Banking industry consolidation in Korea

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1. Introduction

Korea undertook a strong drive for financial liberalisation and market opening from the early 1990s. The structural weaknesses brought about by high costs and low efficiency in its 30-year process of concentrated growth, however, meant that its financial and economic system had become destabilised and barely able to stand the associated strains.

Most notably, in 1997, a string of large corporate insolvencies and the consequent rapid build-up of financial institutions' bad loans undermined their soundness and threatened the systemic health of the financial system. Furthermore, the negative effects of the southeast Asian currency crisis deepened foreign investors' misgivings about the health of the Korean economy. Accordingly, there was a large net outflow of foreign portfolio capital. Korea found itself in crisis, lacking sufficient foreign currency liquidity to meet its maturing liabilities, following a sharp decline in its foreign exchange reserves from early November 1997.

This left the government no option but to turn to the IMF for standby credit. An emergency package was agreed upon on 3 December 1997, under which Korea began an economic reform programme focused on macroeconomic stability and reform of its financial and corporate sectors as well as its labour market. The drive for financial sector restructuring focused on a shakeout among financial institutions, the clearing out of bad loans, the tightening of prudential regulations, the heightening of transparency of financial information, and the reorganisation of corporate governance at financial institutions.

2. Structural reforms in the financial sector

2.1 Closures, purchase and assumption transactions, and mergers

The government adopted a policy of closing down financial institutions which were no longer viable because of an overhang of non-performing loans (NPLs), while inducing an early normalisation of those still viable through injection of public funds under the condition of their own intensive self-rescue efforts.

During the financial crisis period, the top priority in financial sector restructuring was given to the earliest possible resolution of unsound financial institutions. The government acted swiftly and decisively to close down financial institutions deemed non-viable after an exhaustive review of their financial situations.

At the end of June 1998, five banks with capital adequacy ratios below the 8% BIS guideline were forced to exit the market through a "purchase and assumption" formula. Nine banks merged to form four successor banks in 1999, and two were merged to form one successor bank in July 2000. As a result, the total number of banks in Korea had been reduced from 33 to 22 by the end of 2000.

In the case of non-bank financial institutions, 21 merchant banking corporations, six securities companies, eight securities investment trust companies, and 12 insurance companies had been closed down through exits or mergers by the end of August 2000.

Table 1

Changes in the number of financial institutions

	As at end-1997 (a)[1]	Type of resolution			Newly established (c)	As at Aug 2000 (a-b+c)
		Exit[2]	Merger[3]	Total (b)		
Banks	33	5	6	11	–	22
Merchant banking corporations	30	18	3	21	–	9
Securities companies	36	6	–	6	13	43
Securities investment trust companies	31	7	1	8	4	27
Insurance companies	45	5	7	12	1	34
Mutual savings and finance companies	231	52	17	69	–	173[4]
Credit unions	1,666	215	69	284	–	1,391[4]
Total	2,072	308	103	411	18	1,679

[1] Excluding bridge financial institutions and branches of foreign institutions. [2] Including revocations of licence, bankruptcies and liquidations. [3] Represents the number of financial institutions ceasing to exist following mergers. [4] Number of institutions at the end of March 2000.

Table 2

Consolidation in the banking sector: June 1998 to March 2001

Type	Contents	Time
Purchase and assumption	Five insolvent banks were ordered to be taken over by healthy banks through a purchase and assumption formula;	
	Daedong Bank → Kookmin Bank	
	Dongnam Bank→ Korea Housing & Commercial Bank	
	Dongwha Bank → Shinhan Bank	
	Chungchung Bank → Hana Bank	
	Kyungki Bank → KorAm Bank	Jun 1998
Merger	*Government-led mergers*	
	Korea Commercial Bank, Hanil Bank → Hanvit Bank	Jan 1999
	Kookmin Bank, Korea Long-Term Credit Bank → Kookmin Bank	Jan 1999
	Chohung Bank, Chungbuk Bank → Chohung Bank	May 1999
	Chohung Bank, Kangwon Bank → Chohung Bank	Sep 1999
	Voluntary merger	
	Hana Bank, Boram Bank → Hana Bank	Jan 1999
Sell-off	Korea First Bank → Newbridge Capital (US financial consortium)	Dec 1999
Government-initiated financial holding company	Hanvit Bank, Peace Bank, Kwangju Bank, Kyongnam Bank, Hanaro Investment Banking, nine member-bank subsidiaries → Woori Financial Holding Company	Apr 2001

2.2 Injection of public funds

In the process of the sweeping financial sector restructuring, the government had to inject a huge amount of public funds into commercial banks through two government agencies - Korea Deposit Insurance Corporation (KDIC) and Korea Asset Management Corporation (KAMCO).

