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The Need for Improved Risk Management in Corporate Governance of Banks in South Korea

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Abstract

Korea's banking industry underwent incredible growth in the last 50 years and the role of corporate governance has become ever more important. It is now generally accepted that corporate governance is essential for a healthier and stronger banking industry. This is especially relevant because banks directly affect the stability of Korea's financial market and the development of its national economy. Reforming the corporate governance of Korean banks can therefore help prevent financial crises in the future.

This paper provides an overview of Korea's economy and banking industry, and explains their relationships with corporate governance. While there are different aspects to corporate governance of banks, this paper focuses on risk management because it plays a crucial role. This paper concludes by making several recommendations for a more effective risk management system to promote healthier Korean banks.

Key Words: Corporate governance reform, corporate governance of banks, risk management, South Korea, financial industry, banking industry, financial reform, banking reform, financial crisis, IMF crisis

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I. Introduction

Poor corporate governance often plays a key contributing role in financial crises. Corporate governance and fiduciary duty of directors are important for all organizations, but especially for banks because they directly affect the stability of financial markets and national economies. Banks have many aspects that involve more risk-taking than general companies, thus requiring more closely watched corporate governance.[1] For example, balance sheets of banks are structured in a way that causes assets and liabilities to be mismatched in terms of maturity, thereby making long-term assets difficult to liquidate. This makes banks vulnerable to liquidity shocks that are often systematic in nature.[2]

Also, banks manage projects that disproportionately affect entire economies[3] and do not require special equipment or facilities, which expedites their globalization process as long as they have access to information.[4] This means that banks' effects are also world-wide. This is why governmental regulations are generally most strict and international for the finance industry, and more specifically, the banking industry.[5] The momentous effects of banks are noted by the Korean Supreme Court, which had ruled that bank directors must fulfill their fiduciary duties with utmost care, including their duty for providing proper risk management.[6]

It cannot be said that poor corporate governance of financial institutions alone leads to financial crises; research analyzing corporate governance of 37 companies that were excluded from the S&P 500 during the 2008 financial crisis illustrates that poor corporate governance was not the sole

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1) Peter O. Mulbert & Ryan D. Citlau, *The Uncertain Role of Banks' Corporate Governance in Systematic Risk Regulation* 10 (Eur. Corp. Governance Inst., Working Paper No. 179/2011, 2011).

2) *Id.* at 11.

3) *Id.* at 12.

4) Hwa-Jin Kim, *Corporate Governance of Banks and Bank Director Liability*, Seoul L. J. 151, 166 (2010) (S. Korea).

5) *Id.*

6) Supreme Court, 2000Da9086, Mar. 15, 2002 (S. Kor.).

contributor.[7] But it is now widely accepted and nearly undisputed that it played a key contributing role. Many financial institutions that were hit hard with the financial crisis had abnormal manager compensation system[8] and improperly functioning boards that led to greater risks.[9] Also, a large portion of policymaking problems involved board remuneration, which promoted greater and inefficient risk-taking.[10] Many banks had complex and opaque bank structures,[11] as well as perverse incentives that focused on short-term revenues while taking on high long-term risks, which all contributed to the crisis.[12]

After the 2008 global financial crisis, many reforms have been proposed worldwide to counter deficiencies, including clearer separation of management and control functions, greater transparency with the bank structure, and group-wide corporate governance in single entities. Many experts agree that the lack of proper corporate governance with respect to risk-taking was one of the most significant causes to the banking crisis.[13] While there are other areas of improvement, risk management reforms can have directly effective results. It can improve corporate value of banks, prevent systematic risk of care,[14] and help prevent financial crises. Since Korean banks are subject to poor risk management, this paper proposes strengthening their risk management as central corporate governance reform for Korea's financial industry.

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7) Kim, *supra* note 4, at 166.

8) Brian R. Cheffins, *Did Corporate Governance "Fail" During the 2008 Stock Market Meltdown? The Case of the S&P 500,* 65 Bus. Law. 1 (2009).

9) James R. Booth et al., *Boards of Directors, Ownership, and Regulation,* 26 J. of Banking & Fin. 1973 (2002).

10) Lucian A. Bebchuk & Holger Spamann, *Regulating Bankers' Pay*, 98 Geo. L.J. 247 (2009).

11) Klaus J. Hopt, *Corporate Governance of Banks after the Financial Crisis* 11, 12 (Eur. Corp. Governance Inst., Working Paper No. 181/2011, 2011).

12) *Id.* at 12.

13) *See* Basel Comm. on Banking Supervision, Consultative Document, Principles for Enhancing Corporate Governance, Bank Int'l Settlements, 6-7 (Mar. 2010), *available at* http://www.bis.org/publ/bcbs168.pdf.

14) Kim, *supra* note 4, at 180.

II. The Korean Banking Industry

The banking industry of South Korea has evolved during the last 50 years of dramatic changes in the Korean economy. The economic reform led by President Chung Hee Park in 1961 stimulated export-centric growth where exporting firms were granted favors such as low interest loans according to their export performance.[15] Under Park's leadership, the government carried out a currency reform, strengthened financial institutions, and introduced flexible economic planning.[16] The government also emphasized labor-intensive light industries to promote rapid debt-financed industrial expansion.

