

GLOBAL STANDARDS AND KOREA'S ECONOMIC REFORMS

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Korea's economic performance has undergone tremendous scrutiny since the devastating financial crisis of December 1997, and this has forced a reevaluation not only of the miracle of Korean economic growth but more importantly the underlying paradigm.

Unfortunately, countries in crisis have little recourse but to accept the prevailing wisdom as to how the international system operates, and indeed globalization and standardization impose a new discipline on countries that cannot be evaded. In the case of Korea, the authorities were confronted with the dual need of restoring confidence and growth to a demoralized economy and public, while at the same time instigating drastic changes in the conduct of public policy. But the basic policy dilemma between crisis management and institutional reform is seen in the dichotomy of treatment between the "top five" chaebol and the 6-30 or 6-64 firms.

The structure of this paper is to provide a Report Card on Korea's reform from the following perspectives: i) what has the record on corporate restructuring since early 1998; ii) what is the status of corporate governance reforms; and iii) what progress has been made in financial restructuring, particularly the recapitalization and repositioning of the banks.

And the assessment of public policy reveals: i) the importance of sustainable corporate restructuring, both for the long-term viability of the Korean industrial sector but also for the long-term financial health of banks; ii) the need to improve corporate governance and protect the public interest, which will require a further re-mooring of the roles of the corporation, the shareholders, the regulators, and the government; and finally iii) the importance of dealing with the forgotten issue in Korea, namely, the respective roles of the taxpayer and the owners of the chaebol.

1. INTRODUCTION

Korea's economic performance has undergone tremendous scrutiny since the devastating financial crisis of December 1997, and this has forced a reevaluation not only of the miracle of Korean economic growth but more importantly the underlying paradigm. While much had been written of the lessons of Korean development, there was also ample evidence of structural problems in the economy and concerns about the governance failures that accompanied them. Thus, whereas Korea was held up as an example of best practice in a number of areas, including rapid poverty reduction, equitable patterns of economic growth, rapid industrialization and employment generation, adaptation of world-class technology, and penetration of international markets, doubts were also raised in the areas of competition policy, financial sector management, and governance.

In re-examining Korea's performance, new light is being cast for some on Korean institutions. Here again a revisionist tendency exists. Where once there was widespread praise for the public sector, responsible for guiding a highly successful industrial strategy and gradually adopting an efficient social safety net, there emerged a deep skepticism in the mid-1990s that the balance between government and the private sector was correct.

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This revealed itself in regulatory and governance failures. The inability of government to deal satisfactorily with regulation of the corporate-financial sector coupled with glaring lapses in governance provided the cracks in the Korean system that led to the ultimate breakdown of 1997 (see Leipziger, 1998).

The conceptual difficulty of judging Korea's policies since the crisis is that one may either judge them in comparison to best practice or in comparison to Korea's history over the last five decades of economic growth. Judging vis-a-vis best practice, the so-called "global standard," can entail some cultural bias, as is often noted in the evaluations of Japanese economic reforms, and there is merit in considering past legacies. Unfortunately, however, countries in crises have little recourse but to accept the prevailing wisdom as to how the international system operates, and indeed globalization and standardization impose a new discipline on countries that cannot be evaded. That being said, it must also be noted that OECD countries, often used as the benchmark, have themselves been subject to policy errors and policy exceptions-to wit, major bailouts of "too big to fail entities" like Chrysler or Credit Lyonnais or supervision failures in banking in the U.S. or Sweden. Therefore, normative judgments must be exercised with care.

In the case of Korea, the authorities were confronted with the dual need of restoring confidence and growth to a demoralized economy and public, while at the same time instigating drastic changes in the conduct of public policy. An economy that had not experienced negative growth in almost two decades, and one which had not internalized well the lessons of past corporate failure and financial policy mistakes, was ill-equipped to undergo the fundamental change that was required to remoor the economy for the next millennium. The authorities have obviously done well in the former task, as seen by the robust growth rebound of 1999 after the deep recession of 1998; however, this exigency and the constraints imposed by political considerations have limited the revamping of institutions that will be needed. Nevertheless, there are bright spots, as seen in the aggressive and more independent role of the Financial Supervisory Commission and the efforts of the Competition Agency.

The basic policy dilemma between crisis management and institutional reform is seen in the dichotomy of treatment between the "top five" chaebol and the 6-30 or 6-64 firms. The growth at any cost strategy of Korean firms that led to such over-leveraged and under-profitable chaebol has been at the fulcrum of corporate-financial realities for decades. The fact that large chaebol could fail, starting with Kukje in the late 1980s, extending to Hanbo and Kia in the pre-crisis period, and now reaching Daewoo among the top five is an indication of major change. It has been slow in coming, but the recent crisis has hastened the change in orientation. Nevertheless, aspects of corporate restructuring for the top five have been subject to a different set of rules in Korea, and this has hindered the process of reform.

The structure of this paper is to provide a Report Card on Korea's reform from the following perspectives: i) what has been the record of corporate restructuring since early 1998; ii) what is the status of corporate governance reforms; and iii) what progress has been made in financial restructuring, particularly the recapitalization and repositioning of the banks. The approach taken is to take a dynamic look at these issues compared to the initial conditions and then to indicate areas where further progress is warranted to come up to international standards.

Part One: Corporate Restructuring

The government has adopted a three-pronged approach to corporate restructuring, including: a) court-supervised insolvency procedures, b) voluntary debt workouts or out-of-court solutions; and c) special procedures for the top five chaebol.

The bankruptcy process has affected 13 of the top 64 chaebol and placed 11 of them in court sponsored receivership. As is seen in Table 1, this list includes firms owing some Won 33 trillion to their creditors. At the time of default, their leverage (debt/equity ratio) exceeded on average 800% which indicates that they were able to engage in distress financing despite their precarious financial positions. Indeed, Korean banks made upwards of Won 2 trillion in "bankruptcy avoidance" loans between October 1997 and May 1998 to chaebol who later became insolvent, entering either into court-ordered receivership or formal out-of-court workouts. By and large, once the corporation reaches this formal stage of insolvency, equity is lost and management control is wrestled away from owners. In some cases, however, such as the celebrated Kia and Samsung Motors cases, the resolution of the bankruptcy case is to sell the firm to another financially strapped firm. We will revert to this in the next section.