The total amount of financial support devoted to financial restructuring stood at 123 trillion won at the end of 2000. Out of this total amount, 48 trillion won was used for recapitalisation, 42 trillion won for the purchase of NPLs and 19 trillion won for the payment of deposit insurance claims.

In order to support financial restructuring, the government raised a total amount of 104 trillion won of public funds (including 40 trillion won for supporting the second round of financial restructuring) by issuing government-guaranteed bonds - Deposit Insurance Fund Bonds by KDIC and Non-performing Loans Management Fund Bonds by KAMCO. Out of the total amount of 104 trillion, about 73 trillion won had been used by the end of 2000. The government contributed a total of 19 trillion won from fiscal resources.

Table 3

Public funds injected into the banking system (trillion won)

Source	Support type	Nov 1997-Dec 1998	1999	2000	Total
KDIC	Total, of which:	26	28	23	78
	• Recapitalisation	6	16	14	36
	• Compensation of losses	7	4	1	12
	• Purchase of distressed assets	–	3	6	9
	• Insurance claim payment	12	5	2	19
	• Loans issued	2	0	–	2
KAMCO	Purchase of NPLs	12	3	12	27
Fiscal resources	Total, of which:	16	2	–	19
	• Recapitalisation	11	2	–	12
	• Purchase of subordinated debentures	6	1	–	6
TOTAL		55	33	35	123

Fiscal support to financial institutions for recapitalisation was inevitable and necessary in order to ensure the soundness of the financial system and to prevent systemic risk in the process of financial sector restructuring. As a result of this provision of government support, eight of the 17 commercial banks were temporarily nationalised. However, the government is committed to the withdrawal of its involvement in the commercial banking system.

The government sold its majority stake in Korea First Bank to Newbridge Capital, a US investment fund, in December 1999. This represented the first foreign ownership of a Korean commercial bank. As for Seoul Bank, a new chief executive officer has been appointed, and the bank is being groomed for privatisation in consultation with Deutsche Bank. Once a management turnaround has been achieved, the government intends to sell Seoul Bank to foreign investors by June 2001 as originally planned, If the sale does not happen by that time, the government plans to place Seoul Bank under a state-run financial holding company, Woori Financial Holding.

As for other temporarily nationalised commercial banks, the government will sell off its shares in them in steps from the first half of 2002, in accordance with its memorandum on economic policies agreed with the IMF. Government-owned preferred stock is being redeemed.

Table 4

Status of state-ownership in commercial banks (% at end-2000[1])

	Bank	Government[2]	KDIC[3]	Foreigners[4]	Largest shareholder
Nationwide commercial banks	Hanvit	–	100.0	–	KDIC 100.0
	Chohung	–	80.1	0.2	KDIC 80.1
	Korea First	3.1	45.9	51.0	Newbridge Capital 51.0
	Seoul	–	100.0	–	KDIC 100.0
	Korea Exchange	–	35.9[5] (43.2)[6]	26.4 (34.2)	Commerz AG 23.6 (32.6)
	Kookmin	6.5 (5.7)	– (9.4)	58.2 (51.3)	Goldman Sachs 11.1 (9.8)
	Housing & Commercial	14.5 (9.4)	– (10.6)	66.4 (43.0)	Bank of New York 15.4 (9.8)
	Shinhan	– (–)	– (18.3)	49.5 (40.4)	Korean residents in Japan 17.9 (14.8)
	KorAm	2.3 (1.7)	– (18.5)	61.5 (48.6)	Korea Investment 17.9 (14.9)
	Hana	4.2 (2.7)	– (35.0)	32.2 (20.9)	Allianz 12.5 (KDIC 35.0)
	Peace	–	100.0	–	KDIC 100.0
Regional banks	Taegu	0.1	–	0.8	Samsung Life Insurance 8.1
	Pusan	–	–	7.0	Lotte affiliates 14.2
	Kwangju	–	100.0	–	KDIC 100.0
	Cheju	–	100.0	–	KDIC 100.0
	Cheonbuk	–	–	0.1	Samyang affiliates 10.9
	Kyoungnam	–	100.0	–	KDIC 100.0

