Korea: Blanket Guarantee, 1997

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Korea: Blanket Guarantee, 1997

Bailey Decker

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Abstract

Korea entered the Asian Financial Crisis in August 1997 with highly leveraged firms and a banking system inexperienced in managing systemic risk. Korea faced a currency crisis and a banking crisis, as foreign banks froze credit to Korean commercial banks and merchant banks. On August 25, 1997, the Ministry of Economy and Finance (MOEF) announced that it would guarantee all Korean financial institutions’ foreign debt—both existing debt and new borrowings. Nonetheless, foreign lenders continued to withdraw credit from Korean financial institutions. On November 19, 1997, a newly appointed MOEF minister announced a suite of measures to promote foreign creditors’ confidence and bring US dollars back to Korean financial markets. Additionally, to facilitate the closure or mergers of troubled commercial banks and merchant banks, the minister said that the Korea Deposit Insurance Corporation (KDIC) would fully guarantee all deposits (principal and interest) of financial institutions until December 31, 2000. On November 27, 1997, the MOEF said that the government also would guarantee collateralized commercial paper to ease pressure on troubled merchant banks; it lifted this guarantee the following October. The blanket deposit guarantee reverted to a limited deposit insurance scheme as scheduled on January 1, 2001, covering up to 50 million Korean Republic won (KRW; USD 40,000) per depositor. The KDIC continued to guarantee 100% of non-interest-bearing settlement deposits until December 31, 2003. The Korean government ultimately guaranteed USD 22.1 billion in foreign debt, and all foreign liabilities were completely repaid by the end of the program on April 9, 2001. Through end-2000, the blanket deposit guarantee covered KRW 68.8 trillion in deposits. The KDIC ultimately paid KRW 19.2 trillion to depositors at a total of 236 financial institutions that failed, predominantly merchant banks.

**Keywords:** blanket guarantee, Korea, Korea Deposit Insurance Corporation, liquidity

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1 This case study is part of the Yale Program on Financial Stability (YPFS) selection of New Bagehot Project modules considering blanket guarantee programs. Cases are available from the Journal of Financial Crises at https://elischolar.library.yale.edu/journal-of-financial-crisis/

2 Research Associate, YPFS, Yale School of Management.
Overview

The Republic of Korea (Korea) entered the Asian Financial Crisis (AFC) with highly leveraged firms and a banking system inexperienced in managing systemic risk (OECD 1998; Smith 1998). Beginning with economic liberalization in the 1960s, large conglomerates had powered rapid economic growth (Akama, Noro, and Tada 2003; Coe and Kim 2002; OECD 1998). When profits slowed, eight of the top 30 conglomerates became insolvent by July 1997, and nonperforming loans (NPLs) soared for Korean merchant banks and commercial banks (Koo and Kiser 2001; Smith 1998). These domestic financial institutions had borrowed extensively from foreign banks, largely on a short-term basis. As foreign bankers grew concerned about rising NPLs, they withdrew credit from Korean banks en masse. Korea thus faced a twin currency and banking crisis (Akama, Noro, and Tada 2003; Koo and Kiser 2001).

On August 25, 1997, the Ministry of Economy and Finance (MOEF) announced that it would guarantee all Korean financial institutions’ foreign debt—to stem the run and restore liquidity to Korean banks (Koo and Kiser 2001; Yoon 1997). However, the announcement lacked details about process and eligibility. Therefore, market participants and rating agencies were still skeptical, and foreign creditors continued to withdraw from Korea (see Key Design Decision No. 6, Communication) (Lindgren et al. 1999; Yoon 1997).

Key Terms

| Purpose | For foreign debt, to prevent ratings downgrades and stem foreign credit withdrawals. For deposits, to “alleviate anxiety in the financial market resulting from the financial crisis” and to facilitate the closure or mergers of troubled commercial banks and merchant banks (KDIC 2001, 32). For commercial paper, to help troubled merchant banks roll over foreign debt into longer maturities |
| Launch Date(s) | Foreign debt: Aug. 25, 1997; Deposits: Nov. 19, 1997; Commercial paper: Nov. 27, 1997 |
| End Date(s) | Foreign debt: Apr. 9, 2001; Deposits: Dec. 31, 2000; Settlement deposits: Dec. 31, 2003; Commercial paper: Sept. 30, 1998 |
| Eligible Institutions | Banks, securities companies, insurance companies, merchant banks, mutual savings and finance companies, credit unions |
| Eligible Accounts | Foreign debt, all deposits, collateralized commercial paper |
| Fees | Foreign debt: Annual risk-based fees ranged from 0.2%–1.5% of outstanding debt; Deposits: KDIC raised premium rates to supplement the deposit insurance fund; Commercial paper: Unclear |
| Coverage | Foreign debt: USD 22.1 billion; Deposits: KRW 68.8 trillion; Commercial paper: Unclear |
| Outcomes | KRW 19.2 trillion in depositor payoffs |
| Notable Features | First guarantee applied only to foreign debt to address credit runs and foreign debt restructuring; deposit guarantee protected liabilities of merchant banks, which accounted for 72.9% of depositor payoffs; public awareness campaign at the end of the depositor guarantee |

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3 Conglomerates had lending limits only for commercial banks. Thus, conglomerates used merchant banks to exploit regulatory loopholes (Kataoka 1999).
Conditions continued to deteriorate throughout fall 1997. The Korean Republic won (KRW) depreciated\(^4\) from KRW 907 to the US dollar on August 25, 1997, to KRW 1,170 to the dollar on November 28 and KRW 1,960 to the dollar on December 23, 1997, as commercial and merchant banks could not roll over short-term loans (Beckerling 1997; Koo and Kiser 2001). Korean financial institutions' balance sheets worsened. At the end of 1998, NPLs amounted to approximately 80% of banks' capital (Lindgren et al. 1999). Moody's Investors Service cut the credit ratings of four major banks and stated that the financial health of these banks seemed "beyond their own capabilities" and would probably require government intervention (Beckerling 1997). On November 19, 1997, the new deputy prime minister and minister of economy and finance (finance minister), Lim Chang-Yuel, announced a suite of measures to shore up foreign investors' confidence and bring dollars back to the Korean financial system. Also, to facilitate the closure or mergers of troubled commercial banks and merchant banks, the minister said that the Korea Deposit Insurance Corporation (KDIC) would use the existing deposit insurance scheme to fully guarantee all deposits (principal and interest) of financial institutions until December 31, 2000 (Asian Economic News 1997; Lindgren et al. 1999; MOEF 1997a; Reuters 1997b). Under the existing scheme, the KDIC guaranteed certain financial products up to KRW 20 million (USD 19,000) per depositor\(^5\) (see Appendix for an overview of the financial products covered by the KDIC) (KDIC n.d.; KDIC 2000, 7). The government later said that it issued the blanket deposit guarantee to "alleviate anxiety in the financial market resulting from the [AFC]" (KDIC 2001, 32).

