Financial Crises and Policy Responses in Korea
- Focusing on Bank Restructuring

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Outline

I. Introduction

Introduction

- **Structural weaknesses** were widespread in the Korean economy which developed rapidly before 1997 Asian financial crisis.

✓ Also, the economy was **highly vulnerable to external shocks as its growth was largely driven by exports.**

- Financial crises in 1997 and 2008 afforded Korea an opportunity to build an **effective crisis response system**.

✓ 787 ailing financial institutions (37.5% of 2,101 FIs in total) were restructured during the Asian financial crisis in 1997.

✓ But, not a single failure in the banking industry happened during the global financial crisis in 2008.

- This presentation aims to introduce the experience of financial reform, especially **banking sector restructuring**, and share **lessons from the financial crises in Korea**.

II. Asian Financial Crisis and Policy Responses

Main Causes of the 1997 Crisis

▪ **Excessive debts and lack of transparency in the corporate sector** led to a series of bankruptcies of big companies (chaebols) during 1997.

✓ Corporate debt ratio: 424.6% (end of 1997)

▪ **Weaknesses in the financial secto**r and **low level of foreign currency reserves**

✓ Poor asset quality, ALM, excessive risk-taking

✓ Foreign currency reserves: US$ 8.9 bn (1997)

▪ **Inadequate financial regulation and supervision**

✓ Accounting rules, lenient prudential standards and supervisory forbearance

▪ **Prevalent moral hazard** in both corporate and financial sectors

✓ Too-big-to-fail and an assumption of government's protection when necessary

Restructuring Strategy

▪ The Korean government embarked on a major **restructuring in the four areas of finance, corporate, labor and public** with the IMF's consultation.

▪ **Financial Supervision Commission(FSC)** was tasked with overseeing the restructuring of both corporate and financial sectors with **KAMCO and KDIC**.

▪ Speedy and comprehensive crisis responses driven by the Korean government through **injection of huge public funds** (40% of GDP in 1997)

▪ In particular, financial restructuring had **two main goals**.

✓ Building an advanced system through restructuring

✓ Improving and refining the financial safety net

▪ **Temporary blanket guarantee for deposits** till the end of 2000

▪ Measures to **minimize moral hazard and maintain market discipline** were put in place.

Financial Restructuring Stages by Period

STAGE	PERIOD	CHARACTERISTICS
EARLY STAGE	Nov. 97 – Mar. 98	• **Emergency measures** (urgent liquidity injection and support for recapitalization of large banks) • Exit of non-viable merchant banks, securities firms and investment firms • **Laying the groundwork for restructuring**
FIRST-STEP RESTRUCTURING	Apr. 98 – Aug. 00	• **Full-scale restructuring of the corporate and financial sectors** • Focus on normalization of bank operations • **Exit of five regional banks (Jun. 98)** • Exit of four insolvent life insurers (Aug.98)
SECOND-STEP RESTRUCTURING	Sep. 00 – Dec. 02	• **Laying the groundwork for market-led restructuring** • Focus on resolving weaknesses in the non-banking sector • Introduction of **financial holding companies** (encouraging FIs to build size and enter into each other's business areas) • **Privatization** of public fund injected FIs • **Creation of the SAMPF (Dec. 00)**
RECOVERY OF PUBLIC FUNDS	After 03 -	• Development of measures to **recover public funds** (Sep. 02) • Creation of the Act on the Fund for Repayment of Public Funds

Source: FSC

Bank Restructuring during the 1997 Crisis

- A total of 787 out of 2,101 financial institutions had been restructured by June, 2003 (White Paper 2004).

✓ 15 out of 33 in banking industry and 772 out of 2,068 in non-bank financial industry

- **In the banking industry**, 5 banks had their licenses revoked while 10 were merged out of 33 banks in operation at the end of 1997.

✓ **License Revocations**: Dongwha, Dongnam, Kyonggi, Chungchong, Daedong Bank

✓ **Merged**: Boram, Seoul, Chungbuk, Kangwon, Chukhyup, Hanil, Peace, KLTCB, Kookmin, KHB

- Evaluation criteria and Appraisal Committee

✓ Below 8% of BIS capital ratio as of year-end 1997

Banking Sector Restructuring

- **Large banks were rehabilitated after complete reduction of capital** considering the possibility of systemic risk while **small banks were resolved in P&A transactions**.

