Financial Sector Reform in Korea after the Asian Financial Crisis

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Since introducing the IMF stabilizing package in December 1997, major steps have been taken to restructure the financial sector in Korea. The financial sector reform until now is appraised to have laid the foundation for solid economic recovery and restoration of the sovereign credit rating. In particular, various measures to clean the balance sheets of financial institutions were, in a large part, successful in providing the foundation for an early normalization of the financial system and easing the credit crunch situation. (*JEL* Classification: G18)

I. Introduction

Financial sector reform is intended to recover the stability of the financial system in the short-run and to enhance the long-run soundness and efficiency of operations within financial institutions. Since introducing the IMF stabilizing package in December 1997, major steps have been taken to restructure the financial sector in Korea. While the corporate sector reform as well as institutional reform, including stronger prudential regulation and supervision, has proceeded in a similar fashion, the two pillars of the financial sector reform have been the closing of troubled financial institutions and the recovery of the surviving financial institutions' competitive power.

The government created a plan to spend 64 trillion won in public

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funds to revive the financial system by disposing of Non-Performing Loans (NPLs) and providing funds for recapitalization, loss compensation, and deposit payment. After the first phase of the financial sector restructuring was completed, 21 troubled financial institutions had their licenses revoked, and 71 were suspended.

The financial sector reform has laid the foundation for solid economic recovery. In particular, various measures to clean the balance sheets of financial institutions were largely successful in providing the foundation for an early normalization of the financial system and easing the credit crunch situation.

This paper reviews the current financial sector reform. Presenting the details of institutional reform, the fiscal support scheme, and the progress in both the banking industry and non-bank financial institutions, the paper attempts an interim appraisal of the reform process. The current financial sector reform is an on-going process that will require a long period of time to finish. Nonetheless, it seems that now is the right time to make an interim appraisal in order to check what should be implemented in the future. This attempt will be useful in minimizing potential problems and in finishing the reform successfully.

The rest of the paper is organized as follows: Section II reviews institutional reform, describing both the principles set by the government and the improvements in the institutional setting. Section III presents the government's fiscal support scheme for the purchase of NPLs, recapitalization and loss compensation, and deposit payment. Section IV describes in detail the contents of the restructuring of the banking industry and non-bank financial institutions. Section V makes an interim appraisal, and Section VI concludes the paper.

II. Institutional Reform

A. Principles of Financial Sector Reform

The Financial Supervisory Commission (FSC) was established on April 1, 1998 to meet the need for strengthened supervision during the restructuring process. While several supervisory authorities for banks, security houses, insurance companies, and other financial institutions were placed under the FSC since then, they were integrated and the new Financial Supervisory Service (FSS) was established on January 1, 1999.

Together with the Ministry of Finance and Economy (MOFE), the FSC set the principles and developed resolution plans for nonviable financial institutions in accordance with international standards and procedures, as well as a full supporting scheme for other financial institutions that had a chance to return to normal operations. The FSC's underlying principles for the overall financial restructuring are as follows:

① The basis for identifying troubled financial institutions is the capital adequacy standards.

② Those financial institutions that fail to satisfy the capital adequacy standards are required to submit rehabilitation plans.

③ An appropriate appraisal committee of experts is established to evaluate the rehabilitation plans.

④ The FSC determines policies which must be implemented upon reviewing the appraisal committee's evaluation. (i) If the FSC does not approve the rehabilitation plan of a financial institution, then resolution will be pursued. (ii) If the FSC approves the plan conditionally, it will require the submission of forceful self-rescue plans and implementation plans. The FSC will closely monitor the implementation of these plans. (iii) If the FSC approves the plan unconditionally, then it will provide support through the disposal of non-performing loans (NPLs) as well as other measures.

⑤ Policy schemes for the facilitation of the normalization of financial institutions are to be formulated.

⑥ There are three possibilities for transferring business for nonviable financial institutions: Purchase and assumption (P&A), merger between nonviable banks, and merger between a sound bank and a nonviable bank. Among the three, P&A focuses on providing financial support at a level sufficient to prevent the deterioration of the asset quality of acquiring financial institutions. While merger between nonviable banks focuses on the swift creation of competitive and efficient leading banks, merger between a sound bank and a nonviable bank will be utilized as a means to resolve nonviable banks. In a latter case, sufficient financial support will be provided to the merged bank so as to prevent the deterioration of the asset quality of the sound bank.

B. Improvement in Institutional Setting

a) Deposit Insurance System

Major changes have been made such that the amount of guaranteed principal was reduced to prevent moral hazard of depositors and financial institutions. The new deposit insurance system now applies to all deposits except the performance-based investment and trust accounts. It has three categories: Always protected, temporarily protected until the year 2000, and not protected. For example, for accounts opened or deposits made after August 1, 1998, only the principal amount is to be insured for accounts of 20 million won or more per person. In addition, repurchase agreements (RP) issued by banks and securities houses after July 25, 1998 and fidelity/surety insurance policies entered into after August 1, 1998 are not to be covered.

b) Loan Classification Standards and Provision Requirements

In July 1998 there was a major strengthening revision of the loan classification standards and provision requirements. In accordance with international practices, loans in arrears of 3 months or more are now classified as substandard or below, and loans in arrears of 1 to 3 months as precautionary loans. As a consequence, most of the emergency loans made to technically bankrupt companies are now reclassified as substandard loans instead of precautionary loans.

