Notes to this edition

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*A Comparative Study of East Asian Capitalism*
Hong Yung Lee, editor


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In the course of industrialization, both Japan and South Korea (hereafter “Korea”) have consolidated a similar bank-centered financial system for economic development. A bank-centered financial system was consolidated in Japan during the War Economy period (1937–1945) (Noguchi 2002), and Korea’s creation of a bank-centered modern financial system was shaped during the period of Japanese colonial occupation (1910–1945) (see Cole and Park 1983; Kim 1994; T. H. Chung 2000; B. U. Chung 2000, 2004). The colonial imprint remained even after the liberation from colonial rule during Korea’s economic take-off in the early 1960s and 1970s. Learning from the experiences of postwar Japan, the Korean government established specialized development banks to mobilize scarce domestic capital and to allocate it into select firms, chaebols, in order to develop strategic industries for exports (Vittas and Wang 1991; Cargill 1998; Ikeo, Hwang, and Takao 2001). The Korean government also emulated Japan’s “main bank” system, in which banks play a pivotal role in mediating bank-firm relations based on long-term business relations (Aoki and Patrick 1995), as well as its policy financing practices (Cho and Kim 1997; Development Bank of Japan 1994; Cho and Hellmann 1993). While an attempt to emulate the Japanese main bank system, the Korean government’s introduction in the late 1970s of a “principal transactions bank” also was intended to increase government control over chaebols, and, more specifically, to prevent chaebols from over-borrowing from particular banks (Nam and Kim 1994). Until the 1990s, no banks had failed in either country.

In the late 1990s, both Japan and Korea were confronted with a similar problem in the banking sector: growing numbers of Non-Performing
Loans (NPLs). At the end of 1998, the total NPLs in the Korean banking sector amounted 17.8% of Gross Domestic Product (GDP) and 16.8% of all bank loans were NPLs. In March 1999, Japan’s NPL ratio to GDP was 6.7% and the NPL ratio to total bank loans was 6.2%. The NPL problem in both countries escalated into a systemic banking crisis. Under the circumstances, both governments have adopted similar policy measures for speedy resolution of NPLs. Both governments have injected public funds into failing banks to help strengthen the capital base and established a public asset management company—the Korea Asset Management Corporation (KAMCO) in Korea and the Resolution and Collection Corporation (RCC) in Japan—to remove NPLs from the banking sector and to liquidate them in a centralized manner.

Despite the similarity in policy measures, we can observe significant differences in economic outcomes. The Korean government injected public funds, reaching about 16.4% of average GDP between 1998 and 2000, in a very decisive way, while the Japanese government used public funds in an intermittent and indecisive way. The Korean government used about six and a half times more public funds in proportion to GDP for bank recapit-

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1 A non-performing loan is a loan that is in default or close to being in default. The definition of “non-performing” has varied in both Japan and Korea. In the past, loans in default more than six months were classified as non-performing loans, but after the financial crisis in 1997 and 1998, both governments adopted stricter standards; currently, loans in default more than three months are classified as non-performing loans.

2 As the standards of classifying NPLs are a bit different in both countries, we cannot directly compare this NPL ratio. However, under any definition, the NPL problem was much more serious in the Korean banking sector.

3 A systemic banking crisis can be defined as a situation in which both corporate and financial sectors go through a large number of defaults.

4 Recent studies on systemic banking crises have confirmed that past systemic banking crises were ultimately solved by injecting public money in the process of recapitalizing banks and purchasing troubled debts from banks (see Haldane and Kruger 2001; Enoch, Garcia, and Sundararajan 2002; Honohan and Laeven 2005), and by establishing public asset management companies to transfer and resolve troubled assets in a centralized manner (see Klingebiel 2000; Ma and Fung 2002; Fung 2004; He 2004). For example, after the major financial crises of the 1980s and 1990s, governments, on average, used fiscal support for the financial restructuring of about 16% of GDP (see Laeven and Valencia 2008). Between 1991 and 1993, Finland used fiscal support to restructure about 8% of GDP, Norway restructured about 3 to 4% of GDP between 1987 and 1989, Sweden restructured about 4 to 6% of GDP between 1990 and 1993. Mexico restructured about 14% of GDP between 1995 and 1997, and Argentina restructured the largest amount, about 55% of GDP between 1980 and 1982. Recently, the United States government also injected more than 14% of GDP to recapitalize and purchase toxic assets under the Troubled Asset Relief Program.

5 This amount is based on the public funds used only for bank recapitalization. If we include the entire amount of public funds injected to recapitalize non-banking sectors, it increases to about 32% of GDP in 2002. For more detail, see Kang (2009).
talization than the Japanese government, which allocated only about 2.5% of GDP in public funds for bank recapitalization. Interestingly, the Japanese government was allowed by the Diet (the legislature) to use public funds totaling 75 trillion yen (60 trillion yen in 1998 and 1999, plus 15 trillion yen by 2002), but the government actually injected only 16.5% of the total reserve of public funds (10.4 trillion yen in 1998 and 1999 and about 2 trillion yen in 2003) for bank recapitalization. Considering the scale of NPLs in the banking sector—each year between 1998 and 2006, Japanese banks held at least 30 trillion yen in NPLs—this injection of funds was very minimal and insufficient for swift bank recapitalization.

Meanwhile, the actual performance of the RCC and the KAMCO is different as well. The KAMCO purchased NPLs valuing a total of 39 trillion won from all types of financial institutions between 1998 and 2006; those transferred NPLs were fully collected, at a 105.3% collection ratio, for a total of 41.5 trillion won. The annually transferred NPLs to the KAMCO, on average, were over 12 trillion won, which was 71.0% of total NPLs in the banking sector. In contrast, those NPLs transferred from banks to the RCC were very minimal. The RCC purchased NPLs worth a total of 4 trillion yen from 1999 to 2006, which annually was only 500 billion yen, less than 2.8% of annual total NPLs in the banking sector during the period. Interestingly, from 1999 to 2006, not a single city or trust bank sold their bad assets to the RCC. Most of the purchased bad assets originated from small and weak financial institutions such as credit unions or credit cooperatives. We can claim reasonably that the KAMCO played a most critical role in resolving the NPL crisis in the Korean banking sector, but the role of the RCC was very limited and minimal.

These differences in similar policy operations and performance of asset management companies have significantly influenced the speed of NPL resolution. Korea was much faster in NPL resolution, although the problem there was much more serious. It took less than three years for Korea to reduce the NPL ratio to below 4% of total loans, which is regarded internationally as a normal rate of NPLs under normal business conditions; the Korean

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6 The percentage was calculated as follows: The sum of the total NPLs in banks from 1998 to 2006 was divided by nine years to obtain the average annual NPLs held by banks. That amount, 30.3 trillion won, was then multiplied by 0.56, because the percentage of NPLs transferred from banks to the KAMCO out of the total NPLs transferred to the KAMCO was 56%. It is the annual average of NPLs in the banking sector: 30.3 trillion won × 56% = 16.9 trillion won. Then, the annual average of transferred NPLs to the KAMCO (12 trillion won) was divided by this figure (18.8 trillion won).

7 This amount is based on the Financial Revitalization Law account, one of three accounts of the RCC. The RCC was established according to the Financial Revitalization Law in October 1998.
banking sector was rapidly stabilized within three years of the crisis beginning in late 1997. In contrast, in Japan, it took about seven years to resolve the NPLs from the start of the banking crisis in 1997, with the ratio falling below the 4% level only in 2004. The NPL ratio even increased between 1999 and 2001, and then finally began to drop slowly in 2002. During that period, Japanese banks suffered from declining profitability (see table 3.1).

