The banking reform in Korea: issues and challenges

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Introduction

Four months into the financial crisis that broke out in late November of 1997, the Korean government embarked on a complete overhaul of the financial sector. By then two of the six largest commercial banks had already been nationalised, and the operations of 10 merchant banks were suspended. Many other banks and non-bank financial institutions had piled up huge amounts of non-performing loans (NPLs) in their balance sheets, and the losses resulting from the bad loan accumulation were driving these institutions into a state of near bankruptcy. The unsoundness and instability of financial institutions, in particular commercial banks, threatened the stability of the financial system, thereby posing systemic risks to the entire economy.

Beginning in March 1998, the Financial Supervisory Commission (FSC), newly created by consolidating separate institutions for supervision and regulation of different financial industries, went to work. At the outset, the FSC decided to revoke the licences or suspend the operations of non-viable financial institutions; clean up the balance sheets of relatively healthier institutions; create, through mergers, a relatively small number of large banks modelled on the best practice banks in the United States and Europe; and let the restructured banks take charge of corporate restructuring. To this end, Korean authorities were prepared to spend 64 trillion won of public resources.

Few countries have been able to manage such an extensive and comprehensive restructuring of the financial sector in a relatively short period of time. Because of this aggressive reform, commercial banks have become a lot more transparent and healthier than before, and the confidence of foreign investors and financial market participants in the Korean economy has largely been restored.

The reform process is, however, by no means over: it has been plagued by a series of relapses and still faces formidable challenges. This note discusses some of the unresolved issues and draws several lessons from Korea's experience with financial restructuring.

Progress in financial restructuring

According to the FSC's diagnostic review of financial institutions, 12 out of 24 banks in Korea were not viable as they failed to meet the minimum capital adequacy standard as of end-1997. These banks were then ordered to submit their own rehabilitation plans specifying the measures of cost cutting, recapitalisation and management changes before the end of April 1998.[1]

After due diligence, the FSC concluded that all of the plans submitted by the 12 banks were not feasible and rejected them at the end of June. Five banks had their licences suspended, and the remaining seven were given conditional approval. The five insolvent banks were then acquired by other healthier banks through purchase and assumption arrangements. Non-performing loans of these failed banks were purchased by the Korea Asset Management Corporation (KAMCO) at a considerable discount. The acquiring banks also received capital injections through public bonds issued by the Korea Deposit Insurance Corporation (KDIC) and guaranteed by the government, which bears interest costs. Any shortfall in the net value of transferred assets and liabilities was also covered by the government.

The remaining seven banks with conditional approval were in effect asked to merge with other banks or find strategic foreign partners which could replenish their equity capital and bring in expertise for bank management. More specifically, the FSC would purchase their non-performing loans and recapitalise them if they satisfied a set of conditions. To qualify for government support, the seven banks had to reduce manpower by 45–50%, streamline headquarters operations, consolidate the branch network, secure merger or strategic foreign partners and replace the existing management with a new breed of bankers recruited from both within and outside the banks.

[1] On Korea's financial restructuring see FSC (1998a) and Claessens, Ghosh and Scott (1998).

Other banks with a Basel ratio higher than the 8% minimum requirement were also subjected to diagnostic scrutiny. If their balance sheets needed improvement and managerial practices did not conform to international standards, they were asked to take corrective action.

Since implementation of the bank reform began in July 1998, two of the seven banks (Hanil and CBK Bank) with conditional approval, which are also among the six largest Korean banks, merged voluntarily. Another large bank (Chohung Bank) has gone through a series of management changes and internal restructuring and will merge with a regional bank. One regional bank (Chungbuk Bank) has been ordered to take steps to merge with Chohung Bank. The Korean Exchange Bank received a capital infusion conditional on management change, staff reduction, operational consolidation and an additional capital injection by its major foreign partner. There have also been two other mergers between four healthier banks. One of the two nationalised banks (Korea First Bank) has been acquired by a consortium of foreign investors, and another bank (Seoul Bank) will be sold to a foreign concern in the near future.

Most of the commercial banks subjected to restructuring have been successful in carrying out the corrective actions required by the FSC. On average, they have managed to reduce their manpower by 20% and streamline their organisations by closing down more than 700 branches so far. Some of the banks have secured foreign partners, and have made considerable progress in bringing about fundamental changes in their governance and operational structure.

The Korean government initially projected that the fiscal support required to clean up banks and other financial institutions would amount to 64 trillion won. At the end of 1998, the restructuring of commercial banks had absorbed 40 trillion won (FSC, 1999). Although the available estimates vary, the commercial bank restructuring will need a lot more financing than is projected by the government in 1999 if the economy does not recover from the ongoing crisis.