Stage *1* ('98~'99)

Purpose: Improving banks' financial structure to attract investors

Target: 12 banks below 8% BIS tier1 capital ratio at year-end '97

Evaluation: Business restructuring plan from 12 banks

Results: 5 non-viable banks (P&A) and 7 viable banks (OBA)

Stage *2* ('00~'02)

Purpose: Enhancing the competitiveness of the banking industry

Target: 8 banks below 8% BIS tier 1 capital ratio or which had received public funds at Stage 1

Evaluation: Business restructuring plan from 8 banks

Results: 6 non-viable banks (Nationalization by injecting public funds) and 2 viable banks

Banking Sector Restructuring Overview

<table>
<tr><th>'97end</th><th>98.1H</th><th>99.1H</th><th>99.2H</th><th>00</th><th>01.1H</th><th>01.2H</th><th>03end</th></tr>
<tr><td>CBK</td><td></td><td rowspan="2">Hanvit (1.6)</td><td></td><td></td><td rowspan="4">Woori Financial Holding Company (4.1)</td><td rowspan="5">Woori Financial Holding Company (12.31)</td><td rowspan="5">Woori Financial Holding Company</td></tr>
<tr><td>Hanil</td><td></td><td></td><td></td></tr>
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<tr><td>Peace</td><td></td><td></td><td></td><td></td><td></td></tr>
<tr><td>Cho-hung</td><td></td><td rowspan="2">Cho-hung (5.3)</td><td rowspan="3">Cho-hung (9.14)</td><td></td><td></td><td></td><td rowspan="6">Shinhan Financial Holding Company (9.5)</td></tr>
<tr><td>Chung-buk</td><td></td><td></td><td></td><td></td></tr>
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<tr><td>Boram</td><td></td><td></td><td></td><td></td></tr>
<tr><td>Seoul</td><td></td><td></td><td></td><td></td><td></td></tr>
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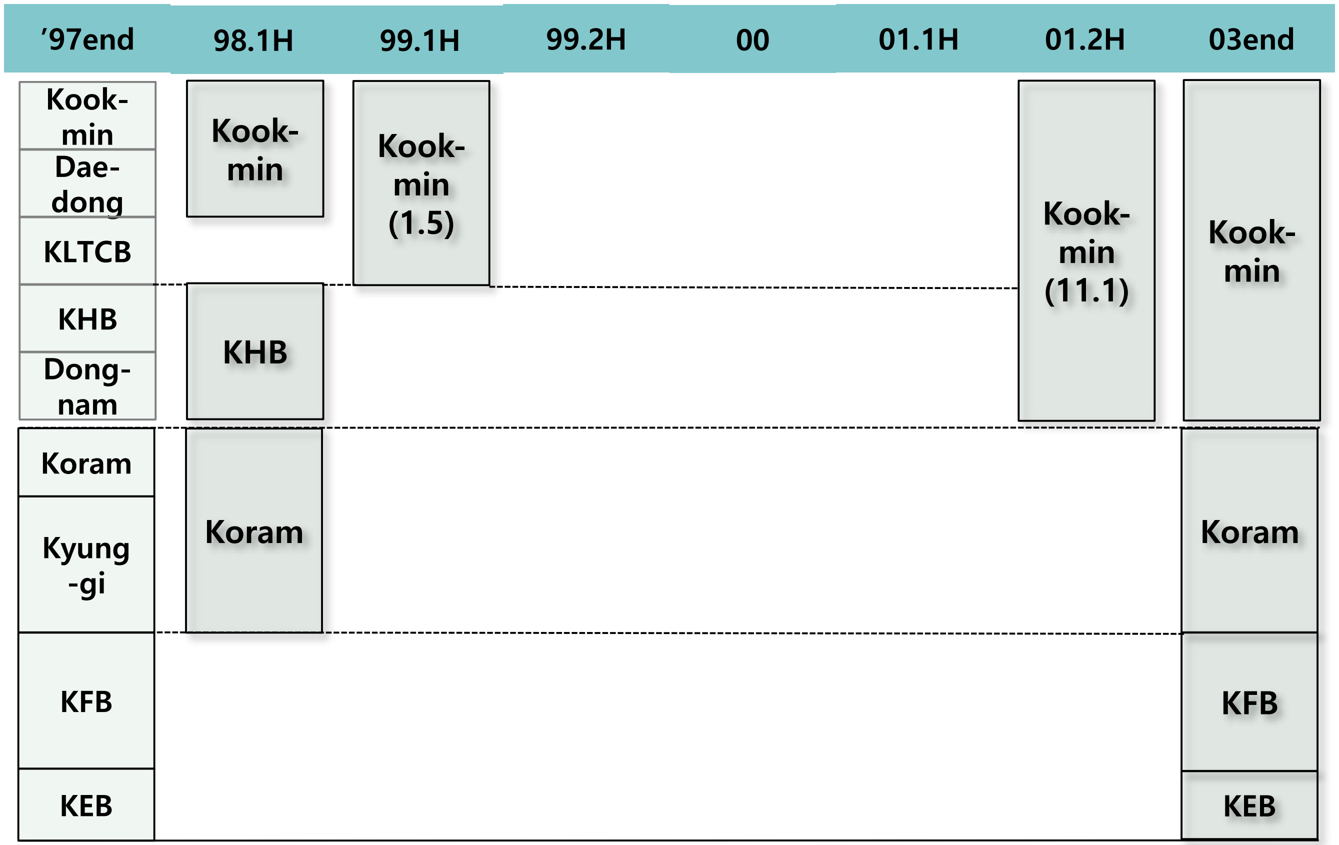
Banking Sector Restructuring Overview (Cont.)



