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10 The Principal Transactions Bank System in Korea and a Search for a New Bank-Business Relationship

Sang-Woo Nam

10.1 Introduction

Korea has a particular form of bank-enterprise relationship that links each large business group to a particular bank (the principal transactions bank) in the context of the credit control system. The major functions of principal transactions banks include monitoring and reporting to the Office of Bank Supervision and Examination the financial situation and investment activities of the corporations, as well as implementing government credit control over the corporate sector.

The nature of credit control has changed, reflecting the emerging challenges faced by the Korean economy. The system was first utilized to encourage large corporations to finance their growth through the stock market. In the 1980s it was used as a means to ease the concentration of economic power by curbing real estate acquisitions and debt-financed business diversification. Despite such changes in the goals pursued, the credit control system remains a regulatory framework to bolster the government's control over the corporate sector. It is far from being an autonomous bank-customer relationship.

However, in the process of opening up the Korean economy, which calls for immense restructuring efforts on the part of corporations, there has been increasing concern that the credit control system poses a serious impediment to the structural adjustment of the economy. As such, the principal transactions bank system must be transformed into a normal bank-customer relationship rather than be allowed to retain its regulatory role of controlling large business groups.

This paper describes the role of the principal transactions bank system in

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Korea and evaluates the costs that accompany such a system. Section 10.2 examines the evolution of the principal transactions bank system in accordance with the shifts in the government's development objectives. Section 10.3 reviews the structure of the present system, which will be followed by a performance evaluation in section 10.4. Section 10.5 will discuss the issues involved in developing a desirable bank-client relationship in Korea with emphasis on comparing Korea's principal transactions bank system with the Japanese main bank system.

10.2 Evolution of the Principal Transactions Bank System

The role of financial institutions as mobilizers of savings in Korea was recognized by the government only after the interest rate reform in September 1965 which contributed significantly to the deepening of the financial market. The military coup in the early 1960s led to the nationalization of commercial banks, and a number of new financial institutions were established in the 1960s to perform specialized activities, such as financing small and medium-sized firms and housing and foreign exchange business.

Throughout the 1970s, the Korean financial system was subject to increasing repression with rigid interest rate controls despite accelerating inflation and extensive government intervention in credit allocation. Consequently, financial development was rather slow. However, with the Presidential Emergency Decree in 1972, which froze the unorganized curb loan market, short-term finance companies and mutual savings and finance companies were established, contributing to the diversification of Korea's financial market. The capital market also has grown rapidly since 1972 as the result of strong promotional measures by the government.

Promotion of the heavy and chemical industries in the 1970s by way of providing subsidized bank loans to these industries created several side effects: inefficient investment allocation, weak capital structure of large corporations, limited access of small and medium-sized firms to bank credit, concentration of economic power, and managerial inefficiency of banks.

This experience of excessive government intervention in resource allocation and its serious consequences gave rise to the need for financial liberalization in the early 1980s. The liberalization effort started with the lifting of many restrictions on bank management and the lowering of entry barriers to various financial services in order to promote competition and efficiency. In addition, the government divested its equity shares in all nationwide commercial banks. Most preferential interest rates applied to various policy loans were abolished and more recently interest rates have been partially deregulated.[1]

1. "Policy loans" are loosely defined as those provided at preferential interest rates or earmarked for specific sectors or industries. Such loans include export financing, the National Investment Fund supplied mainly to the heavy and chemical industries, loans for small and medium-sized

Korea's principal transactions bank system started as part of a credit control system on business groups. The evolution of the credit control system must first be analyzed in order to understand the principal transactions bank system because the role of the principal transactions banks and their relationship with the corporate sector were defined within the structure of the credit control system.

10.2.1 Introduction of Credit Control and the Principal Transactions Bank System

The principal transactions bank and credit control systems were introduced in 1974 with a view to improving the capital structure of large corporations by encouraging direct financing through public offerings of equity shares while holding down borrowing from financial institutions.

The sharp increase in bank lending after the interest rate reform in 1965 and the large-scale, though tightly controlled, introduction of foreign capital in 1966 resulted in excessive dependence on borrowing and insolvency for many corporations despite rapid economic growth. Because of domestic bank guarantees on foreign borrowing, defaulted foreign loans were turned into loans by domestic banks. Between 1965 and 1970, the equity ratio of manufacturing firms showed a significant decline from 51.6 to 23.3 percent. The Korean government undertook the restructuring of insolvent companies between 1969 and 1971 and the Presidential Emergency Decree of 1972 attempted to address fundamentally the problem of Korea's worsening corporate capital structure and excessive financial burden. The government adopted a credit control system as an institutional tool to promote the sound capital structure of corporations. Together with replacing short-term bank loans with long-term loans, the decree required all curb loans outstanding to be reported to the National Tax Administration; most of these loans were either rescheduled to be repaid over several years at low interest rates or converted into equity capital.

Under the administrative guidance of the government, for the purpose of implementing the credit control system, banks agreed to designate the bank with which the principal company of a business group (whose total credit from banking institutions exceeded a certain amount) had major business relationships as the principal transactions bank for all the member companies of that group. The main functions of a principal transactions bank included reviewing and monitoring its client corporations' plans for improving their capital structure, setting credit ceilings for operating capital, and providing business information and managerial guidance to client corporations. When nonprincipal

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firms, housing, agriculture, and fisheries, loans in foreign currency, credit to the Korea Development Bank (KDB) and the Korea Export Import (EXIM) Bank, and special loans for facility investment. In recent years, export financing and loans to specific industries have been phased out significantly, even though credit from deposit money banks to the KDB and EXIM Bank as well as loans for housing, agriculture, and small and medium-sized firms have expanded substantially.

banks extended new credit to a corporation, they had to consult with the corporation's principal transactions bank.

10.2.2 Evolution of the Credit Control System

A noteworthy change in the credit control system in the early 1980s was the shift in the central objective of the system from the improvement of corporate capital structure to the restriction of real estate acquisitions and investment in other companies. This shift was geared to support the September 27 Measure of 1980, which was undertaken with a view to reinforcing corporate competitiveness by checking business expansion financed by debt. In the early 1980s, Korean companies suffered from a severe recession caused by the second oil shock as well as political and social unrest following the assassination of President Park. The government seems to have believed that the weakening international competitiveness of Korean companies was fundamentally attributable to their imprudent investment behavior, such as real estate acquisitions and ill-planned business expansion into new industries. The September 27 Measure forced business firms to repay their borrowing from banking institutions by selling their nonoperating real estate as well as the real estate held by business owners and managers, while coercing 26 business groups with too many member companies or weak capital structure to dispose of some of their member companies.[2]

Meanwhile, the credit control system, based on the assumed collusion among banking institutions, was found to be illegal under the Monopoly Regulation and Fair Trade Act. For this reason, the system was reformed into an official regulatory system following the revision of the General Banking Act at the end of 1982. The act states that the Monetary Board may restrict, by fixing ceilings, the aggregate volume of outstanding loans, guarantees, or assumptions of obligations of a banking institution for any individual business group.

The credit control system has undergone significant changes in its objectives and characteristics since 1984, reflecting the progress in financial liberalization as well as political and social changes. These changes resulted in concentration of credit control mainly on the 30 largest business groups while control on other corporations eased.

The credit control system was reformed for three reasons. First, by the early 1980s, an excessive number of groups and companies were subject to credit control (table 10.1). In addition, since the amount of available credit for a company was decided on the basis of its past credit requirements, small but

2. As a result of the September 27 Measure, 309.9 billion won (2.7 percent of the broadly defined money supply) of borrowing from banking institutions was repaid by selling real estate, and 166 member companies of large business groups were severed from their groups by the end of 1984. Of the real estate that was sold, 56 percent (in terms of value) was purchased by individuals and companies not subject to credit control, and the rest was sold to the Land Development Corporation, a government-invested corporation.

