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Overcoming the 1997-98 Crisis : Financial Reform

March 2010

MINISTRY OF STRATEGY AND FINANCE

Korea Development Institute

Overcoming the 1997-98 Crisis : Financial Reform

Overcoming the 1997-98 Crisis : Financial Reform

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Introduction

In 1997, Korea was hit by an economic shock, the likes of which it has never been seen before. Initiated by a foreign currency shortage, the 1997 financial crisis swept the entire financial sector and every part of the economy. The systemic nature of the crisis demanded an all out approach in implementing reforms in many segments of society, including the financial, corporate, labor, and public sectors. The context of the financial reforms in Korea, its evolution, and its performance since then, has attracted much attention from not only advanced countries but also developing ones. Simply put, Korea has outperformed other countries also swept up by crisis around the same time. Despite some miscues, in hindsight, Korea's financial reform could be seen as a model for institutional building in response to a catastrophic event, more specifically, the use of public funds to dispose of distressed assets of financial institutions, and in some cases, the financial institutions themselves. In taking the good with the bad, Korea also took the crisis as an opportunity to upgrade a variety of outmoded financial practices.

Why has Korea been relatively successful in financial restructuring? As in many reform movements, democratic leadership is crucial, given that the political economy of reform revolves around social pressure stemming from painful shifts in privileges and interests. At the onset of the crisis, Korea had effective leadership. It was fully committed to reforms, and the political environment, which was conducive to reform, allowed it to manage the social fallout. Only 20 days after the crisis shocked the country, a new president was elected for a five-year term, which gave the incoming leadership time to prepare and implement a long-term plan for reforms.

Under strong political leadership, Koreans acted in harmony to yield tangible results. One of the examples of cooperation was the *Gold Collection Movement* in late 1997 and early 1998. In all, only 2.2 billion US dollars worth of gold was collected, but it was symbolic of Korean's

deeply held cultural heritage - its capacity to come together in times of crisis.

Institutional building that was initiated and had been going on before the crisis hit was instrumental in significantly shortening the crisis response period and the inevitable debates over restructuring. For example, preparations had been already made to consolidate the Financial Supervisory Commission (FSC). Thus it was executed at the same time as financial restructuring. The Non-performing Asset Management Fund (NPAF) was founded before the crisis and KDIC was established a year before. All of these mechanisms played crucial roles in the restructuring. Indeed without having thought of the possibility of a crisis coming to Korea within a year, the building blocks for crisis resolution were being laid by the Presidential Committee for Financial Reform (PCFR).

Lastly, but not least, timely international assistance prevented the financial crisis from escalating further, ultimately putting the country at risk of default. The macroeconomic policy (conditions or recommendations) of the IMF still remain controversial, but the restructuring policies, originally prepared by the PCFR, could not have been effectively implemented without the help of the IMF. The World Bank also provided valuable technical supports in micro restructuring, assisting the Korean government authorities which had lacked expertise and suffered from non-economic pressures.

Many Koreans believe that the 1997 crisis was a blessing in disguise. This could not have been more true in regards to the development of financial system in Korea. It paved the way for the financial sector, independent of the government, to support economic growth and reduce business cycle shocks. Despite many attempts to liberalize the financial sector and enhance the competitiveness of the financial industry, institutions and markets, it was not until the 1997 crisis that policy makers actually acknowledged the root cause of financial reform.

This report seeks to give an in-depth account of Korea's experiences in carrying out financial reform. Chapter 1 begins with the financial reform efforts that were underway before the crisis. As described above, financial reform had been put on the policy agenda by Korean economists and practitioners under the PCFR but the reform efforts were bogged down in a battle of interests among politicians, policy makers and related agencies. Despite a lack of consensus, the PCFR's reform recommendations ended up significantly reducing the costs of overcoming a crisis and making way for a structural shift in financial policymaking in Korea. Chapter 2 explains Korea's financial supervisory system. Consolidation of financial supervisory authorities that were decentralized by sector before the crisis was the main achievement. As a matter of fact, the issue on the authority and jurisdiction of the financial supervision was at the center of the debate among government agencies, which seriously setback the reforms initiated by PCFR before the crisis. After the crisis, however, Korea proceeded in strengthening the institutions of the financial supervisory system not just to cope with deep-rooted financial

problems but to prepare for financial consolidation, which was a global trend.

The 1997 crisis gave Korea the momentum to strengthen its financial supervisory practices so as to enhance financial soundness. The financial supervisory authority has been playing a key role in ensuring that financial institutions supply correct and sufficient information with which market participants could make decisions. Priority was also placed on improving the accounting system. In the same spirit, the authority introduced several new measures to facilitate restructuring including Prompt Corrective Action (PCA) and forward-looking criteria (FLC), albeit at the cost of more public funds. From these policies, we could see the strong intentions of Korean policymakers to create a more sustainable financial system. Chapter 2 deals with this aspect of financial reform.

While financial systems serve as a private good in normal times, they can also serve as a public good in times of crisis, since everyone stands to benefit though no one wants to pay for it. On behalf of its people, the government can, and should resolve financial failures by use of public funds. Chapter 3 deals with Korea's experience in deploying public funds: it defines public funds; it gives the background against which public funds were deployed; it describes the way in which public funds were mobilized, administered, and distributed; and it offers policy lessons learnt.

Reform of the banking sector, introduced in Chapter 4, is at the heart of the financial reform carried out in Korea. Before the crisis, big banks had never failed, which was ironically one of the reasons why Korea ended up with the crisis. Once the government allowed a bank to fail, it meant that any bank could meet the same fate, depending on their financial health. This was the basis of restructuring in the banking sector. The Korean government made a bold and decisive decision to accept the cost of restructuring non-viable banks, including the purchase of assets and assumption of liabilities (P&A). The policy actions of the government sent a clear signal to market participants that it would strongly pursue restructuring. From a technical standpoint, the closure of banks raised various anticipated and unanticipated difficulties, which challenged many policy makers and practitioners but did not alter the course of financial reform.

Chapter 5 examines the corporate workouts as part of Korea's financial restructuring. Since debt-laden, unprofitable companies were the root cause of the crisis, it was imperative to turn these companies around by restructuring their debt, reorganizing their business, downsizing their employees, etc. The creditors, or financial institutions, had little choice but to lead the restructuring process considering the limited capacity of the courts. More importantly, the banks stood to lose the most if indeed it came to a court-led workout. For these reasons, a Korean workout program, a creditor-led insolvency program, was introduced, modeled after the so called *London Approach*. It contributed to raising the prospect of debt recovery for creditors and promoting the turnaround of companies. It also provided another method of working out

corporate insolvencies, which is still widely used now.

The resolution of distressed assets is a common challenge found in every financial crisis. Korea's case is discussed in Chapter 6, which could be understood as a standard method for disposing non-performing loans. A key feature of the Korean approach was to accept market prices, whatever they were, of distressed assets. In times of crisis, it is extremely difficult to price distressed assets. Even more difficult is accepting a price offered by the market, when every indication is that the price is reflective of a market flooded with distress assets and too little buyers. This emphasizes the importance of market for NPL's, where a recovery in the asset can be realized. It worked out well in Korea's case, which may differentiate it from other countries in terms of cost to overcome the crisis.

Overcoming the 1997-98 Crisis :
Financial Reform

Chapter 01

Financial Reforms before the Crisis

1. Presidential Committee for Financial Reform
2. Main Recommendations of the PCFR
3. Assessments

Chapter 01

Financial Reforms before the Crisis

1. Presidential Committee for Financial Reform

The imperative to reform Korea's financial system was clearly recognized before the November 1997 crisis. Before the crisis, finance had been understood as a tool for economic growth in Korea. Being an underdeveloped country with a large population and a low level of capital accumulation, Korea directly allocated scarce capital resources into strategically important business areas. The underdeveloped state of the financial markets and high degree of information asymmetry validated the government's intervention. These financial policies helped to achieve take-off in the Korean economy, lifting it from absolute poverty to industrialization. However, the financial system was relatively weak and unsound due to high dependency of financial markets and economic agents on the government.

The government's intervention could be characterized by protection and restriction. Indeed, market-distorting interference was a fundamental cause of the financial crisis, which in turn led to a burgeoning loss of public confidence in the government's capability to conduct financial policy. Moreover, restructuring the banking sector was crucial to putting Korean banks in a position to effectively compete with foreign banks. No Korean bank was listed among the top 100 banks in the world, in terms of equity base. The major Korean banks were far behind western banks in their innovation of products and services, technology infrastructure, and risk management. With the advent of the World Trade Organization (WTO) and Korea's accession to the OECD, open competition might result in foreign financial firms dominating the domestic markets unless efficiency and competitiveness in the Korean financial sector was improved by eradicating outmoded and inefficient practices. Furthermore, the roles of private sector

participants, including financial institutions and markets, should be strengthened to facilitate the efficient allocation of resources to ensure sustainable economic development. Therefore, it was essential and urgent to revitalize the financial industry and restore soundness in the financial system not only for financial development but also for economic causes.

Against this backdrop, the Presidential Committee for Financial Reform (PCFR) was established in January of 1997, with 31 members appointed to the committee from the business, financial and academic sectors. The civil servants were not included in the committee because these reform efforts differed from the previous reforms which sought to address issues from a supply-side perspective.[1]

The PCFR initiated its first set of policy recommendations in April, followed by another set in June, which focused on fostering the competitiveness of Korea's financial system, domestically and globally, and making it reliable and consumer-oriented. The first report contained policy measures that formed the core of the financial reforms. It allowed financial markets to function in an orderly fashion and was less objectionable to the incumbent government officials. The second report, however, attempted to cover more controversial issues that encountered a number of difficulties in actual implementation. The reform initiative to consolidate financial supervision of various sectors was at the heart of the debate.[2]

The PCFR had three main objectives: i) to strengthen the competitiveness of the financial industry; ii) to promote the efficiency of financial markets; and iii) to establish a sound financial system.[3] With these three objectives in mind, the detailed recommendations formed the basis for reforming Korea's financial system, in terms of what was intended before the crisis, and what was implemented during the IMF rescue program (See Table 1-1).

1 _ By the time when the PCFR was assembled in early 1997, Korean economy had a symptom of structural deterioration. Some large business groups became financially distressed to a severe extent and corporate competitiveness worsened due to declining productivity. Financial industries started to suffer from non-performing assets from corporate lending. Under this mood, some government authorities showed dissenting views on necessity of the long-term structural reform task force.

2 _ At the outset of establishing PCFR, the reform on financial supervisory structure was not included in the work scope. After reshuffling of the Presidential Office staffs, the issue became a symbolic agenda for the financial reform efforts. According to the hindsight of the major participants in PCFR, such a sensitive issue to government bureaucrats dominated others so as to dilute initial motivation of reform spirits and lead to overall failure in implementing legislation of reform proposals.

3 _ There existed opinions, mostly inside the government authorities, that called for the initiatives to immediately resolve corporate and financial distresses rather than structural reforms. However, the driving forces to launch the PCFR had views that the Korean financial sector could not sustain without a fundamental shift towards demand-friendly system.

Strengthening the Competitiveness of Korea's Financial Industry

As a top priority, the PCFR sought to transform the financial industry into a strategic industry through unfettered competition and structural reorganization. First, this required financial institutions such as banks, securities firms, and insurance companies to expand their business boundaries in order to promote integrated and efficient business market environments. Second, Korea's corporate governance system needed to promote autonomy and accountability in the management of financial institutions. Third, an automated, digital financial network needed to be built to integrate computerized transaction systems between banks and non-bank financial institutions. Finally, and most importantly, the barriers to entry in the financial industry needed to be lowered to allow inefficient financial institutions to wither away through market competition.

Promoting the Financial Market Efficiency

In order to promote the efficient allocation of funds and to establish fair and competitive environments, restrictions on interest rates and fees needed to be lifted while deregulating the flow of capital to make capital markets more accessible. The supply of funds to small and medium-sized enterprises (SMEs) should be facilitated through the market mechanism. Arbitrary interpretations as well as discretionary implementation of laws and decrees by government bureaucrats should be limited. In short, regulations ought to be minimal, simple, straightforward and transparent.

Establishment of a Sound Financial System

Establishing a truly independent central bank and an effective supervisory system in line with the movement toward universal banking was necessary to achieve price stability on a sustainable basis.[4] Under the reform plan, in other words, the independence of the Bank of Korea (BOK) was reinforced whereas its supervisory powers were to be diminished and transferred to a newly established and separate financial supervisory authority. Since information is crucial to making business decisions for all financial market participants, financial information must also be available and reliable. This can be accomplished by enhancing information-based systems such as corporate accounting system and independent audit system.

4 _ The institutional framework of financial supervision and independence of monetary policy became located at the center of the PCFR agenda, even though they had not been main issues for its establishment. Indeed, the key participants of the PCFR tried to avoid dealing with such delicate matters that would have political implications because they could distract the main motivation of financial reform. Unfortunately, these concerns of topsy-turvy debates became realized so as to entail the overall failure of the reform.

Table 1-1 | Main Agenda of the PCFR

I. Strengthening the Competitiveness of Financial Industry

1. Restructuring the Financial Industry
   - Mutual Expansion of the Business Boundaries of Banking, Securities, and Insurance Industries
   - Revamping Loan-specialized Financial Institutions
   - Upgrading Regional Cooperative Financial Institutions
2. Establishment of the Accountable Management System
   - Improving Governance Structure of Financial Institutions
   - Autonomous Internal Management of Financial Institutions
3. Lowering the Entry Barriers
   - Marking the Licensing Requirements and Procedures Easier and Transparent
   - Improving the Ownership Structure of Banks and Other Financial Institutions
   - Introducing Financial Service Holding Companies
4. Prompt Corrective Action and Early Resolution
   - Enacting Prompt Corrective Action for Undercapitalized Financial Institutions
   - Encouraging M&A among Financial Institutions
   - Improving the Liquidation and Bankruptcy Procedure for Failing Financial Institutions
   - Improving measures to Protect Depositors and Investors against the Failure of Financial Institutions

II. Promoting the Financial Market Efficiency

1. Liberalization of Interest Rates and Fees
   - Liberalization of Interest Rates
   - Liberalization of Fees & Commissions
2. Deregulation of Access to Foreign Capital Markets
   - Easing of Restrictions on Overseas Securities Issues
   - Deregulation of Foreign Commercial and Currency Loans
   - Deregulation of Export and Import Financing
3. Fostering Venture Capital and SMEs' Financing
   - Measures to Activate Venture Firms
   - Measures to Upgrade KOSDAQ
   - Measures to Improve the Support System for SMEs
4. Expediting Financial Deregulation
   - Revisions of Laws
   - Prohibitions against Administrative Guidance and Managerial Interventions
   - Strengthening the Role of the Fair Trade Commission
5. Developing Long-term Capital Markets
   - Developing the Long-term Government Bond Market

- Improving Banks' Trust Operations
- Activating Long-term Asset Management with Social Insurance and Pension Funds
- Activating the Issuance of Asset- or Mortgage-backed Securities

6. Improving the Soundness of Corporate Finance

- Improving Corporate Financial Structure
- Improving the System of Corporate Promissory Notes

III. Establishment of a Sound Financial System

1. Ensuring the Central Bank's Independence
2. Reorganization of the Supervisory System
3. Enhancing the Information Efficiency
   - Enhancing the Credibility of Accounting Systems
   - Improving the Quality and Transparency of Business Information
   - Upgrading the Credit Information and Rating System
   - Facilitating Credit Information Flow
4. Restructuring Government-related Financial Institutions

2. Main Recommendations of the PCFR

2-1. Prompt Corrective Action

The PCFR recommended that unsound financial institutions should be subject to timely and compulsory regulatory sanctions in the form of a prompt corrective action (PCA). PCA is a supervisory measure that automatically triggers corrective actions against weak financial institutions classified by objectively quantifiable criteria. The main purpose of PCA is to mitigate regulatory forbearance which frequently occurs during the early phase of crises. Regulatory forbearance, also called as regulatory gambling, has a high tendency to incrementally increase the costs stemming from crisis resolution, as shown in the experiences of the US in the 1980s. Under the PCA regime, even financial regulators are discouraged from easily bailing-out distressed financial institutions by applying lax assessment standards. In fact, both bankers and regulatory supervisors encounter hard constraints. PCA also serves a function in indentifying and facilitating a corrective response to problematic banks, tittering on insolvency in a timely manner so as to avert more costly and widespread effects of bank failures. Even if banks cannot be saved, PCA provides a less costly way to resolve bank failures.

The PCA system should be designed consistent with international standards, particularly, including corrective measures that can bring about changes to a firm's business operations and management, even a merger. If capital adequacy shows signs of deterioration, supervisory authority shall carry out corrective measures over the financial institutions without a discretionary judgment. The authority should also move swiftly to the next remedial step when capital is further undermined or its recommendations are not adequately fulfilled. It should be empowered to revoke the license of financial institutions in the event that their financial soundness is severely undermined.[5]

The triggering criteria for PCA should be simplified and tailored for each business area of financial industries based on risk-weighted capital criteria. More specifically, the Bank for International Settlements (BIS) capital adequacy ratio was recommended on banks, whereas net operational capital ratio would be a right fit for securities companies. In the case of life insurance companies, the solvency regulations could be stringently enforced for the time being, but a risk-weighted capital measure should be implemented in due time. The criteria applied on banks, or the BIS ratio, can be applied to other deposit-taking institutions such as mutual savings banks and merchant banks.

