04	0.13	0.17	0.14	0.40	0.38	0.33	0.26

Note: Figures in parentheses denote numbers of bankrupt large enterprises
Source: The Bank of Korea

Yet the credit crunch problem could not be resolved without first promptly addressing the issue of insolvency of the financial institutions themselves. Any delays in financial sector restructuring would undermine the soundness of the entire banking system, which, in turn, could lead to serious damage to the fundamental economic base of the nation.

2. Resolution of the Financial Crisis and Financial Restructuring

2.1. Overview

Since December 1997, the nation has embarked on a comprehensive program for economic reform and recovery, which has produced fruitful results in terms of rectifying the causes of the crisis.

It is generally considered important that a financial crisis be resolved quickly to minimize the adverse effects that ensue from distorted incentives due to insolvency problems. Depending on the nature of the crisis, authorities can apply a number of selected support measures. In the case of the financial crisis in Korea, which was characterized by widespread insolvency problems, a more active role of the government was required. Because of the risk of collapse of the financial system and the potential for enormous damage to the economy, the government recognized that it would have to inject public funds and implement other unprecedented measures to facilitate financial restructuring. The government decided that fast bank restructuring had to be the principal focus and that corporate restructuring had to be led by the creditor banks of companies.

2.2. Plan for Financial Restructuring

On April 14, 1998, the Korean government announced a basic plan for financial sector restructuring with the objective of rebuilding a competitive and sound financial system. The restructuring plan has been pursued in two phases, with priority placed first on the banking sector, followed by non-bank financial institutions, as indicated in <Table 3-2>.

At the sixth meeting of the Economic Policy Coordination Committee (EPCC), on May 20, the government estimated the amount of public funds that would be needed, and the methods to be used to raise the public funds were decided. About 50 trillion won would be demanded:[33]

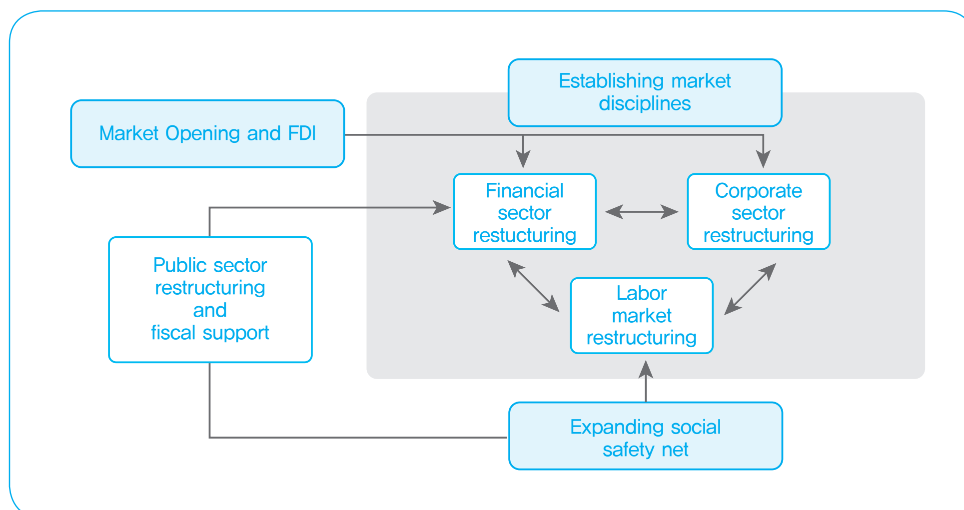
(1) 25 trillion won for the purchase of non-performing assets,

(2) 16 trillion won for capital injection, and

(3) 9 trillion won for substitute payment of deposits.

33. Kyu-Sung Lee (2011).

Figure 3-1 | Basic Framework of Economic Restructuring



Including the 14 trillion won in government guaranteed bonds already used to finance the capital injections at Korea First Bank and Seoul Bank, the substitute payment of deposits for failed merchant banks, and the purchase of non-performing assets, the total package reached about 64 trillion won.

The 50 trillion won (12 percent of GDP) of public funds for the bailout were to be raised through government guaranteed bond issues by the non-performing Asset Management Fund of the Korea Asset Management Corporation (KAMCO) and by the Deposit Insurance Fund of the Korea Deposit Insurance Corporation (KDIC).

Following the agreements with the IMF and the World Bank, the government finalized the schedule for the restructuring of problem financial institutions in June 1998. Financial restructuring required a huge amount of money. Problem banks and non-financial institutions were required to dispose of non-performing assets promptly and raise fresh capital to comply with the minimum BIS capital requirements.

However, when problem banks and non-financial institutions could not raise the necessary capital on their own through the financial markets, government support was deemed unavoidable. Since the outbreak of the financial crisis in late 1997, both the stock market and the real estate market have been depressed and the international investor's confidence in the Korean economy had fallen. Under these conditions, problem banks and non-financial institutions were limited in their capacity to solve their problems. The government had to intervene. There was no other option.

The government provided fiscal support to help financial restructuring, in particular for: (1) the disposal of non-performing loans (NPLs), (2) recapitalization of viable financial institutions, and (3) depositor protection and pay-outs to depositors in the process of closing non-viable financial institutions. Further deterioration of the financial system has been prevented by applying appropriate, prompt and corrective actions. For viable financial institutions, incentives have been provided, such as allowing a broader business scope, to encourage voluntary mergers. Financial institutions have also been encouraged to raise new capital through foreign capital inducement.

Table 3-2 | Government Strategy for Financial Sector Restructuring

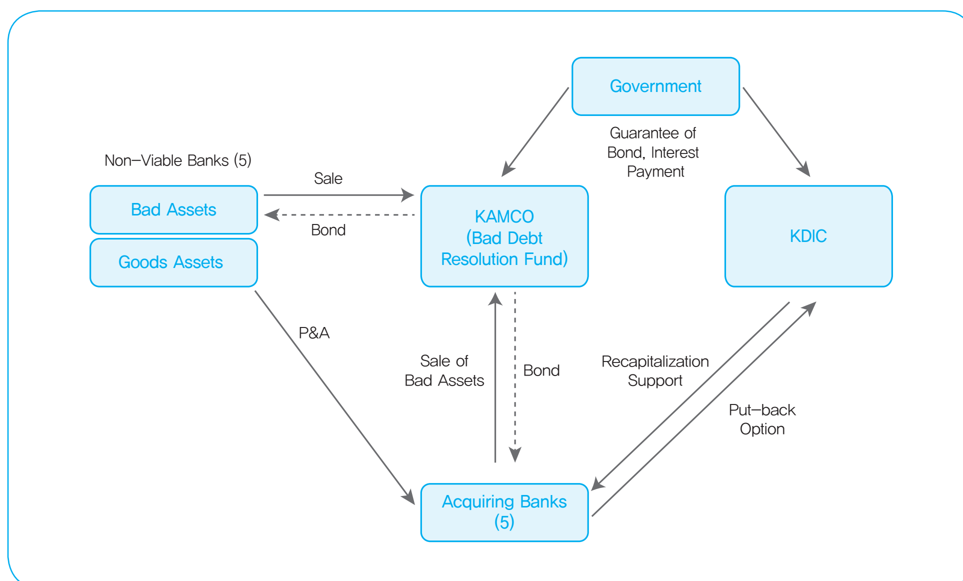
Phase 1: Early Stabilization of Banking Sector	- Facilitate disposal of non-performing assets and support bank recapitalization - Establish leading banks through M&As - Sell Seoul Bank and Korea First Bank
Phase 2: Restructuring of Non-bank Financial Institutions	- Induce self-rehabilitation efforts of major shareholders and management through prompt corrective action - Minimize costs of closure through Purchase & Assumption and/or Bridge Financial Institution methods

With regard to the actual strategy for financial restructuring, the government formulated a detailed plan to facilitate financial institutions' restructuring and financing plans by means of fiscal support. This has involved the establishment of a new institution, the Korea Asset Management Corporation (KAMCO), modeled after the Resolution Trust Corporation in the United States. KAMCO purchases non-performing assets at estimated market prices through public bond issues. KAMCO has played a critical role by ensuring that the resolution of non-performing loans operates under an explicit mandate, that impaired assets are resolved as quickly as possible, and that the process runs consistent with high rates of asset recovery.

Through KAMCO, the government set up the special Bad Debt Resolution Fund to finance the operation, and then expanded its size to 20.5 trillion won to expedite the settlement of bad debts by issuing bonds and asset-backed securities and selling real estate.

The Korea Deposit Insurance Corporation (KDIC), also newly established, covered any shortfall in the net worth of transferred assets and liabilities, also through the issuance of public bonds. In both cases, the government has provided a guarantee on the bond issues and lent interest costs.

Figure 3-2 | Resolution of Insolvent Banks



To support the disposal of NPLs and the recapitalization of viable institutions, the government mobilized fiscal resources in the amount of 50 trillion won. Including those bonds already issued, the total amount of government-guaranteed bonds reached 64 trillion won, 14.2% of the 1998 GDP (449.5 trillion won). Of this total, 20.5 trillion won was directed toward the purchase of non-performing loans by KAMCO, while 43.5 trillion won was set aside for recapitalization and depositor protection through the KDIC. An additional 29.7 trillion won in public funds was injected into financial institutions in 1999.

Table 3-3 | Government Plan to Restructure Financial Institutions

(Unit: trillion won)

Disposal of NPLs (based on assumption of peak core NPLs of 100 trillion won)	
Purchase by KAMCO[1)] Retained by institution Total	50 50 100
Needs of financial institutions To cover losses from NPLs To meet capital adequacy BIS standard Total	 50 4

Disposal of NPLs (based on assumption of peak core NPLs of 100 trillion won)			
Sources of financing	15		
Loan loss provision	20		
Securities issues	19		
Budget[2]	54		
Total			
Fiscal support for restructuring			
KAMCO	25		
Recapitalization of institutions	16		
Depositor protection Fund	9		
Total	50		
	NPLs[3]	Precautionary[4]	Total
Memorandum items			
Problem loans (as of March 1998)			
Banks	40	46	86
Non-bank financial institutions	28	4	32
Total	68	50	118

Note: 1) at 50 percent of book value
2) Of which 3 trillion won represent support to Seoul Bank and Korea First Bank
3) NPLs = non-performing loans 6 months or more in arrears
4) Precautionary loans = loans 3 to 6 months in arrears
Source: Government of Korea, OECD (1998)

The government's fiscal support is to be recouped over time through the sale of collateralized assets, the divestment of acquired equity shares of financial institutions, and the liquidation of insolvent financial institutions.

Table 3-4 | Purchase of Non-Performing Loans by KAMCO

(Unit: trillion won, %)

	End-1997	End-1998	End-1999	End-2000	March 2001
1. Banks	31.6	33.7	39.7	42.1	38.1
2. Non-Banks	12.0	26.5	27.0	22.5	21.4
3. Non-Performing Loans (1+2)	43.6	60.2	66.7	64.6	59.5
4. NPL Ratio (%)	6.7	10.4	11.3	10.4	9.6
5. Purchase [1] of NPLs by KAMCO	11.0	44.0	56.0	95.2	98.3

Note: 1) Accumulated purchase of NPLs
Source: Public Fund Management Committee, Ministry of Finance and Economy

2.2.1. Bank Restructuring

In January 1998, the Monetary Board of the Bank of Korea ordered Korea First Bank and Seoul Bank to reduce their paid-in capital from 820 billion won to 100 billion won – the legal minimum level.

The government injected public funds into Korea First Bank and Seoul Bank. As of the end of 1997, the BIS capital ratio of Korea First Bank and Seoul Bank fell to -2.7 percent and 0.97 percent, respectively. In consultation with the IMF, the government decided to inject public funds, turn the banks around, and then privatize them. On January 30, 1998, the Monetary Board of the Bank of Korea ordered Korea First Bank and Seoul Bank to reduce their paid-in capital from 820 billion won to 100 billion won, the minimum legal level. The government injected 750 billion in assets into each bank, and the Korea Deposit Insurance Corporation (KDIC) also injected the same amount of the public funds. The government and the KDIC owned 94 percent of the equity in these two banks. Much of their senior management has been reshuffled and employees have been reduced considerably.

The first round of banking sector restructuring was completed by the end of August 1998. On June 29, 1998, of Korea's twelve commercial banks that had failed to meet the BIS capital adequacy ratio of 8 percent, five non-viable banks were ordered to close down and transfer their assets and liabilities to relatively sound banks. For those five banks, the FSC ordered a transfer of businesses under a purchase and assumption (P&A) arrangement. The government has offered incentives to the acquiring banks. Following the trimming of non-viable or weak banks, the number of commercial banks decreased from 27 to 17, and the number of employees has fallen by 38 per cent. Those non-bank financial institutions, which were either non-viable or cost too much to normalize, were closed through mergers, P&As or liquidation <Table 3-9>.

<Table 3-9> shows that, out of 2,140 financial institutions that existed before the financial crisis, 672 institutions (31.4%) were closed down by the end of 2002.

Under the P&A arrangement, a closed bank transferred only its performing assets to the acquiring bank, while the non-performing loans were purchased by KAMCO. If the failed bank's total liabilities exceeded the total performing assets, the Korea Deposit Insurance Corporation (KDIC) paid off the difference. In addition, the acquiring bank was able to exercise a put-back option permitting the bank to resell to KAMCO the NPLs that occurred within 12 months of the P&A transaction. The government also supported the acquiring bank's sale of its own NPLs and recapitalization.

Viable banks have carried out active restructuring by attracting foreign investment and issuing new equities on the stock market. In 1998, the domestic banks mobilized USD678 million in foreign capital and successfully launched equity offering programs totaling 14

trillion won. In 1999, these programs brought in another 2 trillion won, thereby raising the BIS capital adequacy ratios of banks above the 8 percent threshold.

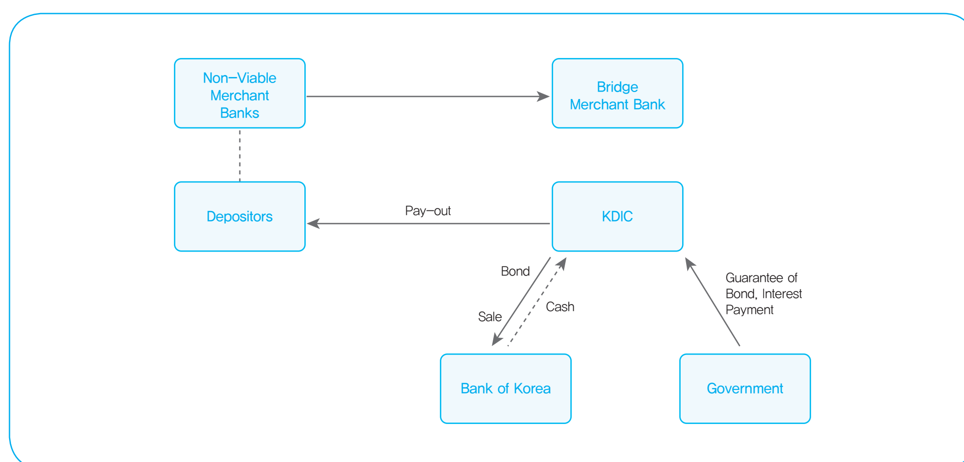
2.2.2. Restructuring of NBFIs

The restructuring of non-bank financial institutions (NBFIs), including insurance companies, merchant banks, and investment trust companies, proceeded based on the major shareholders' initiative. If an institution's liability exceeded its assets, the institution was ordered to reinstate its financial strength through measures such as recapitalization or mergers. If it fails to meet the minimum capital adequacy requirement, then the Financial Supervision Commission (FSC) may decide to suspend its operations and transfer the assets and liabilities to another institution.

In November and December 1997, KAMCO purchased some 3 trillion won in impaired loans from the merchant banks and paid back depositors 5 trillion won. In December 1997, the operations of fourteen merchant banks were suspended and all thirty merchant banks were requested to submit restructuring plans. Eventually, fourteen merchant banks were closed when their plans were assessed to be unacceptable. A bridge merchant bank, which was created on December 3, 1997, has assumed the responsibility of paying depositors and disposing of assets of closed merchant banks.

The Korea Investment Trust Company and Daehan Investment Trust Company fell into financial difficulties largely because of the collapse of the Daewoo Group in 1999. The government injected them with 4.9 trillion won of public funds and allowed them to be transformed to securities companies.

