NEW ERA OF FOREIGN BANKS IN KOREA AND ITS IMPLICATIONS

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Sell-Off of Korea First Bank

Korea First Bank(KFB) has been sold off to a U.S.-based consortium, Newbridge-General Electric (GE) Capital, signaling a near completion of the Korean government's initial financial sector restructuring efforts. After negotiations with two foreign bidders, the U.S.-based Newbridge-GE Capital consortium and U.K.-based HSBC, the Korean government picked the U.S. consortium as the final winner. Newbridge accepted the government's offer to buy a 51% stake in the Korea First Bank while HSBC demanded a higher stake.

The Newbridge-GE Capital consortium is comprised of Newbridge, the largest shareholder of Bank America, and GE Capital, a financial subsidiary of General Electric Co. Newbridge is a financial investment corporation which chiefly seeks investment returns through M&As, refraining from direct management of invested companies. Involved in 28 businesses ranging from leasing to credit cards, insurance, and project financing, GE Capital is the biggest merchant banking corporation in the U.S. The government's original negotiation partner for the sell-off of Korea First Bank was HSBC Holdings, but Newbridge stepped in later and offered better terms and conditions.

As a way to guarantee autonomy of bank management, voting rights for the government's stake will be delegated to the Newbridge consortium. The consortium, however, will be prohibited from selling its stake of the bank without the government's permission for the next 2 years. In the deal, bad assets and a portion of Korea First Bank's liabilities will be separated out. The purchaser will have a put-back option for non-performing loans which surface during the first year, and a limited opportunity to discard non-performing loans arising in the second year. With the sale of Korea First Bank finalized, the government will pursue the sale of Seoul Bank to foreign financial institutions.

Advantages and Disadvantages of the Sell-Off

The sell-off of Korea First Bank to a foreign investor after a nine-month effort indicates a near completion of the government's year-long battle to restructure the domestic banking industry. As a result, the sell-off could make a considerable contribution to boost Korea's sovereign credibility. Buoyed by the successful sell-off of Korea First Bank, the sale of the other ailing commercial bank, Seoul Bank, to foreign investors will be easier and completed sooner or later. And as foreign financial institutions are coming to the Korean capital market one after another, the lending practices of financial institutions are expected to undergo significant changes in the medium- and long-term.

There are short-term disadvantages, however. Newbridge has demanded that Korea First Bank curtail the number of employees and branches by about half before its takeover. If the government accepts the Newbridge offer, strong resistance from the Korea First Bank employees is expected. In particular, Newbridge has insisted on taking over just the healthy assets of Korea First Bank, while demanding

〈Table 1〉 Advantages and Disadvantages of the Sell-Off

Advantages	Disadvantages
① recovery of credibility	① rapid withdrawal of bad loans
② improvement of lending practices	② possibility of hostile M&As by speculative consortiums
③ enhanced transparency of accounting and management	③ decreased job security
④ decrease of government-intervention in finance sector	④ insufficient protection of minority shareholders

write-offs of shares held by minority shareholders.

The Prospects of Korea's Banking Industry

Following the sale of Korea First Bank, Seoul Bank will be sold to foreign financial institutions. Prior to this, the International Finance Corporation (IFC) made a capital investment in Hana Bank. Moreover, Hanvit Bank and Housing & Commercial Bank are seeking to attract foreign capital. Foreign financiers are also expanding their footholds in the non-banking financial industries. With the advances by foreign financial institutions, Korean banks are afraid that they will face hard competition. The domain of the banking industry in Korea will be composed of four sectors: foreign banks (including branches), joint ventures, mega-merged banks, and local banks. The foreign banks are again composed of two sub-groups: newly-invested foreign banks (Korea First Bank, Korea Exchange) and incumbent foreign branches (like CitiBank's branch). The number of joint ventures such as the KorAm Bank will rapidly grow this year. The three mega-merged banks are stepping up efforts to introduce $300 million to $500 million from international capital markets this year to sharpen their competitiveness. These moves will pave the way for greater foreign equity participation in domestic banking; furthermore, they imply a greater involvement of foreign investors in domestic bank's management. The greater foreign equity participation will inevitably give rise to three or four more joint ventures in Korea this year. To survive the tight environment, domestic banks have to change their lending practices. For example, there will be a transition from old-fashioned collateral-based practices to new credit-based practices which put more emphasis on a firm's development prospects and profitability.

