Bank restructuring in Korea

Dookyung Kim

Introduction

The recent crisis has been the most severe to hit Korea in its thirty-five year history of rapid economic development. It was triggered by the loss of the credibility of the Korean economy among international investors following the earlier crises in south-east Asia. Foreign investment houses suddenly became reluctant to make new loans and sought to withdraw existing credit lines to Korean banks and business firms. As a result, usable foreign exchange reserves were severely depleted in a short period of time, bringing Korea to the brink of insolvency.

However, at the root of the crisis lay more fundamental causes; over-borrowing and over-investment by the corporate sector, imprudent provision of loans by financial institutions funded by short-term borrowings in international markets, lack of transparency in the accounting and management of corporate and financial institutions, etc. These structural problems were dramatically laid bare amid a prolonged economic slowdown coupled with the contagion effect of the south-east Asian crisis. Thanks to the arrangement of a prompt rescue package from the international community led by IMF and World Bank, and concerted national efforts to recover from the crisis, the worst phase now appears to be over. Usable foreign exchange reserves expanded from US$ 3.9 billion on 18 December 1997 to US$ 54.5 billion at end-March 1999. This reflected the rapid improvement of the current account position, restructuring of the maturity of external short-term borrowings of domestic banks, and the successful issuance of government Foreign Exchange Stabilisation Fund Bonds in the international market. As the exchange rate of the Korean won stabilised, domestic interest rates, which had risen swiftly to over 30% in terms of call rates, have eased gradually to 4%, well below their pre-crisis level.
However, the real economy has been hit harder than expected due to the sharp reduction of investment and consumption demand. Throughout 1998, real GDP was projected to contract by 5.8%. In the aftermath of the crisis, the Korean government has been carrying out an extensive economic programme focused on macroeconomic stability and structural reform of the financial, corporate and labour sectors. Reform of the financial sector and banks in particular has been given top priority, and it is here that most success has been achieved so far.

The financial sector restructuring is focused on compelling unsound financial institutions to leave the market, resolving the overhang of bad loans, strengthening institutions’ capital base, and ensuring the transparency of management. Although the ultimate goal is, of course, to improve the overall efficiency of management and enhance competitiveness in the globalised market, it is vital for the real economy to recover from its deep recession and move to a sustained growth track. A vicious circle had been set in motion whereby a severe credit crunch associated with financial restructuring brought about an even more acute business slowdown. Banks avoided making fresh loans and sought to call in existing credits, because those which failed to meet the BIS capital adequacy guidelines might be forced to leave the market. This, in turn, triggered increased corporate failures that tightened the credit crunch in the financial markets.

This paper first looks into the explanations for the policy initiatives taken. It then goes on to describe the tasks to be completed in the course of financial restructuring.

**Underlying principles of bank restructuring**

Bank restructuring is being pursued in accordance with fundamental principles as follows.

First, bank restructuring should be completed swiftly and thoroughly to get the intermediation function of the financial markets working properly again as soon as possible. The slower the restructuring process proceeds, the longer and deeper will be the associated credit crunch. Troubled banks will be reluctant to lend to firms due to their great anxiety about creating additional bad loans. This, in turn, will lead firms to go belly-up and further weaken the soundness of banks. Such a circle once set in motion notably increases the cost of restructuring.

Secondly, the burden of fiscal support on taxpayers must be kept to an absolute minimum. Financial institutions should only be supported provided they mount a drive to cut costs and attract foreign investment for recapitalisation.

Thirdly, to prevent moral hazard arising in the course of resolving troubled banks, shareholders, employees and managerial staff should share the pain and the responsibility.

Fourthly, bank restructuring should be implemented in line with transparent and objective criteria to avoid the likelihood of subsequent disputes.

**Specific policy directions**

**Resolution of bad banks and reshaping the banking industry**

Unless ailing financial institutions can be swiftly disentangled from sound ones, confidence in the overall financial system will suffer severe damage, and borrowing money abroad will remain difficult. Thus, top priority is being placed on resolving the unsound financial institutions as promptly as possible in accordance with internationally accepted standards, on assisting the viable banks to raise their efficiency, and on easing the credit crunch.