Figure 3-3 | Resolution of Insolvent Merchant Banks



2.2.3. Progress of Financial Restructuring

To address the continuing problems in the financial sector, the government launched, in September 2000, the second-stage financial-sector restructuring plan, which included 40 trillion won of additional public funds.

The government planned to sell its shares in the commercial banks obtained since the financial crisis. Kookmin Bank, Hana Bank, Koram Bank, Shinhan Bank, and Peace Bank had agreed with the KDIC that the government-owned preferred stock in these banks, which amounted to 1.305 trillion won, would be redeemed according to a redemption schedule. All of these banks have begun redeeming the government-owned preferred stocks and planned to complete the redemption by the end of 2004.

The amount of non-performing loans (NPLs) on the balance sheets of financial institutions was estimated to be 112 trillion won at the end of March 1998. By the end of 2001, 176.5 trillion won worth of NPLs were resolved through financial restructuring and financial assistance. Some 35 trillion won of bad loans remained on the balance sheets of financial institutions by the end of 2001.

This aggressive and comprehensive financial restructuring led to remarkably improved health of the financial services industry. The average BIS capital adequacy ratio of banks that once fell to 7.0 percent at the end of 1997 drastically improved to 11.7 percent by the end of 2001. The stability in the financial market was very much enhanced. However, the ratio of bank loans classified as substandard or worse rose to 12.9 percent in 1999, primarily because of the increasing bad loans associated with the collapse of the Daewoo Group.

Table 3-5 | Trends in Financial Indicators among Banks, 1997-2003

(Unit: %)

Indicator	1997	1998	1999	2000	2001	2002	2003
BIS Capital Ratio	7.0[1)]	8.2[1)]	11.8	10.6	11.7	11.3	11.2
Return on Assets	-0.50	-2.43	-0.83	-0.59	0.66	0.60	0.17
Return on Equity	-11.45	-51.72	-14.38	-11.02	12.76	10.91	3.41
Substandard or below-Loan ratio	6.0	7.6	12.9	8.0	3.4	2.3	2.6

Note: Excluding specialized banks

Source: Financial Supervisory Service

Table 3-6 | Breakdown of Public Funds Used in Financial Restructuring: by Sources of Fund (Nov. 1997-Mar. 2003)

(Unit: billion won)

	Equity Participation	Contributions	Insurance Claim Payments	Purchase of Assets	Purchase of Distressed Assets	Total
Bond Issuance	42.2	15.2	20.0	4.2	20.5	102.1
Recovered Fund	3.9	1.6	6.3	4.4	17.0	33.2
Public Fund	14.1	-	-	6.3[1)]	0.5	20.9
Other Fund	-	0.1	2.9	0.1	1.1	4.2
Total	60.2	16.9	29.2	15.0	39.1	160.4

Note: 1) Purchase of Subordinated bonds

Source: Public Fund Management Committee, Ministry of Finance and Economy, White Paper on Public Funds, May 2003

Table 3-7 | Breakdown of Public Funds Used in Financial Restructuring: by Financial Institutions Supported (Nov. 1997-Mar. 2003)

(Unit: trillion won)

	Equity Participation	Contributions	Insurance Claim Payments	Purchase of Assets	Purchase of Distressed Assets	Total
Banks	33.9	13.7	-	14.0	24.6	86.2
NBFIs	26.3	3.2	29.2	1.0	12.1	71.8
Securities Companies & Investment Companies	7.7	-	0.01	-	8.5	16.2
Insurance Companies	15.9	2.9	-	0.4	1.8	21.0
Merchant Banks	2.7	0.2	17.2	-	1.6	21.7
Mutual Savings Banks	-	0.1	7.3	0.6	0.2	8.2
Credit Unions	-	-	4.7	-	-	4.7

	Equity Participation	Contributions	Insurance Claim Payments	Purchase of Assets	Purchase of Distressed Assets	Total
Overseas Financial Institutions	-	-	-	-	2.4	2.4
Total	60.2	16.9	29.2	15.0	39.1	160.4

Source: Public Fund Management Committee, Ministry of Finance and Economy, White Paper on Public Funds, May 2003

Table 3-8 | Breakdown of Public Funds Used in Financial Restructuring: by Supporting Agencies (Nov. 1997-May 2003)

(Unit: trillion won)

	Equity Participation	Contributions	Insurance Claim Payments	Purchase of Assets	Purchase of Distressed Assets	Total
KDIC	47.5	16.9	29.2	8.7	-	102.3
KAMCO	-	-	-	-	39.1	39.1
Government	11.8	-	-	6.3	-	18.1
Bank of Korea	0.9	-	-	-	-	0.9
Total	60.2	16.9	29.2	15.0	39.1	160.4

Source: Public Fund Management Committee, Ministry of Finance and Economy, White Paper on Public Funds, May 2003

Table 3-9 | Financial Restructuring (1998-2002)

	Number of Institutions as of end of 1997	1998-2001			2002			No. of Institutions as of end of 2002
		License Revoked & Liquidation	Closure Through Merger	Entrance	License Revoked & Liquidation	Closure Through Merger	Entrance	
Banks	33	5	8	-	-	1	-	19
Merchant banks	30	22	6	-	-	-	-	3
Securities companies	36	6	1	17	-	2	-	44

	Number of Institutions as of end of 1997	1998-2001			2002			No. of Institutions as of end of 2002
		License Revoked & Liquidation	Closure Through Merger	Entrance	License Revoked & Liquidation	Closure Through Merger	Entrance	
Investment trust companies	31	6	1	17	-	-	1	31
Life insurance Companies	31	7	5	-	-	-	1	20
Non-life insurance companies	14	-	1	-	-	-	-	14
Credit-specialized Financial Companies	68	14	12	11	3	1	8	57
Mutual savings & finance companies	231	95	26	12	5	1	-	116
Credit unions	1,666	305	102	9	33	3	-	1,232
Total	2,140	460	162	57	42	8	11	1,536

Source: Public Fund Management Committee, Ministry of Finance and Economy, White Paper on Public Funds, May 2003

Table 3-10 | Non-Performing Loan Ratios of Banks[1] (As of End of March 2003)

(Ratio to Total Loans, %)

	End-1999	End-2000	End-2001	End-2002	End-2003
Banks	12.9	8.0	3.4	2.3	2.7
Commercial Banks	13.6	8.8	3.3	2.4	2.6
Specialized Banks	11.2	6.1	3.6	2.1	3.0

Note: 1) Based on forward-looking criterion of classifying asset soundness
2) Non-Performing Loans (NPLs) = Substandard + Estimated Loss + Doubtful
Source: Financial Supervisory Service Information, Financial Supervisory Service, August 2001

Some banks have undertaken M&As to enhance competitiveness. Woori Financial Holding Company was established in April 2001 with four banks, namely Woori, Peace,

Kwangju and Kyungnam, and Hanaro Merchant Bank as subsidiaries. A clean bank was created from the merger of Kookmin Bank and Housing & Commercial Bank in November 2001.

In addition, a partial deposit insurance system was introduced in January 2001, holding individual depositors responsible for their decisions. Under this system, a single financial institution guarantees up to 50 million won per depositor.

Table 3-11 | Financial Restructuring Progress (As of June 30, 2010)

(Unit: %)

Financial Sector	No. of Co's Year-end 1997 (A)	Restructuring Status					Newly Opened	Current Total
		Revocation of Licenses	Mergers	Liquidation, Bankruptcies and/or Transfer of Business	Total (B)	Proportion (B/A, %)		
Banks	33	5	11	-	16	48.5	1	18
Non-Banks	2,069	165	216	569		45.6	159	1,281
Merchant Banks	30	22	8	-	30	100.0	1	1
Securities Companies	36	6	8	2	16	44.4	30	50
Insurance Companies	50	10	7	6	23	46.0	25	52
Asset Management Companies	31	6	8	-	14	45.2	58	75
MSBs	231	116	28	1	145	62.8	19	105
Credit Unions	1,666	2	144	560	706	42.4	14	973
Lease Companies	25	3	13	-	16	64.0	16	25
Total	2,102	170	227	569	966	46.0	160	1,299

Source: Public Fund Management White Book Published in August 2010, KDIC (2011)

Table 3-12 | Public Fund Assistance Provision Status
(Between Nov. 1997 and Dec.31, 2010)

(Unit: trillion won)

Financial Sector		Equity Participation	Contributions	Deposit Payouts	Asset Purchases	NPL Purchases	Total
Banks		34.0	13.9	-	14.4	24.6	86.9
	Merchant Banks	2.7	0.7	18.3	-	1.0	22.8
Non-Banks	Financial Investment Companies	10.9	0.4	0.01	2.1	8.5	21.9
	Insurance Companies	15.9	3.1	-	0.3	1.8	21.2
	Credit Unions	-	-	4.7	0.3	-	5.0
	MSBs	-	0.4	7.3	0.6	0.2	8.5
	Sub-total	29.5	4.7	30.3	3.3	11.5	79.4
	Foreign Institutions		-	-	-	2.4	2.4
Total		63.5	18.6	30.3	17.8	38.5	168.6

Source: Financial Services Commission, KDIC (2011)

3. Financial Crisis and the KDIC

3.1. Broadened Role of the KDIC

The outbreak of the financial crisis at the end of 1997 forced the KDIC to expand the types of deposits and depositors covered and to change from its limited coverage scheme to one of blanket insurance coverage in order to prevent massive financial turbulence due to bank runs.

The KDIC, which was established only three years prior, had been engaged in unprecedented massive financial restructuring. For this purpose, the KDIC had to spend about 67.6 trillion won of its fund either for insurance claim payouts or for financial assistance to, and recapitalization of, failed or failing financial institutions. 488 financial institutions, including 11 banks, had been closed, merged, or sold.

To ensure that the acquiring banks were not overburdened by assuming the assets and the liabilities of the rejected (insolvent) banks, the KDIC took over any liabilities in excess of health assets of the rejected (insolvent) banks.

During financial restructuring and the period of overcoming the financial crisis of 1997, the KDIC acted as a pay-box and an agent of the government to issue bonds guaranteed by the government, executed resolution methods determined by the Financial Supervisory Commission (FSC), implemented recovery functions, and examined the causes and responsibilities for the failure of insolvent financial institutions to punish fraud or illegal behavior by the employees and owners of failed financial institutions.

The successful completion of the financial restructuring has been the most important task for the KDIC. Throughout its efforts, the KDIC has fulfilled its role successfully with limited resources and contributed to the normalization of the financial market and institutions and to the enhancement of the competitiveness of the Korean financial industry.

3.2. Financial Restructuring and the KDIC

3.2.1. Financial Restructuring and Public Funds

The amount of public funds allocated for the restructuring of financial institutions expanded between November 1997 and the end of 1999. In 1999, the KDIC spent 23.4 trillion won for financial restructuring, while KAMCO used 2.9 trillion won. From November 1997 to the end of 1999, the KDIC used 51.3 trillion won, while KAMCO used 22.8 trillion won. The government and the Bank of Korea (BOK) used 18.8 trillion won and 700 billion won, respectively.

The government spent 2.45 trillion won from the budget and the funds for recapitalization of the state-run banks and other financial assistances. The Bank of Korea invested 700 billion won in the Export-Import Bank of Korea, which reallocated part of the funds to the Korea Exchange Bank.

By the end of 1999, the KDIC had used up the 43.5 trillion won mobilized through the Deposit Insurance fund bonds. With the additional 3.4 trillion won recovered during the financial restructuring process, the total expenditure from the Deposit Insurance fund bonds amounted to 46.9 trillion won. The KDIC also used 4.4 trillion won of its own funds.[34]

34. Kyu-Sung Lee (2011), p. 352-356.

Table 3-13 | Use of Public Funds for Financial Restructuring, KDIC 1999

(Unit: billion won)

	Subtotal	Capital increase	Compensation for loss	Purchase of Assets	Substitute payment of deposits
Banks	18,018.9	10,466.6	3,865.9	3,686.4	n.a.
Commercial	18,018.9	10,466.6	3,865.9	3,686.4	n.a.
Regional	n.a.	n.a.	n.a.	n.a.	n.a.
Specialized	n.a.	n.a.	n.a.	n.a.	n.a.
Merchant Banks	n.a.	n.a.	n.a.	n.a.	n.a.
Securities	0.3	n.a.	n.a.	n.a.	0.3
Insurance	5,392.1	5,144.7	247.4	n.a.	n.a.
Investment Trusts	0.1	n.a.	n.a.	n.a.	0.1
Savings and finance companies, credit unions	n.a.	n.a.	n.a.	n.a.	n.a.
Other[1]	0.1	0.1	n.a.	n.a.	n.a.
Total	23,411.5	15,611.4	4,113.3	3,686.4	0.4
Nov.97-Dec.99	51,265.4	21,927.4	11,045.8	3,686.4	14,605.8

Source: MOFE and FSC 2000, Kyu-Sung Lee (2011) p.355

Note: N.A. = not available

1) Contribution to the Resolution and Finance Corporation, a subsidiary of the KDIC

KAMCO used the 20.5 trillion won raised through the Non-Performing Asset Management Fund (NPA Fund) bonds. Of the 2.7 trillion won recovered, 2.1 trillion won was used again to purchase the non-performing assets, and thus the total spending from the NPA Fund bonds reached 22.6 trillion won. KAMCO also used 164.3 billion won of its own funds.[35]

35. Kyu-Sung Lee(2011), p. 352-356.

Table 3-14 | Use of Public Funds for Financial Restructuring, KAMCO, Government and Bank of Korea, 1999

(Unit: billion won)

	KAMCO	Government			BOK
		Capital Increase	Purchase of Subordinated Bonds	Subtotal	
Banks	2,764.0	1,000	550	1550	700
Commercial	2,443.6	n.a.	100	100	n.a.
Regional	298.9	n.a.	450	450	n.a.
Specialized	21.5	1,000	n.a.	1,000	700
Merchant Banks	n.a.	n.a.	n.a.	n.a.	n.a.
Securities	n.a.	n.a.	n.a.	n.a.	n.a.
Insurance	0.3	n.a.	n.a.	n.a.	n.a.
Investment Trusts	n.a.	900	n.a.	900	n.a.
Savings and finance companies, credit unions	105.1	n.a.	n.a.	n.a.	n.a.
Other[1]	n.a.	n.a.	n.a.	n.a.	n.a.
Total	2,869.1	1,900	550	2,450	700
Nov.97-Dec.99	22,776.4	12,406.9	6,371	18,777.9	700

Source: MOFE and FSC 2000, Kyu-Sung Lee (2011) p.355

Note: N.A. = not available

1) Contribution to the Resolution and Finance Corporation, a subsidiary of the KDIC

3.2.2. Privatization of Financial Institutions and the KDIC

The financial restructuring undertaken in early 2000s put emphasis on improving competitiveness through privatization, conglomeration in the financial sector, prevention of further failures and enhancing soundness of problem financial institutions through management control.

To facilitate the privatization of banks, the KDIC endeavored to sell off its ownership stake in banks in compliance with the "2002 Plan for Selling Government-Held Bank Shares." The KDIC sold a portion of its stake in Woori Financial Group and Jeju Bank, and discarded its holdings in Seoul Bank by selling it to Hana Bank in 2002. Korea Life Insurance was sold to the Hanwha consortium in 2002.

3.3. Investigation into Insolvent Financial Institutions and the KDIC

3.3.1. Investigation into Insolvencies

The conduct of parties responsible for, or who contributed to the failure of, an insured financial institution is subject to investigation by the KDIC in Korea. The KDIC performs investigations into insolvent financial institutions to determine the accountability of management, employees and major shareholders for the insolvencies.

As of the end of 2011, the KDIC conducted investigations into a total of 491 financial institutions including 15 banks, 6 financial investment companies, 18 insurance companies, 22 merchant banks, 105 mutual savings banks and 325 credit unions.