For three hours on the morning of November 20, 1997, panicked depositors withdrew KRW 200 billion (USD 175 million) from 23 trust funds across Korea because the finance minister did not mention trust funds in the financial reform package on the previous day. The run subsided later that day after trust funds assured depositors that their money was guaranteed under the blanket scheme. The association of trust funds issued a statement: "Worries that deposits will not be protected are groundless. All the deposits are safely kept by [commercial] banks" (AFP 1997a).

The National Assembly revised the Depositor Protection Act (DPA) in December 1997 to authorize and administer the blanket deposit guarantee, including the consolidation of the Deposit Insurance Corporation, Securities Supervisory Board, Insurance Supervisory Board, and Credit Management Fund into the KDIC (BOK 1998; Lindgren et al. 1999). The new legislation extended the KDIC's deposit insurance to merchant banks and other nonbank financial institutions; it also expanded the definition of “deposit” to include various types of short-term financial liabilities of those financial institutions (BOK 1998). The government announced that the blanket deposit guarantee would revert back to a limited deposit insurance scheme in January 2001 (Republic of Korea 1997a).

Between November 19 and 27, 1997, Moody's downgraded three commercial paper debt instruments of the Korean Development Bank (KDB), affecting USD 370 million of debt (AFP 1997b).

\(^4\) Exchange rates from FRED.

\(^5\) USD 1 = KRW 1,040.00 on November 19, 1997, according to OFX.
On November 27, 1997, the MOEF said that government would guarantee collateralized commercial paper to ease pressure on troubled merchant banks (Bulman 1997a; Korea Economic Daily 1997a; Reuters 1997c).

Around the same time that it announced blanket deposit guarantees, the MOEF was negotiating a standby loan from the International Monetary Fund (IMF) (Bulman 1997a; Park 1997). On December 5, 1997, Korea and the IMF announced a standby arrangement, supported by contributions from the Asian Development Bank, World Bank, and major developed countries (Lindgren et al. 1999; Republic of Korea 1997b). In the arrangement, the Korean government committed that the “blanket [deposit] guarantees which will end in three years will be replaced by a limited deposit insurance scheme” (Republic of Korea 1997b). In a press release dated December 4, 1997, the IMF stated that the blanket deposit guarantee’s scheduled end date and scheduled reversion to a limited deposit insurance scheme was meant to “enhance market discipline and limit moral hazard problems” (IMF 1997).

The MOEF communicated a list of first-line and second-line funds in a press release on January 13, 1998. The first-line fund totaled USD 35 billion: USD 21 billion from the IMF, USD 10 billion from the World Bank, and USD 4 billion from the Asian Development Bank. The second-line fund totaled USD 23.4 billion from Japan, the United States, Germany, England, France, Belgium, the Netherlands, Switzerland, Sweden, Australia, Canada, and New Zealand (MOEF 1998a).

On December 22, 1997, the MOEF announced that the National Assembly had passed legislation on the guarantee of foreign debt, originally announced in August 1997 (Coe and Kim 2002; MOEF 1997c). The press release said that the guarantee was meant to facilitate smooth borrowing of foreign currency funds by domestic banks (MOEF 1997c).

On January 28, 1998, the Korean government announced an agreement with international creditors to reschedule USD 24 billion in short-term debt (mostly held by commercial and merchant banks) into claims of one- to three-year maturities with government guarantees (Frank 1998; Koo and Kiser 2001; MOEF 1998b). Without this extension, Korea would have been subject to country default even with IMF support (MOEF 1999).

The guarantee of collateralized commercial paper ended by October 1, 1998 (KDIC 2000).

The blanket deposit guarantee ended as scheduled on December 31, 2000. Starting January 1, 2001, the blanket deposit guarantee reverted to a limited deposit insurance scheme covering up to KRW 50 million per depositor (KDIC n.d.; KDIC 2001). Through end-2000, the blanket deposit guarantee covered KRW 68.8 trillion in deposits. The KDIC ultimately paid KRW 19.2 trillion to depositors at a total of 236 financial institutions that failed. This deposit

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6English-language sources and Korean-language sources contradict on the scope of guaranteed commercial paper (see Key Design Decision No. 9, Eligible Liabilities).

7 If the short-term debt had not been extended, the government would have continued to supply banks with foreign currency in its foreign reserves so banks could repay loans in time. Foreign reserves would have been depleted, and Korea would have defaulted (MOEF 1999).
payoff was predominantly to merchant banks, which received 72.9% of total funds provided through December 31, 2000 (KDIC 2001).

The Korean government ultimately guaranteed USD 22.1 billion in foreign debt, and banks completely repaid their guaranteed liabilities by the end of the program on April 9, 2001 (MOEF 2001).

**Summary Evaluation**

In December 1997, the IMF wrote that Korea’s guarantees were “piecemeal and failed to calm markets” in a confidential document to its board, obtained by the press (Bulman 1997b).

In a publication from the Federal Reserve Bank of Dallas, Jahyeong Koo and Sherry L. Kiser note that markets did not respond at first to the Korean government’s foreign debt guarantee in August 1997 (2001). The continuing failure of foreign creditors to roll over short-term loans caused runs on the won. The authors say that the rescheduling of USD 24 billion in foreign debt with the guarantee in place in January 1998 halted the won’s fall (Koo and Kiser 2001). A contemporaneous news article from the *Wall Street Journal* characterized the deal as a successful rescue effort from country default (Frank 1998).

