Korea Investment Corporation: Its Origin and Evolution

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ABSTRACT

This paper gives a detailed account of the creation and the evolution of Korea Investment Corporation (KIC) – a sovereign wealth fund established in 2005 by the Korean government. I first pay attention to the debates at the time of its creation among various stakeholders, and how they shaped the governance structure and the management of KIC. The remaining part of the paper discusses the evolving views on KIC's mission. The paper first introduces the early discussion of using KIC as a macroeconomic policy tool to address the problems related to foreign capital inflows. Then, I discuss government's aspiration to make KIC a tool to attract foreign asset management companies and thereby transform Seoul into East Asia's financial hub. Lastly, the paper goes over the newly emerging view that KIC should be used as a vehicle to prevent FX liquidity crisis, such as the one Korea experienced in 2008/9.

JEL Codes: F31, F34, G15, G23, G28, P16
Key words: Sovereign Wealth Fund, FX Reserve, Currency Crisis, FX Swap, Korea

I. INTRODUCTION

For the past few years, policy makers, market practitioners, and academics have shown keen interest in sovereign wealth funds (SWFs). Reflecting this interest, there is now an explosion of research papers on the topic. One strand of research that lags behind, however, is in-depth studies focusing on a single sovereign wealth fund.[1] The purpose of this paper is to fill in this gap by giving a detailed account of the creation and the evolution of Korea Investment Corporation (KIC) – a sovereign wealth fund established in 2005 by the Korean government.

KIC is a small sovereign wealth fund. As of December 2010, KIC manages 37.5 billion US dollars. According to the Sovereign Wealth Fund Institute, KIC ranks number 19 in terms of its total assets under management.[2] Even among SWFs with non-commodity origin, it ranks number 8.[3] But, KIC has a number of unique features that makes it quite interesting and also worth documenting.[4]

First, KIC has been discussed among policy makers as a macroeconomic policy tool, addressing issues such as surges of capital inflows or preventing FX liquidity crisis. Although never officially acknowledged by the Korean government, it is clear that it has the potential of being used for such purpose. Second, KIC has been discussed as a solution to problems countries face when they have accumulated too much FX reserves. The continued reversed margin – higher domestic interest rate – and the depreciation of US dollars made it inevitable for Korea to create a sovereign wealth fund that can reduce the opportunity costs of holding large reserves. Third, it shows how government's policy to promote onshore asset management industry can be related to the creation of a sovereign wealth fund. KIC was created as part of Korea's long-term plan to transform Seoul into Northeast Asia's financial hub.

Fourth, the legislative process Korea underwent to establish KIC and the actual operation of KIC in subsequent years manifest how powerful government bureaucrats are in Korea. Despite the efforts made by other government agencies, civil activist groups, and the opposition party, Korea adopted the Korea Investment Corporate Act considerably favorable to the Ministry of Finance and Economy (MOFE).[5] The

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[1] One exception is a series of works by Gordon Clark and Ashby Monk. See Clark and Monk (2010a, 2010b, 2010c, and 2011).

[2] Abu Dhabi Investment Authority is the largest managing 627 billion US dollars. This is followed by Norway's Government Pension Fund that manages 556.8 billion US dollars. For detailed rankings, visit www.swfinstitute.org.

[3] The top three are all Chinese: SAFE Investment Company (347.1 billion US), China Investment Corporation (332.4 billion USD), and Hong Kong Monetary Authority (HKMA) Investment Portfolio (292.3 billion USD). This is followed by Government of Singapore Investment Corporation (GIC) managing 247 billion USD.

[4] In March 2011, KIC total assets under management increased to 43.5 billion USD. By the end of 2011, it is expected to increase by 51.5 billion USD. This will make KIC the 16th largest SWF.

[5] In 2008, the Ministry of Finance and Economy (MOFE) was renamed as the Ministry of Strategy and

actual operation of KIC in subsequent years confirms such claim. Lastly, the case of KIC effectively shows the problem of having an unclear mission statement. Vaguely defined mission statement allows the mission to evolve over time and also allows them to coexist and sometimes contradict each other.

This paper is organized as follows. Section II gives a detailed account of KIC's origin. In particular, I go through the various motives behind the creation of KIC. This is followed by the discussion on key issues that were debated during the legislative process among various stakeholders. Large portion of discussion is allocated to the governance structure of KIC. Section III discusses the evolving views on KIC's mission and the actual operation of KIC after its creation. It also assesses KIC against the code of conducts set forth by the international community.

II. THE ORIGIN

1. Background and Early Discussions

Resurgence of Capital Inflows

The very first time policy makers discussed the establishment of a Korean sovereign wealth fund – Korea Investment Corporation (KIC) – dates back in November 1999. By then, Korea completely dispersed the concern over its foreign exchange liquidity condition. The KRW-USD exchange rate that peaked at 1,964.8 on December 24, 1997 was already down to 1,155.90 by June 1999.[6] The level of FX reserves, which was only 4 billion US dollars on December 18 1997, reached 70 billion UD dollars by November 1999.

Policymakers at the Ministry of Finance and Economy (MOFE) were instead troubled with an entirely opposite problem: surges of capital inflows. On top of a huge current account surplus (42.6 billion US dollars in 1998 and expecting well above 20 billion US dollars in 1999), they were expecting a surplus even in the financial account. In October, financial account switched to a surplus of 0.9 billion US dollars from a deficit of 1.6 billion US dollars in the previous month. In November, it recorded a 2.6 billion US dollars surplus. Foreign portfolio investment contributed 90% of this surplus. This made policymaker uneasy as surges of capital inflows may appreciate the domestic currency value, and then deteriorate the current account balance. Continued financial account surplus coupled with chronic current account deficit was believed to be one of the key factors behind the 1997 crisis. The policy makers did not want to make Korean vulnerable again to sudden stop of capital inflows.

Engaging in sterilized FX market intervention was one solution, as it can insulate the exchange rate

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Finance (MOSF).

[6] During market hours, on December 24, 1997, the exchange rate went above the 2,000 level.

from capital inflows. But, it was also a controversial solution. Trading partners – U.S. in particular – may accuse such practice as exchange rate manipulation. An alternative measure was to encourage Korean residents to engage in overseas portfolio investment. Their demand for US dollars may mitigate the downward pressure on KRW-USD exchange rate. By November 1999, MOFE was contemplating a measure that exempts capital gains tax on overseas portfolio investment.

Visit to Singapore and Hong Kong (Nov. 29 – Dec. 1, 1999)

Against this backdrop, Ministry officials from the Foreign Exchange Policy Division made a business trip to Singapore and Hong Kong in late November. The purpose was to learn how the Government of Singapore Investment Corporation (GIC) works and how the central banks of Singapore and Hong Kong manage their FX reserves.[7] The trip was short, but fruitful. The Ministry officials realized that setting up a sovereign wealth fund similar to GIC can solve the dilemma they were facing.[8] They learned that Singapore, a country that has adopted exchange rate-based monetary policy, heavily intervenes in the FX market and transfers significant portion of FX reserves to GIC.[9] It is no coincidence that the year Singapore adopted the exchange rate-based monetary policy (1981) is also the year GIC was established. By December, the merits of establishing a sovereign wealth fund were well shared within the Ministry.

The internally circulated document summarized the merits in four areas.[10] First, it can allow Korea to maintain current account surplus even in the midst of continued capital inflows. If significant portion of FX reserves is transferred to a newly established sovereign wealth fund, the reserve would accumulate much slowly, and thus bring about less controversy over Korea's FX market intervention. This obviously would give the government more room to intervene. Second, it allows Korea to benefit from economies of scale. Following Singapore, Ministry officials were thinking of a sovereign wealth fund that manages not only FX reserves, but also the overseas assets held by National Pension Fund and state-owned enterprises.[11] Third, it allows the Korean government to get better access to high quality market information. Ministry officials believed that having such access is crucial in preventing currency crisis.

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[7] The author of this paper headed this mission trip. The trip, however, was first suggested by Hongchul (Hank) Ahn, who was working at the Korea Center for International Finance (KCIF) at that time. KCIF is an organization established by the Korean government and the Bank of Korea in 1999 to monitor movements in international financial markets and issue early warning signals. Mr., Ahn later served as the Auditor of KIC.

[8] At that time, the term "sovereign wealth fund" was not yet used.

[9] On Singapore's unique monetary policy, see Parrado (2004).

[10] The author of this paper authored this internal document.

[11] It was expected that the size of National Pension Fund (NPF) would be phenomenal. The most recent projection, made in 2008, states that the fund will peak in 2043 at 2,607 trillion KRW (approximately, 2.5 trillion US dollars). NPF was established was established by the National Pension Act to serve as a reserve fund to meet the liabilities of the National Pension Scheme.

Fourth, it can serve as a catalyst in developing Korea's asset management industry. Ministry officials were intrigued how Singapore was using GIC and the Monetary Authority of Singapore (MAS) as vehicles in development the Singapore fund management industry. The document reports that GIC and MAS earmarked 35 billion SGD (approximately 19 billion US dollars; 25 billion SGD from GIC and 10 billion SGD from MAS) to be placed out to external managers, regardless of nationality, during 1998-2000. The Ministry officials also believed that the know-how on overseas investment accumulated within the sovereign wealth fund can later be trickled down to other Korean funds, and thereby contribute to the development of Korea's asset management industry.

Deterioration of BOK's Balance Sheet

In 2000 and 2001, Ministry of Finance and Economy informally floated the idea of establishing Korea Investment Corporation (KIC). In August 2001, Minister Jin Nyum stressed the importance of improving returns on BOK's FX reserves. He expressed concerns that the returns on FX reserves are well below the interests BOK pays on its monetary stabilization bonds (denominated in KRW).[12] The Minister clearly had in mind setting up KIC. By then, the size of FX reserve reached 98 billion US dollars.

BOK's response, however, was negative. An anonymous interviewee from BOK showed concern that the size of FX reserve was not yet large enough, and therefore, securing liquidity should have priority over improving investment returns. BOK also criticized that MOFE's intension of establishing KIC is to secure new positions outside the Ministry for its retired bureaucrats.

2. President Noh and Northeast Asia Financial Hub

President Roh's Election Pledge

The discussion of establishing KIC submerged for more than a year. The window of opportunity, however, opened with the new administration that set the goal of making Seoul a financial hub in Northeast Asia. During the election campaign in late 2002, presidential candidate Roh Moo-hyun pledged that he would transform Korea into Northeast Asia's business hub in terms of distribution, finance, and trade.[13] But, it was not until January 2003 when the President-elect and the Transition Committee seriously considered the possibility of making Seoul a financial hub in Northeast Asia. In April 2003, soon after President Roh's inauguration, Korean government established a new task forced named the Presidential Committee

[12] See Kukminilbo (August 27, 2001). The interview took place around the time Korea fully repaid its IMF stand-by loans (19.5 billion USD), three years ahead of schedule.

[13] This idea was not new. It was originally proposed by former President Kim Dae-jung in May 2000 at the Asia-Europe Meeting (ASEM) summit.

on Northeast Asia Business Hub.[14] It was decided that the road map for Northeast Asia financial hub would be jointly prepared by the Presidential Committee and MOFE.

MOFE versus BOK

The road map for Northeast Asia financial hub was officially released on December 11, 2003. But, even before then, popular press started to report that government will establish KIC.[15] They reported that approximately 10 percent of FX reserves would be transferred to KIC, which will be 100% staffed by private sector professionals. This triggered strong resistance from BOK. Its opposition rests on the following six points.[16]

First, BOK refuted the idea that the level of Korea's FX reserve was excessive. BOK argued that the appropriate level of FX reserve should be around 300 billion US dollars if one considers the North Korean factor. The FX reserve reached 150 billion US dollars as of November 2003. Second, BOK repeated its earlier argument that securing safety and liquidity should have priority over improving investment returns, when managing FX reserves. Third, BOK disproved the claim that it is experiencing a loss due to reversed margin. It disclosed its FX reserve asset returns during 1998-2002, which is an unusual practice for a central bank. According to BOK, the return was on average 6.14% per annum during the period. It also stressed that its investment return surpassed the yield on a 2-year monetary stabilization bond (MSB) during 2000-2002. Fourth, BOK repeated its earlier criticism that MOFE is trying to establish KIC to secure new positions outside the Ministry for its required bureaucrats. Fifth, BOK criticized the plan of transferring it reserve assets to KIC separate from its debt. BOK argued that KIC should also assume BOK's debt. This concern, however, was soon alleviated. Government officials clarified in the following day that there will be no change in the ownership of reserve assets. KIC will be one of BOK's external managers that will be managing reserve assets on behalf of BOK.

On December 5, BOK delivered to the Presidential Committee its official stance of opposing the establishment of KIC. Also, it was around this time that China's plan to establish China Investment Corporation (CIC) was known. This worked in favor of the Presidential Committee and MOFE.

The Road Map for Northeast Asia Financial Hub

On December 11, 2003, the Presidential Committee and MOFE jointly laid out their road map to

[14] Originally, the committee was named the Presidential Committee on Northeast Asia Business Center. China and Japan – two other Northeast Asian countries – informally showed concerns over using the term "center."

[15] The earliest news reports were released on November 27, 2003.