The different speeds at which the NPLs were resolved and the banking sectors recovered present intriguing comparative questions: Despite similar policy measures taken to resolve the NPL problem, why was the speed of NPL resolution so different? Why did the governments intervene in bank restructuring in different ways? This chapter explains how similar policy measures (injecting public funds into failing banks) and similarly established public asset management organizations (the KAMCO and the RCC) resulted in the resolution of NPLs at different speeds and with different economic outcomes. By exploring the political, legal, and organizational aspects of these similar policy measures and organizations, this chapter highlights how differences in institutional environments have determined not only the sequence of bank restructuring at the macroinstitutional level, but also the speed of policy implementation at the microinstitutional level. By comparing the institutional dynamics of these two countries, we can gain insights about why two similar financial systems have diverged, and in what aspects they may be converging in the course of adjusting to financial globalization.

In the following section, I first review the differences at the macroinstitutional level, focusing on the initial macropolitical and -economic conditions that determined the governments’ strategy to tackle the NPL resolution and bank restructuring. Then, I analyze the microinstitutional-level differences related to the use of public funds for bank recapitalization. In that discussion, I focus on why the Japanese government did not inject public funds in a decisive way, as was done by the Korean government. Next, I compare the performance of the KAMCO and the RCC, focusing on their role in transferring non-performing assets from failing banks, and their preferred methods in recovering those transferred assets in the market. The chapter closes with a discussion of the merits and the failings of the different paths toward NPL resolution, and their impacts on the consequences of bank restructuring in both countries.

Differences in Institutional Environment

Initial Macroeconomic Conditions

We can observe two major differences in the initial macroeconomic conditions of both countries at the time of the banking crisis. First, the direct

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<td><strong>Korea (trillion won)</strong></td>
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<tr>
<td>Total bank loans (a)</td>
<td>511.9</td>
<td>472.9</td>
<td>526.3</td>
<td>552.9</td>
<td>656.5</td>
<td>719.2</td>
<td>731.6</td>
<td>808.3</td>
<td>975</td>
</tr>
<tr>
<td>Total NPLs (b)</td>
<td>86.0</td>
<td>61.0</td>
<td>42.1</td>
<td>18.8</td>
<td>15.1</td>
<td>18.7</td>
<td>13.9</td>
<td>9.7</td>
<td>7.8</td>
</tr>
<tr>
<td>NPLs ratio (b)/(a)</td>
<td>16.80%</td>
<td>12.90%</td>
<td>8.00%</td>
<td>3.40%</td>
<td>2.30%</td>
<td>2.60%</td>
<td>1.90%</td>
<td>1.20%</td>
<td>0.80%</td>
</tr>
<tr>
<td>ROA¹</td>
<td>-3.3</td>
<td>-0.8</td>
<td>-0.6</td>
<td>0.7</td>
<td>0.6</td>
<td>0.17</td>
<td>0.85</td>
<td>1.27</td>
<td>1.11</td>
</tr>
<tr>
<td>ROE²</td>
<td>-52.5</td>
<td>-14.4</td>
<td>-11.0</td>
<td>12.8</td>
<td>10.9</td>
<td>3.41</td>
<td>15.2</td>
<td>18.4</td>
<td>14.6</td>
</tr>
<tr>
<td>GDP³(c)</td>
<td>484.1</td>
<td>529.5</td>
<td>578.7</td>
<td>622.1</td>
<td>684.3</td>
<td>724.7</td>
<td>779.4</td>
<td>810.5</td>
<td>847.9</td>
</tr>
<tr>
<td>% of GDP (b)/(c)</td>
<td>17.80%</td>
<td>11.50%</td>
<td>7.30%</td>
<td>3.00%</td>
<td>2.20%</td>
<td>2.60%</td>
<td>1.80%</td>
<td>1.20%</td>
<td>0.90%</td>
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| **Japan (trillion yen)** |       |       |       |       |       |       |       |       |       |
| Total bank loans⁴       | 551.4 | 536.1 | 537.1 | 512.1 | 474.6 | 455.5 | 446.1 | 457.5 | 472.7 |
| Total NPLs⁵             | 33.9  | 31.8  | 33.6  | 43.2  | 35.3  | 26.6  | 17.9  | 13.4  | 12.0  |
| NPLs ratio              | 6.2   | 5.9   | 6.3   | 8.4   | 7.4   | 5.8   | 4.0   | 2.9   | 2.5   |
| ROA¹                   | -     | -0.4  | 0     | -0.6  | -0.7  | -0.1  | 0.3   | 0.5   | -     |
| ROE²                   | -     | -25.1 | -0.5  | -12.7 | -17.9 | -2.9  | 4.3   | 12.6  | -     |
| GDP³                   | 504.8 | 497.6 | 503   | 497.7 | 491.3 | 490.3 | 498.3 | 501.3 | 507.7 |
| % of GDP                | 6.70% | 6.40% | 6.70% | 8.70% | 7.20% | 5.40% | 3.60% | 2.70% | 2.40% |

**Source:** Statistics from the Financial Services Agency of Japan, the Bank of Japan, the Financial Supervisory Service of Korea, and the Bank of Korea.

¹ Return on assets.
² Return on equity.
³ GDP is based on current prices in national currency.
⁴ Total loans consist of the loans provided by city banks, long-term credit banks, trust banks, and regional banks.
⁵ The definition of non-performing loans (NPLs) based on the Financial Reconstruction Law (October 1998).
⁶ Japanese figures are based on the fiscal year. For example, the figure listed for 1998 is actually the amount at the end of March 1999.
causes of the banking crises were different. Banking crises usually tend to coincide with currency crises (Bordo and Eichengreen 1999; Caprio and Klingebiel 2002; Eichengreen 2004). The Korean financial crisis was one of these typical “twin crises” in which a currency crisis escalated into a banking crisis. In the Korean banking crisis, the presence of an asset bubble was minimal, and the direct cause of the banking crisis was the currency mismatch between short-term and long-term foreign debts (Coe and Kim 2002). In the Japanese case, the direct cause of the crisis was the asset bubble of the late 1980s and the ensuing collapse of land prices (Michio and Masahiro 2003a, 2003b). In particular, in the Japanese case, the accumulation of NPLs happened slowly over time, beginning in early 1991, when the asset bubble burst, escalating into a systemic banking crisis around 1997/1998. Therefore, we may say that the urgency of the financial problem was much more serious in Korea than in Japan, and this difference influenced the ways the two governments intervened in each banking crisis.

Second, the fiscal conditions were different. Increasing fiscal debt constrained the Japanese government to use the public funds option more aggressively. When the asset bubble burst in 1991, the ruling Liberal Democratic Party (LDP) politicians and the officials of the Ministry of Finance (MOF) launched massive fiscal stimulus packages, including an extensive public works project, to offset the decline in domestic demand. The LDP’s strategy relied more on the political logic, which did not sustain it, as the LDP broke up in 1993. The Hashimoto Cabinet (January 1996 to July 1998) used multiple stimulus packages, including a 16 trillion yen ($120 billion) fiscal stimulus package, which was 2–3% of GDP at the time, and cut 4 trillion yen ($30.5 billion) in income taxes.

With the increase in government spending, the fiscal debt of Japan’s central government reached about 75% of GDP at end of 1997. In contrast, the Korean government’s debt stayed on a much lower level than the average of Organisation for Economic Co-operation and Development (OECD)

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8 At the end of 1997, short-term debt in Korea amounted to $70 billion—three times as much as the country’s total international reserves—and the ratio of short-term debt accounted for 67% of total foreign debt. This was the highest ratio among the crisis-hit Asian countries in 1997 (Asian Development Bank 1999, 32).