Meanwhile, Koo and Kiser (2001) also say that the full deposit guarantee in November 1997 (in conjunction with Korea’s fiscal health and the nationalization of two major commercial banks) prevented runs in the financial sector.

In an IMF working paper, Tomás J.T. Baliño and Angel Ubide (1999) characterize the November 1997 full deposit guarantee as a success. They say that it prevented a run of depositors, considering that no such run occurred after the government (1) suspended 14 merchant banks in December 1997, (2) placed two large commercial banks under supervision in December 1997, and (3) purchased and acquired operations in June 1998. They also state that the deposit base “remained broadly stable” and that the ratio of currency to deposits decreased in 1998 (53). Because a run did not occur, the authors assert, the Korean government could gradually implement financial reform and focus public support on bank solvency rather than matters of liquidity.
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*Sources: Bloomberg; World Bank Global Financial Development Database; World Bank Deposit Insurance Dataset.*
Key Design Decisions

1. Purpose: The MOEF announced guarantees (a) on foreign debt, to stem credit runs and restore liquidity; (b) on bank deposits, to alleviate anxiety in the financial market and facilitate the closure or mergers of troubled banks, and (c) on collateralized commercial paper, to ease pressure on troubled merchant banks.

The MOEF announced the foreign debt guarantee to stem the credit run and restore liquidity to Korean banks (Coe and Kim 2002; Koo and Kiser 2001; Yoon 1997). MOEF Director for International Finance Chin Young-Wook expressed hope that rating agencies would “drop their downgrade plans in the wake of the government’s financial package” (Yoon 1997). When the guarantee was legalized in December 1997, the MOEF said that the guarantee would facilitate the smooth borrowing of foreign currency funds by domestic banks (MOEF 1997c).

The MOEF announced the blanket deposit guarantee to “alleviate anxiety in the financial market resulting from the financial crisis,” according to its annual report in 2000 (KDIC 2001, 32). It also said the guarantee would facilitate the closure or mergers of troubled commercial banks and merchant banks (Reuters 1997b).

The MOEF announced the commercial paper guarantee to ease pressure on troubled merchant banks (Bulman 1997a).

2. Part of a Package: With the first guarantee, the Korean government attempted to facilitate foreign currency financing and liquidity. With the second and third guarantees, the Korean government engaged in bank restructuring, NPL purchases, and capital injections to promote bank solvency.

Foreign Debt Guarantee

To facilitate foreign currency financing, the Bank of Korea (BOK) raised the upper limits on its swap facilities provided to foreign banks’ branches on November 27 and December 27, 1997. On January 16, 1997, the central bank also abolished the mandatory lending ratio and raised the guaranteed profit margin on swap transactions at the end of the term (BOK 1998).

On December 23, 1997, the BOK eliminated the restriction on the maximum interest rates on all foreign currency deposits, except for residents’ short-term deposits with maturities of less than three months. On December 31, 1997, the BOK eliminated the interest ceiling rate residents’ short-term deposits. In its 1997 annual report, the central bank stated that it eliminated these restrictions to “help quell the currency crisis and strengthen the foreign currency funding base of the foreign exchange banks” (BOK 1998, 78–79).

By year-end 1997, the BOK had used the Foreign Exchange Stabilization Fund to provide KRW 149.8 billion in foreign currency call loans to domestic foreign exchange banks (BOK 1998).
Deposit and Commercial Paper Guarantees

The blanket deposit guarantee on all deposits was part of the “Policy Action for Financial Stability and Financial Sector Restructuring,” which the MOEF announced on November 19, 1997. In the statement, the government also announced that it would contribute KRW 7.5 trillion of government-owned public securities to KDIC’s deposit insurance fund and increase premium rates imposed on participating institutions by about 50% (MOEF 1997a; MOEF 1997b). The MOEF announced the KDIC’s commercial paper guarantee on November 27, 1997 (Bulman 1997a; Korea Economic Daily 1997a; Reuters 1997c).

Later on, these guarantees also became part of the Korean government’s bank restructuring plan, using IMF support (Republic of Korea 1997a). The Korean government embarked on bank restructuring in stages, starting in December 1997 with the most clearly insolvent banks. Based on authorities’ examinations to determine solvency, the Financial Services Commission (FSC) required weak institutions to submit rehabilitation plans for how they would raise capital and operationally restructure to improve profitability. Institutions that successfully submitted rehabilitation plans signed memoranda of understanding—promising to meet targets—with the FSC. The FSC suspended institutions that could not provide adequate rehabilitation plans (Lindgren et al. 1999).

Starting July 1, 1998, the government committed public resources (via subscription of capital instruments and NPL purchases) only to institutions that (1) successfully submitted recapitalization plans and (2) collected sufficient contributions from shareholders and other stakeholders. The FSC established evaluation committees to make these determinations (Lindgren et al. 1999).

To confront the high level of NPLs, the government reorganized the Korea Asset Management Corporation (KAMCO) in November 1997 (He 2004; Lindgren et al. 1999). KAMCO’s NPL resolution fund bought nonperforming assets from distressed financial institutions over a five-year period, from November 1997 to November 2002, for trillions of won8 (He 2004; Ungersboeck and Nunn 2021).

Additionally, the KDIC administered capital injections to bank and nonbank institutions in two phases: the first from January 1998 to August 2000 and the second from September 2000 to September 2002. The government sought to prevent banks from further reducing lending during the crisis9 (Kulam 2021; Lee 2011).

3. Legal Authority: The National Assembly passed legislation to guarantee foreign debt, all deposits, and collateralized commercial paper.

In the Korean legal system, the National Assembly passes acts that establish government bodies and outline their purview. The National Assembly passes subsequent enforcement decrees that operationalize these bodies with further details. The president has the power

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8 For a detailed discussion of NPLs, see Ungersboeck and Nunn (2021).
9 For a discussion of the capital injections, see Kulam (2021).
to issue further presidential decrees, within the scope of legislation that the National Assembly has passed.

To better manage crisis-fighting and to comply with the standby arrangement with the IMF, the National Assembly passed legislation reforming the banking and financial system during the AFC (Lindgren et al. 1999; Reuters 1997a). This reform consolidated all deposit protection under the KDIC (KDIC 1999; Lindgren et al. 1999). The legislation also merged all financial sector supervision under the FSC (Lindgren et al. 1999).