[16] For details, see BOK's press release dated December 4, 2003.

transform Seoul into Northeast Asia's financial hub. The plan set 2012 as the target year for Seoul to become Northeast Asia's "niche" financial hub. The Committee intentionally used the term "niche" to indicate that it does not aspire to become a global financial center in the ranks of NYC or London. Its target, instead, was to become a regional hub similar to Hong Kong or Singapore. It also meant that it will target a particular subset of financial industry. That is, the asset management industry among many others.[17]

The Committee laid out a number of rationales behind this decision. First, it is considered as an industry that requires minimal investment in tangible assets, which makes the industry highly mobile, and therefore easier to be relocated. Second, its growth will enlarge and deepen Korea's capital market that is considered to be small relative to the size of its economy. Thirdly, the demand for asset management service is growing rapidly. The life expectancy is increasing and the size of assets managed by National Pension Fund is expected to reach 50% of GDP by 2040. Fourth, despite its growth potential, Asia's asset management industry lags behind those of other regions.

But the proposal that attracted the most attention was establishing KIC. As its *raison d'être*, the road map laid out three points. Obviously, one was managing part of FX reserves in more lucrative assets. The other was to attract foreign asset management companies to Seoul, and thereby transform Seoul into Northeast Asia's "niche" financial hub. As a way of doing this, it suggested that KIC give mandates to foreign asset management companies, and thereby induce them to relocate themselves to Seoul. As mentioned earlier, this is precisely the measure Singapore took in 1998. The joint report also mentioned that setting up KIC would allow Korea to get better access to high quality market information from its service provides. Interestingly, the joint report did not mention the need to use KIC as a countermeasure against capital inflows. The Presidential Committee and MOFE must have considered it inappropriate to explicitly disclose such purpose, even if it was true.

The joint report also set forth the basic legal and financial structure of KIC. First, it was decided that a separate bill establishing KIC be prepared for submission to the National Assembly.[18] Second, KIC be established as a corporation and its initial equity capital would be 200 billion KRW (approximately, 200 million UD dollars). Third, its equity is fully owned by the government. Fourth, at its initial stage, KIC manages 20 billion US dollars, which is 13% of the total FX reserves. Note that Korea's total FX reserve assets are not only held by BOK, but also by the Foreign Exchange Stabilization Fund. The latter fund is managed by MOFE and takes up approximately 15 percent of total reserves. The joint report stated that, in the long-run, KIC will manage not only the FX reserve assets, but also the overseas assets

[17] The road map also set 2020 as the target year to transform Seoul into Asia's top 3 financial centers.
[18] National Assembly is the name of Korea's legislative branch.

held by the National Pension Fund and other state-owned enterprises. The report projected that this will make the total assets under management (AUM) greater than that of GIC. Fifth, it was decided that, in the beginning, KIC invests only in overseas assets. It was also decided that, in its initial stage, KIC manage the assets through external managers.

The joint report also gave some basic directions on the governance structure of KIC. First, establish the Management Evaluation Committee that would oversee the management of KIC. The Committee should be composed of shareholder representatives – government representatives as *ex officio* members – and other financial experts outside the government.[19] Second, the Committee hires a CIO, separate from a CEO. The CIO should be appointed regardless of nationality and also be subject to strict eligibility requirements that can ensure his/her investment management expertise. Also, set the level of compensation high enough to attract talented managers for the position. Third, adopt a system where pay is tightly linked to long-term performance. Fourth, adopt measures that can minimize the risk of National Assembly and Board of Audit and Inspection (BAI) interfering into day-to-day management.[20] Also, in case of sensitive information on KIC's investment management, provide them to the National Assembly and to BAI only on a confidential basis.

Consulting Project Commissioned by the Committee (Jan.10 – Mar. 24, 2004)

The detailed governance structure, however, was not agreed upon between MOFE and the Presidential Committee. The two instead settled that the Presidential Committee commission a consulting project on the governance structure of KIC to outside experts. The idea was to incorporate the suggestions made by the consulting report when MOFE drafts the Korea Investment Corporation Act. This project was carried out by a team of governance experts from January to March 2004.[21] The consultants made a visit to GIC, MAS, and HKMA (January 11-14), studied other sovereign wealth funds, and came up with detailed recommendations. The key features of the final report, dated March 25 2004, are summarized as follows.[22]

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[19] Since the Committee will not have any executives as its members, the establishment of Management Evaluation Committee presumes a two-tier board system.

[20] The Board of Audit and Inspection (BAI) is a constitutional agency established to audit the accounts of the State and to inspect the works performed by government agencies.

[21] The author of this paper led the consulting team. There were two other members in the team: Park, Kyung-Suh (Professor, Korea University Business School) and Lim, Wonhyuk (Fellow, Korea Development Institute)

[22] The report also provided a number of reasons why KIC should be established separate from BOK. First, as a public organization, BOK does not have the commercial incentives to improve the returns on its assets. Second, BOK does not have the compensation system that can attracted talented investment managers. Third, even if BOK does adopt such a system, this will only foster disharmony between investment

First, the report proposes four guiding principles that should be used to shape the governance structure of KIC. They include (i) accountability to the shareholders (government) and ultimately to the public in general, (ii) independence from other government policies, (iii) managerial autonomy and leadership, and (iv) investment expertise and commercial incentives of managers. The four principles, however, may contradict each other. For example, too much emphasis on accountability may make KIC less independent from government. To resolve such conflicts, the report suggests setting clear *ex ante* rules and procedures. Once such rules and procedures are set and disclosed, it would be very hard for the government to intervene in the management of KIC and carry out arbitrary performance evaluation. In this case, accountability would be judged solely based on the managers' compliance with such rules and procedures. Autonomy can also be ensured by giving reasonable degree of discretion to the managers within the pre-set rule and procedures. <Figure 1> shows the relationship among the four principles.

Second, on internal control, the report proposes to adopt a single-tier board system. That is, carrying out two functions – the supervisory role and the management role – in a single board. Under this system, the board will be composed not only of shareholder representatives (government) and outside independent directors, but also some executives.[23] This is in contrast to the earlier proposal to set up Management Evaluation Committee, which does not have any executive members, and therefore presumes a two-tier board system. The report saw more drawbacks from a two-tier system than from a single-tier system. First, given that the National Assembly and BAI may exercise some supervisory roles, having a separate supervisory board is redundant. Second, if the supervisory board becomes inactive or obsolete because of its redundancy, there will be no role for the outside directors to play. Third, if responsibilities are not clearly defined *ex ante* between the two boards, they may shift the blame to each other *ex post*. On candidate nomination, the report proposes to establish a nomination committee, the members of which are, in turn, appointed by the National Assembly, MOFE, and BOK.[24] On eligibility requirements, the report proposes that former government officials or BOK employees cannot serve as a board member unless five years have passed since their departure. Also, the report proposes that executive board members have working experience in the field of investment management for at least 10 years.

Third, on external discipline and monitoring, the report stresses the importance of transparency in

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managers and others. Fourth, as an organization managing FX reserves, BOK is not appropriate to be subject to external monitoring.

[23] The report proposes a board composed of nine members (independent chair, other five outside directors, CEO, and two *ex officio* members from MOFE and BOK).

[24] When nominating outside director candidates, the report proposes a nomination committee composed of 6 members (2 appointed by the Speaker of the National Assembly, 2 appointed by the Minister of Finance and Economy, and 2 appointed by the Governor of BOK). When nominating a CEO candidate, the report proposes a nomination committee composed of 12 members (add 6 outside directors to the outside director candidate nomination committee).

KIC's investment management practices. Although, board meeting minutes and voting results need not be disclosed, it emphasizes that KIC's investment policy statement (IPS), its sub-rules, and related procedures be fully disclosed. It also stresses public disclosure of detailed investment management results. Exceptions would be yearly asset allocation plans and individual securities held by KIC, the disclosure of which may have more problems than benefits. Such prescriptions are in contrast to the earlier proposal prepared by MOFE and the Presidential Committee that supports minimal public disclosure. The report also emphases that private sector institutions – accounting firms and global custodians –play external disciplinary and monitoring roles in addition to the National Assembly and BAI.

Fourth, on KIC's investment policy statement, the report stresses that it is strongly preferable that KIC have a single mission and explicitly argues that "maximizing international purchasing power, taking into account an acceptable level of risk" should be the sole mission of KIC.[25] To give constituents a clear sense of director, the report emphasizes that KIC's IPS makes it clear that other objectives, such as promoting onshore asset management industry, are subordinate to the mission stated above. On KIC's portfolio, the report proposes to ban investments in KRW-denominated assets by law. It expresses concerns that, if domestic investments are allowed, government officials or politicians may be tempted to misuse KIC in their favor. The report also emphases that KIC adopt a clear proxy voting guideline. It also made it clear that the decision to let KIC manage the overseas assets of National Pension Fund (NPF) lies solely in the hands of NPF Management Committee members.

3. Key Issues and Political Process

Presidential Committee versus MOFE

Even before the Presidential Committee finalized its proposal on the governance structure of KIC, MOFE came up with its first draft of the Korean Investment Corporation Act. Since then (April 17), MOFE has gone through at least seven revisions before the government finally submitted the bill to the National Assembly on September 20, 2004.[26] Over this five-month period, there were heated debates between the Presidential Committee and MOFE.[27] In this subsection, I outline the key issues.

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[25] This is also the mission statement of Norwegian Government Petroleum Fund. This fund was renamed in 2006 as the Government Pension Fund of Norway.

[26] Revision dates are April 17, April 30, May 3, May 19, June 18, June 24, and September 20.

[27] From the Ministry of Finance and Economy, the key officials involved in the negotiations include: Choi, Joong-Kyung (Director-General, International Finance Bureau), Choi, Jong-Ku (Director, International Finance Division, International Finance Bureau) and Min, Kyung-Seol (Deputy Director, International Finance Division International Finance Bureau). From the Presidential Committee on Northeast Asia Business Hub, the key officials involved in the negotiations include: Chung, Tae-In (Executive Director), Choi, Myung-Ju (Chair, Financial Hub Sub-committee), Lee, Keon-Beom (Secretary, Finance Team)

First, there were some debates over KIC's mission statement. In MOFE's initial draft, KIC had to serve two objectives. One is to enhance the efficiency in managing FX reserves and other public funds. The other is to contribute to the nation's economy. Negotiations with the Presidential Committee, however, led MOFE to regard the first as an intermediate goal and the second as the ultimate goal. The final September bill states that KIC is established to enhance the efficiency in managing assets entrusted by the Government, the BOK, and others, and thereby pursue the development of financial industry and contribute to the nation's economy. This mission statement is no doubt still vague and elusive.

Second, the Presidential Committee and MOFE had heated debate over board structure. The Presidential Committee supported the single-tier board system, following recommendations made in the consulting report, while MOFE supported the two-tier system. MOFE argued that a single-tier system cannot be justified in the absence of an entity that serves the function of a shareholders' meeting. MOFE also argued that most of the state-owned corporations in Korea have a two-tier system. At the end, a compromise was made. That is, KIC will have a two-tier system, but KIC President will be a member in both boards.[28] In the government's final bill, the board with supervisory role was named Steering Committee, while the management board was named Board of Directors.

Third, there were disagreements on how Civilian Members will be appointed. MOFE's initial draft prescribed that there be three Civil Members: one appointed by the Chairman of Korea Federation of Banks (KFB) among commercial bank presidents, another appointed by the Chairman of Korea Securities Dealers Association (KSDA) among securities firm presidents, and lastly one appointed by the President of Korean Institute of Certified Public Accountants (KICPA) among accounting firm presidents. Given the influence MOFE can exert over these trade associations, it was doubtful that they can be independent from MOFE and perform the necessary monitoring role. The Presidential Committee, on the other hand, supported the position taken in the consulting report. That is, establishing an Outside Director Nomination Committee, the members of which are, in turn, appointed by the National Assembly, MOFE, and BOK. At the end, a compromise was made. In the government's final bill, Civil Members are nominated by a committee composed of at least six members: two appointed by the Minister of Finance and Economy, two by the Minister of Planning and Budget, two by the Governor of BOK, and two by the head of every other organization entrusting assets to KIC above a certain threshold. MOFE had a strong opposition to the idea of giving politicians the power to appoint Nomination Committee members. According to the final bill, the Steering Committee is composed of six Civil Members, the KIC President, and the heads of organizations entrusting more than the amount prescribed in the Presidential Enforcement Decree.

[28] The decision to go for a two-tier system was influenced by President Roh. He favored the two-tier system.

Fourth, MOFE's initial draft was very lax on the expertise requirement of Civil Members. They only had to have experiences and knowledge in the areas of financial industry and corporate management. Working experience in investment management industry was not a necessary condition. Moreover, MOFE's bill was completely silent on the expertise requirement of KIC executives. In response to the Presidential Committee's criticism, MOFE revised its bill. The government's final bill states that Civil Members of the Steering Committee and KIC executives must have expertise in the asset management industry. Detailed requirements, however, were delegated to the Presidential Enforcement Degree.

Fifth, in regards to board chair, MOFE proposed a co-chair system. Under MOFE's proposal, Minister of Finance and Economy and any other member, representing an organization entrusting assets more than a certain threshold, serve as co-chairs of the Steering Committee. The Presidential Committee, on the other hand, proposed that outside board members rotate to serve as chairman. On this issue, the Presidential Committee's proposal won over that of MOFE.