Also, bank restructuring aims to induce the creation of leading banks by mergers between large banks. This would, it is reasoned, enable them to compete with large foreign banks on an equal footing and remove the inefficiencies resulting from over-banking in this country.

After bank restructuring has been completed, the Korean banking sector will take on a new shape. It will comprise three categories: leading banks created through mergers between large banks, medium-sized banks carrying out retail banking and providing housing finance in niche markets, and small regional banks specialised in specific areas.

**Making financial statements and prudential regulations more transparent**

Many experts have pointed to a lack of transparency as one of the primary factors in bringing about the crisis since it caused foreign
Progress in restructuring

In close consultation with the IMF, the government is pressing ahead with the exit of nonviable banks. It is also helping the viable banks to recapitalise and dispose of non-performing loans (NPLs) by injecting public funds on the condition that they make every effort themselves to rehabilitate by mergers, induction of foreign capital and improvement of management.

In a further move to improve banking soundness and efficiency, a systematic policy framework is being prepared. It will include the adoption of prudential regulations in line with internationally accepted standards, the tightening of internal control systems, and the adjustment of restrictions on shareholdings in banks.

Restructuring of distressed banks

The government revoked the foreign exchange licenses of eight merchant banks unable to meet their current liabilities at the time the negotiations with the IMF began in November 1997. On 2 December 1997, business suspensions were imposed on nine merchant banks owing to their liquidity shortages, and then the suspension of an additional five merchant banks was ordered on 10 December following runs on them. In all, 18 merchant banks had their operations suspended, and 16 of these have since had their licenses revoked. As a result, only 14 merchant banks were still operating by end-1998. Among these, though, an additional two merchant banks had merged with commercial banks while one merchant bank had been ordered to suspend business in 1999. Four securities companies on the brink of insolvency had their licenses revoked and one securities company was ordered to suspend its business. In the case of investment trust companies, one company had its licenses revoked and one securities company was ordered to suspend its business. In the case of investment trust companies, one company had its licenses revoked and one securities company was ordered to suspend its business.

Improving the efficiency of banks' management

Banks in Korea had enjoyed a high level of government protection in return for serving as the handmaidens of industrial policy during the period of development finance. For too long, their lending decisions were not based on strict analysis of the profitability of a firm's investment projects. Rather, in the case of large firms, banks showed a tendency to lend money in the belief that these were too big to fail. In the case of small and medium-sized enterprises, lending decisions were based mainly upon the collateral offered.

To transform banks into profit-seeking corporations operating on a commercial basis like other companies, the supervisory authority has introduced a scheme for them to improve their competitiveness by building up their credit-screening capacity and developing risk management techniques and internal control systems.

If they are to become robust and strong players in the globalised market, banks will also have to cut their branch networks and shed staff to enhance their productivity to the level of rivals from developed countries.

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1 The FSS was established on 1 January 1999 by combining four former supervisory bodies: the Banking Supervisory Authority, the Securities Supervisory Board, the Insurance Supervisory Board, and the Non-bank Supervisory Authority.

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was dissolved and another company,\textsuperscript{10} whose business was later taken over by a healthier company, was ordered to suspend business operations.

In this situation it was deemed advisable to liquidate the distressed commercial banks and merchant banks as a first step in the process of financial restructuring. The simultaneous closure of all the troubled financial institutions would have such a large impact on the financial markets that it would have generated serious systemic risk. In the case of non-bank financial institutions such as securities, insurance and leasing companies, the sequencing decided was that those companies facing insolvency in the process of bank restructuring should be liquidated forthwith. The remaining institutions would be encouraged to raise additional capital from calls on major shareholders, and seek a management turn-around through their own efforts. Where such attempts proved futile, they would in turn be forced to leave the market.

The focus of this paper will now be placed on a description of the process of resolving the distressed banks.

Nationalisation and sales to foreign bidders

The problems at Korea First Bank and Seoul Bank were the most severe faced by any of the 26 commercial banks, and posed the greatest threat to the financial system. As a first step, they were both directed in December 1997 to carry out measures to improve their management.