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The Role of Foreign Banks in Korea

The foreign banks in Korea generally show higher ROA (Return on Asset) and ROE (Return on Equity) than domestic banks while foreign bank's ratios of non-performing loans (NPL) are lower than those of domestic banks. According to the statistics from the Financial Supervisory Service, domestic banks posted positive operating income before subtracting allowances and reserves. But the size of allowances and reserves far exceed the operating income and as a result, the net profit falls to a negative figure. This is in sharp contrast to the case of foreign banks, where they have a much lower level of bad loans and thus, a lower level of allowances and reserves. This difference between the domestic and foreign bank's performance indicators imply that the entrance of foreign banks into Korea could contribute to the improvement of Korean financial systems. Surviving domestic banks will develop their banking techniques and improve loan portfolios by coping with the pressure of competitiveness in the new environment.

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Implications

The entrance of foreign banks in Korea's banking industry will eventually help build up an advanced credit-based system of lending practices. Along the way, under-competitive financial institutions which cannot keep pace with this new trend will be exited. Also, in terms of personal finances, individuals with bad credit or insolvency history will find it difficult participate in the newer financial environment.

<Financial Institutions>

Beside the changing lending practices, the Korean financial institutions must offer the qualified customer services to survive the fierce competition. On average, they will enhance the international competitiveness by acquiring advanced banking techniques focusing on high profitability. Toward this end, they should implement an overall asset-liability management system as well as advanced practices of lending.

<Businesses>

As the lending practices in the banking industry change, Korean businesses will face a new environment regarding their financial strategies. First, they should improve the current debt-ridden financial structures. Bad financial structures will not only prevent them from mobilizing funds at lower interest rates but also make it impossible to borrow money at all. Enhancing the transparency of corporate accounting and addressing the malignant aspects of corporate governance are also necessary conditions. While past lending practices basically depended on the size and marketability of collateral owned by a firm and on mutual payment guarantees from other firms the future credit-based sytem will require higher credit ratings and good prospects of a firm. Therefore, from the viewpoint of a firm, managing a good credit rating and solid IR (investor relations) are crucial to adapt to the newer environment.

<Households>

In the case of households, generally speaking there will be more opportunities for bank loans. An average household in need of quick loans would not need to depend on the curb market

(continued on p.18)

〈Table 2〉 The Status of NPL's in Korea (year end)

Items	Domestic Bank		Foreign Bank	
	'96	'97	'96	'97
Non-performing Loan	4.1%	6.0%	0.3%	0.4%
Bad Loans	0.8%	2.6%	0.08%	0.2%

Data: Financial Supervisory Service, BOK.

New Era of Foreign Banks *I.Y. Cheon*

(Cont'd from p. 12)

or seek a payment guarantee from others for a bank loan. Instead, if an individual has a good credit history and a secure job, then most banks will provide various services including credit-based loans. In case of "bad credit" individuals, however, banks are likely to cut down the credit transactions, which would possibly lead to personal bankruptcies. These days, databases on individual credit history, formerly kept and used in separate financial sectors, are now being integrated for a consolidated credit history service. It is of utmost importance for individuals, therefore, to keep a good credit history in every area of personal finance including not only bank transactions but also minor payments of credit card bills, for example.

<Government>

Foreign banks' entry into the Korean financial market will mark the advent of a "credit society." Direct intervention in the bank's lending practices cannot be possible in a "credit society." Instead, the government's role should be confined to more or less indirect but basic and indispensable areas; i.e., the government should provide infrastructure for the "credit society." Its foremost role will be to help the introduction and management of a reliable credit history database for both individuals and businesses. Another important role is to supervise various kinds of financial institutions. By so doing, the government can prevent excessive bad loans and deteriorated financial institutions from recurring in Korea's financial industries. VIP