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IMPLEMENTATION COMPLETION REPORT

THE REPUBLIC OF KOREA

STRUCTURAL ADJUSTMENT LOAN
Loan No. 4302-KO

June 30, 1999

CURRENCY EQUIVALENTS

(as of June 15, 1999)
Currency Unit = Won (W)
US$1.00 = W1,167

ACRONYMS AND ABBREVIATIONS

ADB -	Asian Development Bank
BIS -	Bank for International Settlements
BOK -	Bank of Korea
CAS -	Country Assistance Strategy
Chaebol -	Conglomerate
ERL -	Economic Reconstruction Loan
FSC -	Financial Supervisory Commission
FSS -	Financial Supervisory Service
FTA -	Fair Trade Act
G-7 -	Group of seven industrial countries including: the U.S., U.K., Canada, Germany, France, Italy and Japan
GOK -	Government of Korea
ICR -	Implementation Completion Report
IMF -	International Monetary Fund
KAMCO-	Korean Asset Management Corporation
KDIC -	Korean Deposit Insurance Corporation
KFTC -	Korean Fair Trade Commission
LIBOR -	London Inter-Bank Offer Rate
MOFE -	Ministry of Finance and Economy
NGO -	Non-Governmental Organization
NPL -	Non-Performing Loan
SAL -	Structural Adjustment Loan
SBA -	Stand-By Arrangement
SFO -	Special Financial Operations

FISCAL YEAR

January 1 – December 31

Vice President	Jean-Michel Severino, EAP
Country Director	Sri-Ram Aiyer, EACKF
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Task Manager	Sri-Ram Aiyer, EACKF

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Preface

The first Structural Adjustment Loan (SAL I) to the Republic of Korea in the amount of US$2 billion was approved on March 26, 1998, and made effective and disbursed on March 27, 1998. The loan closed on August 31, 1998, which was the original closing date.

SAL I was the second in a sequence of adjustment operations. This ICR covers the period beginning with prior actions for SAL I and leading up to the prior actions for SAL II. This convention is the same as in the ICR for the Economic Reconstruction Loan (ERL). The ICR for ERL covered events and policies relating to the program up to the effectiveness of ERL and its immediate aftermath, and, therefore reviewed many of the prior actions for SAL I.

This Implementation Completion Report (ICR) was prepared by Richard Carroll as a desk assignment, based on interviews with staff and materials from the project file. Mr. Homi Kharas was the Sector Manager. Messrs. Sri-Ram Aiyer (Country Director and Task Manager for the loan) and Zia Qureshi (Deputy Task Manager for the loan, EACKO) had overall responsibility for monitoring the policy matrix for the first Structural Adjustment Loan. Messrs. Nicholas Prescott (EASHD), Douglas Webb (LEGPS), David Scott (SFO), Robert Holzmann (HDNSP), Behdad Nowroozi (EAPCO), Gerry Meyerman (PSDBE), Klaus Lorch (EASPS), Stijn Claessens (FSPEU), and Clifford Garstang (LEGEA) provided comments for the ICR. Messrs. Aiyer and Qureshi reviewed the report.

IMPLEMENTATION COMPLETION REPORT

THE REPUBLIC OF KOREA

STRUCTURAL ADJUSTMENT LOAN

Loan No. 4302-KO

Evaluation Summary[1]

Project Origin, Objectives and Description

1. The first Structural Adjustment Loan (SAL I - Loan No. 4302-KO) for $2 billion was the second in a series of Bank lending operations in Korea to provide assistance in dealing with the economic crisis. SAL I was the immediate follow-up operation to the $3 billion Economic Reconstruction Loan (ERL). SAL I was approved by the Board on March 26, 1998, became effective, and was fully disbursed on the following day. The objectives of SAL I were to: (1) provide assistance for Korea's immediate foreign exchange crisis; and (2) support a program of major structural reforms in the financial and real sectors to lay the basis for Korea's eventual return to strong and sustained growth in the context of today's more integrated and competitive global economy.

2. Korea made substantial progress in the aftermath of ERL in its stabilization and structural reform program. In addition to avoiding default, between December 1997 and February 1998, the exchange rate appreciated almost 20 percent, the stock market recovered 45 percent, and usable reserves increased to $18.5 billion from a low of $4 billion. The drafting of a debt restructuring agreement in January 1998 with major New York creditor banks eased pressure on Korea's external financial position and increased financial market confidence in Korea's economy.

3. The framework for recovery in Korea supported by SAL I was broad and deep, aiming at the major structural weaknesses in the economy, including those in financial, corporate and social sectors. The Government's framework for structural reforms, supported by SAL I, was specified in the Government's Letter of Development Policy of February 27, 1998. The framework consisted of four elements: (1) financial sector reform; (2) corporate sector reform; (3) the labor market and social safety nets; and (4) economic management and institutions. Substantial progress was made in all of these areas under SAL I.

4. The SAL I reform framework intensified the shift in incentives away from corporate and financial policies that precipitated the crisis. ERL identified the major distortions in the

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[1] The Implementation Completion Report (ICR) for the first Structural Adjustment Loan (SAL I) covers policies and events in Korea relating to the loan prior to SAL I effectiveness and leading up to the implementation of the follow-up loan, the second Structural Adjustment Loan (SAL II) which was approved by the Board on October 23, 1998.

economy, including the excessive corporate leveraging to diversify holdings, weak corporate governance, subsidized interest rates and a captive financial sector. SAL I supported a range ~~of~~ specific reforms to address these distortions. In the financial sector, the government committed to formulating a plan to resolve financial sector distress and establish the basis for a sound, efficient financial system in the future. In the corporate sector, the success of restructuring depended on transparency and a competitive framework. SAL I pursued the strengthening of shareholder rights and of the boards of directors of Korean companies. Improved accounting and audit functions would enhance transparency and provide better and earlier signals of potential future crises. Revamped competition policies, including a more powerful Korean Fair Trade Commission (KFTC) and significant liberalization of foreign investment regulations, would improve Korean corporations' ability to prosper in domestic and international markets.

5. Rigidities in the Korean labor market, in particular the inability to lay off workers, made corporate restructuring difficult. SAL I sought to make the labor markets more flexible by making layoffs feasible for corporations. To soften the impact of this move and to cushion the poor from the crisis, SAL I contained measures to improve and expand the social safety net for released workers, including retirees, and to strengthen poverty targeted programs.

6. **Loan Pricing**. SAL I pricing was non-standard and its negotiation led to some delay of loan effectiveness. Two considerations dictated a higher than standard price: (i) the increased risk posed by the Korean economic crisis; and (ii) the Bank's need to set aside substantial reserves/provisions against the large SAL I, which reduced the Bank's net income. (At the time of SAL I approval, the standard SAL interest rate was 50 basis points above the Bank's cost of borrowing, with no upfront service charge). The features of the SAL I pricing were:

- Interest rate--6-month U.S. Dollar LIBOR plus 0.75 percent
- Upfront fee--1.5 percent of principal at effectiveness
- Term--15 years
- Grace period--5 years
- Ineligibility for waivers of interest or commitment charges

Implementation Experience and Results

Macroeconomic Results

7. An indication of the impact of the recovery program under SAL I is the general macroeconomic developments between SAL I and SAL II effectiveness (October 23, 1998). There was progress on stabilization, with the exchange rate appreciating from W1,600/$ to W1,360/$, a revised current account surplus estimate for 1998 of $40 billion (13 percent of GDP), an increase in gross usable reserves to over $40 billion, a greatly improved term structure of external debt with short-term debt reduced to $32.5 billion (compared with $63.2 billion at the end of 1997 and $93.0 billion at the end of 1996), and an inflation rate around 4 percent. On the negative side, GDP is estimated to have contracted by 5.8 percent in 1998 and unemployment to have risen to 7.9 percent (end of year) compared with 3 percent before the crisis. While the recession was worse than initially expected, in general, the macroeconomy, supported by SAL I, was able to reverse several key negative trends and reduce the threat of default: the rising current account surplus,

increasing usable reserves, increasing rollover ratio for external debt, and reduced interest rates. The ground was laid for economic recovery.

Structural Reforms

8. **Financial sector**. Key actions with respect to remedying financial sector distress included developing a comprehensive resolution strategy. This included arranging for diagnostic reviews to be performed in all commercial banks, and taking appropriate enforcement action where banks were found to be undercapitalized (closure/merger/recapitalization/restructuring). Government agreed to evaluate the remaining merchant banks and close those that were not viable. Steps were initiated toward the privatization of Korea First Bank and Seoul Bank. To lay the groundwork for a stronger financial system, the government agreed to improve the regulatory framework for all financial institutions, including strengthening prudential regulations. To upgrade financial sector supervision, the government embarked upon a comprehensive institutional capacity program for the new, combined supervisory agency, the Financial Supervisory Service (FSS). Steps were taken to promote capital market development, in part by strengthening the government and corporate bond markets, liberalizing the equity markets, promoting institutional investors and strengthening market infrastructure.

9. **Corporate Sector**. SAL I continued progress in the areas of governance with more specific reforms of the roles of boards of directors, the insolvency framework, and financial transparency and accountability. There were early gains in financial disclosure which paved the way for corporate reform and helped restore some confidence by the external market. Further improvement in financial disclosure and transparency lagged in the middle part of 1998, but gained momentum leading up to SAL II. Achievement of objectives was reasonably good with respect to governance and the competition framework, but also lagged in mid-1998. Measures to improve governance included:

- mandating that at least 25 percent of boards be comprised of outside directors.
- lowering the threshold for exercising minority shareholder rights, for example to file a shareholders' representative suit from 1 to 0.05 percent of outstanding shares (and later reduced to 0.01 percent), and for inspection rights from 3 to 1 percent. Thresholds for inspecting company records and calling shareholders' meetings were further reduced.
- new bankruptcy laws that empowered courts to freeze assets within two weeks of a filing for the purpose of providing fair treatment for creditors. Courts could also impose a one year limit on reorganizations.
- Bankruptcy Act gave district courts authority over involuntary bankruptcy and composition and reorganization procedures that were formerly divided
- Reorganization Act: expedited the process by setting deadlines, promoting courts' expertise by creating an administrative body, and enhancing creditors' role by creating a creditors' committee.
- The Composition Act strengthened the implementation process by introducing an administrator of asset preservation, imposing on debtors the obligation to report on implementation, and requiring evaluation of debtors' implementation by creditors.

10. **Improving financial reporting and disclosure**. Although ERL supported some improvements, the accounting and auditing profession still needed fundamental reform to achieve financial transparency and reliability. Important specific measures included:

- Commitment to establish an independent accounting standards setting body and strengthen KICPA's role in issuing auditing standards, monitoring professional quality, and enforcing a code of conduct.
- Commitment to preparation and audit of financial statements of listed companies, banks, and other financial institutions in accordance with accounting and auditing standards that are consistent with international best practices starting with the reporting year 1999.
- Issuance of implementing rules for consolidated financial statements for majority owned companies and combined financial statements for all major commonly controlled companies starting in 1999 (originally slated for the year 2000).
- Completion of the study on introducing audit committees of boards of directors with the goal of upgrading the audit selection committee to an independent and transparent audit committee of boards of directors.
- The External Audit of Joint Stock Corporations Act which accelerated the introduction of consolidated financial statements for corporate groups from the year 2000 to 1999, and required an audit selection committee for listed companies and affiliates of large business groups.

11. **Competition Policy**. Significant prior actions were taken, but partially undermined later by the quality of implementation. It is not clear whether the KFTC has been able to enforce adequately the new, pro-competition regulations (relating to fair trade and mergers and acquisitions) supported by SAL I. Performance on competition policy lagged after SAL I effectiveness and before fulfillment of SAL II prior conditions. Major prior conditions included:

- Foreign Direct Investment and Foreign Capital Inducement Act: permits takeovers of non-strategic companies by foreign investors without government approval, and raises the foreign stock ownership ceiling without approval by the Board of Directors from 10 percent to 33 percent.
- Corporation Tax Act: advances removal of the tax exemption regarding interest costs of excessive borrowings as losses and expenses from year 2002 to 2000.
- Tax Exemption and Reduction Control Act: provides tax breaks for restructuring of firms, including exemption of SMEs from capital gains tax on sale of real estate used to repay debt to financial institutions, and on transfers of real estate through M&A.
- Antitrust and Fair Trade Act: prohibits any new cross debt guarantees and eliminates all existing cross debt guarantees by the end of March, 2000.

12. **Labor Markets/Social Safety Nets**. SAL I substantially broadened the ERL program, laying out specific measures in three areas: the labor market, anti-poverty and pensions. Major measures to improve labor market functioning included:

- Expansion of unemployment insurance coverage to firms with five or more workers.
- The Labor Standards Act which allows firms to make layoffs under M&As and to avoid financial difficulties.
- The Act relating to Protection for Dispatched Workers which introduces manpower leasing services for jobs requiring professional knowledge, skills and experience (a Presidential Decree later limited the application of manpower leasing to 26 occupations, however).

13. **Poverty and support to the unemployed**. To reduce the impact of the crisis on the poor, the GOK committed to at least maintaining constant real per beneficiary public expenditures on targeted poverty programs, and made adequate budget allocations. Additional measures included:

- The Basic Employment Policy Act authorizing the Ministry of Labor to implement unemployment measures, including vocational training to promote employment and financial support to cover living costs and medical care costs for the unemployed.
- The Employment Insurance Act reducing minimum contribution period from 12 to 6 months temporarily until June 30, 1999; and increasing the minimum duration of benefit period to 60 days and minimum amount of Job Search Allowance from 50 to 70 percent of minimum wage.
- The Wage Claim Guarantee Act entitling those laid off at bankrupt firms with more than five workers to a sum equal to three months' pay plus three years' severance pay from a state-managed compensation fund, financed by employers' contribution, from July 1, 1998.

14. **Pensions**. SAL I pursued both short and long-run objectives for the pension system, as well as social and financial. The short-run plan was to ensure adequate protection for those hurt by the crisis. The long-run plan was to ensure fiscal soundness of the pension system well into the next century. One of SAL I's major initiatives was to ensure protection for the elderly poor through a means-tested, non-contributory social pension for the elderly. To improve the management of pension funds, forced government borrowing and directed credits from pension fund reserves had to be phased out. Several measures were instituted to pave the way for investing the pension fund in other assets, and enhancing professionalism in pension fund management. One important step identified was to move toward a secondary market for the government securities that the NPS might hold.