Table 10.1 **Number of Corporations Subject to Credit Control**

Corporate Type	End 1984	March 1985	End 1987	End 1988	October 1989	June 1991	March 1993
Business groups	161	63	50	50	48	50	30
Member corporations	1,459	696	807	845	913	–	1,014
Companies not belonging to business groups	280	–	–	–	–	–	–

Source: Office of Bank Supervision and Examination (1992).

Notes: Criteria for selecting corporations to be subject to credit control:

July 1984: (1) Business groups which have more than 20 billion won in total credit (loans plus payment guarantees) from banks and their member corporations. (2) Corporations that do not belong to a business group but that have more than 10 billion won in total credit or more than 5 billion won of loans.

March 1985: Business groups that have more than 100 billion won in total credit and their member corporations.

January 1987: Business groups that have more than 150 billion won in total credit and their member corporations.

June 1991: The 50 largest business groups selected on the basis of loans from banking institutions (excluding loans of major corporations) and their member corporations.

February 1993: The 30 largest business groups selected on the basis of loans from banking institutions (excluding loans of major corporations) and their member corporations.

quickly growing companies were in dire need of credit. In order to correct such inefficiencies, the number of business groups subjected to credit control was reduced, and basket credit control was adopted which regulated the share of large business groups in the total credit of banking institutions.

Second, the extensive nature of credit control hampered the credit evaluation capability of banking institutions and unduly limited corporate activities. Thus, with the progress in financial liberalization during the 1980s, the major emphasis of the credit control system was placed on discouraging real estate acquisition and investment in other companies.

Third, the objective of easing the concentration of economic power and promoting fair access to bank credit gained importance in the credit control system. The government seemed to believe that promoting economic development by depending heavily on large business corporations might no longer be efficient. At the same time, people became more concerned about allocative equity and more critical of large corporations after the democratic reform in 1987. As a result, the credit control system assumed a rather complicated nature, reflecting certain political and social considerations. Consequently, a strong basket control system was adopted in 1988, which led to a steady reduction of the shares of the 5 largest and 30 largest business groups in total bank credit.

Finally, credit control also played an important role in monetary management because the monetary expansion caused by the foreign sector was enormous as a result of the large current account surpluses between 1986 and 1989.

As exports stagnated and the current account returned to deficit in 1990,

there was renewed concern about the growth potential of the economy as well as about the international competitiveness of the manufacturing sector. In this connection, the credit control system was criticized for impeding the capability of corporations to respond flexibly to the changing economic environment and to strengthen their competitiveness.

As a result, the tight credit regulations of the 1980s began to be relaxed in 1991. The criterion for selecting business groups subject to credit control was changed from those with total bank credit of more than 150 billion won to the 50 largest borrowers from banking institutions. This criteria was further relaxed in 1993 to the 30 largest business groups. Also, to encourage specialization, each of the 30 largest business groups was allowed to select, from among its member companies, up to three "Major Corporations," to be exempt from credit control.

10.3 Structure of the Current Principal Transactions Bank System

10.3.1 Basket Credit Control on Business Groups

Control of bank credit in Korea started as an integral part of monetary (M2) targeting. By setting a ceiling on the share of large business groups in banks' total credit, the government has tried to ensure credit availability for small and medium-sized enterprises under a given M2 growth target. Currently, credit control is imposed on the 30 largest business groups selected annually by the Office of Bank Supervision and Examination on the basis of the average end-of-month outstanding borrowings from banking institutions in the previous year. The Office of Bank Supervision and Examination sets a ceiling on the share of the business groups that are subject to basket control in each banking institution's total loans. A bank should not let the collective shares of the 5 largest and the 30 largest business groups in its total loans exceed the levels set by the office.[3] However, the office does not set ceilings on individual business groups. Loans to Major Corporations and "Corporations with Highly Dispersed Ownership" are exempt from basket control. Loans extended by overseas branches and postshipment export financing are also exempt.

10.3.2 Selection of the Principal Transactions Banks

The principal transactions bank system applies only to corporations that are subject to credit control as designated by the Office of Bank Supervision and Examination. The bank with which the principal corporation of a business group has major business usually becomes the principal transactions bank for

3. E.g., the credit ceilings for the 5 largest and the 30 largest business groups in 1991 were 5.8 and 10.81 percent of total bank loans. The actual shares of the 5 largest and the 30 largest business groups at the end of 1991 were 5.44 and 9.81 percent. Loans from nonbank financial intermediaries and the issuance of bank-guaranteed corporate bonds are not subject to such ceilings.

all the member firms of the group.[4] Although any banking institution is eligible, only the five major nationwide commercial banks and the Korea Exchange Bank have been selected as principal transactions banks for the 30 largest business groups (table 10.2). Corporations try to meet their financing requirements through their principal transactions bank as much as possible before they approach other banks. Therefore, the principal transactions banks are better positioned than other banks to earn fee income. However, principal transactions banks sometimes lend as much to other business groups of comparable size. When necessary, the Office of Bank Supervision and Examination can change a business group's principal transactions bank, and business groups can also ask for a change, though this has rarely happened in the past.

10.3.3 Role of the Principal Transactions Banks

Handling of Information about Credit and Business Activities of Corporations

The principal transactions bank supervises the overall credit situations of its client corporations, including local financing by their overseas offices. Information about the client corporations collected by nonprincipal banks is supposed to be transmitted to the principal transactions bank.

In reality, principal transactions banks obtain this information from the computer network of banking institutions in which data concerning corporations with more than 2 billion won in bank loans are stored with a separate code for each company. However, as information about most nonbank loans is not entered into this network, a clear financing picture of a client group is available only from the report of the group.

Provision of Loans

The principal transactions bank sometimes takes the initiative, with or without government intervention, to organize a loan consortium when large-scale loans and guarantees (such as those related to overseas construction projects) are to be provided to its client group. In this case, the principal transactions bank monitors overall performance of the project and corporation on behalf of other participating banks. However, the fact that principal transactions banks' credit supply to their client corporations is typically inadequate limits the influence of the principal transactions banks over their clients.

Each year principal transactions banks require their client corporations to submit their annual investment and financing plans. A favorable evaluation of the investment plan, however, does not necessarily lead to the bank's financing of the major portion of its client's needs. Likewise, even if a principal transactions bank objects to the investment plan, the corporation may continue with

4. The principal corporation is chosen by the Bank Supervisory Board in consideration of the company's position in the group, which depends on asset size and influence on other companies.

Table 10.2 Status of the 30 Largest Business Groups (end of 1991)