A fall below 8% in a bank's BIS capital adequacy ratio should trigger the first step in the remedial process. For a securities company, actions should be taken when its net operational capital ratio falls below 100 percent. In either case, the financial institution's license should be revoked while the liquidation process should be initiated for failing financial institutions before its net value at the estimated fair market value becomes negative.

Two prerequisites to ensure the success of PCA can be summarized as follows: 1) the application of market-value accounting when calculating capital requirements, and 2) the public disclosure of prudential information concerning capital adequacy.

2-2. Measures to Protect Depositors and Investors

Even though the Deposit Insurance Act was legislated in 1996, the Korea Deposit Insurance Corporation (KDIC) was too early in its development to provide a financial safety net when the crisis hit a year later. Thus, the capacity of the KDIC should be strengthened to protect depositors and investors against failure of financial institutions by introducing a differential insurance premium scheme in concert with the capital adequacy, and by raising the ceiling for emergency loans from the central bank. In addition, the KDIC should be authorized to establish a "bridge bank" that can temporarily take over failed banks while allowing it to transfer

5 _ Detailed explanation about PCA will be provided in Chapter 6.

management to newly appointed directors. Last but not least, a comprehensive depositor protection scheme should be established to ensure against depositor losses.[6]

2-3. Liberalization of Interest Rates and Fees

Financial liberalization had been proceeding since the early 1980s in Korea. The PCFR recommended that liberalization of interest rates at banks and other deposit taking financial institutions should be accelerated. In fact, interest rates were supposed to be fully liberalized by April 2000, which had been gradually proceeding during a two-year period by allowing interest rates to move freely within a band. Deregulation of mandatory reserve requirements, which was a fundamental condition of interest rate liberalization, was also supposed to be completed by the end of March 2000.

The reforms also sought to deregulate commissions collected by banks for processing funds and handling foreign exchange transactions for the government, so that banks could recoup the costs of the services. In addition, deregulation of brokerage commissions of securities companies was also pursued to enhance financial market stability. Fund management fees on trust accounts and commissions related to the early redemption of beneficial certificates were also being fully liberalized.

The PCFR recommended liberalizing the total business expense ratio and assumed acquisition costs of insurance companies by April 2000, and dividends accrued from the difference in assumed and actual expense rates by the fiscal year of 1998.

2-4. Deregulation of Access to Foreign Capital Markets

The reforms sought to lift or ease qualification requirements for the issuing securities overseas. Along the same line, the restrictions on the use of funds raised overseas by service industries, such as construction and retail, were to be deregulated immediately and completely at the earliest possible date. In addition, the reforms sought to lift the ceiling on the annual amount of funds allowed to be raised overseas issues by an individual firm and business group as soon as possible.

6 _ Despite the proposal of the PCFR, Korea's deposit insurance system had been managed in a distorted way due to the occurrence of the 1997 crisis. As a matter of fact, blanket coverage on all deposits was announced for the purpose of stabilizing financial system during the crisis-overcoming period. In the meantime, the KDIC worked as a pay-box of the public funds in the course of financial restructuring. The deposit insurance system became normalized from 2003, while its institutional strengthening was implemented in the 2000 revision of the Depositor Insurance Act.

Also, the reforms sought to lift requirements applied on the uses of foreign commercial loans and currency bank loans, the use of which was limited mainly to manufacturing industries. As such, they could be used to fund R&D and other needs from the service industries such as transportation and retail.

2-5. Reorganization of Supervisory System

The PCFR suggested that an infrastructure be established to ensure the soundness and enhance information efficiency in the financial market. Further, it also recommended that a stable financial environment must be maintained while financial liberalization proceeds. The PCFR recommended transitioning toward a universal banking system to maintain a stable financial environment, and thus promote the importance of prudent regulation of banking activities.

To ensure the independence and autonomy of the financial supervisory body from the policy-setting functions of the Ministry of Finance and Economy, the PCFR recommended having the Financial Supervisory Commission (FSC) under the office of the Prime Minister. The chairman of the commission, with a ministerial rank, would then be appointed by the President upon recommendation of the Prime Minister.

It was recommended that the FSC should have the mandate and absolute authority to supervise financial markets and institutions and to enact oversight laws and regulations. This required the Bank of Korea to transfer its major supervisory authority to the Commission. Nevertheless, the central bank would still have oversight and authority over regulations concerning loan guarantees and assumed obligations, the performance of management, and credit concentration among commercial and specialized banks, including their trust account.

To enhance financial supervision, the PCFR recommended that the three existing supervisory bodies (the Office of Bank Supervision, the Securities Supervisory Board and the Insurance Supervisory Board) be merged into a new financial regulatory body, named the Financial Supervisory Service (FSS). This would then allow the FSC to directly oversee the FSS and the Deposit Insurance Body, or Korea Deposit Insurance Cooperation (KDIC).

After undergoing regulatory restructuring, the supervisory system would function better and have improved supervisory tools such as an early warning system and a steady-base-site monitoring system. As important, mechanisms for self-regulation should be activated by promoting the role of self-regulatory organizations and strengthening risk management skills.

2-6. Credibility of Accounting Systems

Credible accounting systems are crucial to preserve information efficiency. Therefore, it was recommended that every business group that had total bank credit of more than KRW 500 billion should be required to submit a consolidated financial statement that includes a balance sheet, profit and loss statement for constituent companies and cash flow statement for all the companies belonging to the business group. The main purpose of this requirement was to reduce corporate leverage, especially, the high cross dependence on leverage. Eventually, the goal was to require the reporting of a consolidated financial statement for all business groups.

In order to improve the reliability of corporate financial statements, the PCFR supported the reform of the auditing system. Recommendations included making the selection process for auditors more transparent and strengthening the investigation of independent auditors' reports.[7]

3. Assessments

The efforts of the PCFR ended in frustrating failure. Its recommendations were at the mercy of politicians, policy makers and related institutions. After the publication of the second report in June, heated debates on the reform agenda raged among relevant stakeholders. At the center of the debates was the issue of separating banking supervision from the Bank of Korea and consolidating the various financial supervisory authorities. The reform agenda was not welcomed by any related agency including the Ministry of Finance and Economy (MOFE), the Bank of Korea, etc. Parts of the PCFR's recommendations were watered down or altered during the process of legislation. For example, the consolidated supervisory authority was supposed to be under the jurisdiction of the MOFE in the revised draft submitted to the National Assembly. Lawmakers from both ruling and opposition parties opposed the PCFR's recommendations, not because it was impractical but because it was politically expedient to do so. Despite general supports from the media, the PCFR's recommendations failed to be enacted in the National Assembly in November, 1997.

Even though the work of the PCFR did not yield tangible results, its efforts were not in vain. After the Korean government received support from the IMF, the recommendations, which the

7 _ Upgrading accounting system compatible with international best practices was a foremost important task in the area of software restructuring. In fact, hardware restructuring could be fruitless without obtaining transparent and reliable information. In this respect, the establishment of credible accounting system was understood as a platform of institutional strengthening of financial supervision.

IMF was in full support of, were enacted on December 29, 1997 without a major revision to the original draft. It was unfortunate that Korea did not accomplish financial reform on its own will. Korea, as is often the case everywhere else, had to be pushed by external pressure into implementing the reforms.

The immediate implementation of the financial reform enabled Korea to save time and resources in overcoming and rebounding from the crisis. Korea could jump straight into the restructuring processes without wasting valuable time for institutional building. The fact that many of the building blocks of the institutions were in place at the time of the crisis, was an important factor in allowing Korea to successfully overcome the crisis.

Overcoming the 1997-98 Crisis :
Financial Reform

Chapter 02

Financial Supervisory Structure

1. Overview
2. Financial Services Commission (FSC)
3. Financial Supervisory Service (FSS)
4. Related Institutions

Chapter 02

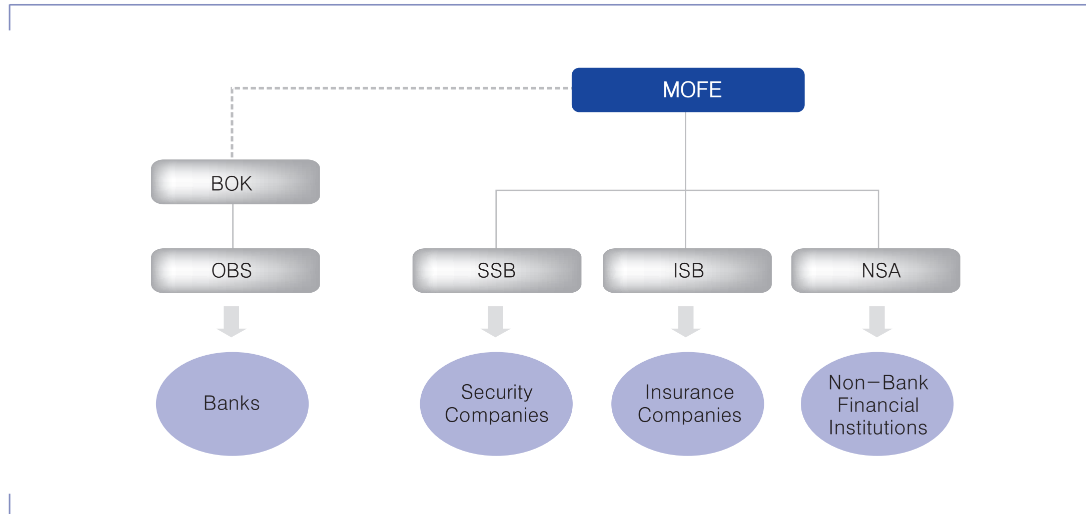
Financial Supervisory Structure

1. Overview

Despite the latent need for the consolidation of financial supervision in Korea since the late 1980s, it was not until the 1997 financial crisis that the momentum had arrived to initiate the much needed reforms. Due to the convergence of financial services and blurring of distinctions among various financial sectors, there had been an increasing need for a consolidated financial market regulator to oversee all the financial institutions and markets under a single entity. Recognizing this, the Korean government formed the Presidential Committee for Financial Reform (PCFR) in early 1997. After conducting a series of analyses and discussions, the committee submitted a host of policy recommendations, one of which proposed the establishment of a consolidated financial supervisory authority.

As seen in Figure 2-1, up until the end of 1997, the Korean financial supervisory system, under the leadership of Ministry of Finance and Economy (MOFE), consisted of four separate public organizations: the Office of Bank Supervision (OBS), the Securities Supervisory Board (SSB), the Insurance Supervisory Board (ISB), and the Non-bank Supervisory Authority (NSA). PCFR's proposal suggested the consolidation of the four institutions, which did not happen until Korea was embattled in a currency crisis in late 1997' and subsequently, received assistance from the International Monetary Fund (IMF). In fact, the Bank of Korea Act and the Act on the Establishment of Financial Supervisory Organizations were submitted to the National Assembly for ratification on August 23, 1997, but were not ratified until December 29, 1997.

Figure 2-1 | Financial Supervisory System before the Crisis



On April 1, 1998, the Financial Supervisory Commission (FSC) was established as Korea's first integrated financial supervisory body, which immediately took on the task of reforming domestic financial institutions and large business groups and oversaw restructuring in the corporate and financial sectors in the wake of the crisis. As part of the reorganization of the financial supervisory authorities, the Securities and Exchange Commission (SEC) was absorbed into the FSC, becoming the Securities and Futures Commission (SFC). On January 1, 1999, OBS, SSB, ISB and NSA were consolidated into a single organization to form the Financial Supervisory Service (FSS).

Korea's financial supervisory structure changed on February 29, 2008, when the Financial Supervisory Commission was integrated with the Financial Policy Bureau of the Ministry of Finance and Economy (now the Ministry of Strategy and Finance) to become the Financial Services Commission. As the principal supervisory authority, the new FSC has been given a broad mandate to carry out three functions: 1) financial policy formulation, 2) financial institution and market oversight and 3) actions against money laundering. The FSC has the statutory authority to draft and amend financial laws and regulations and issue regulatory licenses to financial institutions. Also, the FSC oversees cross-border matters such as supervising foreign exchange transactions conducted by financial institutions to ensure their financial soundness. As for anti-money laundering, the Korean Financial Intelligence Unit (KoFIU) under the FSC leads the government's anti-money laundering and counter-terrorism financing efforts.

2. Financial Services Commission (FSC)

The FSC is led by nine commissioners, consisting of the Chairman, Vice Chairman, two standing commissioners and five non-standing commissioners. Inside the commission, there exist three bureaus and one office with over 150 civil servants.

The chairman is appointed by the President with the recommendation of the Prime Minister. The Vice Chairman is appointed by the President with the recommendation of the Chairman of the FSC and holds the position of the Chairman of the Securities and Futures Commission (SFC)[8] at the FSC.

Two standing commissioners are appointed with the recommendation of the Chairman of the FSC. Out of the five non-standing commissioners, four are ex-officio positions held by the Vice-Minister of the Ministry of Strategy and Finance, Governor of the Financial Supervisory Service, Deputy Governor of the Bank of Korea and the President of Korea Deposit Insurance Corporation. The remaining non-standing commissioner is appointed with the recommendation of the Chairman of the Korea Chamber of Commerce and Industry, who recommends an industry representative.

The FSC is an independent government agency whose officers are barred from holding any political position or engaging in any commercial activity during their tenure on the Commission. The nine commissioners are also barred from participating in the resolution of matters that may raise conflicts of interest. Matters that come before the commissioners for resolution are passed by the majority of the quorum.

As part of its regulatory oversight, the FSC deliberates and decides on policy matters relating to the inspection and supervision of financial institutions and the securities and futures markets. Matters relating to the securities and futures markets are largely delegated to the SFC. The FSC also has the authority to issue and revoke licenses from financial institutions. Legislation relating to the financial sector is drafted and submitted to the National Assembly by the FSC.

The principal role of the SFC is to investigate market abuses, such as insider trading and price manipulation in the securities and futures markets, and to establish accounting standards and audit reviews. The SFC was granted an expanded authority to investigate unfair stock trading and seek prosecution with the amendment of the Securities and Exchange Act on

8 _ One standing commissioner and three non-standing commissioners of the SFC are appointed with the recommendation of the Chairman of the FSC.

February 1, 2002. In addition, the SFC conducts an advanced review of matters relating to the securities and futures markets to be deliberated by the FSC.

3. Financial Supervisory Service (FSS)

The Financial Supervisory Service (FSS) is headed by the Governor. According to the law, up to four Deputy Governors, nine Assistant Governors and an Auditor may be appointed under the Governor. The Governor recommends candidates for Deputy Governor to the FSC for appointment and directly appoints Assistant Governors. These officers have a term of three years.

The FSS is primarily responsible for supervision and examination of the regulated financial institutions. It also has the authority to order the submission of documents, records, or personal testimony necessary for investigation. Non-compliance or providing deliberately false statements in an FSS investigation constitutes an offense punishable under the law. Upon approval from the FSC, the FSS may also recommend dismissal of officers and managers of financial institutions who are found to be liable for violation of rules and regulations.

The FSS serves as a mediator of disputes among financial institutions, investors, depositors and creditors. In order to carry out its broad responsibilities, the FSS maintains about 1,600 staffs.

The FSS has twenty five departments and sixteen offices. In addition to its headquarters in Seoul, the FSS has four overseas and four regional offices. The departments and offices engage in five primary activities: 1) consumer protection, 2) supervision, 3) examination, 4) investigation, and 5) supervision support and general affairs. Separate from these functions is the Internal Audit Office, which is responsible for the internal auditing procedures.

Fees collected from financial institutions and market participants cover most of the FSS budget. The Bank of Korea may partly appropriate funding for the FSS. The FSS budget must be approved by the FSC.

4. Related Institutions

4-1. Bank of Korea (BOK)

The Bank of Korea (BOK) was established in 1950 under the Bank of Korea Act (BKA). The BKA was amended in 1998 to give the BOK greater independence over monetary policy and remove its responsibility for bank supervision. As the central bank, the primary role of the BOK is as follows: 1) issuing bank notes; 2) formulating and implementing monetary and credit policy; 3) acting as banker to the banks; 4) acting as banker and fiscal agent to the government; and 5) other duties, including managing the nation's foreign exchange reserves.

The BOK has the power to request the FSC to undertake its own or joint examinations with the FSS. On October 4, 2002, the BOK and FSS signed a MOU to enhance cooperation and encourage joint examination of banks.

4-2. Korea Deposit Insurance Corporation (KDIC)

The Korea Deposit Insurance Corporation (KDIC) is a public deposit insurance corporation established in June 1996 under the Depositor Protection Act of 1995 for the purpose of operating the deposit insurance system prescribed by the Act. The main body governing the KDIC is the Policy Committee, which is comprised of the President of the KDIC, the Vice-Minister of MOSF, the Vice Chairman of the FSC, the Deputy Governor of the BOK, and the heads of the associations representing banks, insurance companies and other financial institutions. The KDIC may request examinations or joint examinations with the FSS as well as information and documentation. Such requests must be compiled with unless the FSS has a good reason to refuse.

