EFFECTS OF FINANCIAL SECTOR RESTRUCTURING AND FUTURE TASKS

Jin-Kook Lim
(jklim@hri.co.kr)

The Second Stage Financial Restructuring

In September 2000, plans for the second stage financial restructuring were announced. Bad debts in the financial sector will be removed, and the public funds needed for this were collected. The government also announced that it would work to improve competitiveness in the financial industry through a system of continuous reform based on market principles.

Banks that have difficulty normalizing on their own, such as Hanvit, Peace, Kwangju, and Kyungnam will be unified into financial holding companies.

Banking Sector: Creating a system of six large banks

Banks that have difficulty normalizing on their own, such as Hanvit, Peace, Kwangju, and Kyungnam will be unified into financial holding companies. By the end of March, holding companies will be established, and by the end of March 2002, plans to reorganize subsidiary functions are expected to be completed. The mer ger between Shinhan and Cheju banks are in progress, and the merged entity is expected to become a financial holding company.

Bad bank debts will be actively processed through a new policy for bad debt repayments as well as liquidity and asset sales.

Sound banks will also be encouraged to merge and diversify; examples include the merger between Kookmin and Housing Banks, and the creation of a holding company for Shinhan Bank. In addition, bad bank debts will be actively processed through a new policy for bad debt repayments as well as liquidity and asset sales. Through the early processing of bad bank debts, the government aims to reduce the bad debt ratio from 8.9% in 2000 to around 5% by late 2001.

Secondary financial sector: Normalization through processing the Daewoo Group's bad debt

Hanaro Merchant Bank, which is a merged entity of several ailing merchant banks (Korea, Hans, Joongang, and Youngnam) will be made into a subsidiary of a financial holding company, and Regent Merchant Bank has been ordered to reform its management practices, while Dongyang and Hyundai Ulsan Merchant Banks have expressed their voluntary merger. The Hyundai, Samshin, and Hanil life insurance companies will be put up for sale through a P&A method.

Jeil, Kukje, Daehan, and Regent non life insurance firms are under going management reform. Korea Life Insurance and Seoul guaranteed bonds will be sold and management will be normalized after injection of public funds. Hyundai

Table 1. Financial Institutions after the Financial Restructuring (Late February 2001)

Financial Institution	Companies in late 1997	Restructuring Status					Companies as of February 2001
		Cancelled Authorization	Merger	Dissolution, Liquidation	Total	Share	
Banks	33	5	7	1	13	39.3	21
Merchant Banks	30	18	9	27	90.0	5	
Securities firms	36	5	-	1	6	16.7	42
Insurance firms	50	8	6	2	16	32.0	37
Investment trusts	31	6	1	3	10	32.327	
Mutual Savings and Finance	231	53	19	16	88	38.3	144
Credit Cooperatives	1,666	27	101	237	365	21.9	1,310
Lease	25	8	1	0	9	36.0	18
Total	2,102	120	144	260	534	25.4	1,604

Note: Banks include Kookmin-Housing, Shinhan-Cheju, and Hanvit-Kyungnam-Peace-Kwangju Banks. For mutual savings and finance firms and credit cooperatives, the plans for late April are included.

Investment Trust Securities is negotiating with AIG to increase capital through attraction of foreign funds. After September 2000, the management practices of 21 credit depositories and 40 credit cooperatives were investigated, and by the late April, contract renegotiationor liquidation will be completed for 20 ailing mutual savings and finance firms and 25 credit cooperatives.

After September 2000, the management practices of 21 credit depositories and 40 credit cooperatives were investigated.

Additional injection of public funds and repayment progress

As of August 2000, 109.6 trillion won of public funds were injected into the financial sector. By the end of 1999, 64 trillion in public funds was raised through bond issues. Out of this amount, 25.3 trillion was repaid, about 18.6 trillion was reinjected, and 27 trillion in national assets or public funds was injected. As of February 2001, an additional 18.2 trillion won in public funds was injected for restructuring. If one considers the additional bad debts arising from events such as the Daewoo debacle, as well as the increased bad debts from the new FLC standards, 4.1 trillion won of public funds were injected into the banking sector and 9.9 trillion was injected into the second financial sector, resulting in a total additional injection of 18.2 trillion.

As of August 2000, 109.6 trillion won of public funds were injected into the financial sector.

Table 2. Capital Injections by Financial Sector (Late August 2000)

(unit: trillion won)

	1998 Aug. 2000	Feb. 2000
Banks	70.3	7.1
Secondary Financial Sector	39.3	9.9
Merchant Banks	11.9	2.5
Securities	0.1	-
Investment Trusts	12.2	1.9
Insurance	10.5	1.7
Credit Cooperatives	1.5	1.0
Depositories	3.2	2.8
Total	109.6	18.2

By late August 2000, 25.3 trillion won in public funds was repaid.

Repayment of Public Funds

By late August 2000, 25.3 trillion won in public funds was repaid. Collateral real estate and bad loans on 31.1 trillion won of bad debt was also sold. In addition, 41.9 trillion won in held stock was sold[1)], and the recovery of 26.3 trillion in deposit insurance and losses is planned through collection of dividends from bankrupt financial institutions and claims on the individuals responsible for the bad debts[2)].

