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Bank Restructuring in Asia: Crisis management in the aftermath of the Asian financial crisis and prospects for crisis prevention -Korea-

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Crisis management in the aftermath of the Asian financial crisis and prospects for crisis prevention

-Korea-

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Abstract

This paper analyzes the Korean bank restructuring process that started in the wake of its currency crisis of 1997. Korea suffered a heavy currency crisis that was accompanied, if not caused, by acute shortage of dollar liquidity of Korean banks. The currency crisis was essentially banking crisis.

This paper covers topics such as the scheme of capital injection to weak banks, nationalization of insolvent institutions, and setting up a strong financial restructuring agency. Structural problem as well as liquidity problem in banks' balance sheets became serious as the currency crisis deepened. On April 14, 1998, the Government announced the basic restructuring framework aiming to stabilize financial markets. The government's restructuring framework included capital injection to financial institutions, mergers and/or closing down of banks, and asset sales. Regulatory institutions, such as the Korea Asset Management Corporation (KAMCO), the Korea Deposit Insurance Corporation (KDIC) and Financial Supervisory Commission (FSC) were also reorganized or newly created around 1997 and 1998.

Bank restructuring in Korea, after all, in the aftermath of the Asian currency crisis is almost over. The focus of government-led bank restructuring is now shifted to create market-oriented reform, to ensure peace-time operation, and to strengthen Korean banks so that Korea will no longer have financial crisis. It should be pointed out that decisive actions with massive public funds to restructure the financial sector in crisis are important for a strong recovery possible in the medium term.

1. Introduction

This paper analyzes the Korean bank restructuring process that started in the wake of its currency crisis of 1997. Korea suffered a heavy currency crisis that was accompanied, if not caused, by acute shortage of dollar liquidity of Korean banks. The currency crisis was essentially banking crisis. In the wake of the currency crisis, the economy suffered a severe recession, and loan quality quickly deteriorated, making it necessary for the government to carry out a radical restructuring of the banking sector. This paper covers topics such as the scheme of capital injection to weak banks, nationalization of insolvent institutions, and setting up a strong financial restructuring agency. Although Korean bank restructuring was not easy and certainly costly from a macroeconomic point of view, the crisis was basically over by 2002.[1] The banking sector with the fewer institutions is on its way to recovery, as the economy as a whole is also making a strong recovery. In anticipation of concluding remarks, decisive actions with massive public funds to restructure the financial sector in crisis will make a strong recovery possible in the medium term.[2]

Prior to the crisis, Korea was anticipated to have a well-functioning banking system that channeled ample domestic saving into investment that was carried out by chaebols, large conglomerates.[3] By any measure, Korea's economic performance had been impressive prior to the Asian currency crisis. After achieving high economic growth for decades, Korea has become one of

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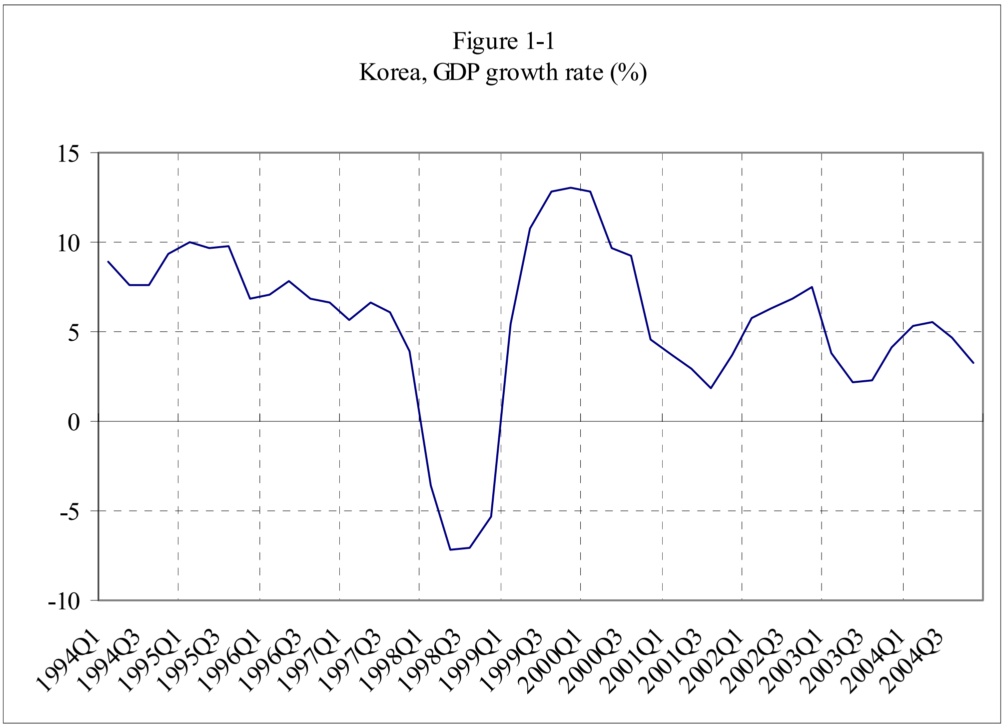
[1] Based on 160 previous episodes of currency crises from 1970 to 1995, Park and Lee (2002) find that a V-shaped recovery of real GDP growth following a crisis was not unique to the East Asian Countries, although the East Asia experienced a far sharper contraction and recovery. This fact attributed to more severe liquidity crises and weaker corporate and bank balance sheets.

[2] As described in Haggard (2001), the evidence from East Asia suggests that adopting a temporary top-down style supervisory body was necessary because corporations and banks moved slowly to restructure outstanding debt, in the hope that economic recovery would obviate the need for write-offs for bank or the surrender of equity control. However, few firms were prematurely liquidated, in part because a working bankruptcy regime was often not in place.

[3] The financial condition at the onset of crisis, the recurring pattern of corporate problems and restructuring of chaebols during the crisis period are documented in, for example, Krueger and Yoo (2002) and Mako (2002).

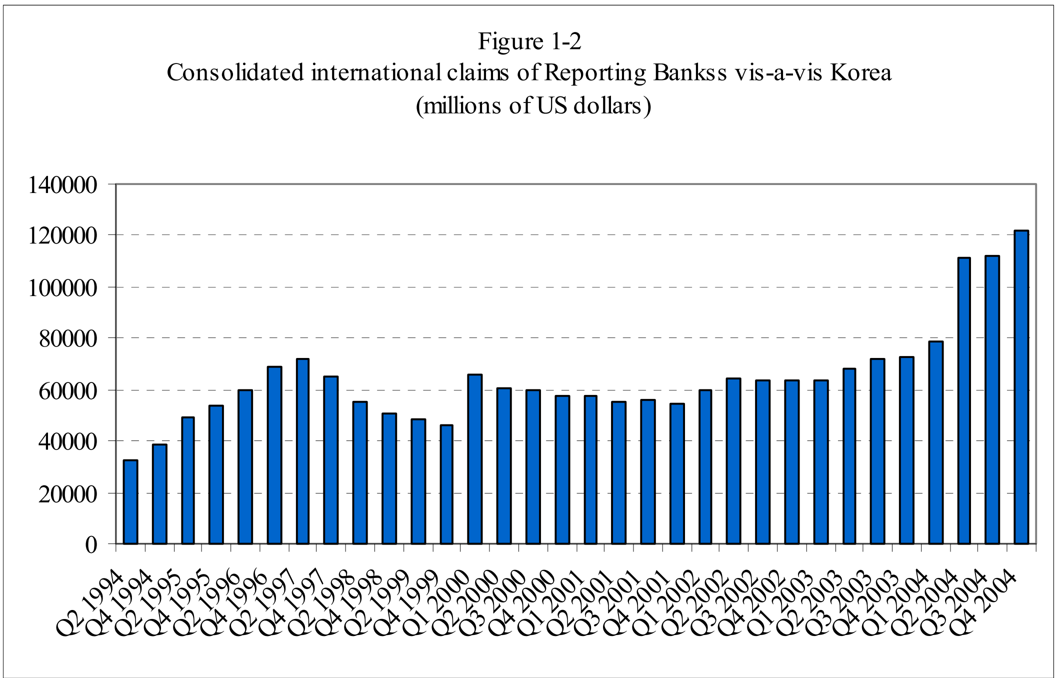
the leading industrial countries by mid-1990s. As shown in the figure below, the GDP growth rate was above 6% for decades until the end of 1996. In December 1996, Korea became the second Asian member of the Organization for Economic Cooperation and Development (OECD).

Immediately after the floatation of the Thai baht in July 1997, the Korean economy was not significantly affected. The depreciation of the Won up to mid-October was rather limited. No warning from the IMF or the World Bank was issued. There was complacency among international organizations as well as officials in Seoul that the country would recover from the currency crisis which had overwhelmed Thailand, Malaysia and Indonesia.



However, the crisis spread to Korea suddenly. The won began to fall in late October 1997, when Kia, one of the three major automakers belonging to one of the largest chaebols, went bankrupt. The economy as a whole rapidly deteriorated and the depreciation of the currencies accelerated in November

1997.[4] As foreign banks started refusing rollover of loans to Korean banks, the liquidity of bank loans in Korea quickly depleted, which induced further depreciation of the Won. Eventually, Korea needed the IMF assistance to avoid default of commercial banks obligations.[5] The overview of the Korean economy and a detailed survey of the Korean bank's debt restructuring process in early 1998 are shown in, for example, Sung (1998), Yoon (1999) and Coe and Kim (2002).



Even before the crisis, the non-performing assets in the banking sector had become increasingly conspicuous as corporate insolvency increased. As of September 1997, the commercial banks' non-performing loans (NPLs) amounted to W28.5 trillion, or 6.3 percent of all outstanding loans. For

[4] Declining inventories was found to play an important role in Korea's GDP reduction. See, for example, Claessens, Djankov and Klingebiel (2001) and Barro (2002).

[5] On November 21 1997, the Government formally requested the IMF for financial assistance. The authorities and IMF agreed on December 3, 1997 on a program amounting to $57 billion: $21 billion from the IMF, $10 billion from the World Bank, $4 billion from the Asian Development Bank, and the rest from bilateral loans. The IMF Board approved the program on December 4, 1997.

example, Krueger and Yoo (2002) address the role of the chaebols in the Korean crisis and find that the corporate sector's profitability fell to very low levels in the 1990s. Despite the deterioration, banks continued to roll over the chaebol's outstanding debt.

When the won sharply depreciated in November and December, many banks and corporations suffered from the balance sheet deterioration. Foreign currency denominated liabilities suddenly became unbearably large. Although the won recovered from the trough at the end of December, it never reached the level before the crisis. Structural problem as well as liquidity problem in banks' balance sheets became serious.[6] By the spring of 1998, it became increasingly clear that Korean industrial companies as well as banks needed restructuring. Structural reforms were planned in consultation with the International Monetary Fund, as Korea had become under the IMF program in December 1998.