The majority of debt workouts have followed so-called London rules, creditor-led, extra-judicial arrangements based on Corporate Restructuring Agreements signed by 210 local banks and non-bank financial institutions (NBFIs) in July of 1998. The Corporate Restructuring Agreement (CRA) entails the acceptance of specific procedures to set up creditor agreements, timetables, standstills, arbitration between creditors, and other rules of the game. The implementation of CRAs is overseen by a Corporate Restructuring

Table 1. Chaebols Under Court-Supervision

(Borrowings in KRW billions)

| Group | Default Date | Leverage | Net Borrowings | Status |
|-----------------|--------------|----------|----------------|-----------------------------------|
| Hanbo | 1/23/97 | 1896% | 4,091 | Court receivership; sale underway |
| Sammi | 3/19/97 | (3324%) | 875 | Court receivership |
| Jinro | 4/28/97 | 4231% | 1,917 | Composition; sale being finalized |
| Daenong | 5/28/97 | (2806%) | 1,172 | Court receivership |
| Hanshin Constr. | 6/2/97 | 649% | 502 | Court receivership |
| Kia | 7/15/97 | 411% | 6,624 | Sold to Hyundai |
| Ssangbangwool | 10/15/97 | 711% | 595 | Court receivership |
| Taeil Media | 10/24/97 | 334% | 588 | Composition |
| Haitai | 11/1/97 | 658% | 3,046 | Court receivership; sale underway |
| Newcore | 11/4/97 | 1222% | 1,215 | Applied for court receivership |
| Soosan Heavy | 11/26/97 | 476% | 639 | Court receivership |
| Halla | 12/5/97 | 2066% | 6,453 | Court receivership |
| Chunggu | 12/27/97 | 484% | 728 | Court receivership |
| Sungwon | 4/12/99 | n.a. | 545 | Composition |
| Samsung Mtrs. | 6/30/99 | n.a. | 4,170 | Court receivership |
| Total | | 822% | 33,160 | |

Source: World Bank

Coordination Committee (CRCC) to oversee the workout process and provide arbitration if needed. This process has been used extensively for the debt problems of the chaebol ranked 6-64 in size (half of the 76 companies dealt with under the framework as of April 1999 were affiliated directly or indirectly with the chaebol and of these five were very large conglomerates, that is to say in the top 30).

The benefits of these CRAs is that lead banks are put in a position to monitor financial performance closely in exchange usually for debt restructuring—interest rate reductions (which are a poor instrumentality for banks) or term extension. It is unclear, however, to what extent managerial practices are changed or to what extent additional equity is required of existing owners. As is reported by the World Bank, based on CRCC and FSC data, in Table 2, the bulk of the refinancing in CRA workouts has come from creditors restructuring the debts of firms, and relatively little has come from new equity, domestic or foreign. Thus, it is not unreasonable to assume that the debt problems have not been solved, but merely deferred for another day or subsequent restructuring. In this area, therefore, the process receives a B+ for problem recognition, but a C+ for problem solution. The problems go far deeper than the resolutions so far, auguring for a second-round of restructuring.

The issue of the top five chaebol is of major importance, although it is noteworthy that the case of Daewoo is a fluid one and one in which the authorities have finally taken a tough stand in the face of recalcitrance on the part of owner-management. Because of their size, importance for exports, employment, and international prestige, the authorities came to treat the top five chaebol differently. In a way their position during the crisis was less precarious as they could access international lines more easily and had core businesses that were seen to be competitive. Nevertheless, their voracious appetite for credit, much of it used in recent years for unbridled expansion into new areas, their initial reluctance to downsize in order to reduce exorbitant leveraging, and their negative impact on domestic financial institutions has meant that to ignore their problems is tantamount to ignoring Korea's major structural deficiency.

The overall approach to the large chaebol has been to rely on Capital Structure Improvement Plans, arranged between lead banks and their debtors to rationalize their operations, improve their leverage ratios, and enhance management. In the view of some observers, the CSIPs have led to marked improvements in at least three of the top firms, Samsung, LG, and SK, but Hyundai is still lagging behind and Daewoo is now part of a specific restructuring operation. The overall debt/equity ratios have improved, although not as much as the CSIPs had planned for; reasons for the slower than anticipated

Table 2. Restructuring Methods and Applications

(ranked by percentage typically applied)

| Debt Restructuring Method | Typical Application | Percentage Applied |
|---------------------------|-----------------------|--------------------|
| Interest rate reduction | Secured debt | 69% |
| Interest exemption | Cross guarantee debt | 15% |
| Convertible bonds | Unsecured debt | 7% |
| Debt/equity conversion | Unsecured debt | 5% |
| Term extension only | Various claims | 2% |
| Forgiveness of principal | Cross guaranteed debt | 2% |

Source: World Bank

progress may include a reluctance to sell assets at the trough of the cycle, the spigot of fresh credit coming from the Investment and Trust Companies (ITCs), and the confusion caused by the so-called "big deals," the swaps of assets between the large chaebol themselves.

In judging the speed with which the top five have restructured, one cannot help but be struck by the fact that the swiftest of the improvements that have been taken still leave Samsung, LG, and SK with debt/equity ratios of 200%-250%, substantially higher than any other industrialized country and highly susceptible to interest rate shocks or renewed attacks of confidence. It is true, however, that additional use of cross guarantees was halted as of end 1998 and will be outlawed early in the year 2000, and that combined financial statements will be required as of the end of 1999. These are major advances, as is the use of international GAAP and other standard practices for accounting rules. Under the circumstances, one can rate the CSIPs for these three chaebols as acceptable, especially since their leveraging has been almost cut in half compared to their crisis levels of December 1997, provided that the trend towards more prudent financial management continues and accompanying changes in corporate governance occur. The Report Card on them yields a more favorable rating.