15. *In summary*, most of the objectives of SAL I were accomplished by the closing date, with most of the major policy actions implemented prior to SAL I Board presentation. SAL I should be viewed as part of a broader, longer-term series of efforts to stabilize the Korean economy and return it to a path of sustainable growth. The overall assessement of SAL I is satisfactory

Bank Performance

16. Although the Bank experienced obstacles in concluding SAL I negotiations, it succeeded in substantially advancing the reform program and in rapidly providing balance of payments assistance. On a compressed timetable, the Bank, with other donors and the GOK, specified conditions to address major areas of stabilization and structural reform. The Bank also effectively supported the IMF efforts by stressing the importance of an effective macro-economic

stabilization plan and a medium-term structural reform framework as essential conditions for Board presentation of SAL I, and by closely monitoring the measures in the policy matrix. Major features of Bank performance include:

- The Bank/GOK reform program achieved substantial progress in most, if not all, areas of structural reform through the Board conditions for SAL I.
- The Bank rapidly pursued a follow-up operation to ERL.
- Some elements of the reform program had to be watered down in order to achieve a quick liquidity transfer.
- The Bank did not explicitly state the higher than standard SAL pricing until the negotiation stage.
- The Bank approved a relatively large TA loan ($48 million) to support the implementation of the SAL I program.

Future Operations

17. The second Structural Adjustment Loan (SAL II) was the immediate follow-up operation, effective October 23, 1998. SAL II ($2 billion) was a two tranche loan to support Government efforts to deepen structural reform in the financial and corporate sectors and further strengthen social safety nets.

Lessons Learned

18. SAL I built on the ERL, and many of the lessons learned under ERL apply to SAL I as well. These lessons are briefly summarized in section I (see ICR for ERL for more detail). Lessons from SAL I are:

- **The costs of preparing a loan on a highly compressed timetable**. The scarcity of time for loan preparation can lead to oversights that lead to a net delay in the final analysis. Under SAL I, the Bank intended to charge a higher than standard price for SAL I. While there were reasons for the Koreans to expect a higher price, there was no explicit indication that the Bank intended to do so. As a result, the Koreans' had a basis to balk at the agreement which led to nearly a one month delay in conclusion of negotiations. That delay was inefficient because that time could have been better employed on the substance of the SAL I program rather than bargaining over the price of the loan. As a result of the further negotiations, the Koreans managed to lower the interest rate by 25 basis points. A more important cost was the lack of time to achieve government ownership on more contentious reform elements such as the audit reforms.

- **Beginning policy discussions with the top policy makers**. It is advisable to initiate adjustment negotiations with senior policy makers who are actually in a position to decide on, or to know about feasible reform commitments. Under SAL I, a fair amount of time was lost in early discussions with technical people who were not in a position to advance policy discussions with the Bank team.

- **The Bank and the Fund and a unified front**. The negotiating positions of both the Bank and the IMF are weakened when their positions are not fully consistent. Borrowing countries can easily detect inconsistencies, especially in the midst of simultaneous negotiations in the same policy areas, and can play one institution against the other. One example was the external audit reforms where the Bank had to accept a less than full commitment.

- **Single vs. double tranche approach.** A single tranche policy-based operation (such as SAL I), with strong up-front actions prior to Board approval, is an effective way to quickly transfer liquidity in urgent situations. The single tranche instrument is best used when the economic situation is volatile, as in SAL I, where the longer term rigidity of second tranche conditions could be disadvantageous. However, single tranche operations offer only a 2 to 3 month window to accomplish reforms. After disbursement, reforms, as in SAL I, may well lag until the next operation's prospect of fund release. Two tranche operations offer a longer period to enact reforms and carry the stronger incentive of tranche release conditions, as opposed to "monitorable indicators." Administratively, it is cheaper to have one two tranche rather than two single tranche operations.

- **One to one on site guidance through reforms**. Slippage in reforms may occur due to a borrower's unfamiliarity with the economics behind the reforms, as in the case of the risk of further concentrating industry through "Big Deals". A seminar on competitive policies is a good way to have government ownership of an increasing competition culture. TA projects may be too slow in matching infusions of technical guidance with actual implementation in a timely way. Assessment of upfront loan fees argues for abundant upfront provision of this type of assistance.

IMPLEMENTATION COMPLETION REPORT

THE REPUBLIC OF KOREA

STRUCTURAL ADJUSTMENT LOAN

Loan No. 4302-KO

PROGRAM IMPLEMENTATION ASSESSMENT

A. Objectives, Background and Description

Objectives

1. The first Structural Adjustment Loan (SAL I - Loan No. 4302-KO) for $2 billion was the second Bank lending operation in Korea in a series to provide assistance in dealing with the economic crisis. SAL I was the immediate follow-up operation to the $3 billion Economic Reconstruction Loan (ERL). SAL I was approved by the Board on March 26, 1998, became effective, and was fully disbursed on the following day. The objectives of SAL I were to: (1) provide assistance for Korea's immediate foreign exchange crisis; and (2) support a program of major structural reforms in the financial and real sectors to lay the basis for Korea's eventual return to strong and sustained growth in the context of today's more integrated and competitive global economy.

Background

2. SAL I followed only three months behind the ERL, and was another large loan to maintain momentum in restoring investor confidence, but also to develop specific measures under the broad reform framework agreed on under ERL. The quick follow-up loan was part of the International Monetary Fund (IMF) and Bank strategy to frontload the $57 billion rescue package in order to prevent Korea from slipping backward to the edge of default. The Bank and GOK prepared SAL I in close cooperation with the IMF.

3. From the December 4, 1997 announcement of the rescue package through SAL I effectiveness, the Bank had already disbursed $5 billion of the (up to) $10 billion pledged, the IMF had disbursed $13 of $21 billion and the Asian Development Bank (ADB), $3 of $4 billion. The "second line of defense" by G-7 countries in the event of a second wave of the crisis, part of the total $57 billion rescue package, has not been activated to date.

4. Korea made substantial progress after ERL effectiveness under its stabilization and structural reform program. In addition to avoiding default, Korea further stabilized the economy, and initiated a medium term framework for continued recovery. On the macro side, the exchange rate appreciated almost 20 percent, the stock market recovered 45 percent, and usable reserves increased to $18.5 billion by the end of February from a low of $4 billion in December. The drafting of a debt restructuring agreement in January 1998 with major New York creditor banks

eased pressure on Korea's external financial position and increased financial market confidence in Korea's economy. Additional details of macroeconomic developments leading up to SAL I are summarized in the Implementation Completion Report for ERL. Developments after SAL I effectiveness are found in Section B below.

5. The framework for recovery aimed to restructure the Korean economy in a way consistent with a more integrated and competitive global economy. SAL I followed the first Bank response to the crisis (ERL) and aimed at resolving underlying structural weaknesses in the economy. As part of the reform agenda supported by SAL I, the Government of Korea (GOK) committed to a medium term framework and undertook a large number of financial, corporate and social sector reforms. Section B below reviews these reforms, many of which were actions required for Board presentation of SAL I (see also Annex B: Prior Actions for SAL I).

6. SAL I was initiated shortly after the December 19, 1997 national election, which the government in power lost. SAL I was prepared and negotiated during a transition phase with both the outgoing and incoming governments. Difficult reforms were discussed in a tripartite forum of government officials, and business and labor leaders. That the new government was elected as a reform government was considered a boost to developing and implementing a reform program with strong measures.

Description

7. **Program elements**. The Government's framework for structural reforms, supported by SAL I, was specified in the Government's Letter of Development Policy on February 27, 1998 which was signed by the Deputy Prime Minister and Minister of Finance and Economy (see President's report P-7225-KO March 19, 1998, Annex 1). The framework consisted of four elements: (1) financial sector reform; (2) corporate sector reform; (3) the labor market and social safety nets; and (4) economic management and institutions. The corporate sector reform element included reforms in corporate governance and competition policies. The IMF took the lead on macroeconomic stabilization measures, as well as trade policy and capital account liberalization. The Bank and the IMF worked together on the financial sector with specific areas of responsibility dictated by each institution's comparative advantage. The Bank led in corporate sector reform and labor markets and social protection.

8. The general framework for the future reform program (to be supported by SALs) was agreed prior to Board presentation. The Country Assistance Strategy (CAS) was outlined in the SAL I President's report. (A formal CAS is being prepared.) The strategy addressed the key structural weaknesses of the Korean economy, especially in the financial and corporate sectors, while simultaneously addressing short and long-term social issues. With the establishment of the policy framework supported by SAL I, the Government met the broad conditions to justify Bank support of $2 billion as part of a total program of lending up to US$10 billion for a two to three-year period. Annex B lists actions required for SAL I Board presentation. Annex C presents the status of policy actions leading up to SAL II (October 1998).

9. The SAL I reform framework intensified the shift in incentives away from corporate and financial policies that precipitated the crisis. ERL identified the major distortions in the economy, including the excessive corporate leveraging to diversify holdings, weak corporate

governance, subsidized interest rates and a captive financial sector. SAL I helped to correct these distortions in the financial and corporate sectors through major policy actions.

10. **Financial sector reforms**. Under SAL I the government committed to formulating a plan to resolve financial sector distress and establish the basis for a sound, efficient financial system in the future. Key actions with respect to remedying financial sector distress included developing a comprehensive resolution strategy. As part of this strategy, government agreed to proceed with the privatization of Korea First and Seoul Bank. They were to arrange for diagnostic reviews to be performed in all commercial banks, and take appropriate enforcement action where banks were found to be undercapitalized. Government agreed to evaluate the remaining merchant banks and close those that were not viable. Asset purchases by KAMCO were to take place only in the context of approved recapitalization and rehabilitation plans. Asset purchases were to be made at market value.

11. To lay the groundwork for a stronger financial system, the government agreed to improve the regulatory framework for all financial institutions, including strengthening prudential regulations. They were to upgrade financial sector supervision by embarking upon a comprehensive institutional capacity program for the new, combined supervisory agency, the Financial Supervisory Service (FSS). Capital market development was to be promoted, in part by strengthening the government and corporate bond markets, liberalizing the equity markets, promoting institutional investors and strengthening market infrastructure.

12. **Corporate reforms**. The success of restructuring depended on transparency and a competitive framework. SAL I pursued the strengthening of shareholder rights and of the boards of directors of Korean companies. With greater participation of shareholders and directors, business decisions would be made for the benefit of the company rather than the elite groups that controlled the companies. Improved accounting and audit functions would enhance transparency and provide better and earlier signals of potential future crises. Revamped competition policies, including a more powerful Korean Fair Trade Commission (KFTC) and significant liberalization of foreign investment regulations, would improve Korean corporations' ability to prosper in domestic and international markets.

13. **Labor markets and social safety nets**. Rigidities in the Korean labor market, in particular the inability to lay off workers, made corporate restructuring difficult. SAL I sought to make the labor markets more flexible by making layoffs feasible for corporations. To soften the impact of this move and to cushion the poor from the crisis, SAL I contained measures to improve and expand the social safety net for released workers, including retirees, and to strengthen poverty targeted programs.

14. **Special issue of non-standard loan pricing.** SAL I pricing, although considerably lower than that of ERL, was higher than that of a standard SAL. Essentially two considerations dictated a higher price: (i) the increased risk posed by the Korean economic crisis; and (ii) the Bank's need to set aside substantial reserves/provisions against the large SAL I, which reduced the Bank's net income. After intensive and protracted negotiations, SAL I pricing was only moderately higher than that of a standard SAL at final loan agreement. The features of the SAL I pricing were:

- Interest rate--6-month U.S. Dollar LIBOR plus 0.75 percent
- Upfront fee--1.5 percent of principal at effectiveness
- Term--15 years
- Grace period--5 years
- Ineligibility for waivers of interest or commitment charges

15. At the time of SAL I approval, the standard SAL interest rate was 50 basis points above the Bank's cost of borrowing, with no upfront service charge. (At the time of this ICR, the standard SAL interest rate is 75 basis points above the Bank's borrowing cost, and there is a 1.0 percent upfront service charge-effective July 1998).

B. Achievement of Objectives

Recent Macroeconomic Performance and Stabilization Results

16. Korea's economy has stabilized further. Shortly after ERL disbursed, in early to mid-January, Korea was still in danger of sinking into default, but development of a framework to restructure Korea's short-term external debt helped calm financial markets. Still, it was not until banks gradually signed on to the debt restructuring agreement, by April, that Korea's debt situation actually began to stabilize. As the financial situation stabilized, monetary policy was eased to pursue further interest rate reductions that were consistent with exchange rate stability. With the advantage of low public debt, fiscal policy could also be relaxed to bolster domestic demand.

Table 1 Selected Economic Indicators

	1995	1996	1997	Est. 1998	Proj. 1999
Real GDP % change	8.9	6.8	5.0	-5.8	4.5
Gross domestic inv.-% of GDP	37.2	37.9	34.2	20.9	27.1
Gross national saving.-% of GDP	35.4	33.5	32.5	33.4	32.3
CPI-end period	4.7	4.9	6.6	3.9	2.0
Terms of trade	-3.5	-11.7	-11.4	1.8	-3.1
Gov't budget balance % of GDP	0.3	0.3	0.3	-3.1	-5.2
Reserve money growth	16.3	-12.2	-12.5	-8.1	19.8
Balance of Payments-US$ billion					
Exports, f.o.b.	124.6	130.0	138.6	131.8	134.3
Imports, f.o.b.	-129.1	-144.9	-141.8	-90.6	-106.0
Current Acct. Balance	-8.5	-23.0	-8.2	40.0	20.4
Usable reserves-months	2.2	2.0	0.6	5.1	6.5
External Debt-Total-US$ billion	119.7	164.3	158.1	149.3	132.8
of which Short-term	78.7	93.0	63.2	30.8	27.2
External Debt-% of GDP	24.5	31.6	33.2	46.6	33.9

Source: IMF

17. Positive macroeconomic developments between SAL I and SAL II effectiveness (October 23, 1998) include progress on stabilization of the exchange rate from around W1,600/$ to W1,360/$, and a revised current account surplus estimate for 1998 up to $40 billion (13 percent of GDP), mainly due to compression of imports, but with some export volume response. In addition, there was an increase in gross usable reserves to over $40 billion, a greatly improved term structure of external debt with short-term debt reduced to $32.5 billion (compared with $63.2 billion at the end of 1997 and $93.0 billion at the end of 1996), and an inflation rate around 4 percent. Interest rates were reduced such that the overnight call rate was 8.5 percent and the three-year corporate bond yield was 12.5 percent leading up to SAL II effectiveness.

18. On the down side, GDP is estimated to have contracted by 5.8 percent in 1998 and unemployment to have risen to 7.9 (end of year) percent compared with 3 percent before the crisis. The decline was worse than originally expected. The three major components of domestic demand fell, first an investment decline, then a drop in private consumption, which, in turn, was made worse by an initially contractionary fiscal policy. Corporate sector distress was exacerbated by interest rate spikes, and the regional contagion that reduced the potential for export-led recovery (half of Korea's exports were within Asia) drove Korea further into recession.. Most of the "first line of defense" resources had also been disbursed.

19. The most significant short-term achievement was to reverse several key negative trends and reduce the threat of default: the rising current account surplus, increasing usable reserves, increasing rollover ratio for external debt, and reduced interest rates. The ground was laid for economic recovery.

Structural Reforms

20. The Government made significant progress on all major fronts associated with SAL I, with most policy actions completed prior to Board presentation. Prior actions are summarized in Annex B. The following summarizes prior actions and actions taken after SAL I effectiveness and leading up to SAL II.