[1] Figures in parentheses represent percentage of shareholding calculated by including preferred stocks issued in the process of financial reforms in 1998-99. [2] Includes government-invested institutions (except financial institutions) in which the government holds a stake of at least 50%, or of which it holds less than half the equity but has provided funding support. [3] Refers to "Korea Deposit Insurance Corporation", which was established in June 1996 for the purpose of operating a deposit insurance system. [4] Includes portfolio investment. [5] The Bank of Korea 17.8%, Export-Import Bank of Korea 16.2%. [6] The Bank of Korea 10.7%, Export-Import Bank of Korea 32.5%.

3. The second round of the financial restructuring plan (since end-2000)

In overcoming the financial crisis, efforts had been exerted to prevent systemic breakdown and to form the framework for establishing a market economy, as well as to raise external creditworthiness by pushing forward with the first-round financial restructuring process.

In spite of all efforts in the course of the first round reforms from January 1998 to August 2000, considerable uncertainty about the financial system remained. Most banks that had received public funds, and some other banks judged viable two years ago, could not turn themselves around. The outcome was that many banks found themselves still in a precarious position, and additional injection of public funds became unavoidable.

Accordingly, the government undertook the second stage of financial restructuring with a focus on strengthening the competitiveness of the domestic financial industry by clearing up bad assets such as NPLs, and implementing forward-looking reforms based on the results of the initial financial restructuring.

From the beginning of 2001, major changes have been taking place in the banking sector as the second round of financial restructuring starts. The second round has three aspects; placing banks under government-led financial holding companies, merging unhealthy provincial banks with healthy ones and allowing mergers among healthy banks. At the end of 2000, the government raised an additional 40 trillion won of public funds to support the second round of restructuring, having used up 64 trillion won of the public funds raised for supporting the first stage of restructuring from November 1997 to August 2000.

3.1 Introduction of financial holding companies

In the past, financial institutions in Korea were prohibited from setting up holding companies. This was because areas of financial activity were strictly demarcated among financial institutions and there were fears that financial concentration through holding companies would hamper the effectiveness of the financial market, and also that the unsoundness of one affiliated company would easily infect other affiliates.

The government, however, changed its policy and lowered the barriers to business diversification by financial institutions, showing a positive attitude toward financial holding companies. It is hoped that the establishment of financial holding companies will have numerous positive effects, such as enhancing credit in the financial market through facilitating economies of scale and scope, lowering financing costs, cutting the duplication of investment in information technology etc.

There is also some truth in the argument that it was the commercial banks' reluctance to participate in mergers that led the financial authorities to adopt a positive attitude toward financial holding companies, considering them another strong tool in effecting the consolidation of financial institutions. Staff resistance to takeover is less when the takeover is performed by a holding company than when it is a consequence of a merger of two banks.

In October 2000, the Korean National Assembly passed the Financial Holding Company Act, and the possibility of creating financial holding companies is now open, although there are still comparatively severe restrictions and government authorisation is needed when one is to be set up.

On 23 March 2001, the Financial Supervisory Commission, the state financial sector regulator, approved the establishment of the state-run financial holding company, Woori Financial Holding. The new company was officially inaugurated on 2 April 2001. Financial organisations under the Woori umbrella include four nationalised banks - Hanvit Bank, Peace Bank, Kwangju Bank and Kyongnam Bank - along with their nine subsidiaries, and Hanaro Investment Banking. These banks were all judged not to be self-sustainable. Consequently the government again injected sufficient public funds into them at the end of 2000 to bring their capital ratios up to 10% and pushed ahead with their rehabilitation through a financial holding company scheme.