The case of the two auto-makers is a different story altogether, since their leverage ratios remained 340% for Hyundai and 590% for Daewoo as of June 1999, and at least for Daewoo we know this hasn't improved. What went wrong? In one case, perhaps, there was a failure to come to grips with the new reality, denial plus a sense that too big to fail was indeed the best defense. It is said that Daewoo anticipated preferential treatment for agreeing to take over Samsung Motors, but in any event its continued short-term borrowing merely added distress financing to its already horrendous inability to cover interest payment due with earnings. Hyundai also took a high risk course, taking over Kia and other costly acquisitions, and its managerial span is still too broad.

An issue certainly worth exploring is the big deal approach itself in which the top five realign themselves into core business areas and agree to swap or sell affiliates among themselves. There are deals in train for companies in semiconductors, petrochemicals, aerospace, autos, rolling stock, ship engines, and power generation. Korean policymakers had in earlier periods tried to force conglomerates to specialize in four main business lines and to direct bank lending only to those core businesses. This policy failed, as firms circumvented policy directives and continued to expand their affiliates. The notion that over-leveraged conglomerates should swap businesses is contrary to the workout process that would obtain in most countries and is unlikely to further the competition agenda. The Report Card on big deals generally can therefore be given no more than a C, although the verdict is still out.

Much of the judgment that needs to be exercised in the corporate workout process is in the hands of the lead banks, they themselves having been bailed out by public infusions of capital. The fact that Daewoo was allowed to drift for so long and the fact that it wasn't until September 13th that the CRCC ruled that workouts needed to proceed on an affiliate by affiliate basis rather than by group and that collateral provided by the group had to be distributed by affiliate shows the weakness of the double standard in dealing with the top five in a more lenient fashion. The fact that Daewoo's flagship company will have to reschedule 75 percent of its debt due to an inability to pay and that the average loan loss will reach 50 percent for major Daewoo subsidiaries indicate the failure of its restructuring plan and the inadvisability of a double standard. For the future, Korean poli-

cy needs to be blind to size, something it has never been, and this requires a fundamental re-orientation.

Part Two: The State of Corporate Governance

In order to discuss the current state of corporate governance, it is of course critical to recall that the relationship between the private sector and the state has been rather unique and controversial in Korea (see Amsden, 1989; Kim and Leipziger, 1997; Stiglitz, 1993; and World Bank, 1987, for example). A good deal has been written on the subject, and while the dominant view is that the relationship served in large measure to propel Korea from a rural, impoverished nation to major industrial power in one generation, there is equally no doubt that in that approach to public-private partnership lay the intense moral hazard that has recurred often in the form of corporate and financial failures (see Leipziger and Petri, 1993). This role of the state, when combined with Korean culture of risk-taking, best epitomized by the Korean saying that it is "best to camp with ones back to the river," which implies that escape is not a viable option, has led to enormous risk-taking. Changing this aspect of Korean corporate behavior is a major undertaking.

The key reform which has yet to take place is the separation of ownership from corporate management, and as a corollary, the reorientation of firms to maximize shareholder value. These are basic tenets of the capitalist system as practiced almost everywhere in the OECD, with the partial exception of Japan, although even there the "zaibatsu" system has long ago been replaced. The expansion of major chaebol into new areas where they had neither comparative advantage, nor resources, nor indeed good business prospects (e.g. Samsung into autos) cannot be rationally explained. Certainly, part of the distress-financing that troubled chaebol engaged in is a reflection both of the ultimate risk-taking one can see with family-owned firms as well as a reflection of the poor corporate governance that dominated the banks. Certainly, the fact that chaebol could in the past own sizeable equity stakes in the banks, and more recently use merchant banks, investment and trust companies, and securities houses that were affiliated with them to tap credit also casts doubts on the regulatory regimes governing corporations and financial entities.

For this reason, corporate governance was identified early on in the Korea emergency package of late 1997 and the World Bank and others became much more visible in raising the issue with the Korean authorities. Some major reforms were agreed upon, including a strengthening of the Fair Trade Commission, the Korean competition agency, as well as reforms in the quality of audits, accounting principles, and most importantly, the preparation of consolidated balance sheets. The recent decision on separating the collateral among Daewoo affiliates is a positive sign in the difficult process of unraveling the myriad of cross guarantees and group pledges of collateral that dominated the system. In this connection, it is impossible to separate the corporate governance issue from the proper functioning of the banking system.

In the financial sector, progress has been made in the oversight that creditor banks exercise over borrowers, and the Financial Supervision Commission has been the lead agent in this process. While the country is still a far distance from balance sheets that are internationally acceptable, and starting with the year 1999 we will see the first consolidated balance sheets, much greater transparency has been forced on the conglomerates by their lead banks than ever before. An equal effort now needs to be made with respect to

