PROSPECTS FOR THE SECOND PHASE RESTRUCTURING

Department of Financial Market Analysis / Policy Analysis

1. Financial Sector

Need for strong government credibility

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For the last three years, Korea has continuously tried to cut the vicious circle of bad debts resulting in credit crunch and economic stagnation. Huge amount of public funds were injected into many financial institutions, and the Financial Supervisory Commission (FSC) has forced the banks to reduce bad loans by closely monitoring companies that have taken too much liquidity risk. However, a few big companies'

Table 1. Main Contents of Second Phase Financial Restructuring

		Main Contents
Banking sector		- Forming the Independent Evaluation Committee and appraising the management improvement plan of six public funds injected banks (Sep-Oct) - Installing at least two large leading banks by this year(Nov)
Non-banking sector		- Non-bank financial institutions be placed under financial holding companies (Nov) - Cleaning bad loans through M&A or P&A (Dec)
	Securities, ITCs	- Monitoring ITCs' financial soundness, Examining the Korea Investment Trust and Daehan Investment Trust's reform plans (Sep) - Starting the restructuring of securities firms (Oct) - Inspecting the ITCs' internal control measures (Nov)
	Insurance	- Inspecting the existing management improvement programs to the troubled insurance companies whose payment capacity is under 100% in June (Sep) - Determining whether a prompt corrective action is applied or not (Sep-Oct) - Reform program of the Samshin Life Insurance (Nov) - Pursuing the sale of the Daehan Life Insurance after the public funds injection of 1.5 trillion won (Nov)
	Others	- Three bad merchant banks under the BIS capital adequacy ratio of 8% be transformed to the subsidiaries of the Deposit Insurance Company through full investigation of their asset and liabilities (Oct) - Determine funds injection to the Seoul Guarantee Insurance (Oct) - Complete restructuring of five lease companies (Dec) - Applying prompt corrective action to a few Savings & Loans (Dec)

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unexpected liquidity crises have aggravated major banks' balance sheets further, and the banks' management has not improved remarkably because of moral hazard faced by the bank managers among others. As a result, the government announced that 40 trillion won of public funds should be raised to complete the financial restructuring - mainly spent to pare bad loans and assets at financial institutions. Therefore, the second phase financial restructuring for enhancing the financial sectors' competitiveness is needed in conjunction with the current corporate restructuring.

The Korean government has a plan to pursue the "hardware" side of restructuring financial institutions including M&As between healthy banks. This is to block off the contagion risk that insolvent enterprises and non-banking institutions' burdens of bad loans undermine the financial soundness of banks.

Currently, six banks - Korea Exchange, Cho Hung, Peace, Hanvit, Kwangju and Cheju - which did not meet the 8% BIS ratio at the end of June, or received public money, are expected to submit their rehabilitation plans to the Financial Supervisory Commission, and overall pictures will be drawn up as late as November. The Ministry of Finance will examine the banks' plans to reduce bad loans, and cut the banking sectors' non-performing loan(NPL) ratio to under 8% by the end of this year, under 4% by the end of next year, and under 3% by the end of 2002 through Bad Banks and Corporate Restructuring Vehicle (CRV).

Recently, as oil prices has elevated steadily and semiconductor prices have dropped dramatically, economic fundamentals have somewhat deteriorated. Especially, the failure to sell off Daewoo Motors induced market sentiment to rapidly cool. Furthermore, financial losses after the Daewoo crisis in the second half of 1999 have spread to investment trust companies (ITCs) and guarantee insurance companies.

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There, fore in order to block the spread of financial instability, compared with the first phase financial restructuring, the second phase needs the government authorities' credibility and leadership more than ever.