Sixth, in regards to internal audit, MOFE wanted to have a statutory auditor, while the Presidential Committee wanted an audit committee. According to MOFE's draft, the auditor is exclusively appointed by the Minister of Finance and Economy. Under the Presidential Committee's proposal, a subset of independent outside board members serves as audit committee members. The Presidential Committee criticized that an auditor appointed by the Ministry of Finance and Economy can never be independent from the Minister, and therefore will not be able to carry out its auditing role. Despite such criticism, MOFE's initial position won over that of the Presidential Committee.

Seventh, on the appointment of KIC President, MOFE initially proposed that Minister of Finance and Economy have the exclusive right to nominate the candidate to the President. The Presidential Committee, on the other hand, proposed that the candidate be nominated by the President Nomination Committee, composed of outside directors and members in the Outside Director Nomination Committee. This is exactly the proposal taken in the consulting report. At the end, the Presidential Committee and MOFE compromised. The government's final bill requires the Minister of Finance and Economy to consult with the Steering Committee before nominating the candidate to the President.

Eighth, on external audit, MOFE initially proposed that the Board of Audit and Inspection (BAI) have no power over KIC. According to this draft, National Assembly is the only outside entity that can request information from KIC. The Presidential Committee, on the other hand, proposed that BAI, in addition to the National Assembly, have power to audit and inspect KIC. On this matter, MOFE yield to the Presidential Committee.

Ninth, on transparency, MOFE's initial draft had no related provision. The Presidential Committee', on the other hand, proposed that KIC disclose its financial statements, investment policy, and investment

performance. The Presidential Committee's proposal, however, delegated the details of this disclosure to the Presidential Enforcement Degree. Negotiations between the two lead MOFE revise its draft. According to the bill submitted to the National Assembly, KIC must disclose the basic directions of its investment policy and the overview of its investment performance. MOFE was not enthusiastic about transparency. According to this bill, the details on this disclosure were delegated to KIC's articles of incorporation (AOI).

Tenth, on the relationship with asset entrusting organizations, MOFE's initial draft states that the Minister of Finance and Economy can request any asset entrusting owner listed in the Presidential Enforcement Decree to entrust the management of its assets to KIC, and upon such request, asset entrusting organizations cannot refuse. Furthermore, the draft states that any investment management contract between asset entrusting organizations and KIC cannot have provisions that can restrict the way KIC manages the entrusted assets. The Presidential Committee strongly opposed to such draconian provisions, which led MOFE to revise the bill.

Government versus PSPD

The government's bill had to overcome a number of hurdles before it finally passed at the National Assembly in March 2005. Since the public notice of the bill in June 18 2004, the government had to confront strong oppositions from the People's Solidarity for Participatory Democracy (PSPD) – Korea's largest civil activist group – and the Grand National Party, the opposition party during President Noh's Presidency. Bank of Korea (BOK) also opposed vehemently. BOK was particularly concerned with the provision that allows the investment management contract between KIC and the entrusting organizations be dictated by the Presidential Enforcement Decree, which is drafted and *de facto* controlled by MOFE. The International Monetary Fund (IMF) also expressed its views on establishing KIC. In the 2003 Article IV Consultation Staff Report (released in February 2004), IMF staffs stressed the importance of safeguarding the independence of KIC and the transparency of its operations.[29]

On July 5 2004, two weeks after MOFE's public notice of the bill, PSPD held a press conference. The purpose was to alert the public of the problems with the KIC bill. PSPD did not oppose the need to

[29] On page 26, the report states "…the staff recognizes that the aim is to spur the development of the asset management sector, rather than to provide a mechanism to intervene in the market or a substitute for exchange rate flexibility. However, it believes that strong safeguards are necessary to guard against the risks involved. The agency's law should guarantee its operational independence, investment guidelines, and rules for any future transfer of reserves. Moreover, the KIC's accounts should be regularly and fully disclosed to the public, and it should refrain from investing domestically, at least until its credibility is established." The author of this paper had a meeting with the IMF Resident Representative (Kenneth Kang) in December 2003 and with the IMF mission team in May 2004.

establish KIC. It concurred that excess FX reserves need to be invested in more lucrative assets. But, it was concerned with the governance structure and the level of transparency the bill was prescribing. Following is the outline of the proposal laid out at the press conference.[30]

First, PSPD was concerned that the bill was giving the Minister of Finance and Economy too much power over KIC. According to the draft bill of June 18, the Minister approves the Articles of Incorporation (AOI) of KIC, nominates the KIC President candidate, appoints the Directors and Auditor of KIC, and requests asset entrusting organizations to hire KIC as its external manager. PSPD argued that such concentration of power in the hands of the Minister will make the Steering Committee obsolete. To let the Steering Committee take leadership role and to let Civil Members effectively monitor the Ministry, it was important that such functions be performed, not by the Minister, but by the Steering Committee.

Second, PSPD was concerned with the level of transparency the draft bill was prescribing. It stressed that the secrecy of its management cannot be justified on grounds that disclosure may weaken the government's ability to defend its currency in times of crisis. KIC will be managing excess reserves that are not likely to be used in FX market interventions. It also stressed the importance of disclosing KIC's target policy mix and the actual allocations. Once disclosed, politicians or bureaucrats will have hard time influencing KIC to invest more in certain asset classes. PSPD also emphasized that sufficient level of disclosure allows the general public to directly monitor KIC and pressure the National Assembly and BAI to carry out their monitoring roles more effectively. In the absence of such public disclosure, PSPD worried that the two organizations may suffer from moral hazard problems.

Third, PSPD expressed concerns over delegating important decisions either to the Presidential Enforcement Decree or to the Articles of Incorporation. Once delegated, the National Assembly will have no control over the matter, and there is a possibility that MOFE might water down the requirements. An example is the eligibility requirements of Civil Members that will be serving at the Steering Committee. Given the importance of ensuring their independence and expertise, it was strongly advised that detailed provisions be stipulated in the Act. This was also the position taken in the consulting report commissioned by the Presidential Committee. On matters related to subcommittees, compliance, and investment ethics, the draft bill was completely silent, in effect, delegating detailed provision either to the Presidential Enforcement Decree or to the Articles of Incorporation.

Fourth, PSPD pointed out that Steering Committee will suffer from a structural problem of pursuing two conflicting interests. According to the draft bill, the Steering Committee will be composed of members representing shareholders (Minister of Finance and Economy), asset entrusting organizations

[30] Among many action bodies of PSPD, this press conference was organized by the Economic Reform Center. As a member of this Center, the author of this paper drafted the proposal.

(Governor of BOK, Minister of Finance and Economy, and other public organizations in the future), and the general public (Civil Members). It is not hard to see that the interests of asset entrusting organizations and that of asset managers will be in conflict. Each party will be involved in the decision that should be determined solely by the other party. PSPD suggested removing members representing asset entrusting organizations from the Steering Committee.

In addition to the proposals mentioned above PSPD made many others. It suggested (i) prioritizing multiple missions, (ii) removing asset entrusting organizations and managers from the Civil Member Nomination Committee to ensure the Committee's independence, (iii) introducing a provision on whistle-blowing, (vi) giving asset entrusting organizations the exclusive right to make decisions on withdrawal, investment restrictions, and management fees, (vii) writing up a short list, which KIC can have the power to veto public disclosure, instead of giving KIC discretionary veto power, and (viii) making it mandatory for KIC to be subject to external audit by private sector accounting firms, in addition to audit and inspection by BAI.

PSPD's public criticism helped the Presidential Committee persuade MOFE and make further revisions to the draft bill before its final submission to the National Assembly in September. It also heavily influenced the National Assembly that later revised the bill substantially.

Government versus National Assembly

The bill was submitted to the National Assembly on September 17, 2004. But, it was not until November 17 that the National Assembly started to discuss the bill. On November 26, the Finance and Economy Committee – the standing committee at the National Assembly overseeing the Ministry of Finance and Economy – organized a public hearing. Among the four experts summoned, two opposed the bill, while the other two supported. Concerns raised by the opposing testifiers can be summarized as follows.[31]

First, they raised concerns that the missions granted to KIC – promoting the advancement of financial industry and contributing to the nation's economy – are too wide and elusive. It does not provide any clear objective, against which one can measure performance. Giving multiple of missions also has the danger of weakening the consistency of KIC's investment management. Measures to promote onshore asset management industry – integral part of the Presidential Committee's vision to transform Seoul into Northeast Asia's niche financial hub – can also harm KIC's investment returns if assets are entrusted to onshore management firms with little track record. They urged to restate the mission as "maximizing

[31] The author of this paper was one of the four that testified before the committee. The summary is based on my own testimony.

international purchasing power, taking into account an acceptable level of risk." This is the exact same phrased suggested in the consulting report commissioned by the Presidential Committee.

Second, they raised concerns over the provisions that allow KIC to incur debts and to make investments in KRW-denominated domestic assets. Under such arrangement, KIC would be vulnerable to pressures to boost up the domestic stock market or to intervene in the FX market.[32] In particular, incurring KRW-denominated debts refutes the very rationale of its establishment. As laid out in the Presidential Committee's report, dated December 11, 2003, the government is establishing KIC to enhance the returns on its FX reserves, and thereby minimize the loss BOK was suffering from high KRW interest rates. Incurring further debts denominated in KRW would only make the matter worse. They urged the law makers to prohibit KIC from incurring debt and from investing in domestic assets.

Third, they strongly argued that BOK, as an asset entrusting owner, should have the exclusive right to make withdraws and to impose restrictions on KIC's asset management. They discussed the practice followed in Singapore between Monetary Authority of Singapore (MAS) and CIG. Accordingly, they suggested removing the provision in the bill that prescribes the investment management contract between asset entrusting owner and KIC be determined by the Presidential Enforcement Decree.

Fourth, they raised concern that the bill is giving too much power to the Minister of Finance and Economy. Minister approves the Articles of Incorporation (AOI), nominates the KIC President candidate, and appoints the Directors and Auditor of KIC. They argued that such powers should be given to the Steering Committee. They also argued that detailed eligibility requirements for Civil Members and KIC President be stipulated in the Act instead of being delegated to the Presidential Enforcement Decree, which is *de facto* under the control of MOFE. Moreover, they suggested having provisions related to subcommittees, compliance and investment ethics in the Act. On subcommittees, they proposed to establish an investment committee and a compensation committee composed of Civil Members of the Steering Committee. This is in contrast to the provision in the bill that allows the establishment of advisory committees, composed of outside experts. To ensure the independence of Civil Member Nomination Committee, the testifiers also suggested adding the speaker of the National Assembly or the Chairperson of the Finance and Economy Committee in the list of persons that can appoint Nomination Committee members.

Fifth, they criticized the level of transparency the bill was prescribing. In particular, they pointed out the problem of giving KIC the power to veto National Assembly's disclosure of KIC-related non-public information. Instead of granting KIC the discretionary veto power, they argued that the Act have a

[32] To purchase US dollars in the FX market, KIC would have to borrow in KRW.

provision listing the items that should not be publicly disclosed. Other items, they argued, should be fully disclosed to ensure effective outside monitoring.

Sixth, they criticized the creation of KIC Establishment Committee that was prescribed in the bill's addendum. According to the addendum, this Committee assumes two important tasks before KIC's official launch. It recommends the KIC President Candidate to the Ministry of Finance and Economy. It also prepares the Articles of Incorporation that will be approved by the Minister of Finance and Economy. The testifiers expressed concern that this Committee significantly weakens the role of KIC Steering Committee. They suggested that the Steering Committee should be created first and then let the Steering Committee recommend the KIC President candidate and approve the Articles of Incorporation.

Between December of 2004 and February to 2005, the Finance and Economy Committee revised the bill taking into considering the criticisms, raised at the public hearing. First, the mission statement was slight modified. Between the two missions – promoting the advancement of financial industry and contributing to the nation's economy – the revised bill dropped the latter. Second, the revised bill removed the provision that gives KIC the right to issue debts. Third, it removed the provision that gives Minister of Finance and Economy the power to approve KIC's Articles of Incorporation. The final approval right was given to the Steering Committee. Fourth, the revised bill adopted provisions that stipulate the eligibility requirements of Steering Committee Civil Members,[33] the KIC President,[34] the CIO,[35] and the auditor.[36] Fifth, the revised bill revamped the composition of Civil Member Nomination Committee. According to the revised bill, it is composed of six members, each appointed by head of organizations stipulated in the Act. The organizations include (i) a finance-related academic association determined by the Presidential Enforcement Decree,[37] (ii) the Asset Management Association of Korea (AMAK), (iii) the Korea Federation of Banks (KFB), (vi) the Korea Life Insurance Association (KLIA), (v) the Korea Securities

[33] On the expertise requirement, Civil Members must either be (i) a person employed at a university or research institute and whose research experience in finance or investment is 10 or more years, (ii) a person with 10 or more years of experience in investment management at international financial organizations or domestic/overseas financial institutions of more than a certain size set forth by the Presidential Enforcement Decree, or (iii) an attorney-at-law or a certified public accountant with10 or more years of experience in finance, investment or company auditing. The revised bill also bans employees of asset entrusting organizations from being appointed as Civil Members of the Steering Committee. The revised bill also imposes a three-year cooling period, during which KIC retirees cannot serve as Steering Committee Civil Members.

[34] The KIC President must have 10 or more years of experience in either finance or investment related areas.

[35] The CIO must have 10 or more years of experience in investment management at international financial organizations or domestic/overseas financial institutions of more than a certain size set forth by the Presidential Enforcement Decree

[36] Auditor must either be (i) a person with 10 or more years of experience in finance or investment related areas, or (ii) a certified public accountant (CPA) with 10 or more years of experience in corporate auditing.