4-3. Korea Asset Management Corporation (KAMCO)

The Korea Asset management Corporation (KAMCO) was originally established under the Korea Development Bank (KDB) Act and was commissioned by the government to manage and dispose of non-performing assets (NPAs) in the financial sector and state-owned properties. In November 1997, KAMCO was formally reestablished to enhance and expand its role. At the same time, the Non-performing Assets Fund was created to acquire, manage, and dispose of NPAs to facilitate financial sector restructuring.

4-4. Self-regulatory Organizations

Formal financial supervision is complemented by self-regulation. As for self-regulatory organizations, there exist numerous associations of financial industries, including the Korea Bank Association and the Korea Financial Investment Association, among others. These industry associations help the FSC/FSS implement supervisory policies by supplying necessary information and also by setting up guidelines that cannot otherwise be established through formal regulation. They provide human resource services to improve the quality of professionals in the industry. The Korea Exchange (KRX) where stocks, bonds and derivative securities are traded, also takes a part in self-regulation. It helps to facilitate the following: the orderly functioning of the market, regulating and supervising its member firms, setting listing requirements, regulating corporate disclosure, etc. The Korea Securities Dealers Association (KSDA) regulates practices related to maintaining fair-trading among members, promoting self-discipline, mediating disputes among public investors and members, protecting investors, and enforcing rules of fair practice.

5. Strengthening Financial Supervision

5-1. Changes in Regulatory Measures after the Crisis

To improve the financial supervisory framework, the Financial Supervisory Commission (FSC), a unified body covering banking, insurance, non-banks and capital markets, was established in 1998. Key elements in strengthening supervision and regulation included prompt corrective action (PCA) to deal with financial institutions failing to meet prudential standards and a new loan classification system based on forward-looking criteria (FLC). Other measures are summarized in Table 2-1. As a result, the supervision of domestic financial institutions has been made more sound by the adoption of advanced corporate credit evaluation standards and additional responsibility taken for credit decisions.

Table 2-1 | Major Steps Taken to Upgrade Prudential Supervision in Korea

- A unified supervisory body, the Financial Supervisory Commission, was created in April 1998.
- Accounting and disclosure standards were brought closer into line with International Accounting Standards.
- A "Prompt Corrective Action" framework has been introduced.
- A "forward-looking loan classification" system has been implemented.
- To supervise banks, the so-called "CAMELS" system has been put in place.
- The calculation of BIS capital adequacy standards has been improve.

- Exposure limits on banks' lending to individual companies and to chaebol were tightened.
- In the insurance sector, a solvency standard based on that used by the European Union was introduced.
- Mark-to-market valuation is now required for ITC funds.
- A partial deposit insurance scheme has been implemented.

Because the assessment of credit risk in the financial sectors depends upon corporate information, reforming measures have been taken on improving corporate accounting standards. Transparent and responsible management can be achieved by instituting regulatory reporting of consolidated financial statements and institutionalizing the appointment of outside directors, with the aim of sweeping away obsolete dictatorial management practices.

5-2. Prompt Corrective Action

Financial institutions are exposed to systemic risks, in which solvent and sound banks are forced to confront bank runs triggered by either misconceptions or rational expectations held by depositors on the health of the bank. In order to contain systemic risks, many countries have introduced a deposit insurance system under which deposits of financial consumers are insured, even on the verge of a systemic crisis. Nevertheless, once a systemic crisis occurs, the deposit insurance fund is not sufficient enough to contain the costs that are usually incurred. In this case, it is often necessary for the government to intervene in distressed financial institutions with taxpayers' money. It has been shown, however, that government intervention may end up being costly due to regulatory forbearance, or policymakers' gambling while trying to manage the crisis, of which a pertinent example was illustrated in Savings and Loan Associations (S&L) Crisis in the United States in the 1980s and 1990s. Prompt Corrective Action (PCA) was instituted against this background for the purpose of minimizing the costs of using taxpayers' money to rescue distressed financial institutions by mitigating regulatory forbearance. Therefore, PCA is directly related to the deposit insurance system, which in turn is built around overcoming systemic risks.

Korea adopted PCA in April 1998.[9] When the BIS capital adequacy ratio or the overall evaluation result of a bank falls below the minimum criteria, the FSC takes prompt and appropriate actions to remedy the problems. As a result, banks subject to a stage one PCA must submit a management improvement plan to the FSC within two months of receiving the PCA. PCA consists of three stages: Management Improvement Recommendation, Management Improvement Requirement and Management Improvement Order (See Table 2-2).

9 _ As mentioned in Chapter 1, the first attempt to introduce was made by the Presidential Committee for Financial Reform.

- *Management Improvement Recommendation*

  Management Improvement Recommendations are issued by the FSC against a bank when (1) the BIS ratio falls below 8%, or (2) the rating for asset quality or capital adequacy is 4 (Deficient) or 5 (Critically Deficient) even though the overall composite rating may be 3 (Less than Satisfactory). Management Improvement Recommendations may entail organizational changes, new allowances against distressed assets, investment restrictions on fixed assets, entry restriction into new business areas, restrictions on new investments or dividend distribution, capital increases or reductions, and disposition of poorly performing assets.

- *Management Improvement Requirement*

  Management Improvement Requirements are issued when the BIS ratio of a bank falls below 6%, (2) the overall composite rating is 4 or worse, or (3) the bank fails to fully comply with FSC Management Improvement Recommendations. Banks that are issued Management Improvement Requirements may be subject to business closure or consolidation of operating branches, a freeze on new investment, reduction of risky assets, restrictions on deposit interest rates, replacement of members of board of directors, officers, and external auditors, and suspension of certain businesses. A merger with or consolidation into another financial institution is also possible.

- *Management Improvement Order*

  Management Improvement Orders are issued when (1) a bank is judged a distressed institution as stipulated under the Act Concerning the Structural Improvement of Financial Industry, (2) the BIS capital adequacy ratio falls below 2%, or (3) the normal operation of the bank is hindered, and the bank either does not or cannot implement its management improvement plan. Banks that receive Management Improvement Orders may be subject to, in addition to the measures from the Management Improvement Requirement, capital write-down, suspension of top management, appointment of a receiver, merger with another financial institution, suspension of business within six months, or revocation of banking license.

In addition to the formal enforcement actions, FSC may also take informal supervisory actions to force banks into undertaking autonomous and preliminary efforts to improve banking operations through an agreement between the FSC/FSS and the bank. The FSC may require a bank to submit a management improvement plan, a letter of commitment, or a memorandum of understanding with the FSC/FSS in the likelihood of further deterioration in the CAMELS ratings or management guidance ratios (BIS capital adequacy ratio, domestic currency liquidity ratio, etc.) of banks.

Table 2-2 | Prompt Corrective Action Enforcement Criteria

Type of PCA	Criteria
Management Improvement Recommendation	• BIS capital ratio < 8%; or • 4th grade for capital adequacy or asset soundness with an overall rating of 4th (Deficient) grade, or 5 (Critically Deficient) even if overall CAMELS rating is 1 (Strong), 2 (Satisfactory), or 3 (Less than Satisfactory).
Management Improvement Requirement	• BIS capital ratio < 6%; or • 4th grade or 5th grade of CAMELS rating
Management Improvement Order	• BIS capital ratio < 2%; • Category of distressed financial institutions; or • Normal operations are hindered and bank does not or cannot implement improvement plan, even though it has been urged to do so

Theoretically, a credit card business, as one of the credit-specialized financial businesses, does not pose a direct systemic risk since credit card companies (CCCs) do not have a deposit taking function. The CCCs obtain their funding from financial professionals like large financial institutions or institutional investors, which are not necessarily protected by the public financial safety net. If fact, these types of moneylenders or investors should not be protected in the sense that market discipline helps bring about a sound management of the financial system. Despite the theoretical rationale, Korea introduced PCA even for credit card businesses on July 1, 2002, in order to emphasize financial soundness among CCCs.

CCCs are subject to a minimum BIS capital adequacy ratio. If the BIS ratio falls below 8%, then a Management Improvement Recommendation is imposed by FSC. Under this measure, the CCC may be subject to organizational changes, specific allowances, restrictions on investments on fixed assets, entry into new business areas, new investments and dividend payments, reduction or increase of its capital, or disposition of non-performing assets. If its BIS ratio falls below 6%, a harsher PCA measure, or Management Improvement Requirement, is automatically triggered. Under this measure, it may be forced to consolidate operating offices, freeze new investments, dispose risky assets, fix its interest rates, replace its senior management and external auditors, suspend certain business areas, or forced to dissolution, or merger or consolidation with another financial institutions. Once a CCC's BIS ratio hovers below 1%, it issued a Management Improvement Order, under which it is subject to a partial or complete cancellation of the company's equity capital, suspension of its top management, appointment of a receiver, merger with or consolidation with other financial institutions, suspension of business for up to six months, or revocation of its business license.

To enhance disclosure, CCCs are required to publicly disclose their annual reports, including the balance sheets and the income statements for each fiscal year. The disclosure must cover

financial information relating to the asset soundness, profitability, productivity, and the sources and uses of their capital. Furthermore, to receive supervisory data on CCCs, FSC and FSS conduct on-site examinations and off-site surveillance.

5-3. Forward-looking Criteria

Banks are required to appropriately classify their assets and ensure their soundness. In classifying assets, a borrower's risk of default is a major consideration. The FSC has revised the Regulation on Supervision of Banking Business to introduce new asset classification standards called Forward-looking Criteria (FLC). The new standards require banks to conduct forward-looking analysis on a borrower's debt-servicing capacity as well as to assess a borrower's past credit history. The FLC went into effect on December 31, 1999. Changes in asset classification standards before and after the introduction of the FLC are summarized in Table 2-3.

Table 2-3 | Changes in Asset Classification Standards

	Pre-FLC	Post-FLC
Overall Comparison	• Uniform standards for all banks • No individual standards for banks	• Minimum guidelines • Banks establish their own standards
Assets subject to classification	• Limited to 13 items including loans and guarantees	• Expanded to all the assets banks need to classify, including lease assets
Classification of Loans	• Based mainly on past borrower credit history	• Based primarily on the borrowers' future capacity to repay and past credit history
Classification of Foreign Bills Bought	• Separate standards are applied	• In principle, the same loan standards are applied, except when necessary due to guarantors' different credit, etc.
Classification of Securities	• Primarily based on valuation and credit risks of issuers • Securities subject to mark-to-market, or equity methods are exempt from classification	• Based on issuers credit ratings (by banks' own credit rating model, or credit rating agencies) • All securities are subject to classification without exemption
Restructured Loans	• No separate standards for restructured loans	• Separate standards for restructured loans

Under the new standards, the FSC provides only minimal guidelines for asset classification and provisioning, and banks must establish their own specific standards for asset classification in evaluating the debt-servicing capacities of borrowers.

In order to calculate BIS risk-adjusted capital adequacy ratio, the assets held by financial institutions should be classified and the corresponding loan losses provisioned. The assets are classified into (1) normal, (2) precautionary, (3) substandard, (4) doubtful, and (5) estimated loss under the forward-looking criteria (FLC). Here is the definition of the above classifications:

- Normal: credit exposures to borrowers who maintain a certain level of credit standing as well as sound business standards and borrowers whose loans are less than on month overdue, but whose debt-serving capacity is sufficient
- Precautionary: credit exposures to borrowers whose banking transactions and credit status call for lender attention; in particular, credit exposures to borrowers whose loans are overdue at least one month but less than three months or whose borrowings exceed the volume of their sales
- Substandard: credit exposures to borrowers with unfavorable patterns of banking transactions or credit status and exposures to borrowers who must agree to a definite repayment schedule; this can include exposures to borrowers who have been in arrears for over three months but no less than six months, or for whom a suspension of serving or reduction of interest has been granted
- Doubtful: credit exposures in excess of the amount expected to be collected from customers classified as substandard that is expected to be a loss, but has not yet been realized as such; normally the overdue restriction on doubtful assets is the same as substandard, but they are deemed more risky
- Estimated loss: credit exposures in excess of the amount expected to be collected from customers classified as substandard that must be accounted as a loss because collection is not possible in a foreseeable period; in the case of credit card companies, more than six months overdue assets are classified as an estimated loss

Table 2-4 | Minimum Loan Loss Provisions

(Unit: %)

	Credit Card Company		Bank		
	Loan assets	Credit Card Loans	Corporate Loans	Housing Loans	Credit Card Loans
Normal	0.5	1	0.5	0.75	1
Precautionary	1	12	2	8	12
Substandard	20	20	20	20	20
Doubtful	75	60	50	55	60
Expected loss	100	100	100	100	100

Financial institutions must accumulate minimum loan loss provisions for their assets according to the asset classifications. The minimum ratio of loan loss provisions varies depending on whether the asset is a loan or credit card asset. For example, the minimum ratio of a normal loan asset is 0.5% but the minimum ratio of a normal credit card asset is 1%. The difference is more vivid in the case of precautionary assets: the minimum requirement for the loan loss provisions of a normal loan is just 1%, but precautionary credit card assets should accumulate at least 12%. This strict provisioning requirement also reflects the high likelihood of distress and loss rates after the default of the classified credit card assets, which occurred during the so called plastic bubble in Korea in 2003 and 2004.

6. Assessments

Within financial supervision, the governance structure is of great importance in maintaining financial soundness and safety. Indeed, the main cause of most financial crises has been blamed on poor governance within the financial supervisory authorities. The natural response has been to reorganize or reshuffle the governance structure of financial supervision.

As shown in Chapter 1, changing Korea's financial supervisory structure was proposed before the 1997 crisis, but did not proceed due to protracted conflict among vested stakeholders. This episode illustrates the difficulty in governance reform, thus, external forces are deemed a necessary condition in facilitating its implementation, though not a sufficient condition. In fact, there have been a number of attempts to change the governance structure of financial supervision ever since it was consolidated. At the center of the struggle has been the division of labor between the Financial Supervisory Commission (FSC) and Financial Supervisory Service (FSS). According to the Korean Law, FSC is a government authority and FSS is a public agent that lies outside of government. For the legal status of those institutions, in respect to each other, has been challenged a few times. This led to changes in the governance structure, resulting in the consolidation of the FSC and FSS, instead of a two tier hierarchy. This was also undone, which reinforced the regulatory power of FSC.[10]

10 _ One of the achievements of establishing a consolidated financial watchdog in the Korean context was that financial supervision was separated from financial policy makers. In other words, FSC which was under the jurisdiction of the Office of Prime Minister set supervisory policy away from the power of the Ministry of Finance and Economy (MOFE) which took charge of financial policies. Thus, there existed a striking balance between policy makers and supervisors. The policy making and supervision tasks were given to the hand of the newly created Financial Services Commission (FSS) in which the previous Financial Supervisory Commission absorbed the Bureau of Financial Policies from MOFE in 2008. In this respect, the separation of financial supervision from financial policy becomes invalidated again.

In addition to the governance structure, the software aspects of financial supervision need to be strengthened. When weaknesses in supervision are exposed during crisis, it offers a great opportunity to upgrade existing practices. As long as a crisis reveals various problems in supervisory rules, it ushers a great momentum in which advanced supervisory practices are introduced. The first step in strengthening financial supervision starts with improving accounting standards. Without transparent and reliable accounting information, even best practices will not work well. Thus, new supervisory practices such as Prompt Corrective Action and Forward-looking Criteria need to be founded on appropriate accounting rules when introduced as a way to improve the sound management of financial institutions.

Chapter 03

Public Fund Management

1. Motivation of Public Fund
2. Governance Structure of Financial Reform and Public Fund
3. First-round Public Fund
4. Second-round Public Fund
5. Assessments

Chapter 03

Public Fund Management

1. Motivation of Public Fund

Immediately after the financial crisis in late 1997, the Korean government implemented a wide range of economic reform measures to foster economic restructuring as well as to restore market confidence. The top priority in financial restructuring was, in particular, given to the earliest possible resolution of insolvent financial institutions. When the government tried to salvage the financial system and to protect depositors, however, the central bank (BOK) and the deposit protection organization (KDIC) did not have sufficient resources to absorb the ensuing costs. Since Korea's international credit rating also suffered significantly from being down-graded during the crisis, it was impossible to raise capital from other financial institutions, corporations, or foreign investors. Thus, public funds were indispensible in the resolution of the financially non-viable institutions. The government, therefore, injected a massive amount of public funds into distressed financial institutions as part of their restructuring efforts.

Public funds, in Korea, are referred to the capital raised by the Korea Asset Management Corporation (KAMCO) and the Korea Deposit Insurance Corporation (KDIC) through the issuance of bonds with a government guarantee on the payment of principal and interest. The KDIC injected money to recapitalize the troubled institutions, thus, improving their regulatory BIS ratio. KAMCO purchased the non-performing assets of financial institutions to improve liquidity. The public funds were required (1) to purchase non-performing assets from financial institutions, (2) to pay out deposit insurance against the insured deposits of failing financial institutions, (3) to recapitalize financial institutions whose balance sheets were weak, and (4) to acquire assets of closed banks.