In January 1998, these two banks were ordered to reduce their paid-in capital from 820 billion won to 100 billion won in each case, meaning that existing shareholders had to bear part of the loss. After that, both banks were nationalised through subscriptions of 1.5 trillion won to each of them by both the government and the Korean Deposit Insurance Corporation (KDIC), bringing their capital to 1.6 trillion won in each case.

The reason why public funds were used to rescue the two distressed banks, rather than forcing their exit, was that if the two banks had been liquidated, all remaining banks would have faced bank runs with severe systemic risk for the financial industry. As Korea had no previous experience of bank closure at that time, and the two banks had a very high profile, the prospect of a heavy run on banks was considered very likely.

Meanwhile, it was agreed with the IMF that Korea First Bank and Seoul Bank would be sold back to the private sector following their recapitalisation by the government.\textsuperscript{11} A privatisation process committee was therefore set up in March 1998 to handle this. Coopers & Lybrand were selected as the accountants responsible for the due diligence evaluation of the two banks’ assets, and Morgan Stanley was chosen as lead manager of the sell-off.

The government signed a memorandum of understanding (MOU) with Newbridge Capital Limited, a major US investment firm, on 31 December 1998 for the sale of Korea First Bank. An MOU was then signed between the government and HSBC on 22 February 1999 for the sale of Seoul Bank. Now due diligence on both banks is underway to allow the conclusion of these agreements.

Exit

In February 1998, the then Monetary Board\textsuperscript{12} (renamed the Monetary Policy Committee from 1 April 1998) issued orders or recommendations for management improvement measures to the twelve commercial banks (other than Korea First Bank and Seoul Bank) which had had BIS capital adequacy ratios of less than 8% at end-1997.\textsuperscript{13} It required them to present management rehabilitation plans, including capital enhancement, by April 1998.

\textsuperscript{10} Hannam Investment Trust (14 August 1998).

\textsuperscript{11} The agreement that the two banks should be sold by 15 November 1998 could not be kept in the absence of a suitable buyer and their sale was postponed to the end of January 1999.

\textsuperscript{12} The provisions of the Act Concerning Establishment of Financial Supervisory Organisations not being in effect in February 1998, the then Monetary Board of the Bank of Korea ordered these measures.

\textsuperscript{13} Banks’ BIS capital adequacy ratio classifications at the end of 1997

<table>
<thead>
<tr>
<th>8% or more</th>
<th>6–8%</th>
<th>Less than 6%</th>
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<tbody>
<tr>
<td>(management improvement recommendation)</td>
<td>(management improvement order)</td>
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</table>

The Financial Supervisory Commission (FSC), established on 1 April 1998, selected six domestic accounting firms associated with internationally recognised accountants. They had them inspect the assets and liabilities of the twelve banks concerned and assess the viability and feasibility of their management rehabilitation plans according to the standards agreed with the World Bank.14

A Management Evaluation Committee, consisting of experts from the private sector, was then set up by the FSC on 20 June 1998, to deliberate on the basis of the accountants’ assessment as to whether the rehabilitation plans should be approved.15

On 29 June 1998, and for the first time in the history of the modern Korean banking industry, the FSC decided to order the exit of five Korean banks (Daedong, Dongnam, Donghwa, Kyungki and Chungchong) deemed by the committee to have little possibility of rehabilitation. The resolution of these institutions was to be achieved through a purchase and assumption formula, whereby each acquiring bank (Kookmin, Housing & Commercial, Shinhan, Koram and Hana) would purchase the sound assets and assume the liabilities of a distressed bank. In accordance with this decision, the operations of the five banks slated for exit were suspended and the green light was given to preparations for their acquisition, including the winding-up of their remaining affairs.

The acquiring banks were chosen on the basis of their having a BIS capital adequacy ratio of more than 9% at end-1997. They are expected to remain under stable management following their acquisition of the distressed banks and to benefit from potential synergies.

To guard against the possible worsening of their asset quality by way of the acquisition, the acquiring banks were granted put-back options under which assets could be sold back to the Korea Asset Management Corporation (KAMCO) within six months after acquisition if they subsequently turned sour. The period within which this option can be exercised has since been extended to one year. Also, to prevent a fall in the BIS capital adequacy ratios of the acquiring banks, public funds were subscribed in the form of government securities to make good any decrease. Some of the bad loans on their own books were purchased by KAMCO, at its standard discount to book value.