Table 2. Comparing between the First and Second Phase Financial Restructuring

	Second phase	First phase
different	- Relatively voluntary restructuring by the assistance of government - Bank loan be more important: Non-banking sectors must be cleaned in this restructuring - Pooling additional public funds will confront the objection of public opinions - Domestic macroeconomic downturn	- Inevitable restructuring by the IMF - Stock issuing surprisingly increased due to the cleaning process of commercial banks and merchant banks which were the biggest financial sources of companies - Pooling public funds be easy relatively - Starting with the fast macroeconomic recovery
common	- Government-led restructuring through public funds injection - Corporate restructuring by banking sector	

The problems of second phase financial restructuring

Most market participants think that government measures to inject large scale public funds are inevitable for fast, sufficient and transparent restructuring. Especially, cleaning out Daewoo-related debt burdens is important to establish the marking-to-market system of bonds and to dispose of Daewoo Motors in an appropriate price range.

However, the standard of determining the financial unsoundness of companies will have a great influence on the financial soundness of the banking sector, so it will be difficult to maintain rationality and appropriateness of the standards due to conflicts of interest between banks.

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Furthermore, banks do not have much incentive to aggressively examine and liquidate unsound companies. And a hasty reform drive may concentrate on superficial and quantitative aspects rather than qualitative ones because economic and social infrastructure to perform "software reform" of companies and banks were not prepared sufficiently.

Furthermore, while companies pointed to "high leverage and high growth" in the past, they now must target "high equity and high shareholder value". In this context, the credit crunch may deteriorate temporarily because the transition process from debt financing to equity financing needs a relatively long and stock offerings are not easy under weak stock market sentiment.

Prospects

In accordance with the evaluation results on the banks' management normalization plans by the planned private evaluation committee, the banks are doomed to be placed under a financial holding company or to implement normalization plans in their own way.

The normalization process seems to be done through the financial holding company system, or paper companies that would control banks, insurance firms and other financial companies. M&A or cleaning bad assets will also be performed voluntarily through the financial holding company system.

One notable thing is a shift of the government's attitude toward bank mergers. Recently, the FSC implied that public bailout funds-injected banks could be merged into the healthy banks. The government has so far reiterated its earlier stance that there would be no M&A deals between the healthy banks and public money injected banks.

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Additionally, banks, insurances, ITCs and merchant banks that received public funds are expected to be deliberately privatized in 2001. Due to the worries of

Table 3. Main Issues of Restructuring in 2001

Issue	Main Contents
management of public funds	- Installing the Independent Evaluation Committee for monitoring and assessing the efficient management and withdrawal of public funds
Sale of government shares	- Disposal of government shares and privatization of banks, life insurances, ITCs and merchant banks for the withdrawal of injected public funds
Building up financial groups	- Introduction of financial holding company, forming banking groups through M&A or P&A
Flexible introduction of new measures	- Fine-tuning of the time of introduction of pre-determined measures such as partial deposit insurance, foreign exchange liberalization and composite taxation of capital income by the extent of financial instability • Partial deposit insurance was to implement entirely in 2001. However, government may delay its introduction to 2002 or 2003 due to the worries of financial instability by large movement of floating funds
Soundness criteria of non-banking sector	- Preparing forward looking criteria for non-banking sector to exercise prompt corrective action

financial instability, the Ministry of Finance also is expected to carefully and flexibly take some controversial measures like composite taxation on capital income, partial deposit insurance and foreign exchange liberalization.

For successful restructuring

The authorities should present a possible action plan and schedule in more detail including any needed measures in each step.

The authorities should present a possible action plan and schedule in more detail including any needed measures in each step. Injection of additional public funds is inevitable, but the government must keep in mind a grand picture of an improved financial sector after restructuring. Furthermore, the Daewoo-related market risk should be removed as soon as possible for example, additional economic losses by the delay of Daewoo subsidiaries' sell-offs must not be witnessed again. A series of fast treatment of the Daewoo's subsidiaries will stimulate the disposal of bad companies.