Business Group	Sales (billion won)	Debt/ Equity (%)	Number of Companies Subject to Credit Control	Number of Companies Satisfying Guided Capital Ratio	Principal Transactions Bank	Share in Principal Transactions Bank's Equity
1. Samsung	21,169	323.6	49	27	Hanil	4.9[a]
2. Daewoo	9,938	298.1	19	9	Korea First	–
3. Hyundai	23,401	443.4	38	19	Exchange	–
4. Hanjin	3,838	1,411.3	17	7	Hanil	–
5. Lucky-Goldstar	12,196	355.1	53	17	Korea First	3.2[b]
6. Sunkyung	6,813	244.2	29	17	Korea First	–
7. Kia	4,144	328.7	8	3	Korea First	–
8. Hanil	759	529.3	12	5	Hanil	–
9. Ssangyoung	5,685	173.4	20	11	Chohung	1.7[c]
10. Kumho	1,402	238.6	25	12	Chohung	–
11. Korea Explosives	2,277	290.6	21	8	Hanil	–
12. Daelim	1,953	436.4	12	7	Hanil	3.7[d]
13. Doo san	1,839	260.8	23	10	Commercial	–
14. Hyosung	2,177	317.0	14	7	Hanil	–
15. Kukdong Oil Refining	–	–	4	1	Commercial	–
16. Dongkuk Steel Mill	1,447	158.6	11	4	Seoul Trust	1.5[e]
17. Lotte	1,384	330.9	29	12	Commercial	–
18. Halla	578	372.5	9	3	Exchange	–
19. Kohap	884	422.6	7	3	Hanil	–
20. Dongbu	1,749	288.5	7	0	Seoul Trust	–
21. Kukdong Engineering and Construction	330	267.5	6	4	Chohung	–
22. Dong-Ah Construction	1,609	1,044.7	13	5	Commercial	–
23. Kolon	1,876	252.6	20	11	Hanil	–
24. Sammi	1,223	280.4	15	6	Commercial	–
25. Byucksan	765	507.2	15	4	Commercial	–
26. Samyang Co.	753	217.5	5	3	Commercial	1.1[f]
27. Jinro	301	421.8	19	5	Commercial	–
28. Oriental Chemical	720	352.0	9	6	Hanil	–
29. Hatai	644	483.1	8	1	Chohung	–
30. Woosung Construction	720	539.6	6	0	Korea First	–

Source: Office of Bank Supervision and Examination (1992).

[a]Holdings of Sumsung Insurance Co.

[b]Holdings of Lucky Securities and Lucky Fire and Marine Insurance Co.

[c]Holdings of Ssangyoung Cement Co.

[d]Holdings of Daelim Industries.

[e]Holdings of Dongkuk Steel Mill.

[f]Holdings of Samyang Co.

its plan in many cases. In practice, the KDB exerts the most influence on corporations' investment plans (even though it does not serve as a principal transactions bank for any business group), as it provides most of the large, long-term funds for facility investment. In tight credit situations, with corporations badly in need of working capital, the opinion of the principal transactions banks has more impact on the corporations.

Guidance for the Improvement of Corporate Capital Structure

The principal transactions bank provides guidance on external financing and its uses to client corporations, urging them to improve their capital structure on the basis of the "guided equity ratio" set by the Office of Bank Supervision and Examination for each industry. If necessary, principal transactions banks must take appropriate measures, such as restricting new credit and urging repayment of loans by corporations not in compliance through the selling of their holdings of securities or real estate. More specifically, business groups are put under special management guidance when their equity ratio, calculated semiannually, declines more than 30 percent from the end of the previous year to below the guided ratio or when the equity ratio falls short of 70 percent of the guided ratio.

However, the principal transactions banks' leverage in corporate management guidance is usually weak because of their limited capacity to meet the credit demands of client corporations under the chronic excess demand conditions in the market. As shown in table 10.2, only 227 (43 percent) of the 523 companies under credit control satisfied the guided equity ratio at the end of 1991, indicating that principal transactions banks' guidance for the improvement of corporate capital structure was not very effective.

Dealing with Troubled Firms

When large corporate borrowers are in financial difficulty, the creditor banks usually play only a minor role in deciding whether these companies will be bailed out. Restructuring or liquidation of a large corporation could cause successive bankruptcies of other companies that have business relationships with this corporation and, as a result, threaten the employment stability of the economy. In addition, bankruptcies of large corporations could have a serious impact on the credibility of Korean companies and banks in international financial and export markets. Therefore, decisions concerning the restructuring of large corporations are usually made at the government level (with the Industrial Policy Deliberation Committee and the Ministry of Finance playing major roles), and the principal transactions banks simply carry out the restructuring plan.

During 1986–88, for instance, as many as 78 corporations, largely selected by the Ministry of Finance, were involved in restructuring. Among the 78 corporations, 21 were restructured as a supplementary measure to earlier restructuring of shipping and overseas construction industries (table 10.3). Most of

Table 10.3 Financial Assistance to the 78 Restructured Corporations (trillion won)

Assistance	Shipping Industry Rationalization	Overseas Construction Rationalization	Other	Total
Grace period for principal repayment	0.8	0.5	0.4	1.6
Long-term loans with interest subsidy	–	–	4.2	4.2
Send money: loans for loss compensation	–	–	0.5	0.5
Write-off of principal	–	–	1.0	1.0
Total assistance (principal)	0.8	0.5	6.0	7.3
Total credit from financial institutions	1.8	1.1	6.8	9.8

Source: Office of Bank Supervision and Examination, internal data.

the remaining 57 companies were formally designated targets for rationalization by the Industrial Policy Deliberation Committee and were entitled to receive tax benefits such as an exemption from corporate income tax and acquisition tax in connection with the sale of real estate or subsidiaries.

The principal transactions banks selected candidate companies that might take over problem corporations and negotiated the terms with them. The terms of the financial support package were then examined and coordinated by the Office of Bank Supervision and Examination before they were confirmed by the Ministry of Finance through consultation with other involved ministries and agencies.

In the restructuring process, financial support played a critical role and was given in the form of (1) grace periods of up to 30 years for principal repayment, (2) subsidized long-term loans, (3) the combination of the previous two, or (4) the write-off of principal. To ease the burden of financial support borne by banks in the course of restructuring, sizable subsidized credit was extended by the Bank of Korea.

Before this massive restructuring, in 1985, the Kukje group, which was the sixth largest business group in terms of total sales at the end of 1983, with 23 member corporations, was completely broken up. Before the break-up, Korea First Bank, the group's principal transactions bank, and several other banks provided substantial emergency credit. Continuing emergency credit to a large business group would have had grave impact on the reserve management of the banks and on the monetary control of the authorities. Thus, the decision to provide or to stop emergency credit could not be made solely by the bank without consulting the monetary authorities. In addition, providing substantial emergency credit required the formation of a loan consortium to relieve the principal transactions bank of the financial burden. However, without leader-

ship strong enough to organize and lead the consortium, a principal transactions bank usually needs tacit support from the government. Together with its decision to stop providing emergency credit, the principal transactions bank formed an inspection team with other creditor banks to examine the financial situation of the group and to search for prospective buyers. Eventually, each member corporation of the Kukje group was taken over by another corporation.

Restrictions on Real Estate Acquisitions and Investment in New Business

Until 1993, business groups had to obtain prior approval from their principal transactions bank when they wanted to invest in new business (i.e., establishing a subsidiary, buying an existing company, equity participation, and merger) or acquire real estate. The restrictions were intended to induce specialization of business groups and discourage debt-financed expansion of business areas and acquisition of nonoperating real estate. In most cases, approval was given on the condition that the business group make "self-help efforts" worth 200–600 percent of the investment amount. Self-help effort included such activities as raising new capital by selling real estate or securities holdings, issuing new stocks, and disposing of shares of large shareholders. The required level of self-help effort varied depending on the purpose of the investment and whether the investing corporation and the business group satisfied their guided equity ratios.

However, entering 1994, the restrictions on investment in real estate and new business were relaxed significantly. They were completely abolished for the eleventh to thirtieth largest business groups. For the 10 largest groups, ex post reporting largely replaced prior approval from the principal transactions bank, and the burden of self-help effort was lightened to 100–200 percent of the investment amount.

10.4 Evaluation of the Principal Transactions Bank System

10.4.1 Performance of the Credit Control System

The role of Korean principal transactions banks is defined within the credit control system imposed on business groups, which began as an institutional mechanism designed to alleviate the side effects of strong government support for business groups through intervention in credit allocation in earlier years. Thus, an evaluation of the credit control system should be based on its contribution to alleviating such side effects—that is, how effectively it (1) improves large corporations' capital structure, (2) alleviates concentration of economic power and corrects disproportionate credit allocation, and (3) strengthens the manufacturing industry's competitiveness.