On April 14, 1998, the Government announced the basic restructuring framework aiming to stabilize financial markets through swift reform and provide sufficient fiscal support and to enhance the efficiency and transparency in the banking sector.[7] Several strong measures were implemented quickly, mostly in conjunction with the IMF program.

A new regulatory framework to supervise the financial sector had to be created.[8] The Korea Asset Management Corporation (KAMCO), which had existed before the crisis, had to be reorganized and given several new

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[6] As of the end of March 1998, total NPLs of all financial institutions amounted to W112 trillion, consisting of W87 trillion of banks and W25 trillion for non-banks. This amount was estimated at about 20 percent of financial institutions' total assets, implying that non-performing assets could approximately be more than quarter of the 1997 GDP of W421 trillion.

[7] The bank recapitalization strategies and financial distress resolutions of four East Asian countries are summarized in Claessens, Djankov and Klingebiel (2001).

[8] A variety of approaches exist with respect to government assumption of financial losses in the banking system. These included direct injection of capital of subordinated debt, provision of loss-sharing arrangements on some pool of assets, grants of government loans, etc. the advantages and disadvantages of these approaches are summarized in, for example, Klingebiel (2001).

mandates, such as to purchase and dispose of NPLs from financial sector.[9] The Korea Deposit Insurance Corporation (KDIC) and Financial Supervisory Commission (FSC) were created. The KDIC was created to work out for provision of financial assistance in 1997, in addition to its primary role of protection of depositors. The FSC was established in 1998 as the single financial regulator in Korea. The restructuring plan for strengthening banking institutions was accompanied by fiscal support from the government as well.

It should be noted that there was a heavy government involvement, with large fiscal expenditures, in the process of banking system restructuring. Public funds were injected to financial institutions for their recapitalization and for purchasing the NPLs. Fiscal assistance was also provided to acquire banks. In order to raise the BIS capital ratio of financial institutions that were regarded as "viable", the government gave financial support. Furthermore, Korea First Bank and Seoulbank was nationalized on January 31, 1998 and Hanvit Bank became a *de facto* state-owned bank in early 1999.

With strong government actions, the total amount of NPLs has been declining and the NPL ratio has substantially declined since 1998. The total NPLs in the financial sector have been reduced by half. It decreased from W60.2 trillion at the end of 1998 to W31.3 trillion at the end of 2001. The overall NPL ratio for financial sector also declined significantly from 10.4% as of December 1998 to 4.9% as of December 2001. The resolution progress of NPLs among banks has been successful so far.

The number of critically ailing banks and other financial institutions posed a major obstacle for restructuring of the banking sector. In tandem with work on NPLs resolution, closures and mergers of financial institutions have been pursued. The total number of financial institutions (commercial banks, specialized banks and merchant banks) reduced from 63 as of December 1997

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[9] Recently, countries have increasingly used publicly owned Asset management Companies (AMC). The AMCs are classified into two types. The first type was to help and expedite corporate restructuring, whereas the second type was to dispose of assets acquired or transferred to the government during the crisis. The latter is known as rapid asset disposition vehicles. See, for example, Klingebiel (2001).

to 32 as of December 2000, and further down to 21 as of December 2004. The merger program for banks and financial institutions initiated in 1998 was, to some extent, successful in bringing down the total number of financial institutions. However, the number of financial institutions in Korea was still excessive.

Although most of the bank restructuring problem has been worked out and the worst is clearly over, some challenges remain. Among the non-bank sector, the total NPLs did not improve significantly.[10] Many merchant banks were closed, and the NPLs among remaining merchant banks have rather increased. Among the smaller financial institutions, NPLs are still a concern: the current NPLs might become long-term NPLs and new NPLs may develop in the near future.

Now large Korean banks have been merged, and some foreign-owned institutions are gaining market share. On the other hand, corporate demand for bank loans has been lower as corporate restructuring reduced the number of large companies in each industry. Lending to households has increased sharply in recent years, and credit quality may be questioned when the next downturn comes.

The rest of this paper is organized as follows. Section 2 describes institutional details of the banking sector in the historical perspective. Section 3 reviews the resolution of non-performing loans in banking sector. Section 4 summarizes the consolidation process of financial institutions through mergers and closures. Section 5 describes the fiscal support for restructuring of banking system through various measures. From Section 6 to Section 8, the creation and reorganization of financial supervisory bodies and their functions are presented. Section 9 concludes this paper.

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[10] The NPL ratio in non-bank sector still exceeded 20% as of end-2000.

2. Banking Institutions

The Korean financial institutions are categorized into three groups: (1) Deposit-taking money banks (Bank), including commercial and specialized banks, (2) Non-Bank banks, including merchant banks, Mutual Savings, Lease Companies, and Credit Unions, and (3) Non-bank financial institutions including development, savings, investment, insurance, and other institutions.

Banks (deposit-taking money banks) are sub-divided into commercial banks and specialized banks. Commercial banks may be (1) nationwide banks, (2) regional banks, or (3) branches of foreign banks. Commercial banks engage in conventional commercial banking business, including deposit-taking, commercial lending, and payments and settlements, and also handling securities businesses subject to certain limitation. They also deal with trust and credit card businesses. However, commercial banks are banned from insurance business. Nationwide banks hold the largest assets among commercial banks and their major funding sources are bank deposits. As of the end of 2004, there were 8 nationwide commercial banks and 5 regional banks. Regional banks were authorized to operate principally within their own provinces.

Figure 2-1
Total Loans & Discounts, Deposit monetary banks (Commercial Banks), trillion won
1994Q1-2005Q1

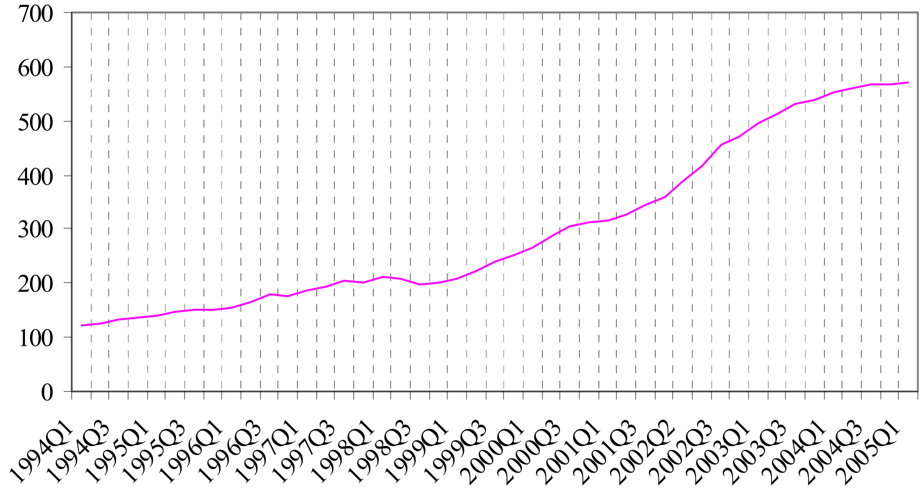
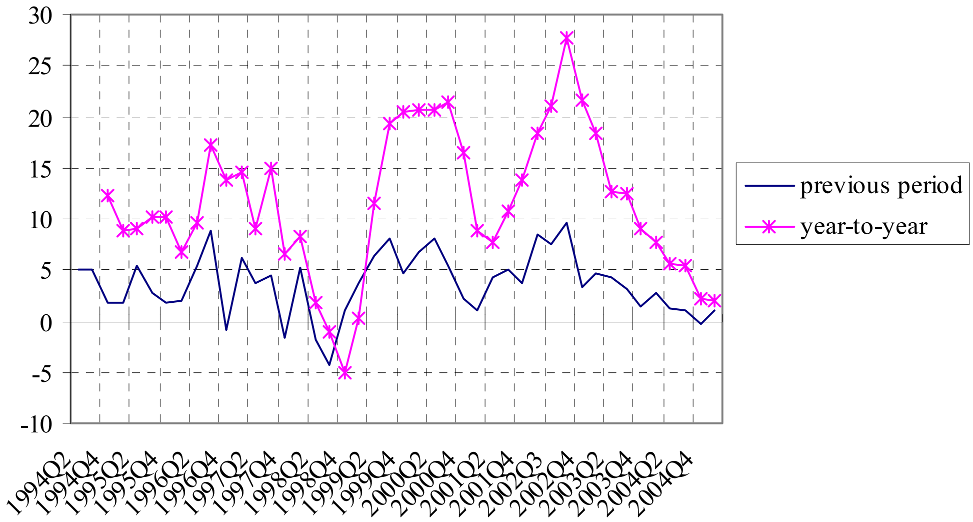


Figure 2-2
Total Loans & Discount, Deposit Monetary Banks
Rate of Change(1994Q1-2005Q1)

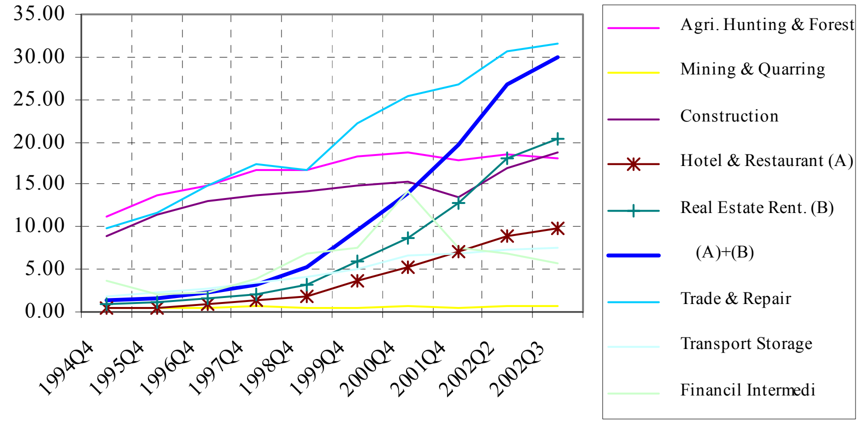


The figures above show the time series of bank loans outstanding and its rate of change from 1994 Q1 to 2002 Q3. The figures show a steady growth of bank loans throughout this period with notable exception in 1998. The rate of loan growth was about 10% on a yearly basis. The banks increased new lending just before the crisis (the rate of loan growth was 17.2%, 13.9%, and 14.6% in 1996 Q3, 1996 Q4, and 1997 Q1, respectively), compared to the previous two years of 10% on average.

It is also remarkable that bank loan growth rates became really high, exceeding 20% in 1999-2000. This loan growth showed the strong recovery of the banking sector and corporate loan demand in the recovery process from the crisis.