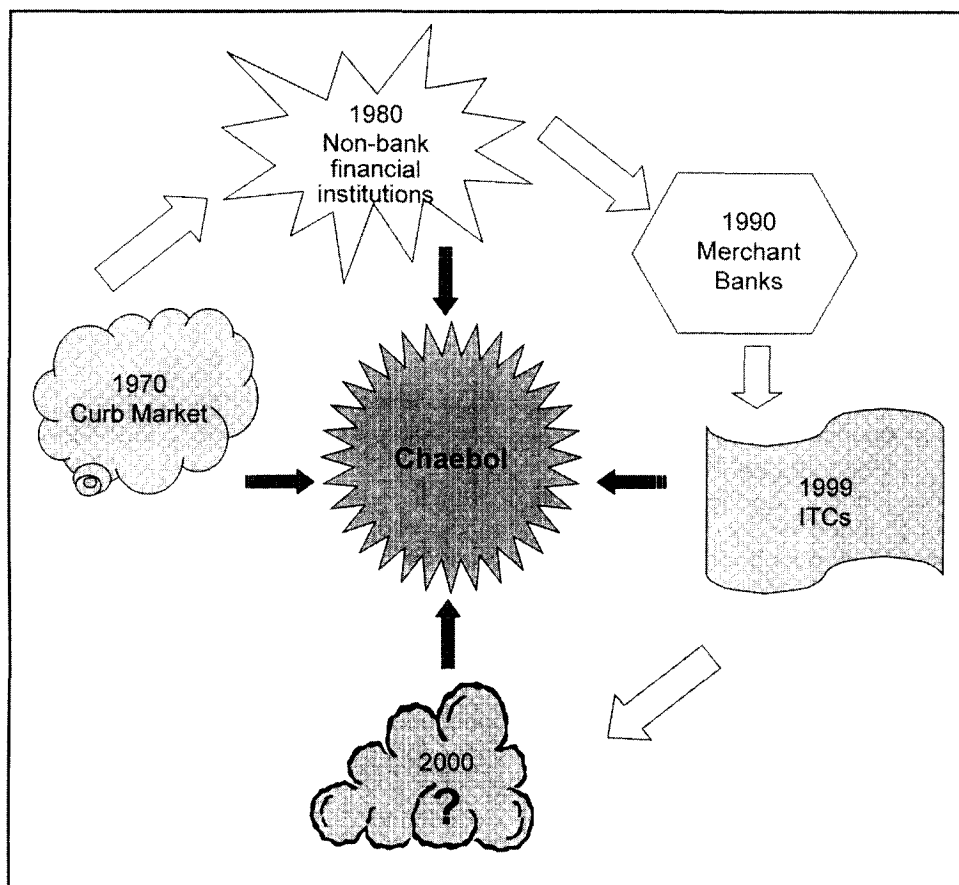


Figure 1. Financing the Chaebol

NBFIs, who have traditionally been the surrogate source of credit (see Figure 1).

The state of corporate and financial sector governance is a function of both the regulatory and legal systems. Great strides have been made in this area, as seen by the fact that firms prefer at all costs to avoid court-ordered bankruptcy procedures, and ultimately liquidation. This discipline needs to be matched by the powers of regulators. So far, while the number of cases successfully brought by the KFTC has increased markedly, the actual fines have been too small to affect behavior. (See Table 5). The powers of the KFTC need to be as strong as those of the financial regulators in order to stave off future problems of corporate misbehavior, and more to the point, to protect the public interest. The actions of the KFTC have begun to be more assertive, but the verdict is still out and it is too early to judge their impact. The actions of the financial regulators have been much more stern, and they are discussed in the following section.

The importance of corporate governance cannot be overstated since the failures of public oversight that lead to economic losses have, as in most countries, become burdens of the state. The bailouts in Korea following the 1997-99 crisis are now expected to cost 18 percent of GNP. Unfortunately, estimates by some indicate that the ultimate cost may

well be double that figure once the full impact of bankruptcies and the full cost of financial sector restructuring is taken in account.

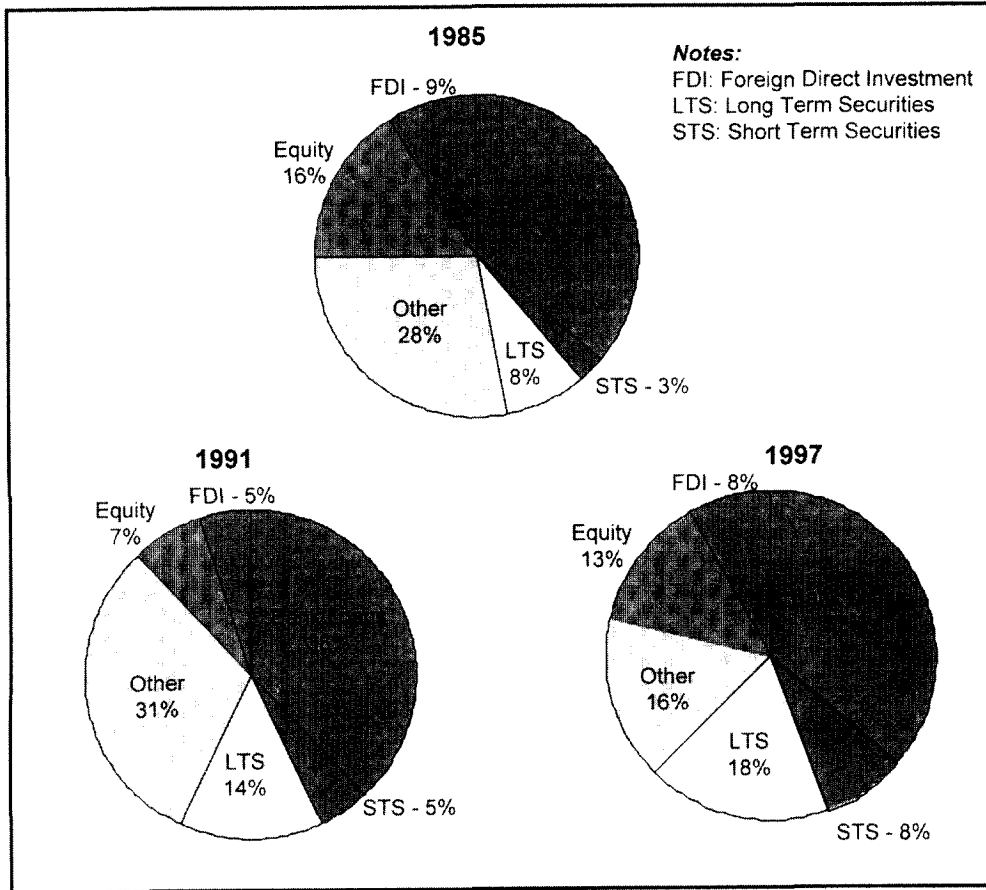
While public losses of this size are not unusual—the bailout in Mexico is said to cost US \$ 100 billion and rising—the per capita price-tag of this fiasco is sufficiently large, as to burden the taxpayer for a long time. Because of this, some have argued for an aggressive program of debt-to-equity conversions, with the prime beneficiaries of the swap being the public at large (see Leipziger, 1998). Let's be specific about this notion, which may at first glance appear to some to be a public takeover of corporations. In essence the public sector already owns outright the banking sector, insofar as all capital added to the banks involves public monies. On the side of corporations, evidence from the restructuring exercises indicates that relatively little of new financing has come from foreign sources, and an even smaller percentage from the owners themselves (see Table 3). The bulk of the refinancing has come from either interest rate forbearance or term extension by creditors, which in most cases comes back to the liquidity of banks that had to be supplemented by the public sector.