1. The credit control system does not seem to have contributed to the improvement of the capital structure of large corporations in any significant way.

No separate data are available on the changes in capital structure of subject companies since the introduction of the credit control system in 1974. However, the capital structure of large manufacturing firms worsened during the 1970s, and these companies faced severe financial difficulties after making large investments in heavy and chemical industries. The equity ratio of the 30 largest business groups rose from 17.4 to 20.8 percent between 1986 and 1990 (table 10.4). This improvement, however, was mainly attributable to the stock market boom between 1987 and 1989. As corporations faced difficulties in direct financing due to the downturn of the stock market in the early 1990s, their capital structure worsened again with increased borrowing from banks.[5]

2. With respect to reducing the concentration of economic power and providing more equitable access to credit, the credit control system seems to have been successful. As a result of introducing basket credit control in 1984, the share of the 30 largest business groups' bank loans that were subject to credit control fell from 25.3 percent of total bank loans in 1986 to 13.5 percent in 1990, on a year-end basis. Including loans not subject to credit control, their share in total bank loans fell from 28.6 percent in 1986 to 19.4 percent at the end of 1990 (table 10.5).[6]

It is noteworthy, however, that the large business groups' share in total credit of nonbank financial institutions (NBFIs) such as short-term finance companies, merchant banking corporations, and insurance companies, whose credit is not subject to credit control, has substantially increased. In other words, the credit control system has, to a large extent, shifted the financing demand of business groups from the banking sector to NBFIs.[7]

Furthermore, the credit control system appears to have been unsuccessful in discouraging business diversification. Between 1986 and 1991, 20 of the 30 largest business groups increased their number of member corporations in spite of the burden of self-help financing effort (table 10.6). Of course, the number of member firms is not an accurate measure of business diversification, and diversification activity might have been more pronounced without credit control.

3. Concern over the deteriorating competitiveness of the manufacturing industry resulted in the exemption of Major Corporations from credit control in

5. Corporate capital structure seems to be determined mainly by a corporation's financing needs. The equity ratios of the major Japanese manufacturing firms declined steadily during the postwar high-growth period from a 40 percent level in 1955 to below 19 percent during 1974–76.

6. The share of the 30 largest business groups in manufacturing sales and value-added began to decline in 1984 at the same time as the start of basket credit control. However, basket credit control was only one of the reasons for this decline. In the mid-1980s, the manufacturing sector showed strong growth accompanied by a large increase in the number of business establishments, which reduced the relative importance of the large business groups. Reinforced fair trade regulations also checked the expansion of these corporations. On the other hand, as the economy became more mature, business groups started to attach greater importance to service industries such as finance and information.

7. The share of the 30 largest business groups in total equity of all financial institutions other than nationwide commercial banks was 45 percent at the end of 1991 (*Maeil Kyungje*, October 16, 1992).

Table 10.4 **The Equity Ratio of Korean Corporations (%)**

	Manufacturing		
Year	Total	Large Corporations	Corporations Subject to Credit Control
1974	24.0	23.7	–
1975	22.8	22.1	–
1976	21.5	21.2	–
1977	22.2	22.3	–
1978	21.4	21.6	–
1979	21.0	20.9	–
1980	17.0	16.5	–
1981	18.1	18.1	–
1982	20.6	20.9	–
1983	21.7	21.7	–
1984	22.6	22.7	–
1985	22.3	22.5	–
1986	22.2	21.9	17.4
1987	22.7	23.1	19.8
1988	25.3	26.0	24.7
1989	28.2	29.4	23.8
1990	25.9	26.7	20.8
1991	24.4	25.6	19.4
1992	23.8	24.8	–

Source: Bank of Korea (various issues).

Table 10.5 **Share of the 30 Largest Business Groups in Bank Loans and in GDP (%)**

	1986	1987	1988	1989	1990	1991
Share in bank loans						
Loans subject to credit control	25.3	21.6	18.6	14.7	13.5	8.8[a]
Total loans	28.6	26.3	24.2	20.7	19.4	18.9
Share in NBFI credit	–	37.9	36.5	42.1	43.6	–
Share in GDP	–	14.6	13.5	14.1	–	–
Equity ratio	17.4	19.8	24.7	23.8	20.8	19.4

Sources: Korea Investors Service, Inc. (1988, 1989, 1990); Management Efficiency Research Institute (1987); *Maeil Kyungje* (March 31, 1992); Min (1991, 117).

[a]Excluding credit to Major Corporations, Corporations with Highly Dispersed Ownership, loans extended by overseas bank branches, and postshipment export financing.

1991. Due to this relaxation, in 1991 bank loans to 76 Major Corporations of the 30 largest business groups rose by 38.1 percent over the previous year. This increase contrasts with those of total bank loans (23.6 percent increase) and loans to non–Major Corporations in the 30 largest business groups (8.6 percent increase). It is still too early to evaluate the impact of this inducement to specialization on the strengthening of manufacturing competitiveness. No such

Table 10.6 Number of Member Companies of the 30 Largest Business Groups

Business Group	1981	1986 (A)	1987	1988	1989	April 1991 (B)	(B) − (A)
Samsung	21	31	31	41	42	48	+17
Daewoo	25	25	28	28	30	24	−1
Hanjin	13	12	16	16	18	22	+10
Hyundai	30	43	30	36	37	42	−1
Lucky-Goldstar	30	43	30	36	37	42	−1
Sunkyong	16	13	16	21	22	26	+13
Hanil	6	10	11	12	14	13	+3
Ssangyong	13	16	21	21	21	22	+6
Kia	12	7	10	10	10	10	+3
Daelim	9	12	13	13	13	14	+2
Kumho	10	5	8	13	14	22	+17
Hyosung	27	19	12	12	14	14	−5
Doosan	14	19	–	20	21	23	+4
Korea Explosives	16	20	21	25	25	27	+7
Dongkuk Steel Mill	–	12	13	13	13	14	+2
Kukdong Oil	–	–	–	4	4	4	–
Kukdong Engineering and Construction	15	12	16	16	16	16	+4
Dong-Ah Construction	15	12	16	16	16	16	+4
Lotte	16	26	26	31	31	32	+6
Dongbu	7	11	12	13	14	11	0
Sam Yang	–	3	–	7	6	6	+3
Kolon	16	10	18	16	18	21	+11
Sammi	4	5	9	11	14	15	+10
Byuksan	–	6	–	14	20	21	+15
Woosung Construction	–	–	–	7	7	6	–
Kohap	5	4	5	7	7	7	+3
Halla	–	–	5	6	6	9	+4
Cho Yang Shipping	–	–	–	–	–	10	–
Jinro	–	–	–	–	18	20	–
Oriental Chemical	–	–	–	–	11	13	–

Sources: Office of Bank Supervision and Examination (1992); *Maeil Kyungje* (May 7, 1991).

impact would be expected to the extent of credit diversion from the Major Corporations to other firms of a business group.

10.4.2 Problems with the Credit Control System

While the credit control system has had only limited success in achieving its goals, it has incurred heavy regulatory costs to both banks and subject corporations. Our interest here is to review the nature and the magnitude of these costs.

Since its launch, the credit control system has been a source of continuous

conflict between the government and the corporate sector. The corporate sector's resistance to the system was not apparent in the beginning but grew stronger in the 1980s as credit control became in essence a way to regulate business activities. This problem became more serious as government support for the corporate sector was largely reduced and stronger private sector initiative became necessary to meet successfully the challenge of intensified global competition.

The credit control system also has seriously hampered autonomous bank management. With the right of prior approval over various corporate activities and the authority to penalize client companies, principal transactions banks are positioned as subordinate organizations of the Office of Bank Supervision and Examination. They are obligated to collect information and report to the Office of Bank Supervision and Examination in connection with the implementation of credit control. They are subject to penalties such as restricted access to central bank credit and penalty interest rates in the event of violating relevant regulations or neglecting their duties as principal transactions banks.