In addition, the provision requirements for precautionary loans have been raised from 1% to 2%. Provision requirements were newly introduced for commercial papers (CP), guaranteed bills, and privately placed bonds belonging to trust accounts. From the end of 1999 the asset quality classification standards based on a forward-looking approach which takes expected future performance into account as a criterion will be introduced.

c) Bank Disclosure System

In October 1998, unified disclosure standards for financial institutions were introduced. As a result, all financial institutions, including banks, merchant banks, securities companies, insurance companies, credit unions, mutual savings and finance companies, and lending-specialized financial institutions, are now subject to the new disclosure system. This new system stipulates a regular disclosure to be made twice a year and strengthens the level of

TABLE 1
DEPOSIT PROTECTION SYSTEM

Financial Institution	Always Protected	Temporarily Protected until the Year 2000	Not Protected
Commercial Banks	Deposits, Installment Savings, Retirement Funds, Principal Protected Trusts	Foreign Deposits, Certificate of Deposits (CD), Development Trusts, Bonds issued by Banks, Repurchase Agreements (RP) issued before July 24, 1998.	Merit-based Bonds, Repurchase Agreements (RP) purchased after July 25, 1998
Merchant Banks	Receipt Notes, Collateralized Notes, CMA		Non-collateralized Notes, Repurchase Agreements (RP)
Insurance Companies	Individual Insurance Contracts, Corporate Insurance in the form of Retirement Funds, Retirement Insurance Contracts	Corporate Insurance except Retirement Funds, Guaranteed Insurance contracted before July 31, 1998	Guaranteed Insurance contracted after August 1, 1998
Securities Companies	Deposits, Futures, Option Deposits, Money Market Funds	Repurchase Agreements (RP) purchased after July 24, 1998	Accounts used for Tax Deferral Purposes
Mutual Savings and Finance Companies	Deposits, Installment Savings, Receipt Notes		
Credit Unions	Deposits and Investments approved by the Credit Unions		

penalty for false or dishonest disclosure.

Also in April 1998 the FSC introduced new disclosure items necessary for judging management conditions. These include the size of non-performing loans and credit and risk management systems. In particular, the first half-year preliminary audit results have become one of the mandatory disclosure items.

TABLE 2

CHANGES IN THE LOAN CLASSIFICATION STANDARDS

Period of Overdue Payment	Old	New
1 month to 3 months	Normal	Precautionary
3 months to 6 months	Precautionary	Substandard or Doubtful
Longer than 6 months	Substandard or Doubtful	Substandard or Doubtful

d) Prudential Regulation of Foreign Exchange Businesses

In July 1998 the regulations were changed to improve risk management for short-term foreign exchange risk such that the provisions would be accumulated to maintain mismatch ratio for current assets to current liabilities (90 days to maturity) of at least 70%. In addition, each financial institution is now required to report maturity mismatches in the categories of 1 to 7 days, 7 days to 1 month, 1 to 3 months, 3 to 6 months, 6 months to 1 year, and over 1 year. A comprehensive risk management system is to be introduced encompassing various risks relating to foreign currency denominated loans, payment guarantees, securities, off-shore funding, etc. Financial institutions are now subject to the overall exposure limit for each country based on international credit ratings.

e) Prompt Corrective Actions (PCA) System

For almost all financial institutions, the prompt corrective actions system was either significantly implemented and strengthened or newly established by June 1998. The most important indicator in the PCA system is now the BIS capital adequacy ratio for banks, the operational net capital ratio for securities companies, and the solvency margin ratio for insurance companies.

The assessment accuracy of capital adequacy was improved by upgrading to international standards asset classification standards, provision requirement standards, and accounting principles. In addition, significant efforts have been made to improve financial institutions' CAMEL system. For commercial banks, risk evaluation and sensitivity to market risk have been added to the existing list.

TABLE 3
CLASSIFICATION IN THE PCA SYSTEM

	First Step	Second Step	Third Step
Bank	less than 8% greater than 6%	less than 6% greater than 2%	less than 2%
Merchant Bank	less than 8% greater than 6%	less than 6% greater than 2%	less than 2%
Securities Company	less than 150% greater than 120%	less than 120% greater than 100%	less than 100%
Life Insurance Company	less than 0% greater than −50%	less than −50% greater than −100%	less than −100%
Non-life Insurance Company	less than 0% greater than −50%	less than −50% greater than −100%	less than −100%
Mutual Savings and Finance Company	less than 4% greater than 2%	less than 2% greater than 1%	less than 1%

f) Accounting Practices

In the past, securities were treated similarly to loans in that they were valued at purchase price. In November 1998 mark-to-market for securities was introduced to evaluate securities at their current market prices for the new funds established after November 15, 1998. Mark-to-market for the existing funds will be introduced in July 2000.

Also from January 1, 1999, the provision for loans classified as substandard or below has been excluded from Tier 2 capital in calculating the BIS capital adequacy ratio.

III. Fiscal Support for Financial Sector Restructuring

The government's basic position regarding fiscal support has been that financial restructuring is to be funded by the financial institutions themselves, and that there should not be any official financial support unless financial institutions undertake individual efforts to reduce costs and recapitalize through foreign investment. In the case where financial support is offered, it ought to be sufficient enough to return solvency to the troubled financial institutions, which are required to write-down capitals of existing shareholders.

As of the end of September 1998, the government planned to spend a total of 64 trillion won (of which 14 trillion won was already spent) in order to facilitate financial restructuring. Of the 64 trillion won, 32.5 trillion won is for financing the purchase of NPLs and 31.5 trillion won is for recapitalization and deposit payment. Capital injections have been used as incentives only for merging banks, while the Korea Asset Management Corporation (KAMCO) purchased NPLs of various financial institutions. Selling NPLs to the KAMCO, financial institutions were paid with bonds that were issued by the Korea Deposit Insurance Corporation (KDIC), a subsidiary institution of the Ministry of Finance and Economy (MOFE). As for the capital injection, the KDIC issued and sold bonds to merging banks. Then, the KDIC purchased new shares of merging banks with the money in exchange for the bonds. As a result, the government holds shares in merging banks.