9 According to an estimate by the Economic Planning Agency of Japan, the collapse of asset (stock and land) prices from 1990 to 1996 resulted in cumulative losses of nearly 1,000 trillion yen (around 7 trillion), or roughly the equivalent of two years of national GDP. Of these losses, over 63% (643 trillion yen) was accounted for by the decline in land prices. See Economic Planning Agency of Japan (1998). Regarding the monetary policy of the Bank of Japan in the 1980s that contributed to creating the asset bubble in the late 1980s, see Ryunoshin (2003).

10 In total, from 1992 to 2002, the government launched twelve fiscal stimulus packages amounting to 136 trillion yen by increasing public works spending (OECD 2002, 53).
The differences in the nature of the crisis and the initial economic conditions had significant impacts on policy choices and implementation. Certain policy options are constrained or enabled according to structural economic conditions. However, economic conditions do not automatically trigger policy changes and they do not determine the optimal content of policy measures. Policymakers are bounded by institutional settings (Simon 1997), and their decision-making process is basically a “muddling through” process (Lindblom 1959). Needless to say, the policy implementation process is further bounded by various factors. As we will see in following section, while the Korean government temporarily nationalized all commercial banks by injecting public funds and sold most of the nationalized banks to foreign financial institutions, this sequence of bank restructuring does not seem applicable to the Japanese policy environment.

Massive bank failures were an unfamiliar, challenging phenomenon for policymakers—politicians and bureaucrats—in both countries. Facing this task required adjusting to a new policy environment. Under the circumstances, policymakers’ initial judgments or estimates about policy options for financial restructuring—which are often influenced by ideological orientation—worked as a foundational cognitive map in the policymaking process. Moreover, NPL resolution was an uncharted task for the bureaucrats of both governments, and required new market rules and new organizations such as the asset management company to resolve the problem successfully. Therefore, we need to explore in detail the policymakers’ grasp of the situation as well as their shared knowledge about the policy tools available to achieve NPL resolution and financial restructuring.

*Political Environment: New Regime vs. Incumbent Regime*

Around 1996, within the policy community of the LDP and the MOF, it became taboo to use public funds as a bailout option to save financial institutions. The Japanese government used public funds for the first time to bail out the *jusen* (housing mortgage) companies in the summer of 1996. The *jusen* bailout plan was strongly opposed by both opposition parties—particularly the New Frontier Party (Shinshinto)—and by the public; after the bailout plan was passed by the Diet, using public funds for the handling of such banking problems became a taboo (Kume 2003). Several financial
institutions collapsed in the fall of 1997 in Japan, only a year after the first use of public funds for the *jusen* problem. This problem quickly worsened into a systemic financial crisis, and through these financial failures, the long-held myths of “no failure” or “too big to fail” for banks under the traditional convoy system was shattered. Consequently, the MOF’s credibility as a financial supervisor was seriously eroded, and the policy option of injecting public funds could not get popular support.

The quickly worsening bank problem provoked a political debate about whether it was better to allow weak but solvent banks to continue operating by injecting public funds or to let them fail (Suda 1998). The LDP tried to fall back on the traditional “convoy” system under which strong banks rescue weak ones through mergers; for example, the LDP attempted to make Sumitomo Trust & Banking take over the troubled LTCB (Rowley 1998, 6). However, the LDP’s rescue/merger scheme did not proceed well at the time because popular support for the ruling LDP was in decline. Support for the Hashimoto Cabinet plummeted after the financial failures in November 1997, and in April 1998, in the middle of pushing a bailout plan to inject public funds, the level of support dropped below 30%. With declining political support, the LDP could not drive the bailout option with sufficient force. Under the circumstances, opposition parties—the Democratic Party of Japan, the Liberal Party, and Shinto Heiwa—strongly demanded that public funds should be administered by an independent organization, one other than the MOF. In the end, the LDP and opposition parties passed the “Financial Function Early Strengthening Law” in October 1998, and, according to this law, the Financial Reconstruction Commission was established to police the infusion of public funds, as an independent organ under the Prime Minister’s Office. Therefore, for purely political reasons—to dilute public criticism by establishing an independent organization to administer the injection of public funds—the Japanese government could not directly use public funds for bank recapitalization (Toya 2006).

In the Korean case, the political environment was more favorable for the government (Haggard and Mo 2000). In contrast with Japan, there was a political regime change in Korea, and for the first time since the early 1960s, an opposition party replaced the incumbent conservative ruling party in the presidential election, which occurred in the middle of the crisis in mid-December 1997. The newly established government was free from political responsibility for any economic turmoil after the crisis, and

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11 In April 1997, Nissan Life went bankrupt—an unprecedented event in the postwar era. Not long after, Nippon Credit Bank required rescue by the MOF. These failures offered a prelude to a systemic financial crisis, which came in the fall of that year. A number of financial institutions began to go bankrupt in November 1997: Sanyo Securities, Hokkaido Takushoku Bank (the tenth largest bank), and Yamaichi Securities (the fourth largest).
it could more easily justify unpopular policy measures by blaming the previous administration. In addition to this, International Monetary Fund (IMF) involvement worked as an important structural condition that enabled the Korean government to weaken resistance from domestic economic actors, and set the pace and direction of reforms.

Degree of External Pressures

Researchers in Japanese studies have identified various sources of the long, delayed economic recovery since the burst of the bubble economy in the early 1990s, which can be categorized into three approaches: (1) a policy-failure approach (Milhaupt and Miller 2000; Cargill 2006; Hoshi and Kashyap 1999, 2001, 2004; Ito 2003); (2) a structural approach (Amyx 2004; Katz 1998, 2003; Iwata and Miyagawa 2003); and (3) a historical approach (Gao 2001). Despite their variations, these explanations share a common view that past institutional arrangements have become too rigid for change. In contrast, few studies on Korea have emphasized institutional rigidity, instead emphasizing external pressures, such as the structural reform programs imposed by the IMF that drove the rapid financial restructuring (Coe and Kim 2002; Chung and Eichengreen 2004). It is true that the structural reform measures agreed to with the IMF spurred financial reforms. However, this view lacks an account of the domestic political dynamics, i.e., how domestic actors have used external pressures to expedite their own political and economic agendas, and how domestic political dynamics accelerated the financial restructuring that the IMF imposed. It is equally inappropriate to attribute institutional rigidity in Japan simply to the lack of external pressures. We need to understand how changes in institutional environments have interacted with endogenous internal dynamics at the microinstitutional level, and how the macro-micro loop (and vice versa) has produced different patterns of institutional transition (Aoki 2001; Vogel 2006).

Immediately after the crisis, the Korean economic bureaucracy—specifically, the Ministry of Finance and Economy (MOFE) and the top-level decision makers—was severely blamed for the crisis. Under the circumstances, MOFE officials tried to counteract public criticism of the government’s culpability in causing the crisis by attributing unpopular policy measures to the IMF conditions, which the Korean government agreed to in return for receiving $57 billion from the IMF (Chopra et al. 2002).

A notable aspect of the political situation is that negotiations with the IMF proceeded in the middle of the power transition. In the middle of negotiating with the IMF about specific measures for structural reforms, there was a presidential election. The ruling party, the Grand National Party, lost the election, and consequently, between December 1997 and the
official inauguration of the new government in late February 1998, the Korean government was in transition. The newly elected president and his party could attribute the whole responsibility of the financial crisis to the former administration and the former ruling party. They were relatively free from public criticism for accepting the IMF conditions. In short, there was no politically accountable force to check the initiative of the Korean bureaucracy in negotiating with the IMF. Under these circumstances, the IMF requested the Korean government inject public funds at the earliest possible time, and the Korean government followed the policy prescriptions quickly to restore financial stability and confidence.