**Foreign Debt Guarantee**

On December 22, 1997, the National Assembly passed legislation authorizing the guarantee of foreign currency debt that was incurred in 1997 and 1998. The bill limited the guarantee to a maximum of USD 20 billion plus interest for a maturity of three years (Coe and Kim 2002). This legislation passed 119 days after the MOEF announced the guarantee of foreign debt on August 25, 1997 (Koo and Kiser 2001; Yoon 1997).

**Deposit Guarantee**

The Depositor Protection Act established the KDIC on January 1, 1996, to manage and operate the deposit insurance fund (DPA 1995, arts. 3, 18). The KDIC assumed staffing and duties on January 1, 1997, and entered into force on March 1, 1997, just months before the blanket deposit guarantee (DPA 1995).

At the initial announcement of a blanket deposit guarantee on November 19, 1997, the legislation applied to “insured bank[s],” which included financial institutions authorized by Article 9(1) of the Banking Act and subject to deposit insurance (DPA 1997, art. 2 [1]). The term “deposit” meant “money raised by an insured bank through deposits, installment savings and money trusts, etc. by which a loss coverage contract has been concluded” (DPA 1997, art. 2 [2]).

Amendments to the Depositor Protection Act as of January 29, 1999, expanded definitions of “insured financial institutions” and “deposits” covered by the deposit insurance system. Article 2 expanded “insured financial institutions” to also cover securities companies, some insurers, merchant banks, mutual savings and finance companies, and credit unions (DPA 1999, art. 2 [1]). Article 2 also expanded “deposit” to cover financial institutions’ liabilities; specific deposits in securities companies insurance premiums received by insurers; bills and financial goods issued by merchant banks; money raised by mutual savings and finance companies through fraternity dues, installments, deposits, and installment deposits; and money raised by credit unions through investments, deposit money, and installment deposits (DPA 1999, art. 2 [2]). This amendment also changed the calculation of insurance coverage by deducting a depositor’s debt from the payoff, excluding security debts (DPA 1999, art. 2 [2]).

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1999, art. 32 [1]). The president could determine the maximum amount of insurance covered (DPA 1999, art. 32 [2]).

**Commercial Paper Guarantee**

Research did not uncover statements from the Korean government citing specific legislation for the guarantee of collateralized commercial paper.

4. **Administration:** The Debt Management Team for Korean Financial Institutions (DMT) administered the guarantee of foreign debt, and the KDIC administered the operation of the deposit insurance fund.

**Foreign Debt Guarantee**

The MOEF announced the foreign debt guarantee in August 1997 (Yoon 1997).

The Debt Management Team for Korean Financial Institutions (DMT) was established on February 8, 1998, to manage the whole debt exchange process. Chairman and President of the Korea Exchange Bank (KEB) Se-Pyo Hong led the DMT, since KEB had the largest eligible debt among the obligors. The DMT identified eligible debt by various categories; appointed reconciliation, calculation, and syndication agents; reviewed documents by legal advisors; conducted meetings to increase the amount of tenders; administered the issuance of government guarantees; and decided how to split administrative costs among the obligors (Coe and Kim 2002).

**Deposit Guarantee**

The newly consolidated KDIC managed the operation of the deposit insurance fund that underlaid the blanket deposit guarantee (DPA 1995, art. 18; Lindgren et al. 1999). The KDIC Policy Committee made decisions on the payment of insurance claims, plans for fund management, settlement of accounts, etc. The KDIC president served as the Policy Committee chair and presided over its meetings. Members included the MOEF vice minister, the FSC vice chair, the BOK vice governor, among others (KDIC 1999).

**Commercial Paper Guarantee**

The MOEF announced the guarantee of collateralized commercial paper (Bulman 1997a; Korea Economic Daily 1997a; Reuters 1997c). However, it is unclear who administered the commercial paper guarantee.

5. **Governance:** The Minister of Finance and Economy supervised the KDIC.

The minister of economy and finance guided and supervised the duties of the KDIC; the finance minister had the power to partially or completely cancel KDIC dispositions (DPA 1995, art. 27). When necessary, the finance minister could demand reports from the KDIC and investigate the KDIC’s records, documents, and facilities (DPA 1995, art. 28).
The finance minister also appointed (and dismissed) one KDIC auditor, who inspected and audited the business and accounts of the corporation (DPA 1995, arts. 11–12).

Research did not reveal oversight of the DMT.

6. Communication: The MOEF said that it wanted to improve Korea’s external credit rating and improve the structure of the financial system.

The MOEF often communicated information about the guarantee of foreign debt, deposits, and commercial paper through press releases.

With the guarantee of foreign debt in August 1997, MOEF Director for International Finance Chin Young-Wook expressed hope that ratings agencies would “drop their downgrade plans in the wake of the government’s financial package” (Yoon 1997). However, the announcement lacked details about eligibility and process. Thus, market participants were still unsure about Korean banks’ ability to meet their obligations. In a Reuters article dated August 27, 1997, several bank executives expressed their concerns (Yoon 1997). Rating agencies forged ahead with their downgrade of Korean banks, and foreign credit lines increasingly withdrew from Korea (Lindgren et al. 1999; Yoon 1997).

In a press release on November 19, 1997, the MOEF characterized the deposit guarantee as a financial stability measure. The announcement said that the government sought to improve the structure of the financial industry and improve Korea’s external credit rating (MOEF 1997a).

For three hours on the morning of November 20, 1997, panicked depositors withdrew KRW 200 billion from 23 trust funds across Korea because the finance minister did not mention trust funds in the financial reform package on the previous day. The run subsided later that day after trust funds assured depositors that their money was guaranteed under the blanket scheme. The association of trust funds issued a statement: “Worries that deposits will not be protected are groundless. All the deposits are safely kept by [commercial] banks” (AFP 1997a).

Research did not uncover contemporaneous statements from the MOEF or KDIC at the announcement of the commercial paper guarantee on November 27, 1997.

In a press release on January 29, 1998, the MOEF said that the debt restructuring agreement with international creditors was possible because creditor banks’ confidence in the Korean system had improved (MOEF 1998b).