In 1970s, Korea directed fiscal and financial policies toward promoting heavy and chemical industries, consumer electronics, and automobiles. Manufacturing continued to grow rapidly in many different industrial sectors in 1980s and early 1990s.[17] Korea consequently achieved one of the world's fastest growth rate from early 1960s to late 1990s; its real gross domestic product (GDP) increased by an average of more than eight percent per year, from US$ 2.7 billion in 1962 to US$ 230 billion in 1989.[18] This economic development is now commonly referred to as the "Miracle of Han River."

Growth of the Korean banking industry paralleled that of Korea's economic development. The country witnessed an average growth of 21.9 percent in total assets of commercial banks from 1989 to 1998.[19] The banks' role in attracting savings and distributing the resulting funds also increased

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15) Myung-Soo Cha, *The Economic History of Korea*, EH.Net Encyclopedia (Feb. 2, 2010, 6:21PM), http://eh.net/encyclopedia/article/cha.korea.

16) *Id.*

17) *Background Note: South Korea*, U.S. Department of State (Apr. 12, 2012), *available at* http://www.state.gov/r/pa/ei/bgn/2800.htm.

18) *South Korea GDP Growth Rate*, Trading Economics, http://www.tradingeconomics.com/south-korea/gdp-growth.

19) Un-Chan Chung, Jee-Man Jung, Shee-Chang Ham & Gyu-Han Kim, *Economies of Scale and Scope in Korea's Banking Industry: Evidence from the Fourier Flexible Form*, The J. of the Korean Econ. 87, 89 (2001).

as the economy grew.[20] This allowed the banking industry to grow faster than the rest of the economy. While there were only eight Korean banks in the world's 500 largest banks in terms of paid-in capital in 1983, this number increased to 18 by 1996.[21] But this rapid growth was challenged by the Korean financial crisis of 1997 ("the 1997 Crisis"), which compelled major corporate governance reforms and thereafter changed the behavior of Korean banks.

1. Leading up to the 1997 Crisis

The rapid growth of the Korean banking industry came with side effects, avalanching into the 1997 Crisis that occurred shortly after Korea's financial liberalization and market opening in early 1990s.[22] Years of concentrated growth had destabilized Korea's financial system and greatly contributed to the crisis.[23] Also, government-led development strategies over the decades preceding the financial liberalization had involved routine government intervention in the financial sector, which prevented market discipline from ever taking root;[24] extensive government involvement in the internal management weakened the autonomy and accountability of the banks' management.[25]

All this steered the banks to focus on attracting savings, which prevented proper development of expertise in screening and monitoring loans,[26] and the banks consequently lacked the ability to assess the profitability and credit risks of firms.[27] Overall, Korean banks substantially lagged behind their western counterparts in terms of staff training, skills,

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20) *Id.*

21) *Id.* at 90.

22) Hyung-Gon Ro, *Banking Industry Consolidation in Korea* 93 (Bank for Int'l Settlements, Working Paper No. 4), *available at* http://www.bis.org/publ/bppdf/bispap04i.pdf.

23) *Id.*

24) Jae-Ha Park, *Corporate Governance of Banks in Republic of Korea, in* 1 Corporate Governance of Banks in Asia 167, 167 (Sang-Woo Nam & Chee-Soon Lum, ed., 2006).

25) *Id.* at 168.

26) Chung, Jung, Ham & Kim, *supra* note 19.

27) *Id.*

and experience,[28] which prevented them from exploiting financial derivatives and newly advanced financial technology.[29] These problems were aggravated by the strict segmentation of the financial industry and high entry barriers that limited the initiative and innovation of banks. Korean banks were thus simply not ready for the financial liberalization that accelerated in the early 1990s when the government lifted various restrictions on asset and liability management of financial institutions and encouraged changes in the existing institutional framework.[30]

These changes increased short-term foreign currency debts held by domestic financial institutions. Banks started to dramatically increase new lending without appropriate credit-risk evaluation that went unchecked because of the inefficient use of the financial supervisory system in Korea.[31] All this ultimately brought on the 1997 Crisis where a string of large corporate insolvencies and rapid build-up of bad loans held by financial institutions threatened Korea's financial system.[32]

2. *During & After the 1997 Crisis*

During the 1997 Crisis, Korea lacked foreign currency liquidity to meet its maturing liabilities, which followed a drastic decrease in its foreign exchange reserves.[33] Several securities companies, 14 merchant banks, and one investment trust company were shut down as a result.[34] The currency crisis quickly escalated into financial and economic crises with the continued loss of confidence of foreign investors. With the exodus of foreign capital and a sharp contraction in corporate investment and consumer spending, the value of the Korean currency (Korean won) fell by more than 50 percent, and Korea's real GDP contracted by six percent in

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28) Chung, Jung, Ham & Kim, *supra* note 19, at 90.

29) *Id.*

30) Park, *supra* note 24, at 168.

31) *Id.*

32) Ro, *supra* note 22, at 93.

33) *Id.*

34) Financial Services Commission, http://www.fsc.go.kr (last visited Apr. 22, 2012).