**Bank Recapitalization: The Issue of Capital Injection**

*Timing and Appropriate Amount of Capital Injection*

Deciding the timing and the appropriate amount of capital injections is critical, if this policy option is to be used to recover confidence in the financial system. In response to the accumulating NPLs and the aggravating systemic banking crisis, both governments tried to strengthen the weakening capital base of banks. Injecting public funds into the failing banks was one viable policy option. However, it was a politically volatile option because the public was strongly against using public funds to save private banks, because it might result in an additional tax burden on the people in the end. Meanwhile, as a practical matter, it was difficult to assess the exact amount of necessary funds for bank recapitalization. Injecting too many funds could not only worsen the moral hazard in the banking sector, but also increase the fiscal burden of the government. Injecting too few funds might prolong instability in the banking system. Both governments had to persuade the public and opposition political groups of the need for this course of action, on the one hand, and they had to minimize the fiscal cost (moral hazard), on the other hand, while recovering financial stability and confidence in the banking system as soon as possible (Kang 2014).

We can observe significant differences in terms of the injection timing and amount of public funds in both countries. In Korea, the government injected public funds both quickly and decisively. Within two years after the emergence of the banking crisis in late 1997, the Korean government injected about 87 trillion won of public funds for banking recapitalization, of which 25 trillion won were allocated for NPL purchasing. The total amount of injected public funds amounted to 16.4% of average GDP in the 1998–2000 period. By the end of 2006, about 55 trillion won—63.3%—was

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12 The total amount of public funds devoted to financial restructuring, including both the banking and non-banking sectors, reached 32% of average GDP in the period 1998–2000.
recovered. By injecting such a huge amount of capital, the Korean government temporarily nationalized all commercial banks. In terms of the scale of capital infusion, in relation to the average GDP of 1998–2000, the Korean government used about 6.5 times more public funds for bank recapitalization than the Japanese government did (see table 3.2).

The Japanese government injected public funds in an intermittent and indecisive way. The Diet allowed the government to use public funds totaling 75 trillion yen—60 trillion yen in 1998 and 1999, and 15 trillion yen in 2002. However, the Japanese government actually injected only 16.5% of the total reserve of public funds—10.4 trillion yen 1998 to 1999 and about 2 trillion yen in 2003—an insufficient amount considering the scale of NPLs in the banking sector (see table 3.2).

Compared with the Korean case, this presents an interesting point for inquiry: Why did the Japanese government fail to inject public funds early enough—and in sufficient quantity—for speedy bank recapitalization, as the Korean government did? Two reasons, among others including the effects the jisen bailout in 1996, made the use of public funds more difficult in Japan. First of all, an institutionalized scheme for identifying the actual scale of the NPLs was lacking. The Japanese government changed the rules on loan classifications gradually. Secondly, legislation permitting the use of public funds in a preventive way was much delayed due to the lack of strong political leadership.

**Rule Change on Loan Disclosure and Assessment: Gradual vs. Abrupt Change**

Creating an appropriate institutional scheme for loan disclosure and assessment is critical in identifying the actual scale of NPLs and the seriousness of the problem. Without assessing the actual scale of NPLs, it is
difficult to come up with the appropriate amount and timing of capital infusion. In the Japanese case, institutional reforms for loan disclosure and assessment were much delayed, and due to the lack of an appropriate institutional scheme to identify NPLs, the Japanese government could not decide on the appropriate amount of public funds to inject. In contrast, the Korean government introduced a variety of new international banking standards, including loan classification and provisioning standards, capital adequacy standards, and accounting and disclosure standards immediately after the crisis.

The standards Japanese banks had applied before the crisis to classify loans as NPLs were loose. Such loose disclosure requirements made it difficult to identify the exact amount of NPLs when the crisis occurred. In fact, before the financial failures of late 1997, the MOF asked all banks to submit their own assessment of risky loans, based on four different categories, by September 1997. Banks also submitted their own assessments of outstanding loans to the MOF. Their financial reports, however, were based on hyperinflated expectations for their outstanding loans. According to the self-evaluations, Japanese banks classified 87.7% of all loans as reasonably certain to be repaid, and 12.3% of loans (76.7 trillion yen) as recoverable but requiring careful collection (Class II or substandard). Interestingly, only the residual 11.4 trillion yen in the two lowest categories (Class III and IV) were considered bad loans, and the proportion of loans in these two categories was only 1.8% of total bank loans (see table 3.3).

Contrary to the self-assessments, however, when banks went bankrupt in late 1998 and 1999, the actual amount of NPLs held by those failed banks was far larger than their original calculations. For example, two major banks went bankrupt in late 1998—the Long-Term Credit Bank (LTCB) of Japan on 23 October and the Nippon Credit Bank (NCB) on 13 December. These two banks were temporarily nationalized; after nationalization, the Japanese government—specifically, the Financial Supervisory Agency (FSA)—found a huge discrepancy between what the banks reported and the actual amount of NPLs. Initially, the LTCB estimated its capital deficit at 340 billion yen, but after the investigation by the FSA, the figure increased more than 7.5 times to an estimated 2.65 trillion yen.

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13 This false reporting is exemplified in the case of Yamaichi Securities, which hid enormous so-called tobashī losses off its books—tobashī is the practice of concealing losses by shifting them among client accounts—in this instance, among thirty-five clients’ accounts. This case led to the first shareholder lawsuit against a firm’s auditors in Japanese history (OECD 1998, 109).

14 The bankruptcy of LTCB was at that time the world’s biggest bank failure. LTCB’s financial derivatives exposure was around 50 trillion yen ($360 billion) at that time, and it had assets of 26 trillion yen.
Ultimately, ten months after nationalization, in August 1999, the estimated capital deficit increased to 3.5 trillion yen (OECD 1999, 78), which was ten times larger than the initial estimate. The NCB bailout also demonstrated this problem. Initially, NCB’s capital deficit was estimated at 94.4 billion yen, but upon closer inspection after nationalization, this figure rose to around 3 trillion yen (OECD 1999, 79). This huge gap between self-assessed and actual NPL amounts was not confined to these two banks (Hall 1999, 69–91). In short, the discrepancy between the actual NPLs and the banks’ self-assessments indicates poor loan disclosure and transparency in financial statements.

Meanwhile, in December 1997, the LDP and the MOF announced the Emergency Economic Package, in which the government would provide up to 13 trillion yen in public funds to failing banks by the end of March 1998; the plan was approved by the Diet in February 1998. However, few banks applied for capital injection. Although the package offered capital at below-market costs, failing banks refused to apply for public funding. It was a rational choice for banks not to apply for public funding, however. As only those banks at risk of default could apply for public funds,

<table>
<thead>
<tr>
<th></th>
<th>Total Credit Exposure</th>
<th>Contribution of Each Class to Total Exposure</th>
<th>Total of II to IV</th>
<th>Total Exposure (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Major banks</td>
<td>431,682</td>
<td>Class I 377,347 Class II 45,302 Class III 6,931 Class IV 2,103</td>
<td>54,336</td>
<td>12.6</td>
</tr>
<tr>
<td>Regional banks</td>
<td>139,153</td>
<td>Class I 124,692 Class II 13,060 Class III 998 Class IV 403</td>
<td>14,461</td>
<td>10.4</td>
</tr>
<tr>
<td>Regional banks II</td>
<td>54,028</td>
<td>Class I 46,118 Class II 6,927 Class III 794 Class IV 189</td>
<td>7,910</td>
<td>14.6</td>
</tr>
<tr>
<td>Regional banks total</td>
<td>193,181</td>
<td>Class I 170,810 Class II 19,987 Class III 1,792 Class IV 592</td>
<td>22,371</td>
<td>11.6</td>
</tr>
</tbody>
</table>

Notes: Unit: billion yen. Classes are as follows:
I. Credit exposures that have not been classified as Class II, III, or IV.
II. Credit exposures for which banks have judged adequate risk management on an exposure-by-exposure basis will be needed.
III. Credit exposures about which banks have serious concerns in terms of their ultimate collection and, thus, are likely to incur losses but have difficulties with rational estimation of time and extent of losses.
IV. Credit exposures that banks have judged to be noncollectable or of no value.
applying for capital infusion could have a devastating impact on their reputation in the markets. Therefore, banks tried to minimize their exposure to this risk by not requesting, or by applying for only a minimal amount of, public funds.