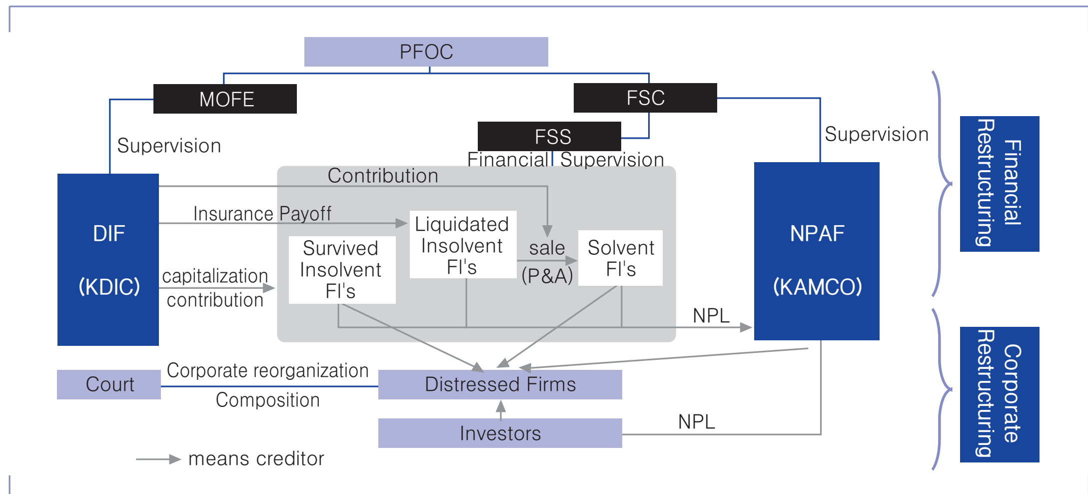
To effectively utilize the public funds and to mitigate moral hazard among rescued financial institutions, the funds were provided in a step-wise process, each stage of the process of injecting funds being subject to the strict conditions. To enhance the transparency of the public fund injection process, the contents of the memoranda of understanding (MOU) was standardized and disclosed to the public.

2. Governance Structure of Financial Reform and Public Fund

After taking emergency measures to stabilize liquidity, the government needed to pave a path out of the crisis in early 1998. These tasks, involving years of careful work, had to be taken to ensure that appropriate institutional arrangements were in place to effectively manage the crisis. In resolving the crisis, it was important to strike a balance between the political and technical aspects, making sure technical experts were delegated appropriate authority and responsibility. This balance can be achieved by forming a special crisis management apparatus, equipped with adequate skills, experiences, capacities and funding.[11]

Figure 3-1 depicts the organizational flowchart of the financial and corporate restructuring process in Korea. Since restructuring involved both the financial and corporate sectors, the two sectors could not be separated from each other, though certain steps for the restructuring processes were ordered in sequence.

Figure 3-1 | Depicts the Organizational Flowchart of the Financial and Corporate Restructuring in Korea



11 _ Swedish experiences were greatly referred to. Foreign experts who had participated in overcoming the Swedish financial crisis worked as consultants to the Korean government.

Before the enactment of the Public Funds Management Special Act in December 2000, the Financial Supervisory Commission (FSC),[12] more specifically, the Structural Reform Unit (SRU) of the FSC, orchestrated the entire financial restructuring effort with the help of the Ministry of Finance and Economy (MOFE). The two major implementing agencies were the Korea Deposit Insurance Corporation (KDIC) and the Korea Asset Management Corporation (KAMCO).

Even though its primary aim lies in the protection of depositors, KDIC had played a role of pay-box in the course of financial restructuring. The KDIC was instrumental in liquidating insolvent financial institutions with deposit insurance payout, participating in the recapitalization of inadequate financial institutions, etc. The funds used in this process, namely the Deposit Insurance Fund (DIF), were mobilized through the issuance of government-guaranteed bonds.

Box 1: Structural Reform Unit

After taking stop-gap measures to stabilize liquidity, the government needed to pave a path out of the crisis from the early 1998. The task at hand that may take years of reform to accomplish, needed to be managed effectively. In setting up the apparatus that will manage the resolution of the crisis, it is important to strike a balance between the political and technical aspects, making sure technical experts are delegated appropriate authority and responsibility. This balance can be achieved by forming a special purpose crisis management team, equipped with adequate skills, experiences, capacities and funding.

On the recommendations of the World Bank, the Korean government instituted the Structural Reform Unit (SRU) at the FSC. The SRU, initially in the MOFE, was to lead the restructuring of the banking sector, but it was transferred to the FSC after its establishment. The Commissioner of the FSC became the head of SRU for the purpose of expediting the reform process, being at the point where information from the financial institutions and markets converge. The FSC's scope of responsibility was expanded to include: monitoring financial institutions and markets, designing overall financial reform agenda, facilitating corporate sector restructuring, especially in the corporate workouts of large and medium-sized business groups, preparing contingency plans, etc.

Even though the FSC commissioner was also the head of the SRU for practical purposes, the SRU took charge of crisis-related tasks, while the FSC played the role of financial supervisory authority in both crisis and normal times. The SRU terminated its operation at the end of 2000, but its functions were absorbed by the FSC and FSS.

12 _ After the Public Funds Management Special Act was enacted in 2000, the Public Fund Oversight Committee (PFOC) has become fully responsible for every operation of financial restructuring that asks for the usage of the Public Funds.

Table 3-1 | International Comparison of Crisis Management Teams

	Corporate Restructuring	NPL Resolution	Resolution of FIs
Korea	CRCC → CRASC	KAMCO	KDIC
Thailand	Corporate Debt Restructuring Advisory Committee (CDRAC) → Thai Asset Management Corporation (TAMC)	• Financial Sector Restructuring Authority (FRA) • Asset Management Corporation (AMC) → Thai Asset Management Corporation (TAMC)	Financial Institutions Development Fund (FIDF)
Indonesia	Jakarta Initiative Task Force (JITF)	Indonesian Bank Restructuring Agency (IBRA)	Indonesian Bank Restructuring Agency (IBRA)
Malaysia	Corporate Debt Restructuring Committee (CDRC)	Danaharta	Danamodal

The main job of KAMCO in financial restructuring was to purchase non-performing assets (NPAs) from not only insolvent but also solvent financial institutions. The funds utilized in this process are called the Non-Performing Asset Management Fund (NPAF).

This kind of restructuring framework is not unique to Korea. Table 3-1 compares the crisis management team in four crisis-hit Asian countries. The overall structure of financial restructuring in all four countries is quite similar. Public AMCs were set up to resolve non-performing assets, while the deposit insurance entities (or funds led by the central banks) dealt with ailing financial institutions. Private organizations, closely monitored by the financial regulators and/or central banks, mediated the process of corporate restructuring.

3. First-round Public Fund

3-1. Background

The government needed to ensure that public funds were sufficient enough to win over the markets, and to remain flexible in case more funds were required. The first task at hand was to assess the extent of the financial distress both at individual financial institutions and in the

entire financial system. It was imperative to first ease the capital crunch in the corporate sector and to restore the system back to functioning order. Approved by the Korea National Assembly in 1998, most of these funds were mobilized by issuing bonds through two entities, KAMCO and KDIC.

Table 3-2 shows the initial estimate of non-performing loans in the financial sector as of the end of March 1998. The total loans most at risk of default, which were the main source of weakness in the financial sector, were estimated to reach KRW 68 trillion. In addition, a total of KRW 118 trillion of loans were found to be non-performing based on the international standard of classifying loans three months overdue as non-performing. With this estimate, the government armed itself with KRW 64 trillion of public funds in the first round, of which KRW 43.5 trillion were issued as DIF (Deposit Insurance Fund) bonds and KRW 20.5 trillion as NPAF (Non-performing Asset Management Fund) bonds. Both of the bonds were secured by the government's payment guarantee.[13]

Table 3-2 | Volume of Non-performing Loans (As of Mar. 30, 1998)

(Unit: KRW trillion)

Section	Substandard Loans	Cautionary Loans	Total
Commercial Banks	40.0	46.0	86.0
Non-banks	28.0	4.0	32.0
Total	68.0	50.0	118.0

Source: Financial Supervisory Commission

3-2. Details of Public Fund Allocations

In the course of dealing with KRW 100 trillion[14] of distressed debt, the Ministry of Finance and Economy estimated that KRW 50 trillion of loses were incurred by financial institutions. Of the remaining KRW 50 trillion, KRW 25 trillion was expected to be recovered through the sale of collateral by financial institutions. The other KRW 25 trillion was expected to be sold to KAMCO.

KAMCO, in accordance with the agreement reached with the IMF, purchased NPLs worth KRW 25 trillion in late 1998. KAMCO was allowed to purchase NPLs from only the financial

13 _ When the size of the first-round Public Funds was set on May 20, 1998, NPAF and DIF bond issuances were KRW 32.5 trillion and KRW 31.5 trillion, respectively. As the government decided to resolve problematic financial institutions including closures instead of NPL resolution in the scheme of open bank assistance (OBA), public funds were tilted toward DIF.

14 _ Out of KRW 118 of the estimated NPLs, KRW 18 trillion of bad assets was subject to self-restructuring by individual financial institutions and companies before the injection of the Public Funds.

institutions whose rehabilitation plans were approved by the Financial Supervisory Commission (FSC).

The financial institutions set aside KRW 15 trillion for loan loss allowances, KRW 6 trillion of this total was expected to raised by issuing stock in 1998 to offset net losses. Furthermore, KRW 4 trillion worth of additional stocks were going to be issued as part of the recapitalization of financial institutions to shore up their capital base and to meet the BIS capital adequacy ratio of 8%.

A total of KRW 39 trillion in new stock issuances was planned, KRW 20 trillion of which was planned to be financed through the efforts of the financial institutions. Since the government already provided KRW 3 trillion to bail out the Seoul Bank and the Korea First Bank before April 1998, stock worth KRW 16 trillion would be bought up by the government using the Deposit Insurance Fund Bond issued by the Korea Deposit Insurance Corporation (KDIC). It also raised as much as KRW 9 trillion in capital through bond issuances to prepare for the possibility of massive bank runs on troubled financial institutions. It was deemed necessary to deal with the large number of insolvent financial institutions. Therefore, the total of KRW 25 trillion in new bonds was issued by the KDIC.

4. Second-round Public Fund

4-1. Background

Despite all the public funds injected in the first round, considerable uncertainty about the financial system remained. Many banks still found themselves in a precarious position, which could only be addressed with additional injections of public funds. Indeed, Daewoo went bankrupt in 1999, while the BIS capital adequacy ratios of eight of a total 17 banks were below 8 percent in late 2000. Against this background, the introduction of a stricter standard for asset classification called "Forward Looking Criteria" (FLC) was being pushed. While the NPL ratio showed signs of improvement in 1999, it sharply increased in 2000, mainly a result of the introduction of FLC. The introduction of a stricter standard of assessing assets had encouraged banks to become more risk-conscious, causing them to reduce their exposure to large companies while increasing lending to households.[15]

15 _ In the first stage of financial restructuring, the government focused on reviving the banking sector while it expected non-banking sectors such as investment trust companies and insurance companies to be rehabilitated through market forces. However, the bankruptcy of Daewoo exposed the distress of non-banking sectors and weakness of bond markets. The second-round Public Funds were the resources with which the government tried to remove economic instability and complete financial restructuring.

Moreover, unfavorable external factors including rising international oil prices, falling semiconductor prices, and growing fears of exchange-rate volatility in Southeast Asia evoked concerns of another economic downturn in Korea. On the domestic side, confidence in business sector waned considerably in 2000, and the post-crisis problems facing the economy were larger than initially thought. The provision of additional public funds had been delayed due to elections in early 2000 and other political disputes late in the year. This delay contributed to tight credit conditions for firms during the course of 2000. Problematic debts stemming from Daewoo Group fueled uncertainty in the financial market. Following the Daewoo crisis in August 1999, non-banking financial institutions such as investment trust companies and insurance firms became unsound. The workout programs of Daewoo Group affiliated companies revealed considerably higher levels of debt, while negotiations to sell Daewoo Automobiles to a major foreign producer (GM) collapsed in September 2000.

Fund flows had been seriously disrupted, as the liquidity within the capital markets dried up and a significant amount of cash flowed out of the investment trust companies. Such conditions in turn imperiled many corporations that had come to depend on the issuance of debentures. Private market participants were not capable of resolving these problems, which made the injection of additional public funds unavoidable.

The second round of public funds sought to: 1) recapitalize distressed banks to enhance their BIS capital adequacy ratios; 2) shore up Seoul Guaranty Corporation's capital base to ensure the guarantees of Daewoo Group and non-Daewoo workout companies; and 3) offset shortfalls resulting in additional sales of non-performing loans.[16]

4-2. Details of Public Fund Allocations

For the second round of public funds, the government obtained approval from the National Assembly to raise an additional KRW 40 trillion, bringing the total amount to KRW 104 trillion. However, the funds were mainly mobilized by way of issuing Deposit Insurance Bonds, previously approved by the National Assembly since the Deposit Insurance Fund accumulated from insurance premium assessments was insufficient. The injection of public funds in this manner may have created moral hazard in some financial institutions. To mitigate possible

16 _ The mobilization of the second-round Public Funds had been delayed due to ill-coordinated policy dialogues and political agenda. In early 1999 when the first-round Public Funds became exhausted, there was an attempt to raise additional public funds in order to complete financial restructuring and prepare for occurrence of latent distresses from massive restructuring in the corporate sector, but an unanticipated happening in the high level meeting masked further discussions on the necessity of public funds. Due to national election for law makers in April 2000, it was not until mid 2000 when the government officially announced to raise the second-round Public Funds.

moral hazard, the government imposed strict conditions in line with international standards on the recipients of public funds.

The accounting and regulatory information existing at that time was quite misleading. There were two reasons for this problem. First, the government did not grasp the veracity of the financial crisis, as non-performing assets were being classified faster than they were being resolved in the early stages of the crisis. The fact of the matter was that all the bankruptcies had not played out yet. Second, the default of Daewoo group, whose total liabilities amounted to $58.3 billion, was an unexpected event. Daewoo was way too leveraged and unprofitable to survive. Nevertheless, no one doubted its survival since it was considered "Too-Big-To-Fail." In August 1999, however, 12 Daewoo subsidiaries entered into the Workout Program after the declaration of a moratorium. This event called for the government to make additional financial arrangements.

In 2000, a total of KRW 50 trillion in public funds was mobilized: KRW 40 trillion of new funds was raised while KRW 10 trillion was recycled from the first round of public funds injected, to be used in financial sector.

In the second round, banks were subject to a more conservative BIS capital adequacy ratio, seeking to raise their ratio above 10 percent by the end of 2000. Banks recapitalized with public funds had to submit management normalization plans to the government by September 2000. The efforts on inter-bank restructuring and the disposal of NPLs were hastened further through various measures such as the establishment of financial holding companies and M&A.

Out of KRW 50 trillion, KRW 6.1 trillion was planned to be used to normalize seven troubled banks including Chohung, Hanvit, Peace, Kwangju, Cheju, Korea Exchange Bank and Seoul Bank. For the non-banking financial institutions, KRW 8.3 trillion was injected into the Seoul Guarantee Insurance Company, and KRW 6.9 trillion into insurance companies, mutual saving & finance companies and credit unions, to facilitate their restructuring. KRW 2 trillion was injected into Hanaro Merchant Bank, which was a combination of several ailing merchant banks: Yongnam, Hans, Korea, and Joongang.[17]

17 _ Hun-Jai Lee, the former Commissioner of FSC and Minister of Finance and Economy, expressed a view that too much of capital was injected in the problematic banks in the second-round restructuring process. Once a government supplies too much money as capital to weak banks, they have little incentives to become efficient through self-restructuring efforts. Furthermore, it is very difficult to re-privatize those banks simply because of huge capitalization. Thus, he stated that the size of recapitalization along with necessary liquidity funding should be deliberately scrutinized in the bank rescuing process.

Table 3-3 | Sources and Uses of Public Funds

Section		Equity Participation	Contribution	Ins Payout	Asset Purchase	Total
by Assistance	Banks	33.9	13.6	-	14.0	86.1
	Securities	7.7	-	0.0	-	16.2
	Ins.	15.9	2.8	-	0.3	20.8
	MBC	2.7	0.1	17.2	-	21.6
	MSFC	-	0.1	7.3	0.6	8.2
	Credit Unions	-	-	3.7	-	3.7
	Over-seas	-	-	-	-	2.4
	Total	60.2	16.6	28.2	14.9	159.0
by Source	Bond Issuance	42.2	15.2	20.0	4.2	102.1
	Recovered	3.9	1.3	6.1	4.4	32.7
	Gov't assets	14.1	0.0	2.1	6.3	24.2

Table 3-3 summarizes the sources and uses of the public funds as of the end of December 2002. Of the total amount of KRW 159 trillion, a majority of the public funds went into commercial banks, but a significant amount was also used for non-bank institutions such as investment trust companies, merchant banks, and insurance companies. Recapitalization via purchase of equity in viable financial institutions totaled KRW 60.2 trillion, or 37.9%, the largest portion, followed by the purchase of NPLs at KRW 39.1 trillion, or 24.6%.