Source: White Paper, Public Fund Oversight Committee

Banking Sector Restructuring

- **Nationalization, P&A, M&A, and OBA were the methods** used for banking restructuring with the injection of public funds by KDIC

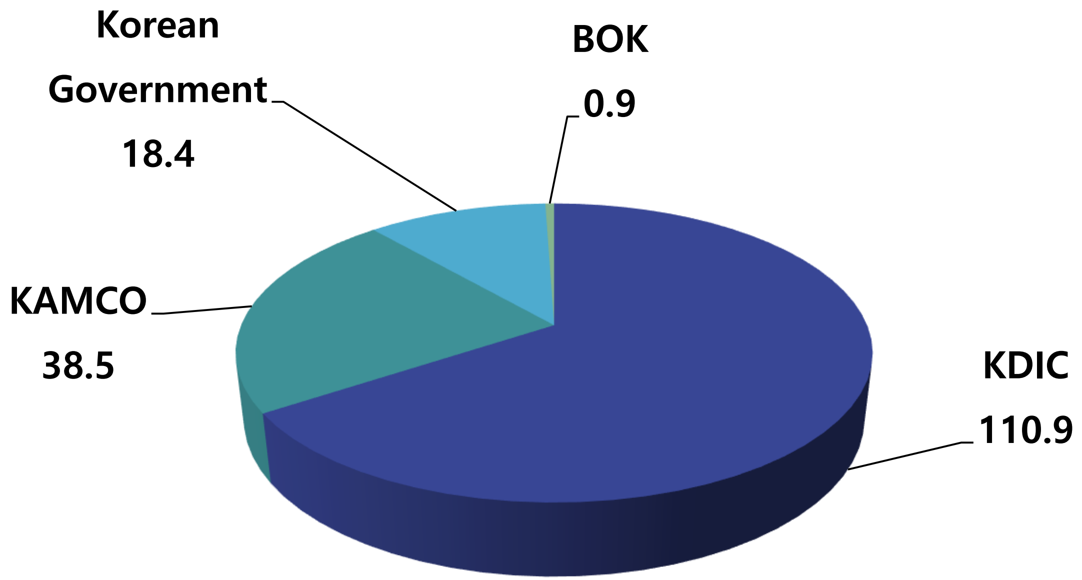
✓ Nationalized banks which had received public fund support were privatized when KDIC sold its stakes to domestic and foreign investors.

Methods	Banks	Results
Nationalization	Korea First Bank Seoul	• KFB sold to NewBridge Capital(2000) • Seoul sold to Hana (2002)
P&A	Dongnam, Dongwha, Chungchong, Kyunggi, Daedong	• Exit from the Market (licenses revoked)
M&A	KCB+Hanil (Hanvit), Choheung+Kangwon+Chungbuk, Hana+Boram, Kookmin+KLTCB	• Hanvit, Gwangju, Kyungnam, Peace Bank → Woori FHC • Chohung and Jeju → Shinhan FHC • Kookmin+KHB → Kookmin
OBA	Busan, Kyongnam, Daegu, Junbuk, Kwangju, Jeju, Peace, KEB	• KEB sold to Lonestar (2003)