The next table and figure show the loans extended to business sectors. Most of the lending went to manufacturing and agricultural sectors. Although the share of lending to hotel and restaurant and real estate sectors was small, their growth rates were quite high. Lending share of these two sectors were about 1 percent of loans in 1994, but grew to 1.5% by 1996. However, the most dramatic increase came after the crisis. The share became 7% by 2002.

Figure 2-3
Loans by Business Sector (trillion of Won)



Before the crisis, financial institutions increased their lending to hotels & restaurants and real estate rent (bubble-related) sectors. The average loan growth of all sectors at the end of 1995 and 1996 were 12.24% and 16.20%, respectively. In contrast, the growth of loans to hotels & restaurants increased from 10.9% at the end of 1995 to 52.6% at the end of 1996, and the growth of loans to real estate sector increased from 21.3% at the end of 1995 to 41.6% at the end of 1996. The average growth of loans to these two bubble-related sectors increased from 17.5% to 45.4%.

However, it is premature to conclude that lending to real estate and property loans before the crisis became a problem for banks. The share in total lending still remained very small, despite a fast growth. The increase after the crisis was even higher compared to the pre-crisis period. Therefore, pre-crisis lending boom did not seem to be a bubble, since there was no burst.

Table 2-1: Loans by Business Sector (Deposit Money Banks) (trillion of Won)

	1994Q4	1995Q4	1996Q4	1997Q4	1998Q4	1999Q4	2000Q4	2001Q4	2002Q2	2002Q3
Agri. Hunting & Forest	11.15	13.68	14.94	16.69	16.70	18.38	18.82	17.78	18.53	18.14
Mining & Quarring	0.36	0.43	0.42	0.57	0.52	0.55	0.64	0.53	0.61	0.72
Manufacturing	57.13	62.39	69.47	74.29	70.69	79.82	89.72	88.05	94.45	95.95
Construction	8.90	11.40	13.07	13.77	14.16	14.81	15.25	13.52	16.97	18.71
Hotel & Restaurant (A)	0.51	0.57	0.87	1.35	1.92	3.69	5.28	7.00	8.86	9.78
Real Estate Rent. (B)	0.89	1.08	1.53	1.96	3.26	6.01	8.74	12.76	18.01	20.26
(A)+(B)	1.40	1.65	2.40	3.31	5.19	9.70	14.02	19.75	26.88	30.04
Trade & Repair	9.78	11.59	14.77	17.34	16.70	22.15	25.28	26.80	30.55	31.67
Transport Storage	1.86	2.24	2.73	3.48	4.09	5.09	6.67	6.82	7.32	7.47
Financil Intermedi	3.66	2.13	2.23	3.86	6.75	7.63	14.17	7.56	6.88	5.77
Households	36.56	41.45	50.19	58.53	55.52	79.13	108.95	157.61	193.19	210.16
Total Loans & Discount	135.85	152.48	177.18	200.40	200.29	250.24	310.80	357.38	416.93	441.17

Source: Bank of Korea.

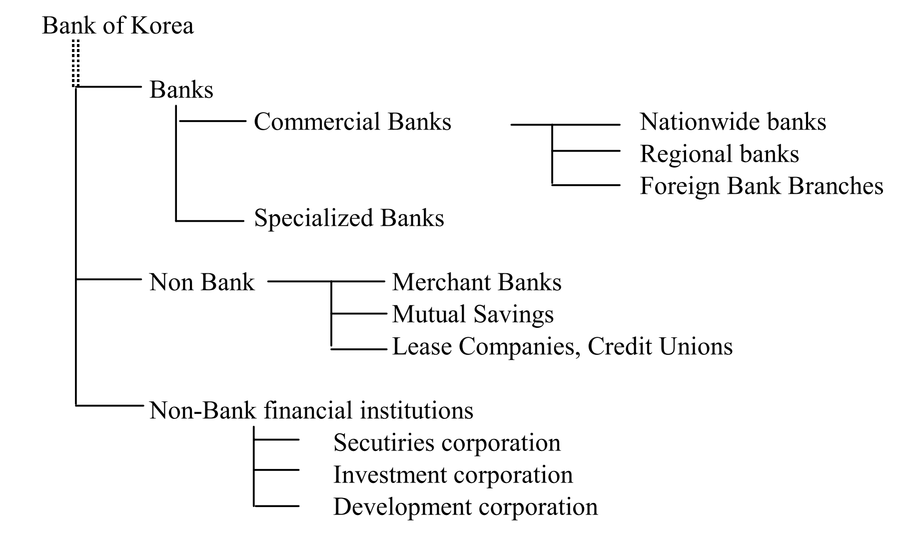
Table 2-2: Loan Yearly Growth Rate by Business Sector (Deposit Money Banks), %

	1995Q4	1996Q4	1997Q4	1998Q4	1999Q4	2000Q4	2001Q4
Hotel & Restaurant (A)	10.89	52.58	55.13	42.73	91.81	43.14	32.51
Real Estate Rent. (B)	21.29	41.61	28.42	66.17	84.17	45.44	45.97
(A)+(B)	17.49	45.40	38.10	56.63	87.01	44.56	40.90
Total Loans & Discount	12.24	16.20	13.10	-0.06	24.94	24.20	14.99

Source: Bank of Korea.

Specialized banks finance small- and medium-sized enterprises as policy finance. They are principally established as a vehicle of the government to control the flow of funds to specific sectors to carry out its industrial policy. They also engage in commercial banking activities. As of December 2004, there were five specialized banks: Korea Development Bank, Industrial Bank of Korea, Export-Import Bank of Korea, National Agricultural Cooperatives. Federation, National Federation of Fisheries. Among these specialized banks, the Korea Development Bank and Export-Import Bank of Korea engage in similar activities. They provide medium- and long-term loans/ credit to sectors such as the export industry and high-technology (R &D) projects.

Figrue 2-4: Banking System in Korea



Non-bank banks includes Merchant banks, Mutual Savings and Lease companies and Credit unions. These institutions work as financial intermediaries in the money and capital markets. Merchant banks in Korea have similar functions to those of merchant banks in Britain and investment banks in the United States. Merchant banks chiefly raise funds through the issuance of their own paper, cash management accounts (CMAs), and borrowing. Merchant banks use their funds in the form of purchasing securities, making loans, and leasing assets. They do not deal with payment settlement, stock brokerage, insurance, and household lending. Merchant banks were originally launched in the form of joint ventures with foreign financial institutions, in order to support the inducement of foreign capital to the private sector and offer comprehensive financial services.

The number of merchant banks increased sharply from 1993 to 1997. A number of investment and finance companies, categorized in Nonbank Financial institutions and specialized in short-term financing business such as the discount and sale of commercial paper and cash management accounts (CMAs), was converted into merchant banking corporations. The background of this conversion from Nonbank financial institutions to Merchant banks reflected the fact that the demand for CMAs in non-bank financial institutions declined sharply due to the financial liberalization; these institutions were re-categorized as merchant banks and encouraged to do new businesses. The merchant banks extended lending to various sizes from very small firms to large government guaranteed companies. However, lending was over-extended without risk management, and quality of loan portfolio quickly damaged. Due to deteriorated balance sheets, the merchant banks were already in trouble by the summer of 1997. In the early stages of the crisis, this was the category of institutions that were identified as the weakest institutions. A large number of merchant banks were liquidated following the outbreak of the currency and financial crisis in 1997-1998.

Table2-3: Number of Merchant banks (at the end of reporting year)

	1985	1990	1995	1997	2000	2001	2002	2003	2004
existing companies	6	6	6	6	7	3	3	2	2
Converted compaies*	-	-	9	24	3	1	-	-	-

source: Financial Systems in Korea, Bank of Korea.

*: Merchant banks converted from investment and finance companies.

Non-bank financial institutions include securities, development, savings, investment, insurance and other institutions. These institutions function as supplementary financial institutions, but do not act as financial intermediaries.

The banking system was the main funding sources for business and firms in the 1960s and 1970s. In the early 1970s, the Government established various NBFIs (Non-bank financial institutions) and developed the securities market to diversify the sources of investment funds. NBFIs have grown rapidly owing to their higher interest rates and greater degree of managerial autonomy. As a result, the banking sector's share of deposits decreased from 51 percent in 1975 to about 20 percent in 1997, while that of non-bank increased sharply.

The banking sector also suffered due to inefficient internal management. The Government-led growth strategy and Government intervention in the financial sector prevented the development of market discipline and caused moral hazard. Investors perceived that commercial and merchant banks have long operated under the implicit Government guarantee that the Government would not allow the banks to fail, although it is not legally codified. Extensive Government involvement in the internal management of financial institutions has undermined their accountability. Its ineffective supervisory system allowed excessive risk taking by financial institutions. In the absence of proper prudential supervision, the domestic financial institutions borrowed more funds abroad and invested in riskier projects. Selective credit allocation and prolonged interest control by the government also resulted in an inefficient and distorted financial system.[11] The financial system as a whole was inadequate by international standards.

In sum, the financial sectors had transformed from a strictly regulated system to a more liberalized system. However, liberalization took place in the form of growing non-bank sectors, especially, merchant banks and non-bank financial

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[11] Barth, Cario and Levine (2001) show that, from their empirical results, the tighter the restrictions placed on the bank activity, on average, the more inefficient banks are and the grater the likelihood of a banking crisis is.

institutions. The growth in non-bank sectors took place without sufficient supervision and prudential regulation.

To some extent, the transformation of the financial sector after the crisis was necessary to correct the overextension of bank loans before the crisis. Liberalization of merchant banking before the crisis seems to be carried out without much prudential regulation.

3. Resolution of Non-Performing Loans (NPLs)

Even before the Thai currency crisis, the financial system in Korea had shown hint of stress in its system. Some of the conglomerates were already in a financially difficult condition even before the Korean crisis erupted in October 1997.[12]

Since no bank failed in the past, implicit government guarantee on deposits and other liabilities of financial institutions were believed to be in place.

