FINANCIAL CRISIS AND FORTHCOMING FINANCIAL REFORM IN KOREA

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Continued Waves of Financial Aid

On December 4, the Korean government announced the conditions for its 58.4 billion dollar rescue package from the International Monetary Fund (hereafter, IMF) to relieve its massive financial crisis. The IMF's first payment of 5.5 billion dollars was transferred to the Bank of Korea's accounts at the Federal Reserve Bank of New York right after the package was approved by the IMF's board of directors. A second payment of 3.5 billion dollars was made available from December 18 after the IMF's first review was completed. Additionally, the emergency loans from the International Bank for Reconstruction and Development (hereafter, IBRD) and the Asian Development Bank (ADB), included in the IMF's rescue package, were delivered on December 24. As the Korean financial crisis continued to grow more serious even after the Korean government and the IMF agreed on the first bailout conditions, the IMF and the G7 governments agreed upon an early delivery of 10 billion dollars on December 24 in exchange for additional wide-ranging market opening.

Strict Financial Reform Requested By the IMF's Rescue Package

With the signing of the 58.4 billion dollar rescue package between the IMF and the Korean government, Korean financial institutions will be forced to compete with their foreign counterparts, who are armed with huge amounts of capital and advanced financing technologies. Up until now, domestic financial institutions have survived under government protection. However, no more government support can be expected under the IMF rescue package, which is taking away a variety of privileges domestic financial institutions have enjoyed and forcing them to be more trans-parent and accountable.

Moreover, massive amounts of hot money, speculative foreign funds seeking short-term profits, are expected to flow into the domestic capital market, which would disturb the financial market. The foreign shareholding limit in listed companies will be raised from 26 percent to 55 percent by year-end and 100 percent by the end of 1998. The short-term capital market, including corporate bonds, commercial paper and CD markets, will also be opened.

The IMF package has advanced the timing for the establishment of subsidiaries and local companies by foreign financiers, including banks, brokerage houses and trust companies, from late 1998 to early 1998. As a result, foreign financial institutions will be allowed to set up locally incorporated financial institutions starting next year. In line with this, foreign financial institutions will also be allowed to take over domestic banks, securities companies and insurance companies through mergers and acquisitions (hereafter, M&A).

Under the IMF-requested reforms, Korean financial institutions must receive strict regular audits on their financial status from internationally authorized accounting corporations. According to the audit results, those with huge amounts of bad loans will be forced to close.

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Korean banks are also required to meet the capital adequacy ratio of 8 percent suggested by the Bank for International Settlement (BIS). Those who fail to meet this ratio may become targets for third party takeovers or M&As in accordance with the IMF's request.

The IMF also requested that legislation which would give independence to the Bank of Korea and reform the government's supervision over the financial sector by combining the different supervisory units together be approved by the National Assembly before the end of the year.

Financial Reform To Be Realized Soon

Right after negotiations between the IMF and the Korean government were concluded, 9 financially constrained merchant banks were temporarily closed and 5 other merchant banks were closed a few days later as well, because their enormous bad loans and short-term borrowing from foreign lenders were the main sources of the financial turmoil today. These merchant banks have been forced to propose recapitalization plans no later than the end of 1997. Additionally, two major security companies, Coryo and Dongsuh, went bankrupt. These processes and actions signal a Korean financial reform which is shocking the Korean people, who never expected the end of such financial institutions.

If the recapitalization plans of closed merchant banks prove inadequate, these merchant banks will be cleared from the financial market. Some of the remaining merchant banks will also be faced with serious problems if the financial panic continues in the near future. The possibility of a chain of bankruptcies among securities companies should not be ruled out because the sharp drop in stock prices has already deteriorated their profit status. Therefore, M&As between the remaining merchant banks and securities companies could result in big investment banks. Their main work areas would be securities dealings and corporate financing, and their main customers would be corporations, households, and institutional investors.

The more important aspects of Korean financial reforms are in the banking sector. Even though each bank will try to meet the BIS capital adequacy ratio by reducing bad loans, some banks can be targets for M&As. Other banks, which are not targets for M&As, are also expected to pursue efficient M&As to prepare for competition with foreign banks.

Three different types of M&As involving banks are expected. The first one is an M&A between two commercial banks leading to a mega-bank that might engage in securities dealing, international financing and derivatives as well as traditional banking. In this type, M&As between two strong banks specializing in different banking areas are preferred. For instance, M&As between banks specializing in wholesale banking and banks specializing in retail banking can be considered. The second type of M&A can be done between domestic banks and foreign banks. Since the share prices of the domestic banks are lower than ever and Korean government has allowed foreign multinational banks to be major shareholders of the domestic banks, this type of M&A can be realized soon. The Korean government is likely to prefer that financially constrained banks are chosen as a target for M&As. The reason is that M&As like this are the only way to strengthen the financing position of financially constrained banks without hurting other relatively strong domestic banks. The last type to be considered is where domestic commercial banks try an M&A with either securities companies or merchant banks. If this type of M&A is realized, the banks' main work will be either securities dealing

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