The credit control burden of commercial banks is known to be so substantial as to require one-third of their loan officers. There are also many difficulties in evaluating whether real estate is nonoperating or not for tax purposes. The many unnecessary and trivial items that need the approval of principal transactions banks have been a major source of inefficiency and conflict between banks and their client corporations.[8]

The bank-enterprise relationship in the framework of the credit control system is that of the supervisor and the supervised. Autonomy in bank management and a cooperative bank-enterprise relationship are seriously impaired under the current system, in which control over corporate clients carried out on behalf of the government constitutes a substantial part of banking business. The current system of credit operation, which focuses on conformity to rules and regulations, should be replaced by one that nourishes a spontaneous and cooperative relationship between banks and their clients. To the extent that the government-bank-enterprise partnership constitutes a critical superstructure in determining industrial competence in the global economy, Korean corporations seem to be handicapped.

The current credit control system pursues two conflicting objectives: strengthening manufacturing competitiveness and reducing the concentration of economic power. This conflict makes the government's policy choices challenging. By exempting the Major Corporations from credit control, the govern-

8. Despite substantial operative inefficiency inflicted on banks and corporations, it is questionable whether overall allocative efficiency was as seriously hampered as operative efficiency. Because large corporations can utilize other financing sources, such as NBFIs, capital markets, and foreign capital, as well as fund diversion among firms within a group, their total financing capacity does not seem to be seriously diminished by limited bank credit. Even though some delay and additional costs are inevitable in financing, it is doubtful that a member firm of a large business group would have given up a promising investment project because of credit control regulations.

ment has given priority to strengthening the international competitiveness of industries at the cost of more equitable access to credit and reduced concentration of economic power.

The problem, however, is that the system might produce results that defeat its goal of strengthened manufacturing competitiveness. For instance, business groups tended to select those firms with large financing requirements as their Major Corporations rather than those with good prospects of gaining international competitiveness. For example, each of the five largest business groups have chosen as one of their Major Corporations a petrochemical company.

The relaxation of credit control on Major Corporations may bring about credit diversion from Major to non-Major Corporations to circumvent credit control. If such diversion actually occurs, the credit control system can no longer correct the concentrated access to credit. Loans to Major Corporations and Corporations with Highly Dispersed Ownership, which are not subject to credit control, accounted for 53.6 percent of total loans to the 30 largest business groups at the end of 1991. Accordingly, the share of loans to the 30 largest business groups under credit control declined to 8.8 percent of total bank loans outstanding at the end of 1991.

Under the Operational Bylaw on Credit Control over Business Groups, principal transactions banks are required to submit quarterly monitoring reports to the Office of Bank Supervision and Examination concerning loans to Major Corporations and to revoke the designation of Major Corporation in the event of diversion of credit to other uses. Despite this severe penalty, room for diversion always exists because monitoring the use of bank loans is practically difficult in the case of operating capital and banks have to make judgments mainly on the basis of data presented by the Major Corporations themselves.

In addition, repayment guarantees issued by the Major Corporations for other member companies, roughly equivalent to three times their equity capital, represent de facto credit diversion. At the end of June 1992, payment guarantees for corporations belonging to the 30 largest business groups amounted to four times their equity capital (table 10.7). To redress such problems, the government revised the Monopoly Regulation and Fair Trade Act, forcing busi-

Table 10.7 Equity Capital and Payment Guarantees of the 30 Largest Business Groups (end of June 1992; billion won)

Groups	Equity Capital (A)	Outstanding Cross-Payment Guarantees (B)	B/A
Groups 1–5	16,315	77,821	4.8
Groups 6–30	15,087	47,831	3.2
Total	31,402	125,652	4.0

Source: Office of Bank Supervision and Examination (1992).

ness groups to limit their cross-payment guarantees to a maximum of 200 percent of their equity capital within three years from April 1993. The task of mitigating economic concentration by business groups, one of the major objectives of the credit control system, has been passed on to the domain of fair trade policy.

10.5 A Search for a Desirable Bank-Business Relationship

10.5.1 Comparison of the Principal Transactions Bank System with the Japanese Main Bank System

Characteristics of the principal transactions bank system become clearer when it is compared with the Japanese main bank system. First, the principal transactions bank system in Korea is officially defined by the regulations of the Monetary Board, while the Japanese main bank system is defined by the conventional customer relationship between banks and their client corporations. Principal transactions banks in Korea, in effect, function as a substructure, or subordinate organizations, of the Office of Bank Supervision and Examination, controlling credit supply to client corporations and gathering and reporting information on their financial and credit situations.

Second, the main bank system in Japan represents a rather broad-based bank-enterprise relationship, with about 30 percent of corporations having such a relationship with their banks (Horiuchi 1990, 1). The principal transactions bank system in Korea, however, applies only to corporations belonging to the 30 largest business groups in terms of borrowing from banks. At the end of April 1992, the number of companies belonging to the 30 largest groups under direct credit control of their principal transactions banks was 591. Other corporations also have banks with which they have closer business relationship than with other banks. These banks, however, do not seem to play special roles which deserve general definition.

Third, the relationship between corporations belonging to Japanese business groups and their main banks is based on mutual equity ownership. In Korea, however, no such relationship is found. Only a few business groups hold equity shares in their principal transactions banks (table 10.2). In some of these cases, the shares just represent shareholding by their securities or insurance affiliates as part of their portfolio management. Also, the level of shareholding by those business groups is far lower than the 8 percent limit that a stockholder can have in the nationwide commercial banks. This lack of interest in holding shares of principal transactions banks might result from the tight credit control over the business groups and the government's influence over bank management, such as the appointment of top managers. On the other hand, there are some cases in which a principal transactions bank holds shares in its client corporations. Such holdings are, however, only for the purpose of asset management and do not represent part of the principal transactions bank relationship. While banks

in the Japanese main bank system often play roles as both lender and shareholder, the role of their Korean counterparts is limited to that of lender. A cooperative relationship between banks and their corporate clients, in which both parties share mutual benefits by reducing information asymmetry, is rarely found in Korea.

Fourth, although both Korea and Japan relied heavily on government-initiated industrial policies, such as government intervention in credit allocation, the passive or subordinate role of Korean banks has led to inefficiency in resource allocation. In Japan, the main-bank-enterprise relationship has provided a double-check mechanism regarding the prospect of planned projects. But Korean industrial policy has left little room for principal transactions banks to evaluate the major industrial projects whose undertaking and undertakers were decided by the government, making it difficult for a principal transactions bank to refuse the loans. When a loan consortium is formed by several banks to meet a large investment requirement, the share of each bank in the consortium has usually been allocated by the government. As a result of this lack of autonomy, banks have been more concerned about securing collateral than undertaking credit evaluation, which in turn has led corporations to hold more real estate to offer as collateral. This difference in the role of main banks in the evaluation of projects and borrowers' creditworthiness must have led to the different investment performances of the two countries.

Finally, the role of a principal transactions bank as an overall financial supervisor and a delegated monitor of its client corporations is much weaker than that of a Japanese main bank. Unlike Japanese main banks, Korean principal transactions banks perform these functions only in special circumstances, as when a large client corporation is insolvent. This limited role seems to reflect primarily the fact that a principal transactions bank neither necessarily accepts a disproportionate share of the cost of rescuing or liquidating troubled firms nor takes strong leadership in forming loan consortiums. It may also represent moral hazard behavior in the belief that the government will take responsibility in the worst-case scenario given the government initiative at the planning stage. Moral hazard might also result from the practice of cross-repayment guarantees among member firms of a group. In fact, except for the Kukje case, in which a whole group was broken up and taken over by other firms, member firms of large business groups have rarely been liquidated or rescued from serious financial difficulty by their principal transactions banks.