Additional steps to improve corporate finance after restructuring are needed. As the Korean stock market has weakened continuously, bank loans have become more important than ever as financial resources for companies. Therefore, the MOF should offer various measures for easing the temporary credit crunch. Especially to vitalize stock market, government should improve the corporate governance of the non-banking sector, and strengthen the function of financial intermediaries considering that many commercial and merchant banks-which used to be the market's major players-are now disappearing. VIP

2. Corporate Sector

Return of market anxiety

The Korean economy has recently been undergoing various internal and external difficulties. Although Korea recovered from the 1997 financial crisis, the recent problems in the economy have raised anxiety about a new crisis. While the steep oil price hikes and the downturn of the business cycle have been factors, some argue that the government's weakened will to reform has been the main cause. But as other countries' experiences tell, the corporate restructuring takes time and pain. After only a couple of years of restructuring in its right sense, it might be too early to fully assess its outcome. In fact, the Korean economy has witnessed many great accomplishments in terms of corporate restructuring. Enhancing accounting transparency and lowering debt ratios of big business groups are examples among others. One could not imagine this kind of progress unless the Korean economy underwent unprecedented hardship during the past several years. With this situation as a backdrop, the Korean economy needs the second phase of restructuring[1) not because the first attempt was inadequate, but to reinforce additional measures in the course of completion of the reform. The most important shortcoming from the first phase could be summarized as "potential bad loans" of some big businesses. The findings of "potential bad loans" in the midst of financial market restructuring would lead to a credit crunch situation because institutions in the financial market themselves are undergoing severe reforms. As a result, in the middle of 2000, the Korean economy is witnessing mounting uncertainty and anxiety in the market, which are the background of the second phase of financial/corporate restructuring.

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In the second half of President Kim Dae Jung's term, however, some would emphasize that there is a political need for the government to enhance the effects of restructuring. According to this logic, because the government will have to inject massive public funds into restructuring, it will have to propose a clear and concrete restructuring plan to avoid a backlash. Regardless of the political background, no one can deny that a new momentum is indispensable for the completion of overall restructuring.

1) The government's plan for corporate restructuring is included in the framework of financial restructuring.

Table 1. Contents of the Second Round Coporate Restructuring Plan

▶ Prompt settlement of the ailing companies
- Main Targets: 12 affiliates of Daewoo, 34 workout companies, companies under court receivership or court mediation

▶ Enhance Monitoring Potentially Non-viable Companies
- Main Targets: Companies which are behind the corporate restructuring program(so called Big-Deal) schedule, the major conglomerates which have achieved the target of below 200% debt-to-equity ratio by the end of 1999, big companies which suffer from severe liquidity problems but do not have a plan for the future.

▶ Establishing a Day-to-Day Corporate Restructuring System
- Corporate Restructuring Vehicle (CRV) and Prepackaged Bankruptcy(PB) will be introduced.
- The current Corporate Restructuring Agreement will be revised so that it can be implemented entirely autonomously by the creditors banks.
- Credit financial institutions will enforce risk management system such as loan interest discrimination according to the credit risk of the company.

▶ Enhancing transparency of company management and improving corporate governance
- Hiring non-executive directors and auditing committee will be enforced to the KOSDAQ listed companies.
- Inside trading of management staff or false entries, will be considered to enforce the investigation function of the FSC.

Contents of the restructuring plan

One is the selective termination of unsound or potentially unviable firms, and the other is the creation of mechanisms to guarantee the market's smooth operation.

There are four categories of corporate restructuring envisioned in the Second Round Financial Restructuring Plan, [1] but the measures basically fall into two categories. One is the selective termination of unsound or potentially unviable firms, and the other is the creation of mechanisms to guarantee the market's smooth operation.

One of the most interesting questions for market participants is how nonviable or potentially nonviable companies will be selected. Another question would be how to tell whether a company is potentially nonviable as opposed to nonviable. The government has stated that it would separate the rescuable companies from non-rescuables, and that it would support the rescuables while exiting the non-rescuables. However, the government has only laid down concrete guidelines for selection, and creditor institutions will make the actual selections.