[37] The Decree later names the Korea Money and Finance Association to be the academic association that can nominate Civil Member Nomination Committee members.

Dealers Association (KSDA), and (vi) the Korean Institute of Certified Public Accountants (KICPA).[38] This was closer to the original draft prepared by MOFE in June 2004. Given the influence MOFE has over these trade organizations, it is doubtful that the Nomination Committee can be independent from MOFE.

Sixth, the revised bill introduced the KIC President Nomination Committee, which is composed of Civil Members of the Steering Committee and members each appointed by organizations that have entrusted assets to KIC above the threshold specified by the Presidential Enforcement Decree.[39] According to the revised bill, the Chairman of the Nomination Committee must be elected among Civil Members. Seventh, the revised bill also introduced provisions related to internal control. Specifically, the bill prescribes KIC to adopt internal control standards, and to appoint a compliance officer. KIC President must secure approval from the Steering Committee before appointing the compliance officer. Eighth, the revised bill removed provisions that allow the investment management contract between KIC and the entrusting organizations to be dictated by the Presidential Enforcement Decree. In effect, the contract became a voluntary one that must be negotiated between the two parties. Ninth, the revised bill introduced a provision that, in principle, bans investment in KRW-denominated domestic assets. Specifically, it states that KIC, in principle, must manage its entrusted assets in foreign currency denominated assets. If KIC manages KRW-denominated assets temporarily for an inevitable reason, it must be either in the form of bank deposits or passively holding public debt. Tenth, the revised bill also prescribed that assets entrusted by different organizations must be kept in separate accounts.

Eleventh, the revised bill prescribes that management fee, its payment procedure, and its form of payment should be negotiated between KIC and the entrusting organization. Twelfth, the revised bill stipulated the items that must be disclosed by KIC. According to this revision, KIC must disclose (i) the financial statements of KIC and the accounting rules used, (ii) the auditors' report, (iii) investment policy statement approved by the Steering Committee, (iv) the total assets under management, (v) the overall investment performance, (vi) asset allocation weights and performance of each asset class set forth by the Presidential Enforcement Committee, and (vii) changes in its fund managers.[40] Lastly, the revised bill removed the provision that gives KIC the power to veto National Assembly's disclosure of KIC-related non-public information. It granted the National Assembly the right to disclosure such information

[38] With the merger between AMAK and KSDA in 2009, the nomination is now carried out by the Korea Financial Investment Association (KFIA).

[39] The Decree later set the threshold to be 1 trillion KRW (approximately, 1 billion US dollars).

[40] It is not clear why the Finance and Economy Committee introduced a provision that requires KIC to disclose the name of its fund managers. To meet this requirement, KIC in practice discloses the names of its internal fund managers. KIC, however, does not disclose the names of its external managers, nor those of its custodians.

provided that it is approved by the standing committee overseeing KIC.

The bill passed the plenary session on March 24, 2005, and took effect from July 1st 2005.

III. EVOLUTION

1. Evolving Views on KIC's Mission

As mentioned earlier, the official mandate of KIC can be found in the Korea Investment Corporation Act. In Article 1, the Act states that KIC is to conduct efficient management of assets which are entrusted by the Government, the Bank of Korea, etc., and thereby contribute to the development of financial industry. The Act or its enforcement decree, however, does not make any further effort to clarify what exactly "efficient management" means or what constitutes "the development of financial industry." Such widely and elusively defined mission statement can give rise to two possibilities. One is that KIC's mission can changed over time. Another is that it can have multiple missions. Both are problematic. Under such circumstances, one cannot have a well designed investment policy statement (IPS) and managers subject to that can lose a sense of direction, ultimately damaging its performance. In this sub-section, I go over how policy maker's view of KIC's mission evolved over time.

Countermeasure against Capital Inflows

As discussed in the previous section, KIC was first discussed as a tool to address the problem related to surges of capital inflows. The outbreak of currency crisis triggered a huge capital outflow. In November and December of 1997, Korea experienced a financial account deficit of 10.5 billion US dollars. Withdraw of dollar loans from Korean banks accounted 99 percent of the outflow. But, foreign exchange shortage soon switched to a surplus. First of all, the weak currency value and the collapse of domestic demand contributed to a huge current account surplus: 42.6 billion US dollars in 1998 and 24.5 billion US dollars in 1999. Consequently, the KRW-USD exchange rate that peaked at 1,964.8 on December 24, 1997 was already down to 1,155.90 by the end of June 1999.

The pressure on exchange rate strengthened in the 4th quarter of 1999 as financial account also switched to a surplus. The successful debt restructuring of Korean banks' short-term external debt in January 1998 slowed down the withdrawal of bank loans thereafter.[41] The fire sale of Korean firms to foreign acquirers also increased foreign direct investments. The successful corporate debt restructuring of Daewoo group – the 4th largest conglomerate as of 1996 – by the end of 1999, also triggered foreign

[41] For a detailed account of Korean bank's short-term debt restructuring, see Kim and Byeon (2002).

portfolio investments.[42] Consequently, in the 4th quarter of 1999, Korea's financial account recorded a 6 billion US dollar surplus. In the following quarter, the surplus increased to 9.6 billion US dollars. <Figure 2> shows a bar chart of monthly financial account surpluses during July 1997 and March 2000.

In the face of this sudden shift to FX surplus, Korean government heavily intervened in the foreign exchange market and accumulated foreign exchange reserves. The reserve, which was only 20.4 billion US dollars in December 1997 – to be exact, 4 billion US dollars on December 18, 1997 – reached 74 billion US dollars by the end of 1999. <Figure 3> shows a bar chart of monthly FX reserves from January 1997 to March 2000. Korean government's market intervention was justified on many grounds. First, accumulating reserves was the key to restore confidence among international investors. Moreover, the accumulation of reserves was inevitable to later pay back Korean government's drawings from the IMF under the stand-by agreement and loans from the World Bank. Third, the KRW-USD market at that time was too thin to handle large foreign exchange transactions. Without smoothing operations, it was obvious that the exchange rate could be easily misaligned from its fundamentals.

Between current account and financial account surpluses, policymakers in Korea were particularly concerned with the latter. They were concerned that surges of capital inflows would appreciate the domestic currency, and then deteriorate the current account balance. The currency crisis in 1997 clearly demonstrated that a sudden stop in capital inflows coupled with current account deficit can make the country extremely vulnerable. Against this policy dilemma, foreign exchange market intervention was the obvious solution for the policy makers. By purchasing dollars in the market, the government can ease the downward pressure on exchange rate, and thereby maintain the price competitiveness of Korea export products. Also, the accumulated foreign exchange reserve can be used later in time of crisis.

But, Korean policy makers understood that foreign exchange market intervention cannot be used for extended years. They feared that it would be viewed as exchange rate manipulation from trading partners. Policy makers wanted a less controversial solution. One was encouraging residents to engage in overseas portfolio investment. If enough money is invested abroad, this will offset capital inflows and thereby ease the pressure on exchange rate. In fact, in December 1999, the Ministry of Finance and Economy announced that it would exempt capital gains tax on overseas portfolio investment. The government, however, did not achieve much to this end. In 2000, private sector's overseas portfolio investment recorded only 0.5 billion US dollars

Against this backdrop, establishing a sovereign wealth fund dedicated for overseas investment was an attractive alternative. One obvious merit is that government can force the fund to invest in overseas

[42] For a detailed account of Korea's corporate restructuring during 1998-2001, see Mako (2002).

assets, while it cannot do so to private sector residents. Since part of the foreign exchange reserve will have to be transferred to the fund, the reserve will accumulate much slowly and thus bring about less controversy.

Greater returns on FX reserve

With the accumulation of foreign exchange reserves a new concern emerged. Since Korea sterilized most of its interventions, it issued huge amounts of KRW denominated debts – either monetary stabilization bonds or foreign exchange stabilization bonds – and the interests they had to pay were well above the interests earned on foreign currency reserves. This problem was aggravated with continued dollar depreciation against the Korean won. So, government lost money on two ends: interests and currency. Clearly, this was a deviation from the interest parity condition. But, this deviation did not disappear for many years, and the loss kept accumulating.[43] <Figure 4> shows the yields on US Treasury notes (2 year) and monetary stabilization bonds (2 year) during March 1999 - December 2003.

By 2003, the issue was well understood even among politicians. At the National Assembly, politicians questioned whether the amount of reserve was excessive. Related to this, in April 2003, the Ministry of Finance and Economy reported that the accumulated loss from its Foreign Exchange Stabilization Fund was 2.4 trillion Korean won (approximately, 2 billion U.S. dollars) as of December 2002.[44] Given that Foreign Exchange Stabilization Fund constitutes only a part of total reserves, the accumulated loss must have been much greater.[45] Of course, maintaining a high level of reserve brings about a number of intangible benefits. It restores the confidence among international investors, it allows Korean banks to borrow at a lower rate, and ultimately prevents future currency crisis. Such benefits certainly outweigh the losses that were reported. Nevertheless, criticism continued.

Against this backdrop, the idea of setting up a sovereign wealth fund emerged again. If part of excess reserves is entrusted or transferred to the fund, and if the fund invests in more lucrative investments, the government can stop the loss from mounting. A long investment horizon and a greater

[43] There are two reasons behind this deviation. One is the near absence of foreigners in the Korean fixed income market. The other is heavy FX market intervention combined with sterilization, which effectively absorbed the downward pressure on domestic interest and exchange rates.

[44] This fund issues KRW-denominated bonds and purchases dollars using the Korean won it financed. It then deposits the dollars at the Bank of Korea (BOK). In 2002, the coupon rate on the foreign exchange stabilization bond was 8.0%, while the deposit rate at BOK was only 2.7%. Korean won also appreciated in 2002 by 10% (1326.1 → 1200.4). The fund's dollar deposits at BOK also constitute the total foreign exchange reserve.

[45] Since foreign exchange stabilization bond is a government bond, its issues requires approval from the National Assembly. Monetary stabilization bond, which is issued by BOK, on the other hand, is not a government bond, and its issuance therefore is not subject to National Assembly's approval.

risk appetite would allow the fund to invest in riskier and less liquid assets, which would normally generate higher returns. This role was certainly in the minds of the lawmakers when they passed the Korea Investment Corporation Act in March 2005. The phrase "efficient management" that appears in Article 1 of the Act meant to say this in a crude way.

Seoul as East Asia's Financial Hub

As mentioned in the previous section, in December 2003, the Presidential Committee on Northeast Asia Business Hub and MOFE released a joint report that proposed the establishment KIC. The newly added rational was to use KIC as a vehicle to attract foreign asset management companies to Seoul, and thereby transform Seoul into Northeast Asia's financial hub. It suggested that KIC give mandates to foreign asset management companies and induce them to relocate themselves in Seoul. This is precisely the measure Singapore took in 1998. As mentioned earlier, GIC and MAS earmarked 35 billion SGD (approximately 19 billion USD; 25 billion SGD from GIC and 10 billion SGD from MAS) to be placed out to external managers, regardless of nationality, over three years till 2000. They were hoping that this will act as seed money to grow the Singapore fund management industry.

As mentioned earlier, the Korea Investment Corporation Act states, in Article 1, that KIC is to conduct efficient management of assets which are entrusted by the Government, the Bank of Korea, etc., and thereby contribute to the development of financial industry. Asset management industry was certainly the key financial industry the lawmakers had in mind when they passed the Act in March 2005.

Preventing FX Liquidity Crisis

Many countries were hit hard by the global financial crisis of 2008. Korea was no exception. With global liquidity quickly drying up, Korean banks failed to roll-over their external debt, the value of Korean won nose-dived against the U.S. dollar, and the size of foreign exchange reserve plummeted in the course of intervention. The KRW-USD exchange rate peaked on March 3rd 2009 at 1,573.60, and reserves dropped by 63.7 billion US dollars over a seven months period (March-November 2008). <Figure 5> shows how the KRW-USD exchange rate and the reserves evolved during the crisis period.

At first glance, the reason behind this acute crisis is not very different from that Korea experienced during the Asian crisis, back in the late 1990s. Korean banks had huge external debt, mostly in short-term. At second look, however, there are fundamental differences. Back then, the crisis was triggered, in large part, by local problems. This time, the crisis originated outside of Korea, triggered by problems in other countries. The nature of excessive short-term dollar borrowing is also quite different. Back then, it was to lend loans to Korean corporations. This time, it was to square the long dollar positions Korean banks

entered when they purchased dollars forward from Korea ship manufacturers and Korean overseas portfolio investors.[46] <Table 1> reports the volume of dollar forwards sold during the pre-crisis period. FX risk management using FX derivatives was at the heart of the crisis.

Another interesting feature of the crisis was that Korea's external debt situation was exacerbated by the local branches of foreign banks. Even when Korean banks could no longer borrow at competitive rates, during the U.S. subprime mortgage crisis in 2007, foreign bank Seoul branches supplied dollars at cheap rates through FX swap.[47] Since these branches financed the dollars from their parent banks, Korea's external debt soared.[48] <Figure 6> and <Figure 7> show the level of Korea's external debt. When the crisis hit, not only Korean banks, but also foreign bank Seoul branches had to pay back their borrowings. This meant that FX swaps could no longer be rolled-over. Korean banks had to pay back not only their direct dollar borrowings, but also their obligations against foreign bank Seoul branches. Appendix 1 summarizes the nature of the 2008 FX liquidity crisis.