5. Assessments

Public funds deployed by the government, and the whole economy, ultimately belong to taxpayers. The argument that the origins of the crisis, often described as a failure of financial institutions and markets, can be traced back to financial consumers and companies, thus, justifying the use of taxpayer money defies fairness and the principle of market discipline. But if the destructive effects posed by a systemic crisis can be lessened, or even averted, by the use of public funds, then the use of taxpayer money may have the *raison d'être*. To be sure, the use of public funds in Korea in response to the 1997 crisis, helped to avert a much greater disaster.

Due to the very nature of *innocent money*, the public funds in Korea were used judiciously, deployed only in the financial sector. Not a single Won was used outside of aiding financial institutions. Indeed, the losses stemming the restructuring of distressed corporate debt were

recognized by the financial institutions, which were then recapitalized with public funds to shore up their weakened capital base. When the KAMCO purchased non-performing assets with the NPAF account, the direct beneficiaries were financial institutions which sold the assets at a reasonable discount. Thus, a realistic loss-sharing scheme, if not fully satisfactory, was instituted. In fact, an acceptable loss-sharing scheme is a condition precedent when using public funds to secure the trust and confidence of taxpayers.

From a practical standpoint, it is imperative to make adequate preparations for the timely deployment of public funds. It is critical to quickly work out the political considerations and the governance structure to minimize the potential losses stemming from a crisis. The Korea's public funds were swiftly mobilized just after the onset of the financial crisis, while the related governance structure was instituted. In this respect, the efficient establishment of the public funds greatly helped in the recovery of Korea's financial system. However, the second round of public funds did not go as smoothly, and experienced delay due to disunity among policymakers and politicians, which resulted in increasing the eventual cost of overcoming the crisis. Thus, the delay in executing the second round of injections of public funds contributed in protracting financial and corporate restructuring between 1999 and 2000.

One positive outcome from the delay was the establishment of a public fund management system. In fact, before the Special Act on Public Fund Management, it lacked basic operating principles to ensure that the funds were deployed in an efficient and transparent manner. In trying to make haste, a thorough cost and benefit analysis was not conducted by the government when it deployed the funds early after the crisis. It was not until the case had to be made for additional public funds that government sought to institute a more systematic approach, reducing discretionary decision-making to bring greater transparency, to public fund management. As such, the Special Act on Public Fund Management was established to ensure the government via documented process was implementing polices that took a path of least cost resolution.

Finally, it is important to bring the use of public funds to a conclusion by establishing a method to recoup the money. Post-crisis, the question of who will pay for it has far reaching implications, affecting the risk-taking behaviors of financial institutions, and the overall soundness of the financial system in the *ex-ante* sense. In Korea, KRW 20 trillion, out of total KRW 69 trillion loses expected from the crisis, is supposed to be recouped from financial institutions over the period of 25 years through a kind of special deposit insurance premium.

Overcoming the 1997-98 Crisis :
Financial Reform

Chapter 04

Banking Sector Restructuring

1. Basic Strategies
2. Rehabilitation of Korea First Bank and Seoul Bank
3. Banks with a BIS Ratio of below 8%
4. Banks with a BIS Ratio of above 8%
5. Assessments

Chapter 04

Banking Sector Restructuring

1. Basic Strategies

Since the 1997 financial crisis, the Korean banking industry has gone through substantial structural reforms. The objectives in restructuring Korea's banking sector have sought to drive out unsound banks from the market, to resolve bad loans, to strengthen the bank's capital base, and to promote transparency and accountability within management. This restructuring has been pursued in accordance with internationally accepted standards. Further, it has been focused on inducing the creation of leading banks through mergers among healthy banks that can compete with foreign banks and to curtail inefficiencies resulting from a crowded banking sector in Korea. Overall, restructuring of Korea's banking sector has pursued not only hardware but also software reforms.

After the onset of the crisis, in close consultation with the IMF and World Bank, the Korean government agreed to shut down non-viable banks, and to assist viable banks remain in business. It was also agreed to dispose of non-performing loans (NPLs) through the injection of public funds based on the condition that public fund recipients would be rehabilitated through mergers, injection of foreign capital, and improvement of management practices.

A capital adequacy ratio based on the standards set by the Bank for International Settlement (BIS), formed the basis for classifying financial institutions into viable and non-viable ones (See Figure 4-1). Based upon the FSC's review of financial institutions, 12 out of 24 banks in Korea were considered as non-viable because they failed to meet the minimum capital adequacy standard as of the end of 1997. These banks were asked to submit a rehabilitation plan, putting

the fate of their destiny in the hands of the FSC, which conferred with the Management Evaluation Committee consisting of the experts from the private sector. Relatively healthier banks, whose BIS ratio was over 8%, also underwent restructuring to strengthen their balance sheets through recapitalizations and separation of NPLs. As for the two commercial banks which were in dire financial trouble even before the crisis, Seoul Bank and Korea First Bank were recapitalized and put up for sale to international investors. Figure 4-1 summarizes banking sector restructuring.

Along with the hardware restructuring of the banking sector, the government implemented software reforms to mitigate further crises stemming from the mismanagement of the bank. The reform efforts mainly sought to improve the banks' solvency and profitability. To improve the credibility of unsound banks, the Financial Supervisory Service (FSS) required banks to adopt internationally accepted accounting standards, to strengthen information disclosure requirements in relation to banks' internal management, and to introduce forward looking criteria for asset classification in September 1999. The adoption of international accounting standards sought to restore confidence in the global financial system and to enhance the soundness of the banking sector.

Figure 4-1 | Bank Restructuring Flowchart

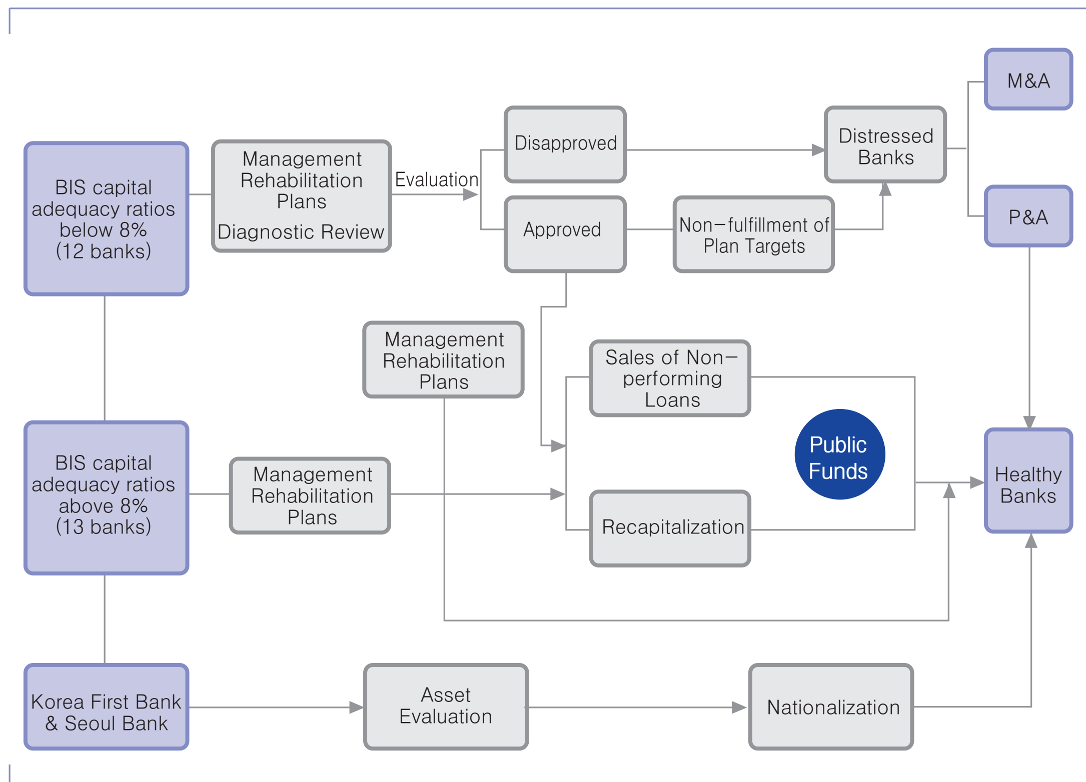


Table 4-1 | Summary of Banking Sector Restructuring

Banks	Restructuring Methods
KFB/SB	Wrote-down capital; Government capital injection Put up for Sale to Foreign Investors
5 Closed Banks	Restructured through P&A
7 Conditionally Approved	Mergers or self-normalization 10% BIS ratio for merged banks Conditional fiscal support
13 Remaining Banks	Mergers: KLB and Kookmin, Boram and Hana Management improvement measures (4 banks) Further consolidation expected

Table 4-2 | Resolution Procedures

Applying capital adequacy ratio and issue PCA	BIS ratio for depository institutions Operational net capital ratio for securities houses Solvency margin ratio for insurance companies
Submission of rehabilitation plans	
Evaluation by third-party experts	Diagnostic reviews by international audit firms Recommendation by appraisal committee
Final decision by the FSC	

With regard to Korea's bank restructuring, this chapter examines the process in which the distressed banks were resolved by dividing them into three sections according to their BIS capital adequacy ratios.

2. Rehabilitation of Korea First Bank and Seoul Bank

2-1. Nationalization via Injection of Public Funds

The problems faced by Korea First Bank and Seoul Bank were the most severe of all the commercial banks, and posed the greatest threat to the financial system. Korea First Bank's capital ratio was in fact negative, while Seoul Bank's capital ratio was less than 1%. The fact that no large bank in Korea was ever shut down before and that the two banks had a very high profile, the risk of a bank run was imminent. These conditionally-approved banks, indeed, were deemed too big to fail.

As the first corrective step, the two banks were recapitalized through an injection of public funds by the government. On January 31, 1998, the banks were forced to reduce their paid-in capital from KRW 820 billion to KRW 100 billion; existing shareholders had to bear part of the loss. Finally, both banks were promptly nationalized following an investment of KRW 1.5 trillion into each bank by the government and the Korean Deposit Insurance Corporation (KDIC). The actions of the government to nationalize them were precipitated by the growing likelihood of a bank run, heightened the systemic risk posed by the banks to the entire financial system.

The government also applied new standards to reinforce prudential regulations governing the banking sector by adopting international best practices applied in loan classification, capital adequacy, accounting and disclosure.

2-2. Decision on Sales to Foreign Bidders

The government policy to enhance global competitiveness was to lower barriers of entry and to adopt internationally accepted regulations and standards. To reduce foreign entry barriers, the government allowed foreign financial institutions to buy domestic banks and removed limitations on foreigners' equity holdings.

The government agreed with the IMF that Korea First Bank (KFB) and Seoul Bank would be sold to foreign buyers once they were nationalized. A privatization process committee was therefore formed at the end of March 1998 to manage the sell. Coopers & Lybrand was selected as the accountants responsible for conducting due diligence on the two banks' assets, and Morgan Stanley was later chosen as a lead advisor to manage the sell.

2-2-1. Korea First Bank

The government signed a memorandum of understanding (MOU) with Newbridge Capital Limited, a US investment fund, on December 31, 1998 for the sale of the Korea First Bank (KFB). An MOU was then signed between the government and the British-owned Hong Kong and Shanghai Bank (HSBC) on 22 February 1999 for the sale of Seoul Bank. The government eventually signed a binding agreement with the Newbridge with regards to KFB in the form of Terms of Investment. The Newbridge acquired 51% of the shares of KFB, thus the government remained as a 49% shareholder. On January 20, 2000, the government received KRW 500 billion from the Newbridge Capital to invest into KFB, followed by the installation of a new management team, including the appointment of Wilfred Horie as the new president of KFB. During this process, the bank was also required to downsize its branch network and lay off employees in order to minimize the burden of taxpayers and reduce further potential risks of

capital management. In April 2005, the government sold its entire remaining equity shares to Standard Chartered Bank.

2-2-2. Seoul Bank

In February 1999, an MOU was also signed with HSBC for the purchase of Seoul Bank. However, the negotiations between the government and HSBC failed to reach a mutual agreement by the end of August 1999. Shortly after the breakdown of negotiations with HSBC, the government undertook a second-round recapitalization in September 1999. Following a complete share reduction of public shareholders, KDIC injected KRW 3.3 trillion into Seoul Bank.

In April 2000, Deutsche Bank was appointed as a financial and restructuring advisor for Seoul Bank, as the government prepared for its privatization. The Public Fund Oversight Commission, which had been granted decision making authority in regards to companies that received public funds including Seoul Bank, selected Hana Bank as the preferred buyer and approved its sell to Hana Bank in September 2002. Hana Bank agreed to pay the Korea Depository Insurance Corporation (KDIC), the sole owner of Seoul Bank, KRW 1.15 trillion in the form of newly issued stocks in the merged bank. By building a new corporate culture based on international best practices in banking, Seoul Bank was successfully restructured, through a privatization and a merger with Hana Bank in December 2002.

3. Banks with a BIS Ratio of below 8%

3-1. Implementation of Prompt Corrective Action

At the end of 1997, the government implemented bank restructuring plans for 12 other distressed banks that had a BIS capital adequacy ratio of below 8%. As for these banks, the FSC carried out Prompt Corrective Action (PCA). On February 26, 1998, the government issued orders or recommendations for capital management improvement measures to these banks. They were required to submit a management rehabilitation plan to increase their BIS capital adequacy ratios above 8% by April 30, 1998. After due diligence, the FSC concluded that the management normalization plans submitted by the 12 banks - Chohung Bank, Commercial Bank of Korea, Hanil Bank, Korea Exchange Bank, Donghwa Bank, Dongnam Bank, Daedong Bank, Peace Bank, Kyungki Bank, Kangwon Bank, Chungchong Bank, Chungbok Bank - were not feasible, and thus rejected the plans at the end of June. Five banks had their banking business licenses suspended, and the remaining seven were allowed to continue operations

subject to conditions.

In 1998 negotiations with the IMF, the government agreed to establish the Special Task Force at the Ministry of Finance and Economy (MOFE) to coordinate and monitor bank restructuring and the provision of public funds. This task force became a bank restructuring unit under the FSC on April 20, 1998. It was then expanded and renamed as the Financial Reform Unit.

3-2. Evaluation of Management Rehabilitation Plans

The Bank Appraisal Committee evaluated the rehabilitation plans of distressed banks and submitted its final report on June 28, 1998. Using this as reference, the FSC classified each bank either as: “approval,” “conditional approval,” or “disapproval.” According to the FSC’s final decision, none of the banks received “approval,” whereas seven banks were conditionally approved, and five banks were disapproved. A bank that received “approval” was required to submit a detailed implementation plan on a quarterly basis, which would be monitored on an ongoing basis. “Conditionally approved” banks were required to submit implementation plans within one month. Banks that did not obtain approval were required to pursue a merger or transfer of business, especially under a P&A (Purchase of assets and Assumption of liabilities) arrangement. Conditionally approved or disapproved banks that voluntarily pursued mergers with sound banks were exempted from being shut down.

3-3. Five Banks Not Approved

The FSC made final preparations to shut down five ailing banks - Daedong Bank, Dongnam Bank, Donghwa Bank, Kyungki Bank, and Chungchong Bank. Considered beyond repair by the committee, the five banks were absorbed by healthier banks through P&A on June 29, 1998. Under P&A, healthier banks were allowed to selectively acquire assets and assume liabilities of unsound banks. This process of P&A was preferred as compared to other methods because it would minimize the banks’ losses, offer greater opportunities to acquire assets with lower risk, and protect depositors.

The acquiring banks were chosen from healthier banks which had a BIS capital adequacy ratio of more than 9% at the end of 1997. This allowed both the acquiring bank and target bank to maintain continuity in management while being able to reap the potential synergies of merging the good assets and liabilities of both banks. To ensure healthy banks did weaken in the process of absorbing assets, acquiring banks were granted put-back options under which assets could be sold back to the Korea Asset Management Corporation (KAMCO) if the quality of the assets deteriorated and became non-performing after being acquired.

Following the decision to close down the five distressed banks, the backlash from labor unions in response to massive layoffs in the banking sector pushed the banks, which acquired the assets of distress banks, into near paralysis. Union members refused to go to work, even engaged in sabotage by concealing important computer manuals.[18] Therefore, management was compelled by the government to minimize layoffs by retaining employees of acquired banks. About 2,800 employees were added to the existing workforce of 8,950 (a total of 10,000 including temporary employees) at acquiring banks. A compromise reached between labor and management allowed business operations to resume normally.

To ensure the BIS capital adequacy ratios of acquiring banks did not worsen, public funds were set aside for this contingency. The closure of Korean banks was significant in the sense that financial institutions would no longer be able to rely on unconditional protection.[19]

3-4. Seven Banks under Conditional Approval

The management rehabilitation plans of seven other banks were given conditional approval by the FSC. In other words, although the remaining seven banks had a BIS capital adequacy ratio of below 8%, they had to submit a substantive management improvement plan which considered recapitalizations, mergers, and downsizing by the end of July, 1998. For these banks, top priority was placed on shoring up their capital base, improving management systems and downsizing operations. In particular, the banks sought to attract foreign investment in a push to improve their international competitiveness. Some of the measures taken by the banks included recapitalizations by foreign investors and cost cutting measures such as layoffs and downsizing their branch network. This forced management to be more accountable and minimize the loss of depositors.