Macroeconomic

21. The macroeconomic framework was agreed with the IMF, which oversaw benchmarks in this area. Improvements in the macroeconomy are summarized above.

Financial

22. Under SAL I, the insolvency of the financial system dictated that GOK first deal with troubled institutions. GOK, working in close collaboration with the Bank, developed a plan to resolve distressed banks as required, with shareholders suffering substantial dilution and top managers losing their jobs, while minimizing disruption to the flow of credit to the economy. In addition to the immediate term liquidations and recapitalizations, the Bank, under SAL I pursued longer term measures in supervision and regulation.

23. **Commercial Bank Rehabilitation**. The Financial Supervisory Commission (FSC) was assigned responsibility for dealing with financial distress. GOK provided support to commercial banks via the purchase of non-performing loans by KAMCO and capital injections.

24. Two major distressed commercial banks (Korea First Bank and Seoul Bank) were nationalized and preparations begun for sale to international financial institutions. After GOK assumed control of Korea First Bank and Seoul Bank and wrote down existing shareholders' stake in the two banks to less than 10 percent of their original stake and injected new capital, investment banks were invited (early 1998) to develop a privatization strategy for these two banks. The government hired an international investment bank to sell both Korea First and Seoul Banks. They also contracted with an international auditing firm to prepare books and records to facilitate due diligence by potential purchasers.

25. Twelve commercial banks that failed to meet capital adequacy requirements at year-end 1997 were required to submit rehabilitation plans to government. At the end of June, following diagnostic audits, five banks' plans were rejected, and they were closed with their assets and liabilities transferred to stronger banks. The remaining seven banks' plans were conditionally approved and they were given one month to submit restructuring proposals (Implementation Plans). Among these seven were the four largest private banks in Korea. In the end, two of the four large banks (Commercial and Hanil) merged and were nationalized by government. Negotiations with the other two large banks (Korea Exchange and Cho Hung) continued beyond the SAL I period. During SAL I one of the three small banks was acquired by a stronger institution, and the two others were subject to close supervision. Diagnostic reviews on the remaining banks (those that met the year-end 1997 capital requirement) were completed during the SAL I period, and none of these were subject to intervention.

26. Support was provided to banks through purchases of NPLs by KAMCO at prices arguably equivalent to market value (though in practice probably somewhat higher), and through capital injections by the new Korea Deposit Insurance Corporation (KDIC), which consolidated the various deposit insurance entities. Capital injections were made only to support acquisition of failed banks by healthier banks, or as part of nationalization. Support was provided in a transparent manner.

27. **Merchant Banks**. The majority of the distressed merchant banks were closed. GOK called for rehabilitation plans of all merchant banks and revoked the licenses and ordered the closure of 10 merchant banks in early February (12 by March 1998, eventually 16). Depositors were paid out and assets of the closed banks were disposed. The 14 merchant banks that remained open were subject to closer supervision. Some progress was made in resolving other non-bank financial institutions (NBFIs) during the SAL I period.

28. **Regulatory Framework**. Progress was made in improving the regulatory framework as some prudential regulations were strengthened (i.e. loan classification and provisioning, foreign exchange positions). Disclosure standards were improved. The government's ability to impose enforcement orders on banks was enhanced. But a substantial work agenda remained for SAL II.

29. **Supervision**. Leading up to SAL I, GOK consolidated four supervisory agencies into the FSS. The FSC became operational on April 1, 1998. This supervisory structure covered banks,

NBFIs and capital markets in one body under the direct supervision of the Prime Minister's Office Diagnostic reviews were programmed to monitor loan loss provisioning. Steps were initiated toward strengthening institutional capacity for supervision. A major institutional development program, supported by international consultants, was planned for launch in the first quarter of 1999.

30. **Developing Capital Markets**. GOK liberalized capital market investment as the government eliminated the restriction (4 percent) on foreign bank ownership of commercial and merchant banks. The Government also liberalized capital markets by opening to foreign investors the domestic bond market and money market instruments issued by non-financial institutions. GOK removed the aggregate limit on foreign investment in equities of listed firms and eliminated restrictions on corporate foreign borrowing. Several public-private sector task forces were formed to build a consensus on a plan for further liberalization and strengthening of market infrastructure, but little progress in actual implementation was made after SAL I disbursement. However, SAL II followed-up in these areas.

Corporate Sector

31. SAL I continued progress in the areas of governance with more specific reforms of the roles of boards of directors, the insolvency framework, and financial transparency and accountability. There were early gains in financial disclosure which paved the way for corporate reform and helped restore some confidence by the external market. Further improvement in financial disclosure and transparency lagged in the middle part of 1998, but gained momentum leading up to SAL II. Achievement of objectives was reasonably good with respect to governance and the competition framework, but also lagged in mid-1998

Governance

32. **Strengthened role of directors of companies**. SAL I sought to remedy several weaknesses in boards of directors of large Korean companies, in particular, their diffuse responsibilities and subordination to large shareholders. SAL I strengthened their function by including at least one outside director on the board. Once GOK agreed with this principle, it then exceeded the target under SAL I by mandating that at least 25 percent of boards be comprised of outside directors.

33. **Strengthening of minority shareholders' rights**. The Securities Exchange Act strengthened minority shareholders' rights by lowering the threshold for exercising rights, for example to file a shareholders' representative suit from 1 to 0.05 percent of outstanding shares (and later reduced to 0.01 percent), and for inspection rights from 3 to 1 percent. For listed companies, the threshold for making proposals at a shareholders' meeting was reduced to 0.5 percent. For unlisted companies the threshold was reduced from 5 percent to 3 percent. Thresholds for inspecting company records and calling shareholders' meetings were further reduced.

34. **Improving the insolvency system**. SAL I made several advances in dealing with bankruptcies and fortifying creditors' rights. Previous to the crisis, bankruptcies were virtually non-existent in Korea (less than 100 annually, including personal bankruptcies) and there was no

clearing system to deal with the new spate of bankruptcies. An exit system was needed for creditors and non-viable enterprises. With SAL I support, Korea pursued voluntary workouts that were backed by a credible threat of bankruptcy litigation under specified time limits. The new bankruptcy laws empowered courts to freeze assets within two weeks of a filing for the purpose of providing fair treatment for creditors. Courts could also impose a one year limit on reorganizations. Voluntary workouts served as a good complement to the court system and reduced the need for litigation. In adjudication, judges were forbidden to consider non-financial arguments in their rulings. For example, adverse social consequences, such as job loss, could not be considered. Specific key measures taken to improve the insolvency system included:

- Bankruptcy Act gave district courts authority over involuntary bankruptcy and composition and reorganization procedures that were formerly divided
- Reorganization Act: expedited the process by setting deadlines, promoting courts' expertise by creating an administrative body, and enhancing creditors' role by creating a creditors' committee.
- The Composition Act strengthened the implementation process by introducing an administrator of asset preservation, imposing on debtors the obligation to report on implementation, and requiring evaluation of debtors' implementation by creditors.

35. **Improving financial reporting and disclosure**. Korea's accounting practices had lagged far behind its economic development. Although ERL supported some improvements, the accounting and auditing profession still needed fundamental reform to achieve financial transparency and reliability. While the profession was highly regulated, the quality of financial reporting and audit was poor and confidence in financial statements was low. The regulatory framework, incentive structure, and culture of minimum disclosure helped create an environment in which accountants and auditors were neither prepared nor held accountable for preparing reliable information, providing assurance, or helping identify weaknesses. Maximum audit fees were set by the Government. The application and enforcement of standards was poor. The Bank supported three areas to upgrade financial reporting: upgrading standards; rationalizing the institutional framework for setting standards, including enhancing the role of the Korean Institute of Chartered Public Accountants (KICPA); and improving the financial oversight role of boards of directors, including the internal audit function and selection of external auditors. Important specific measures included:

- Commitment to establish an independent accounting standards setting body and strengthen KICPA's role in issuing auditing standards, monitoring professional quality, and enforcing a code of conduct.
- Commitment to preparation and audit of financial statements of listed companies, banks, and other financial institutions in accordance with accounting and auditing standards that are consistent with international best practices starting in the year 1999.
- Issuance of implementing rules for consolidated financial statements for majority owned companies and combined financial statements for all major commonly controlled companies starting in 1999 (originally slated for the year 2000).
- Completion of the study on introducing audit committees of boards of directors with the goal of upgrading the audit selection committee to an independent and transparent audit committee of boards of directors.

- The External Audit of Joint Stock Corporations Act which accelerated the introduction of consolidated financial statements for corporate groups from the year 2000 to 1999, and required an audit selection committee for listed companies and affiliates of large business groups.

36. Overall accomplishments were somewhat less than what was sought by the Bank. The Bank encouraged GOK to establish a subcommittee of boards of directors to oversee the financial reporting process and internal control structure of listed companies and act as a liaison with external auditors. The GOK had initiated a reform by requiring the establishment of an audit selection committee that was not sufficiently independent and had responsibility only for the selection of external auditors rather than the full responsibility that should be vested with an audit committee of the boards of directors. This committee represented creditors and the largest shareholders. This arrangement was not consistent with international best practices. There was reluctance initially to adopting international standards. Overall, progress in reducing the role of the Government in setting standards and regulating the accounting and auditing profession was slow.

Competition Policy

37. The record here has been mixed. Significant prior actions were taken, but partially undermined later by the quality of implementation. For instance, GOK announced that business combinations which substantially reduce competition were no longer permitted. However, it is not clear whether the KFTC has been able to enforce adequately the new, pro-competition regulations. Performance on competition policy lagged after SAL I effectiveness and before fulfillment of SAL II prior conditions. Major prior conditions included:

- Foreign Direct Investment and Foreign Capital Inducement Act: permits takeovers of non-strategic companies by foreign investors without government approval, and raises the foreign stock ownership ceiling without approval by the Board of Directors from 10 percent to 33 percent.
- Corporation Tax Act: advances removal of the tax exemption regarding interest costs of excessive borrowings as losses and expenses from year 2002 to 2000.
- Tax Exemption and Reduction Control Act: provides tax breaks for restructuring of firms, including exemption of SMEs from capital gains tax on sale of real estate used to repay debt to financial institutions, and on transfers of real estate through M&A.
- Antitrust and Fair Trade Act: prohibits any new cross debt guarantees and eliminates all existing cross debt guarantees by the end of March, 2000.

38. Measures to strengthen the KFTC were announced, but not fully carried out. Completion of the review of the FTA was delayed, which delayed implementation of FTA amendments recommended by the Joint Public/Private Sector Committee. The FTA did gain some authority and was empowered to eliminate private restrictions to entry and exit, such as the requirement of trade association membership. The requirement that asset sales must be held publicly, not secretly or through swaps among the chaebols, was also instituted. A web page was developed to improve transparency of KFTC operations. Hostile takeovers were also allowed.

39. The Joint Committee performed well, going beyond its requirement to the point of drafting a law against collusion and price fixing on government contracts. The Joint Committee also specified the level of fines and penalties for violations. The ceiling on foreign investment in listed stocks was eliminated ahead of schedule. Foreign ownership of listed Korean companies may now reach 100 percent. In accordance with SAL I reforms, GOK developed comprehensive merger and acquisition guidelines for all sectors, and for inter-firm collaborative agreements.

Labor Markets/Social Safety Nets

40. SAL I substantially broadened the ERL program, laying out specific measures in three areas: the labor market, anti-poverty and pensions.

41. **Labor market flexibility and functioning**. Beyond the major change of lifting a suspension on worker dismissals under the Labor Standards Act of February 1997, SAL I made improvements in unemployment insurance and employment services. One of the key measures was to expand unemployment compensation (and coverage under the Labor Standards Act in general) to firms with five or more workers. (Previously, only firms employing more than thirty workers were covered). GOK conducted a review of employment services, although it was not particularly good quality. GOK also removed at least one serious impediment to private provision of job placement services (approval of the Ministry of Labor). Specific measures to increase labor market flexibility were:

- The Labor Standards Act which allows firms to make layoffs under M&As and to avoid financial difficulties.
- The Act relating to Protection for Dispatched Workers which introduces manpower leasing services for selected jobs requiring professional knowledge, skills and experience (a Presidential Decree later limited the application of manpower leasing to 26 occupations, however).

42. **Poverty and support to the unemployed**. Because the crisis was still fresh, Koreans were still in shock. They had not accepted the concept of a sustained increase in poverty. The common belief was that the poverty was very transitory, with any increase disappearing by the end of 1998. On the contrary, poverty was rising rapidly, engulfing a large share of the population, and would take much longer to alleviate. To know which safety net measures were needed and what they would cost, Koreans had to have a better understanding of the dimensions of poverty. SAL I helped establish a national poverty line, and develop a multipurpose household survey data set in 1998. As a result of the new focus on measurement, GOK discovered that, from the beginning of the crisis until the last quarter of 1998, poverty in Korea, based on the Urban Family Income and Expenditure Survey, had increased from 9 to 15 percent. To reduce the impact, the GOK committed to at least maintaining constant real per beneficiary public expenditures on targeted poverty programs, and made adequate budget allocations. Additional measures included:

- The Basic Employment Policy Act authorizing the Ministry of Labor to implement unemployment measures, including vocational training to promote employment and financial support to cover living costs and medical care costs for the unemployed.
- The Employment Insurance Act reducing minimum contribution period from 12 to 6 months temporarily until June 30, 1999; and increasing the minimum duration of benefit period to 60 days and minimum amount of Job Search Allowance from 50 to 70 percent of minimum wage.
- The Wage Claim Guarantee Act entitling those laid off at bankrupt firms with more than five workers to a sum equal to three months' pay plus three years' severance pay from a state-managed compensation fund, financed by employers' contribution, from July 1, 1998.

43. **Pensions**. SAL I pursued both short and long-run objectives for the pension system, as well as social and financial. The short-run plan was to ensure adequate protection for those hurt by the crisis. The long-run plan was to ensure fiscal soundness of the pension system well into the next century. Korea did not have a fully functional national pension plan at the time of the crisis. In 1988, GOK inaugurated the National Pension Scheme (NPS), but the NPS was not going to pay out full old-age benefits until 2008. As an interim measure, one of SAL I's major initiatives was to ensure protection for the elderly poor through a means-tested, non-contributory social pension for the elderly. Initially (1998), this "Compensation Fund," was funded by budgetary allocation, which subsequently would receive contributions from employers equivalent to 2 to 3 percent of the wage bill. In addition, the NPS was extended to urban self-employed workers and to workers in establishments with fewer than 5 employees.

44. To improve the fiscal status of pensions, under SAL I, the GOK had to simultaneously pursue certain financial reforms. GOK agreed to phase out forced government borrowing and directed credits from pension fund reserves. Several measures were instituted to pave the way for investing the pension fund in other assets, and enhancing professionalism in pension fund management. These measures had the dual objectives of raising returns on Korea's pension reserves, while also helping to develop the capital market. One important step identified was to move toward a secondary market for the government securities that the NPS might hold. This measure would give a more reliable value to pension assets. Private insurance schemes were also examined as a vehicle to broaden the reach of pensions in the longer term. To win support for fiscal measures required for actuarial fitness of the pension system, SAL I also supported a public information campaign.