Another reason for the relative passivity of principal transactions banks is the ownership concentration of large corporations. In 1991, 14 percent of the total shares of the 30 largest groups were held by the group chairmen and their families and another 33 percent were held by member firms of the group. These combined holdings decreased only to 43 percent in 1993. Because the chairman, who has absolute management control of a business group, tends to be very cautious about revealing management information to outsiders, the function of principal transactions banks as monitor and supervisor has inevitably

been weak. Corporate clients' lack of confidence in their principal transactions banks as serious evaluators of the clients themselves or their investment projects might also be partly responsible for the weak role of the banks.

10.5.2 Directions for a New Bank-Business Relationship

The Japanese Main Bank System as a Model

In the search for a more desirable bank-client relationship in Korea, a useful starting point may be an evaluation of the efficiency of the Japanese main bank system. First, the main bank system seems to be efficient in reducing information asymmetry. A Japanese main bank has responsibilities as the leader of loan syndication and as the delegated monitor for other creditor banks. It also takes on a special degree of exposure if necessary and bears loss beyond its exposure if a client defaults on loans. With these responsibilities in a market in which information about borrowers is limited and costly to obtain, main banks make continuous investments in monitoring, which enables them to accumulate information about borrowing firms at lower cost.

This close monitoring may also improve corporate performance by eliminating any motivation to shirk and by reducing other agency costs of external finance. Borrowing firms have incentives to reveal confidential information to their main banks because it helps them to overcome the liquidity constraints of relying on internal finance and to reduce the cost of reorganizing and restructuring in the worst cases of distress. Those main banks or corporate borrowers that have not met their implied obligations and, thus, are perceived to be unreliable partners, suffer serious damage to their reputations. This potential penalty discourages credit diversion or other opportunistic behavior by borrowing firms and makes main banks willingly assume additional risk or loss when their corporate clients are in distress.

Mutual shareholding between main banks and their corporate clients is an important feature of the Japanese main bank system. Main bank ownership of shares of borrowing firms (up to a 5 percent limit) makes the relationship and monitoring close and effective. Bank shares are also frequently held by friendly industrial firms with which they have a main bank relationship. Bank ownership of corporate shares in Japan contrasts with U.S. legislation and British custom, which prohibits such ownership.

The main bank relationship, however, has elements of inefficiency and unfairness as well. The relationship is basically a secretive and exclusive one. Main banks' insider access to information about their client firms and the related nontransparency may create opportunities for fraud or exploitation for the benefit of the banks and involved individuals. The exclusive insider system with barriers to entry by outsiders may result in oligopolistic behavior. More important, the close main bank relationship may tend to bail out firms that should have been liquidated.

Given the overall evaluation, the main bank system would likely serve a

useful function in Korea as well. Korean financial markets are far from perfectly competitive and complete. Systems for corporate accounting, auditing, disclosure, and credit rating are yet to be firmly established in Korea. In a still-shallow securities market, insider trading, price manipulation, and other unfair transactions are not effectively regulated. As a result, information asymmetry is large, the search for accurate information is costly, and incentives for fraud or abuse of conflicts of interest are strong. In this world of incomplete and asymmetric information, the role of banks as credit analysts and monitors of corporate borrowers is critical. This function of banks, however, has been largely neglected owing to the heavy intervention of the government in the allocation of bank credit and the prevalent practice of collateral requirement for bank loans.

However, the drawbacks of the main bank system mentioned above make the question of who will monitor the main banks very important. First of all, the role of the Office of Bank Supervision and Examination would become more important. The office is advised to shift its major effort from controlling credit to securing the soundness of bank management and preventing unfair practices. In Korea, the government is also considering a few alternatives to make banks more responsible for their own management. One of them is to have banks set up a Council of Large Stockholders, composed of five to ten major shareholders who own more than 1 percent of the bank's stock. The council will monitor bank management. Another alternative is to allow an individual to hold up to, say, 15 percent of a bank's stock on the condition that the person does not own any nonfinancial firms. The existence of an owner with management control will make bank management more accountable.

Inducing Autonomous Relationship Banking

The next question is, How can Korean banks and their corporate clients be encouraged to establish close relationships similar to the Japanese main bank system? This task should first be approached by eliminating the institutional constraints and improving the policy environment that have suppressed the incentives for credit evaluation and close monitoring of corporate borrowers. In this respect, the current system of credit control and principal transactions banks should be transformed to a more autonomous bank-client relationship, with less emphasis on the supervisory function of banks. In fact, credit control procedures are being simplified, and the current system of approval by the principal transactions banks for corporate investment in other businesses and real estate is being phased out. Easing of excessive concentration of economic power and specialization of business groups may better be induced with the provisions of the Monopoly Regulation and Fair Trade Act and the Industrial Development Law. Likewise, speculation in real estate may be addressed by strengthening related tax laws and their implementation. Ultimately, the credit control system will have to focus on maintaining prudence and soundness in corporate banking operations.

Moreover, commercial banks should gradually be relieved of the burden of extending policy loans. Policy loans by banks still account for a substantial portion of their loan portfolios. They include loans to development institutions, the housing and agricultural sectors, and small and medium-sized firms and foreign currency loans mainly for capital goods imports. Until commercial banks are freed from the obligation of supplying policy loans, financial liberalization will be limited and an autonomous, cooperative bank-client relationship will be inhibited. Preferential policy loans may be needed in order to alleviate market imperfections, as is the case for risky projects with long gestation periods and anticipated positive externalities for the economy. Subsidized credit may also be provided out of social considerations. This obligation, however, should be fulfilled from the government budget rather than by commercial banks.

Finally, the practice of requiring collateral should be improved to serve as a complement to, rather than a substitute for, costly credit analysis and monitoring. The majority of bank loans in Korea are secured by collateral, whose value exceeds the loan amount by at least 30–50 percent. All the costs of insuring, registering, and disposing of the collateral are also borne by borrowers. In addition, borrowers are required to provide a surety liable jointly and severally for their borrowing. Fully protected from default risk, banks have little incentive to begin serious credit evaluation, monitoring, and investment on information by relationship banking. Banks may actually be better off when borrowing firms go bankrupt and heavy penalty interest is collected for the delay in repayment. This incentive structure is likely to result in adverse selection, which may be even worse when banks are allowed to charge differential interest rates depending on the creditworthiness of borrowers.

The bargaining power of borrowing firms is, however, improving, as the excess demand situation in the bank loan market is eased with the deregulation of interest rates, increase in loanable funds, and diversification of corporate financing sources for larger firms. Even before pressures from the changing market correct the situation, it may be advisable to regulate the irrational practices related to securing bank loans. For instance, security or subrogation by a surety may be limited up to the loan amount.

With a view to encouraging a binding relationship between a bank and its corporate clients, mutual equity holding may be considered. Given Korea's industrial organization and the realities of corporate governance, however, this arrangement may still be premature. As entry into banking is restricted and bank loans have a subsidy element, allowing large business groups to hold controlling shares of banks would be an unjustifiable favor to the business groups. Even when financial markets are competitive with free entry, a mix of financial and nonfinancial products within a business group increases the probability of abuses as long as the member firms have market power in the nonfinancial products. Given the highly oligopolistic Korean market structure, where large business groups have market-dominating power (table 10.8), the

Table 10.8 Share of the 5 and 30 Largest Business Groups in Manufacturing Sales and Employment

	1977	1982	1987	1989
Sales				
5 Largest	15.7	22.6	22.0	21.3
30 Largest	34.1	40.7	37.3	35.4
Employment				
5 Largest	–	8.9[a]	9.9	9.9
30 Largest	–	18.6[a]	18.1	16.8

Sources: Jung and Yang (1992, 40–41); Korea Development Institute, Seoul, and other unpublished survey data at Korea Development Institute.
[a]Figure for 1983.

room for abusing conflicts of interest through tie-in sales, for instance, is potentially great.