A. Purchase of Non-Performing Loans (NPLs)

As of the end of June 1998, NPLs of financial institutions amounted to 63 trillion won of which those of banks were 40 trillion won and those of non-bank financial institutions were 23 trillion won. The total NPLs accounted for 10.2% of total credits. Approximately 1/3 of total NPLs, most of which belonged to troubled banks, were resolved by the end of September 1998.

The government has facilitated the disposal of NPLs for those financial institutions that planned a merger or those whose rehabilitation plans were approved by the FSC. All "substandard loans and below" of these financial institutions were to be purchased by the KAMCO. Small loans of 10 million won or below and bad loans held by offshore branches of Korean banks were excluded. For uncollateralized loans, 3% of book value was paid. For collateralized loans, 45% of the appraisal value of the collateral was paid, excluding claims on wage and advanced lease payment. Long-term loans are to be purchased at a discount rate of 45%. The discount rate is to be settled by the net present value method after the court decision on the terms of repayment is made. When this purchasing process is finished, 100% of NPLs of problem banks and 50% of NPLs of sound banks will have been disposed.

TABLE 4
NON-PERFORMING LOANS (AS OF JUNE 30, 1998)

(unit: trillion won)

	Total Credit	Total NPLs[1]	NPL ratio
Banks	471.6	40.0	8.5%
Non-Banks	153.2	23.5	15.3%
Total	624.8	63.5	10.2%

Note: 1) Loans classified as substandard and below.

TABLE 5
SCHEDULE FOR KAMCO PURCHASE OF NON-PERFORMING LOANS

(unit: trillion won)

	97.11 ~ 98.8[1]	98.9 Banks	98.9 Insurance	98.9 Total	98.10 ~12[2]	1st half of 99	Total	available amount
NPLs	16.0	20.0	3.0	23.0	25-30	12-17	76-86	-
Purchase Price	8.6	8.1	1.0	9.1	9.8	5	32.5	32.5

Notes: 1) Figures are for all commercial banks, including Seoul Bank, Korea First Bank, all merchant banks, and fidelity/surety insurance companies.
2) Figures are for specialized banks, some sound banks, merchant banks, securities companies, and trust companies.

Source: Ministry of Finance and Economy

As of the end of December 1998, the total NPLs were 60.2 trillion won. The size of NPLs was smaller than initially estimated because 44 trillion won of commercial banks' NPLs were disposed of by the end of 1998. The government plans to purchase NPLs of 28.3 trillion won with available funds, which amount to 12.8 trillion won.

B. Fiscal Support for Recapitalization and Loss Compensation

Besides the fiscal support for purchasing NPLs, additional public money has been injected as capital by the government so as to prevent the deterioration of the acquiring banks' BIS capital adequacy ratio. More specifically, for a new bank created by the merger of a sound bank and a troubled bank, enough fresh capital was provided to lift the new bank's BIS ratio to that of a sound

TABLE 6

SCHEDULE OF FISCAL SUPPORT

(unit: trillion won)

1998.1~8	1998.9	1998.10~12	1999.3	Total	available amount
8.1	11.9	1.9	6.5	28.4[1)]	31.5

Note: Loss coverage for Korea First Bank, Seoul Bank, and 5 acquiring banks is not included.

bank. For a new bank resulting from the merger between two troubled banks, sufficient capital was injected to bring the new bank's BIS ratio up to 10%, taking into consideration the possibility that some assets might turn bad before the end of 1998. The capital injection by the government was, however, not free. The conditions included the elimination of redundant employees and branches, the disposal of fixed assets, the replacement of management, the reduction of NPLs through self-financing, loss sharing through the reduction of capital, etc.

C. Fiscal Burden

If a 50% recovery ratio is assumed, the portion resulting from the NPLs among the total loss of the entire financial system amounts to 50 trillion won, which is equivalent to 11.7% of GDP. The total injection, amounting 64 trillion won based on this estimation, is not considered particularly high when compared to the size of the injected public funds in other countries that had experienced financial crises recently.[1] As Table 7 shows, the injected public funds ranged within 5-15% of GDP in those countries.

[1]As of August 1999, the fiscal burden is expected to increase due to the additional NPLs resulting from the workout of the Daewoo group. It is not easy to estimate the size of additional public funds that will be needed at this moment.

TABLE 7
RATIO OF INJECTED PUBLIC FUNDS TO GDP

(unit: %)

	Spain	Finland	Sweden	Norway	Venezuela	Mexico	Hungary
Period	77~83	91~93	91	87~89	94~95	95	93
Ratio to GDP	16.8	8.0	6.4	4.0	18.0	12.0-15.0	10.0

Source: G. Caprio, Jr., and D. Klingebiel, "Bank Insolvency: Bad Luck, Bad Policy, or Bad Banking?" The World Bank, April 1996.

IV. Contents of Financial Sector Reform

A. Banking Industry

The Korean banking sector historically suffered from poor asset quality, regulated interest rates, excessive competition for deposits, and poor asset-liability management. Therefore the profitability of Korean banks had been quite low even before the crisis. From 1987 to 1995 the average ROE of Korean commercial banks was 5.86%, only half of that of American banks. The recent situation facing Korean banks is known as the "twin banking problem": Worsening asset quality and under-capitalization. The domestic debt problem has been characterized by the bankruptcies of large business corporations triggered by over-investment and highly-leveraged financial operations. The consequence of over-investment was deteriorating loan portfolios held by banks. Currently, the large amounts of non-performing loans have caused widespread fears of bank failures, thereby driving depositors toward the better-quality banks.