Funding of Public Funds

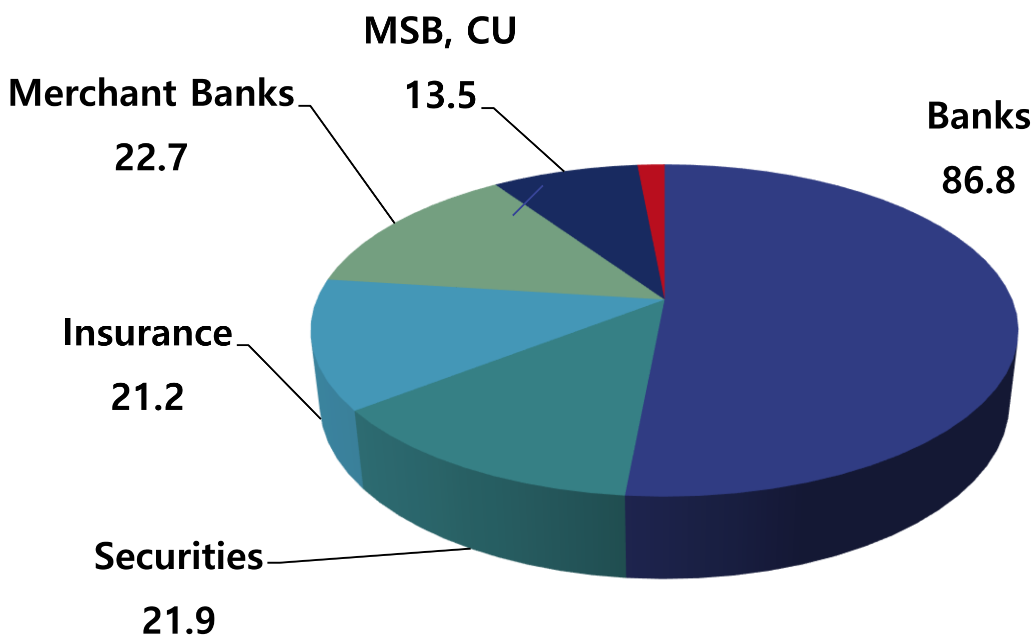
- **KRW 168.6 tril. (39.8% of 1997 GDP) of public funds**

✓ Bond issuance with government guarantee: KDIC 83.5, KAMCO 20.5



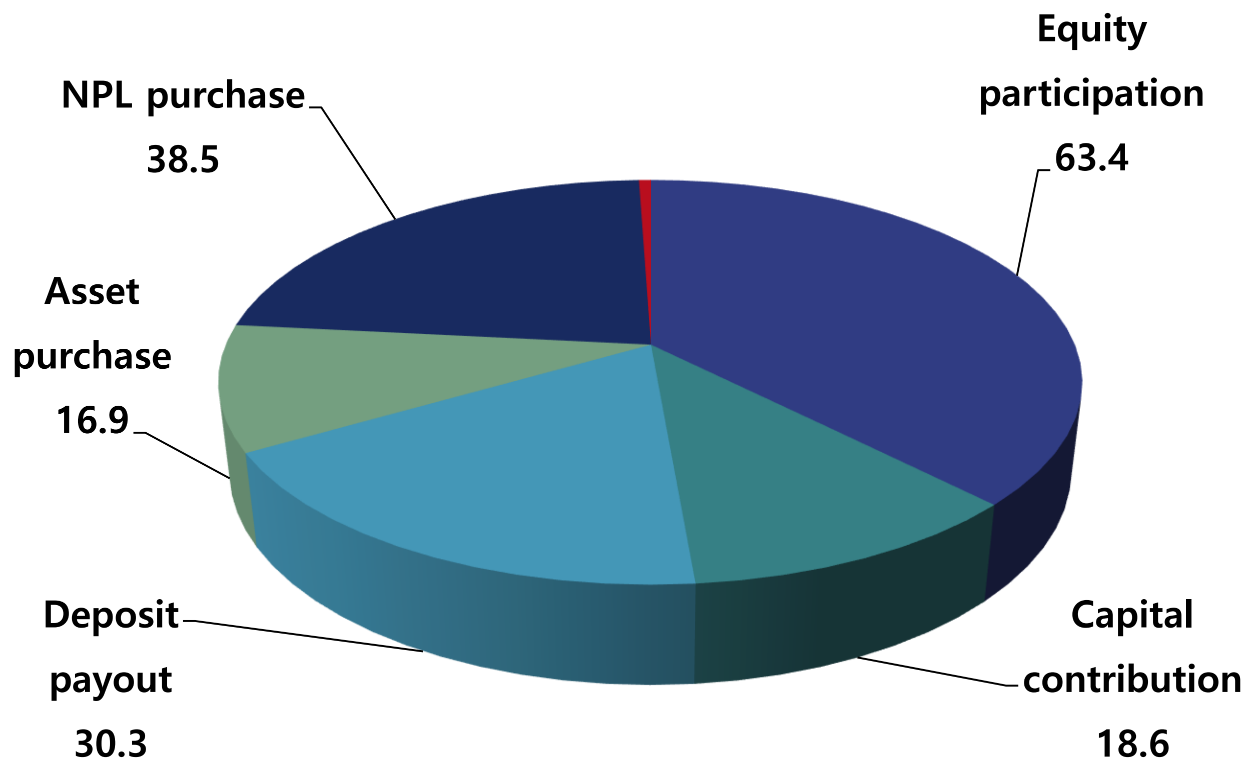
Usage of Public Funds

- Public funds were injected into the following financial sectors.



