POST-RESTRUCTURING PROSPECTS OF FINANCIAL INDUSTRY

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Korean Financial Market in 1999

Low interest rates since mid-1998 have created favorable economic conditions for financial and corporate restructuring in Korea. The burden on the heavily-debted private sector from loan interest has been partly lifted. The real economy recovered its pre-crisis state and market players began to invest in the stock market. This created a virtuous cycle; low interest rates allowed companies to issue huge amounts of common stocks; this not only helped improve corporate financial conditions and increase profit margin but also led to rallies in the domestic stock market, which raised stock prices higher.

On the other hand, financial markets had to faced uncertainties arising from the insolvent Daewoo Business Group. Even though short-term rates (overnight call rate) stayed around 4.75% over a long period of time, long-term rates increased as investment trust companies (ITCs) sold holding bonds to meet higher redemption payouts caused by fears about Daewoo-related bonds. This resulted in marked disparity between short-term and long-term interest rates.

Restructuring of financial institutions since 1998 continued through 1999. Domestic banks fortified insolvent loan criteria. Firms were continuously asked to improve their corporate governance. Furthermore, the foundation of the domestic capital market became solid by the bullish KOSDAQ market and the newly-established forward government bond market.

Above all, the sale of two major troubled banks contributed to raising the quality of financial services and bringing more competition into the market. However, delay of the negotiations cost a heavy sum of four trillion won in public funds, which was injected into the two banks. Insolvent life insurance companies have increased their equity by injecting public funds also. Formation of strategic alliances among insurance companies, banks, security companies and credit card companies actively reflected this structural change. Furthermore, foreign capital flowed into secondary financial institutes without a hitch. The foremost issue of financial restructuring was to resolve the ITC problem. Ironically, the Daewoo crisis induced the early restructuring of ITCs. The Financial Supervisory Commission (FSC) specifically declared Korea Investment Trust and Daehan Investment Trust as insolvent financial institutions and planned to inject three trillion won ($2.5 billion). With agreement between the IMF and the Korean government, the two ITCs are to improve their business management conditions and privatize by June 2000.

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The amount of bad loans in the domestic financial sector during the restructuring process amounted to 63 trillion won as of June 1999, which was 11% of total credit in Korea. Moreover, the strengthened BIS standard and corporate workout programs will produce more depressed loans in the near future.

As financial markets changed, so did the way domestic firms financed themselves. In general, direct financing through the stock market has increased since the foreign currency crisis. Up to the second half of 1999, the total amount of direct fund raising was 5.8 trillion won. During 1999, however, borrowing from banks showed an increasing trend since domestic firms expanded their facility investment, and secondary financial institutions such as ITCs reduced their credit ability after the third quarter of 1999.

Prospects in the year 2000

The pace of restructuring the financial system will accelerate in 2000. From 1998 to 1999, restructuring of the financial sector focused on clearance of depressed assets under government supervision. However, financial markets are expected to face self-directed principles. Increasing presence of foreign financial companies in Korea is likely to further drive market-oriented reforms, since their market share is projected to reach 50% of domestic financial transactions. With new players in the market, strategic alliances and M&A's among financial companies will increase. Also, competition among financial companies will become stiffer due to reduction of savings deposit protection in 2001 and the differentiation of deposit insurance rates. In sum, the domestic financial industry will experience effective clearance of depressed assets, as well as severe competition in the market and structural changes.

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As major international banks have, or plan to, become bigger and more diversified, more domestic banks are likely to merge in order to gain global competitiveness. In addition, the government's intentions to reshape domestic financial institution is more focused on the universal banking system. Therefore, if financial holding companies emerge, then business barriers such as fire wall or Chinese wall will cease to stall market players. The non-banking sector will also expand its business areas with changes in the banking sector. The restructuring process of ITCs will be catalyzed after February 2000, when customers of ITCs will be allowed to redeem their bonds up to 95%. Therefore, restructuring of the financial sector will be nearly completed in the first half of this year.

A system of marking market price on bonds will be introduced on June 2000, which should strengthen the profit margin of ITCs; this will allow proper allocation of their portfolios as well as help proliferate asset-backed securities in the market. Before this system is introduced, it should reduce the number of mark on book-priced bonds and issue more periodical government bonds at benchmark price.

The way of injecting funds into depressed financial institutions should be altered. Up to 1999, public funds were a major funding source of restructuring. However, government debts continued to accumulate and the fiscal deficit amounted to 50% of total GDP. Therefore, private funds in place of public funds are expected to be mobilized for restructuring individual financial companies.

Money will flow into companies with sound financial conditions; companies whose debt-to-equity ratios are over 200% are classified as "credit-watch company". Since the first phase of corporate and financial restructuring will be over within this year, the early redemption of public funds and additional issue of government bonds may hinder financing in the private sector. VIP