Non-performing loans (NPLs) among non-bank financial institutions amounted to W28.5 trillion as of September 1997, or 6.3 percent of all outstanding loans. Merchant banks held W3.9 trillion of bad loans as of October 1997, or 2.9 percent of all outstanding loans. Commercial banks suffered from bankruptcies of borrowers, and NPL amounted to 5.8 percent of total loans by December 1997, compared with 3.9 percent in December 1996. By the end of 1997, commercial banks held 82.5 percent of all NPLs among banks, and 78 percent among financial institutions, making them highly vulnerable to the financial

[12] In January 1997, Hambo Steel, the 14th–largest Korean chaebol (Korean industry conglomerate), collapsed, leaving US$6 billion in debts, followed by the filing for court protection by seven of the thirty largest chaebol. On April 14, the Jinro Group, the country's largest liquor distiller and 19th-largest cheabol, was nearly $3.5 billion in debt and needed a bank bailout to stay solvent. On July 19, 1997, Daewoo, one of Korea's biggest conglomerates, narrowly avoided bankruptcy by pledging $8.6 billion in assets to persuade lenders to roll over debts it could not pay. The chaebol were running up huge debts. The difficulties in manufacturing sectors of large conglomerates spilled over to banks. At this stage, the Korean banking crisis is different from banking crises in Thailand and Japan, where asset inflation and deflation caused the major difficulties to the banking sector.

crisis. Moreover, only two of 12 commercial banks had satisfied the required 8 percent capital adequacy ratio (CAR).

<NPL classification>

In calculating NPLs, classification of loan portfolio is a crucial problem. Korea had adopted a tightened loan classification standard effective on July 1, 1998 in line with international standards. Loans in arrears for three months or more are now classified as substandard or lower, and loans in arrears for one to three months are classified as precautionary.

Table 3-1: Loan Classification

Period of Overdue Payment	Up to June 30 1998	After July 1 1998
1-3 months	Normal	Precautionary
3-6 months	Precautionary	Substandard/Doutful
Longer than 6 months	Substandard/Doutful	Substandard/Doutful

<NPLs in Banks>

Expressed as a percentage of total loans, NPLs for the commercial banks rose from 3.9% as of the end of 1996 to 5.8% at the end of 1997. The NPL ratio further increased to 7.1% at the end of 1998. The total NPLs for commercial banks were W22.4 trillion and W11.4 trillion for specialized banks in December 1998.[13]

In March 1998, the NPL ratio was 8.0% and 7.3% for commercial banks and specialized banks, respectively, and the average NPL ratio for banks was 7.8%. The increase in the NPL ratio was most significant in the case of commercial banks: the NPL ratio had risen from 5.8% as of December 1997 to 7.8% as of March 2000. The NPL ratio of the specialized banks remained relatively stable and decreased a little from 8.0% at the end of 1998 to 7.3% March 2000. The NPL ratio was at its peak in early 2000.

[13] The size of publicly announced NPLs of banking sector was said to be underestimated. The actual size was reported to exceed 30% by Ernest & young's estimation.

Table 3-2: NPLs of Commercial Banks (at the end of year) (in trillion won)

	1994	1995	1996	1997	1998	Mar 2000	2000	2001	2003
Total NPLs	11.7	12.5	12.2	21.3	22.4	27.2	23.8	10.9	12.2
NPL ratio(%)	5.6	5.2	3.9	5.8	7.1	8.0	6.6	2.9	2.6

Source: Financial Supervisory Commission, Press Release, various issues.

Table 3-3: Non-performing Loans of Banks (trillion won)

	Sep 1998	Dec 1998	March 2000	June 2000	Dec 2000	March 2001	June 2001	Dec 2001	Dec 2002	Sept 2003
Commercial Banks	22.4	22.2	27.2	26.7	23.8	19.5	15	10.9	11.3	12.2
Specialized Banks	12.6	11.4	10.6	8.5	5.7	5.9	5.9	4.6	3.8	4.4
Total	35.0	33.6	37.8	35.2	29.5	25.4	20.9	15.5	15.1	16.6

Source: Financial Supervisory Commission, Press Release, various issues.

The NPLs of the banks peaked in early 2000 and then declined toward the end of the year. The NPLs for commercial banks were W27.2 trillion and W10.6 trillion for specialized banks as of March 2000. The NPLs of commercial banks and specialized banks were W23.8 trillion and W5.7 trillion, respectively, as of December 2000. The NPL ratio of banks significantly declined from 7.8% as of March 2000 to 5.6% as of December 2000: 6.6% for commercial banks because KAMCO bought up NPLs from commercial banks. The NPLs resolution was further enhanced during 2001. The total NPLs of banks were W15.5 trillion as of December 2001 but the level slightly increased to W17.3 trillion at the end of 2003. The NPLs of commercial banks reduced W12.9 trillion from the previous year and dropped to W10.9 trillion at the end of 2001, but again, it increased to W12.9 trillion at the end of 2003. The NPLs for specialized banks were W4.6 trillion at the end of 2001 and W4.4 at the end of 2003. Overall, the NPL ratio also declined in banks. As of end of 2003, the NPL ratio was 2.6% for commercial banks and 2.1% for specialized banks. The average NPL ratio of banks, 2.4% at the end of 2003, was even lower than the 1996 level of 3.9% for commercial banks.

<NPLs in non-banks and other financial institutions>

In terms of the NPLs performance of different financial institutions, both non-banks and insurance and securities companies were found to experience a significant increase in their total NPLs and the NPL ratio from 1998 to 2000. The NPL ratio for Non-banks was 24.3% at the end of 1998 and rose to 31.8% in March 2000. The NPL ratio was at its peak of 32.9% for non-banks at the end of 2000.

The total NPLs in non-banks have declined since 1998: NPLs decreased from W21.2 trillion at the end of 1998 to W14.2 trillion at the end of 2000. While the total NPLs in non-banks declined by W7 trillion from the end of 1998 to 2000, the NPL ratio had increased by 8.6%: This was largely due to the fact that the total outstanding loan of non-banks has declined dramatically since 1998, in reflection of the financial and banking crises whereas the resolution of NPLs was rather slow.

The total NPLs and the NPL ratio for non-banks declined to W9.1 trillion and 23.3%, respectively, at the end of 2001. Although both NPLs and the NPL ratio had decreased during 2000 for the non-bank sector, the progress of NPL resolution varied among financial institutions. While the level of NPLs and the NPL ratio had substantially declined in Mutual Savings, Lease Companies, and Credit Unions, the NPL resolution did not show improvement for Merchant banks. Total NPLs in Merchant banks increased from W0.8 trillion at the end of 2000 to W0.9 trillion at the end of 2001. The NPL ratio rose by 8.1% during the course of 2001.

Table 3-4: Non-performing Loans of Non-Banks

(trillion won)

	Sep 1998	Dec 1998	March 2000	June 2000	Dec 2000	Dec 2001
Non-perforning loans	29.0	26.6	16.8	16.2	14.2	9.1
Ratio (%)*	19.0	20.0	31.8	32.7	32.9	23.3

source: Financial Supervisory Commission, Press Release, various issues.
* NPLs to total outstanding loans.

With regard to resolution of NPLs of securities companies, the progress remained slow. The NPL ratio was 46.6% as of the end of 1998 and 52.6% as of the end of 2000. The NPL ratio rose by 6% point in 1999 and 2000. The level of NPL ratio remained relatively the same at the end of 2001, 51.7%, compared with the level at the end of 2000, 52.6%. The total NPLs increased from W3.4 trillion in December 1998 to W4.6 trillion in December 2001.

Table 3-5: NPLs of Non-Bank Financial Institutions

(trillions of won)

	1998	2000	2001
Insurance companies	2.0	2.5	2.1
(ratio, %)	5.2	5.6	4.6
Securities and ITMCs	3.4	4.0	4.6
(ratio, %)	46.6	52.6	51.7

As of the end of reporting year.
source: Financial Supervisory Commission, Press Release, various issues.

<Summary>

On the surface, both the amount of total NPLs and the NPL ratio in financial sector have substantially declined since 1999. The total NPLs in the financial sector decreased by half; that is, from W66.7 trillion at the end of 1999 to W31.3 trillion at the end of 2001. The overall NPL ratio for financial sector also significantly declined from 11.3% as of December 1999 to 4.9% as of December 2001. Among them, the total NPLs (NPL ratio) in banks showed a substantial decline: Despite a swing back of the total NPLs as well as NPL ratio in 2003, the total NPL ratio of banks declined to 2.4% as of December 2003. The resolution process of NPLs in banks was successful.

Despite several measures undertaken for restructuring of NPLs after 1998, the total NPLs in non-banks did not show a great improvement. Although the NPL ratio had declined by 9.6% in 2001 from 33% as of the end of 2000, it still exceeded 20%. Furthermore, the NPLs in Merchant banks had rather deteriorated. Both the amount of NPLs and the NPL ratio had increased during the course of 2001. The amount of total outstanding had also rose at this time. Therefore, there emerged concerns about the accumulation of NPLs: Not only might the current NPLs become long-term NPLs, but the newly created NPLs will also develop in the near future.

Table 3-6: NPL Breakdown by Financial Sector (trillions of won)

		December 1998			March 2000			December 2000			December 2001			December 2003		
		Total	SBA*	NPL**	Total	SBA*	NPL***	Total	SBA*	NPL***	Total	SBA*	NPL***	Total	SBA*	NPL***
Bank	Commercial Banks	300.6		22.2	339.3	47.4	27.2	361.4	32.0	23.8	379.1	12.6	10.9	504.6	16.9	12.9
	(ratio, %)			7.4		14.0	8.0		8.9	6.6		3.3	2.9			2.6
	Specialized Banks	142.8		11.4	146.1	16.7	10.6	164.7	10.1	5.7	172.1	6.2	4.6	206.0	6.3	4.4
	(ratio, %)			8.0		11.4	7.3		6.1	3.5		3.6	2.7			2.1
Bank Total		443.4		33.6	485.4	64.1	37.8	526.1	42.1	29.5	551.2	18.8	15.5	710.6	23.2	17.3
	(ratio, %)			7.6		13.2	7.8		8.0	5.6		3.4	2.8			2.4
Non-Bank	Merchant Banks	28.0		5.6	9.1	1.6	1.6	3.5	1.3	0.8	2.9	1.0	0.9			
	(ratio, %)			20.0		17.6	17.6		37.1	22.9		34.5	31.0			
	Mutual Savings	22.0		5.3	17.4	6.0	6.0	15.7	5.8	5.8	15.9	3.1	3.1			
	(ratio, %)			24.1		34.5	34.5		36.9	36.9		19.5	19.5			
	Lease Companies	25.9		7.8	16.2	6.7	6.7	13.7	6.0	6.0	9.6	3.9	3.9			
	(ratio, %)			30.1		41.4	41.4		43.8	43.8		40.6	40.6			
	credit Unions	11.2		2.5	10.1	2.5	2.5	10.3	1.6	1.6	10.7	1.2	1.2			
	(ratio, %)			22.3		24.8	24.8		15.5	15.5		11.2	11.2			
Non-Bank Total		87.1		21.2	52.8	16.8	16.8	43.2	14.7	14.2	39.1	9.2	9.1			
	(ratio)			24.3		31.8	31.8		34.0	32.9		23.5	23.3			
Insurance	Insurance companies	38.7		2.0	43.9	5.5		44.5	3.8	2.5	45.2	2.5	2.1			
and	(ratio, %)			5.2		12.5			8.5	5.6		5.5	4.6			
Securities	Securities and ITMCs	7.3		3.4	10.5	4.0		7.6	4.0	4.0	8.9	4.6	4.6			
Companies	(ratio, %)			46.6		38.1			52.6	52.6		51.7	51.7			
TOTAL		576.5	71.0	60.2	592.6	90.4	54.6****	621.4	64.6	50.2	644.4	35.1	31.3			
	(ratio, %)		12.3	10.4		15.3	9.2		10.4	8.1		5.4	4.9			