1998.[35] The surge in corporate bankruptcies also increased unemployment rate to over eight percent by the end of 1998 from less than three percent in 1997.[36] Banks were hit especially hard. Bonds issued by one of Korea's biggest banks were trading at 60 percent of face value in December 1997, down from 100 percent of face value in October 1997.[37] Furthermore, the Bank of International Settlements (BIS) capital ratio, a globally accepted indicator of banks' healthiness, dropped to 7.0 percent in 1997,[38] which is well below the requested minimum of 8 percent.[39]

In panic, the Korean government turned to International Monetary Fund (IMF) for standby credit, which responded by signing an emergency package of US$ 58.4 billion on December 3, 1997. The emergency rescue plan required Korea to launch structural reforms in the financial sector, corporate sector, and labor market, along with sound management of macroeconomic policy.[40] This program was led by President Dae-jung Kim, which helped Korea quickly return to growth rates of ten percent in 1999 and nine percent in 2000.[41] Korea swiftly recovered, allowing an early repayment of the loan from the IMF rescue package,[42] which is further evidenced by its BIS ratio improving to 13.1 percent in 2006.[43]

The structural reforms prompted substantial changes in the structure and behavior of banks.[44] By the end of 1997, each of the ten largest Korean banks (based on assets) had undergone consolidation.[45] Eight of the ten

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35) *See* Ja-Hyeong Koo & Sherry L. Kaiser, *Recovery from a Financial Crisis: The Case of Korea*, Econ & Fin. Rev., 4th Q. 2001, at 24, 27.

36) *Id.* at 30-31.

37) John W. Head, *Lessons from the Asian Financial Crisis: The Role of the IMF and the United States*, 7 Kan. J.L. & Pub. Pol'y 70, 70 (1998).

38) Bang-Nam Jeon, *From the 1997-98 Asian Financial Crisis to the 2008-09 Global Economic Crisis: Lessons from Korea's Experience*, 5 E. Asia L. Rev. 103, 121.

39) *See* Shukan Toh-yo Keizai, Why Banks Made Big Mistakes? 30-34 (1998).

40) Jeon, *supra* note 38, at 105.

41) *Background Note: South Korea*, *supra* note 18.

42) Jeon, *supra* note 38, at 107.

43) *Id.* at 121.

44) Soo-Myung Kim, Ji-Young Kim & Hoon-Tae Ryoo, *Restructuring and Reforms in the Korean Banking Industry* 259-268 (Bank for Int'l Settlements, Working Paper No. 28), *available at* http://www.bis.org/publ/bppdf/bispap28q.pdf.

45) Jong-Moo Choi & Michael Papaioannou, *Financial Crisis and Risk Management:*

largest banks either merged or acquired smaller banks to produce the three largest and presumably more competitive banks.[46] These banks focused more on profitability and competitiveness and began assuming a greater role as comprehensive asset managers.[47] Consequently, the Korean banking industry started to demonstrate stronger performance with enhanced profitability, asset soundness, and capital adequacy.[48] They also made considerable headway in enhancing their efficiency and resilience. And while the 2008 global financial crisis hurt the banking industry worldwide and reduced the net income of Korean banks in 2009 to 6.9 trillion won, Korean banks recovered relatively quickly to their previous levels and have since remained in positive territory.[49] All this illustrate the extent of positive impact of effective corporate governance on banks and the national economy.

III. Corporate Governance of Banks

Before the 1997 Crisis, 'bankruptcy of banks' had been viewed as unrealistic and mergers of banks as something that only occurred in other countries.[50] General consensus in Korea had been that banks did not have to strive in maintaining their sustainability.[51] However, the aftermath of the 1997 Crisis showed that bank bankruptcies and mergers were very real possibilities in Korea.[52] Since then, corporate governance of banks and legal liability of bank directors started being treated like that of general

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Reassessing the Asian Financial Crisis in Light of the American Financial Crisis, 5 E. Asia L. Rev. 442, 449 (2010).

46) *Id.*

47) Kim, Kim & Ryoo, *supra* note 44.

48) *Korea's Banking Industry Today*, Korea Federation of Banks, *available at* www.kfb.or.kr/eng/industry/kotoday.php (last visited Apr. 22, 2012).

49) *Id.*

50) Kim, *supra* note 4, at 165.

51) *Id.*

52) Hwa-Jin Kim, *Taking International Soft Law Seriously: Its Implications for Global Convergence in Corporate Governance*, 1 J. of Korean L. 1, 11-33 (2001) (S. Korea).

companies.[53] And management boards of shaky financial institutions during the 1997 Crisis had to face civil and criminal liabilities[54]; for example, directors of Korea First Bank (now Standard Chartered Korea First Bank Limited) were ordered to pay huge damages to its shareholders.