Table 3-15 | Insolvency Accountability Investigations (As of December 31, 2011)

(Unit: billion won)

Classification	Banks	Financial Investment Companies	Insurance Companies	Merchant Banks	MSBs	Credit Unions[1]	Total
Institutions Investigated	15	6	18	22	105	325	491
Persons Accountable for Insolvencies	191	65	244	160	1,023	4,146	5,829
Amount of Losses Incurred	14,080	3,326.6	3,048.2	5,597.7	4,495.1	917.9	18,793.5

Note: 1) Excluding 14 bankruptcy estates of credit unions that were transferred to the National Credit Union Federation of Korea in January 2010

Source: KDIC (2011)

3.3.2. Legal Measures against Insolvency-implicated Persons and Recovery Results

As of the end of 2011, after the respective investigations, the KDIC took measures such as the (provisional) seizure of 764.6 billion won in 2,563 cases and the provisional disposal of properties in 224 cases. As a result, a total of 282.3 billion won had been recovered through a variety of measures such as compulsory execution.

Table 3-16 | Legal Measures Concerning Insolvent Financial Institutions and Recovery Outcomes (As of December 31, 2011)

(Unit: billion won)

Classification	Banks	Financial Investment Companies	Insurance Companies	Merchant Banks	MSBs	Credit Unions[1]	Total
No. of (Provisional) Seizures	37	7	55	123	877	1,464	2,563
Amount Seized (Provisional)	7.6	4.7	24.1	101.0	400.0	227.2	764.6
No. of Provisional Disposals	10	1	1	41	90	81	224
Amount Recovered	10.2	5.4	21.7	66.0	102.3	76.7	282.3

Source: KDIC (2011)

Chapter 4

Management of Deposit Insurance Funds

1. Original Deposit Insurance Fund
2. Deposit Insurance Fund Bond Redemption Fund
3. New Deposit Insurance Fund
4. Special Account of DIF

Management of Deposit Insurance Funds

1. Original Deposit Insurance Fund

1.1. Issuance of Deposit Insurance Fund Bonds

Pursuant to Article 26-2 of the Deposit Protection Act (DPA), the KDIC is allowed to issue Deposit Insurance Fund Bonds ("DIF Bonds") in order to procure public funds for its use. DIF Bonds were issued on eighty-one different occasions during the period of 1998-2002. The total volume of outstanding DIF Bonds amounted to 87.2 trillion won at the end of 2002. The majority of DIF Bonds issued during 1998 and 1999 had maturities of five to seven years, with either fixed or floating interest rates.

Table 4-1 | Issuance of Deposit Insurance Fund Bonds by Financial Sector

(Unit: billion won)

Issue Year	Banks	Securities Companies	Insurance companies		Merchant Banks	MSBs	Credit Unions	Total
			Life	Non-Life				
1998	12,065.0	14.1	1,153.4	-	5,827.2	1,508.5	446.8	21,015.0
1999	15,859.1	0.3	4,142.2	67.8	-	1,597.9	817.9	22,485.0
2000	6,030.7	-	-	1,000.0	1,260.0	650.0	-	8,940.7
2001	7,761.7	3,218.5	3,218.5	6,796.9	7,334.2	3,333.2	202.8	31,059.3
2002	3,660.0	-	-	-	-	-	-	3,660.0
Total	45,376.5	3,232.9	3,232.9	7,707.6	14,421.4	7, 089.4	1,467.5	87,160.0

Source: KDIC (2002)

1.2. Borrowings

Pursuant to Article 26 of the DPA and Article 15 of the DPA Enforcement Decree, the KDIC is authorized to borrow funds from various entities including the government, the Bank of Korea, insured financial institutions, and institutions stipulated by the Presidential Decree when deemed necessary, for payment of insurance claims or resolution of insolvent financial institutions. Interests on these DIF Bonds are paid by borrowings from the government. The funds were borrowed from the government's Special Account for Financial Loans at zero-interest and a 3-year maturity.

The KDIC's borrowings from the government's Special Account for Treasury Loan, especially for interest payments for DIF Bonds and foreign loans, reached a total of 18.6 trillion won at the end of 2002. In accordance with the government's public fund redemption plan, the KDIC has been exempted from its repayment obligation of these loans from 2003.

Table 4-2 | KDIC Borrowings by Lender

(Unit: billion won)

	Borrowed Amounts and Sources				Repaid Amount	Outstanding Balance
	Financial Institutions	IBRD and ADB	Government	Total		
Amount Received	7,601.1	-	-	7,601.1	-	7,601.1
1998	329.5	241.6	1,058.2	1,629.3	933.7	8,296.7
1999	1,387.0	1201.6	2,625.4	5,214.0	3,387.0	10,123.7
2000	9,002.8	1.3	3,953.3	12,957.4	980.2	22100.9
2001	-	0.8	4,967.2	4,968.0	11,019.6	1,6049.3
2002	-	-	5,955.3	5,955.3	0.3	22,004.3
Total	18,320.4	1,445.3	18,559.4	38,325.1	16,320.8	22,004.3

Source: KDIC (2002)

1.3. Financial Assistance

Since the financial crisis of 1997, the KDIC has extended 102.5 trillion won of public funds for the restructuring of financial institutions. The total financial assistance included 45.7 trillion won in equity participation (44.6%) for management rehabilitation, 16.6 trillion won in contributions (16.2%) for purchase and assumptions (P&A), 28.1 trillion won (27.5%) for payments of insurance claims and 12.1 trillion won (11.8%) for purchases of assets and loans.

Table 4-3 | Cumulative Financial Assistance by the KDIC (As of December 31, 2002)

(Unit: billion won, %)

Financial Sector	Equity Participation	Contribution for P&A	Insurance Claim Payments	Asset Purchases	Loans	Total
Banks	22,137.7	13,680.4	-	9,550.3	-	45,368.4 (44.3%)
Securities Companies	4,900.0	-	14.4	-	-	4,914.4 (4.8%)
Insurance Companies	15,919.8	2,675.6	-	344.7	-	18,940.1 (18.5%)
Merchant Banks	705.2	117.3	17,194.9	-	1,291.7-	21,309.1 (20.8%)
MSBs	0.1	134.0	7,273.1	-	853.3	8,270.5 (8.1%)
Credit Unions	-	-	3,655.2	-	36.7	3,691.9 (3.6%)
Total	45,672.8 (44.6%)	16,607.3 (16.2%)	28,137.6 (27.5%)	9,895.0 (9.7%)	2,181.7 (2.1%)	102,494.4 (100.0%)

Source: KDIC (2002)

1.4. Recovery of Public Funds

By the end of 2002, the KDIC has recovered 18,756.4 trillion won of total public fund support it had provided to financial institutions. The KDIC has developed a variety of recovery methods, relying on the form of support given to the financial institutions.

(1) The KDIC recovers public funds injected in the form of equity participation through disposition of equity stakes.

(2) The KDIC recovers public funds provided as contributions to deposit payoffs, for financial institutions that were closed because their liabilities exceeded their assets, through dividends received pursuant to the Bankruptcy Law.

(3) For the assets that the KDIC has assumed and loans it had extended to financial institutions, the KDIC recovers the public funds through disposition of assets or collection of loans employing various methods.

Table 4-4 | Public Funds Recovered by the KDIC (As of December 31, 2002)

(Unit: billion won)

Type	Banks	Securities Companies	Insurance Companies	Merchant Banks	MSBs	Credit Unions	Total
Equity Participation	4,520.1	-	438.7	33.5	-	-	4,992.3
Contributions	62.1	-	0.5	-	19.3	-	81.9
Bankruptcy Dividends	1,414.1	6.8	183.9	4,866.5	588.7	1,078.0	8,138.0
Bankruptcy Dividends for Deposit payoffs	-	(6.8)	-	(4,756.1)	(571.9)	(1,076.9)	(6,411.7)
Contributions	(1,414.1)	-	(183.9)	-	(16.8)	(1.1)	(1,615.9)
Loans	-	-	-	(110.4)	-	-	(110.4)
Loans	-	-	-	1,044.5	37.4	35.4	1,117.3
Asset Sales	4,309.1	-	117.8	-	-	-	4,426.9
Total	10,305.4	6.8	740.9	5,944.5	645.4	1,113.4	18,756.4

Source: KDIC (2002)

1.4.1. Recovery by Disposition of Equity Stakes

The KDIC has recovered the equity investment using a variety of methods.

(1) The KDIC had provided 4.95 trillion won of support to Korea First Bank for its financial restructuring using equity participation in KFB during the financial crisis. The KDIC has recovered a total of 1.92 trillion won (as of the end of 2001) through the disposition of its equity stakes in Korea First Bank (KFB).

(2) The KDIC has invested 1.52 trillion won to purchase the preferred stocks of five acquiring banks (Kookmin, H&CB, Shinhan, Hana, and KorAm) that had purchased the distressed assets of the five failed banks in 1998. By the end of 2002, the KDIC had recovered 1.48 trillion won including 40.3 billion won in dividends.

(3) The KDIC recovered 22.8 billion won by selling its shares of Jeju Bank to Woori Financial Group in April 2002.

(4) In January 2002, in compliance with the “2002 Plan for Selling Government–Held Bank Shares”, Woori Financial Group engaged in its initial public offering.

Stocks of Woori Financial Group held by the KDIC was disposed of through the public offering; 361.5 billion won was recovered.

(5) In compliance with the Public Fund Oversight Committee's "plan to sell or merge Seoul Bank" announced in February 2002, the KDIC sold 10 percent of its 60 percent stakes of Seoul Bank to Hana Bank. A total of 115 billion won had been recovered as of the end of December 2002.

2. Deposit Insurance Fund Bond Redemption Fund

2.1. Deposit Insurance Fund Bond Redemption Fund

The Deposit Protection Act (DPA) was revised in December 2002 to facilitate the recovery of public funds and to address shortfalls in the original deposit insurance system recognized during the course of financial restructuring after the financial crisis of 1997. Pursuant to the revised DPA, the Deposit Insurance Fund (DIF) Bond Redemption Fund was created for the management of assets and liabilities of the Deposit Insurance Fund.

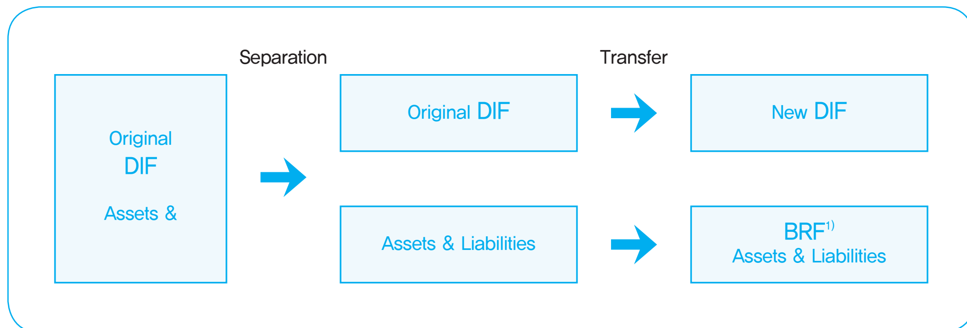
In January 2003, the Public Fund Redemption Plan (Redemption Plan), drafted by the government in 2002, separated the assets and liabilities of the existing Deposit Insurance Fund (DIF) that had been used in the financial restructuring process, and created the Deposit Insurance Fund Bond Redemption Fund (Redemption Fund).

The Deposit Insurance Fund (DIF) Bond Redemption Fund is a fund that was transferred from the existing Deposit Insurance Fund that was created and operated with public funds. It was established to facilitate the completion of the financial structural reform, and to collect and redeem the public funds that were injected during the financial structural reform.

The Public Fund Redemption Fund Act was enacted in December 2002 to allow the government to assume partial responsibility of the irrecoverable public funds in accordance with the government's public fund recovery plans through the creation of the Public Fund Redemption Fund. The Public Fund Redemption Fund made financial contributions to the DIF Bond Repayment Fund as well as the Non-Performing Claim Resolution Fund.

The original deposit insurance fund was mobilized through the issuance of bonds that were approved by the National Assembly and guaranteed by the government. Based on Article 26(3) of the Depositor Protection Act, the Deposit Insurance Fund Bond Redemption Fund may be used when the reasons for payment occurred before December 31, 2002.

Figure 4-1 | Separation of the DIF (January 2003)



Note: 1) Bond Redemption Fund

Table 4-5 | Financial Crisis Management and Role of Deposit Insurance System: An International Comparison

	Crisis management	Policy making/ Implementation	Loss sharing
USA	Separate (S&L crisis)	RTC (separate from DIS)	Major portion paid by taxpayers money
	Legislation allows exceptional resolution method for "system risk determination"	Treasury Dept./FDIC	Special premium levied on the member banks
Canada	Separate (Financial institution Restructuring program: FIRP[1])	Treasury Dept./ Financial Regulatory Authority (SOFI)	Government (taxpayers' money)
Mexico	Mixed	Deposit Insurance Agency	Deposit Insurance Agency (self-financing over a long Period)
Japan	Mixed, but financial Restructuring funds are Separate from the deposit Insurance funds Within JDIC	Financial restructuring Commission/ JDIC	JDIC (not clearly defined)
Korea	Separate (DIF Bond Redemption Fund)	Financial Service Commission/MOSF/ KDIC	Government(taxpayers' money)/ Special premium levied on the member banks/KDIC

Note: 1) FIRP is a program to nationalize failed financial institutions
Source: The major content is from DTT, KDI, KIF Consortium (2000)

Table 4-6 | Financial Assistance by DIF Bond Redemption Fund
(As of December 31, 2011)

(Unit: billion won)

	Equity Participation	Contributions	Deposit Payouts	Assets Purchases	Loans	Total
Banks	22,203.9	13,909.3	-	8,106.4	-	44,219.6
Financial Investment Companies	9,976.9	414.3	11.3	2,123.9	-	12,526.4
Insurance Companies	15,919.8	3,119.1	-	349.5	-	19,388.4
Life Insurance	5,669.7	2,751.8	-	349.5	-	8,770.9
Non-Life Insurance	10,250.1	367.3	-	-	-	10,617.4
Merchant Banks	2,693.1	743.1	18,271.8	-	-	21,708.0
Mutual Savings Banks	0.1	415.7	7,289.2	-	596.9	8,301.9
Credit Unions	-	-	4,740.2	-	-	4,740.2
Total	50,793.7	18,601.6	30,312.4	10,579.9	596.9	110,884.4

Source: KDIC (2012)

2.2. Special Assessment Payments

Pursuant to Article 30.3 of the Depositor Protection Act (DPA) and Article 16.2 of the DPA Enforcement Decree, insured financial institutions are required to pay a given ratio of their deposit balances (deposit balances for life insurance companies would be the arithmetic average of policy reserves and premiums earned) to the KDIC, as Special Assessment Payments (SAPs) for the period from 2003 to 2027. In 2010, the KDIC received 987.1 billion won of SAPs from six insured financial sectors.

Table 4-7 | Special Assessment Rates by Financial Sector

Sector	Banks	Financial Investment Companies	Insurance Companies	Merchant Banks	MSBs	Credit Unions
Special Assessment Rate	1/1,000	1/1,000	1/1,000	1/1,000	1/1,000	5/10,000
Legal Ceiling	3/1,000	3/1,000	3/1,000	3/1,000	3/1,000	3/1,000

Note: 1) Special assessment rate applied to credit unions was raised from 1/10,000 to 5/10,000 effective from 2007
Source: KDIC (2011)

Table 4-8 | Special Assessment Revenues

(Unit: billion won, %)

Year	Banks	Financial Investment Companies	Life Insurance Companies	Non-Life Insurance Companies	Merchant Banks	MSBs	Credit Unions[1]	Total
2003	477.5	15.6	88.9	18.5	2.0	22.2	-	624.7
2004	495.6	16.8	97.8	19.8	0.6	26.4	-	657.0
2005	487.1	14.5	106.9	21.9	0.5	31.9	-	662.8
2006	498.7	15.1	116.0	24.2	0.6	37.0	21.6	713.3
2007	502.7	15.6	126.5	27.8	0.7	43.0	11.6	728.0
2008	497.6	18.5	136.4	31.9	0.8	49.1	12.9	747.2
2009	596.5	16.9	143.0	35.2	1.0	59.3	13.7	865.6
2010	681.1	21.3	153.4	40.9	1.9	71.5	17.0	987.1
2011	778.9	22.7	165.0	48.7	1.2	71.8	20.5	1,108.7
Total	5,015.7 (70.7%)	157.1 (2.2%)	1,133.9 (16.0%)	268.6 (3.9%)	9.3 (0.1%)	412.2 (5.8%)	97.3 (1.4%)	7,094.3 (100.0%)

Note: 1) Credit unions disburse special assessment payments from 2006 to 2017
Source: KDIC (2012)

During the period from 2003 to 2011, the total amount of Special Assessment revenues recorded 7.094 trillion won. Banks and life insurance companies made Special Assessment Payments (SAPs) of 5.016 trillion won (70.7%) and 1.134 trillion won (16.0%), respectively. Other insured financial institutions made SAPs of 0.944 trillion won (13.3%).