Toward the expiration of the blanket deposit guarantee at end-2000, the KDIC embarked on a large-scale public awareness campaign to communicate the main concepts of the transition from a blanket deposit guarantee to a limited deposit insurance scheme. This initiative included large public events, seminars, print advertisements, advertisements by insured institutions, Internet-based advertisements, and media channel advertisements (IADI 2005; KDIC 2001). To gauge public awareness of the transition, the KDIC collected surveys (IADI 2005).
7. Source(s) and Size of Funding: The guarantee of foreign debt received funding from fees and a sinking fund. The guarantee of deposits received funding from fees, loans, funds recovered from mergers and acquisitions, and DIF bonds.

Foreign Debt Guarantee

The legislation authorizing the guarantee of foreign debt limited its size to a maximum of USD 20 billion plus interest for a maturity of three years. The government could issue sovereign bonds up to USD 10 billion (Coe and Kim 2002).

The government funded the guarantee of foreign debt in two ways. First, the government collected payment guarantee fees from commercial and merchant banks: 0.2%–1.5% of the outstanding debt, depending on obligors’ credit ratings and Bank for International Settlements ratios to give preferential treatment to institutions with sound management (MOEF 1998c). The revenue collected from this guarantee fee totaled approximately USD 150 million (Coe and Kim 2002).

Second, the government established a sinking fund to secure bonds where obligors set aside 3% of their outstanding debt to be paid 0.25% monthly in US dollars from May 7, 1998, to April 7, 1999. Obligors could retrieve deposits as they made repayments. For late deposits, obligors paid a penalty: an additional deposit of one-year London Interbank Bid Rate + 100 basis points (LIBID + 100 bps) times the delayed amount (Coe and Kim 2002; MOEF 1998c).

Deposit Guarantee

The blanket deposit guarantee—via the deposit insurance fund—received funding from: one-time initial contributions from financial institutions, quarterly insurance premiums from financial institutions, contributions from the government, loans, funds recovered from mergers and acquisitions of insolvent banks, operating profits, and other sources (DPA 1995, art. 24[2], 37; KDIC 2001).

On November 19, 1997, the government announced that it would contribute KRW 7.5 trillion of government-owned public securities to the KDIC (MOEF 1997a).

To strengthen the fund, the National Assembly passed additional legislation allowing the KDIC to issue Deposit Insurance Fund bonds (DIF bonds) to meet the 100% blanket deposit guarantee (Republic of Korea 1997c). The KDIC issued DIF bonds on 42 occasions from 1998 to 2000 for KRW 43.5 trillion. Most of these bonds had maturities of five to seven years with fixed or floating interest rates linked to the yield of National Housing Bonds. Specifically in 2000, all DIF bonds had fixed interest rates with maturity of five years (KDIC 2001).

The KDIC could also borrow from the government, BOK, insured financial institutions, and other institutions with the MOEF’s approval to support the deposit insurance fund (DPA 1995, art. 26; Enforcement Decree 1996, art. 15; KDIC 1999). The KDIC borrowed funds from 1998 to 2000 for KRW 183.2 billion (KDIC 2001).
By the end of the blanket deposit guarantee, the KDIC had paid KRW 19.2 trillion to depositors at a total of 236 financial institutions that failed. This deposit payoff was predominantly to merchant banks, which received 72.9% of total funds provided through December 31, 2000 (KDIC 2001).

Commercial Paper Guarantee

It is unclear whether the government funded the commercial paper guarantee with the deposit insurance fund or from another source.

8. Eligible Institutions: The foreign debt guarantee applied to all financial institutions. The KDIC insured commercial banks, merchant banks, securities companies, insurance companies, mutual savings and finance companies, and credit unions. The commercial paper guarantee applied to merchant banks.

Foreign Debt Guarantee

The government guaranteed all Korean financial institutions’ foreign debt (Koo and Kiser 2001; Yoon 1997), subject to the condition that the guarantee would be applied only to viable financial institutions. Specifically, eligible obligors included 33 Korean commercial banks, state-owned banks, and certain specialized banks including their foreign banking subsidiaries and their overseas branches and agencies but excluding their nonbank subsidiaries. Eligible obligors also included merchant banks, but not their subsidiaries, provided that they had been determined by the government to be commercially sound and viable before the commencement of the exchange offer. Nine merchant banks were deemed to be commercially sound, and their outstanding debt totaled USD 1.37 billion (Coe and Kim 2002).

Deposit Guarantee

Financial institutions insured by the KDIC included commercial banks,11 merchant banks, securities companies, insurance companies, mutual savings and finance companies, and credit unions. According to the KDIC’s 1998 annual report, coverage was mandatory for financial institutions conducting deposit business (DPA 1999; KDIC 1999).


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11 Trust funds redeposited money at commercial banks and thus were guaranteed under the Depositor Protection Act, though this was not clear to the public at first (see Key Design Decision No. 6, Communication) (AFP 1997a).
Commercial Paper Guarantee

Uncollateralized commercial paper was eligible only if it was issued by merchant banks (Korea Economic Daily 1997a; Korea Economic Daily 1997b).

9. Eligible Liabilities: The foreign debt guarantee applied to interbank deposit obligations and short-term loans owed to foreign banks. The KDIC expanded eligible liabilities during the guarantee of deposits and commercial paper, depending on type and issue date.


Foreign Debt Guarantee

In August 1997, the MOEF announced that the government would guarantee financial institutions’ new and existing foreign debt (Yoon 1997).

After negotiations12 with international stakeholders, the government stated in January 1998 that eligible liabilities included short-term loans, interbank deposit obligations, overnight deposits, floating-rate certificates of deposit (FRCDs) with a maturity of one year or less, long-term loans and long-term FRCDs with annual put options, banker’s acceptances with no underlying physical transaction, syndicated loans, and call money. Call money owed to foreign banks and financial institutions by eligible obligors and maturing during calendar year 1998 was later determined to be eligible since it was considered to be a short-term loan. Repurchase obligations were eligible if they were backed by the BOK’s monetary stabilization bonds or other securities backed by local governments, state-owned banks, or specialized banks (Coe and Kim 2002).