45. *In summary*, most of the objectives of SAL I were accomplished by the closing date, with most of the policy actions implemented prior to SAL I Board presentation. SAL I should be viewed as part of a broader, longer-term series of efforts to stabilize the Korean economy and return it to a path of sustainable growth. SAL I was the second loan in a series of planned adjustment loans dealing with major aspects of the crisis. SAL I implementation supported preparation of the third loan, the second structural adjustment operation (SAL II, loan amount - $2 billion in two tranches, effective October 23, 1998), which deepened the SAL I reform measures and was to be implemented over a longer period. Preparation of a fourth loan is dependent on Korea's needs after implementation of SAL II.

C. Implementation Record and Major Factors Affecting the Project

46. SAL I was part of a continuous operation, following ERL by only three months. Like ERL, lending was prepared and negotiated by the Bank on an accelerated basis, though not as rapid as for ERL, during January and February, 1998. SAL I was declared effective on March 27, 1998 and the entire $2 billion was disbursed on the same day. SAL I closed on August 31, 1998.

47. Because SAL I followed so soon after ERL, the Bank did not have much additional time to design SAL I based on a detailed body of data and analysis. The learning curve was still steep. Nevertheless, SAL I effectively built on the broad structural framework outlined in the ERL and developed detailed and specific conditionality, while also broadening the reform agenda. There was also substantial continuity in the Bank team that had prepared ERL which had expertise on Korea and on countries experiencing financial distress, particularly with the Asian Crisis.

48. The rationale for the Bank following up quickly after ERL was the still urgent need for balance of payments (BOP) assistance. The GOK and the Bank were in agreement on most of the reform agenda, but because of the time constraint, some elements of the agenda were rushed. Under a compressed timetable, measures such as reducing industry concentration to promote competition and establishing viable audit committees of boards of directors, did not have time to season and earn full GOK ownership. Without stronger reforms in both internal and external audits, Korea risked not having the necessary audit function in place to send signals of trouble in advance.

49. Although there was a strong continuity from ERL, SAL I, as its name would suggest, was designed as a more typical structural adjustment operation. There was no issue of precedent or "special circumstances" as there was for ERL. Like ERL, SAL I was also made to a country where no Bank economic and sector work nor country assistance strategy had been done for some years, but with SAL I there was a more typical set of conditions. The Bank overcame the disadvantage of the lack of economic and sector work, as mentioned, by maintaining continuity of expertise from ERL. Staff experienced in Korea and in countries in financial distress had been assembled and could assess conditions in Korea. The Bank continued to exploit expertise in Korea, as well, mostly at universities, think tanks and non-governmental organizations.

50. **Factors not generally subject to Government's control**. Korea continued to suffer from the spread of the Asian crisis in Thailand, Indonesia and Malaysia. Investor confidence in the region was already severely shaken. G-7 countries still faced domestic resistance to another bailout and lobbied the Bank (and the IMF) to continue frontloading, to ease the pressure to tap G-7 funds.

51. Because it was such a large operation, G-7 influence was needed beyond that of the combined power of the IMF and the Bank. The short-term debt restructuring, which was critical to Korea avoiding default, would have been difficult without the pressure of the G-7 on their banks.

52. The victory by the opposition government was an advantage to the reform program. The opposition won on a platform of change and reform, notwithstanding some of the rhetoric of the

campaign. The new government was receptive, for example, to pro-competition policies, a culture not well-developed in the Korean economy.

53. **Factors generally subject to Government control**. The GOK was vulnerable to a complacent attitude once the extreme pressure of massive default had lifted. There grew a lack of willingness to make a clean break with the incentive regime based on a strong element of moral hazard. This incentive regime rewarded conglomerates when economic times were good, but punished the financial sector when times were bad. The complacency may also have been supported by the fact that for several decades, it had been a low inflation, low unemployment, high growth, budget surplus, low public debt country, which contributed to the belief that the crisis was temporary and not requiring deep structural reform.

54. Other measures within the Government's control were laid out in the Letter of Development Policy for SAL I. The substantial progress made with respect to those factors is detailed in Section B. The prior government also allowed Bank staff to brief opposition leaders during the election campaign and the transition period, which helped the new government develop ownership of the reforms. The relatively advanced store of expertise on the Korean economy outside the government also continued to benefit the reform process.

55. **Factors generally subject to implementing agency control**. The BOK's and MOFE's responses were good. The teams from both agencies worked well with Bank and IMF staff during a still difficult period. MOFE played a key role in coordinating reforms that cut across government agencies.

D. Project Sustainability

56. SAL I was part of a continuous reform program during which Korea made substantial progress in structural reforms and other measures. Korea's advantage in extricating itself from the economic crisis is its long record of high growth and its well developed economy. The disadvantage is that Korea has dug a fairly deep hole, especially with respect to corporate debt. Sustained reform offers the quickest exit from the crisis. Thus, one disconcerting element to the trends in reform progress was the ebb and flow in the rate of reform that coincided closely with the proximity of funds release. If no more SALs (or other reform-based assistance) follow, there is the risk that the Bank would lose its leverage. The Koreans might halt the reforms, for example, before the chaebols are fundamentally reformed. There has also been some slippage in enforcement of newly strengthened laws, as in the case of pro-competition laws. However, with the present leadership's demonstrated commitment to significant reform in the past year, there is a strong indication that Korea will continue reforms until fundamental restructuring is complete.

57. The strongest incentive for the continuation of a successful reform program is the desire not to relive the near collapse of the economy and not to prolong the already sharp increase in unemployment. In this regard, the Bank, through TA and supervision, must continue to help the Koreans make the connection between the reforms and sustained, long-run economic improvement. One example is that the high risk premium embedded in the interest rate that the corporate sector faces could be lowered if corporate restructuring progresses. The underlying strength of the reforms is that they are linked to the root causes of the crisis. Therefore, they

offer Korea the best path to strong and sustained growth in the context of today's more integrated and competitive global economy.

58. Another reassurance that the reforms are sustainable is that some of them, such as the disposition of some large companies and banks, are very difficult to reverse and will likely lead to further asset sales. Measures to increase transparency, although progressing slowly, have set a process in motion that will develop a warning system for future financial problems before they get to the crisis stage. Still, although the framework for improved financial and corporate transparency and competition has been enacted, the real test will come in their practical implementation.

59. Despite a stop and go reform rhythm that closely tracked tranche releases rather closely, overall progress in implementing the objectives of SAL I was satisfactory. Subsequent operations (see section H.), if implemented, would support a continued process of stabilization and structural reform that emphasize deeper financial and corporate sector reforms and further mitigation of the social side affects of adjustment.

E. Bank Performance

60. With SAL I, the Bank sought to maintain momentum of the ERL, both in terms of structural reforms and economic stabilization and worked to help the GOK steer through the crisis. Below is a review of Bank performance from the standpoints of what was a reasonable course of action at the time and what would have been the best course in retrospect. Some of the elements of Bank performance cited under ERL (see ICR for the ERL), held for SAL I, but are not repeated here.

- The Bank/GOK reform program achieved substantial progress in most, if not all, areas through the Board conditions for SAL I

  After the ERL helped navigate through the initial shock, SAL I deepened reforms in the financial, corporate and social sectors. Although financial institutions were still being resolved, SAL I moved to longer term reforms in the areas of supervision and regulation. Efforts in the corporate area resulted in strengthening shareholders' rights and the role of the Boards of Directors. Competition policies were agreed upon in principle and enacted, as were key financial and corporate transparency measures, with implementation to be developed over subsequent adjustment operations. First steps were also taken with respect to setting up the pension system and other safety net components in a coherent and sustainable way. With the institution of layoffs, the labor market began to function more flexibly.

- The Bank rapidly pursued a follow-up operation to ERL

  Preparation of SAL I began almost immediately after disbursement of ERL with a target of late February for effectiveness. This rapid follow-up was a response to the fact that while the external situation had improved, the potential for default was still real well into January, 1998. By mid-February, conditions had improved to the point that GOK was

willing to risk some delay in effectiveness in order to negotiate more attractive loan pricing. This was an indication that Korea's situation had significantly improved since the negotiation of ERL.

- Some elements of the reform program were watered down in order to achieve a quick liquidity transfer.

  In addition to not obtaining the audit committee of boards of directors, the Bank, with time running out and without strong support from the IMF, could not get the GOK commitment to use top level external auditors from international financial centers. Thus, there was some sacrifice of quality and independence which was essential to corporate reform. In the end, there was a clear trade-off between maintaining momentum for stabilization, and maintaining leverage for the longer term program.

- The Bank did not explicitly state the higher than standard SAL pricing until the negotiation stage.

  The higher pricing surprised Koreans, who had expected standard terms, and delayed effectiveness (see section B.) Protracted discussion of the pricing issue ensued, in which the Koreans negotiated for better terms and demonstrated that they were willing to live with delayed effectiveness for one month, and, perhaps, did not consider the SAL I BOP assistance as urgent a need as in the few weeks following ERL.

- The IMF took the lead role in overall reform agenda

  The Bank had by this time substantial a experience in designing a reform agenda for countries in distress. The Bank did assert its views in some instances, most notably, the preference for a fiscal stance that was more stimulative and supported larger safety nets. Still, the Bank was reluctant in some cases to take a hard line stance that differed from the IMF's. Although the Bank's reconstruction/adjustment operation was the largest in its history, it was implicit that the much larger IMF program entitled it to take a broad overall lead in the recovery program. The Bank did, however, maintain leadership in the corporate and social sectors.

- The Bank and the Fund communicated well, but had different approaches to policy matrices.

  There was daily communication between the IMF and the Bank. The two institutions' policy matrices overlapped and were largely consistent. The IMF tended to include large portions of the Bank's areas of responsibility, e.g., corporate governance and restructuring, in its own policy matrix, while the Bank policy matrix opted for a very brief summary of the Fund's macro program. For example, to capture the macroeconomic policy domain largely under the IMF, the Bank's policy matrix referred to "Sound management of macroeconomic policies...within an agreed macroeconomic framework." The IMF's practice of including more detailed sections in areas led by the Bank (e.g., corporate sector governance and restructuring and social safety nets) was helpful when the IMF's position was fully consistent with the Bank's, but weakened the Bank's position when it was not. An example of inconsistency was

the IMF's acceptance, and inclusion in its Letter of Intent (LOI), of GOK's use of an audit selection committee rather than an independent audit committee of the boards, which the Bank considered inadequate.

- The Bank approved a relatively large TA loan ($48 million) to help institute new, more transparent practices supported by the SAL I program.

  The need for assistance in new accounting practices, auditing, financial workouts, etc., was vast. This TA emphasized assistance for corporate restructuring ($32 million or two-thirds of the loan). In policy areas where Korean commitment to reform was weaker, the Bank found it more difficult to assist the relevant agencies with sufficient TA. The Bank delivered financial sector assistance through the country unit and through SFO. In the areas of accounting reform and competition policies, TA was a very small share of total TA (about 2 percent combined). The Korean Asset Management Corporation also did not receive adequate TA to carry out its asset sales.

61. In summary, although the Bank experienced obstacles in bringing SAL I to effectiveness, it succeeded in substantially advancing the reform program and in rapidly providing balance of payments assistance. On a compressed timetable, the Bank, with other donors and the GOK, specified conditions to address major areas of stabilization and structural reform. The Bank also effectively supported the IMF efforts by stressing the importance of an effective macro-economic stabilization plan and a medium-term structural reform framework as essential conditions for Board presentation of SAL I, and by closely monitoring the measures in the policy matrix.

F. Borrower Performance

62. As measured by its fulfillment of pre-Board measures and continued commitment to a reform framework, Government performance is considered satisfactory. The Government's policy commitments laid out in its Letter of Development Policy were largely accomplished. The GOK committed to a heavy legislative agenda and held special sessions of the National Assembly. The transition team worked well and with a minimum of infighting between the incoming and outgoing governments, and was efficiently coordinated. There was also continuity of counterparts at MOFE from ERL through SAL I, which facilitated the policy formulation. The newly elected government supported the program during SAL I effectiveness and leading up to SAL II. The GOK, at times, placed very ambitious goals on the reform program. For instance, the Korean President had wanted financial sector restructuring completed by September 30, 1998. However, an overhaul of economic practices that had been pursued since the early 1960s could not be effected in a single year, and is expected to take much longer. In some cases, such as in accounting and auditing reform, empowering the KIPCA, and some competition policies, individual agencies were able to resist or slow major changes and the building up of capacity through infusions of TA.

63. BOK, on behalf of the Government, maintained the accounts for the SAL I. It was agreed that the accounts would be audited and a report prepared within four months if requested by the Bank. Government compliance with legal covenants under SAL I was considered satisfactory.

G. Assessment of Outcome

64. The overall performance and outcome of SAL I was satisfactory. A medium-term framework for structural reform in financial, corporate and social sectors was established, within which GOK implemented significant reform measures. SAL I was also successful as part of the total rescue package, because Korea continued its move away from the precipice of default. This rating is consistent with the rating by EASPR of meeting development objectives (Form 590) at project close (also Satisfactory). Because it was not an investment operation, calculation of benefits in terms of net present value and economic rates of return is not applicable.

H. Future Operations

65. The second Structural Adjustment Loan (SAL II) was the immediate follow-up operation, effective October 23, 1998. SAL II ($2 billion) was a two tranche loan to support Government efforts to deepen structural reform in the financial sector and the corporate sector and further strengthen social safety nets.

I. Key Lessons Learned

66. Because SAL I built on the ERL, many of the lessons learned under ERL apply to SAL I as well. These lessons learned are only briefly summarized here (see ICR for ERL for more detail). Lessons learned specific to SAL I follow.

Summary of Lessons Learned from ERL and Underscored by SAL I

67. **Maintaining a current knowledge base** on countries even when countries graduate can make it much easier to come to a country's assistance. The Bank still had a steep learning curve for preparation of SAL I. The Bank continued to **exploit non-governmental expertise** to help close the knowledge gap. The Bank continued to use the **tripartite forum of major stakeholders** as an effective vehicle to achieve consensus on the more painful reforms.

68. Under SAL I and leading up to SAL II, the Bank learned the importance of maximizing **negotiating results during brief windows of opportunity when crises are most acute** and when countries are most inclined to commit to reforms. Negotiations were much more difficult under the two operations following ERL. Still, the Bank maintained a **streamlined approach to loan preparation in a pressing situation** that allowed a quick follow-up of $2 billion in BOP assistance. At the same time, the Bank should ensure that **program design and loan terms are discussed together from the beginning**. A borrower must know the terms of the loan as it is being designed, especially if the terms are non-standard.