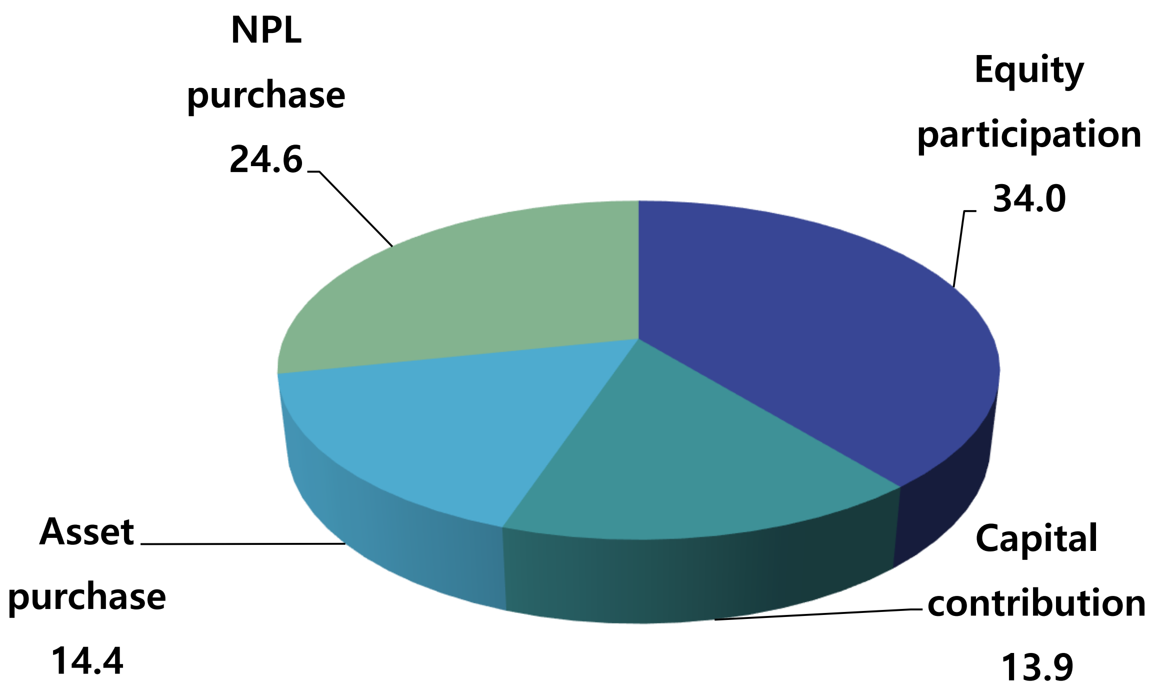
Usage of Public Funds

- Public funds were injected into the financial industry using diverse methods.



Usage of Public Funds in Banking Sector

- Public funds were injected into the banking sector (KRW 86.8 tril.) through equity participation, capital contribution, asset and NPL purchase.