1. Agreement with the IMF

The 1997 Crisis led the Korean banks to install and effectuate the true meaning of corporate governance. Paragraph 4 of the Letter of Intent Korea signed with the IMF acknowledges the need for a comprehensive policy package to improve corporate governance as part of the 'Memorandum on the Economic Program,' an attachment to the Letter of Intent. The Memorandum has four broad paragraphs under the heading "corporate governance and corporate structure." It states "transparency of corporate balance sheets… will be improved by enforcing accounting standards in line with generally accepted accounting practices, including thorough independent external audits, full disclosure, and provision of consolidated statements for business conglomerates."[55]

In 1998, Korea executed another Letter of Intent with a new 'Memorandum on the Economic Program,' which has a section on 'Corporate Governance and Restructuring.'[56] The section lists four specific objectives- transparency, accountability to shareholders, corporate restructuring, and bankruptcy procedures.[57] The Memorandum provides that "the commercial orientation of bank lending will be fully respected and the government will not intervene in bank management and lending decisions."[58] It further states that directed lending shall be immediately eliminated and that the Korean government shall formulate a plan "to encourage the restructuring of corporate finances, including measures to

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53) Hwa-Jin Kim, *Living with the IMF: A New Approach to Corporate Governance and Regulation of Financial Institutions in Korea*, 17 Berkeley J. Int'l L. 61, 81-85 (1999).

54) Kim, *supra* note 4, at 165.

55) Young-Cheol David K. Jeong, *Charting Corporate and Financial Governance in Korea in the New Decade*, 2 Jindal Global L. Rev. 99, 99 (2011).

56) *Id.* at 100.

57) *Id.*

58) Kim, *supra* note 52, at 70.

reduce the high debt-to-equity ratio of corporations, develop capital markets to reduce the share of bank financing by corporations, and change the system of cross guarantees within conglomerates."[59] Under such guidance, the Korean government implemented the long-needed, sweeping reforms.

2. Corporate Governance Reforms

After signing the Memorandum, the Korean government promptly executed a wide range of amendments to the laws and regulations relating to corporate governance. In particular, the government amended the Korean Securities and Exchange Act ("KSEA") and the Korean Commercial Code ("KCC") to reflect the changed circumstances in the capital markets and the Korean firms' new pattern of doing business and methods of financing.[60] The government also introduced provisions to protect unsophisticated investors under the changed regulatory environment.[61] Furthermore, financial reform bills were introduced to improve prudential regulations and accelerate capital market liberalization.[62] They included bills to correct the built-in inefficiency of the financial market by improving independence of the central bank, which was achieved with the neutral consolidated Financial Supervisory Commission (FSC).[63] This implied a shift from a financial policy-making structure dominated by Ministry of Finance and Economy (MOFE) to a decentralized structure with better checks and balances.[64]

The Korean government also pursued important legal and institutional reforms.[65] To limit the risks inherent in concentrated lending, the Korean government imposed a cap—amounting to a maximum of 25 percent of

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59) *Id.*

60) Jeong, *supra* note 55, at 101.

61) Kim, *supra* note 52, at 70.

62) Park, *supra* note 24, at 169.

63) *Id.*

64) *Id.*

65) *Id.*

bank equity capital—on lending to any one borrower and its affiliates.[66] In order to combat the lack of transparency that was a common feature of pre-crisis Korea, the government enacted "Real Name Financial Transactions and Guarantee of Secrecy Act" in December 1997, requiring banks to record the real names of their clients.[67] This greatly supplemented the Emergency Presidential Order Regarding Real Name Financial Transactions and the Protection of Confidentiality that was issued in August 1993 to protect financial institutions against frauds stemming from the use of false names.[68]

A new board governance system was assembled and launched in the Korean banking sector in response to pressing concerns over the viability of major Korean banks. Prior to the 1997 Crisis, Korean corporate boards were nominal organizations under the direct control of controlling shareholders in most cases. The boards were regularly comprised of officer-directors without the participation of outside, independent directors. The role of the board in corporate governance had therefore been minimal.[69] But under the supervision of the FSC, Korean banks were required to establish a board governance system that satisfied the global standard with outside-majority boards and a committee structure; listed companies were required to have a board with a ratio of three officer-directors to one outside director. [70] The Korean Banking Act also introduced a system under which non-officer directors had to hold the majority position on corporate boards.[71] Consequently, the proportion of outside directors in the new boards increased to 60-80 percent.[72]

The Korean banks also adopted the functions of various committees such as a governance committee, an audit committee, a management development and compensation committee, and a risk management committee, all under the supervision of board of directors. These efforts

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66) John W. Head, *The Asian Financial Crisis in Retrospect- Observations on Legal and Institutional Lessons Learned After a Dozen Years*, 5 E. Asia L. Rev. 31, 60 (2010).

67) *Id.*

68) The Emergency Presidential Order Regarding Real Name Financial Transactions and the Protection of Confidentiality, No. 16 (1993) (S. Kor.).

69) Kim, *supra* note 52, at 74.

70) *Id.*

71) *Id.*

72) Park, *supra* note 24, at 169.

allowed the Korean banks to improve their soundness and profitability more quickly than expected.[73] Further, the enactment of the Sarbanes-Oxley Act in the U.S. on July 30, 2002 rekindled the reformative movement for advancing governance structures in Korea.[74] (For example, the movement resulted in requiring CEOs and CFOs to certify financial statements.)[75]

As a result, the board of directors system has functioned much more effectively since the 1997 Crisis. And top management of commercial banks continued to enhance the transparency of bank management in maintaining bank soundness.[76] Corporate governance of banks and legal liability of bank directors now receive greater attention and are more heavily regulated than that of general companies. Unlike pre-1997 Crisis times, terms such as "corporate governance risks" and "CEO risks" of banks are now widely used in Korea.[77] Despite these changes, Korea underwent financial crises again in 2003 and 2009. This shows that while corporate governance of banks is now taken more seriously by the Korean government and banks, there is still room for improvement. And enhancing corporate governance requires more effective risk management;[78] OECD specifically pointed to poor risk management as a leading factor in the 2008 global financial crisis.[79] Reforms that target effective risk management therefore need to be pursued to better safeguard against future financial crises. This is especially the case nowadays as many Korean banks are in a heated race to become a "mega-bank."[80] Birth of such mega-banks is the

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73) *Id.* at 170.