The banking industry in Korea consists of commercial banks and specialized banks. As of the end of February 1998, there were 16 nationwide commercial banks, including Seoul Bank and Korea First Bank, and 10 regional banks. Nationwide banks are termed as "city banks," while regional banks are called "local banks." The 26 commercial banks together with the Korea Long Term Credit Bank (KLTCB) can now be classified into four groups: (1) 5 closed banks; (2) 7 conditionally approved banks; (3) 13 viable banks; and (4) Korea First Bank and Seoul Bank, which were nationalized before the banking sector restructuring framework was put in place.

TABLE 8

BANK PERFORMANCE DURING THE PRE-CRISIS PERIOD

(unit: million won, %)

	1995		1996		1997	
	city	local	city	local	city[1]	local
ROA	0.28	0.56	0.23	0.47	-0.69	-0.94
ROE	3.91	5.63	3.49	5.41	-22.4	-18.1
BIS Capital Adequacy Ratio	8.97	11.44	8.97	10.15	6.66[2]	9.60[2]
Bad Loan Ratio[3]	0.95	0.96	0.83	0.91	2.30	5.82
NEBTR[4]	35,621 (-20.5)	6,260 (9.1)	37,265 (4.4)	6,697 (7.0)	28,864 (-24.2)	5,143 (-23.2)
Net Income	6,784 (-22.5)	1,892 (9.4)	6,535 (-3.7)	1,933 (2.2)	-33,603	-5,595

Notes: 1) Housing & Commercial Bank is included.
2) 100% loan loss provisions and securities valuation losses are applied.
3) Bad Loan Ratio = (doubtful loans + estimated losses)/total loans.
4) Net Earnings before Taxes and Reserves.
5) Figures in parentheses are percentage change from the previous year.

a) Five Closed Banks

On June 29, 1998 the FSC ordered Daedong Bank, Dongnam Bank, Dongwha Bank, Choongchung Bank and Kyunggi Bank, among the twelve banks whose BIS capital adequacy ratios were below 8%, to be acquired by Kookmin Bank, Housing Bank, Shinhan Bank, Hana Bank, and KORAM Bank, respectively. Daedong Bank, Dongnam Bank, and Dongwha Bank were nationwide banks, while Choongchung Bank and Kyunggi Bank were regional banks. This process was done through purchase and assumption (P&A). After the assets and liabilities were diligently reviewed, the closure procedure of the 5 liquidated banks was done by the end of September 1998. Approximately 32% of the acquired banks' total employees were taken over by the acquiring banks. To compensate for the net liabilities transferred to the 5 acquiring banks, 6.1 trillion won of public money was injected. The Korea Asset Management Corporation (KAMCO) spent 2.2 and 1.7 trillion won to purchase non-performing loans (NPLs) from acquired and

TABLE 9

EFFECT OF FISCAL SUPPORT FOR 5 ACQUIRING BANKS

	BIS ratio (%)	NPLs (trillion won)
Kookmin Bank	11.58	2.3 → 1.4
Housing Bank	11.88	1.9 → 1.4
Shinhan Bank	11.07	1.6 → 0.7
Hana Bank	13.30	0.4 → 0.3
KORAM Bank	11.78	0.5 → 0.2

acquiring banks, respectively. In addition, 5.8 trillion won and 1.2 trillion won of public funds have been injected into the acquiring banks to compensate for the acquired net liabilities and for recapitalization, respectively.

b) Seven Conditionally Approved Banks

The FSC conditionally approved the rehabilitation plans of seven banks (Cho Hung Bank, Hanil Bank, Commercial Bank of Korea (CBK), Korea Exchange Bank (KEB), Peace Bank, Kangwon Bank, and Chungbuk Bank). Among the seven, CBK and Hanil Bank merged and became Hanvit Bank on January 1, 1999. In addition to KAMCO's purchase of NPLs (face value of 4.3 trillion won at 1.7 trillion won), the government provided 3.3 trillion won to raise the BIS ratio of the merged entity to 10%.

Cho Hung Bank, having announced a merger with Kangwon Bank and Hyundai Merchant Bank, received financial assistance from the government amounting to 2.1 trillion won and is now implementing self-rescue efforts through foreign capital participation. The FSC has ordered the KEB to normalize its situation through additional contributions by major shareholders. While continuing to look for merger opportunities, the KEB successfully found a capital investment plan of 0.23 trillion won in January 1999 from the Bank of Korea, which is its major shareholder, and additional capital investment from Commerzbank, which is also its major shareholder, in conjunction with its self-rescue efforts.