2.3. Contributions from the Public Fund Redemption Fund

According to the Redemption Plan, the KDIC has received 52.306 trillion won in total during the four-year period from 2003 to 2006 and fully repaid the principal and interest of the Deposit Insurance Fund Bonds (DIF Bonds). The KDIC has not received any money from the government since 2007.

2.4. Deposit Insurance Fund Bonds

Pursuant to Article 26.2 and 26.3 of the DPA, the KDIC may issue Deposit Insurance Fund (DIF) Bonds. From 1998 to 2002, the KDIC has issued DIF Bonds amounting to 87.160 trillion won.

With the creation of the Redemption Fund in 2003, the outstanding balance of DIF Bonds of 80.974 trillion as of the end of 2002 was placed under the Redemption Fund. The DIF Bonds that matured after 2003 were repaid with contributions from the Public Fund Redemption Fund, capital mobilized through the issuance of DIF Bond Redemption Fund ("Redemption Fund Bonds") and existing funds, etc. All DIF Bonds were repaid by the end of 2008.

Table 4-9 | Issuance and Redemption of DIF Bonds 1998-2008

(Unit: billion won)

Issue Year	Issued Amount	Repaid Amount	Balance
1998	21,015.0	-	21,015.0
1999	22,484.9	-	43,499.9
2000	8,940.7	-	52,440.6
2001	31,059.3	1,464.0	82,035.9
2002	3,660.0	4,721.5	80,974.4
2003	-	9,737.1	71,237.3
2004	-	16,622.7	54,614.6
2005	-	18,090.4	36,524.2
2006	-	19,063.6	17,460.6
2007	-	6,067.2	11,393.3
2008	-	11,393.3	-
Total	87,159.9	87,159.9	-

Source: KDIC (2011)

2.5. Deposit Insurance Fund Bond Redemption Fund Bond

As provided in Article 26.2 and 26.3 of the DPA, the KDIC is allowed to issue Redemption Fund Bonds to repay the principal and interest of DIF Bonds. In 2011, the KDIC issued 0.78 trillion won of Redemption Fund Bonds through public offering at a fixed rate with four-year or five-year maturities. The outstanding balance of the Redemption Fund Bonds as of the end of 2011 amounted to 23.74 trillion won.

Table 4-10 | Issuance and Redemption of DIF Bond Redemption Fund Bonds 2004-2010

(Unit: billion won)

Issue Year	Issued Amount	Repaid Amount	Balance
2004	6,500.0	-	6,500.0
2005	7,440.0	-	13,940.0
2006	2,870.5	315.5	16,495.0
2007	2,720.0	45.0	19,170.0
2008	8,800.0	10.0	27,960.0
2009	5,860.0	6,500.0	27,320.0
2010	6,810.0	7,440.0	26,690.0
2011	780.0	3,730.0	23,740
Total	41,780.5	18,040.5	23,740.0

Source: KDIC (2012)

2.6. Borrowings

Pursuant to Article 26 of the DPA, the KDIC is authorized to borrow funds from various entities including the government, the Bank of Korea, insured financial institution, and institutions stipulated by the Presidential Decree when deemed necessary, for payment of insurance claims or resolution of insolvent financial institutions. The KDIC borrowed funds from the government's Special Account, the IBRD, the ADB and financial institutions until 2002.

The previous borrowings of the KDIC were placed under the Redemption Fund, which was created in 2003. Additionally, the KDIC was exempted from repaying all previous fiscal borrowings as of January 1, 2003, in compliance with the Public Fund Redemption Fund Act. The KDIC has not borrowed any money since 2003.

In 2010, the KDIC repaid 116.8 billion won (100 million U.S. dollars) for the principal of the loans it borrowed from the IBRD. The outstanding balance of the KDIC's borrowings as of the end of 2011 stood at 233.6 billion won.

Table 4-11 | Borrowings of the DIF Bond Redemption Fund

(Unit: billion won)

Year	Lender Institutions				Repaid Amount	Outstanding Balance
	Financial Institutions	IBRD and ADB etc.	Government	Total		
Account Received	7,601.1	-	-	7,601.1	-	7,601.1
1998	329.5	241.6	1,058.2	1,629.3	933.7	8,296.7
1999	1,387.0	1201.6	2,625.4	5,214.0	3,387.0	10,123.7
2000	9,002.8	1.3	3,953.3	12,957.4	980.2	22,100.9
2001	-	0.8	4,967.2	4,968.0	11,019.6	16,049.3
2002	-	-	5,955.3	5,953.3	0.3	22,004.3
2003	-	-	-	-	19,599.3	2,405.0
2004	-	-	-	-	1,116.8	1,288.2
2005	-	-	-	-	353.8	934.4
2006	-	-	-	-	116.8	817.6
2007	-	-	-	-	116.8	700.8
2008	-	-	-	-	116.8	584.0
2009	-	-	-	-	116.8	467.2
2010	-	-	-	-	116.8	350.4
2011	-	-	-	-	116.8	2,336
Total	18,320.4	1,445.3	18,559.4	38,325.1	38,091.5	2,336

Source: KDIC (2012)

2.7. Financial Assistance

The KDIC extends public funds in the form of deposit payouts and equity investments, etc. to facilitate resolution of insolvent financial institutions. In compliance with the DPA, the Redemption Fund is responsible for costs occurring due to the resolution of financial institutions that have become, or were declared as, insolvent financial institutions before the end of 2002.

The total amount of public funds provided from the Resolution Fund for the restructuring of financial institutions reached 110.884 trillion won as of the end of 2011. This financial assistance includes 50.794 trillion won (45.8%) in equity participation for the normalization of management, 18.602 trillion won (16.8%) in contribution for purchase and assumption

transactions (P&As), 30.312 trillion won (27.3%) for payments of insurance claims of depositors of failed financial institutions and 11.177 trillion won (10.1%) for the purchase of other assets and loans.

Table 4-12 | Accumulated Financial Assistance from the Redemption Fund

(Unit: billion won, %)

Financial Sector	Equity Participation	Contribution for P&A	Insurance Claim Payments	Asset Purchases	Loans	Total
Banks	22,203.9	13,909.3	-	8,106.4	-	44,219.6 (39.9%)
Financial Investment Companies	9,976.9	414.3	11.3	2,123.9	-	12,526.4 (11.3%)
Insurance Companies	15,915.8	3,119.1	-	349.5	-	19,388.4 (17.9%)
Merchant Banks	2,693.1	743.1	18,271.8	-	-	21,708.0 (19.6%)
MSBs	0.1	415.7	7,289.2	-	596.9	8,301.9 (7.5%)
Credit Unions	-	-	4,740.2	-	-	4,740.2 (4.3%)
Total	50,793.7 (45.8%)	18,601.6 (16.8%)	30,312.4 (27.3%)	10,579.9 (9.5%)	596.9 (0.5%)	110,884.4 (100.0%)

Source: KDIC (2012)

2.7.1. Financial Assistance by Financial Sector

The total financial assistance extended from the Redemption Fund to financial institutions is composed of 44.220 trillion won to banks (39.9%), 21.708 trillion won (19.6%) to merchant banks, 19.388 trillion won (17.9%) to insurance companies, 12.526 trillion won (11.3%) to financial investment companies, 8.302 trillion won (7.5%) to mutual savings banks (MSBs) and 4.740 trillion won (4.3%) to credit unions.

2.8. Recovery

Depending upon the nature of the support provided to facilitate the restructuring of troubled financial institutions, the KDIC employs various methods to recover public funds.

First, the KDIC recovers funds injected in the form of equity participation by selling its equity stakes. Second, in the case of closed financial institutions because their liabilities exceeded their assets, the KDIC recovers funds extended in contributions for deposit payouts by receiving dividends from the bankruptcy estate of the institution concerned. Third, in cases where the KDIC has taken over assets of and provided loans to a failed financial institution, the KDIC recovers the funds through the sale of the assets or collection of loans by employing various methods.

The accumulated amount of public funds recovered as of the end of 2011 reached 48.783 trillion won.

Table 4-13 | Accumulated DIF Bond Redemption Fund Recoveries (As of the end of 2011)

(Unit: billion won, %)

Financial Sector	Recovery of Equity Participation	Settlement of Contributions, etc.	Dividends from Bankruptcy Estates	Asset Sales	Repayment of Loans	Total
Banks	16,079.7	69.8	1,818.1	5,845.5	-	23,813.1 (48.8%)
Financial Investment Companies	1,212.1	323.0	7.5	1,790.6	-	3,333.2 (6.8%)
Insurance Companies	3,415.8	88.4	429.8	232.5	-	4,166.5 (8.5%)
Merchant Banks	138.3	5.9	8,215.9	-	-	8,360.1 (17.1%)
MSBs	-	34.1	5,070.8	-	596.9	5,701.8 (11.7%)
Credit Unions	-	0.4	3,407.5	-	-	3,409.9 (70%)
Total	20,845.9 (42.7%)	521.7 (1.1%)	18,949.6 (38.8%)	7,868.5 (16.1%)	596.9 (1.2%)	48,782.6 (100.0%)

Source: KDIC (2011)

The total accumulated amount of public funds recovered is composed of 20.846 trillion won recovered from equity participation (42.7%), 18.950 trillion won (38.8%) dividends from bankruptcy estates, 7.869 trillion won (16.1%) recovered from asset sales, 0.597 trillion won (1.2%) from repayment of loans and 0.522 trillion won (1.1%) recovered from settlement of contributions.

2.8.1. Sale of Equity Stake

The KDIC sold 7 percent of its equity stakes in Woori Financial Group (WFG) in November 2009 and then disposed of 9 percent minority ownership in a block sale in April 2010. Through those sales, the KDIC recovered 1.161 trillion won and 53.2 billion won respectively from share sales and dividend payments respectively.

The KDIC recovered 168.5 billion won by redeeming callable preferred stocks of Shinhan Financial Group (SFG) in August 2010 and received 12.3 billion won in dividends.

2.8.2. Recoveries by Korea Resolution & Collection (KR&C)

Korea Resolution & Collection (KR&C) uses various recovery methods as well as the traditional method of recovery at asset maturity. The methods consist of (1) sales through M&As; (2) disposition of non-performing loans (NPLs) through the creation of joint venture special purpose companies (J.V.SPCs); (3) issuance of asset-backed securities (ABSs). By the end of 2011, KR&C recovered 39.234 trillion won in total.

The Resolution and Finance Corporation (RFC) was created in December 1999. The RFC was a resolution financial institution that had been doing business after obtaining Hanareum Merchant Bank. The RFC was converted into a paper company called KR&C in November 2009 under the Second Plan for the Advancement of Public Institutions (announced in August 2008). KR&C acquires NPLs from insolvent financial institutions to enhance effectiveness of the contract transfer procedure. It also buys remaining assets from bankruptcy estates to assist their early closure.

Table 4-14 | Accumulated Recoveries from Asset Sales by KR&C (As of the end of 2011)

(Unit: billion won)

<table>
<tr><th>Asset Type</th><th>Asset Type</th><th>Sales Amount</th><th>Sales Method</th></tr>
<tr><td rowspan="3">Loans</td><td>Loans in KRW</td><td>10,093.0</td><td rowspan="2">International bidding, NPL sale, ABS issuance, etc.</td></tr>
<tr><td>Loans in foreign currency</td><td>3,066.0</td></tr>
<tr><td>Sub-total</td><td>13,159.0</td><td></td></tr>
<tr><td>Marketable securities</td><td>Listed and non-listed Stock</td><td>4,961.6</td><td>Block sale, joint sale, etc.</td></tr>
<tr><td>Real estate</td><td>Business buildings, etc.</td><td>622.0</td><td>Public offering and negotiated Contract</td></tr>
<tr><td>Claims</td><td>Claims on payout, etc.</td><td>20,490.9</td><td>Bankruptcy dividends</td></tr>
<tr><td colspan="2">Total</td><td>39,233.5</td><td></td></tr>
</table>

Source: KDIC (2012)

2.9. Bankruptcy Dividends

The KDIC has collected 18.849 trillion won in bankruptcy dividends since 1999 through disposition of its asset holdings in bankruptcy estates that had received public funds. By financial sector, the KDIC recovered 8.174 trillion won (43.4%) and 4.980 trillion won (26.4%) from the bankruptcy estates of merchant banks and from those of MSBs, respectively. The KDIC also recovered 3.406 trillion won (18.1%) and 1.855 trillion won (9.8%) from the bankruptcy estates of credit unions and from those of banks, respectively.

Table 4-15 | Accumulated Bankruptcy Dividend Payments by Financial Sector (As of the end of 2010)

(Unit: billion won, %)

Financial Sector	No. of Bankruptcy Estates	Cumulative Total Amount Recovered Since 1999
Banks	5	1,818.1 (9.6%)
Insurance Companies	10	429.8 (2.3%)
Financial Investment Companies	4	7.5 (-)
Merchant Banks	22	8,215.9 (43.3%)
MSBs	91	5,070.8 (26.8%)
Credit Unions	325	3,407.5 (18.0%)
Total	457	18,949.6 (100.0%)

Source: KDIC (2012)

2.10. Collection of Loans

By the end of 2010, the KDIC had provided a total of 596.9 billion won in loans to financial institutions.

By the end of 2011, the KDIC recovered a total of 521.7 billion won in settlements of contributions, etc. from institutions it supported including SC First Bank, Korea Investment and Securities, Daehan Investment and Securities, and Hyundai Investment and Securities.

2.11. External Evaluation of DIF Bond Redemption Fund

Pursuant to the National Finance Act, the Ministry of Strategy and Finance (MOSF) is required to analyze and evaluate the performance of funds governed by the Act as well as deliberate whether to maintain the funds every three years.

Accordingly, the KDIC submits an annual report on the management of the Deposit Insurance Fund (DIF) Bond Redemption Fund to the Fund Management Evaluation Commission. Based on the report, the Commission discloses the results of its evaluation after carrying out due diligence and an opinion poll. In the 2009 evaluation of the KDIC's management of the DIF Bond Redemption Fund, the KDIC got 3rd place in the area of asset management among seven finance funds and 13th place among all thirty-five public funds.

3. New Deposit Insurance Fund

3.1. Management of the Deposit Insurance Fund

The KDIC operates on the ex-ante funding of the Deposit Insurance Fund (DIF). The fund is financed by insurance premium income, contributions, and operating revenues as normal revenue sources. The KDIC can borrow, issue bonds, or obtain the transfer of national property as contingent sources of the fund.

To maintain DIF's viability in the long run, the KDIC had to address the insolvency problem of the Deposit Insurance Fund (DIF) arising from the massive drain of funds during the financial restructuring. A loss of large magnitude could not be managed by the Deposit Insurance Fund alone.

According to the amended Depositor Protection Act on Public Fund Repayment Measures approved in 2002, the funds in the KDIC are divided into the Deposit Insurance Fund Bond Repayment Fund and the (New) Deposit Insurance Fund. There are differences in the procedure of support between them.

The new DIF, which started from a clean state with insurance premiums from 2003, has been used for the day-to-day operation of the Fund, which is related with insolvencies from 2003 onwards.

3.2. Improvement of the Soundness of the Deposit Insurance Fund

The optimal size of the DIF will depend on various factors such as the probability of failure of financial institutions, the expected size of loss, availability of emergency back-up funding facilities, and the degree of credibility and viability of the DIF that the government would like to maintain.

The risk nature of the financial system in the future and the exposure of the insured financial institutions to the risk are essential elements in designing the desirable size of the DIF. In addition, the failure rate depends on the effectiveness of risk management practices at the individual insured member, the robustness of prudential regulation by the supervisory authority, and the appropriateness of monitoring and early corrective actions to prevent failure of insured financial institutions.