74) Jeong, *supra* note 55, at 101.

75) David A. Skeel, Jr., *Book Review: Governance in the Ruins: Law and Capitalism: What Corporate Crises Reveal About Legal Systems and Economic Development around the World,* 122 Harv. L. Rev. 696, 707 (2008).

76) Park, *supra* note 24, at 171.

77) Kim, *supra* note 4, at 165.

78) *Id.*

79) Michael E. Murphy, *Assuring Responsible Risk Management in Banking: The Corporate Governance Dimension*, 36 Del. J. Corp. L. 121, 122 (2011).

80) *See* Christian Oliver, *South Korea's mega-bank aspirations may soon be realized*, Financial Times (Jun. 16, 2010, 11:18 AM), http://blogs.ft.com/beyond-brics/2010/06/16/south-koreas-mega-bank-aspirations-may-soon-be-realised/#axzz2FNbwks66 (Pressure for a South Korean mega-bank mounted in 2009 when South Korea won a $20 billion deal to export nuclear

exact opposite of a new international trend after the latest financial crisis,[81] and proper risk management would be especially important if such mega-banks were to ever emerge in Korea.

IV. Risk Management

Risk management is especially important in corporate governance as experts have identified poor risk management as one of the greatest contributing causes to financial crises. It is thus important to identify areas of weakness in risk management and improve them to promote a healthier banking industry in Korea.

1. Importance of Better Risk Management

Effective risk management has become more important as risks faced by banks have increased in recent years. Financial markets have become more volatile, which exposed banks to greater fluctuations in interest rates and exchange rates. The process of deregulation in many countries have encouraged and permitted the banks to diversify into other business activities, which further increased greater risk-taking.[82] This is why OECD identified poor risk management as a leading cause of the 2008 financial crisis.[83]

In the years leading up to the 2008 financial crisis, financial institutions of all sizes and types from all over the world were taking greater risks.[84] There were more uses of leverage, on balance sheet and off, larger and

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reactors to the United Arab Emirates and was rankled as buyers insisted the financing be organized by a big foreign lender, Standard Chartered).

81) Sun-Young Lee, *Mega bank in Korea: Good or bad?*, Korea Herald (Jun. 18, 2010, 5:40 PM), http://nwww.koreaherald.com/view.php?ud=20100618000820.

82) *The Importance of Risk Management*, Hong Kong Monetary Authority (Nov. 1995), http://www.hkma.gov.hk/media/eng/publication-and-research/quarterly-bulletin/qb9511/sp06.pdf.

83) Murphy, *supra* note 79.

84) William S. Haraf, *Systemic Risk and the Response to the Crisis,* 8 Berkeley Bus. L.J. 1, 1 (2011).

more aggressively managed trading books, along with greater use of poorly understood structured products. These were joined with weaker liability structures, concentrations in riskier asset classes, and increased lending to weaker borrowers, both commercial and consumer.[85)]

Big Wall Street institutions are good examples of excessive risk-taking. In the eight years from the beginning of 2000 to the end of 2007, the assets of Goldman Sachs, Lehman Brothers, Merrill Lynch, and Morgan Stanley together grew by 350 percent to about US$4 trillion.[86)] This illustrates how investment banks became huge principal investing and trading machines with balance sheets to match.[87)] And a fairly broad consensus had emerged around the world that creditors and counterparties of big financial institutions would always get repaid.[88)] Furthermore, market discipline, which operates as a check against excesses, had failed. Compensation practice and incentives for executives and traders encouraged the weakening of underwriting and credit standards in favor of promoting volume growth. This was worsened by banks' underestimation of the liquidity risk in their funding models, due to the misperception of counterparty risk of complicated derivative instruments.[89)] All this promoted greater risk-taking, which ultimately led to the financial crisis in 2008.

Due to the extent of such negative impact of poor risk management, public policymakers around the world have since focused more on the role and profile of risk management in financial institutions. A study by Ellul and Yerranmilli in 2010 investigated whether strong and independent risk management is significantly related to bank risk-taking and performance by using a sample of 74 large U.S. bank holding companies.[90)] The study constructed a Risk Management Index (RMI) based on five variables related

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85) *Id.*

86) *Id.*

87) *Id.*

88) *Id.* at 2.

89) Choi, *supra* note 45, at 453.