Chungbuk Bank, Peace Bank, and Kangwon Bank have received approval for capital reduction and have completed implementation plans for management improvement. Peace Bank has surrendered its international business and large loan business (credit of 5 billion

TABLE 10
CONTENTS OF SUPPORT FOR MERGED BANKS

Bank	Content
Commercial Bank + Hanil Bank	○ NPLs: Inject 2 trillion won Write off 4.3 trillion won NPLs ○ Recapitalization: 3.3 trillion won
Hana Bank + Boram Bank	○ NPLs: Inject 0.2 trillion won Write off 0.4 trillion won NPLs ○ Recapitalization: 0.3 trillion won
Kookmin Bank + Korea Long Term Credit Bank (KLTCB)	○ NPLs: Inject 0.2 trillion won Write off 0.2 trillion won NPLs

won or more). Its capital was reduced to 0.1 trillion won (the minimum for a commercial bank), and it was required to implement re-capitalization in October 1998 before it finally merged with Cho Hung Bank and Hyundai Merchant Bank.

c) Thirteen Viable Banks

The FSC also reviewed the soundness and management efficiency of 13 viable banks (6 nationwide banks, 6 regional banks, and 1 specialized bank) whose BIS capital ratios exceeded 8% at the end of 1997. Among these, Boram Bank has merged with Hana Bank. It was the first merger between two viable banking institutions. Also Kookmin Bank has merged with Korea Long Term Credit Bank (KLTCB) voluntarily. While KAMCO purchased 0.4 trillion won of NPLs for 0.2 trillion won from Boram Bank and Hana Bank, additional support amounting 0.3 trillion won was provided for re-capitalization before completing the merger process. KAMCO also purchased 0.2 trillion won of NPLs for 0.2 trillion won from Kookmin Bank and KLTCB, as well as 2.3 trillion won of NPLs for 1.1 trillion won from Daegu Bank, Cheju Bank, Pusan Bank, and Kyungnam Bank.

d) Korea First Bank and Seoul Bank

These two banks experienced financial trouble and were nationalized even before the financial crisis. It has been decided to sell them to foreign investors. Consequently, the Korea First Bank exchanged memorandum of understanding (MOU) with the New Bridge Capital consortium at the end of 1998, and Seoul Bank exchanged MOU with the HSBC in February 1999.

B. Non-Bank Financial Institutions

a) Merchant Bank

The first six merchant banks in Korea were established in the late 1970s. They were modeled after the British merchant banks but were also permitted to engage in the financing of medium- and long-term equipment investment. Until recently, a total of 30 merchant banks operated in Korea. They were engaged in a wide range of business activities, including the limited deposit and credit, trusts, securities, international financing, and leasing.

The merchant banks' troubles with bad loans started when the Hanbo group declared bankruptcy in March 1997. Since then, several conglomerates and numerous small- and medium-sized firms collapsed. Many financial institutions, including merchant banks, suddenly found themselves with crushing burdens of NPLs. Each major bankruptcy further eroded international financial institutions' confidence in both the Korean economy and Korean merchant banks, exacerbating the merchant banks' borrowing difficulties at home and abroad. The government finally suspended nine insolvent merchant banks on December 2, 1997 and then suspended five more a week later. Overall, merchant banks collapsed mainly because they had borrowed heavily short term in US dollars without hedging which were lent in US dollars abroad and which were lent in Korean won to local companies. In addition, other failings such as poor credit analysis and unsystematic risk management also contributed to their collapse.

Suspension was only the start of merchant bank restructuring; the first financial sector restructuring effort ever pursued in Korea. All 30 merchant banks were required to submit rehabilitation plans. The Merchant Bank Rehabilitation Plan Evaluation Committee, established on December 29, 1997, audited all merchant banks and assessed their rehabilitation plans in consultation with the IMF and the World Bank.

The first evaluation of the rehabilitation plans was based on whether a merchant bank could maintain a BIS capital ratio above

4%. The second evaluation concerned capital adequacy, quality of assets, liquidity, management strategies, and legality of activities. Based on the Committee's assessment reports, the licenses of 12 merchant banks were revoked. Later the licenses of 6 additional merchant banks were revoked, and one merged with a commercial bank. As a result, there are only 11 merchant banks currently open for business. The government will monitor these remaining merchant banks to ensure management improvement and the fulfillment of the BIS ratio requirement.

The assets and liabilities of all closed merchant banks were transferred to a bridge bank, Hannarum Merchant Bank, which was established with funding from the Credit Management Fund. Transferable assets included loans to financially sound firms, promissory notes, lease assets, and foreign assets that would depreciate significantly if immediately sold off. Transferable liabilities included customer deposits, loans from foreign financial institutions, foreign currency loans that came through the Bank of Korea and the Export-Import Bank, guarantees for promissory notes, and call money. The Korea Asset Management Corporation (KAMCO) purchased 2.7 trillion won of NPLs for 1.8 trillion won from merchant banks. As of August 31, 1998, assets at a face value of 7.8 trillion won and liabilities at a face value of 9.4 trillion won were transferred from the closed banks to the Hannarum Merchant Bank, which is still reviewing these assets and liabilities. Before the transfer of the assets and liabilities, the Korea Deposit Insurance Corporation (KDIC) repaid 4.8 trillion won of deposits, an amount not included in the liabilities of the Hannarum Merchant Bank. The 4.8 trillion won includes the portion provided for deposit insurance for other merchant banks that were not closed.

b) Leasing Companies

The leasing industry was introduced in early 1973 in Korea to provide a source of capital for equipment investment. As of April 1, 1998, there were 25 leasing companies, among which six have established rental companies as captives and 14 have been active in international operations through 30 joint ventures or subsidiaries in 10 countries. Under the "Non-Bank Financing Company Act," which has been effective since January 1, 1998, non-bank financing companies such as leasing companies, credit card companies, venture capital companies, and installment financing companies are to be consolidated. The Act reduces to a minimum overly protective rules and regulation. The most important change related to leasing is the easing of the entry barrier by switching the previous licensing system into the current registration system. Any individual or corporation can enter the industry freely, once having met the minimum paid-in capital requirement of 20 billion won.