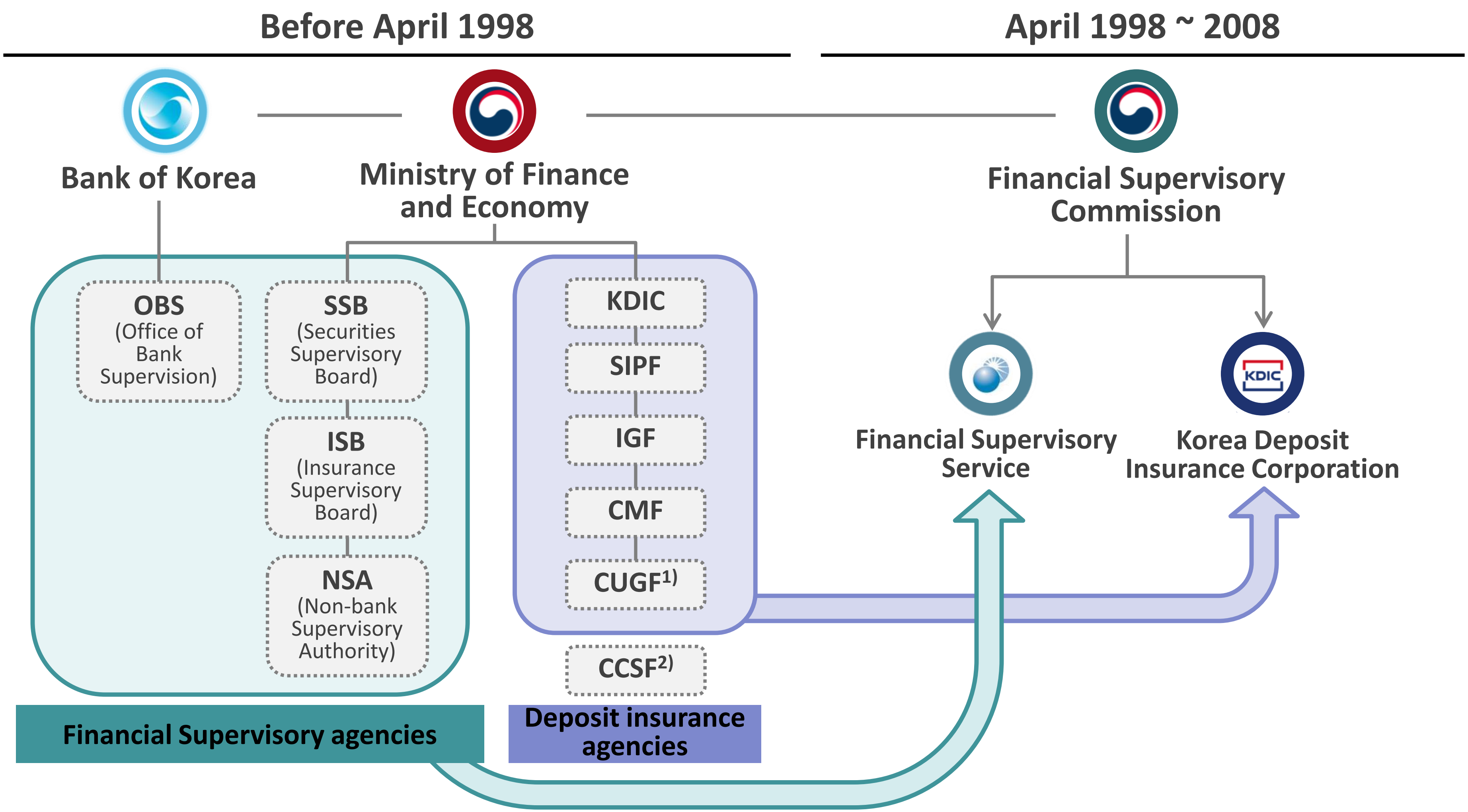


Establishing a Legal Framework

- Legal framework for financial crisis management has been established.

ACTS	MAJOR CONTENTS
Act on the Structural Improvement of the Financial Industry (ASIFI) in Oct. 1997	• FSC & KDIC have authority to determine insolvency • FSC has authority to order **Prompt Corrective Action** (1997) • FSC may order **capital reduction with resolution** of board of directors of insolvent FI • FSC may order suspension of directors, appointment of conservator, P&A, **suspension of operation, revocation of license**
Depositor Protection Act (DPA) in Dec.1995	• KDIC may arrange the 3rd party M&A for insolvent FIs • KDIC may request FSC to order P&A • KDIC may establish a bridge bank • KDIC may provide **financial assistance** in cases where an acquirer of insolvent FI requests or it is necessary to facilitate the resolution of insolvent FI
Special Act on the Management of Public Funds (SAMPF) in Dec.2000	• The **Public Funds Oversight Committee** does a comprehensive review and coordination of matters related to the management of public funds • The Act lays out **principles in injecting public funds into ailing FIs** (e.g.) **Least Cost Principle, Equitable Loss Sharing.** • The Act also indicates how **follow-up management of public-fund injected FIs** should be carried out (e.g.) MOU, management of bankruptcy estate by KDIC

Financial Safety Net in Korea before 2008



Note: 1) Separated from KDIC in 2004
2) Under the Ministry of Government Administration and Home Affairs

Financial Safety Net in Korea since 2008

Ministry of Strategy and Finance

(Fiscal and Foreign Currency Policy)

Financial Services Commission

(Financial Policy)