In determining the proper size of the DIF for normal circumstances, an appropriate reserve ratio or the ratio of fund to the total amount of insured deposits has to be considered. The risk profile of insured financial institutions and financial markets, the expected failure rate of insured financial institutions, the concept of loss distribution, the risk-based insurance premium, and the least cost principle are important issues that the KDIC has to deal with to determine an adequate size of the DIF.

3.3. Target Fund System

The new Deposit Insurance Fund (DIF) came into effect in 2003. Since then, the KDIC has strived to adopt a target fund system that would ensure the viability of the DIF and alleviate the burden of premium payments on insured financial institutions. The Ministerial Meeting for Regulatory Reform, held in May 2006, approved the introduction of the target fund and the differential insurance premium system as a means to reform the insurance premium system and upgrade the overall deposit insurance system. In December 2007, the National Assembly revised the Depositor Protection Act (DPA) through congressional legislation to approve the implementation of the target fund system starting from 2009.

In January 2009, the KDIC adopted the Target Fund System, which aims to set the target size of the deposit insurance fund per sector at an amount sufficient enough to cover future losses.

3.3.1. Purpose of the Target Fund System

Purposes of the target fund system are as follows:

(1) To contribute to minimizing resolution costs in contingency cases;

(2) To disperse resolution costs over a long term;

(3) To provide standards for the adjustment of insurance premium rates;

(4) To maintain public confidence in the deposit insurance system;

(5) To establish the principle of beneficiaries paying resolution costs;

(6) To help financial institutions to forecast future premium liabilities;

(7) To reduce the burden of premium payment once the target is achieved.

The Target Fund System would contribute to the soundness of the deposit insurance fund, relief of financial institutions' premium payment burden, and the stability of the financial system by improving the predictability of the amount of the insurance premiums payable.

A target level for the deposit insurance fund is often described as a desired percentage of insured deposit. For example, the FDIC in the United States sets the target level of the deposit insurance fund at 1.25 percent of insured deposits.

Recently, the legal basis for the introduction of the risk-based premium system by 2014 was also set up.

3.3.2. Hard Target vs. Soft Target

a. Hard Target

The target level under the Hard Target method is set as a point and maintained rigorously.

If the DIF reaches the target, no insurance premium will be levied. On the other hand, if the DIF falls under the target, a higher insurance premium will be levied to rebuild reserves.

This may cause greater volatility in insurance premiums.

b. Soft Target

The target level under the Soft Target method is set as a range and premium rates can be adjusted gradually when the fund level deviates from the range.

The KDIC can maintain the range by changing insurance premium rates.

The soft target method mitigates the problem of moral hazard because it facilitates the continuous levy of insurance premiums and permits the effective adjustment of the insurance premium rates.

The KDIC decided to adopt the soft target method after careful study of the hard target versus soft target method.

3.3.3. Target Size of the Fund

Since the Target Fund System was adopted in January 2009, the KDIC set a target size of deposit insurance fund per sector at an amount sufficient enough to cover future losses. When the target size of deposit insurance fund per specific sector is achieved, financial institutions in that sector are exempted from paying premiums.

The target size of the fund may be set to cover both expected and unexpected losses of the fund. However, a precise estimation of the loss distribution of the DIF is almost impossible in practice. Therefore, the estimated target should be regarded as an anchor.

3.3.4. Approach to Target Size of the Fund

a. Discretionary Method

Under the discretionary method, the size of the target fund is determined based on the following factors:

(1) Financial Institutions' ability to pay insurance premiums;

(2) Historical experiences in resolving financial crises and experiences of other countries;

(3) Measures to provide liquidity to the DIF and other such entities.

For example, if the size of the target fund is determined at the level of 1-2 percent of total insured deposits, then the KDIC would be able to resolve five mid-sized insured financial institutions by implementing deposit payoffs simultaneously.

b. Quantitative Method

Under the quantitative method, the appropriate size of the target fund can be calculated by estimating the probability distribution of DIF losses.

c. Mixed Approach: KDIC's Approach

Under the mixed approach, the target size is determined by taking into account both the calculation outcomes derived under the quantitative method and the various factors to consider under the discretionary method. The KDIC adopted the mixed approach.

3.3.5. Insurance Premiums under the Soft Target Method

If the DIF reaches the target level under the soft target method, there are a couple of options available for the KDIC to set the insurance premium. If the DIF reaches above the

lower limit, the premium will be discounted. On the other hand, if the DIF reaches above the upper limit, (1) premiums exceeding the upper limit will be refunded or (2) the premium will not be levied.

3.3.6. Separate Funds or Single Integrated Fund

The KDIC decided to set target fund levels for each financial sector. As of September 2009, a Target Fund System has been implemented for five sectors including the banking sector. At the end of March 2011, the target fund size per financial sector was reduced to 55 percent of the previous target fund size per financial sector. At the end of 2011, the reserve fund size of banks recorded just 0.613 percent, which is less than the minimum target (0.825%). The reserve fund sizes of financial investment companies and life insurance companies reached 1.474 percent and 1.136 percent respectively, and exceeded their maximum targets of 1.100% and 0.935%, respectively. On the other hand, the reserve fund size of mutual savings banks (MSBs) recorded negative (-) 3.619 percent.

Table 4-16 | Target Fund Size per Financial Sector (As of September 2009)

Target Fund Size	Banks	Financial Investment Companies	Life Insurance Companies	Non-Life Insurance Companies	Merchant Banks	MSBs
Minimum	1.5%	1.5%	1.2%	1.5%	n.a.	3.0%
Maximum	2.0%	2.0%	1.7%	2.0%	n.a.	3.5%

Note: 1) The target fund size is a percentage of insurable deposits as of the last day of the previous calendar year
2) As only two merchant banks are in operation in the market, an adequate target fund size cannot be appropriately estimated

Source: KDIC

Table 4-17 | Target Fund Size per Financial Sector (As of March 30, 2011)

Target Fund Size	Banks	Financial Investment Companies	Life Insurance Companies	Non-Life Insurance Companies	Merchant Banks	MSBs
Minimum	0.825%	0.825%	0.660%	0.825%	n.a.	1.650%
Maximum	1.100%	1.100%	0.935%	1.100%	n.a.	1.925%
Reserve fund at year-end 2011	0.613%	1.474%	1.136%	1.059%	2.323%	-3.619%

Note: 1) As only two merchant banks are in operation in the market, an adequate target fund size cannot be appropriately estimated

Source: KDIC (2012)

Table 4-18 | Target Fund Ratio (Accrual Basis, as of Dec. 31, 2010)

(Unit: billion won)

Sector	Banks	Financial Investment Companies	Life Insurance Companies	Non-Life Insurance Companies	Merchant Banks	MSBs	Total
Fund Balance (A)	4,716.8	292.6	3,182.3	698.5	24.2	-2,139.5	6,773.8
Insurable Deposit (B)	738,224.3	22,206.8	268,954.4	53,566.7	1,225.4	76,601.8	1,160,527.5
Ratio (A/B)	0.64%	1.32%	1.18%	1.30%	1.94%	-2.79%	-
Target Ratio	1.5-2.0%	1.5-2.0%	1.2-1.7%	1.5-2.0%	n.a.	3.0-3.5%	-

Source: KDIC, "Deposit Insurance Fund: Funding & Recent Issues," (2011)

3.3.7. Review of Sufficiency of the Target Fund

Whether the target fund is sufficient or not should be reviewed on a regular basis, for example, every five years, or when there occurs a sudden change in the financial environment.

3.4. Other Improvement to the Soundness of the Deposit Insurance Fund

A revision of the DPA in February 2009 permitted the separation between accounts for life insurance and non- life insurance sectors and a delay in determining the target size for accounts that cover a small number of insured financial institutions. Also, a revision of the Enforcement Decree of the DPA in June 2009 allowed that the Deposit Insurance Committee may decide to discount, exempt, or refund insurance premium payments by a vote if and when the fund reaches its target size.

The major sources of the DIF are insurance premium revenues, contributions from insured financial institutions, deposit insurance bonds issued, domestic borrowings, and other sources including borrowing from the ADB and IBRD.

3.5. Deposit Insurance Premiums

The KDIC receives insurance premiums from insured financial institutions, in accordance with Article 30 of the Depositor Protection Act (DPA) and Article 16 of the DPA's Enforcement Decree. The KDIC also receives special assessments for repayment of deposit insurance fund bonds (hereinafter "special assessment") in accordance with Article

30-3 of the Depositor Protection Act and Article 16-2 of the DPA's Enforcement Decree. "Special assessments" (Deposit Insurance Fund Bond Repayment Special Assessments) refers to the statutory allotments that insured financial institutions must pay for 25 years from 2003 to 2027, according to the Public Fund Recovery Measures established in 2002 to recover the public funds injected during financial restructuring in the past.

Table 4-19 | Rates Applied to Insured Financial Institutions

	Banks	Financial nvestment Companies	Insurance Companies	Merchant Banks	MSBs	Credit Unions
Premium Rate[1]	8/10,000	15/10,000	15/10,000	15/10,000	40/10,000	-
Special assessment Rate[2]	1/1,000	1/1,000	1/1,000	1/1,000	1/1,000	5/1,000
Contributions	1/100	1/100	1/100	5/100	5/100	-

Note: 1) The rates are multiplied by the balance of deposits, etc

2) The rates are multiplied by paid-in-capital or equity participation

Source: KDIC (2011)

3.5.1. Insurance Premiums

Pursuant to Article 30 of the DPA and Article 16 of the DPA Enforcement Decree, insured financial institutions are required to pay a given ratio of their deposit balances to the KDIC. Deposit balances for life insurance companies would be the arithmetic average of policy reserves and premiums earned.

The deposit insurance premiums received until 2002 were allocated to the DIF Redemption Fund while insurance premiums collected since 2003 have been placed in the new Deposit Insurance Fund (DIF). The amount of insurance premiums collected from insured financial institutions and paid into the DIF recorded 1.223 trillion won in 2011.

Table 4-20 | Insurance Premium Revenues of KDIC 1997-2011

(Unit: billion won, %)

Year	Banks	Financial Investment Companies	Life Insurance Companies	Non-life Insurance Companies	Merchant Banks	MSBs	Total
Amount Remitted	-	-	141.4	37.9	84.8	201.7	465.8
1997	32.1	-	-	-	-	-	32.1
1998	129.2	-	38.6	14.3	13.2	39.0	234.3
1999	197.5	5.1	101.1	24.9	33.6	37.7	399.9
2000	263.0	15.6	140.2	37.9	23.3	32.3	512.3
2001	413.9	21.8	193.8	47.8	13.9	52.9	744.1
2002	436.1	26.2	229.5	48.5	13.0	60.4	813.7
2003	477.5	31.2	258.0	53.5	7.3	66.7	894.2
2004	496.0	33.6	283.2	57.1	1.7	79.3	950.9
2005	486.9	30.0	310.9	62.8	1.5	97.4	989.5
2006	498.7	30.3	336.2	69.7	1.9	111.6	1,048.4
2007	502.7	25.6	365.4	80.1	2.2	130.6	1,106.6
2008	480.8	30.5	393.4	91.8	2.4	148.3	1,147.2
2009	529.1	27.6	409.7	101.6	2.9	173.7	1,244.6
2010	545.1	28.4	260.9	69.8	3.4	252.4	1,160.0
Total	5,488.6 (4.7%)	305.9 (2.6%)	3,462.3 (2.9%)	797.7 (6.850)	205.1 (1.7%)	1,484.0 12.6%)	11,743.6 (100.0%)

Source: KDIC (2011)

Table 4-21 | Deposit Insurance Fund Insurance Premium Revenues (As of December 31, 2011)

(Unit: billion won)

Financial Sector	2003	2004	2005	2006	2007	2008	2009	2010	Total
Banks	477.5	496.0	486.9	498.7	502.7	480.8	529.1	545.1	4,016.8 (47.0%)
Financial Investment Companies	31.2	33.6	30.0	30.3	25.6	30.5	27.6	28.4	237.2 (2.8%)

Financial Sector	2003	2004	2005	2006	2007	2008	2009	2010	Total
Insurance Companies	311.5	340.3	373.7	405.9	445.5	485.2	511.3	330.7	3,204.1 (37.5%)
Life Insurance	258.0	283.2	310.9	336.2	365.4	393.4	409.7	260.9	2,617.7 (30.6%)
Non-Life Insurance	53.5	57.1	62.8	69.7	80.1	91.8	101.6	69.8	586.4 (6.9%)
Merchant Banks	7.3	1.7	1.5	1.9	2.2	2.4	2.9	3.4	23.3 (0.3%)
Mutual Savings Banks	66.7	79.3	97.4	111.6	130.6	148.3	173.7	252.4	1,060.0 (12.4%)
Total	894.2	950.9	989.5	1,048.4	1,106.6	1,147.2	1,244.6	1,160.0	8,541.4 (100.0%)

Source: KDIC (2011)

3.6. Contributions from Insured Financial Institutions

Newly-established insured financial institutions should pay a one-time contribution to the Deposit Insurance Fund pursuant to Article 24 of the Depositor Protection Act and Article 14 of the DPA's Enforcement Decree. However, when an insured financial institution receives a license of business or establishment after a merger or divestiture, it does not pay contributions.

In compliance with the Redemption Plan and the creation of the Redemption Fund, contributions received up to 2002 were allocated to the Redemption Fund, whereas contributions made since 2003 have been allocated to the Deposit Insurance Fund. The KDIC received contributions of 1.6 billion won in 2010.

Table 4-22 | Contribution Remittances by Financial Sector 1998-2010

(Unit: billion won)

Year	Banks	Financial Investment Companies	Life Insurance Companies	Non-life Insurance Companies	Merchant Banks	MSBs	Total[3]
Amount Remitted[1]	-	-	-	-	2,400.0	799.8	3,199.8
1998	-	-	-	-	-	20.0	20.0
1999	30.0	105.0	-	3.0	-	71.5	209.5

Year	Banks	Financial Investment Companies	Life Insurance Companies	Non-life Insurance Companies	Merchant Banks	MSBs	Total[3]
2000	6.0	3,281.4	-	3.2	-	-	3,290.6
2001	12.6	75.9	3.0	26.0	150.0	-	267.5
2002[2]	12.5	50.0	-	33.0	-	39.0	134.5
2003	3.0	-	65.0	20.0	-	-	88.0
2004	34.0	20.0	60.0	20.0	-	-	134.0
2005	22.0	20.0	-	-	-	125.0	167.0
2006	38.0	80.0	-	20.0	-	134.0	272.0
2007	-	-	-	-	-	-	0
2008	16.0	1,100.5	-	-	-	55.6	1,172.1
2009	76.6	431.2	41.9	34.2	1.7	77.7	663.3
2010	8.0	58.4	90.0	3.0	-	-	159.4
Total	258.7 (2.6%)	5,222.4 (53.4%)	259.9 (2.7%)	162.4 (1.7%)	2,551.7 (26.1%)	1,322.6 (13.5%)	9,777.7 (100.0%)

Note: 1) Includes the amount transferred from the Credit Management Fund when it was consolidated with the Deposit Insurance Fund in April of 1998

2) Insurance received until 2002 were transferred to the DIF Bond Redemption Fund

3) Excludes the account of Credit Unions in the Deposit Insurance Fund, which was transferred to the Korean Federation of Community Credit Cooperatives on January 1, 2010

Source: KDIC (2011)

3.7. Borrowings

Pursuant to Article 26 of the DPA and Article 15 of the DPA Enforcement Decree, the DIF is permitted to borrow funds from various entities including the government, the Bank of Korea, insured financial institutions, and institutions stipulated by the Presidential Decree, when necessary for payment of insurance claims or resolutions of insolvent financial institutions.

Based upon this authorization, the KDIC borrowed a total of 104.6 billion won in 2003 and 61.8 billion won in 2004 to pay insurance claims to depositors of failed credit unions, as well as 231.4 billion won in 2007 to resolve insolvent mutual savings banks. To reduce the balance of borrowings in the credit union account, the KDIC repaid 42.5 billion won, 38.5 billion won, 6 billion won and 5 billion won in 2004, 2005, 2006 and 2008, respectively. The remaining balance of the Credit Union account was transferred to the Korean Federation of Community Credit Cooperatives on January 1, 2010, which left the account with no

borrowings. The balance of borrowings of 231.4 billion won in the Mutual Savings Bank account was repaid fully by 2008.