On the other hand, banks may enhance their role as shareholders of client corporations. As both a lender and a shareholder, a bank representative may serve as an outside member of the board, with access to corporate inside information. However, corporate management, including that of business groups, is typically very concentrated, with its major owner the central figure. In this management structure, outside board members are not expected to be well utilized as management supervisors. Only when management and ownership are largely separated in Korean business firms may banks be able to play a significant role as shareholders and corporate insiders.

Major Clients for Relationship Banking

As has been the case in Japan for some time, Korea's large business groups will rely less on bank loans because they will borrow increasingly from abroad at low cost and utilize less-expensive securities finance. With the development of such practices as accounting, auditing, securities analysis, and credit rating, which reduce information asymmetry and increase relevant information at low cost, large corporations will find it easier and cheaper to finance in the securities market. However, the role of banks is not confined to lending but includes diverse financial services. Because the number of banks with such capacity is limited, very large healthy business corporations are likely to develop close relationships with several nationwide city banks according to the major strength of each bank.

These relationships between fairly large corporations and their banks will resemble those of Japanese core banks. This relationship will basically be a rather competitive one. The client corporations will not wish to commit themselves to a binding relationship with any one bank but will rather maintain financial transactions with several banks, keeping them at arm's length. Banks will compete with one another to secure better clients and consolidate existing

client relationships, which will improve banking services and enhance banks' capabilities. As the relationship is not an exclusive or binding one, it will always be subject to change depending on the results of competition through repeated transactions.

On the other hand, with the increasing supply of loanable funds relative to demand, banks are expected to form much closer and binding (main bank) relationships with the smaller large corporations and medium-sized firms that have good growth prospects. For small and medium-sized firms, it is difficult to utilize the capital market. This difficulty is due mainly to high transactions costs for small-scale financing, as well as the high cost of information arising from poor bookkeeping and lack of transparency in management. Thus, such firms rely heavily on bank and nonbank borrowing (table 10.9).

Although the major firms of large business groups may opt out of close and binding relationships with banks, many large firms will remain. This is so because the expected returns on continuous investment in monitoring are higher in the case of larger firms. As business firms grow, they typically need wide-ranging consulting and banking services regarding corporate finance and treasury. In return for entering into a special relationship, they have much lucrative financial business to offer to their banks, including transactions deposits, foreign exchange business, trusteeship, and other fee-generating business. Entering a binding relationship with small firms with all the implied commitments is in general too risky for banks, given these firms' uncertain prospects, lack of operational transparency, and paucity of expected banking business.

10.6 Conclusion

The principal transactions bank system in Korea was introduced in order to correct the skewed allocation of bank credit, which was the result of

Table 10.9 **Sources of Funds for Manufacturing Firms (%)**

	Large Firms		Small and Medium-sized Firms	
Source	1984–88	1989–92	1984–88	1989–92
Internal financing	44.8	39.9	38.4	30.3
External financing	55.2	60.1	61.6	69.7
Direct financing	14.9	15.0	9.8	8.1
(Capital increases)	(8.7)	(5.0)	(7.0)	(6.7)
(Corporate bonds)	(6.2)	(9.9)	(2.8)	(1.5)
Borrowing	19.4	27.9	25.7	38.9
(From banks)	(14.8)	(19.0)	(23.7)	(30.6)
Other	21.0	17.2	26.1	22.8
Total	100.0	100.0	100.0	100.0

Source: Bank of Korea (various years).

government-led economic development. Now, two decades after its introduction, there seems to be broad agreement that the current system of credit control and principal transactions banks needs to be redefined in light of the huge challenges of successfully liberalizing and opening the economy.

The regulatory mechanism of the system unduly restricts corporate activity and imposes operational burdens on the principal transactions banks. An autonomous and close bank-business relationship cannot be fostered because the banks have functioned as de facto suborganizations of the supervisory authorities. Korea's principal transactions banks have not assumed the implicit obligations of the Japanese main banks, such as a disproportionate burden in rescuing or liquidating troubled firms. With its role as a delegated monitor very much limited, the banking sector as a whole is not efficient in generating information and reducing information asymmetry about borrowing firms. Furthermore, the current credit control system seems to be ineffective in serving the two conflicting objectives of strengthening industrial competitiveness and mitigating the concentration of economic power.

As envisaged by the government, credit control and other restrictions on corporate investment and financing should be phased out. Such concerns as excessive concentration of economic power and speculation in real estate may be addressed under the Monopoly Regulation and Fair Trade Act and relevant tax laws. Reduction of government intervention in the loan portfolios of commercial banks, such as the obligation to provide policy loans, also will help nourish close and autonomous bank-business relationships. Moreover, the prevalent practices of repayment guarantees by other member firms of a business group and collateral requirements for loans should be discouraged. They largely nullify any need for serious credit evaluation or monitoring on the part of banks.

Excessive collateral requirements, however, are expected to be eased gradually with the deregulation of interest rates, increase in loanable funds, and diversification of corporate financing sources, including access to the capital market. These structural changes in the financial market will also induce the largest and leading business firms to rely less on bank credit and to maintain rather competitive relationships with several "core" banks. Banks are likely to develop closer and more binding relationships with slightly smaller business firms. Attracted by large potential contributions to bank profitability, banks will be willing to enter into exclusive relationships with these firms. Such relationships will most probably imply an understanding that the firm allows the bank to supply a substantial portion of its lucrative banking services, to share its inside information, and to conduct close monitoring in return for the expectation of emergency loans and other rescue operations in situations of financial distress.

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Comment Akiyoshi Horiuchi

Nam gives an overview of the principal transactions bank system in Korea. He describes the evolution of this system, introduced in 1874, evaluates its impact

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on corporate behavior in Korea, and compares it with the Japanese main bank system. His explanation in this paper is excellent. Although I am not an expert on the Korean economy, I have some knowledge of the relationships between Korea's major banks and major corporations and the government policy stance toward credit allocation. I would like to comment on his argument about the workings of the principal transactions bank system and then proceed to discuss briefly his comparison between this system and the Japanese main bank system.

Nam emphasizes that because the principal transactions bank system was introduced on the government's initiative, it has played the subordinate role of implementing credit control designed by the government. According to Nam, this role has been a major reason for the unsatisfactory performance of this system since the 1980s. Since principal transactions banks have not been able to determine credit allocation to the major corporations, they have had little incentive to pursue serious credit evaluation, monitoring, and investment on information concerning major borrower firms. Nam suggests that this attitude on the part of the banking sector produced inefficiency in corporate management.

One of the Korean government's most important goals in introducing the credit control system, through the principal transactions banks, was to improve the soundness of the corporate sector. This policy reminds me of the Japanese government's concern for the soundness of Japan's corporate sector in the first stage of the high-growth period. Like the Korean government, the Japanese government worried about the "abnormally" low equity ratio levels of the major companies. The government, particularly the monetary authorities, urged in vain companies and major financial institutions to improve companies' equity ratios. On the other hand, Japanese banks did not seem to cooperate with the monetary authorities. Rather they actively helped their major client firms increase their leverage ratios. Thus, during the high-growth period, the Japanese main banks contributed to industrial development by making it possible for the corporate sector to decrease equity ratios without incurring substantial increases in bankruptcy costs. In this sense, as Nam points out, the Korean principal transactions bank system is very different from the Japanese main bank system.

In my understanding, the Korean economy has a deep and wide curb capital market. In contrast, there is no comparable curb capital market in Japan. The existence of an informal capital market might influence the performance of credit control policy designed by the government. Nam does not explain explicitly the influence of the curb capital market on the efficiency of government credit control policy.