Bank of Korea

(Monetary Policy)

Korea Deposit Insurance Corporation

(Depositor Protection & Resolution)

Financial Supervisory Service

(Financial Supervision)

Other Institutional Improvements

- **Stronger prudential regulation**

✓ Adoption of the prompt corrective action (PCA) regime in the ASIFI (1997) and the Forward Looking Criteria (FLC) for asset classification based on international standards

- **More authority for KDIC**

✓ Financial assistance to insolvent FIs

✓ Conservator of failing FIs and receiver of bankruptcy estates

✓ Accountability investigations against failed FIs

- **Creation of KAMCO in 1997 for NPL cleanup**

Results of the Financial Restructuring

- **Fast recovery in the banking sector**

✓ BIS Capital Ratio (Banking Sector, Average) : 7.04% ('97) → 10.52% ('02)

✓ Net Profit (Banking Sector, Total) : KRW △12.5 tril. ('98) → KRW 3.9 tril. ('02)

- **Recovery of economic growth** (GDP) : △ 6.9% ('98) → 7.0% ('02)

- **Early repayment of the $ 19.5 billion loan from the IMF** (Aug. '01)

III. Global Financial Crisis and Policy Responses

Comparison of the Two Financial Crises

- The Korean economy in 2008 was stronger than it was in 1997.

		1997 Crisis	2008 Crisis
Causes		Internal factors such as corporate bankruptcies	External factors
Foreign Exchange	Foreign Currency Reserves	US$ 8.9bn	US$ 239.7bn [1]
	ST External Debt / FX Reserves	717%	79%[1]
	Liquid External Debt / FX Reserves	973%	95%[1]
	Total External Debt / FX Reserves	1,957%	177%[1]
Banks	Bank NPL Ratio	6.0%	1.1% [2]
	BIS Ratio	7.0%	12.31% [2]
Corporates	Corporate Debt Ratio	424.6%	106.5% [3]
	Corporate Interest Coverage Ratio	115.0%	404.8% [3]

[1] as of September 2008
[2] as of December 2008
[3] as of end of 2007

Source: FSC(2012)

Responses to the Global Financial Crisis in 2008

	Measures	Commitment	Actual
Initial – Stabilizing the F/X market	Government’ s payment guarantee for foreign currency borrowings by domestic banks	\$100 bn. (3 years)	\$1.3bn.
	Currency swap lines with the U.S., Japan, and China	\$30 bn. (U.S.), \$20 bn. (Japan), 180 RMB bn. (China)	\$16.4 bn. (U.S.)
	Foreign liquidity provision to banks	\$50 bn.	\$26.8 bn.
Mid-term – Boosting the real economy	Fiscal stimulus package[1]	7% of GDP[2] \$57.9 bn. Tax Cuts \$28.8 bn. Public Spending \$29.1 bn.	
	Policy rate[3] cut	5.25% (Aug.’08) → … → 2.0% (Feb.’09)	

Note: 1) For the period between 2008 and 2012
2) \$832.9 bn. in 2009
3) BOK Base Rate: reference rate applied in transactions such as RP

Source: FSC(2012)

Responses to the Global Financial Crisis in 2008

- **Enhancing banks' soundness** by providing liquidity support from special funds

✓ Restructuring Fund, Bank Recapitalization Fund, and Financial Stabilization Fund