Against this backdrop, an idea of using KIC as a substitute of foreign bank Seoul branches emerged. That is, letting KIC enter FX swaps with Korean banks, and thereby replace the role played by foreign bank Seoul branches. Under this new arrangement, Korean banks would enter FX swap agreements with KIC instead of foreign bank Seoul branches. Since KIC does not need to finance dollars externally, Korea's external debt would not increase and therefore would be less vulnerable to external shocks. To date, no official statement was made by the government on this idea. But, it was mildly suggested in the press release (dated June 14 2010) made by the Ministry of Strategy and Finance (MOSF) when announcing measures to limit capital flow volatility.[49] In the press release, the Ministry made it clear that it would increase KIC's asset under management (AUM) to 50 billion US dollars by 2015 and, if necessary, use it as a source of FX liquidity.[50] No details, however, were provided. Prior to this press release, a number of news papers speculated that KIC would enter the FX swap market and replace the role played by foreign bank Seoul branches. They anonymously quoted officials from the MOSF.[51] By August 2010, it became evident that this view is also shared outside the government. One private think

[46] See Appendix 2 on how dollar borrowing can hedge FX risk when a bank has a dollar forward position in its balance sheet.
[47] Dollars were also provided in the form of currency return swaps (CRS). CRS transactions defer from FX swap transactions in two ways: the maturity is longer (more than a year) and it involves an exchange of interest income.
[48] Foreign banks' Seoul branches are considered residents in balance of payments accounting.
[49] In 2008, Ministry of Finance and Economy was renamed as the Ministry of Strategy and Finance.
[50] At the time of this writing (June 2011), it is already expected that KIC's total assets under management would surpass 50 billion US dollars by the end of 2011.
[51] See E-Daily (February 25, 2010 and July 19, 2010). MOSF, however, officially released a commentary stating that the Ministry has never deliberated such an arrangement.

tank released a report proposing that KIC enter the FX swap market.[52] The Presidential Council on National Competitiveness, chaired by the former Minister of Strategy and Finance, also urged in January 2011 that the National Assembly pass the bill revising the Korea Investment Corporation Act. The revision bill allows KIC to hold KRW-denominated assets, which is a necessary condition for KIC to enter the FX swap market.

This new arrangement may have two other benefits. First, KIC may be able to profit from arbitrage opportunities. During the pre-crisis period (2007 2H – 2008 1H), KRW-USD exchange rate deviated substantially from the covered interest parity (CIP) condition. Interest differential (domestic – foreign) was on average higher than the swap rate (F/S – 1) by 200bp. This allowed foreign bank Seoul branches to profit from USD carry trading that involves FX swap (spot sell & forward buy) transactions with Korean banks. <Figure 8> and <Figure 9> depict this deviation during 2008-2009. Second, since KIC will be holding KRW, instead of USD, once it enters FX swap agreements, Korea's foreign exchange reserve will drop, which may mitigate two concerns of hoarding reserves: the opportunity cost of holding low interest dollar assets and the suspicion of exchange rate manipulation raised by trading partners.

There are a number of concerns on this idea though. First, foreign exchange liquidity crisis is now less likely thanks to a number of policy measures taken by the government in recent years. In June 2010, the Ministry of Strategy and Finance announced that it will impose a limit on bank's (including foreign bank Seoul branches) FX forward positions. The limits are 50% and 250% of equity capital for Korean banks and foreign bank Seoul branches, respectively. This measure will limit the amount of FX swap transactions between the two, and thereby lower the level of Korea's external debt. Moreover, in December 2010, Korean government announced that it would impose Macro-prudential Stability Levy on non-deposit foreign currency liabilities. This was announced a month after the G20 Seoul Summit where the leaders have agreed on the need for design and implementation of macro-prudential measures to curb excessive capital flows. The measure has four key features: (i) the Levy will be charged on "non-deposit foreign currency liabilities" that appears in bank balance sheets; (ii) the Levy will first apply to banks including domestic banks and foreign bank branches; (iii) the Levy rate will vary according to debt maturity; (iv) the Levy will be collected in foreign currency and later used in times of crisis to stabilize the financial market. With these two measures, there is less need to use KIC as a vehicle to prevent FX liquidity crisis.

Another concern is that it may give rise to a moral hazard problem. Since KIC will continue rolling over its FX swap agreement even in times of FX liquidity crisis, Korean banks may be *ex ante* less wary

[52] The report by Jeong and Jung (2010) was issued by Samsung Economic Research Institute (SERI).

of their FX liquidity management. In essence, the new arrangement is no different from Bank of Korea directly providing dollar liquidity via FX swap in times of crisis. If this is known *ex ante*, same kind of moral hazard problem may arise.

Lastly, there is an argument that the root cause of excessive FX swap transaction is government's intervention in the spot market combined with sterilization (Song, 2010). Intervention may have slowed down the fall of KRW-USD exchange rate and sterilization may have slowed down the fall of domestic interest rate. This may have caused the continued deviation from covered interest parity and lured in more FX swap transactions between foreign bank Seoul branches and Korean domestic banks. Such diagnosis calls for less FX market intervention, and if this is sufficient to lower the volume of FX swap transactions, there may be no role for KIC to play.

2. Operations and Portfolio Management

Operations

Immediately after the passage of KIC Act, MOFE established two divisions – the Financial Hub Planning Division and the Financial Hub Cooperation Division – in the Ministry that will carry out the tasks concerning Northeast Asia financial hub. Also, pursuant to the KIC Act, MOFE formed the KIC Establishment Committee, which carried out certain tasks prescribed in the Act.[53] In the absence of the Steering Committee, it recommended the KIC President candidate to the Minister of Finance and Economy. It also prepared KIC's first Articles of Incorporation (AOI), which was approved by the Minister of Finance and Economy on June 30, 2005.[54] On the exact same day, the President also approved the Presidential Enforcement Decree of the KIC Act. MOFE's investment of 100 billion KRW (approximately 100 million KRW when using the KRW-USD exchange rate of 1,000) as KIC's paid-in capital also took place on June 30.[55] KIC was ready for its official launched on July 1st 2005.

Just before the official launch of KIC, the President also designated Dr. Kang-Won Lee (July 2005 – July 2006) as the first President of KIC. He was as a former CEO of a major commercial bank, a major securities firm, and a major asset management company. In July, the Minister of Finance and Economy

[53] The Committee was composed of seven members: Vice Minister of Finance and Economy (chair) and members appointed by the six organizations that also appoint the members of the Civil Member Nomination Committee. The names of the KIC Establishment Committee members, however, have never been disclosed to public.

[54] KIC's Articles of Incorporation must be approved by the Steering Committee. The exception is the very first AOI. Pursuant to the KIC Act Addendum, the first AOI is approved by the Minister of Finance and Economy.

[55] Funding was made possible through the Foreign Exchange Stabilization Fund administered by MOFE. The KIC Act limits KIC equity capital at 1 trillion KRW (approximately 1 billion USD).

also appointed the first Auditor of KIC. Mr. Hongchul (Hank) Ahn (July 2005 – June 2008), however, was a former bureaucrat of MOFE. Popular press criticized that MOFE was using KIC as a vehicle to secure new positions outside the Ministry for its retired bureaucrats. In August, the President appointed six Civil Members of the Steering Committee. Dr. In-June Kim (August 2005 – June 2008), professor of economics at Seoul National University, served as the fist Chairman. But, it was not until February 2006 that KIC was able to appoint its first Chief Investment Officer (CIO). Dr. Guan Ong held various senior investment positions for Prudential in Hong Kong (Portfolio Manager), Singapore (Senior Portfolio Manager), and Korea (CIO/CEO).

The investment management contract with BOK was concluded in June 2006. BOK pledged to entrust 17 billion US dollars by the first quarter of 2007. MOFE – Foreign Exchange Stabilization Fund, to be exact – also entered a contract with KIC in October pledging 3 billion US dollars. BOK, however, imposed a restriction that prescribes the assets entrusted by BOK be managed in a way that meets the definition of international reserves.[56] This meant that assets entrusted by BOK cannot be used for investments in private firms.[57] Investments in alternative assets had to be exclusively financed from the Foreign Exchange Stabilization Fund. According to the Presidential Enforcement Decree, BOK can withdraw from KIC if (i) the size of FX reserve fell by more than 10% for two consecutive months, (ii) Korea's sovereign rating fell below investment grade by two or more international credit rating agencies headquartered either in the US or in UK, or (iii) KIC breached the investment management contract and did not rectify such breach within 30 days. With the initial installment of funds from BOK, KIC launched its global fixed income investment in November 2006.

Since its inception, KIC had three CEOs. The first two, however, did not serve their three-year term. The first CEO, Dr. Kang-Won Lee, stepped down from his position serving only for one year. He was prosecuted for multiple accusations related to his work at Korea Exchange Bank (KEB) where he served as CEO before joining KIC. In October 2010, the Supreme Court released its final verdict sentencing him an 18-months imprisonment and levying him a fine of 150 million KRW for making slush funds and taking bribes. The second CEO, Serck-Joo Hong, served only for two years, again falling short of his three-year term. His replacement has to do with Korea's practice of replacing the heads of public institutions during the first year of Presidency. The positions are often replaced with people who helped

[56] The fifth edition of the IMF Balance of Payments Manual (BPM5), a country's international reserves refers to "those external assets that are readily available to and controlled by monetary authorities for direct financing of payments imbalances, for indirectly regulating the magnitude of such imbalances through intervention in exchange markets to affect the currency exchange rate, and/or for other purposes."

[57] According to BPM5, securities should include highly liquid, marketable equity and debt securities. Liquid, marketable, long-term securities (such as 30-year U.S. Treasury bonds) are included. Nonissued securities (that is, securities not listed for public trading) are excluded.

the President win the election. According to one study, there were a total of 280 CEO replacements in public institutions during a four-year period between May 2006 and April 2010.[58] But, 45% of the replacements took place over a six-month period between May 2008 and October 2008. Many CEOs had to step down before their term expired. President Myung-Bak Lee inaugurated in February 2008. The third CEO, Young-Wook Chin, served three full years. But, his appointment was criticized as he was a former bureaucrat who worked at MOFE for many years.

The appointment of KIC Auditors also raised concerns. First, among the three that served as KIC Auditors, only two are known to public. Even if one visits KIC's homepage, carefully reads its annual reports, or conducts extensive news article search, the second Auditor cannot be identified. Second, the first (Ahn, Hongchul) and the third Auditors (Kang, Hyung-Wook) are both former bureaucrats that have worked extensively at MOFE. This confirms BOK's earlier accusation that KIC might be used as a vehicle to secure outside positions for retiring bureaucrats.

The appointment of first CIO also raised concerns. During the inspection of state affairs in October 2006, Sang-Jung Shim, a member of the National Assembly, questioned whether Guan Ong meets the expertise requirement prescribed in the KIC Act. She claimed that his investment management experience spans only for 8 years (1998-2006), which falls short of a 10-year minimum set forth by the KIC Act. No concerns have been raised against the second CIO. Scott Kalb was an ex-hedge fund manager at Tudor Investment Corp. He also served as managing director at Citigroup's Smith Barney International Asset Management.

Since its inception, KIC's Steering Committee had three Chairs. The first Chair (In-June Kim) served his first term in full, but had to step down in mid 2008 in the middle of his second term. Notice that Civil Members of the Steering Committee have a two-year term. His replacement again has to do with Korea's practice of replacing the heads of public institutions during the first year of Presidency. The second Chair (Yoon-Dae Euh) was a former President of Korea University, from which President Myung-Bak Lee graduated. Dr. Euh was actively involved in the Presidential election. Dr. Euh, however, stepped down from his position in a year. A year later, in June 2010, Dr. Euh was elected as the CEO of KB Financial Group. Dr. Ke-Sop Yun assumed the Chair position in September 2009. He was a professor of finance at Seoul National University.

KIC Steering Committee formed a number of subcommittees. As of December 2010, it has two standing subcommittees – Investment and Risk Management – and two non-standing committees – Budget Review and Management Compensation. Each subcommittee is composed of four Civil Members.

[58] See Kim (2010b).

Pursuant to the Act on Public Institutions Management, KIC is required to disclose it executives' annual salaries and the minutes of its Board meetings.[59] The CEO received 480 million KRW (approximately 480,000 US dollars) each year during 2006-2007. In 2008, the pay level dropped down to 161 million KRW (approximately 161,000 US dollars). This was due to MOSF's new policy to lower executive pay of public institutions. During 2009-2010, the level of pay normalized back almost to its original level. The CEO was paid 467 and 391 million KRW, respectively, in 2009 and 2010. KIC also discloses the pay to its Auditor. The Auditor received 340 million KRW (approximately 340,000 US Dollars) each year during 2006-2007. In 2008, the pay level dropped down to 129 million KRW (approximately 129,000 US dollars). During 2009-2010, the level of pay normalized back. The Auditor was paid 232 and 252 million KRW, respectively, in 2009 and 2010. KIC, however, does not disclose the pay package for its CIO.

Pursuant to the Act on Public Institutions Management, KIC discloses its Board meeting minutes. But, the level of disclosure is minimal. They only disclose agenda titles. No underlying documents are attached, nor are any substantive discussions revealed. In case of Steering Committee meetings, KIC does not even disclose their agenda items.