It is therefore fairly straight-forward to conclude that the Korean taxpayer in large measure owns the chaebol. How does the new owner of the corporation exercise his rights? The answer lies in the much larger question of who controls the corporation, the family who created the firm or the actual shareholders? This begs the question for the moment of cross-ownership of firms, which still dominates the Korean corporate scene, but as noted in Figure 2, the pattern of corporate finance is strikingly not much different from a decade ago. Proposals could be entertained that could lead to a shift in ownership of chaebol, with the attendant benefit that some of the limitations on minority shareholders, although there have been some reforms, would not apply to a public trust exercising the rights of a large share of the ownership. What is being suggested may look like pub-

Table 3. Corporate Restructuring Agreements: Burden - Sharing Formula

| Self Help Measures | Percentage |
|------------------------------------|------------|
| Asset sales | 10.7 |
| Affiliate sales | 2.6 |
| Foreign Capital | 5.8 |
| Owners' contribution | 1.1 |
| Other | 2.0 |
| | 22.2* |
| Debt Restructuring Measures | |
| Rate/term adjustment | 50.9 |
| Interest exemption | 12.7 |
| Conversion to equity | 3.4 |
| Conversion to CB | 4.9 |
| Write-offs | 1.3 |
| Term extension | 4.9 |
| | 77.1* |
| (* rounding errors) | |

Source: CRCC, FSS, World Bank



Source: World Bank

Figure 2. Pattern of Corporate Finance

licly-managed corporations, akin to government-linked corporations in Singapore, but it provides an alternative paradigm to either the family-owned and managed firm that cannot really be effectively regulated because the incentives of the family-dominated firm are so strongly at variance with the rights of other shareholders-the Chairman's Office etc.-or a process to gradually reforming that system to match up with market capitalism as practiced elsewhere.

This is not to say that there haven't been important steps in the right direction with respect to corporate governance reforms. Some efforts have been made to strengthen the rights of minority shareholders, to bring suits and secure information, but these are still far removed from the OECD best practice. Actions to place outside Directors on boards, to improve disclosure and transparency, to standardize accounting practices, and to see legal enforcement of corporate rules including class-action suits, are all welcome indications. What could make these actions even more effective would be the encouragement of strong public interest institutions, untied to the government or the private sector, to pursue issues in the public interest. These types of institutions have been very effective in

the US and elsewhere in influencing the political debate by providing neutral information. Examples are groups that can analyze the rate increases of utilities, health cost burdens on the poor, misbehavior of insurance companies or bilking of the customer by private firms. Corporate governance in Korea may need this type of external stimulus and independent assessment.

Indeed, one may argue that the extent of reforms needs to “over-compensate” for the practices of the past, in particular since the family-ownership pattern still prevails in Korea. Practically speaking, the degree of cross-ownership among large firms, is not materially different than in the past with about 44% of top 30 ownership prior to the crisis in the hands of family and subsidiaries. Indeed the activities of some ITCs and other NBFIs highlights the importance of stricter governance of these financial entities that appear to be owned or controlled by the conglomerates themselves.

Clearly the issue of corporate governance is most intrinsically linked to the issue of financial transparency. Financial disclosure needs to disentangle the web of cross-guarantees, now officially halted we are told, as well as the vague assignment of collateral and intra-group loans. The resolution of the Daewoo case may well be the harbinger of more fundamental reforms, but one can not be over-confident. Recent past actions to open up the corporate sector to foreign influence, unrestricted purchases of shares and so-called “hostile takeovers,” has not yet had the desired effect because it can be seen as part of a submission to outside forces. It should more properly be seen as a protection of the domestic share-holder, who, until now, has not had the required set of rights that are expected to come with equity ownership. It remains to be seen whether the appointment of outside Directors for 25% of the seats for publicly traded corporations will have any discernable impact on the actions of Boards in the face of continued family ownership.

A major actor in the area of corporate governance is the Korea Fair Trade Commission (KFTC), which has undergone major re-invigoration and is trying to fulfill its public mandate as the “competition advocate.” It has initiated many more cases recently, as seen in Table 4; however, it can still be argued that it has spent too much time on cases of unfair trade practices, predatory pricing, illegal subcontracting and the like and only 5% of its cases (but perhaps not its energies) on true cases of collusive behavior. Of course, the KFTC may have limited remedies in imposing fines. It may also be but one voice in policy deliberations that ended up endorsing the policy of big deals which was aimed at fostering a re-concentration of chaebol effort around core business lines. The big deal approach is certainly inconsistent at one level with increased competition. It was seen by government as necessary, however, to restore domestic and international confidence. It is noteworthy that the KFTC approved 156 of the 158 merger notifications of the largest 30 chaebols that were requested in the first 11 months of 1998 without objection. Seen by the outside world, for example, the fact that Hyundai ended up being the buyer for Kia, when Hyundai itself was leveraged to the gills, is seen as running contrary to open and competitive markets. Perhaps other legal entities and other legal remedies need to be employed to foster truer competition, but these actions will need as their basis strong, objective analysis and clear criteria to judge what is in the public interest. Thus, the link between better governance, strong and independent regulators, and public interest groups is central for Korea’s future.