Excluded liabilities included trade finance, publicly traded securities, commercial paper, overnight deposits, contingent obligations (for example, derivatives), and obligations owed to controlling shareholders of eligible obligors. The guarantee also excluded new loans toward overseas subsidiaries (Coe and Kim 2002).

Deposit Guarantee

Before November 1997, the KDIC guaranteed certain financial products under a limited deposit insurance scheme up to KRW 20 million per depositor; the KDIC expanded the eligibility of insured financial products—depending on type and issue date—under the blanket deposit guarantee (see Key Design Decision No. 3, Legal Authority; see also Appendix) (KDIC n.d.; KDIC 2000).

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12 For a detailed account of these negotiations, see Coe and Kim (2002, 417–32).
Commercial Paper Guarantee

The KDIC guaranteed collateralized commercial paper (Korea Economic Daily 1997a; Korea Economic Daily 1997b; MOEF 1998d). Uncollateralized commercial paper was eligible only if it was issued by merchant banks13 (Korea Economic Daily 1997a; Korea Economic Daily 1997b). Merchant bank customers had the option of switching uncollateralized commercial paper to cash management accounts, which were covered by the guarantee (Korea Economic Daily 1997b).

10. Fees: For foreign debt, commercial and merchant banks paid fees depending on their credit ratings and capital ratios. For deposits, financial institutions paid an initial fee and a quarterly fee to the KDIC; the KDIC raised premium rates and their upper limits under the blanket guarantee.

Foreign Debt Guarantee

The government collected payment guarantee fees from obligors: 0.2%–1.5%, depending on obligors’ credit ratings and capital ratios to give preferential treatment to institutions with sound management (MOEF 1998c).

Deposit Guarantee

Newly established financial institutions paid an initial, one-time fee to the KDIC to be covered by the deposit insurance fund: a ratio of their initial capital/paid-in shares (DPA 1995, art. 24; KDIC 1999). Banks, securities companies, insurance companies, and credit unions paid the maximum limit set by law: 1%. Merchant banks, mutual savings banks, and finance companies paid the maximum limit set by law: 10% (KDIC 1999).

Financial institutions also paid insurance premiums each quarter: the deposit balance multiplied by a ratio not to exceed 5 bps per annum. The KDIC’s Policy Committee could issue a resolution eliminating, reducing, or deferring the insurance fee for an institution when problems arose (DPA 1995, art. 30).

To supplement the deposit insurance fund under the guarantee, the KDIC raised both the premium rates and their upper limits in 1998 for a number of financial institutions (KDIC 1999; MOEF 1997b; MOEF 1998e). Before June 1998, the maximum premium rate was between 0.05% and 0.15%. On June 15, 1998, the MOEF announced a new maximum premium rate of 0.5% (MOEF 1998e). See Figure 1 for total fees collected during the guarantee.

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13 English-language sources contradict Korean-language sources on the scope of commercial paper guaranteed. According to Reuters, the KDIC categorically guaranteed all commercial paper, collateralized and uncollateralized (Bulman 1997a; Reuters 1997c). The author relies on a primary source, the MOEF, and a Korean-language news outlet, Korea Economic Daily.
Figure 1: Total Fees Collected by the KDIC from Financial Institutions

<table>
<thead>
<tr>
<th>Year</th>
<th>Total initial, one-time contributions collected</th>
<th>Total quarterly premiums collected</th>
</tr>
</thead>
<tbody>
<tr>
<td>1998</td>
<td>KRW 239 million</td>
<td>KRW 234.3 billion</td>
</tr>
<tr>
<td>1999</td>
<td>KRW 209.8 million</td>
<td>KRW 416.1 billion</td>
</tr>
<tr>
<td>2000</td>
<td>KRW 32.9 billion</td>
<td>KRW 540.3 billion</td>
</tr>
</tbody>
</table>


Commercial Paper Guarantee

Research did not uncover whether any fees were associated with the guarantee of collateralized commercial paper.


Foreign Debt Guarantee

On January 28, 1998, the MOEF announced a tentative agreement with international creditors to reschedule USD 24 billion in short-term debt on a voluntary basis (mostly held by commercial and merchant banks) into claims of one- to three-year maturities with government guarantees (Coe and Kim 2002; Frank 1998; Koo and Kiser 2001; MOEF 1998b).

Each creditor had to read the Exchange Offer Memorandum and submit a Letter of Acceptance to the exchange (or reconciliation) agent to state its intended participation in the exchange, the new loan maturity, and currency denomination of the new loan. By March 16, 1998, 134 creditors from 32 countries submitted Letters of Acceptance amounting to USD 21.8 billion (Coe and Kim 2002).

The DMT drafted a Guarantee Agreement for each foreign creditor that contained details of the guarantee, such as information on fees and the sinking fund. Each foreign creditor signed the Guarantee Agreement and sent it back to the DMT along with the government guarantee application form, debt repayment schedule, and debt repayment schedule in case of a default. The DMT reviewed each submission from each creditor and signed the Master Loan Agreement on March 31, 1998, rendering the guarantee legally binding on all parties (Coe and Kim 2002).

The principal was repaid in full at maturity, and the interest was repaid every six months. The DMT and foreign creditors agreed that interest rates would be differentiated by maturity and that loans with one-year maturities could not be repaid early (see Figure 2) (MOEF 1998b; MOEF 1999).
In the event of default, the government made payments from the Foreign Exchange Stabilization Fund, which also housed the sinking fund. The government made payments from the Foreign Exchange Stabilization Fund—later replenished from the government budget—to avoid lag time in payments (Coe and Kim 2002).

**Figure 2: Interest Rates by Maturity**

<table>
<thead>
<tr>
<th>Maturity</th>
<th>% of total loans extended</th>
<th>Interest rate</th>
<th>Early repayment?</th>
</tr>
</thead>
<tbody>
<tr>
<td>One-year</td>
<td>17.2%</td>
<td>LIBOR + 2.25%</td>
<td>Not possible</td>
</tr>
<tr>
<td>Two-year</td>
<td>45.0%</td>
<td>LIBOR + 2.50%</td>
<td>Allowed after six months</td>
</tr>
<tr>
<td>Three-year</td>
<td>37.8%</td>
<td>LIBOR + 2.75%</td>
<td>Allowed after six months</td>
</tr>
</tbody>
</table>

*Sources: Coe and Kim 2002; MOEF 1998b; MOEF 1999.*

**Deposit Guarantee**

The KDIC Operating Committee drew up a duties execution manual to obtain authorization from the MOEF before administering the fund. The duties execution manual contained information on insurance fees, insurance money, funds support, and other relevant information necessary for the execution of the KDIC’s duties (DPA 1995, art. 19).