The banks were also required by the FSC to improve their management by appointing outside directors including foreign experts. Korea Exchange Bank, for instance, attracted foreign capital of KRW 350 billion from Commerz Bank of Germany in July 1998, and then merged with Korea International Merchant Bank in January 1999. Furthermore, KEB appointed

18 _ Many policymakers recalled that the resistance of labor union against decisions on bank closure was the most difficult part of the financial reform.

19 _ In the first stage of bank restructuring it was of great importance to distinguish viable banks from non-viable ones. The government made every effort to revive the latter, whereas it sent a clear message to close down the latter through P&A. Such thorough decisions and actions were not kept in the second stage of bank restructuring since 2000 and thereafter. For the reason that the government made a decisive action, including costly resolutions such as P&A, the first stage bank restructuring is differentiated and evaluated as successful. In hindsight, Hun-Jai Lee stresses that, once less costly resolution methods such as M&A should be hired in consideration of socio-economic costs, there exists little hope of successful banking sector restructuring.

two non-resident directors in July 1998 as part of its cooperation with Commerz Bank. Their plans were reviewed quarterly. If the plans were disapproved during the review period, the bank could have been subject to a mandatory merger or transfer of business. In the meantime, Korean Commercial Bank merged with Hanil Bank, which essentially became a *de facto* government bank, as its recapitalization was mostly funded with public funds. Other banks also became government owned banks after they were recapitalized with public funds. KEB and Peace Bank were expected to stand alone.

After its bank recapitalization efforts, the government sought to enhance the value of banks by subjecting them to performance targets. The government attempted to re-privatize the state-owned banks as soon as market conditions permitted. Meanwhile, they were expected to write management contracts with CEOs who were independent of the government. Specifically, highly qualified foreign management teams were expected to encourage efficient management and secure the confidence of foreign investors. To minimize the burden of taxpayers and the risk of moral hazard, government support was provided only to supplement the bank's own recovery efforts while recapitalizing viable institutions only if the self-imposed rescue plan of the ailing bank was successfully implemented.

To enhance efficiency, banks implemented cost cutting measures in reducing the number of employees and branches, resulting in downsized operations. This was expected to improve productivity by reducing expenses. The role of the board of directors, which included outside directors, had been strengthened as a major decision maker on bank strategy and risk management.

4. Banks with a BIS Ratio of above 8%

Banks with a BIS capital adequacy ratio of above 8% received a conditional approval on their management rehabilitation plans from the FSC. Nevertheless, they were also subjected to diagnostic scrutiny. That is, if their balance sheets needed to be strengthened or failed to conform to international standards, they were required to take corrective actions. The government, meanwhile, had encouraged mergers among sound banks of substantial size.

In addition to the merger between Hanil Bank and Commercial Bank, Hana Bank merged with Boram Bank, while Kookmin Bank paired off with Korea Long-Term Credit Bank. Chohung Bank also merged with Kangwon Bank, which earlier merged with Hyundai Merchant Bank, and with Chungbuk Bank. Again, these banks were injected with public funds to prevent the possible deterioration of their financial condition following the acquisition.

Accordingly, four bank mergers were completed by the end of 1999, encouraged by the FSC's willingness to purchase NPLs or to recapitalize banks that made acquisitions. The bank mergers result in: Hanvit Bank (Commercial Bank of Korea and Hanil Bank merger); Hana Bank (Hana Bank and Boram Bank merger); Kookmin Bank (Kookmin Bank and Korea Long-term Credit Bank merger); and Chohung Bank (Chohung Bank, Chungbuk Bank, Kangwon Bank merger). Some banks had to reduce their capital as a condition of receiving support. To ensure the soundness of acquiring banks, only high-grade assets of the liquidated banks were transferred, while nonperforming assets were excluded.

After review of the six banks' management improvement plans was completed in October 2000, the FSC assessed Hanvit Bank, Peace Bank, Kwangju Bank and Cheju Bank as being non-viable, and would not receive additional injection of the public funds. The turnaround plans of Korea Exchange Bank and Chohung Bank were given conditional approvals. In April 2001, Hanvit Bank, Peace Bank, Kwangju Bank and Gyungnam Bank became subsidiaries of Woori Finance Holding Company. Cheju Bank was put under the management supervision of Shinhan Bank, which later formed a holding company.

5. Assessments

The restructuring of the financial sector in the post-crisis period was divided into two stages in Korea. The first stage focused on restoring financial stability; the second stage sought to unwind the role of the government in the financial sector into a market-based system. In both stages, the banking sector was at the center of the restructuring efforts. The swift resolution of distressed banks was necessary to stabilize the financial system. Enhancing the competitiveness of banks by restructuring their balance sheets brought closure to the reforms.

In the first stage, the restructuring initiatives in the banking sector were quite bold and successful. Prior to the crisis, Korea had never closed a large commercial bank. Because commercial banks had functioned as public institutions, rather than profit-making companies, during the rapid growth period, no one would stand for private losses at the hands of a failed bank. At the time, the state ultimately took on the risks accompanied by the growth-oriented policies. However, the state could not act as the shock-absorber when faced with a systemic crisis. If the banks had not failed, the state could have failed instead eventually. Faced with the tough reality, sweeping restructuring measures could be pursued unabashed. It was very simple: unless a bank was assessed to be viable, then it was subject to restructuring or face the possibility of closure. This signal was sent to all market participants who could otherwise have manipulated the process.

In the second stage, restructuring of the banking sector was disjointed. The policy efforts to enhance the financial system up to the level of advanced countries were not clear-cut. The government-driven effort to move the financial system toward a market-oriented system had limitations, not only in tools[20] but also in concepts. The capacity of individual banks to improve management practices was rather weak. The size of the public funds used to recapitalize the banks in the second round is open to much debate since the considerable size of the capital injections may not incentivize bank management and employees to restructure and raise competitiveness on their own. It also makes re-privatization more difficult due to the government's huge equity stake in the banks.

In sum, restructuring in the banking sector produced only partial success, considering the achievements of the first stage while efforts initiated in the second stage have yet to fully materialize. Indeed, software restructuring requires a longer digestion period to see any measureable outcome. So, it is premature to provide a full assessment of the restructuring carried out in the banking sector so far.

Box 2: Restructuring Merchant Banks

During the 1997 financial crisis, the weak financial regulatory and supervisory system for Korea's merchant banking corporations was a major contributing factor to the deterioration of the country's financial system.

Merchant banking corporations were originally modeled on the Merchant Banks of England as well as being allowed to engage in other businesses including investment banking, leasing and lending. They were mainly engaged in underwriting securities, leasing and short-term lending, and catered to the corporate sector. The merchant banks would fund themselves by issuing bonds and commercial paper and also by borrowing from the inter-bank and foreign markets.

In the early 1990s, there were only a total of six merchant banking corporations in Korea, and all of them were foreign affiliates. Following the financial liberalization policies initiated during the mid-1990s, however, the entry barriers into the merchant banking industry were substantially lowered. As such, 30 merchant banking corporations were established by the end of 1996. In the second half of 1997, CP (commercial paper) discounts were allowed to banks and securities companies.

Through financial liberalization and deregulation, merchant banking corporations engaged in increasingly risky business and exposed themselves to significant interest rate, currency and credit

20 _ The FSC mediated the merger between good banks, or Kookmin Bank and Korea Housing Bank, in order to create a leading bank that could initiate upgrading of banking practices and compete with foreign banks. However, such a attempt did not meet pre-merger expectations on the trickling-effects on the banking industry.

risks. Their loans were concentrated in low credit-rated conglomerates (*chaebols*), which relied on short-term borrowing at low interest rates. The merchant banks could only access short-term borrowing at higher interest rates due to their lack of international credentials and experience in international businesses. Furthermore, the common belief that large conglomerates were too-big-to-fail also contributed to increasing leverage. As large conglomerates went into bankruptcy, the liabilities of merchant banks grew significantly. When merchant banking corporations defaulted on their loans, it precipitated a foreign currency liquidity crisis, nearly shutting off access to foreign currency borrowing in the international financial market.

Being a contributing factor to the 1997 financial crisis, legislation on financial restructuring was immediately initiated, followed by the bailout by the International Monetary Fund (IMF). The restructuring of merchant banking corporations carried out by the Korean government are summarized below. A Management Rehabilitation Plan was imposed on 30 merchant banks on December 3, 1997. This included assessing the bank's BIS capital adequacy ratio, liquidity and feasibility of their turnaround plan. From February to July 1998, the Financial Supervisory Commission (FSC), revoked the licenses of 14 merchant banks (Kyungnam, Kyungil, Korea, Samsam, Shinsaegae, Shinhan, Ssangyong, Chungsol, Hangdo, Hanwha, Hansol, Daegu and First) based on the evaluation of their Management Rehabilitation Plans. In August 1998, it also suspended the licenses of Saehan and Hankil Merchant Banks. In February 1999, Korea Exchange Bank merged with its subsidiary, Korea International Merchant Bank, and Hyundai Merchant Bank merged with Kangwon Bank, and Daehan Merchant Bank's license was revoked in June. In October 1999, LG Securities announced a merger agreement with LG Merchant Bank to be LG Investment Securities.

In 2000, the government announced plans to develop the merchant banking industry by encouraging voluntary mergers of merchant banks with other financial institutions, and policy measures aimed at expanding the business scope of merchant banks, and deregulation.

Overcoming the 1997-98 Crisis : Financial Reform

Chapter 05

Corporate Workout Programs

1. Background
2. Overview of the Korean Corporate Workouts
3. Specific Restructuring Methods in Detail
4. Assessments

Chapter 05

Corporate Workout Programs[21]

1. Background

The wide variety of corporate finance tools under bankruptcy came into play in the wake of the financial crisis in 1997 in Korea, which experienced massive distress in the corporate sector, and its financial market was in danger of collapsing as most of the commercial banks were significantly undercapitalized. The financial crisis imperiled the viability of not only individual firms but also the entire financial system, hindering the wind-down of most distressed companies through formal resolution methods, or court bankruptcy proceedings. The weak capacity and lack of expertise of the courts were rendered inadequate and inefficient by the sheer number of companies in distress and the size of their debt, which stood to further worsen Korea's crisis-torn economy. Indeed, more than 80 percent of the corporate restructuring, according to World Bank (1999), are typically resolved through private agreements among relevant stakeholders rather than the court during crisis situations.

The Korean Corporate Workout Program was established in the wake of the crisis in 1998. It sought to wind down distressed companies which also threatened the fate of financial institutions. Most financial institutions, including major commercial banks, left weakened by inadequate capital, could not afford to bring bankruptcy proceedings on their non-performing borrowers. Though fair, it would have been costly. The financial institutions needed time and resources that allowed them to reorganize. From the government's perspective, it would have been way too costly to take a market-based approach to resolving the distressed companies

21 _ This chapter is partly reedited based on Kang (2004).

through court-led restructurings, which would have ended in liquidation in many cases. The owners and management of the distressed companies preferred to take the route of corporate workout, seeing that they stood a better chance to remain in management. The employees of these companies also expected to retain their positions. Otherwise, the employees would have been laid off in the course of restructuring. Under this incentive structure, the government proposed pursuing a corporate workout program, thus, reaching an agreement with all the other related stakeholders.

Box 3: The London Approach

There are, in general, three types of corporate restructuring methods: a centralized approach, a decentralized approach and the London Approach. The London Approach, developed by the Bank of England during the recession in the early 1990s, is a mixture of both centralized and decentralized approaches in that corporate restructuring is led by an arbitrator mediating between the troubled firms and financial institutions.

The Korean government developed a framework for the corporate restructuring based on the London Approach. To be specific, three different approaches to corporate restructuring were applied based on the firm's restructuring capacity. These workout programs were mainly aimed at 1) minimizing losses of debtors and maximizing returns to creditors; 2) sharing losses among creditors, management, shareholders, employees and other interested parties; and 3) improving transparency in the course of restructuring.

In the process of the corporate restructuring, the 6th to 64th largest conglomerates, ranked by asset size, adopted the workout program. They were the insolvent firms operating diverse lines of businesses including semiconductors, heavy engineering industries and automotive assembly, but on a much smaller scale than the top five *chaebols*. The workout program was created to recover those companies that seemed promising in the long term but financially constrained in the short term. Among the top 64 *chaebols* with corporate debt of KRW 250 billion or more, 30 business groups were required to undertake the corporate restructuring.

2. Overview of the Korean Corporate Workouts

2-1. History

From the beginning of 1997, just before the outbreak of the financial crisis, a few large corporations went into bankruptcy and many sizable business groups became financially distressed due to a liquidity crunch, which promptly led creditor financial institutions to call in

their loans, especially merchant banks. As the risk of a systemic crisis loomed ever so large over the entire economy, creditor banks took the lead in the resolution of the distressed companies under the so-called Insolvency Respite Agreement on April 18, 1997. This led to a respite in the market, but it would be only temporary. Until the end of 1997, the agreement was applied to 33 companies, of which 6 companies filed for court-led corporate reorganization and 25 companies filed for composition. In addition to non-participating creditor financial institutions such as investment trust companies, insurance companies, brokerage houses, merchant banks, etc., being made part of the agreement, the lack of mediators to bridge differences among the creditors limited the agreement's ability to secure a successful conclusion. The management and/or owners of the troubled companies were reluctant to take financial assistance under the agreement, worried about losing their management of their company. In the end, this exercise proved to be ineffective in achieving corporate restructuring under best practices during a crisis situation where all economic agents do not concern themselves with anything beyond their own interests.

The massive corporate distress, on the verge of insolvency, at the time of the financial crisis, posed a risk to not only sound firms in the corporate sector but also most of the financial institutions. With the credit crunch in the financial markets worsening, the court-led restructuring of the troubled companies could have disrupted the flow of funds and the operation of businesses, further exacerbating the fragile situation and sending the economy into a vicious downward spiral. Least of all, the health of most financial institutions would not allow them to absorb the losses stemming from a court-led restructuring. Under these circumstances, the Korean Corporate Workout Program was initiated under the Financial Institutions Agreement for Promotion of Corporate Restructuring (hereafter the Agreement) signed by 210 creditor financial institutions on June 25, 1998, which succeeded the previous Bankruptcy Respite Agreement.

2-2. Characteristics

Workouts refer to a negotiated agreement between the debtor and their creditor outside the bankruptcy process. In workouts, the debtor has to convince the creditors that they would be financially better off with the new terms of a workout agreement than the terms of a formal bankruptcy. The main benefits of workouts are cost savings and flexibility. These benefits, however, do not come without risks. The key risk is a holdout problem resulting from a breach of the agreement by a stakeholder. If this problem cannot be addressed appropriately, then workouts less effective compared to the formal bankruptcy filing.

The Korean Corporate Workout Program has the common features found in ordinary workouts, but is not exactly the same in terms of its objectives and procedures. It was initially prepared to restructure financially unhealthy medium sized *chaebol* companies, targeting the 6th

to 64th largest conglomerates in asset size. It's objective can be defined as a corporate sector restructuring program aimed at resolving corporate distress, but it can also have a secondary role in supporting financial sector restructuring. In fact, its role of supporting financial sector restructuring came to the fore during the crisis, as policy priority was placed on reviving the hard-hit financial system.

The workout program in Korea is understood as being semi-formal, instead of being informal, in terms of policy-making structure. Officially, the creditors' committee (Council of Creditor Financial Institutions) is supposed to amend original debt covenants. . Practically, the Corporate Restructuring Coordination Committee (CRCC), a mediator that creditors established in order to resolve technical problems in the process of negotiations, played a critical role in brokering agreements. Though consisting of private members, CRCC had close ties with the Financial Supervisory Commission (FSC), which acted as a control tower orchestrating the restructuring of both financial and corporate sectors. CRCC and FSC collaborated in restructuring the corporate debt by ruling on the amount to be written off, maturity extensions, use of debt-equity swaps, etc. The amount of debt that was restructured also affected the amount of new capital via public funds that was going to be injected into the bank. Government involvement in the corporate workout process was inevitable when the depth of the corporate and financial sector distress were considered. When banks face a high risk of being shut down, it is to their best interest to remain passive: otherwise, they would risk insolvency or liquidity crisis. After the CRCC approved the restructuring plans, the banks took a more active role in terms of execution, implementation, monitoring, and even arranging additional loans. In summary, the Korean Corporate Workout Program was mixed in the way that restructuring was pursued and overseen by the government: the restructuring was market-based in form and creditor-led in practice.

2-3. Workout Companies

By the time Kohap Group's main creditor initiated corporate workout for four of its subsidiaries on July 6, 1998, 104 companies were in the process of workout under the Agreement. The workouts for 8 companies were stopped due to doubts held by the creditors of the company's going concern or doubts held by the owners of their ability to retain management control. Thus, the creditors commenced corporate workouts for 96 ailing firms. In the course of the workouts, 17 companies consolidated into their parent company, while 4 subsidiaries of Daewoo Corp. and the Daewoo Heavy Industry, Ltd were spun off. The total number of companies in workout was whittled down to 83.[22] Table 5-1 summarizes the number of companies in workout.

22 _ This paper sets the number of the entire sample of the workout companies to be 83 hereafter.