3.8. Financial Assistance

Since 2003, the KDIC has provided public funds to facilitate the resolution of insolvent financial institutions or those institutions declared insolvent. In 2010, the KDIC provided 994.2 billion won to Mutual Savings Banks (MSBs) to assist their restructuring from the DIF's MSB account. From 2003 to late 2010, a total of 4.528 trillion won was extended to sixteen MSBs including Gimcheon MSB that was declared to be insolvent.

Table 4-23 | Accumulated Financial Assistance from the DIF (As of December 31, 2010)

(Unit: billion won)

	Financial Sector	Equity Participation	Contribution	Insurance Claims Payments	Loans	Provisional Insurance Payments	Total
Assistance in 2010	MSBs	34.5	544.7	300.3	92.8	21.9	994.2
Accumulated Assistance	MSBs	121.1 (2.2%)	2,454.2 (44.4%)	1,441.5 (26.1%)	489.1 (8.9%)	21.9 (0.4%)	4,527.8 (100.0%)

Source: KDIC (2011)

3.8.1. Financial Assistance to Mutual Savings Banks (MSBs)

Jeonil MSB was declared insolvent in 2009. To resolve Jeonil MSB, the KDIC transferred its sound assets and deposits to Yenarae MSB, a bridge bank set up in 2010, and transferred bad assets to KR&C (formerly the RFC). The KDIC contributed 518.2 billion won to make up for net asset deficiencies caused due to the transfer of contract from Jeonil MSB to Yenarae MSB, and provided 34.5 billion won in equity investment. The KDIC extended a loan of 92.8 billion won to KR&C to pay for the acquisition cost generated by the contract transfer.

Table 4-24 | Insurance Claim Payments to Depositors of Failed MSBs 2003-2011

(Unit: billion won)

Year	Number of Institutions	Payment Amount
2003	1	76.4
2004	3	177.0
2005	7	452.7
2006	7	32.6
2007	6	134.5
2008	11	90.6
2009	9	177.4
2010	11	300.3
2011	16	6,545.0
Total	-	7,986.2

Source: KDIC (2011, 2012)

3.9. Recovery

The KDIC employs the same methods as those used for the Redemption Fund to recover the public funds provided by the DIF. Such methods include:

- Recovering funds by selling equity stakes in financial institutions in which it invested;
- Collecting bankruptcy dividends by participating in the bankruptcy procedure; and
- Collecting loans it extended to financial institutions.

The total amount of public funds recovered through these methods from 2003 to 2010 recorded 1.009 trillion won including 391.6 billion won recovered in 2010.

Table 4-25 | Accumulated DIF Recoveries

(Unit: billion won)

Year	Financial Sector	Equity Participation	Contribution	Insurance Claims Payments	Recovery of Loans	Total
Recoveries in 2010	MSBs	1.5	42.3	208.0	139.8	391.6
Accumulated Recoveries	MSBs	253.0 (25.1%)	56.8 (5.6%)	365.1 (36.2%)	333.9 (33.1%)	1,008.8 (100.0%)

Source: KDIC (2011)

3.9.1. Recovery through Bankruptcy Dividends

The KDIC received bankruptcy dividends through disposing its asset holdings in bankruptcy estates that had received public funds from the DIF. The cumulative total bankruptcy dividends amounted to 365.1 billion won by the end of 2010. In 2010, the KDIC got 208 billion won of bankruptcy dividends.

Table 4-26 | Bankruptcy Dividend Recoveries by Financial Sector (As of December 31, 2010)

(Unit: billion won)

Financial Sector	No. of Bankruptcy Estates	Recovered Amount	
		Jan.-Dec. 2010	Cumulative Total Since 2004
MSBs	16	208.0	365.1

Note: The credit union account in the DIF, which was transferred to the Korean Federation of Community Credit Cooperatives on January 1, 2010, was excluded

Source: KDIC (2011)

3.9.2. Collection of Loans

Since 2003, the KDIC has extended loans amounting to 489.1 billion won to KR&C (former RFC) and Busan Solomon MSB to facilitate the restructuring of twelve MSBs including Kyungbuk MSB. The total amount of loan recoveries by the KDIC from 2003 to 2010 recorded 333.9 billion won. In 2010, the KDIC recovered 139.8 billion won in principal and interest from ten MSBs.

4. Special Account of DIF

4.1. Mutual Savings Banking Industry

Mutual Savings Banks (MSBs) started to operate their services as community banks based upon the legalization of private financing in 1972. As of the end of 2010, there were 105 MSBs in total which accounted for 4.5 percent of the 1,441 trillion won in total loans extended by the financial industry. MSBs began to lose their niche market as the regulation that had prohibited commercial banks to provide loans to some businesses was repealed. Thereafter, MSBs began to confront fierce competition with large commercial banks in the financial market. MSBs adopted a business strategy of seeking growth that includes the

investment of larger amount of deposits collected by offering high interest rates into high-risk and high-return assets.

Table 4-27 | Assets and Liabilities of the Mutual Savings Banking Industry (As of the end of 2010)

(Unit: trillion won)

Total Assets	Total Loans	Total Deposits	Number of Deposits
86.9	64.9	77.0	4.4 million

Source: KDIC (2011)

4.2. Real Estate Project Financing Since 2005

Mutual savings banks (MSBs) were mutual savings and finance companies until March 2002, when they were allowed to convert into mutual savings banks. MSBs are regionally-licensed small financial intermediaries. They have provided real estate project financing (PF) since 2005. MSBs extended loans to property developers so that they could fund their projects based upon project profitability forecasts, and collect advanced loans after the completion of the project.

Mutual savings banks provided real estate developers with so-called bridge loans for land purchases. The bridge loan was extended at the most risky stage of project finance (PF) in the development process. To get return for assuming high risk, MSBs charged a variety of fees in addition to high lending interest rates. In retrospect, the relatively high cost of the bridge loan may not have been high enough, considering the massive failures of MSBs in the late 2000s after the housing boom ended.

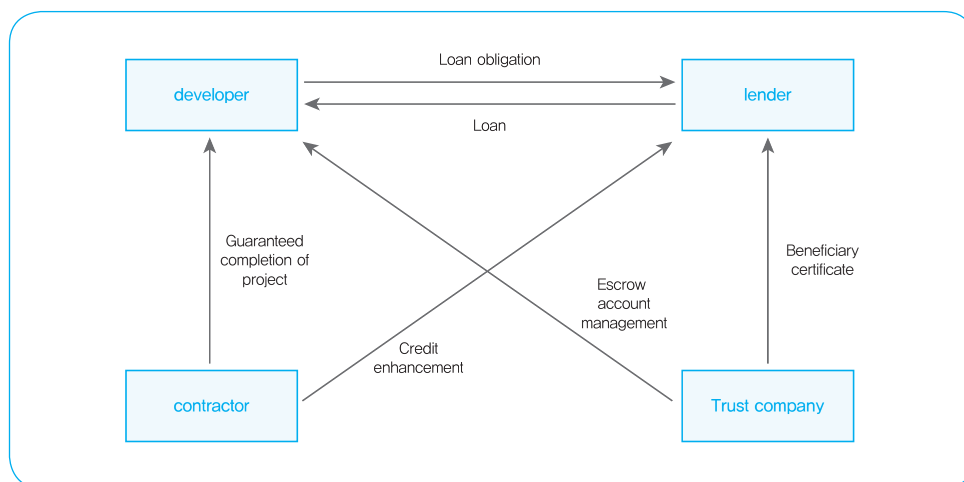
On the other hand, commercial banks usually provided the main project finance (PF) loan after the land purchase was completed and government permits for the real estate development project were obtained. The main PF loan was extended only after a creditworthy contractor provided triple guarantees. Therefore, the main PF loan was a relatively low-risk, low-cost loan compared with the bridge loan.[36]

Total PF loans of financial institutions increased 98 percent and 42 percent in 2006 and 2007, respectively. PF loans provided by MSBs also expanded 84 percent in 2006 and recorded 11.6 trillion won at the end of 2006. The explosive growth of PF loans reflected the

36. Jae Young Son,"Korea's Development Finance at the Crossroad," Contemporary Real Estate Issues in Korea and China, September 2012.

construction booms during those periods. The housing market, however, had been struck severely by the global financial crisis in 2008 and began to fall into recession.

Figure 4-2 | Project Finance Structure



Source: Jae-young Son (2012)

Table 4-28 | Trend of Project Finance Loans Outstanding

(Unit: trillion won)

	Dec. 2005	Dec. 2006	Dec. 2007	Dec. 2008	June 2009	Dec. 2009	Dec. 2010	Mar. 2011
Commercial Banks	14	26	42	52.5	54.1	51.0	38.7	36.5
MSBs	6.3	11.6	12.1	11.5	11.0	11.8	12.2	7.0
Insurance Companies	-	-	-	5.5	5.5	5.7	4.9	5.1
Securities Companies	-	-	-	2.9	2.8	2.7	2.2	1.8
Total	24.8	49.2	69.7	83.0	84.0	81.5	66.5	58.6

Source: Financial Supervisory Service, Son (2012)

The housing market, however, had been severely struck by the global financial crisis in 2008 and began to fall into recession. The sluggish recovery from the 2008 global financial crisis in the real estate market has cut into profits and asset qualities of MSBs as well as commercial banks.

Table 4-29 | Real Estate Project Financing by MSBs

(Unit: trillion won)

	Dec.2005	June2007	June 2008	June 2009	June 2010	Dec.2010
Total Assets	41.66	53.16	63.50	74.90	86.46	86.89
Total Loans	34.67	42.85	50.59	57.01	62.36	64.63
Real Estate Loans	14.00	22.34	25.58	28.99	30.35	31.01
PF Loans	5.63	12.55	12.24	11.10	12.28	12.25
ROA	0.61	1.38	0.67	-0.08	-0.85	-1.68

Source: KDIC, "Deposit Insurance Fund: Funding & Recent Issues," (2011)

4.3. MSB Failures after Launch of New DIF

4.3.1. Failure of MSBs

The default rates of MSBs' PF loans have been much higher than those of commercial banks' PF loans in the late 2000s and climbed up to 25 percent in December 2010 from 10.6 percent in December 2009. The default rates of MSBs' PF loans were higher than 20 percent, even after the worst portion of non-performing loans of MSBs were taken over by the bad bank created by the Korea Asset Management Corporation (KAMCO) on several occasions.

Table 4-30 | Trend of Default Rates of Project Finance Loans

(Unit: %)

Financial Institutions	June 2008	Dec. 2008	June 2009	Dec. 2009	June 2010	Dec. 2010	March 2011
Commercial Banks	0.7	1.1	2.6	1.7	2.9	4.3	5.3
MSBs	14.3	13.0	9.6	10.6	8.7	25.1	22.8
Insurance Companies	2.4	2.4	4.1	4.6	7.9	8.3	-
Securities Companies	6.6	13.9	24.5	30.3	29.5	29.8	26.6
Total	3.6	4.4	5.9	6.4	7.3	12.9	12.3

Source: Financial Supervisory Service, Son (2012)

Thirty-two MSBs failed during the period from 2003 to 2010. In particular, in 2011, as many as 16 MSBs went bankrupt.

Table 4-31 | Number of Business Suspensions of MSBs

(Unit: number of MSBs)

Year	2003	2004	2005	2006	2007	2008	2009	2010	2011	Total
	1	3	3	1	3	3	2	0	16	32

Source: KDIC (2011)

There are several reasons for the failures of MSBs since 2003. The reasons are (1) increasingly fierce competition in the financial industry, (2) sluggish local economy, (3) an increase in real estate project financing loans which are high-risk assets, (4) the economy falling into a recession after the global financial crisis in 2007, and (5) falling real estate prices causing many project financing loans to become problem loans.

The total assets of sixteen failed MSBs in 2011 amounted to 21,752.2 billion (21.8tn) won. Many MSBs failed because (1) an increasing number of project financing loans became defaulted, (2) the capital of MSBs eroded, and (3) MSBs ran out of liquidity as depositors withdrew their money from MSBs.

The Financial Services Commission declared sixteen MSBs as failed financial institutions and imposed business suspensions on them in 2011. Those MSBs have been put under the resolution procedure in accordance with the least cost test.

4.4. Threat to Financial Health of the DIF

There have been 16 failures of MSBs during the period from 2003 to 2010. The deficit in the MSB sector account of the DIF recorded 2,828 billion won as of the end of 2010 due to the continuous failures of MSBs. The deficit in the MSB sector account was covered by borrowings from other sectors' DIF accounts.

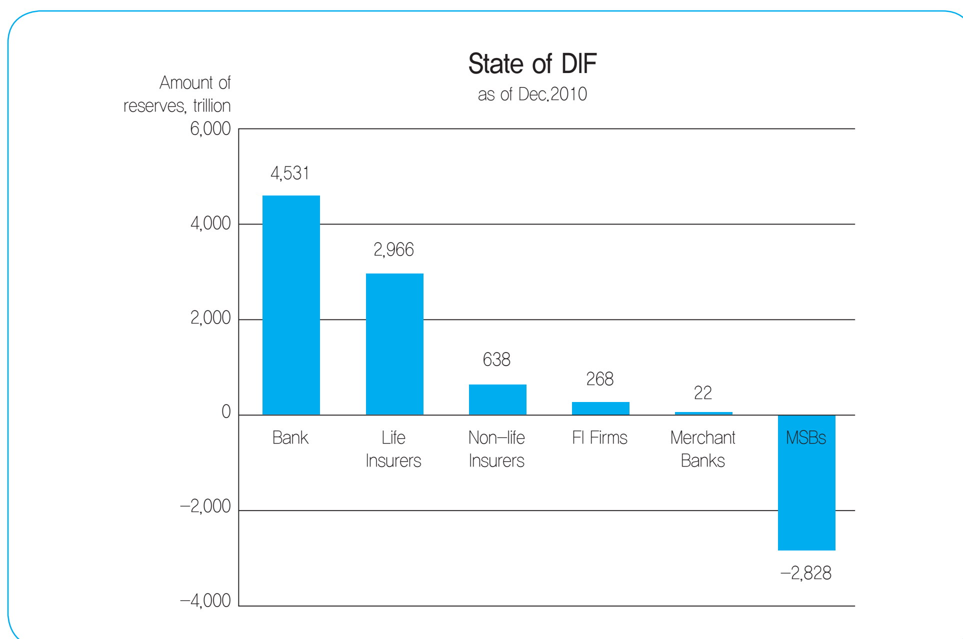
Table 4-32 | State of the Deposit Insurance Fund
(Cash Basis, As of the end of 2010)

(Unit: billion won)

Classification	Banks	FI Firm	Life Insurers	Non-life Insurers	Merchant Banks	MSBs	Total
Income	4714.6	294.8	3058.0	677.6	26.4	2,108.7	10,881.2
Expenditure	181.5	27.5	92.4	39.6	4.4	4,936.8	5,281.1
Difference	4,533.1	268.4	2,965.6	638.0	22.0	-2,828.1	5,599.0

Source: KDIC (2011)

Figure 4-3 | State of the Deposit Insurance Fund



Source: KDIC (2011)

4.5. Creation of a Special Account for Restructuring of MSBs

The KDIC and the government submitted a bill to the National Assembly which aimed to create a special account for restructuring MSBs as a part of measures to reinstate the financial health of the MSB sector account and the DIF. The bill was approved by the National Assembly in March 2011.

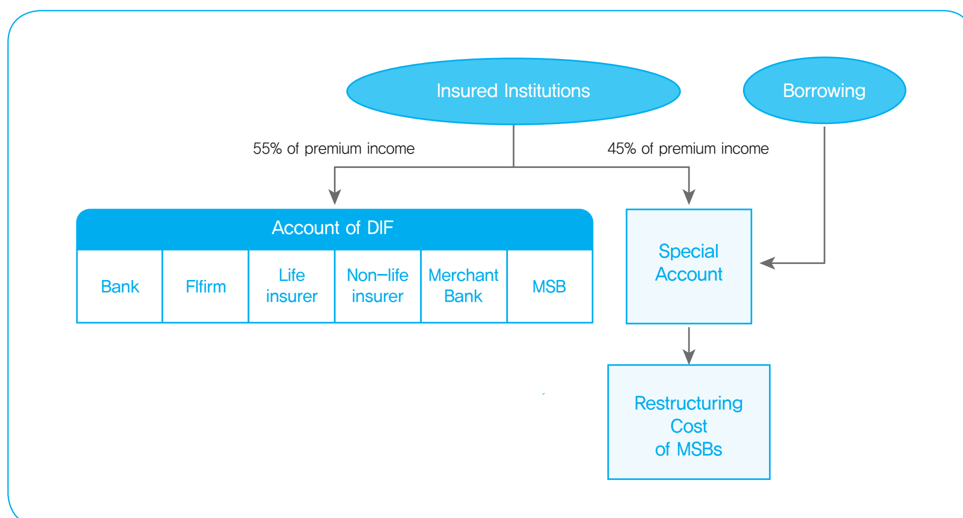
The cumulative deficits of the mutual savings banking sector reached 2.1 trillion won at the end of 2010.