During fiscal year 2010, KIC earned an aggregate investment management fee of 74.5 billion KRW, which is approximately 67 million US dollars (using the exchange rate of 1,100 KRW/USD). Given that the total size of entrusted assets is 36.9 billion US dollars, as of December 2010, average investment management fee can computed to be approximately 1.8%.[60] This level of management fee seems extremely high, given that KIC does not need to engage in any fund raising activities and given that 87.7% of assets are invested in public securities. Moreover, KIC re-entrusts 30% of entrusted assets. Thanks to such generous management fee, KIC has been recording positive net income since 2008.[61] During 2009-2010, it also paid out cash dividends to MOFE (20% dividend payout ratio).

As of December 2010, KIC has three divisions (Investment Management Division, Corporate Management Division, and Risk Management Division), one overseas office (New York Office), and hires 85 employees. The Investment Management Division is headed by the CIO who oversees the Investment Strategy Team, the Public Markets Group, and the Private Markets Group. Auditor heads the Audit Unit and appoints the external auditor. Samil PricewaterhouseCoopers has been KIC's external auditor since 2006.

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[59] They are available via www.alio.go.kr (in Korean).

[60] The size of total entrusted assets is slightly smaller than the size of total assets under management.

[61] Net incomes were -5.1 billion KRW (2006), -3.1 billion KRW (2007), 10.2 billion KRW (2008), 27.9 billion KRW (2009), and 16.3 billion KRW (2010). The drop in net income in 2010 is related to the fact that KIC started to make investments in alternative assets. Cash dividends to MOFE were 5.6 billion KRW in 2009 and 3.3 billion KRW in 2010.

Portfolio Management

As of December 2010, the total assets under management are 37.5 billion US dollars. This ranks KIC the 19th largest sovereign wealth fund (SWF) in the world. Among SWFs with non-commodity origins, it is the 8th largest. According to the government, KIC's total assets under management will be increased to 50 billion US dollars by 2015.

Pursuant to the KIC Act, KIC discloses its Investment Policy Statement (IPS).[62] Despite the mission statement in the KIC Act, the IPS of KIC states that it should achieve a stable and continuous return exceeding the benchmark within an appropriate level of risk. Benchmarks are disclosed in KIC's annual report.[63] Other than that, the IPS does not give much useful information. There is no discussion about KIC's risk tolerance level, nor does it give out strategic asset allocation (SAA) weights. The IPS discusses tactical asset allocation (TAA) and portfolio rebalancing, but does not give out any information on its tolerance bands. The level of disclosure is so poor that it raises the concern that KIC is in breach of the KIC Act. Also, it undermines the very reason why the National Assembly revised the bill and explicitly prescribed KIC to disclose its long-term investment policy statement. The idea was to allow the general public to monitor the operations of KIC. With the current level of disclosure, such purpose cannot be served.

Actual asset allocations and investment performances are disclosed in KIC's annual report. <Table 2> shows the allocations, as of December 2011. 87.7% of the assets are allocated in public securities: 41.8% in public equities and 45.9% in public bonds. Alternative assets take up 5.6-9.2%, depending upon whether or not one classifies KIC's Special Investments in the alternative asset class. Special Investments include KIC's direct exposure to strategically chosen industry sectors, such as energy and finance. All other alternative asset class investments are carried out by external managers. One issue regarding KIC's asset allocation is that its weight on public bonds may be considered to be too large. If the purpose of setting up KIC was to improve the returns on Korea's entire FX reserve, KIC's investment in public bonds does not serve the purpose at all. Investments in corporate bonds take up only 17.7% of KIC's exposure to public bonds.[64]

<Table 3> reports KIC's investment performance, which is not at all impressive. Since inception, its

[62] Detailed information on KIC's governance structure, operations, and investment policy can be found from its homepage (www.kic.kr/en).

[63] Morgan Stanley Capital International All Country (unhedged) for equities, Barclays Capital Global Aggregate (unhedged) for bonds, Barclays Capital Global Inflation-linked for inflation-linked bonds, S&P GSCI Light Energy for commodities, and G7 inflation+5% for other alternative assets (hedge fund, private equity, and real estate).

[64] Government bonds, securitized bonds, agency bonds respectively take up 45.9%, 20.5%, and 15.9%.

excess return over benchmark is -0.07%p. The level of disclosure is also poor. First, it is not clear whether the returns are net of fees. Second, it does not disclose the performance on its alternative investments. No discussion is found in the annual report on fair value pricing. Third, KIC no longer maintains its practice of reporting investment performance separately for each asset class. During 2007-2009, KIC used to report the performance on equity and fixed income, separately, but it stopped doing so since 2010. This is related to the way the Presidential Enforcement Decree defines asset classes. Instead of using the classifications familiar in the industry, the Decree lists securities, deposits, real estate, and others as separate asset classes. So, *de jure*, KIC is not in breach of the KIC Act. But, in spirit, it is clearly in breach. Fourth, there is no attribution analysis, nor is there any discussion about the level of risk KIC is taking.

Until August 2007, all the investments of KIC were carried out by external managers. In-house management, however, steadily increased.[65] As of December 2010, internal management takes up 70.7% of the traditional portfolio.[66] KIC, however, does not disclose the list of its external managers. Nor does it disclose its global custodian. Instead, it discloses the names of its internal fund managers. This is related to the careless drafting of the KIC Act that prescribes KIC to disclose changes in its fund managers. KIC interpreted this as disclosing the names of each internal fund manager.

In its annual report, KIC briefly discusses on how it exercises its voting rights. The annual report states that KIC has drawn up related procedures to ensure voting rights are exercised appropriately. But, KIC does not disclose its proxy voting guidelines, nor does it disclose the related procedures. Moreover, the annual report states that KIC's basic policy is to maintain a neutral stance for holdings of less than 1% or in the case of externally managed investments.

Among the KIC's Special Investments, the most noteworthy is its 2 billion US dollars acquisition of Merrill Lynch preferred stocks back in January 15, 2008. KIC was joined by two other investors: Kuwait Investment Authority and Japan's Mizuho Financial Group. Also, Temaseck Holdings was the largest shareholder of Merrill Lynch holding 9.6% of common shares. This was the time when sovereign wealth funds were in herds to acquire ailing US banks. They were betting that US will soon recover from its subprime mortgage crisis, which proved to be wrong.

More specifically, KIC purchased mandatory convertible preferred stocks with a 9% dividend yield that is scheduled to be converted to 38,160,000 common stocks in October 15, 2010.[67] KIC projected that the conversion will give KIC a 3% stake of Merrill Lynch. As market conditions worsened, Merrill Lynch

[65] In-house management of global fixed income investment started in August 2007. The in-house management of global equity investment started in March 2008.

[66] If we assume that special investments (3.7%) are internally managed and all other alternative assets (5.6%) are externally managed, the fraction of internal management drops slightly down to 69.8%.

[67] The conversion price is, in effect, 52.4 US dollars (= 2,000,000,000 US dollars / 38,160,000).

continued to take write-downs and make losses. As of July 25, common share price fell down to 27.5 dollars. Pursuant to the price reset clause, this prompt KIC to renegotiate the conversion terms with Merrill Lynch. On July 28, KIC announced that it converted its preferred shares into 72,243,217 common shares of Merrill Lynch and also received a dividend worth of 30 million US dollars. This was an inevitable move to minimize the loss. At the time of conversion, preferred shares were worth only 1,473 million US dollars for KIC.[68] Conversion made its investment worth 2,138 million US dollars.[69] Continued turmoil led Merrill Lynch to be taken over by Bank of America (BOA). In an all-stock transaction, each Merrill Lynch common share was exchanged for 0.8595 shares of BOA. This deal valued Merrill at 29 dollars a share, which represented a 70 percent premium. By the end of 2010, BOA's share price fell down to 13.23 dollars. If KIC still holds 62 million shares, its investment is worth only 821 million US dollars. This is approximately a 54.5% loss over a three-year period.[70] As of December 2010, KIC holds only a 0.61% stake of BOA.[71]

In 2010, KIC made a number of cross-border acquisitions in the energy sector. In June, it made a 200 million US dollars investment in Chesapeake Energy Co., a US natural gas company. KIC purchased convertible preferred shares jointly with CIC and Temasek Holdings.[72] In August, it made a 76.2 million US dollar investment in Laricina Energy, a Canadian thermal oilsands developer. KIC purchased 2.55 million common shares.[73] In November, it made another investment in the oilsands sector. KIC made a 99 million US dollar investment in Osum Oil Sands Corp. It purchased 7.7 million common shares.[74]

Assessment against Global Standards

KIC does not seem to be abiding by the Santiago Principles.[75] First, according to Principle 2, the policy purpose of the SWF should be clearly defined and publicly disclosed and the pursuit of any other types of objectives should be narrowly defined and mandated explicitly. As mentioned earlier many times, KIC's

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[68] 1,017 million USD worth of common stocks (38,160,000 shares X 26.65 dollars) + 397.5 million USD of dividend expected until October 2010 + 58.5 million USD of dividend KIC already received = 1,473 million USD.

[69] 1,925 million USD worth of common stocks (72,240,000 shares X 26.65 dollars) + 30 million USD of dividend + 58.5 million USD of dividend KIC already received = 2,138 million USD.

[70] [(821.5 million USD worth of common shock + 88.5 million USD worth of pre-paid dividends)/(2,000 million USD worth of initial investment)] – 1 = -0.545 (54.5%).

[71] Such holdings are not disclosed by KIC. This is based on the author's own calculation.

[72] The conversion price is 27 dollars per share. Dividend yield is 5.75%.

[73] Since KIC does not disclose ownership percentage of company holdings, the figures are based on web search.

[74] Again, the figures are based on web search.

[75] It is a code of conduct drafted by 27 IMF member countries with sovereign wealth funds in October 2008. It is also known as the Generally Accepted Principles and Practices (GAPP).

mission statement is unclearly defined with multiple objectives. Second, according to Principle 6, the SWF's operational management should be conducted on an independent basis. Early dismissals of its executives and appointment of former bureaucrats are jeopardizing KIC's independent operation. Third, according to Principle 21, SWFs should publicly disclose its general approach to voting securities of listed companies, including the key factors guiding its exercise of ownership rights. Also, to dispel concerns about potential noneconomic or nonfinancial objectives, SWFs should disclose *ex ante* whether and how they exercise their voting rights. Moreover, to demonstrate that their voting decisions continue to be based on economic and financial criteria, SWFs could also make appropriate *ex post* disclosures. According to the same principle, SWFs are also expected to disclose their general approach to board representation. As mentioned earlier, KIC does not *ex ante* disclose its proxy voting guideline, nor does it make appropriate *ex post* disclosure of its proxy voting. Also, no policy has been disclosed by KIC regarding board representation.

According to the Sovereign Wealth Fund Institute, KIC scores 9 out of a perfect score of 10 in terms of its transparency.[76] My own calculation, however, reveals that KIC should score 6. It should get 0 points on the following evaluation items: (i) Fund provides ownership percentages of company holdings, and geographic locations of holdings, (ii) fund provides total portfolio value, returns, and management compensation, (iii) fund provides guidelines in reference to ethical standards, investment policies, and enforcer of guidelines, (iv) if applicable, the fund identifies external managers.

[76] The index is named as the Linaburg-Maduell Transparency Index.

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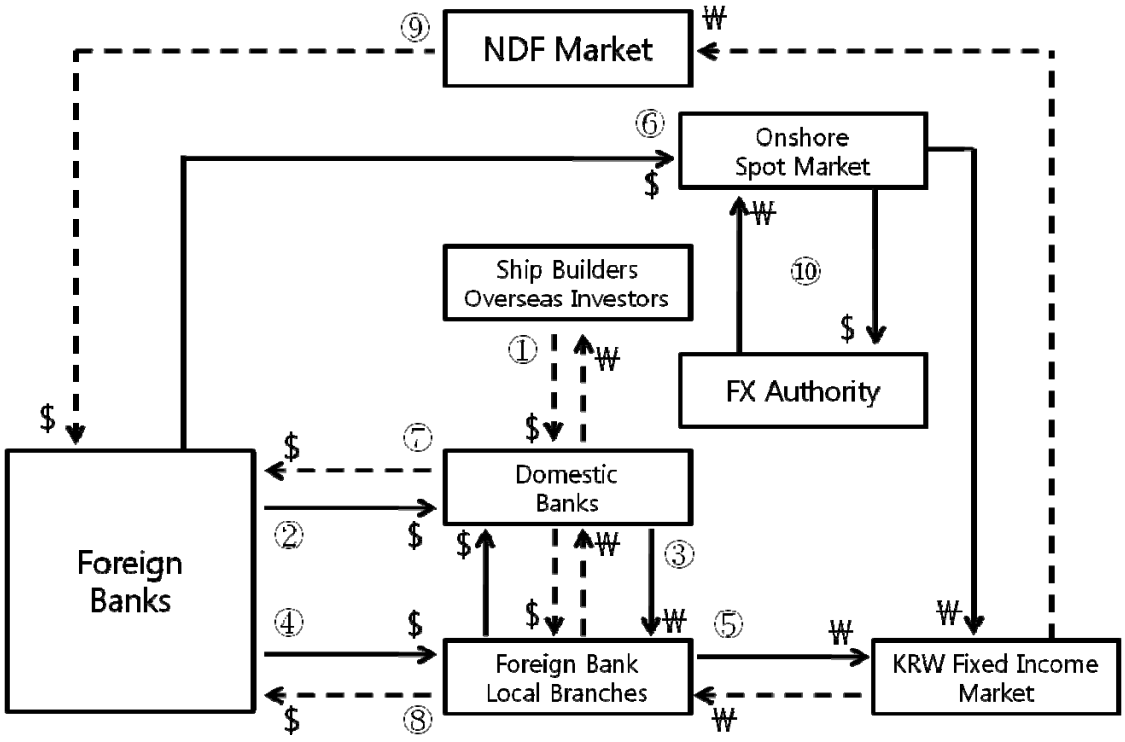
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APPENDIX 1
Korea's FX Liquidity Crisis of 2008-2009

Following chart effectively shows what happened before (2005-2006) and during (2008-2009) the crisis. The chart is originally from Kim (2010a).