Table 4. Actions by Korea Fair Trade Commission

| Type of case | 1993-96 No. of cases | 1998: first half No. of cases | % of total cases |
|---------------------------------|-------------------------|----------------------------------|---------------------|
| Abuse of market power | 7 | 3 | 0.3 |
| Anti competitive M&As | 96 | 13 | 1.2 |
| Concentration of economic power | 30 | 3 | 0.3 |
| Collusive activities | 97 | 44 | 4.0 |
| Trade association activities | 220 | 87 | 7.9 |
| Unfair trade practices | 1349 | 417 | 38.0 |
| Unfair international contracts | 234 | 0 | 0.0 |
| Unfair subcontract transactions | 1323 | 408 | 37.0 |
| Others | 205 | 125 | 11.4 |

Source: Fair trade Commission. Figures for 1993-96 taken from Yoo Seong-min, 1998

Part Three: Financial Sector Restructuring

The link between corporate restructuring and financial restructuring is such that one cannot claim to examine one without judging the effectiveness of the other. Indeed, the Financial Supervisory Commission is the lead agency in the bank recapitalizations and also in overseeing the Corporate Restructuring Coordination Committee, charged with overseeing the work of the lead banks in the workout process. The manner in which these workouts is handled will determine to a large extent the future health of the banks, now essentially publicly owned. In opting for the "London Principles" for extra-judicial workouts, a great deal of responsibility is placed on lead banks. Recall that these are the same banks that forgot to do due diligence in lending before and whose behaviors caused irresponsible lending. How are they doing now after the shattering crisis? How are they going to be restructured while cross guarantees are still prevalent? These are critical questions in judging the integrity and sustainability of the financial workout process.

The facts of the financial sector restructuring are well known by now, including the closure of 16 of the 30 merchant banks which triggered the crisis with their reckless borrowing and lending strategies, the merger of a dozen weak commercial banks with larger ones, and the intervention and recapitalization of the two largest private banks accounting for 40 percent of deposits. Among the NBFIs, actions were required of some insurance companies and a few securities firms, but relatively little to date of the investment trust companies (ITCs). The balance sheets of the open commercial banks were remedied in order to meet the 8 percent capital adequacy rules, at considerable cost to the taxpayer, as in other OECD countries.

Of course, the quality of a portfolio is hardly static and changes in the credit culture and bank managerial practices are important in preventing future crises. Of paramount importance, given the asset concentration of banks is the condition of the chaebol. We have some evidence on how the 6-64 chaebol are being handled as well as some on how the small and medium enterprises are being dealt with. The top 5 were handled in a different manner, with a good deal of government guidance, and the Daewoo case is certainly instructive in that regard. The problem with being seen as too big to fail is that it undermines the new behaviors one wants to see in Korean banks. Nevertheless, the lead

Table 5. NBFi Ownership by Chaebol (1998)

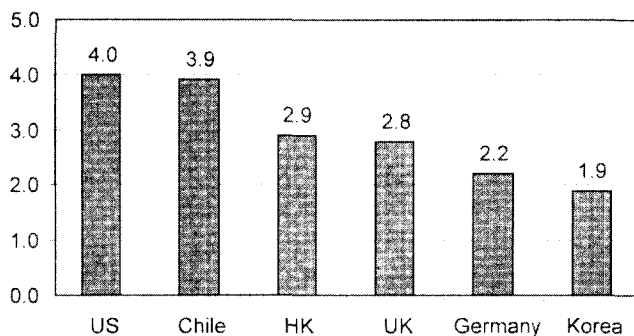
| Merchant Banks | Securities Cos. | ITC | Life Ins. | Ins. | Total |
|----------------|-----------------|-----|-----------|------|-------|
| 16 | 30 | 30 | 33 | 17 | 126 |

banks seem to be acting much more responsibly, reflecting in part the guidelines of the inter-creditor agreements signed by all 210 Korean banks and NBFIs. Of course, the governance of the NBFIs is still in doubt, especially since many are still either owned or controlled by the big conglomerates (see Table 5). The top 5 are connected to the Investment Trusts whose assets total \$46 billion, thus constituting a major piece of the financial sector but also a larger, new risk element. The fact that Daewoo and Hyundai had major stakes in the largest ITCs, which ended up buying risky debt from these two automakers, indicates that supervision and governance rules require re-examination.

The rehabilitation plans agreed to by the workout groups require very little additional equity investments and thus continue the tradition of essentially rolling over debts. In examining the quality of the financial decision-making by banks, one is struck by the fact that while the leverage of restructured chaebol has improved, the quality of those assets is still very fragile and subject to future debt renegotiation. Recall that up to now, non-performing loan classification is based on past payments record, which may not be the best indicator of future performance. Under current provisioning requirements, many firms whose ability to cover interest payments is impaired would not need to be preemptively provisioned.

Changes in the loan classification rules are planned by year's end, classifying companies with less than 50% interest covered by EBIT (earnings before taxes and interest) as doubtful and provisioned at 75%, while those with less interest coverage require full provisioning. That still leaves those debtors with say 50-75% interest covered as sub-standard, and these warrant more than the 20% provisioning now practiced for sub-standard loans. This movement towards risk-based asset classification will affect bank balance sheets but hopefully will not require forbearance against capital requirements. Supposedly, after the massive intervention of the major commercial banks, and the resulting infusions of public funds to meet BIS norms, commercial banks were to provision as needed against risky assets. Of course, the question of asset valuation is critical, and measuring at the nadir of values, especially where backed by collateral whose value has plummeted, can be tricky. Nevertheless, given that KAMCO, the Korea Asset Management Corporation, already took about 46 trillion won of NPLs off the balance sheets of the commercial banks, and given that Government injected additional capital in the form of equity and subordinated debt through KDIC equivalent to 28.6 trillion won into the banks, it would not seem wise to allow for significant forbearance against prudential norms at this point, especially since the economy is on the rebound and interest rates are low.

Some questions have been raised about the quality of the restructuring programs themselves, and the extent to which they will be successful as structured. Indicators used include the limited use of foreign advisors, the sparse addition of new equity, and less than full transparency of balance sheets to date. It is also not clear how the lead banks exercise rights in the managerial hierarchy of the chaebol, where, as the major creditors, they should be playing a very strong role. Continuation of debt rollovers will not improve the banks' poor profitability as seen in Figures 3's comparative past performance in inter-



Source: World Bank

Figure 3. Pre-Crisis Net Interest Margins of Banks (1993-1996)

est rate margins. If the banks are ever to return to private sector hands, their profitability must improve dramatically. The fact that no re-privatizations of the major banks has yet occurred leads to the worry that the banks are still not operating efficiently and with sufficiently clean balance sheets.