90) Vincent Aebi, Gabriele Sabato & Markus Schmid, *Risk Management, Corporate Governance, and Bank Performance in the Financial Crisis* (Oct. 11, 2011), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1942896.

to the strength of a bank's risk management.[91] Their findings indicate that banks with high RMI values in 2006 were less active in trading off-balance sheet derivatives, and had lower exposure to private-label mortgage-backed securities, a smaller fraction of non-performing loans and lower downside risk, and a higher Sharpe Ratio during the crisis years 2007/2008.[92] In essence, the study showed that effective risk management makes banks significantly less vulnerable to financial crises. Corporate governance reforms with a greater emphasis on risk management are therefore crucial.

And this is especially important for Korean banks because they have become more globalized and susceptible to foreign influences. They are exposed to greater foreign currency liquidity risks because the Korean won is not accepted as a key currency.[93] Moreover, since international trade plays an important role in Korea, foreign currency liquidity risk management is crucial for the soundness of Korean banks.[94] Potential global financial turbulence and growing household debt are also reasons for Korean financial services to place greater priority on controlling risks.[95]

2. *Legal Concept of Risk in Korea*

Korean laws and model codes explicitly recognize the role of risks in banks. Article 1 of the Financial Holding Companies Act states that it promotes the establishment of financial holding companies and the prevention of risk transfers and excessive control.[96] It also aims to promote sound management of financial holding companies and their subsidiaries, and to protect the rights of interested parties, so that competitiveness of the

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91) *Id.*

92) *Id.*

93) Korea Inst. of Fin., *Regulation and Supervision for Sound Liquidity Risk Management for Banks* (Feb. 2010), www.aseansec.org/documents/ASEAN+3RG/0910/FR/17a.pdf.

94) *Id.*

95) You-Kyung Lee, *S. Korean Banking Groups to Focus on Risk Management This Year*, Yonhap News Agency (Jan. 2, 2012), English.yonhapnews.co.kr/business/2012/01/02/85/0503000000AEN20120102004500320F.HTML.

96) Geumyung jiju hoesa beop [Financial Holding Companies Act], Act No. 10361, Jun. 8, 2010, art. 1 (S. Kor.).

financial industry and the overall economy can be improved.[97] Furthermore, Enforcement Decree of the Financial Investment Services and Capital Markets Act ("Capital Markets Act") employs the term 'risk' in Article 31 in the context of internal control management.[98] In Articles 30 and 31, regulations on supervising banking institutions state that banks are responsible for constructing a risk management system and establishing a risk management structure surrounding the board.[99]

The recently revised Code on Internal Group Control of Financial Holding Companies specifically mentions the concept of risk.[100] Article 2 of this Code defines group internal control standard as a process that protects financial consumers by maintaining the integrity of financial subsidiary companies and preventing conflicts of interests, while abiding by the law and performing risk management.[101] Title of Article 6 explicitly reads 'Risk Management' and states that (1) financial holding companies must establish risk management policies and standards for conducting asset management duties, and must also turn all risk into quantifiably measurable variables that are consistently recognized and evaluated; (2) financial holding companies must establish a risk management system capable of managing previously uncontrolled risk and a system capable of inspecting the suitability of the risk management system; and (3) risk management of financial holding companies must be performed in all work areas. A special department may be created for handling risk management.[102] These illustrate that risk management is being actively introduced into Korea's laws. But laws on risk management are still not sufficiently detailed and risk management practices in Korean banks have much room for improvement.

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97) *Id.*

98) Jabonsijanggwa geumyungtujaeobe gwanhan beobyul sihaengryeong [Enforcement Decree of the Financial Investment Services and Capital Markets Act], Presidential Decree No. 22718, Mar. 22, 2011, art. 31 (S. Kor.).

99) *Id.*

100) Code on Internal Group Control of Financial Holding Companies (S. Kor.).

101) *Id.*

102) *Id.*

3. Risk Management at Korean Banks

Today, Korean banks' risk management practices conform for the most part to internationally accepted standards under the current supervisory framework.[103] And the overall risk management performance of Korean banks surveyed is relatively good. In the case of credit risk area, most banks have written credit policies and procedures about the key items recommended by the Basel Committee, especially in regard to the structure of limits, approval authorities, and price and non-price terms.[104] Now, financial holding companies and banks of Korea generally have risk management committees installed within their board where outside directors are given risk management responsibilities. According to a 2008 research, a majority of Korean financial holding companies had risk management committees[105] and about 50 percent of risk management committee members were made up of outside directors.[106] These risk management committees are responsible for overseeing all risks, more specifically for setting the limits for different types of risks, and distributing risky capital for various projects.[107]

Korean banks also have compliance officers who are directly linked to corporate governance issues.[108] A mandatory compliance officer was introduced to financial institutions in Korea including banks, security companies, and insurance companies in 2000 in response to the 1997 Crisis. Accordingly, a bank is required by Article 23-3 of the Banking Act to appoint a compliance officer and establish a compliance program.[109] A compliance officer is a person that ensures that the company complies with outside regulatory requirements and internal policies. If internal control standards are violated, the compliance officer is responsible for reporting to

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103) Park, *supra* note 24, at 216.

104) *Id.*

105) Hwa-Jin Kim, *supra* note 4, at 162.

106) Hee-Ju Kang & Joon-Woo Jo, *Discussion on Corporate Governance of Banks,* Lee & Ko 1, 19 (2012), *available at* www.leeko.com/publications.

107) *Id.*

108) Jeong, *supra* note 55, at 509.