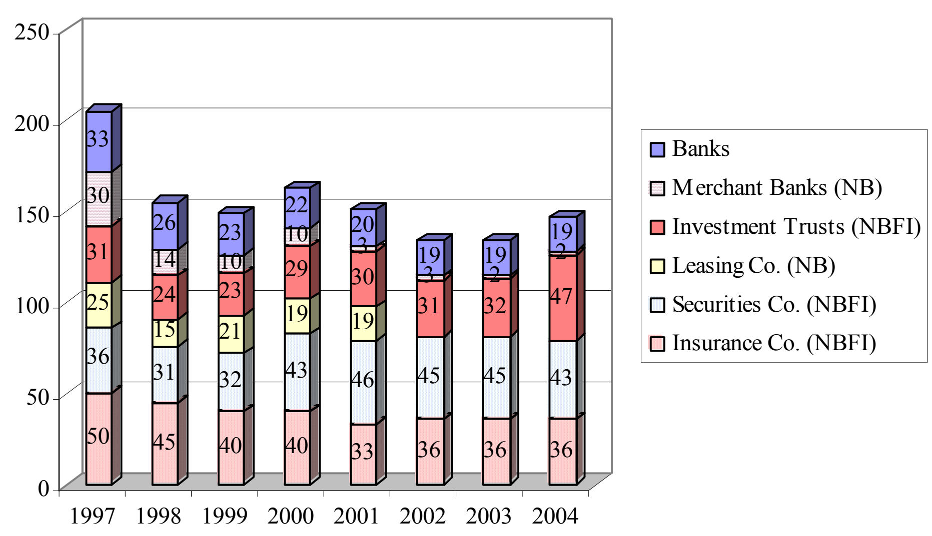
Souce: Financial Supervisory Commission
* Substandard or Below
** based on asest classification standard applied to banks
*** Sum of loans 3 months or more
****Excluding NPLs of Insurance & Securities Companies

4. Mergers and closures

The currency crisis that started in Thailand in July 1997 worsened the existing serious conditions of the balance sheets (accumulated non-performing loans (NPLs)) of financial institutions. In order to restore external confidence as well as to stabilize the financial market, the Government pressed ahead with financial reform program agreed upon by the government and the International Monetary Fund (IMF). The distressed commercial banks and Merchant banking corporations with large NPLs and poor asset quality had to be closed down. The number of banks declined from 33 at the end of 1997 to 19 at the end of 2004. The number of Merchant Banks declined significantly from 30 at the end of 1997 to 2 at the end of 2004. For viable financial institutions, the government provided funds through the recapitalization and the purchase of their NPLs on the condition of their own intensive self-rescue efforts. To qualify the government's assistance, banks and financial institutions were required to downsize their branch network and layoff employees.

Figure 4-1

Number of Financial Institutions at the end of reporting year



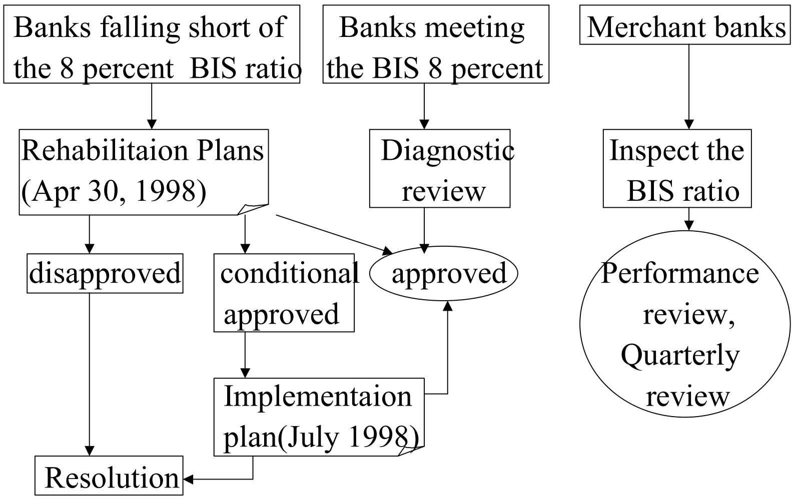
<Mergers and Closures of Banks>

The financial supervisory Commission (FSC) had surveyed assets and liabilities of twelve banks that had failed to meet the BIS 8% capital adequacy ratios at the end of 1997. These banking institutions were required to submit management rehabilitation plans. Upon its examination of these plans, the FSC determined five commercial banks (Daedong, Dongnam, Dongwha, Kyungki and ChungChong) as non-viable on June 29, 1998. The five banks were requested to be liquidated and to have their good assets and liabilities transferred to stronger banks under a purchase and assumption (P&A) arrangement. The P&A order was a historical event: No Korean bank had ever been closed before 1997, and it gave a clear signal that financial institutions would no longer enjoy unconditional protection. The assets of the five closed banks constituted only 7.3 percent of the 12 undercapitalized banks' total assets. The acquiring banks (Kookmin, Housing & Commercial, Shinhan, KorAm and Hana) would purchase the sound assets and assume the liabilities of those acquired banks. These five acquiring banks were chosen on the criterion of the holding of a BIS capital adequacy ratio of more than 8% at the end of 1997.

The restructuring process of banking sector is summarized in the figure below.[14]

[14] See Wang and Zang (1998).

Figure 4-2: Bank Restructuring Flowchart



Among banks whose BIS ratios exceeded eight percet at the end of 1997, Boram Bank was merged (consolidated) with Hana Bank. Korea Long-term Credit Bank was absorbed by Kookmin Bank. Of its total capital share, 17 % was acquired by Goldman Sachs Capital Partners in May 1999.

Other financial institutions that had not been involved in the merger or takeover activities were Korea Exchange Bank and Peace Bank. As for the Korea Exchange Bank, Commerzbank of Germany contributed W350 billion. Peace Bank withdrew from international business.

The seven approved banks with strict conditions were requested to submit revised management reforms and recapitalization plans, including foreign fund inducement and bank merger by the end of July. The plans were reviewed quarterly. If the implementation plans were disapproved, a mandatory merger or transfer of business order had to be imposed.

However, a few of the approved banks with conditions were too big to fail. Korea First Bank and Seoulbank proved insolvent in 1997 and were recapitalized fully by the Government in January 1998 and February 1998, respectively. These two banks were permitted to continue their operations.

In 1999, serveral bank mergers were completed. In the process of financial institutions merger, the government and FSC injected public funds to support financial institutions through their recapitalization and the purchase of their NPLs. Commercial Bank of Korea and Hanil Bank were conditionally approved for restructuring by FSC in 1998. These two banks were merged into Hanvit Bank in January 1999. Chungbuk Bank, Kangwon Bank and Hyundai Merchant Bank (non-bank) merged with ChoHung Bank and renamed as ChoHung Bank.

The banking sector restructuring through merger further proceeded in 2000 and in 2001. In July 2000, National Livestock Cooperative Federation merged with National Agricultural Cooperative Federation. In 2001, several healthy banks merged or converted to a financial institution. The government pursued the liquidation of non-viable financial institutions. The Korea Deposit Insurance corporation (KDIC) established Woori Finance Holdings Company in March 2001, bringing Hanvit, Peace, Kwangju, and Kyongnam Banks, and Hanaro Merchant Banking Corporation under its umbrella. All of these institutions had been fully recapitalized by KDIC under Woori Finance Holdings Company. In October 2001, Kookmin Bank merged with Housing & Commercial Bank. The government had Havit Bank absorb the bank and trust accounts of Peace Bank, whose financial status worsened due to accumulated bad loans, and finally authorized the latter's conversion into Woori credit Card Company in December 2001. In 2002, Seoulbank, which had been solely owned by the Korea Deposit Insurance Corporation, was sold to Hana Bank.

By the end of 2004, there were 19 banks (8 Nationwide commercial banks, 6 regional banks, and 5 specialized banks). However, the number of banks declined by 14 by the end of 1997. The bank consolidation in Korea was faster than in any other Asian countries in crisis.

Table 4-1: Changes in the Number of Commercial Banks* (at the end of reporting year)

Group of Banks	1997	during 1998 exit	during 1998 Merger	end-1998	during 1999 exit	during 1999 Merger	end-1999	during 2000 exit	during 2000 Merger	end-2000
Nationwide banks	17	5**	(5**)	12	-	1***	11	-	-	11
Regional (Local) banks	10	2**	(2**)	8	2****	(2****)	6	-	-	6
Specialized banks	6			6	-	-	6	-	1*****	5

Group of Banks	during 2001 exit	during 2001 Merger	end-2001	during 2002 exit	during 2002 Merger	end-2002	end-2003	end-2004
Nationwide banks	-	2******	9	-	1*******	8	8	8
Regional (Local) banks	-	-	6	-	-	6	6	6
Specialized banks	-	-	5	-	-	5	5	5

source: Bank of Korea, Annual Report, various issues.

* Excluding foreign bank branches.

**5 closed Nationwide banks 2 closed Regional banks were merged to Nationwide banks.

***Hanvit Bank (merger of Commercial Bank of Korea(N) and Hanil Bank(N)).

****Merger of Chungbuk Bank and Kangwon Bank into Chohung Bank (N).

*****National Livestock Coop.Fed. merged with National Agricultural Coop.Fed. In July 2000.

******Kookmin Bank and Housing & Commercial Bank merged as kookmin Bank; Peace Bank converted into a credit card company.

*******Seoul Bank, which had been solely owned by the Korea Deposit Insurance Corporation, was sold to Hana Bank.

<Other financial institutions>

As for merchant banks, after evaluating the management rehabilitation plans of a total of thirty merchant banks, the government revoked sixteen insolvent institutions' license in 1998. Their assets and liabilities were transferred to a bridge merchant banking corporation. In 1999, one merchant bank (Daehan Investment Banking) was ordered to exit. Two other merchant banks were merged with commercial banks: Hyundai Merchant Bank with Kangwon Bank, which was later absorbed into Chohung Bank, and Korea International Merchant Bank with Korea Exchange Bank.

Many non-bank financial institutions either exited the market or merged with other institutions in 1998 and 1999. As a result, the number of merchant banks had dwindled to ten by the end of 2000.