We need to take a close look at the capital condition of banks. It is assumed that the banks that are open meet the Basle capital adequacy requirements. Their situation with respect to non-performing loans (NPLs) was improved through the purchases of KAMCO of some 46 trillion won worth of impaired assets. Still, sources indicate that at the end of 1998, at least 34 trillion won were still non-performing in commercial banks and another 27 trillion won in NBFIs. Taken along with the KAMCO purchases, we are talking about 105 trillion won without considering the Daewoo issue. If estimates for 1999 are at least 30 trillion higher, it would mean that as much as 30% of the financial system was non-functional (Cho, 1999). Although much progress has been made in the commercial banking side, their ability to regain profitability is still suspect.

Estimates so far have KAMCO costing the taxpayer some 20 trillion won, KDIC another 28 trillion in depositor coverage and subordinated debt into banks. In total we are told that the government has earmarked about 64 trillion won through these two entities for bank support. It is worth looking at the risk-bearing capacity of banks' balance sheets. We pay close attention to the ability of the chaebol to cover their interest payments, and most scenarios would indicate that their ability is still largely impaired and that banks will not be able to count on the returns to assets that are implicit in their books. This can lead to further losses and additional public support.

Another important element are the smaller firms. Clearly, small and medium enterprises (SMEs) are the unknown but important segment of the manufacturing sector, accounting for 47% of value-added and 42% of exports. SMEs account for 78% of employment. The smaller firms of less than 300 workers are the ones suffering most from the credit crunch. Rollover problems emerged very strongly after the crisis, particularly since half the SMEs were linked in some fashion to the chaebol and therefore didn't have to post clear collateral records in the past. During fateful 1998, the SMEs are said to have lost 10% of their access to credit, this figure bolstered substantially by the actions of the Korea Credit Guarantee Fund which aims to help SMEs, but this is probably an underestimate. This has been supplemented by special credit and trade lines arranged by the

government and a special SME restructuring fund of 1.6 trillion won established by domestic banks at government behest. Thus, Korea has acted forcefully to protect its SMEs from further damage. Without these actions, the bankruptcy rate, already extraordinarily high, would have been even worse.

Another perspective can be gleaned by looking at the NBFIs. Consider, for example, that in the last two years the Investment Trusts Companies (ITCs) segment has increased its share of assets from 10% to 20% of the system (Cho, 1999). Unfortunately the auditing of these firms and their governance is suspect. Neither the investors nor the supervisors have had sufficient oversight of this market segment, as documented by the fact that one-third of the total debt of Daewoo workout affiliates of 59 trillion won is held by ITCs. Much of this 21 trillion won of now at-risk debt was taken on in the post-crisis environment, as was supposedly a total of 20 trillion won in new bank debt that was extended to Daewoo. Whereas the potential new NPLs in the banking sector can be simulated, depending on interest coverage rates, a more opaque picture exists with respect to the NBFIs, whose losses have already exceeded 27 trillion won, according to Korean sources. Based on this, we are inclined to give the supervisors a B+ for the bank restructurings, but a C for the supervision of the NBFIs.

The announcement in early November 1999 that public banks will put \$2.5 billion in capital into two large, troubled ITCs that bought a good deal of Daewoo debt once again raises the moral hazard problem in the financial sector. Two of the three largest ITCs will now be government-owned. Investors in ITCs ignored the "buyer beware" admonition and they will again be bailed out. The Financial Supervisory Service insists that this will be the last bailout, but one has to be struck by the fact that no depositor or investor in Korea has yet to lose a penny! It would be incumbent on the FSC to limit the deposit guarantee in future and to clearly signal which instruments and financial market segments it will not supervise actively. Clearly ITCs acting like mutual funds fall outside their supervision, although investment regulations need to be enforced and independent ratings can supplement public sector actions.

A final public policy issue worth considering is the extent to which the financial regulatory function (as seen by the FSS) should be separated from the FSC's work as the orchestrator of workouts. This question is not to imply that the FSC is not doing a commendable job, which is, but rather to wonder whether the interests of the bank regulator is identical with the exercise of bank ownership rights (as the commercial banks currently negotiating major restructuring and debt-equity conversions, as in the Daewoo case, are government-owned). A clarification of roles may be useful in future, as exists in other countries, although the Korean situation is understandable in light of the fact that the combined Financial Supervisory Board came into existence in the midst of the 1997-98 crisis.

2. CONCLUSIONS

A concluding assessment of where Korea stands in the areas of bank and corporate restructuring needs to take cognizance of the fact that policy in the areas of industrial exit and financial sector independence were long ago recognized as problematic in Korea (see Box A). It is in that context that the summary assessment of public policy contained in Table 6 needs to be viewed.

Box A: Not all Legacies are Positive: The Pre-Crisis Situation in a Nutshell

"Putting this another way, we favor giving conglomerates full responsibility for their futures, but only subject to transparent and rigorously enforced rules. We favor independence for banks, but also subject to regulations that insure safety through adequate capital and supervision. Adopting this approach would represent a radical departure from Korea's past policies. It would require the strengthening of independent regulatory institutions, such as the Bank of Korea (BOK), Korean Fair Trade Commission (KFTC), and the Office of Bank Supervision and Examination, as well as the creation of new ones, such as Bank Examination Offices for nonbank financial institutions (NBFIs) and government banks." p. 20

"The best way to address this dilemma is to relax direct financial controls on the chaebol, and to shift the job of controlling the chaebol to independent regulatory bodies, and to greater private-sector competition in both the financial and industrial sectors of the economy. This "new compact" would give the chaebol more freedom in raising and spending money, both at home and abroad. At the same time, it would subject them to stricter regulation and greater competition. The end result would be checks on chaebol behavior administered by private institutions and markets instead of government. This would free the government to pursue broader micro- and macroeconomic objectives." p 23

"There are, of course, many different models for organizing the relationship between "banks" and "industry"; but in each of the advanced countries there is substantial, independent decision-making authority vested in financial institutions. A weak financial sector may have suited Korean policymakers in the past, because it permitted government to pursue an active industrial policy. It is now a liability, which undermines the country's resource-allocation process." p 24