The KDIC made insurance payments under two circumstances. First, the KDIC paid claims arising from the suspension of payment for deposits in financial institutions by order of the FSC. In this scenario, the KDIC had to decide whether to make insurance claim payments within the first three months of suspension. Second, the KDIC paid claims arising from the cancellation of a license of an insured financial institution by the MOEF. In this scenario, the KDIC had to make insurance claim payments (KDIC 1999).

At the beginning of the blanket deposit guarantee, the KDIC fully paid insurance claims on the principal and interest. Moral hazard concerns emerged when weak banks began to offer high interest rates to attract deposits. Consequently, authorities decided in July 1998 to limit the guarantee for deposits. For deposits received after August 1, 1998, depositors with more than KRW 20 million received only the principal and no interest (Baliño and Ubide 1999; KDIC 1999). Those with less than KRW 20 million received the principal plus the market interest rate but not the bank's higher interest rate (Baliño and Ubide 1999). In January 1999, the KDIC began to deduct a depositor's debt from the payoff, excluding security debts (DPA 1999, art. 32).

The KDIC notified depositors through public notices—containing the time and procedure for payment—whenever it made insurance payments or advance payments (KDIC 1999).
Commercial Paper Guarantee

Research did not uncover whether the commercial paper guarantee followed the same process as the deposit guarantee or had a separate process.

12. Other Restrictions: Research did not uncover additional restrictions associated with the guarantee.

The guarantees did not appear to have any additional restrictions on institutions or accounts.

13. Duration: The commercial paper guarantee ended by October 1, 1998. The MOEF announced the successful repayment of all guaranteed foreign debt as of April 9, 2001. The guarantee of all deposits ended as scheduled on December 31, 2000, though non-interest-bearing settlement deposits were guaranteed through December 31, 2003.

Foreign Debt Guarantee

The DMT restructured foreign debt for one-, two-, and three-year maturities (see Figure 2) (Coe and Kim 2002).

In a press release, the MOEF International Finance Division announced the successful repayment of all foreign debt as of April 9, 2001 (USD 22.1 billion in total) that had been extended under the guarantee (MOEF 2001).

Deposit Guarantee

Upon the initial announcement of the temporary scheme, the MOEF set an expiration date for the blanket deposit guarantee of December 31, 2000 (Republic of Korea 1997a). On January 1, 2001, the KDIC reverted to a limited deposit insurance scheme of KRW 50 million per depositor (see Figure 3) (KDIC n.d.). The government and KDIC raised the upper limit to KRW 50 million “in consideration of the possibility that further destabilization of the financial market may be caused by drastic deposit migration” (KDIC 2001).

The KDIC guaranteed 100% of non-interest-bearing deposits (temporary deposits and current deposits) in settlement-oriented accounts until December 31, 2003, to maintain the stability of commercial transactions (KDIC 2001; KDIC 2004).
Figure 3: Timeline of KDIC Coverage for Deposits

<table>
<thead>
<tr>
<th>Date</th>
<th>Coverage</th>
</tr>
</thead>
<tbody>
<tr>
<td>June 1, 1996–November 18, 1997</td>
<td>KRW 20 million per depositor</td>
</tr>
<tr>
<td>November 19, 1997–December 31, 2000</td>
<td>Temporary blanket coverage scheme</td>
</tr>
<tr>
<td>January 1, 2001–indefinite duration*</td>
<td>KRW 50 million per depositor</td>
</tr>
</tbody>
</table>

Note: The KDIC guaranteed 100% of non-interest-bearing settlement deposits until December 31, 2003.

* At the publication of this case study, KDIC coverage was still KRW 50 million per depositor, according to the KDIC’s 2020 annual report (KDIC 2021).


Commercial Paper Guarantee

The guarantee of collateralized commercial paper ended by October 1, 1998, as the guarantee only covered issuances before September 30, 1998 (KDIC 2000).
References and Key Program Documents

Documents cited in the text are introduced with a parenthetical author-date citation. Documents that are relevant to this case but have not been cited in text do not include this parenthetical reference.

Summary of Program

Webpage containing information on the history of the KDIC.
https://ypfs.som.yale.edu/node/22050

Memoir by former Minister of Finance and Economy Kyu-Sung Lee about the Korean financial crisis of 1997, describing the macroeconomic and financial background leading up to the crisis, and including a timeline of when and how the government responded.

Implementation Documents

Letter of intent from Korea describing the policies the government planned to implement in response to a three-year stand-by arrangement with the IMF.
https://ypfs.som.yale.edu/node/22051

SBA between the IMF and Korea.
https://ypfs.som.yale.edu/node/22052

Letter of intent between the IMF and Korea in December 1997.
https://ypfs.som.yale.edu/node/22053

Legal/Regulatory Guidance

Act establishing the KDIC.
https://ypfs.som.yale.edu/node/22055/

Act amending the Depositor Protection Act that was in force at the start of the blanket deposit
guarantee.
https://ypfs.som.yale.edu/node/22056

https://ypfs.som.yale.edu/node/22057

https://ypfs.som.yale.edu/node/22101/

https://ypfs.som.yale.edu/library/enforcement-decree-depositor-protection-act

**Media Stories**

https://ypfs.som.yale.edu/node/22060/

https://ypfs.som.yale.edu/node/22059

https://ypfs.som.yale.edu/node/22061

https://ypfs.som.yale.edu/node/22062

https://ypfs.som.yale.edu/node/22063

https://ypfs.som.yale.edu/node/22063
deposits, and commercial paper.
https://ypfs.som.yale.edu/node/22102

News article on Korea’s rescheduling of USD 24 billion in foreign debt in January 1998.
https://ypfs.som.yale.edu/node/22103

News article on commercial paper covered by Korea’s blanket guarantee (in Korean).
https://ypfs.som.yale.edu/node/22104