To promote increased consolidation in the domestic banking sector, the government may also offer priority approval to sound banks and regional banks if they are willing to integrate voluntarily as a financial holding company. Banks wishing to join Woori will be included in it if this will contribute to the formation of a large and financially sound “leading” bank.

Shinhan Bank, one of the nation’s leading commercial banks, is expected to set up its own holding company as soon as May 2001. Its five existing subsidiaries and Cheju Bank, a financially troubled local commercial bank, will be brought under the holding company.

3.2 Mergers between sound banks

During the second stage of financial reform and restructuring now under way, additional mergers between sound banks and the formation of further financial holding companies are expected as banks continue to seek to improve their levels of financial soundness and competitiveness.

Negotiations are already under way between two healthy banks; on 22 December 2000, Kookmin Bank and Housing & Commercial Bank, two of the healthiest domestic banks, officially announced that they had agreed to merge to create a new bank on 30 June 2001. Final merger negotiations are currently in progress. Shinhan and Cheju are currently involved in discussions with a view to consolidation. Other healthy banks are also being encouraged to consider mergers.

4. Main features of consolidation and recent developments

4.1 Mergers pursued as a means of financial reform

As stated above, mergers have been the typical form of consolidation in the Korean banking industry. This is because the top priority in financial sector restructuring was originally given to the resolution of unsound financial institutions. It can be said, therefore, that most of the recent mergers in the Korean financial sector had nothing to do with voluntary restructuring in a true sense, although their aim was the same: to improve individual institutions' competitiveness or their financial status. In line with this, mergers undertaken as the main tool in the resolution of unsound financial institutions were carried out mainly on the purchase and assumption basis.

During the first round of financial restructuring, the government implicitly expressed its hope that voluntary mergers among banks would occur, and announced that preferential tax treatment would be given in cases of mergers. To induce more mergers, it revised the relevant legislation to permit any financial institution to either maintain its existing form, or convert itself into a different type of financial institution through merger with a financial institution of a similar or different type, or convert itself into a different type of financial institution. This paves the way for mergers between banks and non-bank financial institutions.

The government believes that large banks have many competitive advantages in the new financial environment, in which universal and internet banking are flourishing while the internationalisation of the domestic financial market accelerates. It also expects that mergers will increase the efficiency of bank management as a result of downsizing to eliminate the duplicate organisational structures and staff.

4.2 The first round of restructuring cannot be judged a success

Though huge amounts of public money were injected into troubled financial institutions in the course of the first stage of financial sector restructuring during 1998 to 2000, a few banks still had substantial levels of bad loans and failed to achieve the 8% BIS capital adequacy ratio. This has forced the government to undertake the second stage of financial restructuring.

Merged banks have not pursued the hoped-for synergies. The management performance of Hanvit Bank, the result of merging two banks with equal shares, has been very disappointing. An additional 3 trillion won of public money was injected into Hanvit Bank to clean it up, despite its having already been recapitalised with a previous 3 trillion won of public money.

4.3 Mergers among good banks initiated in recent months

Most of the mergers during the first round of the financial restructuring process occurred in response to government prodding. Individual banks were reluctant to merge, and worried about severe staff layoffs in the event of absorption. Every bank considering a merger wanted to be the initiator, not the one taken over in a hostile merger.

Recently, major changes have been occurring in the banking sector as the second phase of financial restructuring starts. Voluntary mergers between sound banks are currently being negotiated.

4.4 Business diversification expanded in the banking industry

Traditionally, there had been strict turf boundaries between the various types of financial business in Korea, and commercial banks could engage only to a very limited extent in the securities business, while being in principle prohibited from carrying on insurance business.

More recently, however, there has been strong pressure to ease the business demarcation among financial institutions. Commercial banks have sought numerous ways to circumvent the boundary lines by setting up subsidiary companies or entering into cooperative alliances with other related companies. This new trend is mainly due to the rapid progress both of information technologies and of securitisation in the financial market.

Domestic commercial banks had a total of 91 subsidiary companies as at April 2001, of which 11 were securities-related companies. As of the end of June 1999, moreover, domestic commercial banks had entered into 265 formal contracts establishing cooperative alliances with other institutions. Of these, fund transfer contracts numbered 136, accounting for the majority.