The MOF asked banks not to undermine the credibility of the whole bank recapitalization endeavor and to accept funding, with the promise of fair treatment. In the end, twenty-one institutions, including all but one of the major banks, made formal applications in March 1998, however, most of the available funds were left unused: the total injection was only 1.8 trillion yen (13.8%) of the 13 trillion yen made available for capital injection. This 1.8 trillion yen was neither sufficient to fully recapitalize failing banks nor to solve the structural problems that the Japanese banking system faced (see table 3.4).

It is not yet clear yet whether the Japanese government was fully aware of the seriousness of the NPL problem in the banking sector during the banking crisis in 1997 and 1998. But considering the weak institutional scheme for loan disclosure and assessment and the intermittent way public funds were injected at the initial stage of the banking crisis, it appears that Japanese financial authorities were not fully aware of the scale of actual NPLs in the banking sector. Such a lack of information made it difficult for the Japanese government to use the fiscal money more decisively.

Table 3.4. Status of Capital Injection and Disposition (Japan, 1998–2006)

<table>
<thead>
<tr>
<th>Governing Law</th>
<th>Injection Period</th>
<th>Number of Financial Institutions</th>
<th>Total Injected Amount (billion yen)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Financial Function Stabilization Law</td>
<td>March 1998</td>
<td>21</td>
<td>1,815.6</td>
</tr>
<tr>
<td>Early Strengthening Law</td>
<td>March 1999–March 2002</td>
<td>32</td>
<td>8,605.3</td>
</tr>
<tr>
<td>Act on Organizational Restructuring</td>
<td>September 2003</td>
<td>1</td>
<td>6.0</td>
</tr>
<tr>
<td>Act on Strengthening Financial Functions</td>
<td>November and December 2006</td>
<td>2</td>
<td>40.5</td>
</tr>
<tr>
<td>Deposit Insurance Law</td>
<td>June 2003</td>
<td>1</td>
<td>1,960.0</td>
</tr>
<tr>
<td>Total</td>
<td></td>
<td>137</td>
<td>12,427.4</td>
</tr>
</tbody>
</table>

Source: DICJ 2006, 90.
In contrast, to recapitalize banks the Korean government introduced various new international banking standards immediately after the crisis, according to the agreement with the IMF. For example, the loan classification of NPLs became tougher. In the past, NPLs were defined as loans in arrears for more than six months, but this was revised to include debts of three months or more. At the same time, the Korean government quickly adopted international accounting standards, and requested all banks to submit to diagnostic reviews by internationally recognized accounting firms. With such an abrupt rule change, most banks could not meet the requirement and became subject to financial assistance from the government; the rapid rule change in accounting standards also ensured the banking problem was disclosed early on.

Legislation for Capital Infusion: Slow vs. Fast

We can observe a similar contrasting pattern again in regard to the legislation process for capital infusion: the Korean government intervened first by presidential decrees and then relevant legislation followed. In Japan, only after long-delayed legislation was the government able to inject public funds.

In Korea, the government first injected public funds, and then enacted legislation for the sound management of those funds. Initially, the Korean government injected public funds through an emergency bailout measure by a presidential decree issued in the middle of the financial crisis in late 1997,15 which was then amended five times before May 2000. After the injection, the management and the recovery of public funds came to be a politically sensitive issue. People demanded more transparency in the use of taxpayers’ money, and, as a result, the Public Fund Oversight Committee was created, following another presidential decree that created the Public Fund Oversight Special Act in February 2001. Finally, after a long delay, the Public Fund Redemption Fund Act was enacted for the speedy recovery of the injected public funds in December 2002.

In Japan, the government injected public funds in different periods based on five different laws—the Financial Function Stabilization Law (February 1998), the Early Strengthening Law (October 1998), the revised Insurance Deposit Law (2003), the Organizational Restructuring Law (September 2003), and the Act on Strengthening Financial Functions (2006). The Japanese government was not permitted to preventively inject public funds before a bankruptcy, until 2003 in the case of the Resona Holdings’ failure. Without an official declaration of default or a voluntary

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15 The “Enforcement Decree of the Act on Efficient Disposal of Non-Performing Assets of Financial Institutions and Establishment of Korea Asset Management Corporation.”
Myung-koo Kang

application on the part of a financial institution, the Japanese government could not inject public funds to failing financial institutions. Lacking a legal framework that gave the government the power to inject public funds, the government could not explicitly force banks to receive public funds.

Why, then, was legislation empowering the government delayed for such a long time? To resist increased governmental oversight and control upon receipt of public funds, bankers aligned with LDP politicians to delay the revision of public fund-related laws, while trying to gain time in resolving their NPL problems. Meanwhile, LDP politicians did not want to risk losing popular support by passing an unpopular bill related to the injection of public funds, instead introducing “deferred tax” accounting for banks’ core capital.\(^\text{16}\)

Deferred tax accounting was introduced in October 1998 and became effective in April 1999. This method of accounting estimates future capital gains (taxable profits) and records them as assets.\(^\text{17}\) One of the critical problems of booking this deferred tax as an asset lies in the calculation of the preadjustment taxable income based on projected future business performance: if the projected taxable income fails to be achieved, there will be no tax-reducing effect, and in such a case, the deferred tax asset will disappear, thus depleting the capital base. This accounting procedure involves subjective estimates of future capital acquisitions, and this subjective factor raises a critical issue: what is and what is not a deferred tax asset?

From 2002 to 2004, major banks estimated the five-year total of preadjustment taxable income, pushed to the utmost limit, and booked this estimated taxable income as their actual assets (Mochizuki 2006). The net proportion of deferred tax assets was the most important source of the major banks’ capital base, and it grew continuously from 1998. By 2002, out of the total capital base (14 trillion yen) of the twelve major banks, the proportion of deferred tax assets was 51.7\%, while the proportion of public funds was about 45\% (Cabinet Office 2003, 154).

This huge proportion of deferred tax assets did not substantially decrease between 2003 and 2004. While net deferred tax as a percentage of

\(^\text{16}\) The difference between tax expense and tax payable is referred to as deferred tax.

\(^\text{17}\) All Japanese banks base these calculations on the No. 4 Example Section Provision Clause in the Administrative Guidelines of the Japanese Institute of Certified Public Accountants, which reads:

In cases when forwarded losses occur as a result of business restructuring, revisions of laws or other regulations or other unordinary and special reasons, it shall be the judgment that deferred tax assets will be recovered, with the limit being taxable income within a period of time capable of being rationally estimated in the future (generally five years), referring to the portion for which temporary differences may be scheduled during the said period of time (as quoted in Mochizuki 2006; emphasis added by author).
both core capital and total qualifying capital had slightly declined before 2002, the average net deferred tax as a percentage of core capital was 34% for all five banking groups in 2004.\textsuperscript{18} Interestingly, these two years overlap the period when the major banks were forced by the Japanese government to push NPLs to below the 4% level by March 2005. The resulting write-offs of NPLs caused more deficits for the major banks. In short, although official NPL ratios substantially decreased, it remains questionable whether all those disposals were genuine and not simply a result of changing Japanese accounting practices (Kuroda and Hamada 2001). As of 2006, if the deferred tax assets were substantially reduced in calculating capital adequacy ratios, all the major banks’ BIS ratio (total capital to total assets ratio) would go down below 8%\textsuperscript{19}.