Other Lessons Learned from SAL I

- **The costs of preparing a loan on a highly compressed timetable**. The scarcity of time for loan preparation can lead to oversights that lead to a net delay in the final analysis. Under SAL I, the Bank intended to charge a higher than standard price for SAL I. While there were

reasons for the Koreans to expect a higher price, there was no explicit indication that the Bank wanted to do so. As a result, the Koreans' had a basis to balk at the agreement which led to nearly a one month delay in effectiveness. That delay was inefficient because that time could have been better employed on the substance of the SAL I program rather than bargaining over the price of the loan. As a result of the further negotiations, the Koreans managed to save a further 25 basis points. A more important cost was the lack of time to achieve government ownership on more contentious reform elements such as the audit reforms.

- **Beginning policy discussions with the top policy makers**. It is advisable to initiate adjustment negotiations with senior policy makers who are actually in a position to decide on, or to know about feasible reform commitments. Under SAL I, a fair amount of time was lost in early discussions with technical people who were not in a position to advance policy discussions with the Bank team.

- **The Bank and the Fund and a unified front**. The negotiating positions of both the Bank and the IMF are weakened when their positions are not fully consistent. Borrowing countries can easily detect inconsistencies, especially in the midst of simultaneous negotiations in the same policy areas, and can play one institution against the other. One example was the external audit reforms where the Bank, under time pressure, accepted a less than full commitment. Another was where Korean Banks wanted to defer losses so that they could more easily meet capital adequacy which was not consistent with best practices. GOK prevailed on the IMF to allow this, but the Bank held very firm and the IMF relented.

- **Single vs. double tranche approach.** A single tranche policy-based operation (such as SAL I), with the framework for policy actions clearly laid out and a substantial part of it implemented prior to Board approval, is an effective way to quickly transfer liquidity in urgent situations. The single tranche instrument is best used when the economic situation is volatile, as in SAL I, where the longer term rigidity of second tranche conditions could be disadvantageous. However, single tranche operations offer only a 2 to 3 month window to accomplish reforms. After disbursement, reforms, as in SAL I, may well lag until the next operation's prospect of fund release. Two tranche operations offer a longer period to enact reforms and carry the stronger incentive of tranche release conditions, as opposed to "monitorable indicators." Administratively, it is cheaper to have one two tranche rather than two single tranche operations.

- **One to one on site guidance through reforms**. Slippage in reforms may occur due to a borrower's unfamiliarity with the economics behind the reforms, as in the case of the risk of concentrating industry further through "Big Deals". A seminar on competitive policies is a good way to have government ownership of an increasing competition culture. TA projects may be too slow in matching infusions of technical guidance with actual implementation in a timely way. Assessment of upfront loan fees argues for abundant upfront provision of this type of assistance.

Part II. Statistical Tables

Table 1: Summary of Assessments

A. Achievement of Objectives	Substantial (✓)	Partial (✓)	Negligible (✓)	Not applicable (✓)
Macro Policies	☒	☐	☐	☐
Sector Policies	☐	☒	☐	☐
Financial Objectives	☐	☐	☐	☒
Institutional Development	☐	☒	☐	☐
Physical Objectives	☐	☒	☐	☐
Poverty Reduction	☐	☒	☐	☐
Gender Issues	☐	☐	☐	☒
Other Social Objectives	☐	☒	☐	☐
Environmental Objectives	☐	☐	☐	☒
Public Sector Management	☐	☐	☐	☒
Private Sector Development	☐	☒	☐	☐
Other (specify)	☐	☐	☐	☐

B. Project Sustainability	Likely (✓)	Unlikely (✓)	Uncertain (✓)
	☒	☐	☐

C. Bank Performance	Highly Satisfactory (✓)	Satisfactory (✓)	Deficient (✓)
Identification	☐	☒	☐
Preparation Assistance	☐	☒	☐
Appraisal	☐	☒	☐
Supervision	☐	☒	☐

(Continued)

D. Borrower Performance	Highly Satisfactory (✓)	Satisfactory (✓)	Deficient (✓)
Preparation	☐	☒	☐
Implementation	☐	☒	☐
Covenant Compliance	☐	☒	☐
Operation (if applicable)	☐	☐	☐

E. Assessment of Outcome	Highly satisfactory (✓)	Satisfactory (✓)	Unsatisfactory (✓)	Highly unsatisfactory (✓)
	☐	☒	☐	☐

Table 2: Related Bank Loans/Credits

Loan/credit title	Purpose	Year of approval	Status
Preceding operations			
1. Financial Intermediation Loan	Provide TA to GOK and BOK to develop a program of structural reform in the financial sector	FY 94	Closed
Following operations			
1. Financial and Corporate Restructuring Assistance Project	Strengthen financial management, monitoring and regulatory framework. Improve enterprise transparency and governance	FY 99	Under Implementation
2. Structural Adjustment Loan II	Restore financial stability, mitigate social costs of adjustment and support deep structural reforms in the corporate and financial sectors.	FY 99	Under Implementation

Table 3: Project Timetable

Steps in Project Cycle	Date Planned	Date Actual/ Latest Estimate
Identification (Executive Project Summary)		
Preparation		1/98
Appraisal		2/98
Negotiations	2/98	2-3/98
Letter of Development/Sector Policy (if applicable)		2/98
Board Presentation	2/98	3/98
Signing	2/26/98	3/26/98
Effectiveness	2/26/98	3/27/98
First Tranche Release (if applicable)	2/26/98	3/27/98
Midterm review (if applicable)		
Project Completion		
Loan Closing		8/31/98

Table 4: Disbursements: Cumulative, Estimated and Actual
(*US$ millions*)

	FY98
Appraisal estimate	2,000
Actual	2,000
Actual as % of estimate	100
Date of final disbursement	3/27/98

Table 5: Project Implementation

	Estimated	Actual
I. Key implementation indicators in PAD		
1. For all indicators, see Annexes B and C		

Table 6: Key Indicators for Program Operation

	Estimated	Actual
I. Key operating indicators in PAD		
1. For all indicators, see Annexes B and C		

Table 7: Studies Included in Program

Study	Purpose as defined at appraisal/redefined	Status	Impact of study
1. NO STUDIES			

Table 8.A: Program Costs

Item	Appraisal estimate (US$ millions)			Actual/latest estimates (US$ millions)		
	Local costs	Foreign costs	Total	Local costs	Foreign costs	Total
1.Balance of Payments Assistance		2,000	2,000		2000	2,000
Total		2,000	2,000		2,000	2,000

Table 8B: Program Financing

Item	Appraisal estimate (US$ millions)			Actual/latest estimates (US$ millions)		
	Local costs	Foreign costs	Total	Local costs	Foreign costs	Total
IBRD		2,000	2,000		2,000	2,000
Total		2,000	2,000		2,000	2,000

Table 9: Economic Costs and Benefits

NOT APPLICABLE

Table 10: Status of Legal Covenants

Agreement	Section	Covenant Type	Present Status	Original Fulfillment Date	Revised Fulfillment Date	Description of Covenant	Comments
Loan	3.02 (b)	1	C	6/30/94		Audit of Deposit Account	Not yet requested by Bank

Covenant types:

1. = Accounts/audits
2. = Financial performance/revenue generation from beneficiaries
3. = Flow and utilization of project funds
4. = Counterpart funding
5. = Management aspects of the project or executing agency
6. = Environmental covenants
7. = Involuntary resettlement
8. = Indigenous people
9. = Monitoring, review, and reporting
10. = Project implementation not covered by categories 1-9
11. = Sectoral or cross-sectoral budgetary or other resource allocation
12. = Sectoral or cross-sectoral policy/ regulatory/institutional action
13. = Other

Present Status:

C = covenant complied with
CD = complied with after delay
CP = complied with partially
NC = not complied with

Table 11: Compliance with Operational Manual Statements

Statement number and title	Describe and comment on lack of compliance
1.	FULL COMPLIANCE

Table 12: Bank Resources: Staff Inputs

	Planned		Revised		Actual	
Stage of project cycle	Weeks	US$	Weeks	US$	Weeks	US$
Preparation	69.5	215.0			17.6	49.2
Appraisal	4.0	13.6			9.5	19.4
Negotiations	0	0			9.2	14.2
Supervision	40.0	84.6			68.9	231.5
Completion	4	10.3	6.0	17.2	3.0	7.5
Total	117.5	323.5			105.2	314.3

Table 13: Bank Resources: Missions

Stage of project cycle	Month/ Year	No. of Persons	Days in Field	Specialization[1]	Performance Rating[2]		Types of Problems[3]
					Implem. status	Developm. objectives	
Appraisal through Supervision	1/98-8/98	18	210	E,F,L,S,CS	S	S	
Total							

1 - Key to Specialized staff skills:
E-Economics, F-Finance, L-Legal, S-Social Sector, CS-Corporate sector

ANNEX A

BORROWER'S CONTRIBUTION

MINISTRY OF FINANCE AND ECONOMY
Republic of Korea

July 3, 1999

Mr. Sri-ram Aiyer
Country Director
World Bank

Dear Mr Aiyer,

I am delighted to send you the "Borrower Contribution to the ICR for SAL" which you has requested us on the letter dated June 23 As you have informed us, we understand that it will be included as an annex to the ICR

I would like to express my heartfelt gratitude for your continued cooperation and expect that our close ties will continue into the future

Sincerely yours,

Yang Cheon Sik

Cheon-Sik Yang
Deputy Director-General
International Finance Bureau
Ministry of Finance and Economy
Republic of Korea

Borrower Contribution to the ICR (Implementation Completion Report)
SAL (Structural Adjustment Loan)

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1. Efforts to Overcome Crisis

Since the ERL (Economic Reconstruction Loan) was introduced from the World Bank, Korea accelerated its efforts to overcome the financial crisis. The first quarter of 1998, during which SAL was introduced, marked a critical turning point in reversing dangerous flows. At the onset of the crisis, the very first task of the Korean government was to secure the supply of foreign liquidity to stabilize the situation. At the same time, recognizing the deeper structural origin of the crisis, the Korean government embarked on establishing the legal and institutional framework for wide ranging structural reforms.

2. Korea's Recovery Process

Through intense negotiations with international financial institutions and creditor nations, the Korean government was able to secure financial assistance totaling US$21.4 billion from the IMF, the World Bank, and the Asian Development Bank by March 1998. It also succeeded in extending the maturities of eligible short-term debts of the banking sector totaling US$21.8 billion in March 1998, and in issuing sovereign bonds worth US$4 billion in April 1998. In addition, the nation-wide movement of "gather-gold-for-export-and-repayment-of-national-debt" raised a total of US$2.1 billion in the first quarter of 1998. Such grass-root sacrifice and dedication to national cause left the international audience with special impression of the Korean people and contributed to restoring the international confidence in Korea. Thanks to such endeavors, Korea succeeded in amassing the usable foreign exchange reserves to US$30.8 billion by the end of April from the near-depletion level of US$3.9 billion in mid-December 1997.

3. Charging Ahead with Reforms

From the onset of the crisis, the Korean government under the leadership of President Kim Dae-jung understood the root causes of the crisis and set out to restructure entire sectors of the economy. The US$2 billion SAL was the second in a sequence of adjustment borrowings from the World Bank, and its reform programs were quite compatible with the new government's policy directions. Recognizing that moral hazard problem of lending and borrowing practices were at the core of the structural failure, the new government put heaviest emphasis on restructuring the financial and corporate sectors simultaneously. In addition, labor and public sector restructuring has also been pursued to give each sector the flexibility and efficiency necessary to keep up with other sectoral reforms.

4. Key Lessons Learned from the SAL

A few lessons can be obtained from Korea's experience with the SAL. First, the World Bank and the IMF should work together to better coordinate their positions in negotiating programs with borrower countries. Discrepancies between the Bank and the IMF regarding the same issues often cause much confusion for the borrower country. To avoid unnecessary complications, it is desirable for the Bank and the IMF to delineate their roles and target areas between themselves. Second, the Bank" inclination for negotiations with senior policy makers has a weakness which should not be overlooked. Although negotiations with senior policy makers can expedite the negotiation procedure, leading to an early conclusion of discussions, the programs may become vulnerable to unexpected problems which can arise during the implementation process if practical deliberations by technical-level persons are omitted. Third, the policy programs should be formulated on the basis of good will and transparency. Ambiguous conditions such as "announce an implementation plan acceptable to the Bank" endows one side with excessive authority to determine the implementation status of the condition. Devoid of concrete specification, the borrower country cannot be sure whether its measures will meet the condition or not. In this sense, it is most desirable to avoid equivocal terms that can be used as criteria of arbitrary judgment. Finally, the policy

matrix needs to be made in a prudent manner. For example, during the SAL II negotiation process, the World Bank's staff raised a slippage matter in implementing SAL I condition concerning the amendments to the FTA (Fair Trade Act). The dispute between both sides revolved around the interpretation of the phrase "adopt appropriate legislation". The confusion may have been prevented if more clear terminology was used such as 'submit' or 'amend' instead of 'adopt' in order to clarify the targeted stage of the legislation.

5. Korean Government's Commitment to Reforms

Confronting serious challenges, Korea bravely bit the bullet and pushed for sweeping reforms designed to secure the country's recovery into the 21st Century. The rapid transformation of the Korean economy in such a short period of time has restored the international community's confidence in the Korean economy. Many analysts believe that the Korean economy had already bottomed out of the trough in the fourth quarter of 1998. The Korean economy is headed for a full recovery and the government is committed to bringing about this result. The Korea's drive for reform is adamant, and no complacency will weaken it.

ANNEX B

PRIOR ACTIONS FOR SAL I

ANNEX B Prior Actions for SAL I

Program of Actions Taken by the Borrower

1. Endow the Special Task Force at the Ministry of Finance and Economy (MOFE) (and its successor later at the Financial Supervisory Commission) with adequate powers to coordinate the development and implementation of the Borrower's financial sector recapitalization and restructuring strategy, under mandate set in consultation with the Bank.

2. Adopt legislation acceptable to the Bank to give supervisory authorities increased power to intervene and resolve troubled financial institutions.

3. Announce timetable acceptable to Bank for upgrading bank accounting, auditing and reporting to international standards.

4. Announce a policy of requiring financial institutions to close books and report publicly on a quarterly basis at the earliest date possible.

5. Notify banking industry of the Borrower's policy of non-intervention in bank management, including the appointment or approval of directors and managers.

6. For merchant banks, put in place the following to the satisfaction of the Bank:

    - issuance of written instructions for due diligence reviews;

    - arrangements for internationally recognized firms to conduct rehabilitation plan evaluations;

    - adoption of standardized templates for review of bank rehabilitation plans and recommendations;

    - application of clear standards and instructions for merchant bank evaluations providing the basis for well-documented decisions on closure or continuation of operation; and

    - establishment of a process to monitor conditionalities placed on merchant banks allowed to continue to operate, including capital adequacy thresholds.

7. For merchant banks, implement the following actions to the satisfaction of the Bank:

    - evaluate the legal basis for bank closure and asset transfer, and take procedural and legislative steps to address potential legal vulnerabilities; establish the legal order of creditor repayment;

    - clarify bridge bank's role as liquidator, asset manager, and deposit insurance paying agent;

- prepare procedures for banking license revocation, bank closure, physical control, inventory/due diligence, and asset valuation; if external bids for merger/acquisition are allowed, establish when external bids will be accepted after license revocation; and

- establish how funds realized from asset sales will be distributed.