Upon completion of due diligence of the assets and liabilities of the resolved banks on 19 September 1998, KAMCO purchased bad loans with a book value of 4.16 trillion won on 28 September. The KDIC put up the 5.78 trillion won by which the liabilities of the resolved banks exceeded their assets on 29 September. The licenses of the resolved banks were revoked on 30 September.

Meanwhile, an unexpected set-back occurred in the process of closing down the five failed banks when union members at those banks refused to attend their offices, changed computer passwords, and concealed important computer manuals. Due to this situation, business at the acquired banks was paralysed for about a week. Under a compromise agreement worked out between labour and management, however, it was possible for business operations to be resumed on a normal basis.

Restructuring of viable banks

The remaining seven banks which had BIS capital adequacy ratios below 8% but were deemed to have the potential to stage a turnaround and had had their turnaround plan conditionally approved were required to file implementation plans for management rehabilitation plans according to the standards agreed with the World Bank.

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The FSC had a Review Team operating under the FSS, and consisting of professors, accountants and financial experts, inspect and supplement these implementation plans, before their finalisation on 15 September 1998.

Accordingly, the seven banks have been carrying out their rehabilitation plans through mergers, capital increase by inducement of foreign capital, consolidations with subsidiaries, and partial limitation of their banking business activities. The supervisory authority appraises their progress in this regard, and where this is unsatisfactory, it may either require them to change their management team or issue an order

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14 To evaluate the appropriateness of such matters as capital adequacy, plans to raise additional capital, prudential classification of assets, plans for reducing non-performing assets, plans for cutting costs, and plans for management improvement, etc.

15 So as to ensure the objectivity and professionalism of the evaluation, the Management Evaluation Committee is made up of twelve members including accountants, lawyers, university professors and researchers.
By end-March 1999, NPLs with a book value of 11.4 trillion won had been cleared from the books of those conditionally approved banks that had actively pursued management rehabilitation plans and mergers. These non-performing assets were acquired at a discount by KAMCO.

**Mergers**

The government has been encouraging mergers between banks that are both sound and of substantial size. Its objectives are to hone the competitive edge of the Korean banking industry through economies of scale and remove the inefficiency caused by the presence of many relatively small banks. Accordingly, in addition to the merger between the conditionally-approved Commercial Bank of Korea and Hanil Bank, Hana Bank, which had a BIS capital adequacy ratio of more than 8% at end-1997, merged with Boram Bank, while Kookmin Bank paired off with Korea Long-Term Credit Bank.

Moreover, Chohung Bank is to merge with both Kangwon Bank, which earlier amalgamated with Hyundai Merchant Bank after having written down its capital to 25 billion won, the minimum...and with Chungbuk Bank, which was ordered by the FSC to write off its entire capital and to merge with another entity.

The Korean government acted to improve the merging banks’ BIS capital adequacy ratios through the injection of public funds, to avoid the possible deterioration of their status. Where it was deemed necessary, the conditions for their receipt of this assistance included the reduction of their capital and moves to turn themselves around. On 14 September 1998 the amended Act Concerning the Structural Improvement of the Financial Industry came into force, providing for the simplification of merger procedures and tax incentives for mergers between financial institutions.

Major elements of the act are that the FSC is given the right to order mergers of distressed financial institutions and that the Minister of Finance and Economy can, if need be, grant exemptions from the corporation or personal income taxes payable on income arising from the liquidation of a financial institution. He may similarly waive or reduce acquisition or registration tax payable on real estate purchased in the course of the merger.
Improving related systems, such as prudential regulatory standards

The evaluation standard for marketable and investment securities held by banks was changed from the lower-of-cost-or-market method\(^\text{17}\) to the mark-to-market method. Likewise, since the semi-annual closing at end-June 1998, full 100% provisioning for loan-losses, retirements, and valuation losses on securities investment must now be set aside following the tightening of accounting standards for the closing of accounts.\(^\text{18}\)

In a further move, from July 1998 prudential regulation has been tightened by classifying loans in arrears for three months or more as “substandard” instead of “precautionary”, and those in arrears for from one month to three months as “precautionary” instead of “normal” loans. Also, the required provisioning rate for precautionary credits was raised from 1% to 2%.