Non-performing loans and competitiveness of banking institutions

As of end-September 1998, total non-performing loans classified as either substandard, doubtful or estimated loss of 22 commercial banks amounted to 7.1% of total bank loans (FSC, 1998b). Although the loan classification standards were strengthened as loans in arrears for more than three months are now defined as non-performing (instead of six months before), the ratio dropped because of the sale of non-performing loans to KAMCO.

In recapitalising commercial banks, the Korean authorities considered it prudent to maintain banks' capital adequacy ratios somewhere in the range of 10–13%, higher than the minimum standard, since there were considerable uncertainties regarding asset qualities, risk concentrations and other adverse financial conditions at most of the banks. This increase, it was thought, was vital to restoring the credibility of, and the confidence of foreign investors in, the Korean banks. Although the government has poured in 40 trillion won so far to meet the Basel target ratios for capital adequacy among the banks, it is not altogether clear whether Korean banks are any stronger and sounder than before in terms of their capacity to bear risks and absorb losses in the eyes of foreign investors and international financial market participants.

The credibility problem is related to the lack of agreement on the international loan classification standards. At present, any loans in arrears for more than three months are classified as substandard or below and non-performing. However, a new trend in banking eschews the mechanical loan classification in favour of a diagnostic standard, a classification based on the ability of borrowers to repay their bank loans. According to this standard, obtaining a precise figure for non-performing loans at a bank requires due diligence of its asset portfolios. Since the ability to repay depends in a large measure on the prospects of earning performance and cash flow generation of its borrowers, the amount of NPLs could vary substantially depending on how macroeconomic prospects of the economy, among other things, are perceived.

Since the Korean economy has not fully recovered from the financial crisis and, more importantly, corporate restructuring has just started, it is argued that a substantial portion of precautionary loans, those loans in arrears by one to less than three months, should be classified as non-performing. If the diagnostic standard is adopted, therefore, the official figure of NPLs may be grossly underestimated. Recognising this problem, the FSC has set aside 5 trillion won to purchase additional non-performing loans at the banks that are likely to appear in the future.

This precautionary measure has done little to improve the standing of the Korean banks.

The use of a diagnostic standard poses a number of difficult problems for the Korean authorities. In order to mitigate the confidence problem, they could provide more financial support to the banks. But this could be very costly. From the government point of view, there is also the question of deciding how much additional support would be adequate, since the earning prospects of corporate borrowers and hence their ability to repay depends on the speed of economic recovery.

Higher Basel ratios could help enhance banks' soundness and stability in the short run, but would cut into their earning capacities. If this happens, then it may take a long time for the banks to regain their competitiveness. This prospect may then undermine their soundness and hence weaken their competitiveness further. This competitive disadvantage could be more serious if financial markets are opened up while the financial sector restructuring is being carried out. This is because internationally active banks entering the Korean market could afford to maintain low Basel ratios as they are able to manage the quality and risk of their asset portfolios better than domestic banks.

High capital adequacy requirements may also produce perverse effects on macroeconomic policy management. Knowing that economic recovery is imminent and could improve the quality of assets held by commercial banks and hence lessen their burden of holding a large amount of capital, policy-makers may be more inclined to reflate the economy than recapitalise the banks.

New governing and operational structure of commercial banks

One of the conditions for the government's fiscal support for recapitalisation is that commercial banks reform their management structures using US and British banks as a model. According to the FSC's best practice model, major decisions concerning banks' business strategy, risk management and the appointment and performance evaluation of senior management would be made by an independent board of directors. The bank is also to be organised around several business units engaged in lending and investment, such as consumer and corporate banking and capital market transactions, and supporting units such as general administration, information technology and risk management. Departing from the old structure, branches are to be reorganised basically as sales outlets instead of full service banking units as they were before.

Unfamiliar with the workings of the new management system, bank managers and staff find it difficult to adjust to a new environment and often rebel against the reform. In the light of the experience of banking reform in other countries, it may take several years to complete the structural reform at the operational level. The operational reform can be costly as well, because bank staff have to be retrained, and during the period of adjustment banks also suffer from confusion and lack of coordination among different business and support units and often lose deposit and loan customers as they move from an old centralised system to an untested decentralised structure.

The inertia problem is often compounded by the desire of senior management as well as the supervisory authorities to turn around a bank's performance as soon as possible. As far as top executives are concerned, an improvement in a bank's income statement, which is visible, would help enhance their reputation and also the chances of staff staying in their jobs, more than progress in operational restructuring, the benefits of which will only be realised in the long run and are not visible in the short run. For these reasons, senior management does not have any strong incentive to develop necessary internal policies and procedures and deploy adequate resources for implementation of the reform, all the more so in the face of staff opposition. Top executives are in fact inclined to sacrifice long-term gains for short-run profitability.

