FINANCIAL RESTRUCTURING: THE KEY FOR THE ECONOMIC RECOVERY

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Since last November, the Korean economy has suffered from unprecedented economic difficulties. The financial meltdown induced a credit crunch, which caused the failure of financial firms to play their proper intermediary role, huge corporate bankruptcies, and massive lay-offs. The real economy has also sharply deteriorated. A severe recession is now unfolding in Korea, with real GDP in 1998 expected to decline to even -5%. In the process of recovery, current account adjustment has taken place in Korea. However, trade adjustment alone is not a sufficient condition for a sustained recovery. A sustained recovery is unattainable if the financial system lacks the capital to extend its balance sheet. Whether the Korean economy will return to robust growth or just limp along over the next few years will depend mostly on the results of the efforts to the restore the banking system.

In general, financial restructuring aims to improve financial institutions' performance—that is restore solvency and profitability, improve the banking system's capacity to provide financial intermediation between savers and borrowers, and restore public confidence. To do so, three important improvements are required. First, financial institutions must improve their balance sheets. This can be done by raising additional capital, receiving cash from existing or new owners or from the government, by reducing liabilities, or by boosting the value of assets. Second, they should enhance their profitability. Measures can include renewed attention to business strategy, improved management and accounting systems, and better credit assessment and approval techniques. In addition, operation costs may be cut by eliminating branches and staff. Thirdly, improving supervision and prudential regulation is required. In other words, the resolution of widespread banking problems usually requires the adoption of a carefully designed financial sector restructuring strategy to restore confidence in the banking system and set it on a path that will return it to soundness and profitability.

Fragmentation of the Korean Banking Sector

(number of financial institutions)

Commercial Banks	State Banks	Merchant Banks	Securities Companies	Foreign Financial Institutions	Total
26	8	30	53	52	169

In line with this, the Korean government has designated the goals and principles of the restructuring process. Troubled financial institutions will be restructured and recapitalized within a specified time frame. A credible and clearly defined exit strategy will involve requiring troubled institutions to present a viable rehabilitation plan, and the closing of insolvent financial institutions and those failing to carry out their rehabilitation plan within the specified periods.

Restructuring could also involve mergers and acquisitions by domestic and foreign institutions, provided the viability of the new groupings is assured. The disposal of nonperforming loans will be accelerated. All forms of assistance to banks, including through the Korean Asset Management Corporation (KAMC) and the deposit insurance funds, should be provided only as part of viable rehabilitation plans. All support to financial institutions, other than Bank of Korea liquidity credits, will be recorded transparently in the fiscal accounts. Market-oriented terms and conditions will be established for any support to financial institutions.

The government is preparing a comprehensive action program to strengthen financial supervision and regulation in accordance with international standards. It is convinced of the need not only to address the immediate problems of the financial system, but more fundamentally to set the basis for a strong domestic financial system. To do this, efforts will be made to increase market discipline.

How Serious Is It?

Knowing the direction of restructuring is one thing and implementing the plan is another. Looking at the cost of restructuring is scary. According to JP Morgan's estimation, getting banks to meet the 8% BIS standard level creates a recapitalization need for the distressed Korean banking system that will range up to 30% of GDP. By comparison, the recapitalization need of the U.S. banking system was roughly 4-5 % of GDP in 1984-1991 and Mexico's was roughly 12-15% in 1995-1997. This shows that the banking difficulties have already spread to the real sector, which is reducing the production activities. All in all, this will not be an easy task for the Korean government.

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Where We Are Heading

Under the current financial restructuring plan, the remaining 7 of the 12 undercapitalized banks submitted implementation plans on July 31. The Financial Supervisory

The Cost of Recapitalization of the Korean Banking Sector

Domestic Credit	Nonperforming Loans	Capital Asset Ratio (CAR)	CAR after NPL write-off	Recapitalization need
165 (% of GDP)	25-30(% of total loans)	6-10%	-10 %	30 (% of GDP)

* Source: JP Morgan

"With the government's fiscal resources limited and private domestic resources largely depressed, foreign capital will have to play a key role in funding the recapitalization of financial institutions and buying distressed assets."

Commission (FSC) will announce its decision on the implementation plans within the next month or two. Banks whose implementation plans are not approved will be subject to mandatory mergers or transfers of business under the Purchase and Assumption (P&A) rule, or exit under prompt corrective action procedures. If approved plans are not achieved, banks will be subjected to graduated responses depending on the seriousness of the failure.

The remaining 12 commercial banks which have been above the 8% BIS ratio will be evaluated by the FSC for asset quality and managerial capacity by internationally recognized accounting firms. If the capital asset ratio of a bank subsequently falls below 8%, the FSC will invoke prompt corrective action procedures.

To improve the competitiveness of the financial sector, the FSC is encouraging financial institution recapitalization and mergers where there is adequate burden sharing. Recently two commercial banks have announced a merger which will result in the nation's largest financial institution with more than $82 billion in assets.

The union of Commercial Bank of Korea and Hanil Bank has raised hopes for the emergence of a globally competitive Korean bank. The new mega-bank, tentatively named Commercial Hanil Bank, will rank about 100th in the world in terms of assets. While not big enough to be called a "super bank" by global standards, it is still formidable. This mega-merger will galvanize endeavors to restructure the banking sector and is expected to trigger a series of other marriages among Korean banks.

The first restructuring of non-banking institutions will be implemented based on competitive and autonomous economic principles by September. The FSC will decide on P&A transactions or direct recapitalization by the government with full write-down of shareholder capital and replacement of management in insurance companies in August, and securities firms in September.

Still Bumpy Road

The huge recapitalization needs and the manner of the financial reform imply an enormous burden on the public. This raises the question of whether there are enough fiscal resources available. Certainly, the government should not take and is unlikely to bear the full cost of the recapitalization. The fiscal deficit should also be reinbursed at a later time through the sale of the distressed banks or other acquired financial assets through a Special Purpose Company (SPC).

Privatization of public companies is one alternative for the government to improve its funding. However, the deflated economic situation is producing little interest in state enterprises except in the telecommunications sector.

With the government's fiscal resources limited and private domestic resources largely depressed, foreign capital will have to play a key role in funding the recapitalization of financial institutions and buying distressed assets. In line with this, the Korean government has removed or sharply reduced most foreign ownership restrictions. However, the poor disclosure and transparency of information and financial statements often discourages foreign investments. VIP