- **Corporate restructuring** led by the creditor financial institution

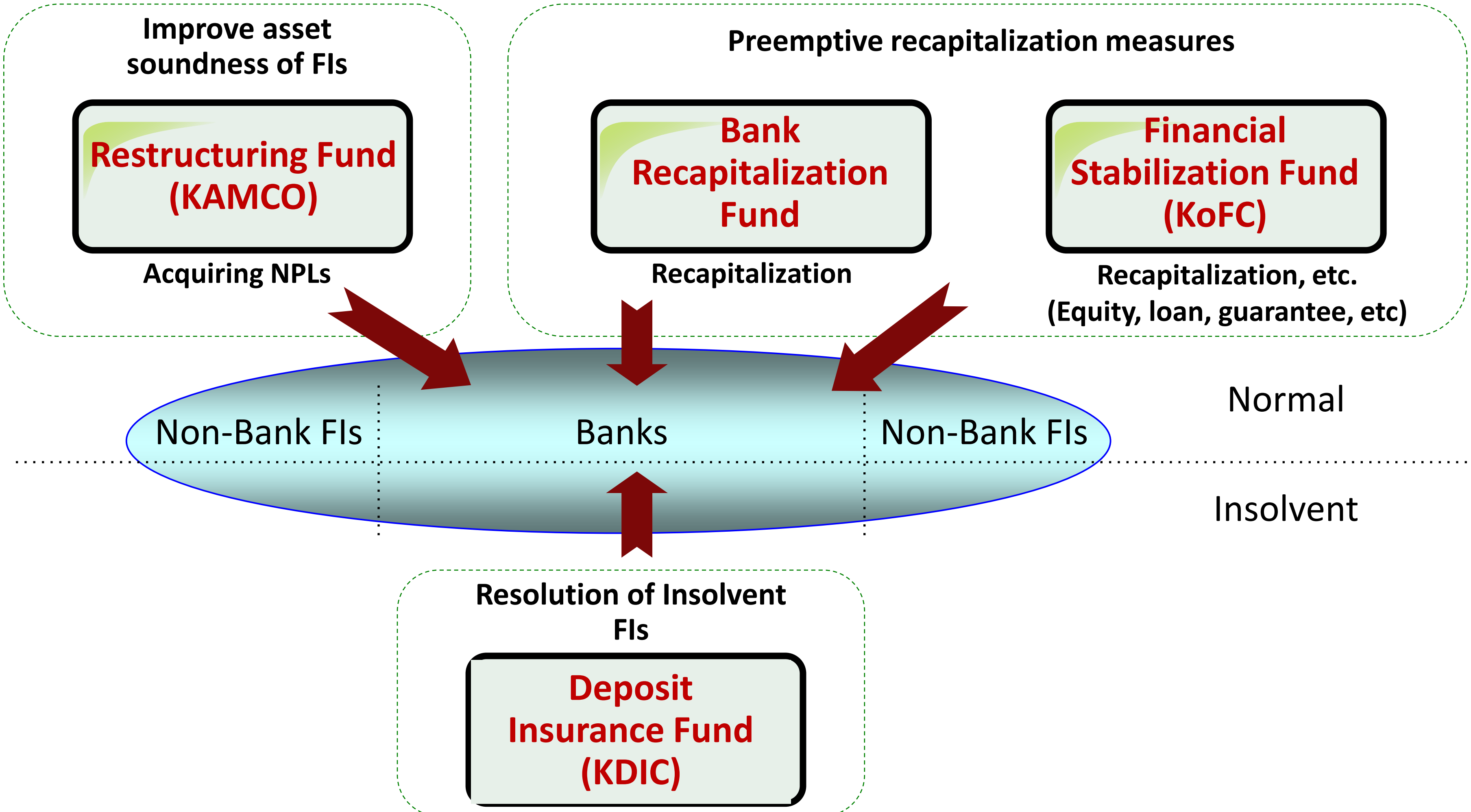
- Thanks to the **prompt and preemptive responses** led by the government, the financial system became stable **without any single bank failure during the crisis**.

- However, KDIC had to **resolve 30 insolvent mutual savings banks (MSBs)** between 2011 and 2014 through P&A and bridge bank methods.

✓ Due to concentrated loan portfolio in real estates, inadequate governance and compliance, supervisory forbearance among others

Special Measures to Assist the Financial Sector

- Public-private joint measures to enhance soundness of capital and assets



IV. Lessons from the Two Crises

Lessons from the Two Crises

- **Prompt and comprehensive financial restructuring led by the Korean government** through the injection of public funds during the 1997 crisis was regarded as successful. (WB 2000, IMF 2001)

- **Legal framework** for an effective financial restructuring should be in place.

- **Enhancing coordination and cooperation among financial safety net (FSN) participants**

✓ MOSF, FSC, BOK, FSS, and KDIC

- Measures to **minimize moral hazard and maintain market discipline**

✓ No too-big-to-fail, least cost principle, loss sharing, self-help efforts, among others

- **Enhancing protection of financial consumers and confidence in the financial system**

✓ Market efficiency, transparent governance, competitiveness of financial firms

Lessons from the Two Crises

- **Criticism**

✓ **Demand for a single control tower** to handle financial restructuring in the early stage

✓ **Ad hoc state support for** failing FIs through public fund injection before the enactment of SAMPF in 2000

✓ 52.7% of public funds was recovered by June, 2007 and sunk **cost was shared by the taxpayers and surviving FIs**.

- **Future challenges**

✓ **Developing market-oriented crisis prevention and response mechanism** such as Bail-in, RRP, stress tests, ex-ante funding mechanism for SIFI, etc.

- **Prevention is always better than crisis containment, however effective it may be!**

Thank you for your kind attention!

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