109) *See* Eunhaengbeop [Banking Act], Act No. 10866, Jul. 21. 2011, art. 23-3 (S. Kor.).

the auditing committee.[110] To ensure independence, compliance officers are prohibited from engaging in other business activities.[111] Furthermore, compliance officers have the authority to request that management produce or submit information or documents, and are responsible for monitoring compliance in order to report to the audit committee or standing auditor.[112] While Korean banks now have measures against excessive risk-taking, they can be improved to prevent future financial crises.

V. Recommendations

Risk-management procedures, especially effective controls system and risk management function, are important.[113] And the first step for ensuring effective risk-management procedures is ensuring that board risk committees are independent and functioning effectively.

1. Board Expertise & Experience Must Be Improved

The essence of banking is management of risks, and a bank director's duty of risk management must therefore be considered as an essential part of his duty of care.[114] And compared to directors of general companies, a greater duty of risk management must be required of bank directors because they generate system risks through multiple contracts signed with other financial institutions.[115] Despite having a large number of outside directors within the risk management committees of Korean banks, the committees do not function as effectively as they can. This is because many outside directors lack the necessary expertise in banking.[116]

Therefore, there must be greater board expertise regarding risk

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110) Boheomeopbeop [Insurance Business Act], Act No. 6891, May 29. 2003 (S. Kor.).

111) *Id.*

112) *Id.*

113) Hopt, *supra* note 11, at 25.

114) *Id.* at 170.

115) Kim, *supra* note 4, at 169.

116) Kang, *supra* note 106, at 19.

management issues.[117] With respect to implementation of risk management committees, the global financial crisis showed that the inclusion of board members with diverse expertise mattered.[118] The report of the Senior Supervisor's Group, prepared by representatives of the Federal Reserve Board, the Securities and Exchange Commission, as well as several regulators from the United Kingdom, France, Switzerland, and Germany, concluded that certain risk management practices involving board expertise differentiated firm performance during the crisis.[119]

Most importantly, firms that fared best were the ones with senior management oversight of risk, in the form of a high-level committee, which served as a locus for sharing information and understanding the magnitude of risks facing the firm.[120] Thus, many large foreign banks have made efforts to strengthen the board expertise of risk management committees.[121] For example, in 2009, Citigroup installed a risk management committee that is independent of the board of directors, where four out of five committee members had substantial expertise and working knowledge and experience in the financial industry.[122]

On the other hand, risk management committee members of Korea's four largest banks have insufficient work experience in the financial sector; most of the outside directors in the risk management committees only had experience as financial researchers or as employees of supervisory organizations.[123] Therefore, Korean banks need to have management teams comprising members with extensive prior experience in capital markets and have senior management that "includes people with expertise in a range of risks since the source of the next disruption is impossible to

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117) Mulbert, *supra* note 1, at 22.

118) *Id.* at 24.

119) *Id.* at 24-25.

120) *See* James A. Fanto, *The Role of Financial Regulation in Private Financial Firms: Risk Management and the Limitations of the Market Model*, 3 Brook. J. of Corp., Fin. & Com. L. 29 (2008).

121) See-Yeon Lee & Bon-Seong Gu, *Proposal for Relieving Corporate Governance Risks of Financial Companies*, Korea Institute of Finance 1, 15 (2011), *available at* http://www.kif.re.kr/KMFileDir/129610656430808750_KIFPS2011-03.pdf.

122) *Id.*

123) *Id.*

predict."[124]

2. *Risk Management Committees Must Meet More Often*

On a related note, risk management committees need to meet more often to be effective. For example, in 2009, risk management committees of major Korean banks and financial holding companies each held 10 or less meetings.[125] Meeting less than once a month is not sufficient for a risk management committee to effectively fulfill its duties. Foreign banks renown for effective risk management such as Banco Santander and BBVA have frequent risk management committee meetings. Risk management committee of Banco Santander met 100 times in 2006 and 98 times in 2007, while that of BBVA met 81 times and 74 times in those respective years.[126] On the contrary, the now bankrupt Bear Sterns and Lehman Brothers each held only one or two annual risk management committee meetings. Bear Sterns had a risk committee, but it never met.[127] Risk management committees of Korean banks therefore need to have more frequent meetings in order to maximize their efficacy.

3. *There Must Be A More Independent Compliance Officer*

The risk management function must be performed in an independent manner. In the U.S., this function has been strengthened by having a chief risk officer (CRO) who is responsible for all the bank's principal risks.[128] And the role of CROs cannot be emphasized enough. As Warren Buffet stated in his 2008 letter to the shareholders of Berkshire Hathaway Inc., his belief is "that the CEO of any large financial organization must be the Chief Risk Officer as well."[129] Since the business of banks is risk, the CRO must hold a powerful role within banks. The CRO role is fulfilled by a compliance

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124) Mulbert, *supra* note 1, at 25.

125) Lee, *supra* note 121, at 21.

126) *Id.* at 22.

127) *Id.* at 23.

128) *Id.*

129) Aebi, *supra* note 90.

officer in Korea. To live up to these expectations, the compliance officer must be substantially independent while having access to the necessary channels to perform its duties. This is especially so in Korea where the government still maintains a strong voice in selecting top management at banks.