Table 5-1 | Summary of the Workout Companies

Application	Rejection	Workout Companies			
		Approved	Merger (△)	Partition	Total
104	8	96	17	4	83

Out of the 83 companies in workout, 55 entered workout programs in 1998. These companies belonged to medium sized chaebols or stand-alone companies. After a moratorium was declared on the debt of Daewoo Group, the second largest chaebol in Korea, in July1999, 12 Daewoo subsidiaries and related companies were put into workout (See Table 5-2). In terms of the number of companies, Daewoo subsidiaries accounted for one fifth of the total companies in workout, but nearly two thirds of the total distressed debt. Out of a total KRW 103.8 billion, Daewoo's liabilities to the financial institutions amounted to KRW 66.6 billion (See Table 5-3).

Table 5-2 | Companies Entering into the Corporate Workout Program

	1998	1999	2000	Total	Ratio (%)
Daewoo	-	12	4[1]	16	19.3
Non-Daewoo	55	10	2	67	80.7
6-64 group	26	3	2	31	37.3
Others	29	7	-	36	43.4
Total	55	22	6	83	100.0

Note : 1) Partitioned companies from Daewoo Corp. and Daewoo Heavy industry, Ltd.
Source : Financial supervisory Service (2003).

Table 5-3 | Notified Debts of the Workout Companies

(unit: 100 million, %)

	1998	1999	2000	Total	Ratio
Daewoo	-	665,767	-	665,767	64.1
Non-Daewoo	333,817	15,838	22,536	372,191	35.9
Total (ratio)	333,817 (32.2)	681,605 (65.6)	22,536 (2.2)	1,037,958 (100.0)	100.0

Source: Corporate Restructuring Coordinating Committee.

The outcomes of the workouts as of the end of 2002 are reported in Table 5-4. Out of the entire sample, 40 companies graduated from workout while 15 companies underwent restructuring outside of the Council of Creditor Financial Institutions. From the creditors' point of view, the 55 companies in these two groups, classified as normalization, had a high

probability of being restructured successfully. However, the workout program was suspended for 16 companies while progressing for 12 companies.

Table 5-4 | Results of the Workout Companies as of the end of 2002

	Total	Normalization			Distress		
		Graduation	Self-restructuring	Subtotal	suspension	In-Progress	Subtotal
Chaebol	47 (100.0)	20 (42.6)	8 (17.0)	28 (59.6)	9 (19.1)	10 (21.3)	19 (40.4)
Others	36 (100.0)	20 (55.6)	7 (19.4)	27 (75.0)	7 (19.4)	2 (5.6)	9 (25)
Total	83 (100.0)	40 (48.2)	15 (18.1)	55 (66.3)	16 (19.3)	12 (14.5)	28 (33.8)

Note : ( ) is ratio in percentage

2-4. Initial Financial Conditions of Workout Firms

There are a number of factors that could affect the performance of corporate workouts. Much literature has reported the initial conditions of the workout companies as being one of the most important factors.

Table 5-5 depicts the initial debt structure and operational health of 73 non-financial companies in workout. The banks' credits ratio compared to the total notified credits is around 30%, which does not vary much over industry, irrespective of the workout outcome and Daewoo affiliates. The top five creditors' credit ratio is about 70%, while the average total number of creditors is 24.5. Debt is fairly concentrated among a small number of creditors. The number of Daewoo's creditors is also in line with other companies; but data for Daewoo should be taken with care because the numbers were collected after workout was initiated. Before the Daewoo subsidiaries were put into the workout program, it had 480 creditors from 69 countries. To maximize the efficiency of the corporate restructuring, the government got involved in the debt negotiations with foreign creditors. As a result, the Korea Asset Management Corporation (KAMCO) purchased Daewoo's foreign debt at the nominal amount of 36.9 billion US dollars, or at 43 cent on the dollar on average.[23] Table 4-5 does not capture this simplified process. This table also reports the average ratio of going concern value to liquidation value of a business in the last column.

23 _ See Jeong and Hong (2003) for the detailed story of the KAMCO's acquisition of the foreign debts of the Daewoo subsidiaries.

Table 5-5 | Initial Debt Structure and Business Conditions of the Non-financial Workout Companies

	Section	Relative to Total Credits of Financial Institutions(%)					GCBV1) (LV)2)
		Banks' Credits	Top Five Creditors' Credits	Guaran-tees	No. of Creditors	No. of Banks	
Industry	Manufacturing [53]	31.2 (14.3)	71.3 (16.4)	34.0 (20.4)	24.4 (16.6)	8.8 (5.1)	1.5 (0.5)
	Construction [10]	25.4 (10.7)	63.6 (16.3)	26.3 (14.0)	28.0 (13.7)	12.3 (5.8)	1.6 (0.4)
	Retail & Wholesales [7]	29.9 (17.1)	67.0 (15.1)	23.4 (17.4)	25.9 (23.2)	9.7 (5.0)	1.5 (0.4)
	Others [3]	51.2 (17.5)	92.0 (13.0)	39.8 (22.0)	9.7 (7.2)	4.3 (3.5)	1.8 (0.1)
Workout Result	Graduation [36]	31.5 (13.9)	74.4 (15.9)	34.3 (22.2)	18.1 (10.7)	7.8 (3.9)	1.6 (0.4)
	Self-Restructuring [12]	41.6 (19.7)	75.1 (15.8)	32.9 (11.7)	21.4 (13.7)	7.8 (4.7)	1.3 (0.8)
	In-Progress [12]	25.0 (10.3)	59.5 (10.7)	24.3 (11.0)	38.3 (13.9)	12.2 (5.9)	1.5 (0.4)
	Suspension [13]	27.0 (12.1)	67.4 (19.9)	32.9 (22.3)	31.2 (24.1)	11.4 (6.9)	1.3 (0.4)
Daewoo	Daewoo [10]	23.2 (10.3)	61.2 (18.3)	13.7 (8.8)	39.4 (23.7)	11.7 (5.8)	1.5 (0.5)
	Non-Daewoo [63]	32.3 (15.0)	72.2 (16.1)	35.1 (19.1)	22.1 (14.2)	8.8 (5.1)	1.5 (0.5)
All [73]		30.9 (14.7)	70.7 (16.6)	31.7 (19.7)	24.5 (16.6)	9.2 (5.2)	1.5 (0.5)

Note: [ ]: number of observations
( ): standard deviation
1) GCBV: Going Concern Business Value
2) LV: Liquidation Values

3. Specific Restructuring Methods in Detail

Corporate restructuring aims at reorganizing the financial and business structures of ailing or failing companies through various methods. By and large, we can categorize the reorganizing efforts into the following four groups: debt, business, employment, and governance. This subsection overviews the specific corporate restructuring methods used in the workouts.

3-1. Debt Restructuring

Debt restructuring is at the core of corporate workouts because the direct causes of corporate distress stem mostly from high external debts relative to a company's debt service capacity. Interest relief and composition are typical methods of debt restructuring. Interest relief includes extension of debt payment terms and/or conditions, lower interest rates on debts, etc. Composition means a haircut to the principal of the debt. When the creditors exempt the debtors from paying the principal, creditors swap debt for equity in the company, thus reducing its equity, in the form of straight equities or convertible bonds (CBs) in order to recoup the upside potential if a company recovers.[24]

Interest rates on debt are reset by the creditor based on its estimate of the company's future free cash flows and sustainable debt amount. The amount over what the company can afford in debt is converted into equities or CBs and then interest rates are lowered on the remaining debt. Table 5-6 summarizes the methods of debt restructuring used in the workouts. The major instrument is the reduction of interest payments. For KRW 66.1 trillion of debt, or 67% out of the total KRW 98.7 trillion of debt restructured, interest rates were lowered or periods of interest payments were extended. Debt-to-equity and debt-to-CB conversion for the unsecured claims[25] were widely used in the corporate workouts, too: KRW 15 trillion and KRW 3.3 trillion, respectively.

Table 5-7 shows interest rates on the debt of workout companies over time. From 1998 to 2002, corporate loan rates declined monotonically as the economy recovered from the crisis and inflation stabilized. Furthermore, the improved health of financial institutions, which allowed

24 _ In order to facilitate equity conversions, the government revised regulations on the financial institutions. In the case of an equity investment on the workout companies, the ceilings on securities investment of financial institutions, or less than 15% of the voting stock in any other company, are not applied.
25 _ The secured creditors tried to avoid equity conversion, worrying about the losses from security evaluations. However, there are cases in which secured creditors participated in the recapitalization. In such cases the stock price exceeded the face value in the exchanges or put-back option was provided.

them to absorb losses from the non-performing loans, led to a decline on the interest rates applied to the debt held by workout companies until 2001. In 2002, interest rates rose on the debt held by workout companies as a significant amount of debt was converted into equity, especially in the case of Daewoo subsidiaries, which reduced the amount of debt with low interest rates.

Table 5-6 | Debt Restructuring for the Workout Companies

(unit: KRW 100million)

	Debt relief			Debt-equity conversion			Others[1]	Total
	Interest rate reduction	Normal interest rate	Subtotal	Equity conversion	CB conversion	Subtotal		
Normalization	65,689	30,563	96,252	95,374	14,582	109,956	45,519	251,727
In Progress	134,978	17,624	152,602	51,817	12,966	64,783	17,045	234,430
Suspension	460,701	10,023	470,724	2,466	5,728	8,194	13,901	492,819
Total	661,368	58,210	719,578	149,657	33,276	182,933	76,465	978,976

Note: 1) netting deposits and loans, discounted debt redaction, exemption of guaranteed debts.

Table 5-7 | Interest Rates on the Workout Companies

(unit: %. %p)

	1998	1999	2000	2001	2002	Average
Secured Credits (A)	9.8	8.3	8.2	5.4	6.9	7.7
Unsecured Credits (B)	9.9	5.2[1)]	6.6	5.0	6.5	6.6
Difference (A-B)	- 0.1	3.1	1.6	0.4	0.4	1.1
Average for workout companies	9.9	5.8	7.2	5.1	6.6	6.9
Corporate loan rate	15.2	8.9	8.2	7.5	6.5	9.3

3-2. Business Reorganization

As a condition for restructuring their debt, the creditors usually require debtors to reorganize their business with a long-term view of raising profitability. Also, the companies unable to survive on debt restructuring alone are also required to restructure their business. Restructuring can take many forms including sale of assets like real estate properties, securities, businesses, etc., and recapitalization by issuing new equity.

Accordingly, the government made statutory changes to facilitate these restructuring efforts of the companies. For example, corporate partition was introduced by amending the Commercial Act, to allow comprehensive transfer of businesses. This helped to reduce the costs

of selling a business, and subsequently, those of corporate restructuring.[26] In order to facilitate M&A, the investors of companies in workout were exempted from tender offer clauses in the Securities and Exchange Act.[27] To attract foreign investment in distressed companies, restrictions on the gross amount of investment applied to foreign investors was lifted. Through a number of revisions of the Special Tax Treatment Control Act, tax benefits for corporate restructuring were instituted as well.

Table 5-8 reports data on restructuring efforts carried out by companies on their own to turn their businesses around. Most of the restructuring was concentrated in Daewoo; more than 70% of business restructured involved Daewoo subsidiaries. As a matter of fact, various approaches were used in their restructuring.[28]

Table 5-8 | Business Restructuring Efforts by the Workout Companies

(unit : KRW 100 million)

	Asset Sales					Sub-sidiary	Capitali-zation	Owner Contri-bution	Others	Total
	Real Estate	Security	Business	Other Assets	Subtotal					
Daewoo	20,135	4,960	23,192	3,856	51,454	4,647	9,897	1,205	2,867	70,081
Non-Daewoo	7,819	7,247	6,388	2,659	24,113	2,207	202	0	3,171	29,693
Total	27,954	12,207	29,580	6,515	75,567	6,854	10,099	1,205	6,038	99,774

3-3. Employment Restructuring

The restructuring of a company's workforce is one of the components of restructuring, but should be discussed separately due to the sensitive nature of the issue. In pursuing corporate workouts in times of crisis, as opposed to private workouts in normal times, policy makers should be wary of weighing both the negative impact of unemployment and the positive impact of achieving efficiency, taking a more collective approach rather than at the sacrifice of an individual group when trying to overcome a crisis situation. From a micro perspective, pursuing

26 _ The Daewoo Corp. and the Daewoo Heavy Industry adopted spin-off strategies for prospective businesses according to the legal grounds for corporate partition.

27 _ According to the paragraph (1) of the Article 21 in the Securities and Exchange Act, a person who intends to acquire voting stocks through a purchase outside the securities market or the association brokerage market shall acquire the stocks through a tender offer in a case where the total number of the stocks held by such person and specially connected persons after the purchase is 5/100 or more of the total number of the stocks.

28 _ As for the cases of restructuring the Daewoo subsidiaries, see Korea Development Bank (2003).

drastic downsizing measures at the cost of employees may fail to obtain cooperation from laborers, one of the essential stakeholders to the success of corporate restructuring.

Table 5-9 shows the percentage changes in the number of employees and the personnel expense of workout companies. Overall, 32.6% of employees were laid off between the beginning and the end of the workouts. This means over 31,000 laborers were laid off. The restructuring is more severe in the case of Daewoo subsidiaries in terms of both the percentage and amount. It is also interesting to note that the personnel expense on a per capita basis has increased, since the number of employees decreased more than total personnel expenses. The workers who were able to keep their positions in the workout companies seem to be better off.

Table 5-9 | Employment Restructuring in the Workout Companies

	Percentage Changes in		
	No. of Employees	Amount of Personnel Expenses	Per Capita Personnel Expenses
Daewoo	-39.29%	-21.10%	29.96%
Non-Daewoo	-26.51%	-1.38%	34.20%
Average	-32.55%	-11.21%	31.65%

3-4. Governance Restructuring

Weak corporate governance has long been blamed as one of the causes of the financial crisis in Korea. Corporate governance reform achieved in distressed companies such as the firms in workout is of particular importance; in that, the workout forced existing management and owners accountable for their actions but also provided the impetus to turn the company around. That is, the improvements in governance are in line with the principles of fairness and efficiency.

As of the end of 2002, many of the previous owners stepped down from top management in 56 out of 83 workout companies. The previous existing owners retained management control in the other 27 cases, of which most graduated from workout by initiating restructuring efforts and improving their business operations.

4. Assessments

Korea's year experience in instituting a corporate workout program was experimental in trying to pursue corporate restructuring, employing a private, or semi-private at least, creditor-led workout. The experience was quite unique in the sense that data on the methods used for corporate rehabilitation, and the absolute nature of their results of either having been a success or failure, are available to the extent in which empirical analyses could be feasible. In general, corporate restructurings are conducted in a series of confidential negotiations, where the terms of contracts are kept private, so that only a piecemeal set of information is available. In Korea's case, the restructuring efforts by both creditors and debtors were documented by the government, which allowed us to get clearer picture. The characteristics of Korea's corporate workouts, and the use of public funds, made the collection of data possible, though not publicly available.

Based on the empirical analyses, we can make the following remarks on the performance of Korea's corporate workouts based on the evidence. First, the initial status variables were the key success factors in the corporate workouts. The ratio of top five creditors' credits to total credits was the most significant factor in the rehabilitation of workout companies in terms of debt service capacity. Also, as the ratio of over 10% creditors to total creditors increases, the more likely distressed companies are able to turn their businesses around. In other words, restructuring of the workout company's debt structure was the dominant factor. The importance of a simple debt structure in a workout is consistent to the analysis by Gilson, John and Lang (1990), which concluded that the private workouts did not perform well in the case of U.S. companies due to existence of many bondholders which resulted in a more complex debt structure.

Second, debt-to-equity swaps were the most effective tool among various debt restructuring methods, though it does not seem to be very significant. Other methods used to relieve the debt burden of workout companies had the opposite effect on corporate rehabilitation. In particular, debt-to-CB conversions adversely affected the capability of the distressed companies to redeem debts in a very significant manner. These observations can be understood as the result of the creditor-led corporate restructuring. As mentioned earlier, the main objective of the Korean Corporate Workout Program was restructuring the distressed financial institutions. Corporate restructuring was a secondary objective, as a way to boost the recovery of NPLs of the corporate sector. Thus, conservatively restructuring as little debt as possible led them to minimize the losses. The positive correlation of the debt-to-equity swap with rehabilitation from the creditors' perspective is thought to be the sorting results of the financial institutions, of which private information takes a larger portion than publicly available information. Creditors had swapped debt for equity only for prospective companies.

Third, the role of business and employment restructuring turned out to be insignificant. As for almost all of the proxy variables for these categories, the null hypothesis that the coefficient is zero cannot be rejected. Only in the results of the business rehabilitation from the debtors' perspective, per capita personnel expenses, one of the employment restructuring variables, are relatively significant and consistent.

Fourth, it is quite delicate to interpret the effect of governance restructuring on the performances of the workouts. Under the criterion reflecting creditors' position, this variable is quite significant, but in reverse. The more extreme the change to management and ownership is, the worse the recovery in debt service capacity is. Under the criterion reflecting debtors' position, however, it is less significant, but in a consistent way. The more extreme the change to management and ownership is, the better the business operations are. One of the possible explanations for this phenomenon is that the creditors and management of the workout companies may collude with each other in line with their own incentives. Their incentives are quite clear. The creditors sought to maximize their recovery, while the management sought to retain their control. If they act on their incentives, the empirical observations forecast that the debt service capacity would increase while the distressed companies would be less likely to turn their business around. This is just a conjecture, so further research is needed to verify the true relationship between changes in governance and a company's ability to turnaround.