From 1999, banks are required to set aside provisions for losses from guarantees at the end of each fiscal year. The provisions of those credits classified as substandard or lower are to be deducted from Tier 2 capital in calculating the BIS capital adequacy ratio, and asset quality classification standards are to be introduced based on the assessed future ability of borrowers to honour their obligations.

A bank’s large exposure limit on credit to a single borrower or a single group, which is now 45% of its equity capital, will be reduced to 25% of its total capital for a single group, and to 20% for a single borrower from 1 January 2000. The definition of large exposure for the purposes of the ceiling limit on the sum of large exposures was changed from 15% of equity to 10% thereof on 1 April 1999. This ceiling on the sum of large exposures is currently set at five times total equity capital.

Moreover, the scope of large credits falling under this ceiling was extended from loans and contingent liabilities to total credit which includes commercial paper, corporate bonds, etc. The definition of capital in the denominator was amended from equity capital to total (Tier 1 and 2) capital.

Also, to encourage banks to strengthen their internal controls, a system requiring the matching of the raising and operation of foreign capital by maturity\(^\text{19}\) was introduced in July 1998. Derivatives contracts amounting to more than 5% of a bank’s equity capital can be entered into only after screening by its risk management committee. Banks’ plans for rehabilitation must include arrangements to maintain capital adequacy, and measures to strengthen credit analysis and ex post facto credit administration.

In January 1998, to improve the internal governance structure of banks, the General Banking Act was amended. The supervisory authorities are now able to carry out fit-and-proper tests of major shareholders and senior management by inspecting the adequacy of the composition of shareholders, the source of funds used in the acquisition of stocks, and the integrity and the suitability of the management team. After also amending the Act Concerning the Structural Improvement of the Financial Industry, the government can now order the destruction of the equity of shareholders deemed to bear responsibility for the insolvency of banks which the government has recapitalised or decided to recapitalise.

In April 1998, the related legislation was amended to grant the FSC the right to demand management changes, capital reduction, mergers, business transfers and third party acquisitions in relation to banks whose BIS capital adequacy ratios and management status evaluation results fall below a certain level. In this context, on 28 June 1998, the FSC required the seven conditionally approved banks to change their management teams substantially by the appointment of outside directors including foreign experts. The KEB subsequently appointed two non-resident directors\(^\text{20}\) in July 1998 as part of its cooperation with Commerz Bank of Germany. Other conditionally approved banks have also changed the make-up and size of their boards.

\(^{17}\) Whereby the value of a security is taken as the lower of the carrying value (or acquisition value) and the fair market value.

\(^{18}\) It applies from September 1998 for securities companies and from the fiscal year ending March 1999 for merchant banks and insurance companies.

\(^{19}\) To prevent a shortage of foreign currency liquidity arising from the diversion of short-term foreign borrowings to long-term applications, this system regulates the ratio (gap ratio) between net assets arranged by term to total foreign assets, after the classification of foreign assets and liabilities based on maturity.

<table>
<thead>
<tr>
<th>As per term</th>
<th>0–7 days</th>
<th>7 days–1 month</th>
<th>1–3 months</th>
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<tbody>
<tr>
<td>Regulatory gap ratio</td>
<td>0% or more</td>
<td>below –10%</td>
<td>below –20%</td>
</tr>
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</table>

\(^{20}\) The General Banking Act was amended to allow the appointment of non-resident directors of banks on 25 May 1998.
In February 1998, to activate the function of shareholders and internal auditors in monitoring management status, the requirement conditions for the exercise of minority shareholders’ right to initiate a class action were eased. The listed financial institutions had to appoint external auditors (accounting firms) at the request of the nomination committee which consists of the internal auditor, the outside directors, representatives of shareholders, and creditors.

The conditions for taking prompt corrective actions have been clarified and made mandatory by linking them to the BIS capital adequacy ratios in order to avoid possible bias on the part of regulators. The FSS intends to alter the components of the bank management status evaluation system from CAMEL to CAMELS to incorporate market risk assessment from 1999.