The May 2003 failure of Resona Holdings,\textsuperscript{20} the fifth-largest banking group at the time, clearly demonstrates this problem. The financial statements for Resona Holdings had included large deferred tax assets as part of their capital, accounting for 70% of Tier 1 capital according to Moody Investor Services (Ibison 2003).

Under the circumstance, two auditing companies—Asahi & Co. and Shin Nihon—disputed the bank’s profit forecasts, on which the deferred tax assets depend, and refused to give a clean audit report unless Resona cut its deferred tax assets by 40%. In April 2003, a month before the failure, the capital adequacy ratio of Resona Bank stood at about 2%, which was half the required minimum of 4% for domestic banks, and one-quarter of the minimum of 8% for international operations. Without including the deferred tax assets, Resona Holdings would have gone bankrupt. In the end, 2 trillion yen of public funds was injected as a preventive measure to stall the collapse, and the bank was nationalized. In short, after a long process of muddling through the case of Resona Holdings, the Japanese government revised the law regarding the injection of public funds, becoming

\textsuperscript{18} Those five banking groups are Mizuho Holdings (September 2000), Sumitomo Mitsui Banking Corp. (April 2001); Mitsubishi-Tokyo Financial Group (April 2001); United Financial of Japan (UFJ) Group (April 2001); and Resona Group (March 2003). For more detail, see Gee and Tomoko (2006), table 5.

\textsuperscript{19} With the announcement of the “Program for Financial Revival” in 2002, the FSA organized a working group on the regulation of the capital adequacy ratio, releasing a report of its conclusions in June 2004. The report confirmed the need to modify the regulatory treatment of deferred tax assets in calculating capital adequacy ratios, but it indicated that it needed to be modified only after the banks had achieved their objective of reducing NPLs to below 4% by March 2005. For more detail, see Financial Services Agency (2004).

\textsuperscript{20} It was originally established with the goal of creating a super-regional bank in December 2001 with mergers of regional banks. It started as Daiwa Bank Holdings, Inc., the result of the consolidation of Daiwa Bank, Kinki Osaka Bank, and Nara Bank. After acquiring Asahi Bank on 1 March 2002, the company was renamed Resona Holdings, Inc., on 1 October 2002.
able to inject public funds even into supposedly sound financial institutions when it anticipated impending financial turmoil.

The Role of the Asset Management Company

Performance Comparison

Both governments tried to resolve the NPL problem by establishing an asset management company—the Resolution and Collection Agency in Japan, and the Korean Asset Management Corporation. The Japanese government established the RCC in April 1999 as a 100% subsidiary (limited company) of the Deposit Insurance Corporation of Japan (DICJ) through a merger of the Housing Loan Administration Corporation (HLAC)\(^{21}\) and the Resolution and Collection Bank (RCB)\(^{22}\) which were established to resolve the *jusen* problem. The main role of the RCC was to accelerate the recovery and collection of NPLs transferred from failed financial institutions by repackaging them for quick sales either through auctions or as a securitized asset. Meanwhile, the Korean government expanded the functions of the KAMCO. The KAMCO was established in April 1962 as a subsidiary of the Korea Development Bank to dispose of distressed assets of financial institutions, but in the wake of the financial crisis of 1997, the government mandated the KAMCO to acquire and dispose of the NPLs of the financial sector. The KAMCO’s role was broadened further when a bill was passed on 30 April 1999 to allow the KAMCO to function as a corporate restructuring agent for non-performing assets (see table 3.5).

The actual performances of the RCC and the KAMCO are strikingly different. From 1996 to 2006, the total amount of NPLs transferred to the RCC—consisting of the HLAC (*jusen*) account,\(^{23}\) the RCB account,\(^{24}\) and the Article 53 account\(^{25}\)—was 9.7 trillion yen, with 8.9 trillion yen actually collected. From those three accounts, the cumulative total amount of NPLs transferred from financial institutions according to the 1998 Financial Revitalization Law that enabled the establishment of the RCC was only 4 trillion yen (book value). From 1998 to 2006, the total bank loan in Japan, on average, was about 480 trillion yen, and the average NPL ratio of all

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\(^{21}\) HLAC was established in July 1996 to prompt the collection of NPLs related to *jusen* companies, as a 100% subsidiary of the DICJ, with a capitalization of 200 billion yen.

\(^{22}\) RCB was established in September 1996 to prompt the disposal and management of NPLs transferred from failed credit cooperatives as a 75% subsidiary of the DICJ, with a capitalization of 120 billion yen.

\(^{23}\) Assets purchased by the HLAC since the *jusen* problem in 1996.

\(^{24}\) Assets purchased by the RCB from failed financial institutions.

Table 3.5. Functions and Power of RCC and KAMCO

| Set-up Year       | Ownership                        | Fund-raising           | Function                                  | Preferred Resolution Methods | Special Legal Powers | Independence | External Audit |
|-------------------|----------------------------------|------------------------|-------------------------------------------|-------------------------------|----------------------|--------------|----------------|----------------|
| RCC               | 1999, a merger of HLAC and the RCB | 100% government funding (DICJ) | 11 trillion yen * collection + resolution * corporate restructuring by IRCJ | reorganization (no joint venture partnership) | No                   | Limited      | No             |
| KAMCO             | 1962, role expanded in 1997       | Government (42.8%) + KDB (28.6%) + 18 banks (28.6%) | $17 billion: NPA bond (95%), financial institutions (2.7%), KDB loan (2.3%) | collection + resolution + corporate restructuring | liquidation, joint ventures, international bidding, auction, and public sale | Yes          | Strong         | Yes            |

Sources: RCC and KAMCO, annual reports.
banks was more than 6%. Japanese banks held at least 30 trillion yen of NPLs annually. Considering the scale of NPLs in the banking sector during the period, the amount of transferred NPLs to the RCC was minimal (see tables 3.1 and 3.6).

In contrast, the KAMCO purchased a total of 39 trillion won in NPLs from all types of financial institution between 1998 and 2006, and those transferred NPLs were fully collected (41.5 trillion won; see table 3.6). Among them, about 56% came from the banking sector (KAMCO 2002, 17). The average amount of NPLs transferred annually to the KAMCO—111 trillion won divided by nine years—was over 12 trillion won. This accounted for 71.0% of total NPLs in the banking sector, a much higher proportion than what was transferred to the RCC. We can claim reasonably that the KAMCO played the most critical role in the resolution of NPLs in the Korean banking sector. As in Japan, no banks had failed before the crisis in Korea, and therefore the markets for distressed debt from failed or failing financial institutions did not exist at all. Why, then, has the performance of the RCC and the KAMCO been so different?

To answer this question, we need to understand the negotiating process for purchasing non-performing assets between debtor financial institutions and asset management companies, and the liquidation methods adopted by the RCC and the KAMCO.

