ICR Review
Operations Evaluation Department

Report Number : ICRR10580

1. Project Data :		Date Posted :	05/23/2000	
PROJ ID:	P004172 OEDID: L3689		Appraisal	Actual
Project Name :	Financial intermediation project	Project Costs (US$M)	250	
Country:	South Korea	Loan/Credit (US$M)	100	99.74
Sector, Major Sect .:	Financial Sector Development, Finance	Cofinancing (US$M)	0	
L/C Number:	L3689			
		Board Approval (FY)		94
Partners involved :		Closing Date	06/30/1999	06/30/1999
Prepared by :	Reviewed by :	Group Manager :	Group:	
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2. Project Objectives and Components
a. Objectives
(a) To support the government's program for accelerating deregulation of the financial system; (b) to support the institutional building programs of Industrial Bank of Korea (IBK), the Citizens National Bank (KB) and the Korea Technology Banking Corporation (KTB); (c) to provide long-term credits to eligible private manufacturing enterprises--mainly small and medium ones--through IBK, KB and KTB; and (d) to improve technical capabilities of the officials in the government organizations responsible for financial sector policies and financial institutions through training and technical assistance programs to be managed by the Korea Banking Institute (KBI).
b. Components
The loan consisted of a line of credit of $94 million and a technical assistance of $6 million.
c. Comments on Project Cost, Financing and Dates
Total project costs were estimated at $250 million, of which $241 million were for the credit component and $9 million were for the technical assistance component. The Bank disbursed the $94 million for the credit line and the $6 million for the technical assistance component.

3. Achievement of Relevant Objectives :
Deregulation. Reforms in the financial sector proceeded faster than called for under the project. By early 1997 the government had (a) lifted controls on the interest rate on loans and other financial instruments; (b) reduced to about one percent of total credit the amounts under directed credit (in 1993 the share was 22 percent); (c) stopped interfering in the nomination of bank presidents; and (d) opened the capital account significantly.
Institution building. The program envisaged (a) annual audits by independent external auditors and a two-year program for staff training in IBK, KB and KTB; (b) compliance with capital adequacy requirements for IBK and KB, and with long-term borrowing limits for KTB; (c) full privatization for KB, partial privatization for IBK, and implementing an agreed program of privatization for KTB. While the audits took place as scheduled, IBK and KB met their 8 percent of capital adequacy in 1998, two years later than agreed in loan covenants. KB and KTB are now private banks, but the government still owns 98 percent of IBK, after capitalizing it in 1998 to compensate it for the losses incurred during the financial crisis.
Credit. The three financial institutions had to onlend the $94 million of the Bank's loan to small- and medium-sized private enterprises. The three institutions onlent the amount agreed, of which about one third is still outstanding.
Improve technical skills. The loan financed training worth $3 million for KBI and $3 million for the Ministry of Finance, later changed to $2 million for KBI and $4 million for the Ministry. Training programs used $5.75 million of the $6 million lent; the remaining $0.25 million was cancelled at the closure of the loan.

4. Significant Outcomes /Impacts:
Deregulation. A substantially liberalized financial sector and, eventually, a more solid one. The depth and severity of the 1997 financial crisis led the government to reform the financial sector far beyond the reforms envisioned in the loan. Although by 1997 the reforms agreed in the loan were on course, the crisis brought changes in regulations and commercial practices that should eventually strengthen the financial sector and capitals market of Korea. Banks have to meet minimum capital adequacy ratios, and when they cannot they must submit business plans, identify

sources of new capital and changes in management and ownership. Interest rates are free, except for demand deposits in commercial banks (8% of deposits in the system), and almost all policy loans have been discontinued according to official reports. Capital account transactions have been partially liberalized, foreign banks can own shares in Korean banks, and the limit on foreign investment ownership in listed firms has been removed.
Institution building. Financial statements for the three banks show that IBK and KTB performed poorly, while KB performed well and became one of the best commercial banks in Korea. Assets of IBK and KTB grew at 19 and 39 percent per year, but their net worth declined at 0.13 and 10 percent per year respectively. KB's total assets and net worth increased at 23 and 39 percent per year, respectively. During the crisis, depositors moved their money to KB, attracted by the institution's good quality.
Credit. The three institutions lent to small- and medium-sized enterprises as envisaged in the project documents.
Improve technical skills.KBI's training program ended in June 1997, and 401 trainees from 50 financial institutions benefited from it during 1994-97. In the program managed by the Ministry of Finance, 62 government officials (48 of which from the Ministry of Finance) were sent abroad for two years of training in economics, finance and other related areas.

5. Significant Shortcomings (including non-compliance with safeguard policies):
The financial intermediaries often financed highly leveraged subprojects which affected borrowers' ability to repay debts after the crisis started. Project agreements failed to specify upper limits for debt service coverage and loan to value ratios, which might have helped reduce the exposure of the institutions to highly leveraged borrowers. All subloans exceeding $1 million failed to meet the criterion of having a financial rate of return of 15 percent at least; only one loan had a 13 percent rate of return, while the rest of the loans in this category had financial rates of return below 3 percent.

6. Ratings:	ICR	OED Review	Reason for Disagreement /Comments
Outcome:	Satisfactory	Marginally Satisfactory	Policy outcomes were good, but the rate of return on the large subloans was lower than market rates of interest. No judgement can be made on the small subloans because the ICR does not inform about their results.
Institutional Dev.:	Partial	Modest	Same rating.
Sustainability:	Likely	Likely	
Bank Performance:	Deficient	Unsatisfactory	Same rating.
Borrower Perf.:	Satisfactory	Satisfactory	
Quality of ICR:		Satisfactory	

7. Lessons of Broad Applicability:
The long-term solvency of financial institutions in a deregulated environment requires prudential regulations, effective supervision, transparency in accounting and information systems, and management accountability. Therefore, in its policy dialogue with the government, the Bank should try to reach an agreement on a plan with proper sequencing and timing of the actions to be taken.
Weak financial infrastructure in borrowing countries could mean that the financial position and performance of banks may be much worse than publicly reported.
In large economies such as Korea's, the Bank cannot induce changes in behavior when financial companies operate in an environment that discourages change.

8. Audit Recommended? ○ Yes ● No

9. Comments on Quality of ICR:
The ICR provides adequate information to judge the project's achievements and shortcomings. The ICR, however, could have had a short paragraph on the background and rationale for the project, thereby making the document and the analysis stand on their own. As it is now, to understand the project and the content of the ICR, the reader must read the President's Report and the Staff Appraisal Report. The ICR could have explained better the difficulty of getting information from the supervision reports. The ICR's author could only find one supervision mission in the paper trail of the project. Certainly, there were more supervision missions for the project, most or all of which seemed to have been associated with the supervision of Bank-financed projects in other Asian countries.
ICR presents limited information on financial rates of returns or other indicators of performance for the lending operations. The ICR informs that nine projects financed with loans of $1 million or larger had financial rates of return of 13 percent (two loans), or below 5 percent (seven loans), but it fails to inform about outcomes for loans below $1

million. The absence of that information reduces the benefits of the ICR and the conclusions about project outcome that one can draw from it.