Since the mid 1990s, the domestic leasing industry has shown a decelerated growth rate in terms of both contract and acquisition volume as the Korean economy has floundered and the resulting economic recession further reduced firms' demand for long-term capital investment. Keener competition among financial institutions in the leasing business and a continuing economic recession decreased profit figures of leasing companies during the last couple of years. As a result, many of the 25 leasing companies have had problems of substantial non-performing lease assets and sizable losses in security investments. Consequently, all 25 leasing companies were audited and ordered to submit rehabilitation plans in May 1998. In the next month the FSC, together with the MOFE, ordered ten leasing companies to be either liquidated or acquired, according to decisions made by their major shareholders. Currently those not undergoing liquidation are having their assets and liabilities transferred to the Korea Non-Bank Lease Financing Company, a bridge leasing company established in July 1998. In addition, three leasing companies are making efforts to survive through the "work-out" plan. The FSC and MOFE will be monitoring the remaining leasing companies to ensure the implementation of rehabilitation plans.

c) Securities Companies

Securities companies reported net losses for the three fiscal years before the financial crisis, mainly due to the lackluster stock market and rising operating and financial expenses. Meanwhile, the law concerning the opening of branch offices was deregulated in 1996, and most brokers increased branches even though the industry's total number of branches increased by over 20% in the last five fiscal years. These new investments resulted in higher operating costs and decreased net profits. Moreover, during the past two years, many securities companies experienced a sharp increase in the cost of funding due to increased short-term borrowing and a drop in customer deposits.

During spring 1998 two securities companies had their licenses revoked and another two were suspended. In July 1998, additional four companies with operational net capital ratios of less than 100% were ordered to submit management improvement plans. After diagnostic reviews by an evaluation committee, two among these four were suspended and the remaining two had their rehabilitation plans approved in September 1998.

From April 1, 1998, domestic and foreign securities companies were allowed to set up new securities firms. During the second half of 1998 a capital adequacy regulation, conceptually similar to that recommended by the BIS, was put into operation. The regulation not only forces some inefficient and incompetent securities firms to exit, but also prevents investors from being vulnerable to the risks of the bankruptcy or insolvency of securities companies, and thus improves the safety and stability of the securities industry.

d) Securities Investment Trust Companies

The securities investment trust business was introduced in 1970 to support corporate financing. The existing investment trusts in Korea resemble the contractual-type British unit trust rather than the corporate-type American mutual funds. There are now four investment trust companies (ITCs). The ITC serves as fund manager, beneficiary certificate seller (distributor), and investment advisor. There are also investment management companies (IMCs) specializing only in fund management and investment advisory services. As of the end of 1997, there were 23 IMCs in Korea. The difference between ITCs and IMCs also lies in the fact that ITCs are institutional investors while IMCs are not.

Since late 1997, ITCs have been suffering from a bearish stock and bond market, causing unrealized capital losses on the ITCs' securities accounts. The high bond yields beginning at the end of 1997 also encouraged many investors to redeem their beneficiary certificates, seeking higher interest rates for their money. In response, the ITCs had to borrow a lot of money to redeem the bonds, as they were unable to sell them in the market. The large debt in turn led to huge interest payments, which made things even worse. As of 1997, interest payments were estimated to be as big as the sum of management fees and performance fees for most ITCs. The ITCs continued to guarantee a return that they are unable to realize on their own investments. As a result, losses mounted to 1.7 trillion won, giving them a negative overall value.

Securities investment trust companies have so far undergone relatively less restructuring than other financial institutions. The government cannot liquidate these ITCs, however, because of the destabilizing effect such a liquidation would have on the economy. So far, one investment trust company (Hannam) had its license revoked and another is currently under suspension, having transferred its business to a bigger investment trust in September 1998 and started liquidation procedures. While the government has announced that it would restructure the existing IMCs and ITCs after the first half of the year 2000, it will continually induce management improvement and monitor the implementation of rehabilitation plans.

The government has introduced a scheme to improve the regulatory framework for the investment trust business. Among its goals are: To enhance asset management soundness and protection toward beneficiaries by introducing mark-to-marketing of securities; to make provisions for non-performing assets; to require more stringent disclosure of asset management; and to install a fund to protect beneficiaries.

The government is also actively looking for foreign investors to enter the investment trust business and play an important role in the restructuring process. Under the revised Securities Investment Trust Business Act, foreign IMCs are allowed to establish domestic branches upon approval of the Minister of Finance and Economy. Those branches can operate as fund managers but not as distributors. Foreign IMCs also can sell foreign trust certificates through domestic ITCs or securities companies.

e) Insurance Companies

The Korean insurance system is divided into life and non-life insurance. As of the end of 1997 there were 21 domestic life insurance companies, 7 joint ventures with foreign insurance companies, and 5 subsidiaries of foreign life insurance companies in the life insurance industry. Non-life insurance industry comprised 11 domestic direct non-life insurers, 2 fidelity and bond insurance companies, and a single re-insurance company. Until recently 13 non-life foreign insurers were actively engaged in business for re-insurance brokerage along with three foreign insurance companies branches.

The polarization of, in particular, the life insurance industry has deepened since November 1997. The troubled small- and medium-sized life insurers have been experiencing difficulties in managing liquidity as the new business ratio decreased while the number of paid claims was on the rise. This was largely due to the loss in confidence on their credit-worthiness and their insufficient solvency margins. The loss of small- and medium-sized life insurance was due to excess management expenses, since the distribution system of the life insurance industry is out-of-date and relies too much on solicitors. Due to the accumulation of net loss the earnings of life insurance companies were, on average, negative.