In 2001, several healthy banks established a financial holding companty as part of the drive toward enlargement of scale. Shinhan Bank, Shinhan Securities company, Shinhan capital Company and Shinhan Investment Trust Management Company established Shinhan Financial Group (financial holding company) in September 2001. The Government also revoked the licenses of four merchant banking corporations, Korea, H&S, Yeungnam, and Central, which had ben consolidated into Woori Merchant Banking Corporation in November 2000. Regent Merchant Banking Corporation whose operations had been suspended in December 2000 merged with Tongyang-Hyundai Merchant Banking Corporation. Through these mergers closures, the number of merchant banking corporations, which had reached 30 before the currency crisis, dramatically dropped to two at the end of 2004.

Table4-2: Number of Merchant banks (at the end of reporting year)

	1985	1990	1995	1997	2000	2001	2002	2003	2004
existing companies	6	6	6	6	7	3	3	2	2
Converted compaies*	-	-	9	24	3	1	-	-	-

source: Financial Systems in Korea, Bank of Korea.

*: Merchant banks converted from investment and finance companies.

<*de facto* Nationalization and sell off to foreign capital>

Before the financial crisis, there were 33 banks in the country: 17 nationwide, 10 regional and 6 specialized banks. With a number of closures and mergers, a total of 19 banks remained as of the end of 2004: 8 nationwide, 6 regional and 5 specialized.

Through its support of recapitalization efforts, the Government has become a controlling shareholder of some of the remaining banks. Korea First Bank and Seoulbank have been Government banks since January 31, 1998. Hanvit Bank, merger of Hanil Bank and Commercial Bank of Korea in early 1999, became *de facto* Government banks, since the public fund injected for their recpaitalization amounted as much as the amount injected to KFB and Seoulbank. Other banks have also become *de facto* State banks because the Government was heavily involved in their recapitalization process. NPLs of these *de facto* nationalized banks were acquired by KAMCO and then KDIC made capital injection to these institutions.

Banks that required government assistance in recapitalization were Hanvit Bank, Korea Exchange Bank, Korea First Bank, Seoulbank, and Chohung Bank. In order to meet BIS CAR after June 30, 1999, each bank estimated to require W2.0 trillion.

The two nationalized banks, Korea First Bank and Seoulbank, were sold to foreign banks in line with the government's protracted privatization effort. The Government sold 50.99% of its shares of Korea First Bank (whose equity it had acquired in full) to an US investment firm, Newbridge Holdings LTD., in December 1999. The sell-off procedure finalized in January 2000.

The basic agreement on sell-off of Seoulbank to HSBC took place in February 1999, but the plan was called off in August 1999. The acquisition of Seoulbank was planned by Hana Bank as of August 2002.[15] The sale of Seoulbank to

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[15] On August 19, 2002, Hana Bank has finally been officially selected by the Public Fund Oversight Committee as a prime bidder to take over the Seoulbank. Hana bank and the US investment fund, Lone Star, had been waging a race for Seoulbank since the government accepted bids on July 31. Hana offered an all-stock bid valued at about W1.1 trillion with a guarantee that Hana would compensate the government for future declines in its share price, while Lone Star offered to buy 100% of Seoulbank for W900 billion in cash and agreed to share W350 billion of future profit with the government. (Financial Times, Asian Wall Street Journal, August 20, 2002)

Hana Bank was the biggest privatization of banks in Korea since 1999. Hana Bank emerged as the country's third largest bank, following Kookmin Bank and state-run Woori Finance Holding.

<Summary>

The management of banking sector, in particular the merger program for banks and finance institutions that initiated in 1998 was, to some extent, successful in bringing down the total number of financial institutions. The number of banks had decreased by one third, from 33 banks at the end of 1997 to 19 in December 2004. During the restructuring process, five banks did not meet BIS capital adequacy ratios as of the end of 1997 and were required to present management rehabilitation plans. They were finally regarded as nonviable in June 1998 and then closed. Since no Korean banks had ever been closed under the implicit government's protection, these closures were considered as a clear signal that financial institutions would no longer enjoy unconditional guarantee from the government. The management of failed financial institutions was forced to leave.

It should be mentioned that there was heavy government involvement in the process of banking system restructuring. The government provided a lot of public fund to financial institutions during the course of mergers. Public funds were injected to financial institutions through recapitalization and the purchase of NPLs. From November 1997 to June 2001, W53.6 trillion was injected into financial institutions for recapitalization through KDIC and Bank of Korea. KAMCO purchased W38.2 trillion value of NPLs. Fiscal assistance was provided to acquire banks in mergers. In order to raise the BIS capital ratio of institutions regarded as "viable", the government made financial support amounting to W27.7 trillion in the form of purchase of asset, subordinated debt, and compensation of losses. Furthermore, Korea First Bank and Seoulbank have been nationalized since January 1998 and Hanvit Bank became *de facto* Government bank. In total, the Korean government injected W139.5 trillion (or equivalent of US$120 billion), 26.7% of GDP, for restructuring the banking sector. Details of these spending will be described in section 5.

Table 4-3: Number of Financial Institutions, at the end of reporting year*

		1997	1998	1999	2000	Mar2001	Jnne2001	2001	June 2002	2002	2003	2004
Banks	Banks	33	26	23	22	22	22	20	20	19	19	19
	Merchant Banks	30	14	10	10	5	4	3	3	3	2	2
Non-	Leasing Co.	25	15	21	19	19	19	19	18			
banks	Mutual Savings & Finance Co.	231	211	186	146	146	125	121	117	117	114	113
	Credit Unions	1666	1592	1444	1317	1311	1280	1268	1252	1233	1086	1066
Insurance	Life & Non-life Insurance Co.	50	45	40	40	40	42	44	44	36	36	36
Security-	Securities Co.	36	31	32	43	43	45	45	44	45	45	43
related	Investment Trusts	31	24	23	29	29	29	30	31	31	32	47**
Total		2102	1957	1758	1626	1615	1566	1550	1529	**1484**	1334	1326

Source: Financial Supervisory Commission/Financial Supervisory Service, Annual Report, 2000;
Financial Reform & Supervision in Korea, Financial Supervisory Commission/Financial Supervisory Service, 2001;
Financial System in Korea, Bank of Korea, 2002; Bank of Korea, Annual Report, 2001.
*Excluding bridge financial institutions and branches of foreign institutions.
**Investment trust management companies and the former asset management companies have been classified among asset monagement companies since 2004. Prior to 2003, the figure were compiled on the basis of investment trust management companies, but those for 2004 included the former asset management companies(13 companies as of the end of 2003)

With regard to banking system restructuring, especially through mergers, it is essential to understand that the consolidation of banking system cannot be attained through only mergers. The restructuring of Banks and Merchant banks seemed to have solved the issue of reducing number of financial institutions. At the same time, some financial institutions were found to be "too big to fail" and received public assistance. There were still many non-bank financial institutions. Weak, or nearly insolvent financial institutions had to be nationalized and restructured by the government, before they were sold to healthier banks or foreign capitals.

It is always difficult to balance between strengthening banks with capital injection and forcing them to fail. In this regard, the liquidation of non-viable merchant banks and other financial institutions made possible by the Government through merger of the revocation of their license should be appreciated. The attempted sale of nationalized banks to foreign buyers and the establishment of a finance holding company among healthy financial institutions can be evaluated as a new, practical approach to banking sector restructuring.

Table 4-4: Changes in the Number of Financial Institutions during 1998-2004

Group		1998			Newly	1999			Newly	2000			Newly	2001		
		Liquidation	Merger	Total	Created	Liquid	Merger	Total	Created	Liquid	Merger	Total	Created	Liquid	Merger	Total
banks	Banks	5	3	8	-	-	2	2	-	-	1	1	-	-	2	2
	Merchant Banks	16	-	16	-	1	3	4	-	1	-	1	1	4	3	7
Non-	Leasing Co.	10	-	10	-	-	-	-	-	-	-	-	-	-	-	-
banks	Mutual Savings & Finance Co.	22	2	24	4	21	10	31	6	28	13	41	2	23	1	24
	Credit Unions	69	14	83	9	103	45	148	-	83	42	125	-	48	1	49
Insurance	Insurance Co.	4	1	5	-	-	-	-	-	1	5	6	-	2	-	2
Security-	Securities Co.	6	-	6	1	-	-	-	1	-	1	1	12	-	-	-
related	Investment Trusts	7	-	7	-	-	1	1	-	-	-	-	3	-	-	-
Total		139	20	159	14	127	61	188	7	113	62	175	18	113	62	175

Group		2002			Newly	2003			Newly	2004			Newly	Jan 1998-December 2004		
		Liquidation	Merger	Total	Created	Liquid	Merger	Total	Created	Liquid	Merger	Total	Created	Liquid	Merger	Total
banks	Banks	-	1	1	-	-	-	-	-	-	-	-	-	5	9	14
	Merchant Banks	-	-	-	-	-	1	1	-	-	-	-	-	27	7	34
Non-	Leasing Co.	-	-	-	-	-	-	-	-	-	-	-	-	8	1	9
banks	Mutual Savings & Finance Co.	4	2	6	1	3	-	3	-	1	-	1	-	103	28	131
	Credit Unions	32	3	35	-	145	2	147	-	20	-	20	-	503	107	812
Insurance	Insurance Co.	-	-	-	3	2	-	2	3	1	-	1	2	12	6	18
Security-	Securities Co.	-	2	2	1	1	-	1	1	1	1	2	-	8	2	10
related	Investment Trusts	-	-	-	1	-	-	-	1	-	1	1	3	9	2	11
Total		36	6	42	6	151	3	154	5	23	2	25	5	675	162	1039

source: Annual Report, Bank of Korea, various issues.

*Excluding bridge financial institutions and branches of foreign institutions.