"The key to eliminating the need for these interventions is to make the financial sector independent. In a private financial system, effectively regulated and supervised, firms would have clear financial incentives to issue equity, to pursue promising business ventures, and to abstain from high-risk investments. One argument that is frequently used against the full privatization of the banks is that they would be controlled by the chaebol themselves. According to the Office of Bank Supervision and Examination, the top 10 conglomerates officially own about 20 percent of the top six commercial banks. As Table 19.10 shows, the role of large shareholders is even greater in nonbank financial institutions (NBFIs). Conglomerates also increased the number of NBFIs they owned—the top 10 owned 31 NBFIs in 1989—because the credit obtained from them is not subject to the same credit controls as normal bank credit." p 24

"The supervision of commercial banks in Korea is the responsibility of the Office of Bank Supervision and Examination, an agency affiliated closely with the BOK. The NBFi sector, which now intermediates 60 percent of financial savings, is regulated by the Ministry of Finance. In most developed countries, bank supervisory agencies are independent and subject to transparent reporting requirements. To be sure, regulatory independence is not always sufficient for proper oversight, as is so evident in the case of the U.S. savings and loan crisis. But it is also true, as demonstrated by the recent financial scandals in Japan, that ministries of finance have too many other conflicting goals to operate effectively as an overseeing body. A separation of the regulatory/supervisory functions from government business and political influence is a necessary, although not sufficient, requirement for effective supervision." p 27

"Supervision is made difficult in Korea by the widespread practice of cross-corporate guarantees. Affiliated of the chaebol endorse each other's liabilities, so that the distinction between active and contingent liabilities is blurred. BOK data submitted to the National Assembly suggest that conglomerates in Korea have offered payment guarantees on liabilities equal to at least three times their net worth by a factor of 3.7. Banks are not able to say with clarity what capital is being pledged as collateral for a given liability. Overall lending by conglomerates is not tallied in a way that makes it possible to assess the risks facing a bank's portfolio. This problem is exacerbated by the blurred line between personal borrowing by chaebol owners and corporate borrowing, weak corporate disclosure requirements, and generally weak coordination among regulatory agencies." p 27

Source: Leipziger and Petri (1993)

The main conclusions that we draw are: i) the importance of sustainable corporate restructuring, both for the long-term viability of the Korean industrial sector but also for the long-term financial health of the banks; ii) the need to improve corporate governance and protect the public interest, which will require a further re-mooring of the roles of the corporation, the shareholders, the regulators, and the government; and finally iii) the importance of dealing with the forgotten issue in Korea, namely, the respective roles of the taxpayer and the owners of the chaebol.

In the latter regard, if we take as a given, as Cho (1999) does, that the total equity of the corporate sector is roughly 200 trillion won and that leverage for the sector is still 4:1, we realize that the health of the financial sector is still at considerable risk. In current global circumstances, and for the next millennium, all efforts should be made to reduce vulnerability. In the absence of massive foreign capital infusions, the path towards lower leverage is to increase capital. The household sector may be induced in time, if corporate governance reforms are successful, to be the source of such capital. To begin this process, however, and given the regulatory weaknesses surrounding capital markets, a model of a national mutual fund is worth considering.

Put rather simply, the Korean taxpayer will have to buy government bonds in future to help pay for the current spate of bankruptcies. Given the traditionally low rate of interest, the returns to the taxpayer will be modest. The corporate sector stands to gain the most. Rather than only share the downside risk, the citizens should share in the upside rebound of the corporates through greater shareholder ownership. At present the household sector owns only 39% of corporates, with the bulk, almost 50% owned by other corporates, banks and NBFIs. Certainly those holdings are highly concentrated as well. A more

Table 6. Korea's Public Policies

| Area of Government Action | Comparison with average Global Standard |
|-------------------------------------------------------------------|-----------------------------------------|
| Banks Restructuring | |
| Bank closures | rapid |
| Bank recapitalization | rapid |
| Bank labor force downsizing | rapid |
| Supervision changes | improvement* |
| Write-down of NPLs | slower |
| Reprivatization | slower |
| Asset disposition | average |
| Management improvements | unclear |
| Corporate Restructuring | |
| Closures/receiverships | rapid |
| Corporate Restructuring Agreements | average |
| Corporate Structure Improvement Plans for Top 5 | below average to average |
| Long-term sustainability of CSIPs | below average |
| Role of Lead banks | average |
| Corporate governance reforms | incipient but below average |
| Accounting changes, cross guarantees, consolidated balance sheets | incipient but below average |
| Openness to foreign equity | Improved but still below average |

Note: *excluding NBFIs

broadly owned Trust akin to a National Mutual Fund would be worth examining. That trust should appoint independent managers whose job it is to maximize shareholder value. My guess is that corporate decision-making would be considerably different under these circumstances. The trust can be set up with explicit rules as to privatization objectives and uses of net equity in future. Clearly this would need to be handled in a non-partisan manner as befits the past sacrifices of the Korean people.

As I have argued elsewhere (Leipziger, 1998), the burden on the Korean taxpayer has been enormous and will continue to be large in future. World Bank estimates show an 18% of GDP fiscal cost being borne in 1998 and additional incremental costs of sizeable proportions in outer years, just how large depending obviously on the servicing of the still massive chaebol debt to the publicly owned banks. Whatever estimates are used, it is clear that the real owners of the chaebol are now not the family-owners, not the banks, but the taxpayers who implicitly recapitalized those banks. Therefore, the outcome that is favored here is the establishment of a national trust to exercise the shareholder rights of the citizens who really own the chaebol.¹

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¹Another practical alternative that emerges is for the creditor banks to engage in debt for equity swaps, as is now envisaged on a massive scale for Daewoo. It is reported that creditors will accept \$20 billion in convertible bonds and \$5 billion in debt for equity conversions. Without going into the details, the lead banks could end up officially owning Daewoo, exercising ownership rights over management, and ultimately (if Daewoo recovers), they could more easily repay the subordinated debt owed the government. Of course these are one-off deals and do not cover the cost of reschedulings that occurred without ownership transfers.

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