News article on the possibility of switching unsecured commercial paper to cash management accounts (in Korean).
https://ypfs.som.yale.edu/node/22105/

News article on Korea’s reform package and Finance Minister Lim Chang-Yuel’s press conference.
https://ypfs.som.yale.edu/node/22064

News article on Korean financial reform bills during the Asian Financial Crisis.
https://ypfs.som.yale.edu/node/22065

News article on the announcement of deposit guarantees in Korea during the AFC.
https://ypfs.som.yale.edu/node/22066

News article on Korea’s deposit insurance program in November 1997.
https://ypfs.som.yale.edu/node/22067

News article on credit ratings and external liabilities guarantees by the Korean government during August 1997.
https://ypfs.som.yale.edu/node/22068/
Press Releases/Announcements

IMF press release about the stand-by arrangement with the Republic of Korea. 
https://ypfs.som.yale.edu/node/22069

Document from MOEF with details on the guarantee of all deposits, principal and interest, in November 1997 (in Korean). 
https://ypfs.som.yale.edu/node/22106

Press release by MOEF announcing increases to premium rates and their upper limits during the blanket guarantee (in Korean). 
https://ypfs.som.yale.edu/node/22107/

Press release from MOEF announcing details about the guarantee of foreign debt liabilities (in Korean). 
https://ypfs.som.yale.edu/node/22108

Press release by MOEF with updates on negotiations between the Korean government and foreign creditors (in Korean). 
https://ypfs.som.yale.edu/node/22109

Press release by MOEF detailing the negotiations and process of guaranteeing Korea’s foreign debt liabilities (in Korean). 
https://ypfs.som.yale.edu/node/22110

Press release from MOEF containing details on funding and fees associated with the guarantee of foreign debt liabilities (in Korean). 
https://ypfs.som.yale.edu/node/22111
Press release by MOEF highlighting amendments to the Depositor Protection Act, effective July 1, 1998 (in Korean).
https://ypfs.som.yale.edu/node/22112

Press release by MOEF announcing changes to the Depositor Protection Act as they related to the maximum insurance premium rate and calculation of deposit insurance (in Korean).
https://ypfs.som.yale.edu/node/22113/

Report containing information on the rescheduling and guarantee of foreign debt, one year after the Master Loan came into force (in Korean).
https://ypfs.som.yale.edu/node/22114

Press release announcing the successful repayment of all extended foreign liabilities as of April 9, 2001 (in Korean).
https://ypfs.som.yale.edu/node/22115/

Reports/Assessments

Annual report by the BOK for 1997.
https://ypfs.som.yale.edu/node/22070

Annual report by the KDIC for 1998.

Annual report by the KDIC for 1999.

Annual report by the KDIC for 2000.


Key Academic Papers


Discussion paper focusing on post-AFC banking reform in Korea.  
https://ypfs.som.yale.edu/node/15577/

Dallas Fed case study on Korea’s recovery from the AFC.  
https://ypfs.som.yale.edu/node/22084/

YPFS case study examining Korea’s capital-injection program in the AFC.  
https://elischolar.library.yale.edu/journal-of-financial-crisis/vol3/iss3/19

Paper discussing respective government responses to the AFC.  
https://ypfs.som.yale.edu/node/16271

Book bringing together analyses of responses of Asian countries during the Asian Financial Crisis.  
https://ypfs.som.yale.edu/node/22134

YPFS case study examining Korea’s asset management program.  
https://elischolar.library.yale.edu/journal-of-financial-crisis/vol3/iss2/19
## Appendix

### Figure 4: KDIC Coverage (as of December 31, 1999)

<table>
<thead>
<tr>
<th>Financial institution</th>
<th>Insured financial products</th>
<th>Excluded financial products</th>
<th>Notes</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Always covered</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Covered until end-2000</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Banks</strong></td>
<td>Individual/corporate deposits</td>
<td>Government/regional authorities/BOK/FSC</td>
<td>Loans (call)</td>
</tr>
<tr>
<td></td>
<td>Deposits, savings, installments, secondary bills, principal covered trusts</td>
<td>Foreign currency deposits, certificates of deposit, development bank trusts, bank bonds</td>
<td>Performance dividend trusts, repos</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>Repurchase agreements (repos) issued before July 25, 1998, were covered until end-2000</td>
</tr>
<tr>
<td><strong>Securities houses</strong></td>
<td>Individual/corporate deposits</td>
<td>Government/regional authorities/BOK/FSC</td>
<td>Loans (call)</td>
</tr>
<tr>
<td></td>
<td>Client deposits, securities savings</td>
<td>Pre-collected tax payments, collateral for loaned liquid securities</td>
<td>Surety policies, reinsurance policies</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>Repos issued before July 25, 1998, were covered until end-2000</td>
</tr>
<tr>
<td><strong>Insurance companies</strong></td>
<td>Individual/corporate deposits</td>
<td>Government/regional authorities/BOK/FSC</td>
<td>Loans (call)</td>
</tr>
<tr>
<td></td>
<td>Individual policies, severance pay policies</td>
<td>Corporate policy</td>
<td>Surety policies, reinsurance policies</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>Surety policies issued before August 1, 1998, were covered until end-2000</td>
</tr>
<tr>
<td><strong>Merchant banks</strong></td>
<td>Individual/corporate deposits</td>
<td>Government/regional authorities/BOK/FSC</td>
<td>Loans (call)</td>
</tr>
<tr>
<td></td>
<td>Promissory notes, secondary notes, cash management accounts</td>
<td>Bills sold, foreign currency loans, investment securities, repos, merchant bank bonds</td>
<td>Commercial paper secured before September 30, 1998, was covered at all times</td>
</tr>
<tr>
<td><strong>Mutual savings and finance companies</strong></td>
<td>Individual/corporate deposits</td>
<td>Government/regional authorities/BOK/FSC</td>
<td>Loans (call)</td>
</tr>
<tr>
<td></td>
<td>Loan association funds, installments, deposits, savings, secondary bills</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Credit unions</strong></td>
<td>Individual/corporate deposits</td>
<td>Government/regional authorities/BOK/FSC</td>
<td>Loans (call)</td>
</tr>
<tr>
<td></td>
<td>Contributions, deposits, savings</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

_Source: KDIC 2000._