Table 4-5: Restructuring of Banks

	end 1997	end 1998	end 1999	end 2000	end 2001
Nationwide	(17)	(12)	(11)	(11)	(9)
1	Korea First	Korea First	Korea First	Korea First	Korea First
2	Commercial Bank of Korea	Commercial Bank of Korea	Hanvit	Hanvit	Hanvit
3	Hanil	Hanil			
4	Seoul	Seoul	Seoul	Seoul	Seoul
5	ChoHung	ChoHung	ChoHung	ChoHung	ChoHung
6	Korea Exchange	Korea Exchange	Korea Exchange	Korea Exchange	Korea Exchange
7	Hana	Hana	Hana	Hana	Hana
8	Boram				
9	Kookmin	Kookmin	Kookmin	Kookmin	Kookmin
10	Korea Long-Term Credit				
11	Daedong				
12	Shinhan	Shinhan	Shinhan	Shinhan	Shinhan
13	Dongwha				
14	Korea Housing	Korea Housing	Korea Housing	Korea Housing	
15	Dongnam				
16	KorAm	KorAm	KorAm	KorAm	KorAm
17	Peace	Peace	Peace	Peace	converted to Woori credit card company
Regional	(10)	(8)	(8)	(6)	(6)
1	Daegue	Daegue	Daegue	Daegue	Daegue
2	Pusan	Pusan	Pusan	Pusan	Pusan
3	Kwangju	Kwangju	Kwangju	Kwangju	Kwangju
4	Cheju	Cheju	Cheju	Cheju	Cheju
5	Jeonbuk	Jeonbuk	Jeonbuk	Jeonbuk	Jeonbuk
6	Kyongnam	Kyongnam	Kyongnam	Kyongnam	Kyongnam
7	ChungChong				
8	Kangwon	Kangwon	Kangwon		
9	Chungbuk	Chungbuk	Chungbuk		
10	Kyonggi				
Specialized	(6)	(6)	(6)	(5)	(5)
1	Korea Development Bank	Korea Development Bank	Korea Development Bank	Korea Development Bank	
2	Industrial bank of Korea	Industrial bank of Korea	Industrial bank of Korea	Industrial bank of Korea	
3	Export-Import Bank of Korea	Export-Import Bank of Korea	Export-Import Bank of Korea	Export-Import Bank of Korea	
4	National Fed. Of Fisheries	National Fed. Of Fisheries	National Fed. Of Fisheries	National Fed. Of Fisheries	
5	National Agricultural Coop. Fed.	National Agricultural Coop. Fed.	National Agricultural Coop. Fed.	National Agricultural Coop. Fed	
6	National Livestock Coop. Fed.	National Livestock Coop. Fed.	National Livestock Coop. Fed.		

source: various reports from BOK, KAMCO, FSC.

Table 4-5: Restructuring of Banks(Cont'd)

	end 2002	end 2003	end 2004
Nationwide	(8)	(8)	(8)
1	Korea First	Korea First	Korea First
2	Hanvit	Hanvit	Hanvit
3			
4			
5	ChoHung	ChoHung	ChoHung
6	Korea Exchange	Korea Exchange	Korea Exchange
7	Hana	Hana	Hana
8			
9	Kookmin	Kookmin	Kookmin
10			
11			
12	Shinhan	Shinhan	Shinhan
13			
14			
15			
16	KorAm	KorAm	KorAm
17			
Regional	(6)	(6)	(6)
1	Daegue	Daegue	Daegue
2	Pusan	Pusan	Pusan
3	Kwangju	Kwangju	Kwangju
4	Cheju	Cheju	Cheju
5	Jeonbuk	Jeonbuk	Jeonbuk
6	Kyongnam	Kyongnam	Kyongnam
7			
8			
9			
10			
Specialized	(5)	(5)	(5)
1	Korea Development Bank		
2	Industrial bank of Korea		
3	Export-Import Bank of Korea		
4	National Fed. Of Fisheries		
5	National Agricultural Coop. Fed		
6			

source: various reports from BOK, KAMCO, FSC.

5. Fiscal Support for Financial Restructuring---Capital Injection

The main task of financial restructuring is the disposal of NPLs. Regarding financial sector restructuring, there are two critical questions: (1) how to share the costs among the institutions concerned and (2) how to mobilize the additional resources. Upon the institutions' own restructuring efforts, several measures such as capital injection by the government should be taken so that the taxpayers' burden and the moral hazard can be minimized. Institutions judged as non-viable should be closed. Then, the government should inject public funds into troubled financial institutions, in order to reverse the deterioration of the balance sheet and also to Bank for International Settlements' Capital Adequacy Ratio (BIS CAR) of institutions up to 10%. The fiscal support was provided only to (1) supplement the institutions' own restructuring and financing plans, and (2) purchase NPLs, recapitalize viable institutions, and pay off deposits, but only if the self-rescue plans of ailing institutions were successfully implemented.[16]

The government's basic principles for fiscal support were as follows: (1) it would not support financial institutions unless they exerted appropriate self-rehabilitation efforts, and (2) fiscal support should be sufficient to make troubled financial institutions solvent. Public funds injection was made through the Korea Deposit Insurance Corporation (KDIC), the Korea Asset Management Corporation (KAMCO), Bank of Korea (BOK) and from fiscal resources.

Capital injection by KDIC was used for recapitalizing financial institutions, compensating the losses sustained by the financial institutions that had acquired troubled institutions at government request, and purchasing assets of troubled institutions. KDIC also provided public funds for the repayment of deposits of closed financial institutions. KAMCO purchased the NPLs of financial institutions. The government provided public funds from fiscal resources. Bank of Korea injected capital into financial institutions.

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[16] For discussion and survey on recapitalization through public funds, see Enoch, Garcia and Sundararajan (2001).

In order to promote the recapitalization of banks and to resolve NPLs, the government injected a total of W63.6 trillion through the KDIC, KAMCO, BOK and by ways of Fiscal Resource between November 1997 and December 1998. The government provided a total of W27.8 trillion through the KDIC to protect depositors and to prevent deterioration of the management status of the acquiring banks in the process of the resolution of insolvent financial institutions. Of this amount, W14.6 trillion was for the repayment of deposits with closed institutions and W6.9 trillion was the compensation for the losses sustained by the acquiring banks.[17] In order to prevent any further decline in their BIS capital adequacy ratios, the government injected a total of W6.3 trillion through the KDIC into the acquiring banks and into banks arranging to merge.[18] As for Korea First Bank and Seoulbank which were nationalized since January 1998, the government singed MOUs with a U.S. financial consortium led by New bridge Capital to sell its shares to Korea First Bank, as well as with a British financial corporation, HSBC Holdings BV, to sell its shares to Seoulbank.

Moreover, the government set up the Non-performing Asset Management Fund in November 1997 and had it purchased at discount NPLs with a book value of W44.8 trillion for W19.4 trillion in the period between November 1997 and December 1998. The government provided W16.3 trillion from fiscal resource for recapitalization of Korea Development Bank, Export-Import Bank of Korea, Industrial Bank of Korea, Korea Investment Trust Company, and purchase of subordinated debt in order to raise BIS capital ratios.

In 1999, the government made a total of W31 trillion of public funds injection into financial institutions. Categorizing the sources, the KDIC provided a total of W23.8 trillion. Of this amount, W13.7 trillion was for recapitalization of financial institutions, and W4.1 trillion for compensation of losses in financial institutions that had acquired troubled financial institutions at

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[17] On June 29, 1998, the Financial Supervisory Commission (FSC) ordered the closure of five banks: Daedong, Donghwa, Dongnam, Kyunggi, and Chungchong banks.

[18] In the banking sector, Korea First Bank and Seoulbank, the two banks in deepest trouble, were recapitalized by the government and the KDIC in January 1998. The KDIC made a contribution amounting to W5.8 trillion to the five merger banks in September 1998.

government request. Another W3.7 trillion was for the purchase of assets of Korea First Bank. A total of 2.3 trillion was for the repayment of deposits at closed financial institutions.

In addition, KAMCO provided a total of W4.5 trillion for purchasing the NPLs of financial institutions. The government devoted a total of W2.4 trillion from fiscal resources for recapitalization and purchase of subordinated debt. Of this amount, W1.8 trillion was used for recapitalizing Korea Development Bank, Export-Import Bank of Korea, Industrial Bank of Korea, Korea Investment Trust Company, and Daehan Investment Trust Company. Another W600 billion was used to purchase subordinated debt. The Bank of Korea made W700 billion of capital injection into the Export-Import Bank of Korea.

In 2000, the government devoted about W35 trillion in public funds to support financial institutions. Of this amount, KDIC provided W22.6 trillion, KAMCO provided W12.1 trillion, the government devoted W100 billion from fiscal sources, and the Bank of Korea injected W200 billion into financial institutions.

The W14.6 trillion provided by KDIC was for recapitalization and W0.7 trillion for compensation of losses in financial institutions. In addition, a total of W5.4 trillion was used to purchase the assets of financial institutions, and W2.4 trillion was for the repayment of deposits at merchant banking corporations, mutual savings and finance companies, and credit unions that had exited the market.

In terms of the assistance from public funds by type of financial institution, W11.4 trillion in public funds went to banks, W2.8 trillion to merchant banks, and W4.6 trillion to insurance companies.

As of December 2004, a total of W405.1 trillion of public funds had been injected into financial institutions since November 1997. KDIC injected a total of W164.1 trillion and KAMCO has purchased NPLs amounting W38.4 trillion. The government has provided W18.8 trillion from fiscal resource for recapitalization and purchase of subordinated debt, and the Bank of Korea has injected W900 billion into financial institutions. Among the capital injection of W164.1 trillion by KDIC since 1997, W62.9 trillion was used for recapitalization and W27.2 trillion was for compensation of losses in the financial institutions that had acquired troubled financial institutions at government request. About W20.3 trillion was used to purchase those assets of financial institutions. A total of W53.8 trillion was made available for the repayment of deposits at financial institutions that had exited the market.

<Summary>

The government's basic principles for fiscal support for financial restructuring have been that (1) it will not provide financial assistance to institutions unless they exert appropriate self-rehabilitation efforts and practice fair loss sharing among concerned parties, and (2) fiscal support should be sufficient to make troubled financial institutions solvent.

From November 1997 to December 2004, the government had injected a total of W405.1 trillion into financial institutions, among which W38.4 trillion worth of NPLs and W6.4 trillion worth of subordinate debt and/or assets were purchased by the Government. In addition, a total of W76.2 trillion were spent for recapitalization of institutions. According to the plan, most of the fiscal support was expected to be recouped through (1) sale of collateralized assets, (2) divestment of acquired equity shares of financial institutions, and (3) liquidation of insolvent financial institutions. Thus, the authorities insisted that the burden on taxpayers would be limited to the interest costs related to public bond issues which would decline over time correspondingly.