Effects and Evaluation of Financial Restructuring

(1) Restructuring after the Financial Crisis

After the outbreak of the financial crisis in late 1997, restructuring was planned and implemented at the behest of the IMF until late 1998.

First Phase

After the outbreak of the financial crisis in late 1997, restructuring was planned and implemented at the behest of the IMF until late 1998. To establish the framework for restructuring, organizations for financial supervision were merged, public funds were raised, organizations to aid operation and exit unsound firms were created, and viability standards on par with international practices were introduced. Starting with six ailing banks, unsound institutions in all sectors of the financial industry were shut down, and 64 trillion won in public funds were injected in the process.

1) Sales are expected to begin in the second half of 2002, with the expected management normalization of financial institutions in order to repay public funds.

2) Employees of financial institutions that received public funds are under civil or criminal investigation, or administrative responsibility. By late November 2000, the Financial Supervisory Committee investigated 279 financial institutions, leading to the dismissal of 2,169 employees, and criminal proceedings against 1,043 employees. Meanwhile, a total of 452.3 billion won in charges are being pressed by the Korea Deposit Insurance Corp. against 1,350 persons responsible for bad debts.

Additional measures

Following the Daewoo crisis in August 1999, many firms in the second financial sector, such as investment trusts and insurance firms, became unsound. This led to additional exits of ailing financial institutions. In July 2000, the mark-to-market evaluation system was introduced.

Second Stage

From September 2000 to February 2001, potential bad debts were processed with the help of additional public funds, and the framework for continuous restructuring was established. An effort to normalize the financial market was made by raising 40 trillion won in additional public funds and injecting it in stages to process bad debts. In addition, the introduction of primary CBOs promoted the smooth operation of corporate finance, and the approval of CLOs actively promoted bank loans to the corporate sector.

From September 2000 to February 2001, potential bad debts were processed with the help of additional public funds, and the framework for continuous restructuring was established.

(2) Evaluation

Although the large scale debts in the financial sector have been processed, a considerable amount of potential bad debts still exist, requiring continued effort to by financial institutions to process these liabilities. Efforts to normalize the financial system have begun in earnest after the sector recovered from the shock of the Daewoo Group's collapse. After late 2000, with the continued downturn in the world economy and little prospect of a swift rebound, corporate performance will probably worsen in the near future.

Although the large scale debts in the financial sector have been processed, a considerable amount of potential bad debts still exist.

Continuous progress is being made in improving governance structure in the banking sector but the excessive government stake in the sector poses a problem for bank independence. The corporate governance system is moving to one led by outside directors, and management transparency and rationality is increasing through capital cooperation with foreign financial institutions. Prospects for the early privatization of banks are still unclear, and efforts to create a system of continuous restructuring are being delayed by the slow recovery of the financial intermediary function. In particular, bank-centered wholesale finance functions are becoming increasingly contracted while the securities industry, which is a potential substitute, is currently unable to emerge from stagnation. Therefore, the floating capital effect in corporate finance is expected to continue in the near future.

Continuous progress is being made in improving governance structure in the banking sector but the excessive government stake in the sector poses a problem for bank independence.

While the financial sector's stability has increased thanks to higher standards for financial institution soundness, the financial innovation and regulatory reform needed to recover the financial intermediary function are still considered to be lacking. Regulations to increase soundness, such as introduction of FLC standards, introduction of a continuous exit system for unsound firms, and application of the BIS ratio to the second financial sector, are continually being implemented. However, for bad assets (especially in the banking sector) to be voluntarily processed, a new profit source will be needed. In addition, corporate restructuring systems such as the

CRV should have a rationale in profitability. In addition to the diversification of investment and commercial bank activities with the repeal of the Glass-Stegal Act in the US, a system of competition between banks, securities, and insurance firms should be gradually permitted to provide opportunities for additional profit.

Future Tasks

In the next two or three years, the government will make efforts to install a practical "software" infrastructure to maintain stability based on the free market.

The government seems to have the right overall approach, and the main task for restructuring is to strictly abide by this approach. In the next two or three years, the government will make efforts to install a practical "software" infrastructure to maintain stability based on the free market.

As a supplementary task, considering that the nation will probably have a low credit rating during the next one or two years, the government's credit guarantee activities should be guaranteed, and restructuring should be pursued through government-business cooperation. Based on a thorough credit risk evaluation system, the government should actively support private firms' efforts to attract foreign capital. For corporate restructuring measures such as the CRV to help normalize the Korean economy, the government should act as a major investor and invest for profit, and government-business cooperation should be flexibly pursued to improve efficiency and profitability. VIP

Table 3. Goals and Tasks for Future Restructuring

	Future Tasks (Voluntary "software" adjustments)
Basic Aim	Continuous Restructuring/ Upgrading viability standards
Main Goals	Forming Large-scale Banks, Allowing prompt exit of ailing companies
Measures	-Pursuing sale of Seoul Bank -Introducing an advance adjustment system for continous restructuring -Introducing a new BIS ratio reflecting market risk -Implementing a partial deposit guarantee system -Further establishment of bank holding companies
Characteristic	-Creating the basis for an advanced financial sector by reorganizing the entire industry
Market Conditions	-Pressure from approaching maturity of National bonds, Corporate bonds, CBO -Lower corporate profitability due to world economic downturn