With a view to reducing moral hazard and improving customers’ discrimination among banks, the interim blanket guarantee of deposits and interest payments introduced in the run-up to the financial crisis to secure stability was removed by imposing maximum insurance limits. In particular, only the principal of single deposits of more than 20 million won per depositor made after 1 August 1998, are now guaranteed.

**Improving the efficiency of bank management**

To increase the efficiency of bank management through downsizing their organisation and staff, which had been allowed to swell with little regard for profitability, all conditionally approved banks shed more than 32% of their workforce as of end-1997 under an agreement reached in talks with labour in 1998. Some banks, notably Chohung and KEB, have reduced their workforce further. They are also boldly downsizing their head offices and branches, to improve productivity by reducing expenses.

In addition, much of the discretionary authority concerning loan decision-making formerly given to presidents and branch managers has been removed, and banks have now generally established credit appraisal committees whose main function is to assess the status of potential borrowers before providing any large-scale loans.

Furthermore, to enhance corporate governance, the role of the board of directors, a majority of which is now formed by outside directors, has been strengthened so as to act as a major decision-maker on bank strategy and risk management.

**Fiscal support for financial restructuring**

The most difficult problem in the process of financial sector restructuring is how to raise the funds necessary for the restructuring programme. In principle, financial restructuring should be funded by the financial institutions themselves. However, given the very real possibility that turmoil in the financial system could trigger an economy-wide crisis and the great difficulty for the financial institutions themselves to raise funds in the bearish stock and real-estate markets in 1998, the provision of public funds to financial institutions was unavoidable.

Therefore, the government set up basic principles to improve the efficiency of fiscal support and to avoid moral hazard arising within financial institutions. Banks were required to downsize their staff and branch operations, and to improve productivity and profitability. They have also taken steps for self-rescue such as raising additional capital from abroad. Losses due to management failure should be shared by stockholders and the management team responsible by means of capital reduction or replacement of management.

The government supplied public funds in sufficient quantity to ease the credit crunch swiftly, and thereby to return banks to normal. To this end, it is raising a total amount of 64 trillion won to facilitate financial sector restructuring, of which 32.5 trillion won is to be used to finance the purchase of NPLs, while 31.5 trillion won is to be spent on recapitalisation, deposit payments, etc. The funds are being raised by issuing bonds of the Non-performing Asset Management Fund (run by KAMCO) and the Deposit Insurance Fund (run by the KDIC), both of which are guaranteed by the government. To prevent possible side-effects like a run-up in interest rates or crowding-out through their issue in the market, the government either pays financial institutions for the purchase of bonds or borrows from them.

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21 The equity ratios required for exercise of minority shareholders’ rights have been lowered as follows:
- right to initiate class action: 1.0% to 0.05%;
- right of claim for dismissal of directors and internal auditors: 1.0% to 0.05%;
- right of inspection of accounting books: 3% to 1%, etc.

22 This 64 trillion won (fiscal funds) for financial sector restructuring is equivalent to 15% of 1997 GDP.
of NPLs directly with the bonds or participates in the equity of banks by subscription of the bonds for their recapitalisation.23

Purchase of non-performing loans
To resolve the large amounts of NPLs held by financial institutions, the government set up the Non-performing Asset Management Fund in KAMCO in November 1997. At this stage, KAMCO purchases NPLs from financial institutions planning mergers or carrying out self-rehabilitation plans.

By end-March 1999, KAMCO had purchased at a discount 44 trillion won (book value) of NPLs for a total of 20 trillion won, paying directly with Non-performing Asset Management Fund Bonds. Currently, KAMCO pays 45% of the appraisal value of collateral in the case of collateralised loans, while it pays just 3% in the case of uncollateralised loans.

As KAMCO will purchase additional NPLs that arise during 1999, it is anticipated that Korean banks will become 'clean banks' with balance sheets as healthy as banks in advanced countries.

To date, the disposal by KAMCO of its acquired non-performing assets has reached about 2.4 trillion won, with proceeds standing at 1.1 trillion won at end-March 1999.