One of the side effects of the financial restructuring has been a relatively severe credit crunch. Korean commercial banks have been trying to improve and expand their risk management capacities by recruiting risk management experts, but the experienced people who could manage credit, market and other risks involved in bank investment and lending are in short supply. Having operated for so long under a tightly controlled regime, the Korean banks have had no need to strengthen their risk management, but with the speed of market liberalisation and opening accelerating, they realise a simple mistake or misjudgment in risk management could easily impair the quality of their balance sheets. Owing to a lack of experience in analysing credit risks associated with their lending, in particular to small and medium-sized firms, and together with the need to increase the BIS ratios, domestic

banks retrenched from lending much more than called for. In so doing, they contributed to prolonging the credit crunch that was initially caused by tight monetary policy at the early stage of the crisis.

Privatisation of commercial banks

In the process of restructuring the financial sector, the government had to assume the ownership of a number of major Korean banks. The government replaced their management and set in motion internal changes necessary to improve their efficiency and stability. The government plans to privatise these banks as soon as strategic investors with expertise to manage banks can be found. Domestically, they will not find many qualified buyers; chaebols and large corporations are effectively barred from owning banks. Even if they are allowed, they may not be able to mobilise enough capital to purchase banks.

Unable to find qualified domestic buyers, the government may have to turn to foreign financial institutions and investors for the sale of domestic banks at bargain prices. Since domestic banks' competitiveness has been so much weakened, the free entry into the Korean financial market may lead to the foreign domination of Korea's banking sector. If the Mexican experience is any guide, the domestic banking sector could easily be dominated by banks owned and controlled by foreign interests as weak domestic banks are driven out of the market. The foreign dominance could raise sensitive social and political issues.

In Korea's experience, the presence of foreign banking institutions either as branches or as joint ventures with Korean partners has not contributed to upgrading the quality of the financial sector or to bringing in foreign expertise. Instead, they have adjusted to the domestic banking environment so much that there are not many operational differences between foreign and domestic banks. At present, foreign banks could help facilitate the restructuring of the corporate sector as they have more experience and better skills than the Korean banks. However, if foreign investors buy Korean banks, they are certain to buy clean banks and then will not be involved in the workout. It is an open question how their expertise and experience could be transferred to other Korean banks wrestling with the disposition of corporate debts.

For more than a year, the government has been searching for suitable foreign buyers for the two nationalised banks. However, there have not been many foreign investors interested in buying Korean banks. Korea First Bank, one of the two banks which were put on the market for sale to foreign investors, has been taken over recently by a consortium of foreign investors after a long period of negotiation. The sales negotiation dragged on because the interested buyer and the Korean government could not agree on the put-back option, that is, the disposition of new NPLs that surface during the first two years, which the buyer wanted the Korean government to assume. The negotiation for the sale of another government-owned bank, Seoul Bank, has met similar problems, although the bank is expected to be sold soon.

If these experiences are any guide, foreign investors with capital and expertise in managing banks may not be easily found. Indeed, it may take a long time to privatise government owned banks. Until suitable investors are found at home or abroad, the government will continue to assume the responsibilities of ownership. The government is not expected to intervene in day-to-day operations of these banks except to exercise its voting rights as a major stockholder.

But many people are openly questioning whether the Korean authorities could adhere to a hands-off policy, given the long tradition of government intervention in the management of financial institutions.

Commercial banks leading corporate restructuring

One of the major structural problems that precipitated the crisis in Korea was excessive corporate borrowing, much of which was short-term. The debt/equity ratios of some of Korea's major industrial conglomerates rose to 500% at the start of the financial crisis. With the increase in interest rates, the debt burden became so severe that most Korean firms, both small and large, could not remain solvent. With the onset of the crisis, the Korean authorities realised early on that the resolution of corporate debt problem was a prerequisite for the recovery of the economy from the financial crisis.[2]

Immediately after Korea agreed to the IMF programme that raised the market interest rate above 30% per annum, some of the relatively small chaebols went bankrupt and the number of business failures

[2] On Korea's corporate restructuring, see Lieberman and Mako (1998) and FSC (1998c).

jumped up sharply. Since the bulk of non-performing loans at the banks were overdue loans extended to major Korean chaebols, commercial banks could not extricate themselves from corporate debt problems.