Table 5

Status of subsidiaries of commercial banks

	Securities companies	Investment trust companies	Insurance companies	Credit card Companies	Merchant banks	Financial companies specialising in loan business[1]	others[2]	Overseas subsidiaries	Total
Nationwide banks	4	7	2	3	2	13	19	31	81
Regional banks	–	–	–	–	–	7	3	–	10
Total	4	7	2	3	2	20	22	31	91

Notes: [1] Refers to venture capital companies and leasing companies. [2] Refers to economic research institutes, credit information companies, futures companies, asset management companies, factoring companies, etc.

Table 6

Types of contract for cooperative alliances of commercial banks (June 1999)

Types	Details	Contents
Settlement and fund transfers	Funds transfer (136)	– Depositing, withdrawing, remitting, transferring of funds for securities companies and insurance agencies
	Credit card business (44)	– Issuing credit cards – Matters relating to debit cards and affiliate cards
	Electronic banking (21)	– Phone banking, firm banking, or PC banking
	Internet shopping mall (2)	– Settlement service for trading through internet shopping mall
Strategic alliances with non-banking financial industries	Stock trading business (2)	– Opening accounts for stock trading – Depositing and withdrawing funds for stock trading
	Asset management or consultation (15)	– Asset management, such as the management of money in trust through stock trading – Consultation
	Insurance business (4)	– Insurance services connected with deposits
Agent service and other services	Interbanking business cooperation (3)	– Business cooperation for international banking or foreign exchange transactions – Joint promotion of business financing projects
	Other services (38)	– Subscribing for online services by proxy – Selecting competent export companies and handling related matters – Bond collection services – Selling travellers' cheques – Consulting

The number of cooperative alliances of financial institutions in 1999 was increasing explosively, especially between banks and non-banking financial institutions.

Table 7

Trends of strategic alliances of financial institutions

	Banks				Non-banking financial institutions			Between same industries (A+D)	Between different industries (B+C+E)	Total
	Between banks (A)	Between banks and non-banking financial institutions (B)	Between banks and others (C)	Sub-total	Between non-banking financial institutions (D)	Between non-banking financial institutions and others (E)	Sub-total			
1995	–	5	7	12	6	15	21	6	27	33
1996	–	–	4	4	1	7	8	1	11	12
1997	2	3	4	9	2	3	5	4	10	14
1998	1	1	2	4	–	1	1	1	4	5
Jan-Aug 1999	3	16	10	29	2	6	8	5	32	37
Total	6	25	27	58	11	32	43	17	84	101

4.5 Internet banking on a sharp rise

Although it is still in its infancy, having begun only one or two years ago, internet banking has been spreading at an overwhelming speed. All domestic commercial banks have introduced internet banking and are expanding its scope.

Table 8

Status of internet banking use

	March 2000		September 2000	
	Volume (thousands)	Value (trillion won)	Volume (thousands)	Value (trillion won)
Information inquiries	3,809	–	16,670	–
Funds transfers	1,005	9.8	2,700	30.1
Loan applications	21	0.2	97	0.9
(Loans executed)	(–)	(–)	(24)	(0.2)
Total	4,835	–	19,467	–

5. Prospects

The financial holding company system will be the axis of the future domestic financial industry, which is now rapidly restructuring. The emergence of financial holding companies will reduce the number of individual financial institutions specialised in specific financial businesses and increase the permeability of the remaining barriers separating banks, securities firms and insurance companies.

Future financial institutions will be classified as bank holding companies, non-bank holding companies, affiliated companies or individual companies. They will also be classified as companies concentrating on the banking business, the securities business or the insurance business.

Table 9

Transition of financial structure in Korea

Before financial crisis in late 1997	At present	After allowing bank holding companies
Banks	Banking focus (banks, merchant banks, mutual savings and finance companies, etc)	Bank holding companies
Securities companies		
Insurance companies	Securities focus (securities companies, investment trust companies etc)	Non-bank holding companies (focusing on insurance and securities)
Investment trust companies		
Merchant banks	Insurance focus (life insurance companies, non-life insurance companies)	Parent-to-subsidiary or inter-subsidiary ties
Mutual savings and finance companies		
Financial companies specialising in loan business etc	Others	Individual financial institutions