Compliance officers must have greater independence in order to become more effective; they must be closely linked and embedded in the bank's affairs while maintaining independence. Compliance officers must to a considerable degree be independent even from the chief executive officer (CEO). It has been found that banks in which the CRO reports directly to the board of directors perform substantially better in financial crises than banks in which the CRO reports to the CEO.[130] This is because CEO's main interest is often maximizing growth in sales, assets, and profits, which mean that the assessment and treatment of risks might be a lower priority. The CEO and compliance officer may thus have conflicting interests, and if the compliance officer reports to the CEO, the risk agenda may not receive the proper attention.[131]

Therefore, the compliance officer must have access to quick and direct information and must have a direct reporting line not only to the CEO or CFO, but also to the board or the board risk committee (especially to the chairman of the committee).[132] This may sufficiently empower the compliance officer to serve as a check on the CEO's potential pursuit for short-term profits at the expense of excessive risk-taking. This could be further strengthened with special protections against the removal of the compliance officer such as requiring majority consent of the board and public disclosures in general.[133] Non-executive directors should also have the right to regular meetings with the compliance officer in the absence of senior management.

4. Special Attention Must Be Paid to CEO Risks

Special attention must be paid to CEO risks that are prevalent in Korean

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130) *Id.*

131) *Id.*

132) *Id.*

133) Hopt, *supra* note 11, at 26.

banks. An important element of corporate governance of banks is the selection of CEOs. Since a bank is a corporation, its CEO is chosen by a board of directors that is selected by shareholders. To minimize the influence of family members of the founder and other political factors, this board should be composed mostly of outside directors who are independent from bank management. But this is not always the case in Korea. Article 22 of the Banking Act and Article 40 of the Financial Holding Company Act only specify that half of the board of directors needs to be outside directors.[134] Shinhan Financial Group's internal feud between the Chairman Eung-chan Ra and the CEO Sang-hoon Shin is a good example of the damaging effects of CEO risks in Korean banks.[135]

CEO risks must be minimized by increasing the number and the role of outside directors. Furthermore, supervisory system must be placed to oversee whether banks are properly preparing for a succession.[136] And financial companies should be equipped with a system for CEO selection that can be relied upon in case of an emergency.[137] It must be the board of directors that searches and selects CEOs based on the banks' long-term management strategies, and not the other way around where long-term management strategies are based on the newly elected CEOs.

Lastly, age limits may be a good way to limit CEO risks. Major foreign banks such as Citibank in the U.S. and the Royal Bank of Canada already have measures restricting the age of their CEOs to 72 years and 70 years, respectively. This restriction will prevent situations like that of Shinhan where the former chairman of Shinhan Financial, Eung-chan Ra, served at the top for nearly two decades.[138]

5. Special Attention Must Be Paid to M&A Risks

Change in ownership structure caused by an M&A leads to changes in

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134) Kim, *supra* note 4, at 167.

135) Jae-Kyeong Kim, *Shinhan- case of CEO Risk*, The Korea Times (Sep. 15, 2010, 6:44 PM), *available at* www.koreatimes.co.kr/www/news/biz/2011/04/123_73127.html.

136) *FSS Takes Steps to Curb CEO Risk*, KDB Bank (Jan. 25, 2011), *available at* http://www.kdb.co.kr/weblogic/Board?BID=25&NID=44767&ACTION=VIEW.

137) *Id.*

138) *Id.*

corporate governance and positions, compensation, and welfare levels of management and employees. Banks generally seek M&A to achieve management synergy through horizontal union, which requires extensive structural modifications.[139] Here, post-merger integration (PMI) is the most difficult task to overcome. M&A between Housing & Commercial Bank and Kookmin Bank is a good example.[140] Thus, the board of directors must consider the fact that banks face the greatest risk during an M&A or privatization, and pay special attention to providing efficient corporate governance during and after the M&A. Great corporate governance and excellent board leadership can create synergy, leading to competitive strength. If this condition is not satisfied, banks will be haunted with resistance and demands of the bank unions, thereby preventing the fulfillment of M&A's intended purpose.[141]

VI. Conclusion

South Korea's economy and financial industry have gone through incredible growth and maturing in the last fifty years. This rapid growth came with side effects, however, and the country's economy plummeted during the 1997 Crisis. Even though there were other factors involved, poor corporate governance and risk management played a significant role in inducing the crisis. In response, South Korea began a series of financial reforms including installation of a corporate governance system for banks. These reforms helped the country's economy to bounce back and for its real GDP to continue growing. But as events such as the Shinhan situation and financial crises in 2003 and 2008 indicate, there is still much room for improving corporate governance of banks.

Corporate governance reforms with a focus on better risk management can address these problems and help the Korean banking industry to mature. There are several risk management functions installed in the Korean financial industry that satisfy the Basel recommendations.

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139) Kim, *supra* note 4, at 168.

140) *Id.*

141) *Id.*

Although this seems to illustrate a strong risk management system, there are still problems that need to be solved. This paper focuses on greater board expertise, more frequent risk management committee meetings, a more independent compliance officer, and better addressing of CEO risks and M&A risks, in order to improve the risk management system of Korean banks. These recommendations can help prevent financial crises in the future.

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