In the end, four life insurance companies were ordered to close in August 1998. Their assets and liabilities are to be transferred after a due-diligence review in late October 1998. It is estimated that purchasing the non-performing assets of these four life insurance companies needs four billion won, and that compensating for the gap between liabilities and assets needs an additional 1.2 trillion won, of which 0.9 trillion won was already supplied by the end of September 1998. The authorities also ordered two fidelity/surety insurance companies to submit revised rehabilitation plans containing provisions for a merger and management replacement, with the aim of inducing merger by November 1998. The purchase of non-performing assets of these companies (one trillion won) was completed in September 1998. As of August 1999, the process to sell six life insurance companies with financial troubles is in progress.

f) Other Financial Institutions

Out of 230 mutual savings and finance companies, the FSC imposed management control measures on 6 companies and management guidance measures on 11 companies with the goal of inducing rehabilitation. In addition, 20 companies that were deemed incapable of recovery were closed through a business transfer and 6 companies were sold. A bridge company specifically for mutual savings and finance companies was established in September 1998 to manage the closure process.

In addition, 38 credit unions were liquidated, and 50 credit unions became subject to management guidance measures. Troubled unions will be required to pursue individual efforts or undergo mergers to induce rehabilitation.

V. Interim Appraisal

A. Basis

It is a difficult task to appraise the financial sector reform. This is not only because the target of the reform has been so wide-ranging, but also because the reform is an on-going process that requires a long period of time to finish. Nonetheless, it seems that now is the right time to review what has been done so far, and to prepare for what should be implemented in the future. This attempt will be useful in minimizing potential problems and finishing the reform process successfully.

Naturally, this attempt should not be a final appraisal. It must be one that evaluates the degrees of achievement so far relative to what was initially planned. In this respect, the basis of appraisal is of great importance. This paper takes the goals set initially as the basis. They include (1) normalization of financial services; (2) recovery of sovereign credit rating; (3) acceleration of corporate sector reform; (4) security of financial stability; (5) enhancement of financial industry's international competitive power; and (6) conformity to international best practice.

B. Appraisal

a) Normalization of Financial Services

On the one hand, complete normalization of financial services is still remote, for the working of financial markets is still not based on market principles.[2] The high-interest rate policy to prevent capital outflows and the resulting credit crunch after bail-out loans from the IMF were not proper market operations, nor were the low-interest rate policy and the following low interest rates since the second half of 1998.

Currently the biggest obstacle to normalizing financial services is the concentrated economic power of large conglomerates called 'Chaebols'. Chaebols have always consumed more financial resources than what would enable financial institutions to operate

[2]There are people who have the view that the success of the financial reform depends on how smoothly the government gives up the power which is not necessary any more and allows the market forces to take over the job. They argue that the attitude of the government has not changed much and has been enjoying even stronger muscles after the crisis.

normally, based on market principles. While market interest rates have not fully reflected the risk premium that corresponds to Chaebols' excessive credit risk, Chaebols have enjoyed low financing costs. In such a situation, increases in uncertainty like the recent financial crisis necessarily result in a deep credit crunch. At the same time, increases in credit risk will reduce the amount of financial resources that are available for companies not belonging to Chaebols, or will raise overall financing costs. In short, the risk premiums on the massive credit risk of Chaebols have been continuously transferred to non-Chaebol companies.[3]

On the other hand, the injection of public funds has been successful in making it possible for the real sector to maintain minimum production activities during the crisis period, thereby overcoming the credit crunch and providing the basis for a rapid recovery. One should, however, admit that the current level of commercial banks' capital is not sufficient. A large external shock may yet cause another credit crunch.

b) Recovery of Sovereign Credit Rating

The financial sector reform should be given credit for helping the sovereign credit rating recover. International credit rating agencies have given credit to Korea's efforts towards financial sector reform. Net foreign portfolio investment has increased and the spreads on the foreign exchange stabilization fund bond have dropped significantly. All major international credit rating agencies have upgraded Korea's sovereign credit rating in 1999, especially in the presence of increasing credit risk of emerging economies such as China, Brazil, and Russia.

The current sovereign credit rating of Korea is not at a satisfactory level because it is not high enough to recommend aggressive investment in Korea. The level only shows that Korea has barely escaped the crisis.

c) Acceleration of Corporate Sector Reform

To appraise the corporate sector reform is not a main goal of this paper. It is, however, meaningful to check how the financial sector reform has contributed to accelerating the corporate sector

[3]Some economists criticize that the financial crisis has been simply substituted with the fiscal crisis and hence a fiscal reform will be needed in the near future.

TABLE 11

TREND OF KOREA'S SOVEREIGN CREDIT RATING

S&P	pre-crisis	97.10.24	97.11.25	97.12.11	97.12.23	98.2.17	99.1.25	
	AA-	A+	A-	BBB-	B+	BB+	BBB-	
Moody's	pre-crisis	97.11.28	97.12.11	97.12.21	98.2.12			
	A_1	A_3	Baa_2	Ba_1	Baa_3			
Fitch IBCA	pre-crisis	97.11.18	97.11.26	97.12.11	97.12.23	98.2.2	99.1.19	99.6.24
	AA-	A+	A	BBB-	B-	BB+	BBB-	BBB

Source: Ministry of Finance and Economy

TABLE 12

FOREIGN PORTFOLIO INVESTMENT, FDI, AND SPREADS ON FOREIGN EXCHANGE STABILIZATION FUND BOND

(unit: million $, bps)

	98.1	98.3	98.6	98.9	98.12	99.3	99.5
Net Foreign Portfolio Investment	990	1160	-400	283	173	224	400
FDI	110.4	184.1	464.7	544.0	330.3	330.0	364
Spreads on Foreign Exchange Stabilization Fund Bond (10 year)	342[1)]	440[2)]	487	697	374	258	233

Notes: 1) April 1998, 2) May 1998
Source: Bank of Korea

reform, and the result is rather disappointing.