Schedule for KAMCO's purchase of NPLs

<table>
<thead>
<tr>
<th></th>
<th>Nov. 97–Sept. 98</th>
<th>Oct. 98–Mar. 99</th>
<th>From April 99</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>NPLs</td>
<td>39</td>
<td>5</td>
<td>32–42</td>
<td>76–86</td>
</tr>
<tr>
<td>Purchase price</td>
<td>17.8</td>
<td>2.2</td>
<td>12.5</td>
<td>32.5</td>
</tr>
</tbody>
</table>

1 30 commercial banks and specialised banks, 30 merchant banking corporations, and two fidelity/surety insurance companies. 2 Specialised banks, some sound banks, merchant banking corporations, securities companies, mutual savings companies. 3 Newly arising NPLs.

Recapitalisation support and loss compensation
Banks acquiring resolved banks or consolidating with other banks by merger run the risk of a deterioration of their management status and shrinkage of their banking activity. To prevent this, the government has established a programme to inject public funds into the recapitalisation of newly merged banks and make up the losses arising from the acquisition of resolved banks.

For banks acquiring resolved banks, the shortfall between the assets and the liabilities of the acquired banks is to be fully made up by the government, so as to prevent deterioration of their management status. The government also injects sufficient capital into the acquiring banks to prevent any decline in their BIS capital adequacy ratios. For new banks created by mergers between troubled banks, capital would be injected to bring their BIS capital adequacy ratios up to 10%. In the case of mergers between sound and troubled banks, the new banks are to have enough fresh capital pumped in to maintain the previous BIS capital adequacy ratios of the sound banks.

By end-March 1999, the government had devoted a total of 23.6 trillion won to these purposes. Until August 1998, 8.1 trillion won had already been spent for recapitalisation of two ailing commercial banks (Korea First Bank and Seoul Bank), and for the repayment of deposits with resolved merchant banks. The large remaining amount of 10 trillion won was spent in the one month of September 1998 for the recapitalisation of several banks.

In the last quarter of 1998 and the first quarter of 1999, an additional 5.5 trillion won was used not only for the recapitalisation of a number of banks including five acquiring banks but also for the redemption of deposits held with mutual savings companies and credit unions whose business had been suspended, the sixteen merchant banking corporations that had left the market and newly-resolved non-bank institutions, etc.

Schedule of fiscal support

<table>
<thead>
<tr>
<th></th>
<th>Jan. 98–Aug. 98</th>
<th>Sept. 98</th>
<th>Oct. 98–Mar. 99</th>
<th>From April 99</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>8.1</td>
<td>10.0</td>
<td>5.5</td>
<td>7.9</td>
<td>31.5</td>
<td></td>
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</table>
Nor will this be the end. In the near future, additional fiscal funds will be needed to cover losses resulting from the sales of the government’s stakes in Korea First Bank and Seoul Bank to foreign investors, and exercise of the asset put-back option by the five banks which acquired the resolved banks earlier.

Tasks to be completed

Major steps in the bank restructuring process appear to have been completed successfully so far. However, the benefits of bank restructuring will be increased provided a number of associated measures can also be carried out without delay.

Accelerating corporate restructuring

At this stage, formerly ailing Korean banks have been converted to clean and healthy banks by eliminating NPLs and injecting new capital. However, the delay in corporate sector restructuring may give rise to additional NPLs. In the long run, it will reduce the benefits of banking sector restructuring.

Therefore, in order for Korea to pull through its present difficulties and regain a track of sustained economic growth, there seems to be no alternative other than swift and intensive corporate restructuring, to reduce credit risks and to eliminate the possibility of additional NPLs.

In this regard, the restructuring process in the top five interlinked business groups, or chaebol, has already been given strong government encouragement.

To restructure the top five chaebol in a more timely and effective manner, they agreed with the government and major creditor banks to close nonviable affiliates, restructure business to focus on core competencies, eliminate cross guarantees between companies within each chaebol and substantially improve capital structure. Meanwhile, the asset swaps and merging in seven industries, popularly known as ‘big deals’, are now in their final stage.