**Pricing of Non-Performing Assets**

In general, when asset management companies transfer or purchase non-performing assets, one of the most sensitive issues is the determination of the “proper” price of those assets, often a point of contention between financial institutions and asset management companies. In this case, the asset management companies (RCC and KAMCO) tried to minimize the cost to the public funds, while financial institutions wanted to maximize their asset prices. Purchase prices varied according to the type of loan. In the beginning, for loans with collateral, the KAMCO’s purchase price was generally equal to 75% of the book value, while loans without collateral were purchased at very deep discounts. However, to expedite the speed of purchasing non-performing assets from financial institutions, the

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26 The distribution of purchased NPLs as of the end of 2006 is as follows: banks (56%), investment trusts (20.3%), insurers (6.4%), merchant banks (3.2%), and other (14.1%).

27 This percentage was calculated as follows: The sum of the total NPLs in banks from 1998 to 2006 was divided by nine years to get the average annual NPLs in banks (30.3 trillion), then multiplied by 0.56, because the percentage of NPLs transferred from banks to the KAMCO out of the total NPLs transferred to the KAMCO was 56%, equaling 16.9 trillion won. This figure was then divided by the annual average of transferred NPLs to the KAMCO (12 trillion won), equaling 71% (18.8 trillion won).
KAMCO paid relatively high prices; on average, such prices were approximately 36% of the book value. In contrast, the RCC paid less than 11% of the book value of the non-performing assets (see table 3.6).

In Japan, because of the very low buying price, most banks did not want to sell their non-performing assets to the RCC. This becomes evident when we look at the type of financial institutions that sold their bad assets to the RCC. From 1999 to 2006, not a single city or trust bank sold their bad assets to the RCC. Only one regional bank (Ashikaga Bank), which failed in 2004, transferred its bad assets to the RCC. Most of the purchased bad assets originated from small and weak financial institutions such as credit unions or credit cooperatives. The pattern shows that the NPL resolution process was carried out in two tracks: NPL resolution for major banks was conducted separately from resolutions for small and weak financial institutions. Because of the low purchase price, those bad assets transferred to the RCC were the worst kind of bad assets held by these smaller and weaker financial institutions, making the liquidation of those assets more difficult.
Major banks in Japan, on the contrary, preferred to sell their NPLs to private servicing companies established by the banks, rather than to the RCC. For example, to promote the rapid sale of bad assets by banks, the Japanese government established the “Banks’ Shareholdings Purchase Corporations” (BSPC) in 2002. However, because the regulatory authorities (the FSA and the MOF) levied an 8% premium on banks for purchasing and selling the bad assets, banks successfully lobbied LDP politicians, and this plan was cancelled. Major banks did not use the BSPC and established instead their own bad asset resolution companies. In short, we can say that in Japan, a more creditor- (bank-)centered NPL resolution method was carried out, while in Korea a more regulator- (government-)centered resolution was executed. Meanwhile, the legal powers granted to the RCC and the KAMCO in the debt collection process influenced the speed of NPL transfer. Usually, governments give special legal power to asset management companies that enable them to seize assets, foreclose on loans without going through the courts, buy or sell non-performing assets without the debtor’s approval, or grant exemptions to taxes. Such special legal powers were granted to the KAMCO, but not to the RCC.

In Korea, the foreclosure of non-performing assets from financial institutions was executed like a “war” between the KAMCO and those institutions required to transfer their rights on the assets (Chung and Hong 2003). For instance, in June of 1998, the Korean government—the Financial Supervisory Committee, specifically—ordered the KAMCO to finish the transfer of the non-performing assets from the five license-revoked banks within twenty days. Workers in those five banks strongly resisted license cancellation, even blocking KAMCO staff from entering their branches. Under the circumstances, in most cases, the police accompanied KAMCO staff in the process of foreclosing the non-performing assets.

In contrast, in Japan, the RCC foreclosed non-performing assets from failed or failing financial institutions on a case-by-case basis through the courts. Interestingly, one of the three guidelines for the RCC’s debt recovery is “preservation of human dignity.” Even after the RCC foreclosed the bad assets, the RCC made it a rule to get an approval from debtors when it sold the assets in the markets. In fact, in April 2000, when the Civil Rehabilitation Law took effect in Japan, this law allowed a debtor to keep its operation as a debtor-in-possession (Bhala 1999). Therefore, it took more time to collect and then liquidate NPLs.

In short, the KAMCO purchased non-performing assets at more

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29 Interview with senior staff members of the RCC (23 June 2004).
elevated prices than the RCC did, which could weaken the principle of self-responsibility for financial institutions. In contrast, the RCC applied very strict market principles in purchasing and liquidating the bad assets of the banks. In reducing moral hazard, this approach was appropriate. However, because of such a low purchase price, the transfer of NPLs to the RCC was delayed.

Resolution Methods of NPLs: Rapid Sale vs. Reconstruction

Once non-performing assets were transferred to the KAMCO and the RCC, the next crucial task was to resolve NPLs while maximizing their resolution value. Both the KAMCO and the RCC employed diverse disposal methods such as bulk sale, individual sale, and establishing joint ventures. However, each country preferred different resolution methods for NPLs. We can observe three distinctive patterns.

First, the KAMCO put more emphasis on the speedy disposal of NPLs than on maximizing the recovery value of those transferred NPLs. Out of the two basic ways of disposing NPLs—liquidation-oriented disposal and reconstruction-oriented disposal—liquidation-oriented disposal more than the reconstruction-oriented disposal. In every case, the goal of the KAMCO was to dispose of those transferred NPLs as quickly as possible in order to avoid further deterioration in value and to minimize the carrying cost of the bad assets, or so-called snowball effects. Consequently, by the end of 2000, about 50% of those transferred NPLs were recovered. Accordingly, the NPL ratio in the banking sector rapidly declined, falling below 4% in 2001. In contrast, in the case of the RCC, as the transfer of NPLs was dragged out due to the low purchase prices, the liquidation process was also much delayed. As we can see in table 3.7, the RCC resolved the majority of transferred NPLs in 2004 and 2005.

Second, the KAMCO's resolution process was excessively dominated by foreign capital. When the KAMCO tried to sell NPLs beginning in late 1998, no domestic demand existed because of the devastating impact of the crisis. The only demand was from foreign companies specializing in distressed debt investment. Under the circumstances, the KAMCO sold much of its NPLs to foreign asset management companies through bulk sales that typically included the issuance of Asset Backed Securities (ABS) and international bidding. Those foreign companies played the

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30 Liquidation-oriented disposal means loan abandonment and write-offs under liquidation-oriented bankruptcy procedures (bankruptcy and special liquidation). Reconstruction-oriented disposal includes loan abandonment and waivers through special and other civil conciliation, and out-of-court workout.

31 Issuing asset-backed securities is a method of liquidating assets by issuing securities
Myung-koo Kang

role of wholesaler, not restructuring vehicle. Foreign capital had strong incentives for quick capital gains through resale to other foreign financial institutions, instead of restructuring the ailing companies. This rapid foreign sale was also heavily influenced by the agreement with the IMF. The IMF requested that the Korean government dispose of at least 50% of the NPLs that the KAMCO had acquired with public funds within three years, and, complying with the request, the KAMCO focused more on expeditious NPL resolution rather than maximizing recovery value. Later, the KAMCO’s foreign sale methods provided a model for the privatization of Korean banks beginning in 2001. In contrast, the RCC has not relied on foreign sale.

Third, the KAMCO resolved much of its acquired NPLs by establishing based on the future cash flow of underlying assets, and securitization is the process by which loans or other credit exposures are pooled and reconstituted into securities, with one or more classes or positions that may be sold.