It can be pointed out that the degree of concentration of financial resources to Chaebols has actually intensified during the reform period. In addition, achievement in the corporate sector reform has not been great. The corporate work-out, in which financial institutions determine whether or not to pursue the recovery of financially troubled companies at their own discretion, has proceeded in a way that has delayed solving the problems. This all indicates that the supporting function of the financial sector reform has not worked well. A major reason is that injection of public

TABLE 13

NON-PERFORMING LOANS (AS OF THE END OF MARCH 1999)

(unit: trillion won, %)

	Total			Banks			Non-banks		
	98	99.3	change	98	99.3	change	98	99.3	change
Total Loans (A)	576.5	571.6	-4.9 (-0.8)	443.4	442.3	-1.1 (-0.2)	133.1	129.3	-3.8 (-2.9)
NPLs (B)	60.2	65.4	5.2 (8.6)	33.6	37.6	4.0 (11.9)	26.6	27.8	1.2 (4.5)
Ratio (B/A)	10.4	11.4	1.0	7.6	8.5	0.9	20.0	21.5	1.5

	Commercial Bank	Specialized Bank	Securities Company	Insurance Company	Merchant Bank
Total Loans	299.1	143.2	7.7	42.5	22.6
NPLs	25.9	11.7	2.4	5.3	2.7

	Mutual savings and Finance Company	Leasing Company	Credit Union	Total
Total Loans	21.0	24.7	10.8	571.6
NPLs	8.4	6.1	2.9	65.4

Source: Financial Supervisory Commission

funds has not been sufficient to make the servicing function of financial institutions recover fully. Consequently, financial institutions do not possess a level of capital that would enable them to swallow all the costs resulting from the corporate sector reform.

It is entirely not right to downgrade the overall contribution of the financial sector reform on the real sector just because of this reason. It is, however, important to recall that one of the goals of the financial sector reform is to make financial institutions financially secure so as to be able to write-off exposures to companies whose recovery prospect are dim.

d) Stability of Financial System

It is too early to evaluate progress towards the long-term goal of overall stability in the whole financial system. Nevertheless, the financial sector reform has proceeded in the right direction. In particular, establishment of the principle that the stability of individual financial institution cannot collateralize that of the whole financial system is worthy of credit.

The current stability of the financial system has been brought about by government intervention, not by competition among financial institutions. What is most worrisome in obtaining the long-term stability of the financial system is insufficient recapitalization of financial institutions. Actions have been delayed, preventing the fulfillment of the recapitalizing plans of most institutions. The financial institutions that have been successful so far in attracting foreign capital are actually the ones with minimal NPLs.

e) International Competitive Power of Financial Industry

The Financial industry's international competitive power has not been enhanced much since reform began. This is because the financial sector reform has been proceeded in such ways as to close those hopeless financial institutions or to endow recoverable financial institutions with minimum competitive power for survival. As for international competitive power, the government and supervisory institutions have merely advised financial institutions to learn advanced business techniques from foreign consulting firms or to hire foreign experts. International competitive power shall be obtained through individual institution's efforts.

f) Conformity to International Best Practice

Significant efforts have been made in improving the institutional setting, especially to make prudential regulations move closer to international best practice. The results are a stricter review of financial institutions' capital adequacy, larger provision requirements, a stronger Prompt Corrective Action (PCA) system, a more transparent accounting system, tighter accounting practices, tighter disclosure rules, and advanced liquidity management of foreign exchange risk.

The movement towards international best practice has been an unavoidable choice so far. Some resistance, however, is possible in the future if the domestic financial market is fully stabilized and the attraction of foreign capital becomes much easier.

VI. Concluding Remarks

Since introducing the IMF stabilizing package in December 1997, major steps have been taken to restructure the financial sector in Korea. The main goals of the current financial sector reform have been to recover the stability of the financial system in the short-run and to enhance the long-run soundness and efficiency of the operations of financial institutions. Together with the Ministry of Finance and Economy, the Financial Supervisory Commission set the principles and developed resolution plans for nonviable financial institutions and the full supporting scheme for other financial institutions with a chance to return to normal operations.

After the first phase of the financial sector restructuring was completed, a number of troubled financial institutions had their licenses revoked and were suspended. While the two pillars of the financial sector reform have been the closing of troubled financial institutions and the recovery of surviving financial institutions' competitive power, there have also been significant improvements in institutional setting. Such institutional reform includes major changes in the deposit protection system, major strengthening revisions of the loan classification standards and provision requirements, introducing the unified disclosure standards, improving risk management for foreign exchange risk, a stronger prompt corrective actions system, etc.

The financial restructuring has been facilitated by the injection of public funds amounting to 64 trillion won, of which 32.5 trillion won is for financing the purchase of NPLs and 31.5 trillion won is for recapitalization and deposit payment. Capital injections have been used as an incentive only for merging banks, while the Korea Asset Management Corporation (KAMCO) purchased NPLs of various financial institutions. The total injection of 64 trillion won is now considered not too high when compared to the size of the injected public money in other countries that had experienced financial crises recently.

The financial sector reform until now is appraised to have laid the foundation for solid economic recovery and restoration of the sovereign credit rating. In particular, various measures to clean the balance sheets of financial institutions were, in a large part, successful in providing the foundation for an early normalization of the financial system and easing the credit crunch situation. Despite the affirmative appraisal, some serious problems still remain. Namely, its contribution on accelerating the corporate sector reform is rather disappointing, and the international competitive power of the financial industry has not been enhanced as much as would be preferred since the reform began.

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