Before the dollar liquidity crisis

① Korean shipping companies and overseas portfolio investors sell dollar forwards to Korean banks.
② Korean banks borrow dollar loans, mostly in short-term, from foreign banks
③ Korean banks enter swap agreements (spot buy & forward sell) with foreign bank Seoul branches.
④ Local branches of foreign banks borrow dollar loans, mostly in short-term, from parent banks.
⑤ Local branches of foreign banks invest in KRW-denominated fixed income securities.
⑥ Foreign banks directly engage in dollar carry trading.

After the dollar liquidity crisis

⑦ Foreign banks stop rolling-over short loans to Korean banks.
⑧ Foreign banks stop rolling-over short loans to their Korean braches.
⑨ Korean banks that sold dollars forward experience a loss
⑩ Market intervention by FX authority (MOSF and BOK)

APPENDIX 2
FX Risk Hedging by Korean Banks[77]

Suppose a Korean bank entered a forward contract with a ship building company, the former taking a long position in USD and the latter taking a short position. This bank's balance sheet and foreign exchange position will be as follows.

Balance Sheet

On B/S	
Off B/S	
Buy forward	+ 100 USD

FX Position

Spot Position	0
Forward Position	+ 100 USD
Buy forward	+ 100 USD
Overall Position	+ 100 USD

This bank, with its long USD position, will experience a translation loss if the value of USD falls against the KRW. To hedge against this, it needs to square the position, and this can be achieved in the following four ways. During the pre-crisis period, Korean banks mainly took the last three measures.

1. USD Forward Sell

If this bank enters a separate forward contract (100 USD) and take a short position, it can square out the original long position. Since this does not involve any transactions in the spot market, there will be no pressure on the KRW-USD spot rate.

Balance Sheet

On B/S	
Off B/S	
Buy forward	+ 100 USD
Sell forward	+ 100 USD

FX Position

Spot Position	0
Forward Position	0
Buy forward	+ 100 USD
Sell forward	- 100 USD
Overall Position	0

2. Currency Return Swap (CRS) Receive + Spot Sell

An alternative is to enter a CRS receive contract (100 USD) and sell the exact same amount of USD in the spot market. This CRS receive contract allows the bank to enter a short position that will square out the original long position. The contract also increases bank's USD deposits. To square out this newly created long position, it needs to sell USD in the spot market, which will lower the level of USD deposits to its original level. Since this alternative involves a spot sell, there will be a downward pressure on the KRW-USD spot rate.

[77] This appendix is originally from Kim (2010a).

Balance Sheet		FX Position	
On B/S		Spot Position	0
USD deposits	+ 100 USD	USD deposits	+ 100 USD
USD deposits	-100 USD	USD deposits	-100 USD
Off B/S		Forward Position	0
Buy forward	+ 100 USD	Buy forward	+ 100 USD
Sell forward	+ 100 USD	Sell forward	-100 USD
		Overall Position	0

3. Foreign Exchange Swap (FX Swap) Buy & Sell + Spot Sell

Another alternative is to enter an FX swap contract (100 USD) that involves a spot buy and a forward sell. Forward sell allows the bank to enter a short position that will square out the original long position. Since the contract involves a spot buy, it increases the bank's USD deposits. To square out this newly created long position, it needs to sell USD in the spot market, which will lower the level of USD deposits to its original level. Since this alternative also involves a spot sell, there will be a downward pressure on the KRW-USD spot rate. The balance sheet and the FX position table will be exactly same as those under CRS receive plus spot sell.

Balance Sheet		FX Position	
On B/S		Spot Position	0
USD deposits	+ 100 USD	USD deposits	+ 100 USD
USD deposits	-100 USD	USD deposits	-100 USD
Off B/S		Forward Position	0
Buy forward	+ 100 USD	Buy forward	+ 100 USD
Sell forward	+ 100 USD	Sell forward	-100 USD
		Overall Position	0

4. Dollar Borrowing + Spot Sell

Lastly, the bank can borrow USD (100 USD) and sell the exact same amount in the spot market. Since dollar borrowing will increase the bank's USD deposits, borrowing itself does not square out the original long position. It needs to sell USD in the spot market, and thereby create a short position. This will lower the USD deposits to its original level. Since this measure also involves a spot sell, there will be a downward pressure on the KRW-USD spot rate.

Balance Sheet		FX Position	
On B/S		Spot Position	-100 USD
USD borrowings	+ 100 USD	USD borrowings	- 100 USD
USD deposits	+ 100 USD	USD deposits	+ 100 USD
USD deposits	-100 USD	USD deposits	-100 USD
Off B/S		Forward Position	+ 100 USD
Buy forward	+ 100 USD	Buy forward	+ 100 USD
		Overall Position	0

Figure 1: Four Guiding Principles When Designing the Governance Structure of KIC

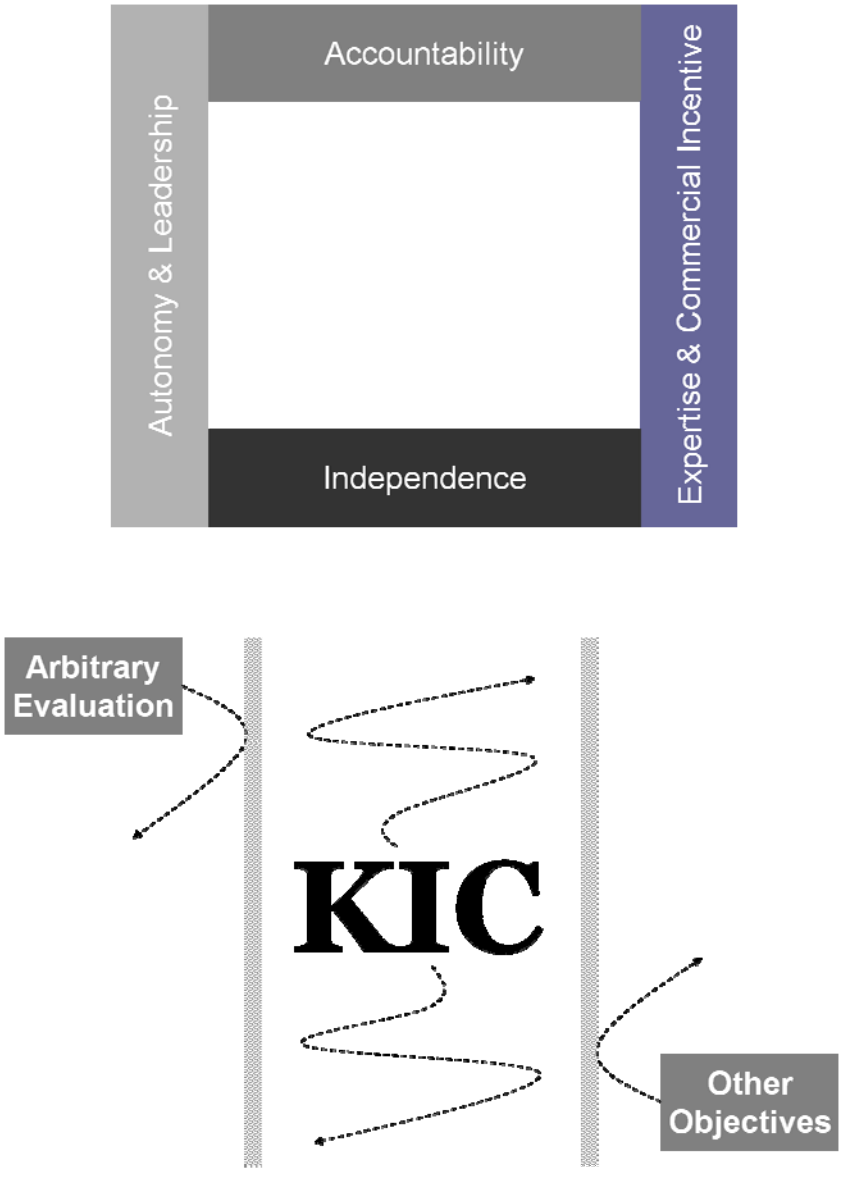
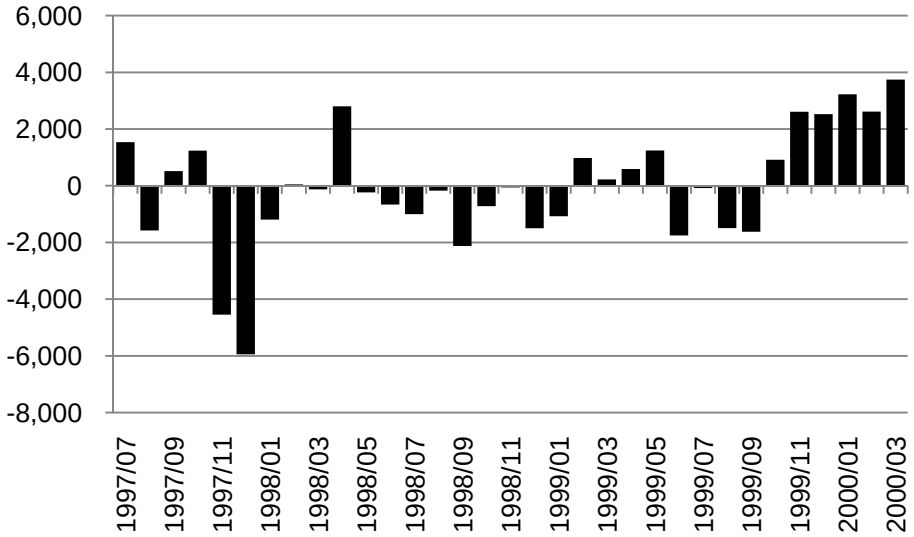
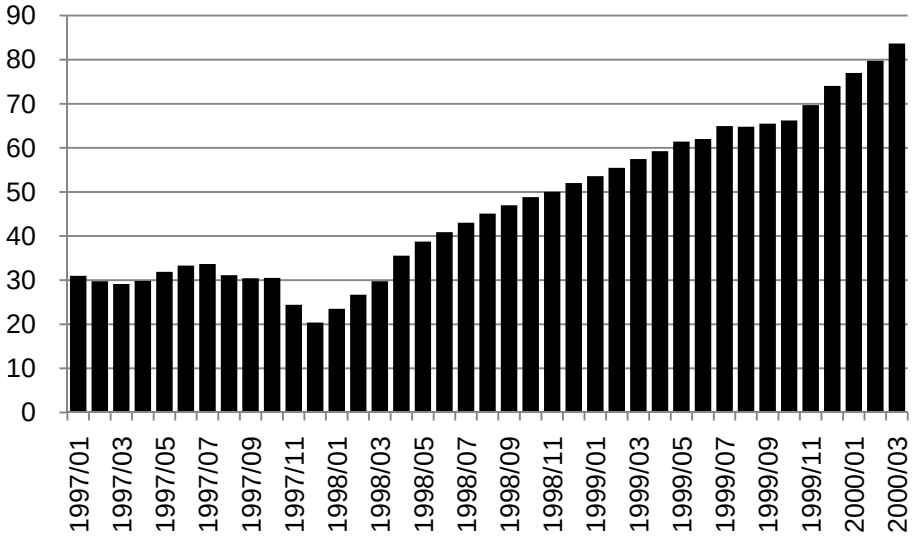


Figure 2: Korea's Financial Account Surplus (million USD, July 1997 – March 2000)



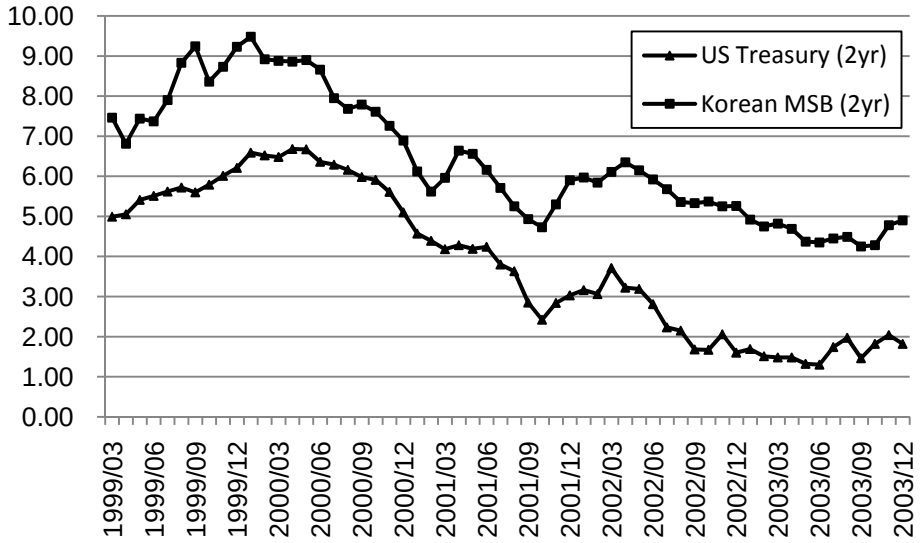
Source: Bank of Korea (BOK)