Indeed, when the restructuring plan was announced in September, the government did not state any criteria for selecting nonviable firms, but merely proposed some financial criteria such as the debt-to-equity ratio and interest coverage ratio, as well as non-financial criteria such as industry conditions and future prospects. On October 5, the government announced that potentially non-viable corporations would be subject to credit-risk assessments. According to this, potentially non-viable companies include those with the size of credit of over 50 billion won, those labeled "precautionary" or below by asset soundness criteria, or those with interest coverage ratio of over 1.0 over the last three years. In addition, firms that are declared as potentially non-viable from banks are also included. After separating the companies by November, the creditor banks will proceed with appropriate measures including: additional support, court recieveship, transition to CRV, liquidation, mergers, or sale.

The government plans also include various institutional reforms to prevent companies from becoming unsound. However, there is little that is new in these measures, and they are mostly a confirmation and legislation of existing approaches. In addition, the mechanism for restructuring has basically remained the same, in that the government will decide the principles of restructuring even though it will be carried out by creditor financial institutions. The government considers this to be in accord with market principles.

The government plans also include various institutional reforms to prevent companies from becoming unsound.

Since the second phase restructuring is meant to be reinforcing additional measures, one should fully examine whether or not relevant circumstances exist. Factors such as the business cycle downturn, the difficulty of laying off workers, and the capacity of financial institutions to judge the performance of companies are examples.

Table 2. Schedule of the Second Round Corporate Restructuring Plan

October	• Creation of a credit monitoring system and preventive mechanism for corporate unsoundness • Allocating responsibility for unsound companies and drafting of a joint agreement for recovery of bonds by financial institutions • Re-evaluation of prospects for companies with liquidity problems • Creation of specific regulations and guidelines for creditor banks and establishment of “Credit Risk Assessment Committees” • Introduction of bills concerning restructuring (October and November)
November	• Deciding on debt-for-equity swaps or exit procedures for cash-strapped companies • Deciding on workouts, court-recievership, or other agreements for unsound companies (November and December)
December	• Establishment of normalization procedures for companies under going business line restructuring, or “big deals”

Getting it right

Over the years, Korea has attempted many economic reform policies. Both the government and the private sector have become somewhat exhausted with these attempts, so the policies should not be pursued without a solid strategy. Considering this, the second stage of restructuring is commendable in that it has maintained the existing policy direction, but the question is how these plans will be executed. The author proposes five principles for successful restructuring.

The restructuring should be viewed from a future-oriented, long-term perspective.

First, the restructuring should be viewed from a future-oriented, long-term perspective. The main goal of restructuring is to improve the competitiveness of companies, industries, and as a result, the economy. Exiting unsound firms is only a means to this end. The government should keep a long-term vision for the economy and should try to establish an economic system in which the government, financial institutions, and companies all play a rational role.

The process should be market-oriented.

Second, the process should be market-oriented. Unsoundess of both financial institutions and companies are interrelated, and one should not simply think that corporate unsoundness has caused financial restructuring to falter. For corporate restructuring to be successful, financial institutions should have the capacity to evaluate companies and rationalize governance structures.

In determining criteria for unsoundness and applying them, social costs should be minimized by adopting transparency and objectivity.

Third, the restructuring should naturally try to gain the greatest effect at the lowest cost. Factors that may affect costs, such as an economic downturn or labor disputes, should be carefully considered. In determining criteria for unsoundness and applying them, social costs should be minimized by adopting transparency and objectivity. Also, while unsound firms should be quickly restructured, the selection process should be done with care. The mistaken restructuring of a healthy firm would have worse consequences than delayed selection.

Fourth, the government should be flexible in creating and applying its standards for unsound firms. Financial indicators such as debt ratios or interest coverage ratios cannot be absolute standards for determining a firm’s soundness. When studying the conditions and prospects of a firm’s main industry, factors such as the industry’s characteristics, overall economic fluctuations, and the industry’s position in the national economy should be considered.

Finally, the parties wielding restructuring power should have a clear sense of responsibility. This is the only way to prevent waste during the process or ethical confusion. Documentation of the decisionmaking process and adoption of a “real name” policy accountability system are possible approaches to encourage responsibility. VIP