Table 3.7. Liquidation Trend of NPLs by RCC and KAMCO

<table>
<thead>
<tr>
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</tr>
</thead>
<tbody>
<tr>
<td>RCC</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Recovery value (billion yen)</td>
<td>95.5</td>
<td>166.2</td>
<td>593.8</td>
<td>1062.2</td>
<td>1706.4</td>
<td>2690.1</td>
<td>912.4</td>
<td>7226.6</td>
</tr>
<tr>
<td>Ratio²</td>
<td>1.3%</td>
<td>2.3%</td>
<td>8.2%</td>
<td>14.7%</td>
<td>23.6%</td>
<td>37.2%</td>
<td>12.6%</td>
<td>100.0%</td>
</tr>
<tr>
<td>KAMCO</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Recovery value (billion won)</td>
<td>20,963</td>
<td>5,321</td>
<td>3,987</td>
<td>2,532</td>
<td>1,572</td>
<td>2,196</td>
<td>4,938</td>
<td>41,509</td>
</tr>
<tr>
<td>Ratio²</td>
<td>50.5%</td>
<td>12.8%</td>
<td>9.6%</td>
<td>6.1%</td>
<td>3.8%</td>
<td>5.3%</td>
<td>11.9%</td>
<td>100.0%</td>
</tr>
</tbody>
</table>


¹ RCC data is based on the fiscal year from 1999 to 2006, and KAMCO data is based on the year-end figure from 1998 to 2006.
² This ratio is the average portion of the 1998–2006 period.
³ The total recovered value does not include the recovery value before the establishment of the RCC (HLCA plus RCB). So, the total value is slightly different from the total recovered value in table 3.6 (8.9 trillion yen).
joint ventures with foreign and domestic companies, while the RCC has not used similar loss-sharing partnerships with foreign or domestic private investors. When the KAMCO tried to resolve NPLs by international bidding or ABS in 1999 and 2000, the KAMCO did not have specific experiences or expertise in these processes. Under the circumstances, the KAMCO tried to utilize the specialized know-how and expertise in asset management held by foreign investment companies by establishing joint venture partnerships (He 2004; Chung and Hong 2003). Moreover, joint ventures with foreign investment companies were useful in blocking political interventions into the purchase and sale of bad assets from politically well-connected companies. For example, the KAMCO established a joint venture with 50/50 ownership with foreign investment banks, but the ultimate decision-making was left to foreign institutions, thereby allowing the KAMCO staff to block pressures from politically well-connected financial institutions regarding the NPLs resolution (Chung and Hong 2003, 276).

Concluding Remarks

We find two distinctive styles of government intervention in Japan and Korea. In the sequence of NPL resolution, the Korean government adopted a centralized, regulator-centered approach, while the Japanese government took a dual-track, creditor-centered approach. Both cases show that a regulator-centered, decisive intervention for NPL resolution can be more effective in minimizing overall costs than a creditor-centered approach to minimize the moral hazard of banks. Moreover, these different approaches demonstrate that policymakers’ initial judgment or estimate about the magnitude of the crisis and their policy preferences for tackling the crisis are critical in NPL resolution. Their initial judgment about the appropriate government intervention for resolving the systemic banking crisis worked as a cognitive map in the policymaking process and determined not only the sequence of bank restructuring at the macroinstitutional level, but also the speed of policy implementation at the microinstitutional level.

In terms of intervention style, we may say that the Japanese style of state intervention was a kind of “cooperation model,” while the Korean was a “command model.” The Japanese government used an indirect inducement strategy. This pattern reflects the policy network structure in Japan. The Japanese authorities acted much more deliberately because the sector was organized as a more horizontal network among ruling-party politicians, the bureaucracy, and banks. The delayed resolution of Japan’s 33 For more detailed theoretical discussion on these two different approaches to handling systemic financial crises, see Kang (forthcoming).
NPL problem highlights the paradox of institutionalization; that is, a network structure based more on relationships than rules can be strong internally, but it can be also weak in producing strong leadership for change in a crisis. Indeed, Japan’s ultimate problem in regard to financial reform is preeminently a political one: a lack of strong leadership to break up the resilient conservative alliance. Indeed, strong political leadership that can insulate or protect regulators from the pressures by debtors or creditors is a critical factor for rapid resolution of NPL.

By contrast, the Korean government was able to respond in a more decisive and centralized fashion because the financial sector was organized into a hierarchical policy network with the regulator at the apex. It had merits for swift decision-making and implementation in response to the banking crisis. But this pattern does not necessarily mean that the integrity of the Korean financial policy network was strong. In fact, the opposite might be true: Its structure was much more vulnerable to changes in the policy environment, particularly to a change in political leadership and external pressures.

We can identify merits and demerits in both cases. The speedy NPL resolution makes it appear that the Korean way of state intervention is more efficient. The swift application of international banking standards contributed to creating an appropriate institutional scheme to identify the scale of the NPLs at an earlier time. But with such an abrupt rule change, more banks went bankrupt and more public funds had to be injected. The decisive capital injection contributed to restoring financial stability quickly. However, it is questionable whether such a huge amount of capital injection was appropriate and necessary, especially when it was clear that the injection would not contribute to strengthening market discipline. In particular, it is doubtful whether it was a wise policy choice to sell those temporarily nationalized banks to foreign investment companies within such a short period of time. Begun with the foreign sale of NPLs, foreign ownership has rapidly increased in the Korean commercial banking sector, reaching more than 70% by the end of 2007. This increasing foreign ownership has had a significant impact on the pattern of financial intermediation. As those banks taken over by foreign financial institutions have engaged increasingly in retail banking, this competitive pressure has forced domestic banks to engage in retail banking more and more. This, in turn, has accelerated loans to households relative to the corporate sector. Consequently, all banks have been increasingly engaged in less risky and more profitable retail banking (Kang 2009). In fact, the total amount of loans to households by commercial banks increased more than four times between 1999 and 2006—from 63.3 trillion won to 248.0 trillion won—and loans toward
households increased far more rapidly than any other types of loan provided to the corporate sector. To date, increasing foreign ownership has not necessarily contributed to the efficient financial intermediation of domestic financial resources, and this pattern cannot be easily reversed (Kang 2009).

In the Japanese case, we can observe an institutional mismatch between the micro- and macroinstitutional levels. At the microinstitutional level, the RCC applied very strict market principles in purchasing the non-performing assets of the banks. In reducing moral hazard and strengthening market discipline, this approach was appropriate and rational. However, because of the strict application of self-responsibility or the least cost principle, the resolution of NPLs was much delayed, and, in the end, the overall economic cost of NPL resolution increased. Meanwhile, at the macroinstitutional level, LDP politicians and regulatory authorities put more emphasis on maintaining the stability of the financial system, and therefore they gave more time to the major banks to increase economies of scale first and tackle the NPL problem later. However, this strategy has not substantially contributed to increasing the efficiency in bank performance, in particular, in channeling domestic financial resources for more productive industrial sectors (Kang 2010). It is true that the dual-track approach in Japan has much delayed NPL resolution, and the delayed NPL resolution slowed down the economic recovery. Yet we need to consider how the different economic sectors complement one another. Banking reform in Japan had to proceed alongside corporate and legal reforms, as well as institutional reforms. Consequently, although the economic results may not be economically optimal, they may be more socially appropriate given the complementary nature of institutional arrangements in Japan’s political economy.

It is too early to tell which method of financial restructuring is better, because each adaptation has its own institutional logic within its respective sociopolitical context. One thing, however, is clear: the way of resolving NPLs and the following bank restructuring has intensified the institutional divergence in the banking sector between the two countries, and Korea is rapidly moving away from the Japanese model of development in the course of adjusting to financial globalization.

References


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Government Intervention for Resolving Non-Performing Loans


