SCENARIOS FOR BANK SECTOR MERGERS

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Recent Trend in Financial Restructuring

The government is considering large scale bank mergers in the banking sector to clear bad loans and gain global competitiveness.

The government is considering large scale bank mergers in the banking sector to clear bad loans and gain global competitiveness. Currently, laws on the founding of financial holding companies are being drafted, and new regulations such as the introduction of the equity exchange system, removal of double-taxes, and relaxation of shareholding limits are expected. Other measures include a depositor's protection act expected in 2001, an overall raising of fees, and differentiation of insurance fees after 2002.

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Restructuring in the securities industry will aim for free competition and variation of profit structures rather than M&As of securities firms or investment trust companies (ITC). The government is supporting Korea ITC and Daehan ITC with public funds, and normalizing other ITCs under their main shareholders. When the mark-to-market bond valuation system in introduced in July, funds will move to healthy ITCs and money-losing ITCs will have to leave the market. Considering the financial instability of domestic securities firms due to excessive dependence on brokerage fees, the government is allowing products such as wrap accounts and corporate pensions.

Table 1. Second Phase of Financial Sector Restructuring

Category	Number of Firms		Tasks for Restructuring
	End of 1997	March 2000	
Banks	33	23	-Creating a leading bank, restructuring banks into a financial holding company
Merchant Banks	30	10	-Promoting merchant banks, easing transformation into securities firms or investment banks
Securities	36	30	-Liquidation of unsound firms, such as the sale of Daewoo and Ileun Securities
Life Insurance	50	44(39)	-Processing of Korea Life Insurance and Daehan and Seoul Guarantee, listing of healthy life insur-ance companies
Investment Trust	31	24	-Injection of 4-5 trillion won of government funds into Korea ITC, and Daehan ITC
Mutual Savings and Finance	231	175	-Measures to promote treasuries, M&A of unsound treasuries
Credit Cooperatives	1,666	1,414	-Creation of large regional financial institutions
Lease	25	20	-Market-led restructuring

The insurance industry is also undergoing restructuring. New measures plan to arrange M&As for unsound insurance companies, while listing healthy companies on the stock exchange or converting them to mutual companies.

Institutional incentives exist for merchant banks to transform into investment banks, and individual merchant banks are planning to induce foreign capital or become securities firms.

Bank mergers are forecast to accelerate in response to three events: enactment of the Financial Holding Company Law, the Partial Depositor's Protection Act expected in 2001, and the continually expanding market share of foreign banks. With the lowering of deposit insurance limits coming in 2001 and resulting money flows to the most competitive banks, it is possible that domestic bank mergers will occur as early as July. Another factor raising the possibility of mergers is the entry of foreign banks into sectors such as housing, credit cards, and small business financing.

The bank merger debate

There are three main scenarios for domestic bank mergers.

There are three main scenarios for domestic bank mergers. Mergers could center around banks in which the government holds a large share, they could involve the formation of financial groups led by government-owned banks, or they could consist of voluntary mergers around large and competitive commercial banks.

In the first scenario, several banks with a large government ownership will form a financial holding company. The government will return its shares to the banks, which will be affiliates of the holding company. This scenario will allow government funds to be retrieved early after the holding company shares are sold. The disadvantage of this method is that some legal issues such as revision of the Financial Holding Company Law and limits on ownership shares need to be addressed.

The second scenario proposes a merger between government-owned banks and commercial banks.

The second scenario proposes a merger between government-owned banks and commercial banks. Since government-owned banks can be controlled by the government, mergers can be implemented with relative promptness. One proposal is a two or three-party merger resulting in a bank specialized in venture or small business finance. This scenario has not been discussed concretely by the respective parties, and is stilla speculation.

The third scenario envisions mergers between commercial banks. A large scale merger between leading banks could create a bank ranked within the world's top 100. The merged bank would focus on retail banking and would combine banks that specialize in corporate finance with retail banks. A drawback to this type of merger would be that the new bank may have too much influence on the retail banking sector. Another possibility is a merger between large banks and healthy small banks, with the large banks acting as the core of the newly merged entity. However, it is uncertain whether small banks would want to be absorbed into a new large bank.

If banks plan to survive on their own in the short term, they will have to strengthen their competitiveness through strategic cooperation or foreign funds. The banks may have to consider mergers in the long term to expand their market shares. The government's emphasis on the negative rather than the positive aspects of bank mergers may excessively prolong the discussion of bank mergers.

Table 2. Main Merger Cases

Reason for Merger	Main Cases	Assets (US$ billions)
Raising Market Occupancy	-Deutsche Bank + Paris Nationale/Pariba Bank + Banker's Trust Bank = Formation of a top international bank	799.2
	-Mizuho Bank Group = Dainichigankyo · Huji · Asahi Bank	962.6
Expanding business or geographic areas	-CitiCorp (bank holding company) + Travelers (insurance) + Salomon Smith Barney (investment bank) = Diversifying operations	663.6 (excluding investment banks)
	-Nations Bank + Bank of America = Expanding coverage from USA's east and west coast	616.8
Cutting Costs	-Swiss Union Bank + Swiss Bank = Reducing staff by about 23% and costs by 15% to 20%	682.2

Note: Asset figures are for the end of 1998

Evaluation and suggestions

To invigorate the domestic financial market, laws on financial holding companies should be passed more quickly.

To invigorate the domestic financial market, laws on financial holding companies should be passed more quickly. Despite the adoption of the Financial Holding Company Law, inefficient practices such as regulations on ownership and double taxation still remain in the financial sector.

A large merger in the banking sector will probably bring stability to the financial market.

A large merger in the banking sector will probably bring stability to the financial market. Bank mergers will allow the smooth recovery of government funds from banks. In addition, an improved financial sector will make the domestic manufacturing sector more competitive.

While a successful reorganization of the banking sector will act as a shock absorber against financial market jitters, instability may result from the attempted changes. If banks cannot see beyond their short-term rankings, or if they cannot agree on the best way to merge, the market for loans may become rigid and banks may become passive in their asset management. VIP