In addressing both the banking and corporate financial problems, the Korean authorities chose to restructure commercial banks in advance of restructuring corporate debts.[3] The underlying argument for the bank-led approach was that once their soundness was restored, commercial banks would be in a position to lead corporate restructuring. This approach was consistent with market liberalisation policy and has a number of advantages, as Claessens and et al (1998) point out. In a market oriented economy, the government should not involve itself directly in restructuring corporate debts, as government intervention would, among other things, result in a repetition of the moral hazard of bailouts, in the end causing higher costs of restructuring. Since the government guarantees banks' liabilities, the banks are in fact responsible for corporate restructuring.

Despite some of the apparent advantages of the bank led approach, it has not worked as well as it was expected. The fundamental problem of this approach is that five of the largest banks – FKB, Seoul, Chohung, KEB and Hanvit, which account for the lion's share of total borrowings by Korea's 30 chaebols from commercial banks – have in effect been nationalised after the restructuring. Except for a few smaller national banks and regional banks, the government now owns practically all large commercial and specialised banks in Korea and hence should ultimately bear the responsibilities of restructuring corporations.

However, the Korean authorities have been reluctant to direct the corporate restructuring for ideological and political reasons, the banks do not believe that they have either financial clout or authority, and those workout candidates, for understandable reasons, have been uncooperative. The lack of clarity on sharing responsibilities and coordination among the major players has delayed the restructuring process.

Questions have been raised as to whether the major creditor banks have developed an institutional capacity adequate to dispose of the massive debts of a large number of corporations, especially those of chaebols. Korean chaebols are also too big and too powerful for the creditor banks to resolve their debts on their own. Even for smaller

[3] See Lieberman and Mako (1998) and FSC (1998c).

firms, banks have shown themselves reluctant to play an active role in the debt workout, for fear of being held responsible in case the workout does not succeed and also because of the social and political consequences of failure.

Currently, seven companies including 65 affiliates belonging to 24 chaebols are undertaking workout processes, but there are indications that in many cases creditor banks were unable to control those firms under the workout arrangements because they could not agree on how the debts should be restructured, and in some cases the workout process has served to keep alive insolvent firms instead of helping viable firms with short-term financial and management problems to improve their financial and competitive strength.

Recognising these constraints, the government took a major initiative in December in restructuring the nation's top five chaebols in cooperation with the creditor banks.[4] The leading role of the government in corporate restructuring raises a number of difficult questions. The debt restructuring may involve debt/equity swaps and hence result in commercial banks holding large amounts of corporate equities. Since the banks are, in fact, nationalised, the government will end up owning a large number of corporations in Korea.

The bank-led approach was chosen to mitigate the moral hazard of bailouts that occurs when the government is directly involved, but in the end the government is unable to avoid the problem. Therefore, the strategy to clean up banks before addressing corporate debt problems may require repeated recapitalisation because of the slow progress in the workout and the corporate equities held by commercial banks which cannot be disposed of quickly.

The bank-led approach poses a more fundamental problem related to macroeconomic management. Korea's major corporations including those belonging to the chaebols must not only restructure their massive debts, but also carry out the restructuring at the operational level. For example, they should: consolidate their business lines to concentrate on core ones where they have competitive advantage; institute corporate governance with an independent board of directors; adopt international accounting and disclosure standards; and develop a more profit oriented corporate culture.

[4] See FSC (1998d).

It is widely recognised that without both financial and operational restructuring, Korea will remain vulnerable to systemic crises. How does the government induce the corporations to undertake operational restructuring?

The Korean government's strategy has so far used the debt restructuring – debt write-off and extension and debt/equity swaps – as an incentive for the operational restructuring. The strategy, however, has conflicted with macroeconomic management. Beginning in the fourth quarter of 1998, there have been many signs suggesting that the economy is coming out of the recession. The economy is forecast to grow by 4–5% in 1999 as against a minus figure only a few months ago. The sovereign rating of Korea has moved up to investment grade. The stock market has also recovered, increasing the possibility of raising equity capital.

This sharp turnaround in growth prospects has also affected the behaviour of corporations in their debt workout negotiations with the banks. Korea's major chaebols are starting to believe that with some luck they might be able to ride out the debt crisis. Certainly, the bullish expectations on the future expansion of the economy suggest to both the corporations and the banks that the amounts of financial support needed for the corporations will decline. The greater availability of liquidity will then weaken the resolve of both the banks and the corporations to proceed with their workout plans. Since the creditor banks are also reluctant to get actively involved in the debt workout, they may tend to slow down or delay the workout process on the grounds that the economic recovery is likely to change the profile of corporate debts.

The rise in unemployment may indeed call for expansionary monetary and fiscal policy as corporates' earning prospects improve. There seems to be a trade-off between corporate restructuring, on the one hand, and macroeconomic policy supporting economic recovery on the other. The Korean policy-makers have yet to find an optimal strategy which will promote growth without jeopardising economic restructuring.

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