Furthermore, workout programmes24 for weak but viable companies25 among the top sixth through sixty-fourth largest chaebol and other large corporations, in terms of credit from the organised financial system, are being put in place by the creditor financial institutions. They are reviewing various packages of possible measures to recover the value of their loans to these firms. One of the major programmes is debt restructuring through, for example, the conversion of short-term loans into medium and long-term loans, the granting of a grace period on servicing payments, reductions of interest payments, and debt for equity swaps.

As of 2 March 1999, 83 corporations were in workout programmes and among these 72 corporations had come up with feasible workout schemes.

Strengthening management accountability at financial institutions

To prevent deterioration in the management status of financial institutions, it is necessary that bank ownership system and governing structure be improved so as to strengthen the management accountability of financial institutions. As a part of such efforts, there have been debates about such issues as the elimination or raising of the ceiling on stock holdings of a bank.

Another important task is to strengthen market discipline exercised by interested parties, such as shareholders and depositors, by providing them with accurate and timely information about the management and financial status of banks. The FSC has increased the frequency of regular disclosure from once a year to twice a year (quarterly disclosure will be recommended after the introduction of quarterly closing accounts from September 1999) and has prepared sanctions against cases of misleading or untruthful disclosure.

It has also increased the regular disclosure items to include all those requested by the International Accounting Standard. These include risk

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24 Each creditor bank set up its workout team on 20 June 1998. In addition, in order to ensure collaboration among creditor financial institutions regarding the assessment of corporations’ viability and the method of providing financial assistance to them, a corporate restructuring agreement was signed on 25 June 1998, by 33 financial institutions on behalf of 224 financial institutions. These included banks, merchant banking corporations, insurance companies, securities companies, and financial companies specialized in the loan business. Creditor financial institutions have been selecting corporations for workout programmes through negotiations with them.

25 In May–June 1998, creditor banks assessed the viability of a total of 313 corporations including eleven emergency loan recipients and weak corporations affiliated with the top sixty-four business groups. Based on this assessment, 55 companies classified as non-viable were resolved by merger (eleven companies), sale to a third party (15 companies) and liquidation (25 companies) while four are in court receivership.
management, off-balance sheet transactions including derivatives, asset classification, and so on, and special disclosure items such as those related to financial mishaps, the loss of a lawsuit for a large sum, etc.

In addition, it is also vital that a system that operates fully in accordance with market principles should become firmly entrenched. Financial institutions should make decisions on lending based on analysis of the profitability of firms’ investment projects. The transparency of the decision-making process will also make it clear where responsibility lies for NPLs that arise in the future.

Toward a more competitive financial sector

While strengthening prudential regulation, the supervisory authority still needs to ease restrictions on the range and methods of banking business so as to afford banks more alternatives in their management strategies.

In line with this, measures are being sought to develop the Korean financial industry to the level of developed countries by instilling greater competitiveness into the financial sector. To make financial institutions more competitive, it is an urgent task to establish firmly a general practice of allowing market forces to resolve financial institutions lacking the capacity to turn themselves around by their own efforts.

Conclusions

What lessons can Korea draw from its harsh economic ordeal? Perhaps the most important is a renewed recognition of the significance of the financial industry for the overall economy. In the process of pursuing economic development from the 1960s, the basic functions of the financial industry, such as credit screening, had been largely neglected because the financial sector had been regarded simply as a means of supporting the real sector. This eventually served to bring about the recent crisis. When many large firms collapsed, financial institutions were left with the problem of heavy bad loans on their hands.

Throughout the long haul of recovery from the crisis, non-viable financial institutions have been leaving the market on an unprecedented scale. It cannot be denied that Korean financial institutions had long neglected sound management and invested recklessly in high-yielding but

high-risk assets, sustained by the belief that ‘financial institutions would not be allowed to fail’. However, these recent exits have come as a salutary warning to the contrary to the remaining financial institutions.

Financial institutions have been forced to desist from practices that involve moral hazard and must now operate their businesses in accordance with market discipline, which requires transparent financial statements and profit-oriented, sound and accountable management.

Provided that financial restructuring and a major part of corporate restructuring are completed successfully, we expect the normal operation of the financial system to be resumed and a ... domestic business and consumer confidence will pick up, moving the Korean economy back onto a sustained growth track.