8. Require that all commercial banks not meeting BIS capital adequacy standards on December 31, 1997 provide recapitalization and rehabilitation plans of scope and detail acceptable to the Bank; same condition to apply to those banks not meeting these standards on June 30, 1998 and subsequent mandatory reporting dates.

9. Hire internationally recognized firms on terms of reference acceptable to Bank to assess commercial bank recapitalization and rehabilitation plans.

10. Account for all past support by the Borrower to troubled financial institutions and corporate enterprises in a transparent manner, recording not only interest costs in the budget but also the stock of debt incurred by the Borrower and its agencies in the overall public debt figures; provide a report on these estimates to the Bank.

11. Announce policy that, with effect from the date of the policy announcement, Korea Asset Management Corporation (KAMC) and other agencies involved in government support will provide such support only as part of approved recapitalization/rehabilitation plans or liquidation.

12. Issue written procedures for KAMC and bridge bank operating process, internal control, transfer pricing, asset valuation, asset sales and bid process (where applicable) and governance.

13. Establish task force (including private sector experts as well as public authorities) to study policies to promote primary and secondary debt market.

14. Establish task force to review appropriateness of current capital market configuration.

15. Announce that financial statements of listed companies, banks and other financial institutions, as well as all joint stock companies with assets in excess of 7 billion won, will be required to be prepared and audited in accordance with standards consistent with international best practices and standards beginning with the year 1999.

16. Adopt legislation amending insolvency laws (bankruptcy, composition, and corporate reorganization) to resolve jurisdictional conflicts, build administrative capacity, expedite procedures, enhance creditor participation in the reorganization process and establish economic criteria for the initiation of plans of reorganization.

17. Issue a policy statement announcing the following measures regarding the restructuring of chaebol, so as to ensure the full application of the Borrower's Fair Trade Act to increase accountability and transparency and provide equal economic opportunity:

- business combinations which substantially reduce competition in a given market are not permitted;
- entry and/or takeover of divested chaebol operations by new domestic or foreign firms are to be encouraged;
- information on the reasons and factors considered in permitting/disallowing business combinations among the chaebol is to be made public; and
- the use of mutual guarantees by affiliates/subsidiaries is to be further reduced.

18. Appoint a joint private/public committee, with terms of reference acceptable to the Bank, to recommend amendments to the Borrower's Fair Trade Act and identify measures which:

    - strengthen its market efficiency objectives;
    - make its provisions fully and uniformly applicable to all economic sectors, including the public enterprises;
    - increase investigative powers;
    - increase sanction powers of Korean Fair Trade Commission (KFTC); and
    - provide appropriate consumer protection from unfair trade practices.

19. Issue a policy statement that the Borrower will take active steps to reduce public and private barriers to entry and exit of firms and design a regulatory framework to promote competition among monopolized infrastructure services and utilities, through such measures as fostering new domestic and/or foreign private sector market entrants.

20. Develop strategies for institutional development of KFTC to enhance its ability to implement competition law and policy in accordance with best practice, including a detailed technical assistance program.

21. Repeal the two-year suspension in effectiveness of Article 31 of the Borrower's Labor Act and clarify definition of dismissal for managerial reasons.

22. Allow operation of private manpower leasing services.

23. Commit to relax legal restrictions on the private provision of job placement services.

24. Commit to expand coverage of the Borrower's Unemployment Benefits Scheme to firms with fewer than 5 workers as early as possible.

25. Commit to maintain constant in real terms the level of public expenditure per beneficiary on major antipoverty programs of the Borrower, including the livelihood program and the medical aid program.

26. Commit to expand in real terms Borrower's total budget allocations to antipoverty programs proportionately with any increase in the prevalence of poverty due to the current financial crisis.

27. Implement the planned non-contributory and means-tested "social pension" financed from Borrower's general budget for individuals aged 65 and above.

28. Communicate that the sustainability of the current pension system needs to be improved and that in an upcoming reform adjustments in the contribution and benefit structure must take place.

29. Commit to gradually phase out government borrowing from pension fund reserves in the form of direct credits and to gradually phase in government borrowing from pension fund reserves in the form of sales of marketable government bonds.

ANNEX C

POLICY AGREEMENTS AND ACTIONS

AS OF OCTOBER, 1998

ANNEX C: Policy Agreements and Actions as of October 1998

Macroeconomic Framework

Objectives	Policy Measures	
	First Tranche	Second Tranche
Restoration of financial stability and resumption of sustainable growth.	Sound management of macroeconomic policies—fiscal, monetary, exchange rate, and external debt and reserve management policies—conducive to financial stability and an early recovery of economic activity.	Continued adherence to a sound macroeconomic framework.

Financial Sector Reform

Objectives	Policy Measures	
	First Tranche	**Second Tranche**
Resolution of Weak Financial Institutions Develop financial sector restructuring strategy	Further develop and clarify strategy, in consultation with the Bank, including ensuring adequacy of public resources for use in recapitalizing and restructuring the financial system.	Continue to develop strategy (supported by TA). Issue written policies and guidelines consistent with that strategy (ongoing). In consultation with the Bank, adopt process and principles necessary to ensure adequate public resources will be made available by Government in financial system recapitalization and restructuring.
Resolve 5 undercapitalized commercial banks	FSC to agree specific contract terms with acquiring banks and communicate complete contract terms to Bank (August 31). Terms shall include: i) firm agreement on definition of amount and approach to non-performing assets subject to put-back taking into consideration non only past due status, but also qualitative factors affecting loss potential; ii) provision of enough time for acquiring banks to evaluate quality of acquired assets; iii) finality of contractual terms precluding subsequent renegotiation by acquiring banks.	Monitor implementation of contracts and performance (ongoing).
Resolve 7 undercapitalized commercial banks	Banks to submit implementation plans by July 31. FSC to distribute a template for review of implementation plans of the four largest conditionally approved banks to aid in evaluating the feasibility of banks' plans. (July 31). FSC to contract, under TORs agreed with Bank, with international experts to support in-depth analysis of the banks' implementation plans and any other submissions by banks related to the provision of government financial support (September 15). Adopt objectives and principles, acceptable to the Bank, to be used by Government in making decisions on banks' implementation plans, including provision of financial support by Government (August 31).	Announcement by FSC of its decision on implementation plans by September 30 (decision processes supported by domestic and international experts, chosen in consultation with the Bank). Banks whose implementation plans are not approved to be subject to direct recapitalization, mandatory mergers, transfer of business under P&A, or exit under PCA procedures. For banks which are subject to direct recapitalization by government, government will assume the responsibilities of ownership, including contracting with experienced senior managers to undertake restructuring, until sale to strategic investors with sufficient capital and expertise to manage banks. If a plan is approved, the bank will agree on an MOU with FSC covering, among others, recapitalization and merger plans, measures to manage and reduce non-performing assets, and timetable for achieving performance indicators (including capital adequacy targets). Dividend payments to be allowed only when performance indicators are met.

Objectives	Policy Measures	
	First Tranche	Second Tranche
		Banks whose approved plans are not, in the event, achieved will be subject to PCA.
Evaluate remaining commercial banks and take appropriate actions	Initiate diagnostic reviews of remaining commercial banks (on the basis of June 30 data) by internationally recognized accounting firms, signed by domestic and international partners (August 15).	If a commercial bank's capital ratio is found to be below 8% as of end-June 1998, FSC will proceed on a similar basis to that described above for 7 banks (September 30). If the capital ratio of a bank that had been above 8% subsequently falls below 8%, FSC will invoke PCA procedures. Based on the diagnostic review results, administrative guidance to strengthen banks' operations will be provided.
Complete privatization of Korea First Bank and Seoul Bank	Government to agree with the lead manager selected for privatization on the general deal structure (including confirmation to the Bank of the modalities of provision of public support), and to authorize lead manager to contact investors (September 15).	FSC/FSB will continue to conduct intensive supervision of these two banks, including in-depth analysis of management capacity, rehabilitation strategy, and financial condition (September 30). Obtain bids for sale of the banks to strategic investors with sufficient capital and expertise to manage banks (November 15); achieve progress, satisfactory to the Bank, toward sale.
Evaluate remaining merchant banks	FSC/FSB to strengthen supervision of existing merchant banks, including conducting on-site examinations to update assessment of financial condition, determine capital ratio integrity, and assess compliance with previously approved rehabilitation plans (August 31).	Implement strengthened supervision (ongoing). Banks falling short of minimal capital adequacy requirements or in substantial non-compliance with previously agreed rehabilitation plans, subject to resolution process.
Review specialized and development banks	Sign contracts for diagnostic reviews, including assessment of asset quality, with internationally recognized accounting firms, as for commercial banks (September).	Complete diagnostic reviews of at least the major specialized and development banks (December 15).
Use of public funds Adopt sound principles for the use of public funds in financial system restructuring and recapitalization	Government confirms that public funds will be used only: • in the context of: i) FSC-approved plans developed by banks for restructuring and recapitalization, whether as stand-alone entities or via acquisitions or mergers; ii) government takeover of undercapitalized banks; or iii) bank liquidation; with adequate burden sharing, including contribution of new capital by qualified investors and/or dilution of ownership interests of existing shareholders ; where acquisition of equity positions in government recapitalized banks will be through a transparent process and open bidding (exceptions to open bidding must have strong justification);	Firm adherence to these principles for the use of public funds (ongoing).

Objectives	Policy Measures	
	First Tranche	**Second Tranche**
	• where the bank is making adequate progress on implementation of sound corporate debt restructuring; and • in the context of NBFI resolutions, to cover the difference between explicitly government-guaranteed liabilities and the market value of assets acquired by purchasers, or to payoff explicitly government-guaranteed liabilities in the case of liquidation. Any additional use of public funds for NBFIs will be limited to exceptional cases where failure of these institutions poses a systemic risk. Any such use of public funds would be made in the context of a comprehensive restructuring plan for the relevant NBFI sector.	
Resolve policy issues regarding asset management	Purchases by KAMCO will be at prices that reflect actual and expected recovery rates as well as the opportunity cost of the funds employed for collateralized loans, and nominal prices for unsecured loans (August 31).	Adoption by KAMCO of principles, acceptable to the Bank, for the disposition of troubled assets acquired by KAMCO, including the sale of a majority of assets within three years of acquisition. Adoption of procedures, sources and instruments of funding for KAMCO acceptable to the Bank (December 15).
Strengthen KAMCO's financial reporting and disclosure	Agree to publish complete semi-annual and annual audited financial statements (which include results of reviews of asset portfolio revaluations) prepared by an audit firm with international experience in asset revaluation (August 31).	Contract with audit firm, with the first audit to be conducted on June 30, 1999 financial statement (December 15).

Objectives	Policy Measures	
	First Tranche	**Second Tranche**
Strengthen KAMCO's infrastructure	Hire qualified experts to assist in the design and implementation of the organizational and operational structure based on TORs acceptable to the Bank (August 31). Contract with data management (MIS) firm with proven track record, according to TORs agreed with the Bank, for installation of asset inventory and management information systems (August 31).	Complete design and agree to implement recommended actions (December 15). Installation of system in process (ongoing). Contract with at least one international asset management company to manage and sell assets, according to TORs agreed with the Bank (October 31), and have the asset management company in place (December 15).
Strengthen Supervision and Regulation Strengthen independence and authority of supervisory agencies	Prepare three-year FSB operating budget. Allocate adequate, separate funds for FSB startup costs, and initial operating and extraordinary expenses (including costs of procuring information technology, and TA needs).	Consistent with the Basle Committee's 25 Core Principles for Effective Banking Supervision, enhance independence of FSC/FSB through ensuring operational independence and adequate resources. Issuance and revocation of financial institutions' licenses to be carried out upon recommendation of FSC. Review the adequacy and effectiveness of FSC's governance structure and organization, including the need for greater representation of members nominated by independent associations as the current FSC members' terms expire. Establish the legal framework through which FSB may assess fees on supervised institutions, with revenues specifically dedicated to the operations of FSB. Evaluate funding needs and establish FSB's internal budgetary and funding systems (December 15). Complete unification of supervisory organizations. Enhance consolidated supervision and extend supervisory arrangements for commercial banks to all NBFIs as appropriate (December).
Institutionally strengthen FSC	Request proposal for contract with internationally recognized consultant firm, according to TORs agreed with Bank, to implement the strategic blueprint for FSC/FSB institution building, supervisory consolidation, information technology, upgrade of human resources, and strengthening of supervisory policies and processes (August 31). FSC/FSB to establish and operationalize a special implementation task force fully dedicated to the tasks of agency consolidation and strengthening of supervision and human resources. Task force to report to Chairman of FSC and empowered to access personnel in each of the 4 supervisory agencies (August 31).	Establish management group within FSB and implement enhanced managerial structure (December 15). Implement other major elements of strategic blueprint, including information systems, policies, operational procedures, human resources, and budgetary/administrative functions. Contract signed with internationally recognized consultant firm (September 30) and major elements implemented (December 15).

Objectives	Policy Measures	
	First Tranche	**Second Tranche**
Enhance supervision	With respect to specialized and development banks, delegate to FSC powers to examine and to make recommendations as to consequential remedial actions for these institutions (August 31).	On the basis of examinations of specialized and development banks at the delegation of MOFE, FSC will make recommendations to MOFE as to any consequential remedial action required (ongoing). FSB to strengthen supervisory policies, processes and procedures for all subject financial institutions, including on-site supervision, off-site surveillance, monitoring, and enforcement.
Upgrade regulation	Issue implementation plan to bring Korea's prudential regulations closer to international practice as expressed in Basle Committee's 25 Core Principles for Effective Bank Supervision (August 15). Plan will cover rules relating to capital definition, loan classification, disclosure of trust accounts, segregation of trust accounts and treatment of trust accounts with guarantees as on-balance sheet items. Submit legislation to amend the Act Concerning the Structural Improvement of the Financial Industry, inter alia, to redefine a "distressed" financial institution so as to allow imposition of sanctions before actual insolvency and to permit the full write down of shareholder equity (August 31).	Issue regulations to extend, effective January 1, 1999, prudential rules applied to commercial banks to specialized and development banks taking into account the special characteristics of the institutions (November 15). Extend connected lending regulations that apply to commercial banks to merchant banks. Adopt timetable for reductions in connected lending limits; connected lending audited and disclosed in annual financial statements (effective January 1, 1999). Submit to National Assembly amendments to General Banking Act, and similar act for merchant banks, to lower single borrower and group exposure limits over time (October 31).
Improve troubled debt restructuring		Issue guidelines by FSC for troubled debt restructuring and workout processes in banks, including best practice regulations regarding treatment of Other Assets Owned (including maximum holding periods, yearly valuations, validation by third-parties, and write-downs, if necessary), workout policies, and asset management plans (October).
Rationalize deposit insurance		Rationalize deposit insurance scheme, including through phasing out of general guarantee (ongoing).
Capital Market Development Enhance functioning and competitiveness of securities markets	Strengthen prudential rules for securities markets' activities of all financial institutions, including strengthening standards for internal risk management, adoption of appropriate timetable for moving to mark-to-market accounting for all financial institutions, and use of credit rating (August). Develop implementation plans, with timetable to: i) promote self-regulation, including through delegation of	Submit to National Assembly necessary changes in Securities and Exchange Law to enhance the role of SROs (December 15).