The KDIC created the special account within the DIF separate from sector-specific accounts in April 2011. Forty-five percent (45/100) of insurance premiums paid by insured financial institutions will be allocated to the new special account on a temporary basis (effective for fifteen years until 2026) to support the resolution of failed MSBs that occur from January 2011.

The resolution of failed MSBs will be funded first with reserves in the mutual savings bank account. If the cost exceeds the reserves in the mutual savings bank account, then resources in the special account will be used.

The KDIC mobilized about 12.6 trillion won in total through insurance premiums, borrowings and bond issuances, and financed deposit payoffs to depositors of failed Samwha MSB and the resolution cost of other failed MSBs in 2011.

Figure 4-4 | Special Account Structure



4.5.1. Controversy over the Special Account

There has been a hot debate over the creation of the special account.

a. Opposition from other financial sectors

Five financial sectors other than the MSB sector opposed the creation of the special account. Their views can be summed up as follows:

(1) To create a special account to support restructuring the MSB sector violates the principle of managing a separate account for each financial sector;

(2) There is a risk that financing the deficit in the MSB sector's account with the resources of other sectors' accounts will lead to financial instability of other sectors' accounts;

(3) If resolution of failed MSBs are financed with resources mobilized with depositors' money from other financial sectors, it will impair depositors' confidence in the deposit insurance system and, furthermore, worsen the moral hazard of failing mutual savings banks.

b. The Necessity of the Special Account

Proponents of the special account argued that there are benefits of creating the special account:

(1) The special account will minimize taxpayers' burden;

(2) Restructuring of insolvent mutual savings banks could be implemented with timely fund raising;

(3) Systemic risk from spreading throughout the financial system could be prevented.

The government and the KDIC will take necessary measures to cope with adverse effects of the special account including:

(1) Raising insurance premiums of MSBs to 0.40 percent from 0.35 percent to prevent moral hazard of mutual savings banks;

(2) Pursuing stern punishment against those people who are responsible for causing bank failures through accountability investigation;

(3) Requiring the KDIC to submit a report to the National Assembly regarding how it will manage and settle the special account.

4.5.2. The Special Account for Restructuring of MSBs

In April 2011, the KDIC created the special account for restructuring mutual savings banks (MSBs) in the Deposit Insurance Fund to prepare financial resources that would be used to resolve insolvent MSBs and to guarantee the soundness of the mutual savings bank account in the DIF. Financial resources of the special account relied on deposit insurance premiums, borrowings and bond issuances.

To assist in the restructuring of failed mutual savings banks, the KDIC mobilized and provided 12.6 trillion won in financial assistance to reimburse depositors of insolvent mutual savings banks, including Samhwa Mutual Savings Bank, in 2011. As for the Special Account set up for the restructuring MSBs, a total of 10 trillion, 419.9 billion won was borrowed from insured financial institutions including banks. By issuing "Deposit Insurance Fund (DIF) Bonds for Special Account for MSB Restructuring" in December 2011 without a government guarantee, the KDIC repaid 1.2 trillion won of the borrowings from banks.

Table 4-33 | Preparation and Use of the Special Account (As of December 31, 2011)

(Unit: trillion won)

<table>
<tr><th colspan="3">Amount Provided in Financial Assistance</th><th colspan="2">Amount Raised</th></tr>
<tr><td rowspan="2">8 MSBs including Samhwa MSB</td><td rowspan="2">Provisional payment, deposit payoffs, advance payment of bankruptcy dividends, contributions, etc.</td><td rowspan="2">7.7</td><td>Transfer from other accounts</td><td>1.8</td></tr>
<tr><td>Borrowings from local banks</td><td>10.4</td></tr>
<tr><td>8 MSBs including Kyongeun MSB</td><td>Provisional payment, deposit payoffs, etc.</td><td>4.9</td><td>Deposit insurance premiums, etc.</td><td>0.4</td></tr>
<tr><td colspan="2">Total</td><td>12.6</td><td>Total</td><td>12.6</td></tr>
</table>

Source: KDIC (2012)

In 2011, a total of 12 trillion, 592 billion won was extended to 16 insolvent mutual savings banks from the Special Account of the DIF. For the 16 failed mutual savings banks, the KDIC made deposit payoffs including provisional deposit payments and extended financial assistance.

Table 4-34 | Financial Assistance and Deposit Payoffs from the Special Account of DIF (2011)

(Unit: billion won)

Account	Equity Investment	Contribution	Deposit Payoffs	Loans	Advance Payment of Bankruptcy Dividends	Total
Banks	-	-	-	-	-	-
Insurance Companies	-	-	-	-	-	-
Financial Investment Companies	-	-	-	-	-	-
Merchant Banks	-	-	-	-	-	-
MSBs[1]	-	-	-	-	-	-
Special Account	97.2	5,851.3	6,545.0	56.7	41.8	12,592.0
Total	97.2	5,851.3	6,545.0	56.7	41.8	12,592.0

Note: 1) The MSB account did not receive additional assistance in 2011
Source: KDIC (2012)

Chapter 5

Assessment and Policy Implications

1. Adoption of Explicit Deposit Insurance System
2. Korean Deposit Insurance Scheme and Contributions
3. International Comparison of Financial Restructuring
4. Policy Implications to Developing Countries

Assessment and Policy Implications

1. Adoption of Explicit Deposit Insurance System

The goals of implicit deposit protection systems (IDPSs) and explicit (formal) deposit insurance systems (EDISs) are fundamentally the same – to promote financial stability and to protect small depositors from losses when financial institutions fail. However, there are some differences in the features of IDPSs and EDISs. The EDIS results in faster and smoother failure resolutions because it operates on the basis of established rules and procedures set in deposit insurance law. In contrast, the whole process of dealing with failing financial institutions and protecting depositors of an IDPS is discretionary and ad hoc. The government will have to decide a source of funding. Moreover, an IDPS is liable to be subject to substantial political pressures, thereby producing less foreseeable and consistent results over time.

Events during the Asian financial crisis of 1997 and the global financial crisis of 2007-2208 demonstrated the importance of effective depositor protection schemes. It is an enormous challenge for the developing countries to design and operate an efficient deposit insurance system. One challenge is to strike an optimal balance between the benefits of preventing crises in advance and the cost of controlling insured financial institutions and customer risk-taking. There are various different designs for deposit insurance arrangements that may meet the objectives of deposit insurance systems. Deposit insurance arrangements should be adaptable to country environments and circumstances.

The global financial crisis of 2007-2008 provided lessons for countries that operate the deposit insurance system. The effectiveness of their deposit insurance systems in protecting depositors and maintaining financial stability was put to the test. The prompt adoption of extraordinary arrangements to improve depositors' confidence by many countries with

deposit insurance systems reveals the importance and necessity of operating an effective deposit insurance system.

The global financial crisis prompted changes in the prevailing views about the role of the deposit insurance system. The crisis brought about convergence in practices and provided the momentum for consensus about the proper design features to come out. The explicit limited deposit insurance system has been chosen by many Financial Stability Board member countries including Korea.

Prudential regulations set up the outside limits and constraints imposed on financial institutions to ensure the safety and soundness of the financial system. Prudential regulations are essential elements to prevent and limit the losses caused by poor management of financial institutions. The absence or weakness of prudential regulations in important areas could result in failures of financial institutions and systemic instability. Regulation and supervision can contribute to minimize the adverse effects of moral hazards and relative price shocks on the financial system, thus reducing the likelihood of failures of financial institutions and financial system distress. In countries with inadequate and ineffective supervision and regulation, deposit insurance may offer a false sense of security and result in the taking of reckless and undesirable risks.[37] The effects of the explicit deposit insurance are strongly dependent on the quality of banking regulation and supervision.

2. Korean Deposit Insurance Scheme and Contributions

In the beginning, the Korean deposit insurance system was classified as a ”pay-box system” in view of its role and responsibilities defined by its law and actual business activities. The Korean deposit insurance system was not intended to deal with systemic crises like the 1997 financial crisis. However, the rights of the KDIC were enhanced in several ways during the process of financial restructuring after the financial crisis. The Korean deposit insurance system has developed an advanced administrative process for resolving failures of financial institutions and has been, in general, effective in protecting small savers. Now the KDIC is classified by the Financial Stability Board as a deposit insurer with a “risk minimizer” mandate.

The outbreak of the financial crisis caused many decisions and events that had a huge impact on the deposit insurance system. The limited coverage system was changed to one of blanket coverage to stabilize the financial system during the crisis and to protect depositors. As a result, the deposit insurance scheme in Korea has become considerably exposed to moral hazard problems. The government reintroduced a limited coverage system in January

37. Polizatto (1992).

2001 as planned to deal with the moral hazard problem and to strengthen market discipline after the second round of restructuring was finished. The KDIC raised the coverage limit from 20 million won to 50 million won in order to prevent withdrawals by large depositors and to maintain financial stability.

Insurance premium rates for insured financial institutions were raised several times after the financial crisis of 1997 to strengthen and reinstate the financial health of the Deposit Insurance Fund. Insurance premium rates for banks and mutual savings banks reached 0.08% and 0.40%, respectively. In June 2010, the KDIC announced "the Plan for the Launch of the Differential Premium System in 2014". The KDIC is expected to implement a risk-based insurance premium system in 2014.

The single integrated deposit insurance system in Korea provides protection for up to 50 million won to deposits held by not only banks, but also finance investment companies, insurance companies, merchant banks and mutual savings banks. In order to deal with the shortcomings of the single integrated deposit insurance system, the deposit insurer should differentiate the size of the deposit protection for each financial sector based on idiosyncratic features and varying degrees of risk of each financial sector.

The Financial Services Commission (FSC) decides the resolution method and thus it is responsible for adopting the least-cost resolution method. The KDIC implements the approved resolution method and thus it is responsible for maximizing recovery given the resolution method decided by the FSC. The KDIC has a responsibility and compelling incentive to adopt the least-cost resolution method because it is responsible for implementing the least-cost resolution and attaining maximum recovery. In the late 2000s, the KDIC began to participate in the decision-making process of the resolution method when the FSC determined the resolution method of failed mutual savings banks. The deposit insurance agency should be proactive in resolution planning process to minimize the loss in resolving insolvent financial institutions.

Forbearance of failing mutual savings banks resulted in a huge increase in cost of resolving insolvent mutual savings banks in the 2010s in Korea. Prompt resolution of failing mutual savings banks could have saved much financial resources of the Deposit Insurance Fund.

Since effective prudential regulation and prompt corrective action are important factors that influence the appropriate size of the deposit insurance fund (DIF), the KDIC put priority on the risk control activities in the deposit insurance system.

Although the KDIC did not have sufficient experiences and knowledge during the financial crisis of 1997, the KDIC has concentrated its resources in supporting the nation's restructuring process and significantly contributed to the task of completing the financial

restructuring. Under a variety of constraints, the KDIC has endeavored to strengthen its role and function, which is aimed at protecting depositors, preventing the failure of insured financial institutions, and contributing to the stability of the financial system and market.

The swift and effective financial and corporate restructuring orchestrated by the Financial Supervisory Commission (FSC) with the help of the Ministry of Finance and Economy (MOFE) and implemented by the Korea Deposit Insurance Corporation (KDIC) and the Korea Asset Management Company (KAMCO) have facilitated effective turnarounds among financial institutions. The swift injection of public funds into troubled banks, and recapitalization of banks by the KDIC, enabled many banks to maintain the BIS capital adequacy ratios of 10-13 percent by the end of 1999. Banks could resume the supply of credit to companies. The resumed adequate supply of credit by banks contributed significantly to ameliorating the stifling credit conditions facing companies and easing the credit crunch and ending the vicious circle of mutually reinforcing stresses in the financial and corporate sectors. Expanded bank lending to companies was one of the preconditions for the financial support to banks by the government and the KDIC. Also, the supply of credit to small- and medium-sized enterprises (SMEs) could be resumed in the course of restructuring.

The substantial financial restructuring and the financial support of public funds by the KDIC and KAMCO coordinated by the government have established the foundation for a healthier and more efficient financial system in Korea. In the course of the financial restructuring, around 670 non-viable financial institutions were closed. The Korean financial sector has been significantly consolidated during the financial restructuring. The KDIC provided the financial support of public funds worth of approximately 102 trillion won to the troubled financial institutions, and spent about 30 trillion won for insurance claims payout to depositors of failed financial institutions. The KDIC had also spent about 48 trillion won and around 17 trillion won for equity participation and contribution to financial institutions, respectively. KAMCO had spent about 39 trillion won of public funds to resolve non-performing assets of troubled financial institutions.

The aggressive and comprehensive financial restructuring led to remarkably improved health in the financial services industry. The average BIS capital adequacy ratio of banks that once fell to 7.0 percent (at the end of 1997) drastically improved to 11.7 percent by the end of 2001. The stability in the financial market was very much enhanced.

The fast and unwavering resolution of non-performing loans with public funds reduced the NPL ratio from 12.9 percent at the end of 1999 to 3.4 percent at the end of 2001.

The return on equity (ROE) of banks that had declined to -11.5 percent and -51.7 percent in 1997 and 1998, respectively, jumped up to 12. 8 percent in 2001 after the restructuring as

financial institutions reformed their credit risk management and huge amount of previous non-performing loans were resolved with public funds.

Creditor financial institutions that have met, at least, the minimum capital requirement with the financial support of the KDIC could participate in the corporate restructuring, including the corporate workouts program for distressed or failing companies, orchestrated by the FSC.

The consolidated Financial Supervisory Commission (FSC) was established in early 1998, just after the financial crisis in 1997, and orchestrated the financial and corporate restructuring with the help of the Ministry of Finance and Economy. The KDIC was established in 1996, a year ahead of the financial crisis. The Non-Performing Asset Management Fund (NPAF) was set up in KAMCO before the financial crisis. The FSC, the MOFE, KDIC and KAMCO performed crucial roles in the restructuring.