It is worthwhile to note whether it is appropriate to apply the corporate workout program to large corporations such as the Daewoo Group and its affiliates. By and large, it is better to adopt a court-led corporate restructuring procedure in such a case, for Daewoo's debt structure was much more complex. The empirical study states that the simple nature of the companies' debt structure was one of the single most important success factors in producing fruitful results in corporate restructuring. However, the Korean situation in 1999 could not help but to utilize the creditor-led workout program in the case of Daewoo. Again, the main rationaleis that Daewoo was "Too-big-to-fail." Given the precondition of having to rescue a majority of the companies, creditors and the Korean government tried to minimize the direct losses and derived side effects incurred from them. Under the circumstances, a court-led insolvency regime was not a practical choice in view of the time and costs. Notwithstanding, it is a fundamental question whether another failure at a large corporation which poses systemic risks should be resolved through an informal insolvency regime again.

Chapter 06

Distressed Assets Resolution

1. Basic Principles of Distressed Assets Resolution
2. Operation of Asset Management Corporation
3. Resolution Methods
4. Assessments

Chapter 06

Distressed Assets Resolution

1. Basic Principles of Distressed Assets Resolution

A huge amount of non-performing loans is one of the direct causes of most financial crises. In Korea, NPLs of KRW 118 trillion, almost 15% of annual GDP, were not by any means manageable based on level of capital held by Korean financial institutions. Resolution of NPLs demanded special expertise, but Korean banks lacked the relevant experiences and skills as well as incentives. Furthermore, the quality of the NPLs tended to deteriorate unless they were carefully managed. These were the reasons why the public asset management corporation (AMC) that specialized in the disposal of NPLs was required in Korea, and KAMCO took the job.

Coincidentally, almost at the same time of the currency crisis, the Non-performing Asset Fund (NPAF) was established in November 1997, which was entrusted to KAMCO. KAMCO purchased NPLs from all financial institutions near the fair market price, in other words, at a heavy discount to their book value.[29] Since the transaction of NPLs and thus the relevant market price did not exist during the crisis, the actual transactions between the financial institutions and KAMCO could not help but be led by the government. FSC played a role in qualifying the NPLs, and then mediating the price based on the loan recovery rate, default rate, auction discount rate, etc.[30]

29 _ As of October 2002 the average discount rate for all acquired NPLs is 63%, or the price of NPLs is 37 cents per a dollar.

Table 6-1 | KAMCO's Acquisition and Resolution of NPLs(As of June 30, 2002)

(unit: KRW trillion)

Classification	Purchased		Resolved	
	Face Value	Purchase Price	Face Value	Recovery Value
Ordinary Loans	29.8	9.2	24.0	10.4
Corporate Loans under In-court Restructuring	41.1	17.0	33.5	15.4
Corporate Loans under private Restructuring	34.5	13.2	4.2	2.6
Total	105.4	39.4	61.7	28.4

Source: Korea Asset Management Corporation (KAMCO)

Table 6-1 shows NPLs of KRW 105.4 trillion, or US$ 87.8 billion, in face value at the purchasing price of KRW 39.4 trillion, or US$ 32.8 billion, were acquired by KAMCO during the four and half years of operation. Out of the acquired assets, KAMCO disposed of KRW 61.7 trillion, or US$ 51.4 billion, at the selling price of KRW 28.4 trillion, or US$ 23.7 billion. Table 3-7 shows the details in NPLs resolution by methods. Note that various kinds of methods and techniques have been employed depending on the quality and characteristics of the NPLs. Details will be explained in section 3.

2. Operation of Asset Management Corporation

Generally speaking, Asset Management Corporations (AMCs) are used in the disposal of assets, and are classified in terms of their scope of activities. If an AMC acquires distressed assets from financial institutions and keeps them in its book without taking any active measure to either sell or restructure the portfolio, it is called a warehouse type of AMC. If an AMC actively engages in the restructuring of distressed debtors such as applying haircuts, modifying interest rate on debt, rescheduling debt payments, and even, imposing changes to management reshuffling and downsizing of employees, then it is called restructurer type of AMC. In the middle between a warehouse and restructuring AMC, there exists a seller type of AMC. Its main activities are to dispose of distressed assets to investors at market prices.

In an advanced country where expertise and experiences in restructuring have been

30 _ Even though FSC intervened in distressed asset resolution processes from the perspective of restoring financial soundness in the banking sector, the government authorities such as FSC and MOFE maintained a position to follow market principles in most actual practices.

adequately accumulated, a restructurer type of AMC can be effective. Swedish Securum is a good example. But, there are preconditions to instituting a restructure type of AMC. Distressed assets held by AMCs should be secured by relatively good real estate collateral. The leverage ratio should be also moderate. For this type of asset, there is a good chance of a price recovery during the upturn in the business cycle.

Massive and serious corporate distress and a restructure type of AMC, however, do not make for a good match even in advanced countries. A large chunk of corporate value comes from intangible assets such as intellectual property right, sales network and goodwill. Once corporations become operationally unviable, these intangible assets lose value. In order to rehabilitate them, special restructuring efforts are needed, but such expertise cannot be properly provided by public organizations like AMC. In this case, a seller type of AMC may prove to be a better alternative.

A salient example is the Korea Asset Management Corporation (KAMCO). Since KAMCO compiled a portfolio of debt of highly leveraged distressed companies and did not have the necessary expertise to conduct corporate restructuring, its immediate strategy was to sell assets at market prices, whatever they were.[31] From a systematic perspective, KAMCO chose a division of labor in terms of expertise: it hired private market expertise and provided incentives with which to reorganize distressed companies. Recalling that one of the key success factors in KAMCO was not to have any reservation price, in other words, KAMCO accepted any price determined by market demand and supply. As such, bold and decisive decisions by the government are essential in the success of a seller type of AMC. In general, the first observable price just after the crisis tends to be too low to accept as a market price. Korean experiences show that the belief and consistency in market transactions, even if they are not favorable to policy makers, will turn out at the end to be a successful story. A bonus of taking this approach is facilitating development of the financial market; in that, accepting market prices even at unfavorable terms instills investors' trust in the policies, thus, helping to develop financial markets in depth and breadth.

The worst case scenario for an AMC can often be found in a warehouse type. This type of AMC is created, in order to clean up the financial messes made by banks. Following a model of

31 _ It is not easy to follow market principles in the absence of well-functioning markets. In a crisis when financial system malfunctions, observable prices are quoted by buyers. Then, sellers of distressed assets should admit heavy discounts. Under the circumstances where public funds are injected, KAMCO did not have much room for accepting hostile offer from international investors because the low price could be understood as drainage of national wealth. As a matter of fact, many crisis-hit countries did not accept market prices of distressed assets during crisis periods for this reason. However, accepting market prices, whatever they are, and thus creating markets are very effective strategies to overcome a stalemate clogged by NPLs.

good bank and bad bank, the AMC takes on the role of bad bank. Still the bad bank should take initiative; otherwise, its situation will worsen. Some AMCs, which did not start as a warehouse type, often became inactive *ex post* because they had not acquired assets at market prices. If the price of a distressed asset is too high, AMCs do not have any incentive to recognize losses except in the case where loss recognition is explicitly admitted. Thus, pricing works as a limitation against the mandate of the AMC.

For the AMC to operate successfully, it needs to be equipped with supporting infrastructure. KAMCO needed to have special authority to acquire distressed assets to bypass various legal proceedings. One of the examples was the debtor's agreement on the transfer of credit. The Civil Law requires that creditors notify debtors when their debt is transferred to a new creditor. If such a procedure had existed, then KAMCO would have had to spend enormous effort and time on procedural matters. Many countries bestow a special right to public funds to bypass such notification requirement.

KAMCO also needed to receive support from the private sector. Since it did not have the technical expertise at the beginning, KAMCO hired experts in law, finance and accounting. Sometimes, it proposed legal amendments to break through institutional constraints. Most importantly, it received mentoring during the overall planning.[32] Such services should be properly supplied upon demand.

3. Resolution Methods

The following methods have been taken to resolve NPLs.

3-1. Outright Sale to Third Party

Outright sale is the action of selling directly to a third party, with the aim of recovering loans at the highest price possible. These sales are either made individually or in bulk.

- Individual Sale: The individual sales method can be classified into court auctions and corporate loan sales. Court auction is used for the process of selling secured loans.

32 _ Just after the 1997 crisis the Korean government learned experiences and lessons from the Swedish experts who had worked for their crisis recovery in the early 1990s. In fact, such an early mentoring service turned out to be effective to many Korean policy makers.

Auctions are held after a creditor's request to the court to hold an auction according to foreclosure laws, and the court pays the sale proceeds to the creditor. Loans are recovered by selling the collateral properties without title acquisition by the creditor. The corporate loan sales method, a method utilized by KAMCO to sell loans separately, can be classified into M&A and Individual Corporate Loan Sales (ICLS). KAMCO's Corporate Disposition Department performs individual corporate loan sale for borrower companies that have both high brand value and liquidity problems, or companies that have a high possibility for recovery.

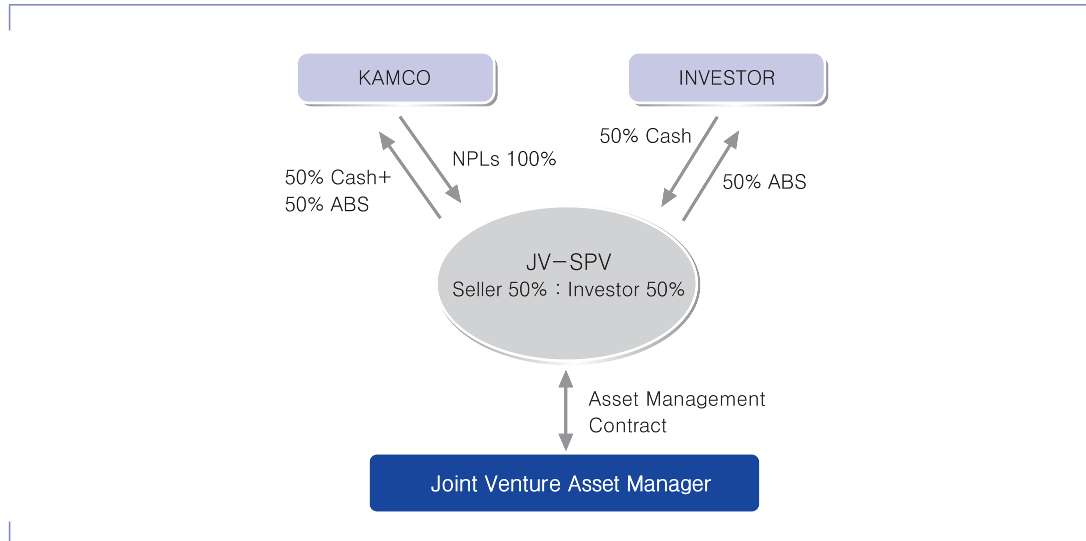
- Bulk Sale: The Bulk sales method is a sales method that involves pooling assets such as NPLs and real estate collateral and selling them to a third party for quick cash. By adapting this sales method, the seller can resolve a massive amount of NPLs through auctions or negotiations. In addition, the seller will be able to enhance its balance sheet, while the buyer achieves better management of assets through the economy of size. As the buyer most likely purchased the NPLs at discount, he is in a stronger position for debt negotiation than the originating bank. Furthermore, the seller will be able to sell off the worst assets by pooling them with relatively healthy ones.

3-2. Sale to a Joint Venture SPV

KAMCO and an investor formed a Joint Venture Special Purpose Vehicle to store NPLs for future resolution through disposal and restructuring. In this process, KAMCO moves NPLs to the SPV, which then issues bonds and equity. KAMCO and JV Investor equally subscribed to the SPV issued securities. KAMCO pays 100% in NPLs and receives 50% cash and 50% securities issued by the SPV. The investor pays 50% in cash and receives 50% in the same securities. KAMCO and the investor also form a JV-Asset Manager to professionally manage the warehoused NPLs. Even though KAMCO has 50% ownership of the Joint Venture SPV, the SPV is legally independent of KAMCO, hence KAMCO can recognize legal and accounting sales on their balance sheet.

The benefits of selling to a joint venture SPV as opposed to an outright sale is that KAMCO can realize the upside potential of NPLs value in the future, through a capital gain in the SPV equity owned by KAMCO. However, only half of the cash value is at the initial sale to the SPV.

Figure 6-1 | Joint Venture SPV



3-3. Asset Backed Financing

To more fully realize the benefits of the SPV as a warehouse for NPLs, KAMCO established its own SPV for the resolution of NPLs in the future through disposal or restructuring. In this process, KAMCO transfers NPLs to a SPV at a fair price determined by an independent accounting firm. The SPV issues bonds and equity up to the value of the NPLs acquired. KAMCO subscribes to the SPV-issued equity only, and a 3rd party investor subscribes to the SPV-issued bonds. KAMCO pays 100% in NPLs and receives approximately 90% cash and the balance in equity securities, while the investor pays in 90% in cash only. The purpose of issuing 10% in equity is to provide a buffer over the collateral amount to the investor, in case the value of the NPLs does not recover. KAMCO's Disposed Asset Management Department manages the warehoused NPLs, as the SPV does not have any capacity to do so. Even though KAMCO has partial ownership in the SPV, the SPV is legally regarded as independent of KAMCO, hence KAMCO can recognize the sale as legal and account it on their balance sheet.

The benefits of selling to a KAMCO sponsored SPV is that KAMCO is entitled to the whole upside potential of NPLs value in the future. The gain can be realized as a capital gain on the SPV equity owned by KAMCO. Additionally, 90% of the cash value is raised at the initial sale to SPV.

3-4. Debt to Equity Swap

- From the lenders' viewpoints: For lenders, debt to equity conversion has the following advantages; 1) resolution of NPLs, 2) meeting the BIS standards, and 3) normalizing corporate operations and reinforcing the supervisory function of corporations. However, there are the following disadvantages; 1) losing rights (security rights) as a creditor, 2) possibility of leading to corporate insolvency in case of liquidation, and 3) danger to be used as a cover-up for insolvent loans.

- From the viewpoint of borrower corporations: The advantage of a debt-equity swap is a lower debt-to-equity ratio as it is not converted into bonds. The disadvantages is the potential to lose management power due to lower shareholdings

Debt-equity swap should be implemented to improve the financial structure of companies under the restructuring program. For this purpose, the Ministry of Finance and Economy should address the legal hurdles to debt-equity swaps.

4. Assessments

Adoption of the market price *vis-á-vis* NPLs has an important policy implication on KAMCO's disposal of acquired assets. Since KAMCO purchased NPLs at close-to-market-price, it could make profits if it was able to add value through restructuring and/or pooling bad loans, for example. Otherwise, it stood to make losses whatever it did, for not all of the value of the NPLs could be recovered. This approach removed the binding constraints on selling prices from the viewpoint of KAMCO. Actually KAMCO performed quite successfully, making a profit of KRW 3.2 trillion as of June 2002 (See the details for the performance of NPL resolution by KAMCO in Table 6-2).

In addition to rapid and efficient disposal of NPLs, KAMCO contributed to creating an NPL market and helped build up the necessary capacity to resolve distressed assets in Korea. In the absence of relevant infrastructure at the beginning of the 1997 crisis, KAMCO functioned as a market where NPLs were traded and played the role of market maker. In the process of selling the NPLs to not only international and domestic investors, KAMCO enlisted various services from law, accounting, real estate, and management consulting firms. These services enabled KAMCO to accumulate a great deal of experience and expertise. Also, KAMCO hired many domestic investment banks to engage in NPL transactions.

From an institutional aspect, insolvency laws, credit collection laws, laws and regulations on securitization, etc. have been upgraded and/or newly made into law. This system provides a platform to dispose of NPLs even in the normal times. In fact, the crisis was an opportunity to upgrade Korea's finance-related infrastructure.

Table 6-2 | KAMCO's NPL Resolution by Methods (As of June 30, 2002)

(unit: KRW trillion)

Classification	Accumulated Resolution			
	Face Value	Purchase Price	Recovery Value	Profits
International Bidding	6.1	1.3	1.6	0.29
ABS Issuance	8.0	4.2	4.1	-0.08
Sale to AMC	2.6	0.7	0.9	0.26
Sale to CRC	1.8	0.4	0.7	0.31
Individual Loan Sales	2.0	0.5	0.6	0.14
Court auction, Public Sales	8.2	2.5	3.1	0.57
Collection	10.6	3.6	5.0	1.41
Others[1]	2.2	1.5	1.9	0.32
Sub Total	41.5	14.7	17.9	3.23
Recourse & Cancellation	18.1	9.7	9.7	-
Total	59.5	24.4	27.6	3.23

Note: 1) CRV resolution, recovery by restructuring plan, etc.
Source: Korea Asset Management Corporation (KAMCO)

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