Objectives	Policy Measures	
	First Tranche	**Second Tranche**
	increased regulatory and supervisory authority to self-regulatory organizations (e.g., KSE, KSDA, KITCA); and ii) reform governance structure of these SROs with the aim to promote their commercial sensitivity and independence (September 15). Develop implementation plan to liberalize trading systems, including allowing for proprietary trading systems, and to strengthen clearing and settlement systems (September 15).	Announce key elements of action plans and achieve progress in implementation (December 15).
Develop bond markets	As outcome of existing task force, create institutional setup to formulate an action plan, with timetable, to develop bond markets (primary and secondary), including: development of a (rolling) three-year plan for central government financing (including funding costs associated with financial restructuring), standardization of new government and government agencies' funding instruments, and consolidation of existing instruments (August).	Announce key elements of action plan with appropriate timetable to develop the bond market, including standardization of new funding instruments and replacement of government-guaranteed bonds with sovereign bonds (December 15). Institutionally strengthen Treasury-functions (December 15). Introduce a framework to develop market-makers network, including adoption of minimum rules and time-table to select primary dealers in government bonds, and authorize banks to act as market-markers in government bonds (December 15).
Develop public asset-liability system	Initiate external debt management component of a comprehensive, integrated external and internal public asset-liability management system (ALM), supported by Bank TA-loan (August).	Implement actions of agreed program on external debt management component and complete report detailing actions with timetable to extend ALM to internal debt and contingent liability components (December 15).
Develop institutional investors	Submit Securities Investment Company Act to allow, among others, the establishment of mutual funds (August). Submit legislation to allow asset-backed securities (August).	

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Corporate Sector Reform
Part A: Corporate Financial Restructuring

Objectives	Policy Measures	
	First Tranche	**Second Tranche**
1. Develop framework and capacity to do voluntary corporate workouts		
(a) Provide an overall framework of principles and procedures.	FSC provides guidelines on the following: - selection of corporate restructuring candidates; - a Corporate Restructuring Agreement ("Agreement") to provide a structure for creditor/debtor negotiations; - creation and operation of a Corporate Restructuring Coordination Committee ("Coordination Committee") to resolve inter-creditor disputes; and - "London rules" type principles to guide voluntary corporate workouts (July). FSC to monitor workouts under Agreement to ensure consistency with the issued guidelines for workouts (August).	Continued monitoring of the implementation of the framework and guidelines.
(b) Assign responsibility for leading voluntary corporate workouts.	FSC identifies Lead Banks (July).	
(c) Gain creditor support for approach to voluntary corporate workouts.	FSC obtains adherence of major creditors to Corporate Restructuring Agreement (July).	
(d) Provide necessary professional resources for Lead Banks.	Lead Banks to establish workout units (July). Lead Banks to retain internationally accredited advisors by September 15.	
(e) Provide means to resolve inter-creditor disputes.	Facilitated by FSC, banks to establish a Coordination Committee (July). Coordination Committee to hire staff by August 15 and, as necessary, retain internationally accredited advisors.	
2. Provide policy support for corporate restructuring		
a) Curtail emergency loans.	While financial institutions may provide new or additional loans to distressed but viable corporates as part of a Corporate Restructuring Agreement workout, FSC will provide guidelines for such lending by August 15. These guidelines would include the following:	Monitor observance of the guidelines.

Objectives	Policy Measures	
	First Tranche	**Second Tranche**
	- GOK will refrain from directing the banks to make such loans; - the size of any loan would normally be limited to the shortfall needed to meet interest expense and trade payables during the "standstill" period; - in return, the debtor would facilitate complete access by the Lead Bank's financial advisors (e.g., auditors) to the debtor's records; - during the standstill period, the Lead Bank's financial advisors would assess the debtor's viability, review the debtor's liabilities and cash flow projections, and – as appropriate – value assets and indicate how best to maximize the return to creditors – i.e., through voluntary workout, composition, reorganization, or liquidation. In exceptional cases, debtors due to be restructured, but not currently in the workout process, will require new loans. In such cases, if the banks are agreeable to providing such loans they will be provided per the guidelines noted above and for a maximum initial period of six months.	
(b) Facilitate use of debt/equity conversions to address excessive leverage among *chaebol* affiliates.	GOK will review if there are any tax disincentives and regulatory impediments to the conversion of corporate debt into equity or near equity and will submit legislation to National Assembly as necessary (September 15). GOK will submit legislation to National Assembly on mutual funds (August 30). FSC will meet with experienced asset managers, corporate turnaround experts, and investors in distressed securities from the private sector to assess options for "corporate restructuring vehicles" (CRVs). Privately financed and managed, CRVs would purchase and/or manage corporate equity acquired by financial institutions as a result of debt/equity conversions. Key issues for FSC to discuss with potential CRV managers would include appropriate business forms for CRVs (e.g., partnerships, blind trusts, stock funds) and potential tax, legal, and regulatory issues (August). GOK will identify legal, tax, and regulatory impediments – if any – to the establishment of CRVs (September 15).	Based on this review, and if necessary, GOK will submit legislation to the National Assembly enabling and regulating the formation of CRVs and removing tax, legal,

Objectives	Policy Measures	
	First Tranche	Second Tranche
		and regulatory impediments to CRV formation and operation (December 15).
(c) Reduce cross guarantees.	FSC will encourage creditors to reduce cross guarantees through voluntary workouts conducted under the Corporate Restructuring Agreement (August). FSC will issue a communication to banks suggesting market-based approaches for "buying out" cross guarantees. These approaches could include, for example, conversion of cross guarantees into guarantor's equity or equity warrants or into a non-guaranteed loan at a higher interest rate (August). FSC will require financial institutions to report on the stock of guaranteed loans to the 64 *chaebol* as of June 30, 1998, by September 15; and ,starting with the fourth quarter of 1998, FSC will require quarterly progress reports from banks on progress in reducing cross guarantees for the 64 *chaebol* (August 15).	Ongoing FSC will establish appropriate internal interim benchmarks to monitor progress toward the reduction of cross guarantees (October).
(d) Provide additional encouragement for corporate mergers and acquisitions, debt restructuring, and asset dispositions as means of corporate restructuring.	GOK to submit to National Assembly proposed package of tax measures to encourage corporate M&As, asset sales and debt restructuring (September 15).	GOK will submit additional legislation to National Assembly removing tax disincentives to corporate M&As, asset disposals, and debt restructuring (December 15).
(e) Improve procedures and coordination for court-supervised insolvency.	GOK will establish a Task Force under TORs acceptable to the Bank to review existing insolvency laws for further improvement, focusing on expedited procedures (e.g., pre-packaged bankruptcies resulting from the workout process) (September 15). FSC and MOJ, subject to agreement with the Supreme Court, will establish a liaison committee comprising these three entities to ensure prompt resolution of issues that affect both voluntary restructuring and court-supervised insolvency (September 15).	MOJ will agree to announce, based on the review, its draft amendments to existing insolvency laws designed to promote expedited insolvency procedures for public hearing and subsequent submission to the National Assembly by February 1999 (December 15).

Objectives	Policy Measures	
	First Tranche	Second Tranche
3. Accelerate implementation of corporate restructuring		
(a) Complete "triage" analysis.	Lead Banks will complete their assessment of *chaebol* affiliates (including those from the top 5) that have received "anti-bankruptcy" loans or which are on bank "watch" lists and will indicate whether each is best suited for court supervision, voluntary workout under the Corporate Restructuring Agreement, or normal operation (July). A special Task Force has been convened amongst four of the Lead Banks to focus on a system for monitoring the top five *chaebol*. The Task Force will also examine the workout programs of the top five *chaebol*. The Task Force will complete its assessment by end-September.	Monitor follow-up. Monitor follow-up.
(b) Pursue inter-creditor agreements, under the Business Restructuring Agreement, on corporates to be restructured.	First Creditors Council meetings will be convened by each of the Lead Banks under terms of the Agreement (July/August). FSC will direct each Lead Bank to provide monthly reports on the status of corporate workouts (September 15).	Ongoing Ongoing FSC will direct the Coordination Committee to provide monthly reports to FSC on inter-creditor disputes and their resolution (October).
(c) Pursue a timely exit strategy for the 55 non-viable corporates.	FSC will direct Lead Banks to stop new lending and withdraw existing loans for each of the 55 (July).	Lead Banks to provide monthly reports to FSC on progress in exiting the 55.
(d) Identify additional non-viable corporates.	FSC will require monthly updates from Lead Banks on additional corporates identified as non-viable during the course of Corporate Restructuring Agreement workouts (August).	Ongoing
(e) Initiate resolution of corporates that are not under court supervision, but which have received emergency loans.	FSC will direct Lead Banks to send auditors into *chaebol* affiliates that have received emergency loans – but which are not operating under court supervision – and give the auditors 60 days to review corporate liabilities, cash flow projections, and asset values, assess viability, and indicate how to maximize the return to creditors – e.g., through voluntary workout, composition, reorganization, or bankruptcy (August).	Monitor follow-up.

Objectives	Policy Measures	
	First Tranche	**Second Tranche**
(f) Expedite resolution of corporates under court supervision in which the GOK is a major shareholder.	KDB will invite international bids under transparent and fair procedures for Kia (July). KFB will invite such bids for Hanbo by September.	Monitor next steps.
(g) Develop an ability to anticipate corporate default or insolvency.	FSC will establish a "situation room" to monitor corporate/financial sector solvency (July).	
(h) Promote self-restructuring by the top 5 *chaebol.*	FSC will provide guidelines to Lead Banks to strengthen the "capital structure improvement plans" of the top 5 *chaebol*, including decreases in debt/equity ratios, disposal of non-viable affiliates, and reductions in cross guarantees (July). Fair Trade Commission will monitor and take actions against the top 5 *chaebol* that engage in anti-competitive intra-group transactions (July).	Monitor implementation of the guidelines. Continued monitoring and enforcement.

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Corporate Sector Reform
Part B: Corporate Governance, Competition Policies, and Reform and Privatization of SOEs

Objectives	Policy Measures	
	First Tranche	**Second Tranche**
Corporate Governance (a) *Corporate Boards and Shareholder Rights*		
Promote effective monitoring of corporate performance.	Submit to National Assembly changes to the Commercial Code to impose on directors and "shadow" directors a duty to act in the interests of the company .	Enact the changes to the Commercial Code.
	Require listed companies to have a minimum of 25% of their boards comprised of outside directors.	
	Submit to National Assembly legislation to further reduce the thresholds for exercise of minority shareholder rights.	Enact the legislation.
	Establish a study team to provide a report and recommendations to Government on the introduction of class action law suits.	Completion of the report and submission of its recommendations to Government on the introduction of class action law suits.
	Establish a study team to provide a report and recommendations to Government on the role and functions of boards of directors.	Complete the report, draft legislation to give effect to its recommendations, and announce a timetable acceptable to the Bank for submission to National Assembly.
	Remove restrictions on the voting rights of institutional investors in listed companies.	
(b) *Legal Framework for Creditors' Rights*		
Improve the insolvency system and strengthen capacity to handle bankruptcy cases.	Creation of bankruptcy commission to assist Seoul District Court by handling aspects of insolvency litigation.	
	Appoint a task force comprising representatives of the judiciary and MOJ under TORs acceptable to the Bank to study the speedy adjudication of bankruptcy cases, including the establishment of one or more specialist bankruptcy courts.	Establish a pilot specialist bankruptcy court in Seoul with dedicated judges.
Facilitate lending to SMEs through improved tools for secured lending.		Establish a Task Force to design a modern system for secured lending on movables and a national registry system. The Task

Objectives	Policy Measures	
	First Tranche	Second Tranche
		Force to complete its work and make its recommendations by December 15.
(c) *Financial Transparency and Accountability*		
Rationalize the institutional framework for setting standards, regulating and overseeing the accounting and auditing profession.	Establish a Task Force under TORs acceptable to the Bank to review and recommend revisions to relevant laws and regulations to: rationalize the role of various government agencies in supervising the accounting and auditing profession; strengthen the role of KICPA as a self-regulating body consistent with international best practice; and develop an implementation plan for establishing an independent accounting standard setting organization. Commitment to establish an independent accounting standard setting organization by June 1999.	Complete the review and remove all directives affecting accounting and auditing standards and practices by various government agencies including the Bank Supervisory Board and Insurance Supervisory Board and consolidate appropriate regulatory responsibility in the Securities Supervisory Board. Adopt and announce an implementation plan acceptable to the Bank for the establishment of an independent accounting standard setting organization by June 1999. Submit to National Assembly amendments to applicable laws and regulations to give effect to the recommendations of the Task Force, including changes in CPA Law, External Audit Law, and Securities and Exchange Law.
Strengthen KICPA and make it independent of government and the primary source of guidance in auditing.	Establish a Task Force under TORs acceptable to Bank to: review and strengthen KICPA's charter, operational structure and capacity; assess the appropriateness of rules and regulations on auditing including maximum audit fee, numerical restrictions based on CPA head count, minimum audit contract period, evaluation of audit firms by government, and allocation of audit clients by government; and strengthen KICPA's role in issuing auditing standards, monitoring professional quality, enhancing professional ethics and enforcing the code of conduct.	Complete the review and adopt a time-bound implementation plan satisfactory to the Bank. Begin implementation of recommended changes in rules and regulations. Submit to National Assembly amendments to applicable laws.
Upgrade accounting and auditing standards to make them consistent with international best practice, requiring that financial statements of companies and financial institutions be prepared in accordance with these improved standards with effect from the 1999 reporting year, as agreed under SAL I.		Adoption and issuance by FSC of improved accounting and auditing standards for financial institutions, listed companies and joint stock companies consistent with international best practice and prepared with participation of representatives of internationally recognized accounting firms, and institution and announcement of the requirement that financial statements of financial institutions, listed companies, and joint stock companies with assets in excess of W7 billion will be prepared and audited in accordance with these standards from fiscal year 1999. The improved accounting standards will include, inter alia, standards covering financial instruments, leases, asset classification, troubled debt restructuring, asset revaluation, translation of foreign currencies, loss and income recognition, financial statement disclosure, and combined financial statements.