3. International Comparison of Financial Restructuring

Thailand, Indonesia and Korea suffered from the Asian financial crisis that erupted in 1997; Malaysia was buffeted by the Asian financial crisis. These four countries implemented comprehensive financial restructuring strategies. The allocation of responsibilities for dealing with the financial restructuring was a critical first step in the restructuring strategy. Governments of these four countries set up a variety of institutional structures in order to conduct bank restructuring after the financial crisis. The overall institutional structure of financial restructuring in these four countries is similar. Public Asset Management Companies (AMCs) were established to resolve non-performing assets. Deposit Insurance Agency (in Korea) or other special fund and/or agency set up by the government (in Indonesia) or central banks (in Thailand and Malaysia), implemented resolution of failing financial institutions, protected depositors of insolvent financial institutions, and provided liquidity support to troubled financial institutions. Private institutions closely monitored by the financial regulators and/or central banks mediated corporate restructuring in conjunction with financial restructuring.[38]

3.1. Indonesia

In Indonesia, no institution was in charge of bank restructuring until the Indonesian Bank Restructuring Agency (IBRA) was set up in January 1998 under the auspices of the Ministry of Finance. Initial problems in giving adequate legal and regulatory powers to the IBRA postponed the effective part of bank restructuring and asset management. In October 1998,

38. Dongsoo Kang (2003).

the banking law was amended. These amendments of the banking law terminated restrictions on foreign ownership of banks and also empowered the IBRA to operate effectively.[39]

The banking crisis in Indonesia, which at first was limited to some unsound banks, subsequently developed into an overall systemic crisis. Bank reconstruction measures, which started with the abrupt closure of 16 banks, were another factor that amplified the turbulence. Main problems in the bank reconstruction process included, among others, the fact that the introduction of the blanket guarantee for bank deposits were postponed until January 1998, and that the authority of the IBRA was not elucidated until 13 months after its establishment. The measures that the central bank of Indonesia announced in November 1997 included insurance coverage for deposits of 20 million rupiahs or less, which covered 93 percent of all depositors. However, unprotected large depositors at the 16 closed banks and large depositors at other banks became surprised, leading to runs on banks. Then, at the end of January 1998, the central bank of Indonesia finally introduced a blanket guarantee system for all deposits, and liquidity support loans offered by the central bank of Indonesia to affected banks during the intervening three months recorded 46 trillion rupiahs (equivalent to 4.5 percent of GDP).[40]

As of mid-1999, the public contribution to financial sector restructuring has amounted to 51 percent of GDP. The largest shares of the contribution have been used for recapitalization of banks including outlays for deposit guarantee (23% of GDP) and for central bank liquidity support assumed by the budget (12% of GDP). The contribution has also been used for purchases of non-performing loans or capital for asset management company (12% of GDP). The government and the IBRA strengthened their loan recovery efforts.[41]

The government decided to establish a deposit insurance agency in 2004. The government plan called for the gradual decrease in the ceiling on the guaranteed deposits from the full amount at first to 100 million rupiahs (about U.S, $12,000) by 2007.[42]

39. Carl-Johan Lindgren, Tomas Balino (1999).

40. Yuri Sato (2005).

41. Carl-Johan Lindgren, Tomas Balino (1999).

42. Yuri Sato (2005).

Table 5-1 | International Comparison in Crisis Management Structure

	Corporate Restructuring	NPL Resolution	Failing Financial Institution's Resolution
Korea	CRCC → CRASC	KAMCO	KDIC
Thailand	Corporate Debt Restructuring Advisory Committee (CDRAC) → Thai Asset Management Corporation (TAMC)	Financial Sector Restructuring Agency (FRA) Asset Management Corporation (AMC) → Thai Asset Management Corporation (TAMC)	Financial Institutions Development Fund (FIDF)
Indonesia	Jakarta Initiative Task Force (JITF)	Indonesian Bank Restructuring Agency (IBRA)	Indonesian Bank Restructuring Agency (IBRA)
Malaysia	Corporate Debt Restructuring Committee (CDRC)	Danharta (Asset Management Company)	Danamodal (Bank Recapitalization Company)

Source: Dongsoo Kang (2003)

3.2. Thailand

In Thailand, no new agency was established with specific responsibilities for bank restructuring. The Financial Institutions Development Fund (FIDF), a legal entity within the Bank of Thailand, has been in charge of managing liquidity and solvency support to intervened banks. Most decision-making has been done by the Ministry of Finance. The FIDF has been hindered by a lack of well-defined legal power. The Financial Sector Restructuring Agency was established to assess the viability of the 58 suspended finance companies and to liquidate the assets of the 56 companies that were closed.[43]

During the Asian financial crisis that began in Thailand in 1997, the Thai government's Financial Institutions Development Fund (FIDF) announced that it would fully protect all financial institutions' deposits in case of bankruptcy or closure. During the 1997 financial and economic crisis, the FIDF had to assume more than THB 1.3 trillion of liabilities to rescue depositors and creditors of failed financial institutions and banks.

The Deposit Protection Act was established to take effect in August 2008. Under the new Act, 38 designated financial institutions are required to pay 0.04 percent of their average annual insured deposit accounts into the Deposit Insurance Protection Fund that was initially funded with THB 1 billion. The Deposit protection Act (DPA) of 2008 initially aimed at decreasing taxpayer losses during any future financial crisis by imposing a ceiling

43. Carl-Johan Lindgren, Tomas Balino (1999).

on state coverage of bank failures. In the first year from August 2008 to August 2009, the Deposit Insurance Protection Fund covered 100 percent of all deposits in the designated financial institutions. However, the insured amount was gradually reduced to THB 1 million beginning in August 2012.[44]

During the Asian financial crisis, the FIDF conducted quasi-fiscal activities such as providing full guarantee to the depositors and creditors of closed financial institutions, recapitalizing numerous financial institutions, and bearing the additional cost of non-performing assets of financial institutions transferred to the Thai Assets Management Corporation (TAMC). The Bank of Thailand (BOT) estimated the FIDF's losses at THB 1.4 trillion. A portion of FIDF's losses has been covered by the issuance of THB 500 billion worth of government bonds in 1998. In 2000, the FIDF issued FIDF bonds worth THB 112 billion with a government guarantee to reimburse the losses. In September 2002, THB 305 billion of savings bonds were issued to repay a portion of the FIDF's liabilities in the money market. In summary, in total THB 0.9 trillion of the estimated financial institutions restructuring cost of THB 1.4 trillion has been reimbursed. Payments of principal on bonds issued for financing the FIDF losses are expected to come from mostly the BOT's proceeds from operations, while the government is expected to reimburse the interest payments.[45]

3.3. Malaysia

In Malaysia, an institutional framework supported by legislation was already in place. The restructuring has been coordinated by the Steering Committee on Restructuring chaired by Bank Negara Malaysia and includes managers of the three other agencies such as Danamodal (the bank recapitalization company), Danaharta (the asset management company), and the Corporate Debt Restructuring Committee (the corporate restructuring agency). Danamodal was established in August 1998 as a limited liability company wholly owned by Bank Negara Malaysia.

The objectives of Danamodal were to provide new capital to undercapitalized banks and facilitate the rationalization of the banking system. Danamodal played a supportive and complementary role in the overall government's program towards the consolidation and restructuring of the banking system. The general policy positions of Danamodal included principles of reining in the use of public funds and discovering least-cost solutions to the government. Bank Negara Malaysia injected RM 3.0 billion as seed capital into Danamodal. Danamodal mobilized a further RM 7.7 billion by issuing zero-coupon bonds

44. Tummanon, Anchalee, "Deposit insurance will change Thai banking landscape," Asia-Pacific Housing Journal, 2012.

45. Yuwawan Rattakul, "Thailand's recent public debt issues," BIS Paper No. 20, 2003.

in October 1998. As of the end of March 1999, Danamodal have spent 2 percent of GDP for recapitalization of banks and deposit guarantee.[46]

Bank Negara Malaysia (BNM) announced explicitly on September 1, 2005 that all depositors will get their deposits back should a bank fail in its operation. The official announcement by the BNM made an obvious difference to the previous implicit guarantee from the government. The Malaysian deposit insurance system is administered by the independent statutory body, the Malaysian Deposit Insurance Corporation (MDIC). Under the deposit insurance system, eligible deposits will be insured up to the prescribed limit of RM 60,000 per depositor, per member institution. After this, an amendment was made in October 2008 where MDIC announced that 100 percent of the deposit is fully guaranteed in case of bank collapse. To participate in the deposit insurance system, the financial institution will have to pay a flat-rate insurance premium of either 0.02% of their total deposits, or 0.06% of their total insured deposits, with a minimum of RM 250,000.[47]

The MDIC examined commercial banks documents and decided to report them to the Bank Negara Malaysia (BNM) and compel the commercial banks to reform bank operations. Under such power, the MDIC had the right to order seriously mismanaged financial institutions to temporarily end the business for consolidation. In extreme cases, the MDIC could withhold insurance coverage.[48]

4. Policy Implications to Developing Countries

Korea's experiences of implementing and operating the deposit insurance system during the financial crisis of 1997 and thereafter provide following policy implications to developing countries.

Events during the financial crisis of 1997 revealed the importance of effective and explicit prefunded depositor protection systems. Korea's experiences of adopting and operating the explicit prefunded deposit insurance system demonstrate that the explicit prefunded deposit insurance scheme is a better choice than reliance on implicit deposit protection.

The KDIC was established in June 1996 and embarked on the task of deposit insurance protection as an ex-ante prefunded system for banks. In addition, each non-bank financial sector had its own method of depositor protection, usually in the form of a fund. As the financial crisis occurred in late 1997, the government could immediately use the KDIC as an instrument of public policy. The government and the KDIC could implement faster and

46. Carl-Johan Lindgren, Tomas Balino (1999).

47. Tuan Hock Ng, Ying San Lim and Nya Ling Tan (2010).

48. Devinaga Rasiah and Peong Kwee Kim (2011).

smoother failure resolutions of insolvent financial institutions because they could operate on the basis of established rules and procedures set in the Depositor Protection Act. The KDIC acted as agent of the government to issue Deposit Insurance Fund bonds guaranteed by the government, executed resolution methods determined by the Financial Supervisory Commission (FSC), and fulfilled recovery functions. The functions of KDIC were expanded in several ways to support and facilitate the process of financial restructuring of insolvent financial institutions after the financial crisis.

The explicit prefunded deposit insurance scheme in Korea has been a part of a well-designed financial safety net, supported by strong prudential regulation and supervision of financial institutions conducted by the Financial Services Commission (FSC) and the Financial Supervisory Service (FSS), effective laws that are established and enforced by the Ministry of Strategy and Finance (MOSF) and the government, and an adequate amount of deposit insurance funds and public funds mobilized by the government and the KDIC.

One lesson of the 1997 financial crisis with regard to the deposit insurance system in Korea is the importance of speedy and decisive reaction by authorities, including the government, financial regulatory and supervisory authorities, and deposit insurers, to restructure failing financial institutions, contain losses, and eliminate the underlying causes that triggered the crisis. Swift and effective resolution mechanisms orchestrated by the Financial Supervisory Commission (FSC) with the help of the Ministry of Finance and Economy (MOFE) and implemented by the Financial Supervisory Services (FSS), the Korea Deposit Insurance Corporation (KDIC) and the Korea Asset Management Company (KAMCO) have been crucial for constraining losses and for preventing prolongation of harmful effects of financial crises on the financial system as well as real economy in Korea.

A greater emphasis should be placed on early detection and warning of potential problems, timely identification of risks and intervention in failing financial institutions. The Financial Supervisory Commission (FSC) and the Financial Supervisory Services (FSS) adopted and implemented the prompt corrective action (PCA) system to deal with problem financial institutions. The KDIC has endeavored to improve risk surveillance of insured financial institutions to facilitate the early detection of risks and prevent those risks from leading to failures of financial institutions. However, since the Depositor Protection Act (DPA) that defines the scope of duties of the KDIC does not include a provision for proactive risk surveillance, risk surveillance activities of the KDIC have been constrained.

The deposit insurer should adopt the blanket insurance coverage system during the financial crisis in order to improve and maintain depositors' confidence and to stabilize the financial system, and then reintroduce a limited coverage system when deemed appropriate. In Korea, limited coverage was changed to blanket coverage to stabilize the

financial system and to protect depositors during the financial crisis of 1997. The Korean government reintroduced a limited coverage system in January 2001 to deal with the moral hazard problem and to strengthen market discipline after the second round of financial restructuring was finished.

The single integrated deposit insurance system in Korea provides protection for up to 50 million won to deposits held by not only banks, but also by finance investment companies, insurance companies, merchant banks and mutual savings banks. However, in order to deal with shortcomings of the single integrated deposit insurance system, the deposit insurer should differentiate the size of the deposit protection for each financial sector based on idiosyncratic features and varying degrees of risk of each financial sector. Coverage limits are especially important in controlling moral hazards.

Prompt resolution of failing insured financial institutions can save many depositors and much financial resources of the deposit insurance fund. Forbearance of failing financial institutions would result in huge increase in cost of resolving insolvent financial institutions. The deposit insurance agency should be proactive in resolution planning processes to minimize the loss in resolving insolvent financial institutions. In the late 2000s, the KDIC began to participate in the decision process of the resolution method when the FSC decided the resolution method of failed mutual savings banks.

The deposit insurance agency should endeavor to use the least-cost resolution method to minimize the losses on the deposit insurance fund and thus, the burden on depositors and taxpayers. The Financial Services Commission (FSC) and the Korea Deposit Insurance Corporation (KDIC) have been responsible for conducting the least-cost resolution method in the resolution of failing financial institutions.

The deposit insurance system should ensure that adequate deposit insurance funds are available to deal with problems as they occur. An adequate amount of deposit insurance funds and public funds, and timely funding, are necessary to implement the financial restructuring of the insolvent financial institutions and to protect depositors. A deposit insurance system with a large deficit or insufficient insurance funds would not be able to implement the financial restructuring and to protect depositors. Inadequate funding may lead to delays in resolving insolvent financial institutions and a considerable increase in resolution costs. In Korea, the KDIC did not have adequate resources to cover the costs of implementing the financial restructuring and protecting depositors. Therefore, the government had to arrange public funds. The KDIC mobilized 81.6 trillion won of public funds during the period from November 1997 to June 2011 by issuing Deposit Insurance Fund (DIF) bonds guaranteed by the government to support the financial restructuring and to protect depositors.

The government and the KDIC suffered from a shortfall of public funds towards the end of 1999. However, timely funding has been postponed due to political and bureaucratic interests and consideration in mobilizing the second-round public funds. Belatedly, the second-round public funds were mobilized by issuing 40 trillion won of DIF bonds during the period from December 2000 to December 2001.

Insufficient funds in the MSB account of the Deposit Insurance Fund (DIF) may have been one of factors that led to forbearance of failing mutual savings banks and then resulted in huge increases in the cost of resolving insolvent mutual savings banks in the 2010s in Korea. The government and the KDIC had to create the special account for restructuring mutual savings banks (MSBs) as a part of measures to reinstate the financial health of the MSB sector account and the Deposit Insurance Fund (DIF) because the MSB sector account of the DIF recorded large deficits due to continuous failures of the MSBs.

The deposit insurer should set the target amount of the deposit insurance fund. In Korea, the KDIC implemented a Target Fund System and set target fund levels for five financial sectors, including the banking sector, in September 2009. The target size of the deposit insurance fund per financial sector should be set at an amount sufficient to cover future losses. The deposit insurance fund per financial sector should be independently managed and should not duplicate the Korean DIF's unpleasant experiences of creating the special account for restructuring MSBs in the DIF. In principle, the reserve deposit insurance fund of different financial sectors should not be mobilized to cover losses of the deposit insurance fund of a particular financial sector.

A deposit insurance agency should have powers to implement its mandate efficiently and these powers should be formally specified. In the beginning, the Korean deposit insurance system was a "pay-box system" in view if its role and responsibilities and the KDIC could not implement its responsibilities effectively during the financial restructuring of insolvent financial institutions after the financial crisis.

The Deposit Protection Act had to be revised several times to support the expanding mandates of the KDIC to facilitate the financial restructuring of insolvent financial institutions and to strengthen the financial health of the deposit Insurance Fund (DIF) after the financial crisis in Korea.

The deposit insurance agency should be made financially and operationally independent and accountable and shielded from inappropriate political and industry influence. The Korean government and the KDIC have been under heavy political pressure to expand the deposit insurance coverage to deposits of more than 50 million won at several insolvent mutual savings banks (MSBs) under the limited deposit protection system in 2000s.

The deposit insurer should implement a risk-based deposit insurance system to mitigate the problem of moral hazards. The risk-based insurance premium system can play a significant role in disciplining the risk-taking behavior of insured financial institutions. It can thereby reduce the burdens which the deposit insurer should bear in lessening the potential losses to the deposit insurance fund. The KDIC is expected to implement a risk-based insurance premium system in 2014.

The deposit insurer should be given certain instruments that would be available to a private insurer to constrain costs. These include: 1) The ability to promptly stop the insurance coverage when a financial institution is operating in a precarious manner, and 2) the authority to examine and assess risk at all insured financial institutions. Since the Depositor Protection Act (DPA) does not give the KDIC such tools, the capabilities to control costs of the KDIC have been constrained.

In order to effectively and efficiently conduct the technical matters related with responsibilities of the deposit insurer, in particular during a financial crisis, the deposit insurance agency should endeavor to strengthen its capacities in the core financial areas, such as operation of the deposit insurance fund, risk management, resolution and recovery, and supporting management information systems. Furthermore, the deposit insurance agency needs to design and implement a comprehensive human resource development program to improve staff skills. The KDIC had recruited many experts and lawyers to conduct its business efficiently and effectively during the financial restructuring of insolvent financial institutions after the financial crisis.

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