Figure 3: Korea's FX Reserve (billion USD, January 1997 – March 2000)



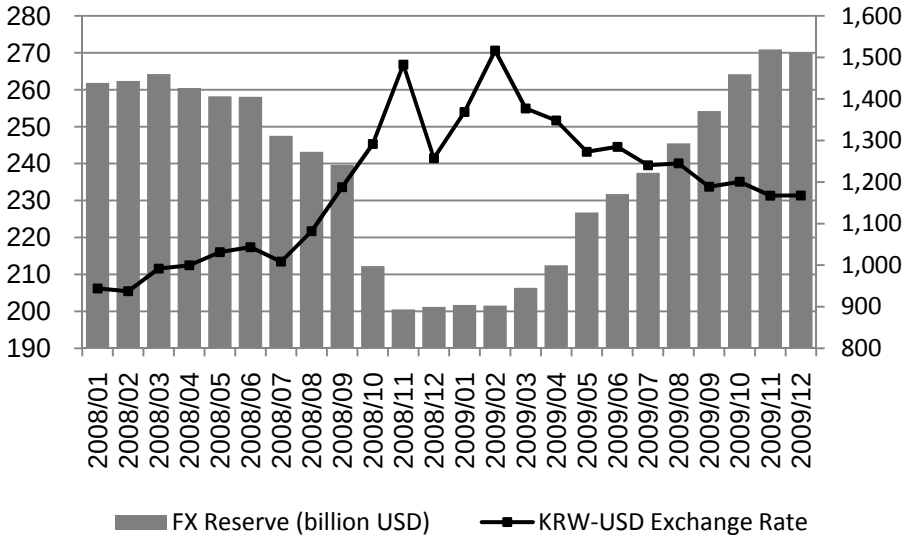
Source: Bank of Korea (BOK)

Figure 4: US Treasury (2yr) and Korean MSB (2yr) Yield (Mar. 1999 – Dec. 2003)



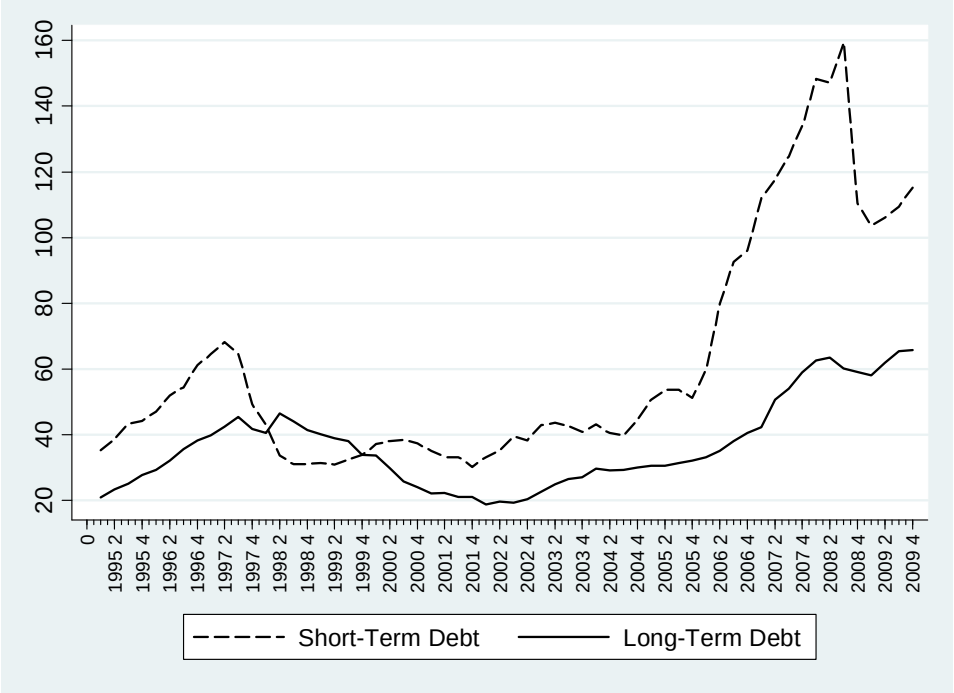
Source: Bank of Korea (BOK)

Figure 5: Korea's FX Reserve and KRW-USD Exchange Rate (2008-2009)



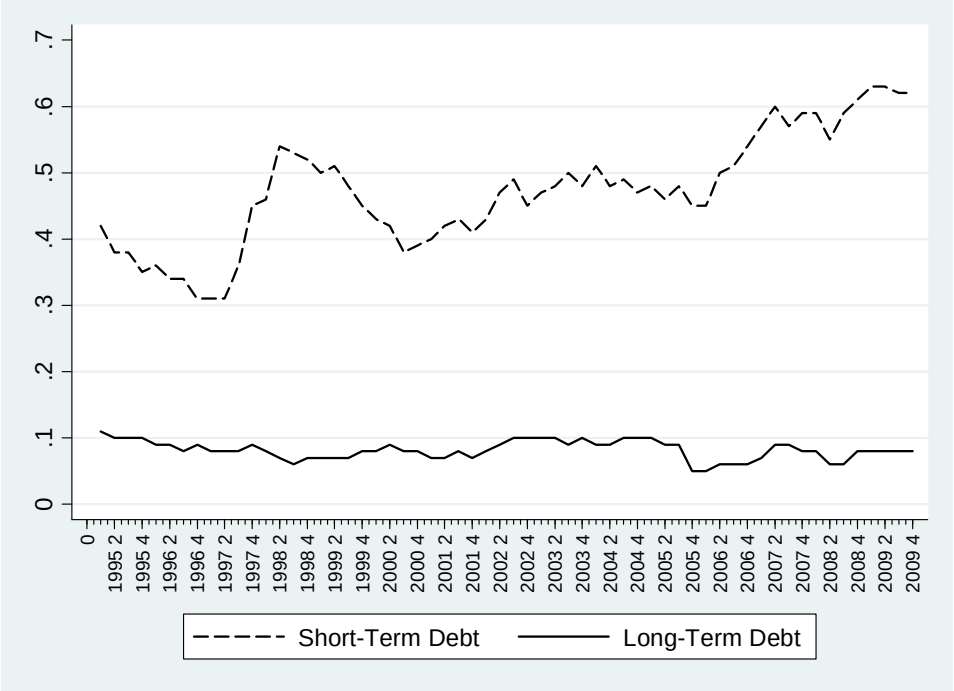
Source: Bank of Korea (BOK)

Figure 6: Korea's External Debt (Short-term vs. Long-term, 1995-2009)



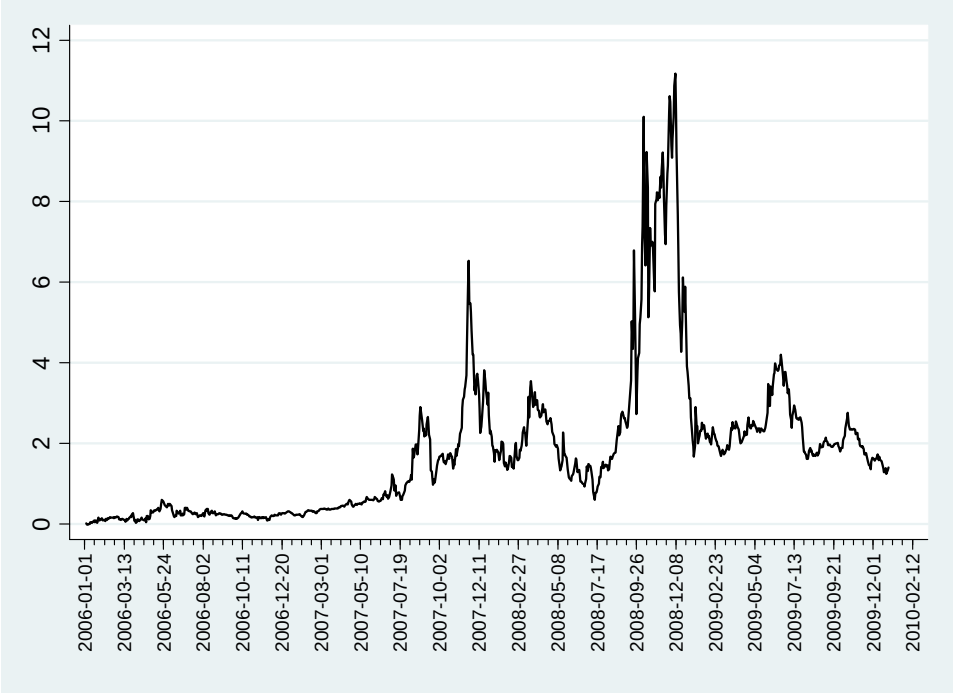
Source: Bank of Korea (BOK)

Figure 7: Korea's External Debt (Korean Banks vs. Foreign Bank Branches, 1995-2009)



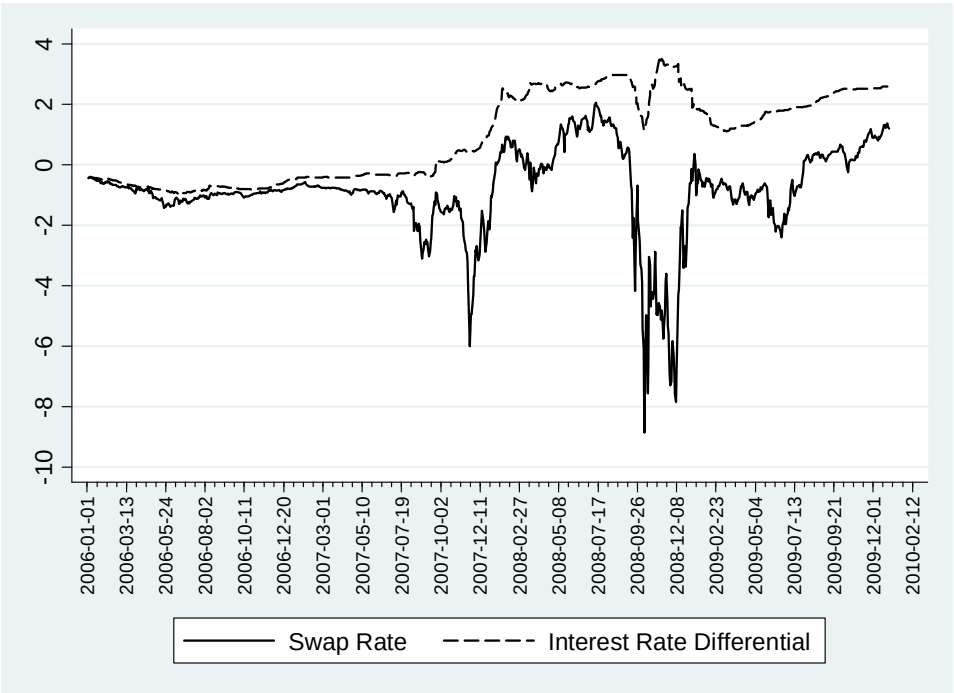
Source: Bank of Korea (BOK)

Figure 8: Deviation from Covered Interest Parity Condition (Jan. 2006 – Mar. 2010)



Source: Bank of Korea (BOK) and Bloomberg

Figure 9: Interest Rate Differential and Swap Rate (Jan. 2006 – Mar. 2010)



Source: Bank of Korea (BOK) and Bloomberg

Table 1: Korea's FX Forward Transaction Volume (2005-2008)

(unit: 100 million USD)

	2005	2006	2007	2008 (Jan.-Jun.)
Forward Sell (A)	731.6	1,127.7	1,531.7	964.6
Ship Building Firms	223.4	430.5	622.8	403.3
Others	493.2	566.2	636.9	524.3
Overseas Portfolio Investors	15.0	131.0	272.0	37.0
Forward Buy (B)	424.7	503.8	542.0	344.1
Oil Refinery Firms	60.7	10.1	25.1	33.1
Others	364.0	493.7	516.9	311.0
A - B	306.9	623.9	989.7	620.5

Source: Yang and Lee (2008)

Table 2: KIC's Asset Allocation

(unit: million USD)

	Asset Class	AUM (US$mn)	Weight (%)
Traditional Assets	Public Equities	15,711	41.8
	Public Bonds	17,229	45.9
	Inflation-linked Bonds	527	1.4
	Cash, other	622	1.7
Alternative Assets	Commodities	485	1.3
	Private Equity	670	1.8
	Hedge Funds	500	1.3
	Real Estate	430	1.1
Special Investments	Finance Energy (Chesapeake, Laricina, Osum)	1,379	3.7
Total		37,553	100.0

Source: KIC Annual Report (2010)

Table 3: KIC's Investment Performance

Asset Class	Returns					Excess Return				
	2007	2008	2009	2010	Since Inception	2007	2008	2009	2010	Since Inception
Equities	9.91	3.81	8.56	-	-	0.09	-1.36	1.71	-	-
Fixed Income	5.19	-41.43	31.96	-	-	-1.19	-0.11	-0.23	-	-
Traditional Assets	7.4	-13.71	18.67	8.46	20.08	-0.25	-0.66	1.42	0.05	-0.07

Source: KIC Annual Reports (2007-2010)