Objectives	Policy Measures	
	First Tranche	Second Tranche
Improve the financial oversight role of boards of directors and enhance the effectiveness of the internal audit function.	Complete the study on introduction of audit committees of boards of directors and improvement of the effectiveness of the internal audit function for listed companies and financial institutions under TORs acceptable to the Bank, as agreed under SAL I.	
	Appoint a Task Force under TORs agreed with the Bank to: review and rationalize the function of the audit selection committee to make it an independent and transparent entity and develop an implementation plan to upgrade it to an audit committee of boards of directors, taking into account the conclusions of the above study; and recommend changes in relevant laws and regulations.	Completion of the review. Adoption and announcement of an implementation plan and schedule acceptable to the Bank for the institution of a requirement for the establishment by listed companies of audit committees of boards of directors, and completion of a draft of necessary changes in laws and regulations to give effect to this requirement.
Improve the quality and frequency of financial reporting by listed companies.		Require listed companies to publish quarterly financial statements with adequate disclosure consistent with international best practice starting in 2000 Q1.
Competition Policies Increase competition across all sectors.	Complete draft of amendments to Fair Trade Act (FTA), acceptable to the Bank, based on recommendations of the Joint Public/Private Sector Committee.	Enact the amendments.
	Commitment to fully enforce provisions of the FTA in the restructuring of chaebols in accordance with the policy statement issued under SAL I.	KFTC to provide the Bank with a detailed report and analysis of all cases of chaebol M&A, divestiture and restructuring notified and considered prior to the second tranche release, in a format agreed with the Bank.
		Enact the Act on Comprehensive Regulation of Cartels.
		Review and propose revisions as required to the GOK procurement guidelines to assure transparency, and limit opportunities for collusion and corruption.
	Issue and implement comprehensive M&A guidelines.	Monitor compliance, especially in chaebol restructuring.
Strengthen the enforcement of rules limiting transactions between related corporations, companies, financial institutions, their owners, directors, shareholders and employees.		Apply existing laws stringently and uniformly, and propose amendments to the FTA to further limit such transactions.

Objectives	Policy Measures	
	First Tranche	Second Tranche
Establish a more transparent framework for corporate group rights and obligations.		Enact legislation, satisfactory to the Bank, modifying restrictions under the FTA on the creation of holding company structures so as to permit such structures subject to conditions to avoid undue ownership concentration.
Strengthen the operational capacity of KFTC.	mplement the agreed work plan for the Policy Analysis and Evaluation Group.	Develop detailed KFTC operational guidelines (e.g., investigative guidelines) and achieve satisfactory progress in implementing an appropriate upgrading program.
Further deregulate domestic industry to promote competition.	Complete submissions to the Deregulation Committee on regulatory barriers in different industries.	Achieve satisfactory progress in implementing necessary legislative or regulatory changes.
Promote foreign direct investment.	Enact the Foreign Investment Promotion Act.	Implement the new Act (simplification of procedures, improved support system).
Support competition in domestic industry by easing import requirements and administration.	Review customs clearance and product certification/registration procedures and develop a plan to streamline them.	Achieve satisfactory progress in implementing the streamlining plan.
Reform and Privatization of SOEs		
(a) *SOE Restructuring and Governance Reforms*		
Ensure that SOEs that are to remain under state control or are to be privatized gradually, operate in an efficient and accountable manner.	Review the Basic Law on Management of "State-Capitalized" Enterprises in order to improve management structure of such SOEs, including the allocation of policy, regulatory and ownership functions.	Submit to National Assembly legislation to improve the management structure of SOEs.
(b) *General Privatization Program*		
Ensure that the Government's proposed privatization and SOE reform program is implemented within a sound framework.	Announce a program of privatization, including identification of SOEs to be offered for sale, extent of proposed share or asset sales and, as appropriate, proposed methods and target schedule for the completion of such proposed sales. Establish a steering committee, supported by task forces, to oversee implementation of the privatization program. Review need for any enabling legislation.	Submit any necessary privatization legislation, including amendments to the privatization law, to National Assembly.
(c) *Infrastructure Sectors*		
Improve regulatory and institutional framework for increased private	Adopt and announce an overall strategy acceptable to the Bank for dealing with structural, regulatory and	Satisfactory progress in implementing the privatization and SOE reform program in infrastructure sectors in accordance with the

Objectives	Policy Measures	
	First Tranche	**Second Tranche**
participation in the provision of infrastructure services.	institutional issues in privatization and SOE reform in infrastructure sectors, including, inter alia, the priority to be given to transition toward more competitive market structures and establishment of appropriate regulatory structures, and sequencing of structural, regulatory and ownership reforms.	principles included in the strategy statement.
	Undertake a study on reforms to the regulatory and institutional framework for involving private participants in greenfield infrastructure projects.	Announce key elements of proposed reforms.
Telecommunications	Undertake a study on reforms to pricing, interconnection and universal service arrangements, and the establishment of an independent regulatory authority.	Announce key elements of proposed reforms, including timetable for implementing those reforms, prior to any further privatization of KT and, in any case, before December 15.
Power	Undertake a study on structural and regulatory reforms in the power sector, including the establishment of an independent regulatory authority.	Announce key elements of proposed structural and regulatory reforms, including timetable for implementing those reforms.
Gas	Undertake a study on structural and regulatory reforms in the gas sector, including the establishment of an independent regulatory authority.	Announce preliminary findings of the study by December 15. Announce key elements of proposed structural and regulatory reforms, including timetable for implementing those reforms, before proceeding with the privatization of KOGAS.

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Labor Market and Social Safety Nets

Objectives	Policy Measures	
	First Tranche	**Second Tranche**
Integration of Social Policy Reform Agenda Improve the framework for the design and coordination of social safety net policies.	Commitment to clearly mandate and adequately staff the National Committee on Social Security chaired by the Prime Minister, to coordinate cross-cutting reforms in social policies in order to achieve coherence across concerned ministries and agencies.	Establishment of a Working-Level Committee under the National Committee on Social Security, anchored in the Prime Minister's Office and provided with adequate professional staff capacity, to serve as a focal point. Complete interim assessment report on cost-effectiveness of integrating contributions to social risk management funds for pensions, medical insurance and unemployment insurance, including: (a) collection mechanisms; (b) contribution base determination; and (c) cross-checking features. Complete interim assessment report on the aggregate payroll tax and labor market implications of adjustments in coverage and contribution rates for pensions, medical insurance and unemployment insurance.
Social Protection for Workers Expand sustainable coverage of income support provided by the unemployment insurance (UI) component of the Employment Insurance Scheme (EIS).	Extend UI to firms with fewer than 5 workers and to temporary and part-time workers with effect from October 1998. Commitment to maintain actuarial integrity of the UI scheme, i.e. positive financial reserves, and zero leakage to other programs (per SAL I agreement).	Adjust contribution rates if necessary in order to maintain financial viability of UI scheme for FY99 given anticipated unemployment rate and any changes in benefit structure (per SAL I agreement).
Increase employment by enhancing labor market flexibility.	Commitment to implement fully the layoff provisions of the 1998 Labor Standards Act so as to remove undue labor market impediments to efficient corporate restructuring.	Achievement of progress, satisfactory to the Bank, on enhancement of labor market flexibility. Complete report providing recommendations for appropriate expansion of public employment services without crowding out private employment services.

Objectives	Policy Measures	
	First Tranche	**Second Tranche**
Improve efficiency of active labor market programs by eliminating cost-ineffective programs provided under the employment security (ES) and vocational ability development (VAD) components of EIS.	Commitment to limit expenditure on ES and VAD programs by containing contribution rates at or below current levels (0.3% for ES and averaging 0.4% for VAD) and maintaining positive financial reserves. Commitment not to provide budget subsidies that increase the scope of ES and VAD activities beyond self-financed operations. Commitment not to expand coverage of ES and VAD programs any further. Finalize TOR acceptable to the Bank and initiate formal evaluation of cost-effectiveness of ES and VAD programs	Complete interim evaluation report on the cost-effectiveness of ES and VAD programs (per SAL I agreement). Hold national workshop with stakeholders to discuss the interim evaluation report. Disseminate the interim evaluation report. Announce policy adjustments to eliminate ES and VAD programs found to be cost-ineffective
Protecting the Poor		
Expand provision of workfare for the unemployed who are not insured.	Implement expanded Phase II of the temporary public works program at wage levels designed to target the poor jobless by self-selection. Restrict participation to the unemployed who are not currently eligible to receive UI benefits.	Allocate adequate FY99 budget to absorb supply of labor forthcoming for public works at targeted wage levels (not higher than Phase II in real terms). Relax capacity constraints on workfare expansion by involving NGO and private sector contractors.
Expand provision of means-tested noncontributory income support for the poor.	Commitment to expand budget allocation in FY99 to the temporary noncontributory means-tested allowance for the unemployed poor in line with increases in the eligible target group. Commitment to expand budget allocation in FY99 to workfare and other forms of income support for able-bodied beneficiaries of "self-support" under the livelihood protection program for the poor.	Allocate adequate FY99 budget. Allocate adequate FY99 budget.
Maintain real expenditure per eligible beneficiary on existing livelihood protection programs for the poor (self-support, home care and institutional care programs).	Initiate analytical report assessing trends in the 1998 inflation rate adjusted for consumption patterns of poor households. Initiate analytical report assessing 1998 trends in the number and characteristics of people living in poor households.	Complete the two reports by October 30. Allocate adequate FY99 budget taking into account: (a) adjustment of nominal per capita benefits to compensate for inflation among the poor; and (b) adjustment of total budget to absorb increased number of eligible poor.

Objectives	Policy Measures	
	First Tranche	Second Tranche
Strengthen information base for regular poverty monitoring and analysis.	Implement special National Survey of Employment Assistance and Welfare Needs of the Unemployed (KIHASA/KLI/NSO collaboration). Assign institutional responsibility for coordinating interagency inputs to design of an integrated multipurpose national household survey.	Hold national workshop to review design options for a regular national multipurpose household survey, including a panel subsample, incorporating comprehensive data on household welfare and coverage of government programs. Complete feasibility report for introducing a regular national multipurpose household survey, including questionnaire design, sample size, field operations, policy analysis and institutional responsibilities.
Financial Risk Management for Health Improve efficiency of financial intermediation by public sector health insurers through reducing the unit costs of administration per insured under the national Medical Insurance System (MIS).	Complete prospective assessment report on cost-effectiveness of alternative options for consolidation of the fragmented insurance societies belonging to Self-Employed Medical Insurance (SEMI) component of MIS. Commitment to incorporate the financial operations of MIS into the consolidated fiscal accounting framework of the published Government Finance Statistics for the public sector, beginning with FY99 fiscal accounts.	Implement consolidation plan for insurance societies under SEMI.
Strengthen supply-side incentives for efficient provision of medical care.	Commitment to implement a universal reform of the provider payment system to improve cost containment incentives based on DRG-based pricing.	In consultation with the Bank, announce a detailed timetable for implementation of the provider payment reform plan beginning with the year 2000.
Improve demand-side protection against major financial risks for MIS beneficiaries and for poor Medicaid beneficiaries by reducing out-of-pocket copayments.	Commitment to significantly reduce by FY2000 the effective coinsurance rate for hospital inpatient care, combined with an income-related catastrophic cap, both for MIS and Medicaid. Initiate preparation of a coinsurance reform plan, both for MIS and Medicaid, including adjustments to special treatment changes, inclusion of noncovered services, and reallocation of health insurance coverage from minor to major risks.	Adopt and announce key elements of the coinsurance reform plan, both for MIS and Medicaid, including the timetable for implementation beginning with FY2000.

Objectives	Policy Measures	
	First Tranche	Second Tranche
	Commitment to harmonize Medicaid provider reimbursement levels with MIS. Implement an official investigation of leakages of allocated budget funds from reaching poor beneficiaries of the Medicaid program.	Commitment to allocate adequate FY2000 budget to implement provider reimbursement reform for Medicaid beneficiaries. Complete investigation report and initiate implementation of its recommendations.
Diversify policy instruments for pooling financial risks of medical care.	In consultation with the Bank, finalize TORs and initiate evaluation report on introduction of individual medical savings accounts (MSAs) to finance intermediate financial risks associated with medical care.	Hold public workshop to review findings and recommendations of assessment report on introduction of MSAs.
Social Protection for the Elderly Mitigate impact of the economic crisis on living standards of the elderly.	Initiate analytical report assessing the effectiveness of the means-tested noncontributory "social pension" for elderly aged over 65 in terms of coverage of the target group, and prevention of poverty among recipients.	Complete the analytical report and allocate adequate FY99 budget for the social pension to achieve effective coverage of the poor elderly target group.
Improve transparency and governance of financial operations of all public pension schemes (NPS and occupational schemes for civil servants, teachers and military).	Commitment to establish an Office or function of the Actuary in the Office of the Prime Minister responsible for annual projections of the long-term actuarial status of all public pension schemes based on consistent macroeconomic and demographic assumptions. Commitment to incorporate the financial operations of the Teachers and Civil Servants pension schemes into the consolidated fiscal accounting framework of the published Government Finance Statistics for the public sector, beginning with FY99 fiscal accounts.	Establish the Office/function of the Actuary. Allocate adequate FY99 budget to prepare and publish the first annual status report for FY98.
Develop an integrated pension reform proposal that fully recognizes and rationalizes the mandatory public and private components of the existing pension system.	Finalize TORs acceptable to the Bank governing the structure, composition and mandate of the Government Task Force responsible for the planned comprehensive White Paper on Pension Reform (per SAL I agreement).	Establish the Government Task Force by October 1998 (per SAL I agreement). Commitment to complete draft White Paper no later than November 1999 (with background papers completed by June 1999) on an integrated pension reform package combining public/private and mandatory/voluntary pensions pillars designed to attain: (a) a reasonable replacement rate target for the average worker; (b) reasonable protection from poverty for the aged; and (c) long-term financial sustainability. Completion of progress report on the work program of the Task Force.

Objectives	Policy Measures	
	First Tranche	**Second Tranche**
Achieve more efficient allocation of National Pension Fund (NPF) assets.	Adopt and announce a timetable for implementation of the reduction in forced government appropriation of the flow of NPF surpluses (per SAL I agreement) as follows: 65% of the NPF surplus flow in 1999, 40% in 2000, 20% in 2001 and 0% in 2002. Announce that the stock of outstanding loans to government from NPF will be repaid in full at maturity without rollovers. In consultation with the Bank, announce specific guidelines for governance of NPF reserves, including: (a) the task of the asset management committee; (b) investment rules and rating procedures; (c) benchmarking and reporting mechanism; and (d) index-based criteria for selecting external fund managers.	Implement the phased reduction of forced government appropriations from NPF agreed with the Bank, through adoption of legislation satisfactory to the Bank, including necessary revisions to the Public Fund Management Act. Implement plan to strengthen the professional investment unit in the National Pension Corporation (per SAL I agreement), including: (a) achievement of a high standard of staff qualifications and supporting technology; and (b) adequate resources to monitor external fund managers. Announce a schedule acceptable to the Bank for contracting out asset management and implement plan to increase gradually and substantially the share of NPS assets outsourced to external fund managers (per SAL I agreement), including: (a) increased unit amount outsourced per external fund manager in order to attract interest of reputable firms; and (b) adoption of revised criteria for selecting and recontracting external fund managers to reflect diversification of investment risks. Commitment to: (a) phase out per agreed timetable all lending from NPF to program participants using their contributions as collateral; and (b) refrain from providing financial assistance from NPF to restructuring of financially distressed corporations

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