Nam strongly argues that the Korean economy should have much more autonomous bank-enterprise relationships, like Japanese main bank relationships. I fundamentally agree with his argument that the Korean banking sector should be much freer from government control. But I would like to emphasize

that the main bank relationship in Japan is not almighty in financially promoting industrial development. The main bank can be an efficient monitor of its client firms' managers so as to prevent inefficient management. But Japan's capital markets have not yet resolved the problem of who can efficiently monitor the monitor. Furthermore, major companies have gradually extended their fund-raising opportunities outside the bank loan market. If capital markets outside bank loan markets are not efficient enough, this expansion of firms' fund-raising power may weaken banks' power to control corporate management. This structural change may threaten development potential in the Japanese economy. The recent experience in the Japanese corporate sector clearly suggests the need for a well-developed capital market competitive with banking in order to preserve efficient industrial evolution.

We have observed both in Japan and Korea the progress of securitization in major firms' finance. The weight of banking business has thus shifted gradually from big-company finance to small-scale enterprise finance. But some scholars worry that the full-scale development of capital markets might prevent banks from cultivating relationships with small-scale enterprises. This is because developed capital markets would give rise to a problem of time inconsistency in the sense that, while in their infancy borrower firms are eager to receive financial support from their main banks, after establishing their own status in financial markets, such firms would wish to sever relations with their main banks. If this is a possibility, banks would hesitate to develop intimate main bank relationships with newly established enterprises. Thus, a well-developed capital market outside the banking sector ironically may hinder main bank relationships with small-scale enterprises, as suggested a few years ago by Colin Mayer (1988).

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Comment Shang-Jin Wei

A well-written paper is a discussant's enemy, and this paper is my enemy. In this smoothly constructed paper, Sang-Woo Nam has presented a clear description of the main features of the current principal transaction bank (PTB) system, its shortcomings, and a proposal for reform. I have no ground to dispute the factual description.

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A discussant's job is not complete if he does not quibble. I have two quibbles on this paper. First, I will express my idiosyncratic view on where Nam's analysis of the PTB system may be modified. Second, I will suggest that Nam's reform proposal needs more justification that he has offered so far.

Let me start with my first comment. The PTB system in Korea has three salient features: (1) The government designates, or induces the banking sector and firms to self-designate, a PTB for each large business group (according the borrowing volume of the main firms in a group). (2) Other banks do not lend to a business group without first consulting with and presumably obtaining some tacit approval from the relevant PTB. (I may be reading too much into the paper on this point.) (3) A PTB is to undertake monitoring of investment and other financial transactions for all firms in the business group, to enforce credit control (later on to discourage real estate transactions), and to report to the Office of Bank Supervision and Examination. Later, each group can designate a few firms to be exempted from credit control.

A few implications are immediately clear from this setup. First, the PTB-firm relationship is a government-fostered creature, as opposed to a market-generated institution. Second, there is an anticompetitive element in the system for Korea's banking sector. That is, the PTB system enables the five large banks to divide up the banking business of large business groups and then maintain a quasi-monopolistic position in the relevant segment of the market. Third, the PTBs operate as an extension of a government regulatory agency, namely, the Office of Bank Supervision and Examination. These features are important in one's evaluation of the system.

I agree with Nam's evaluation of the PTB system with one exception. Let me explain this exception. Nam argues that the system has been successful in reducing the concentration of economic power and providing equitable access to credit. As supportive evidence, he cites data on the share of large business groups' loans (which fell from 25.3 percent in 1986 to 13.5 percent in 1990). I think that he may be too generous on this point. As Nam realizes, there was a great deal of substitution of borrowing from nonbank financial institutions for borrowing from the banks. Taking into account this substitution, the actual constraint the PTB system places on the large business groups is substantially more limited than their numerical share in total bank loans may imply. Second, as far as concentration of economic power is concerned, it seems that a better indicator might be the shares of the large business groups in total output, total employment, or total manufacture sales. Nam's paper does report some statistics on the share in manufacture sales (table 10.8). Indeed, during the period 1977–89, there was no evidence that the large business groups' share was declining. On the contrary, the top five groups' share increased from 15.7 percent in 1977 to 21.3 percent in 1989. One reason that the large groups were still able to expand rapidly despite the PTBs and the associated credit crunch, I believe, was the large groups' ability to substitute among financing sources.

Another aspect of the PTB system which Nam has not sufficiently investi-

gated is the magnitude of the efficiency loss. The restriction on large groups' credit access appears to be entirely motivated by equity or redistribution considerations. There is a nonnegligible amount of efficiency loss due to this administrative, and to a large extent arbitrary, restriction. It would be interesting to see whether there is a way to quantify the magnitude of this efficiency loss. Such a quantification seems to me to be an important element in any evaluation of the system. (Of course, if one believes that there is inherent market failure in the banking sector, and less access to loans by firms outside the large business groups is a consequence, then there will be certain efficiency gains in the PTB system resulting from correcting the market failure. This can offset the efficiency loss associated with the administrative credit crunch. I see no convincing argument for the existence of market failure. Hence, the effect of the PTB system is probably negative on pure efficiency grounds.)

My second comment is on Nam's reform proposal. Nam says that the Japanese main bank system, despite its many problems, is a model for Korea's banking sector. I do not necessarily disagree with this. But I think that more careful justification may be needed. Broadly speaking, there are two models of bank-business relationships in capitalist economies. One is the Anglo-Saxon system, in which the stock market plays a significant role in corporate governance. Shareholder meetings as well as the possibility of takeovers injects discipline into the management of publicly listed firms. Banks, for the most part, act more as passive fund providers than as active monitors of firms' management. The alternative model is the so-called German-Japanese model, in which banks play an active role in monitoring, managing, and strategic planning or other operations of the firms. (There may be other variants of the two models, or a mixture of these features with others. For example, McKinnon might suggest a third category, say the Taiwanese model, in which the informal financial market is large in magnitude. For our discussion, we focus on the dichotomy of relative roles of banks vs. equity markets in corporate governance.)

I am not aware of any conclusive evidence favoring one particular system over the alternative in the long run. This is probably a result of my ignorance of the relevant literature. But it seems that each system has its advantages and disadvantages. For example, Nam has argued that one advantage of the Japanese model is that it may reduce information and agency costs between banks and firms. But at the same time, the Japanese model can also *raise* agency costs between banks and depositors. As a bank's involvement with a firm is more than proportional to its loans, there is also greater scope for moral hazard. Contrary to depositors' interests, banks may extend loans to a firm that should be liquidated.

From a global and historical perspective, there are successful economies with either financial model. Indeed, there is a bit of mutual convergence between the two systems. Financial reforms in Japan have given impetus to the development of its capital market, making it several notches closer to the Anglo-Saxon system. On the other hand, the pending deregulation of the bank-

ing sector in the United States is making it more like the German-Japanese financial system. To summarize, it appears that either model can be compatible with the successful development of a market economy.

If the long-run economic effects of the two model systems are comparable, is there any short-run reason to favor one model over the other? There may be two reasons for an affirmative answer. First of all, there is substantial initial cost to the development of a capital market. Given the small size of the equity market, the closer bank-firm relations within the main bank system are desirable because they at least provide some external discipline to firm management. The second reason is of the hysteresis type. Given that Korea already has a PTB system, it may be more efficient and less costly to reform it to a main bank system than to dismantle it and foster a parallel capital market. The question is whether these benefits are large enough to overcome the moral hazard problem associated with closer bank-firm relationships. My position is not that a PTB or main bank system is undesirable for Korea, but that more explicit investigation might be useful before proposing a particular bank-business relationship.