Table 5-1: Public Funds injected into financial institutions (trillion of Won)

Source	Support Type	Nov.97-Dec.98	Jan.99-Dec.99	Total (1997-1999)	Jan00-Dec00	Total (1997-2000)	Jan01-Dec01	Total (1997-2001)	Jan02-Dec02	Total (1997-2002)	Jan03-Dec03	Total (1997-2003)	Jan04-Dec04	Total (1997-2004)
	Recapitalization	6.3	13.7	20.0	14.2	34.2	9.6	43.8	0.0	43.8	0.0	43.8	19.1	62.9
	Compensation of losses	6.9	4.1	11.0	0.7	11.7	4.5	16.2	0.3	16.6	6.1	22.6	4.6	27.2
KDIC	Purchase of assets		3.7	3.7	5.4	9.1	0.6	9.7	0.7	10.3	5.3	15.6	4.6	20.2
	Repayment of deposits	14.6	2.3	16.8	2.4	19.2	10.4	29.6	2.4	32.0	11.0	42.9	10.9	53.8
	Sub total	27.8	23.8	51.6	22.6	74.2	25.1	99.3	3.4	102.6	22.3	124.9	39.2	164.1
KAMCO	Purchase of NPLs	19.4	4.5	23.9	12.9	36.8	2.0	38.7	0.3	39.1	-0.6	38.4	0.0	38.4
Fiscal	Recapitalization	10.5	1.8	12.3	0.1	12.4		12.4		12.4		12.4		12.4
Resource	Purchase of subordinated debt	5.8	0.6	6.4		6.4		6.4		6.4		6.4		6.4
	Subtotal	16.3	2.4	18.7	0.1	18.8		18.8		18.8		18.8		18.8
BOK	Recapitalization		0.7	0.7	0.2	0.9		0.9		0.9		0.9		0.9
	Total	63.6	31.3	94.8	35.8	130.7	27.0	157.7		161.4		183.0		222.2

source: Bank of Korea, Annual Report, various issues; Financial System in Korea.

With regard to the recapitalization, part of the fiscal support was made in order to raise the BIS capital ratio of institutions. In addition, three banks have been nationalized in the process of rehabilitation. However, perhaps more banks could have been nationalized, if the rules were strictly applied. Some of the public fund might have gone to institutions that were "too big to fail".

With benefit of hindsight, there is an argument from the viewpoint of financial strain that KFB should have been liquidated, not nationalized, in its early stage of restructuring because the capital injected to KFB amounted far larger than initially expected. It is, however, difficult to decide whether and when bank would liquidate because of the difficulty to estimate necessary expenses. If once the government made capital injection to a financial institution, the ex-post incurred cost for capital injection, rehabilitation, and privatization would be far larger than in the case of liquidating the business.

6. Financial Supervisory Commission (FSC)

Korea lacked an integrated regulator that would be able to conduct a full range of financial supervision and regulation before crisis. There was a growing need for a change in the supervisory system: the industry-specific supervisory organizations lacked efficiency and thereby created difficulties in maintaining consistent supervisory policies across the institutions. On April 1, 1998, the Financial Supervisory commission (FSC) was established as an integrated financial supervisory institution in Korea. Under the new system, all financial institutions were subject to the supervision of a single supervisory body, the FSC, an independent government agency. The Financial Supervisory Service (FSS), its executive arm, was subsequently established in 1999 to lead the reform drive in the financial market. The FSC served as the headquarters, whereas the FSS took practical programs of action for resolution of financial sectors. Most of the staff working in FSC was transferred from KOEF, while the people in FSS were mainly recruited from the private sector.

<Objective>

The FSC is broadly charged with policy formulation for the financial market. As part of its supervisory responsibilities, the FSC deliberates and resolves policy matters pertaining to the inspection and supervision of financial companies and securities and future markets. The FSC also has the authority to issue and revoke business licenses to financial companies. The FSS is charged with overseeing and supervising financial business entities and other participants in the market.

<Banking Sector Regulatory System>

Before the crisis, regulatory responsibility was divided between BOK and MOFE with BOK supervising commercial banks and MOFE supervising Nonbank financial institutions.[19]

The Office of Bank Supervision (OBS) was an internal organization of BOK and supervised commercial banks. The trust business of commercial banks, however, was under the supervision of MOFE, which also had the authority to grant and revoke bank licenses. Lack of coordination between BOK and MOFE turned out to be inefficient cooperate governance of the banking sector in Korea. Merchant banks and other financial institutions were under MOFE regulation, but each was supervised by independent supervisory agencies.

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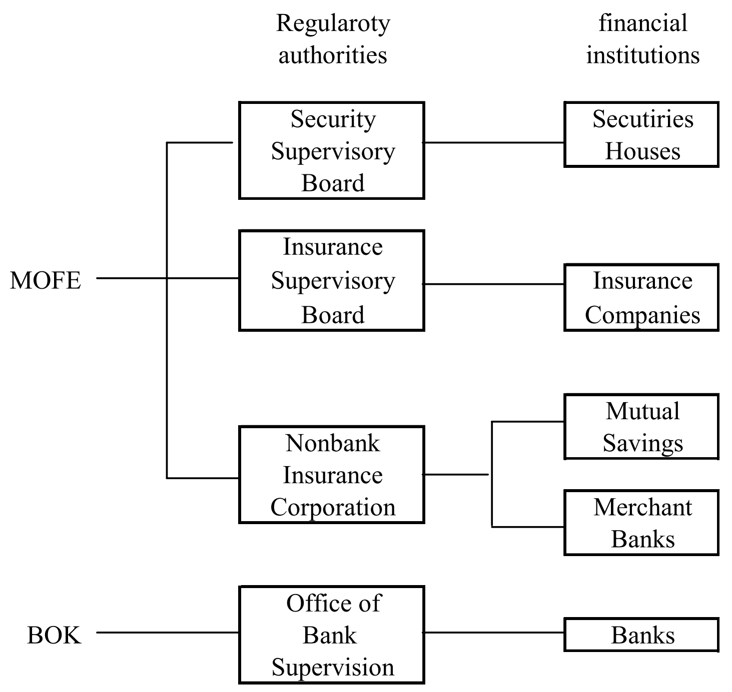
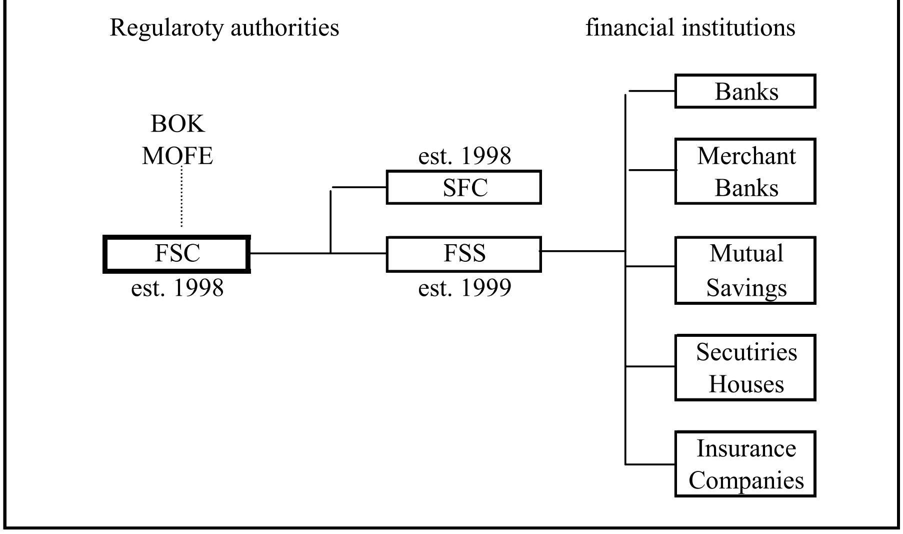
[19] As is described below, MOFE supervised trust business of commercial banks and specialized banks, in addition to the supervision over non-bank financial institutions.

Figure 6-1: Pre-crisis Regulatory Structure



In April 1998, the government established FSC under the Office of the Prime Minister to function as a neutral and independent agency. FSC took over the supervisory power of MOFE. The four agencies—the Office of Bank Supervision, Securities Supervisory Board, Insurance Supervisory Board, and Nonbank Supervisory Board—were merged into the Financial Supervisory Service (FSS) in January 1999. FSC also established a subcommittee, the Securities and Futures Commission (SFC) in April 1998. Under the guidance of the FSC, the SFC oversees the securities and futures markets. Its principal functions include the investigation of market abuses, such as insider trading and market manipulation, and supervision of the accounting standards.

Figure 6-2: Post-crisis Regulatory Structure



The consolidation of regulatory structure was intended to divest MOFE of its supervisory power. A regulatory structure was required to be neutral and independent in order to enhance the banking sector restructuring. The change of the system was also intended to resolve concerns that the dual regulatory structure, the MOFE and BOK supervisory system before the crisis, was ineffective and apparent to contributed to the crisis. The supervisory role and its functioning body were also required to meet the international standard.

<FSC, MOFE, BOK>

Regarding relationships with other authorities and agencies, the Bank of Korea (BOK) and the Korea Deposit Insurance Corporation (KDIC) may also request the FSC/FSS to inspect financial companies when necessary. Joint inspection of financial companies by the FSC/FSS, BOK and KDIC may also be conducted. In this way, FSC works closely with the Ministry of Finance and Economy (MOFE), BOK and other authorities in carrying out its supervisory mission and formulating financial policies.

Despite the change of regulatory system, the MOFE still holds legislative authority over any opening, closing, and merger of financial institutions and is responsible for drawing up of supervision related bills. The BOK and its Monetary Board remain as a completely independent body responsible for monetary policy. However, the BOK, as the last resort for banks, does retain some of its previous supervision functions such as checking prudential requirements for banks. The Monetary Board has the right to request the FSC to reconsider any decision that may involve measures directly related to monetary policy. The BOK and the KDIC may request the FSC to inspect financial institutions when necessary, and they may also request joint inspections. The MOFE, the BOK, and the FSC may request information and documents from one another.

<Additional Public fund injection>

Immediately following the onset of the financial crisis in late 1997, recapitalization of both Banks and non-banks was crucial to protect depositors and normalize their credit intermediary role. By the end of 1999, the Government appropriated W64 trillion to facilitate restructuring of viable lenders and liquidate those that were failing. A significant portion of the public funds was used for the purchase of NPLs through the KAMCO and the KDIC.

However, efforts to recapitalize the banking sector and resolve NPLs were hampered by the confluence of negative internal and external factors, such as the collapse of Daewoo Group, rising oil prices, falling semi-conductor price, the recession in the US and in Japan, etc., starting in the fourth quarter of 1999. These were expected for another severe economic downturn in Korea. As a result, domestic financial companies continued to suffer from adverse market conditions, and credit crunch became more severe. Faced with the rapidly deteriorating economy, the Government responded with additional public funds aimed at removing the lingering uncertainties in the banking sector.

For the W50 trillion that had been estimated to complete the financial restructuring, the National Assembly approved additional public funds of W40 trillion in December 2000, with the remaining W10 trillion to be raised through the recovery of previously injected public funds. Approximately W19.9 trillion was allocated to ailing financial institutions by the end of March 2001.

Table 6-1: Allocation of Additional Public Funds by End-March 2001

(trillions of won)

	Equity Participation	Capital Injection	Asset Purchase	Others	Total
Banks	4.1	0.2	1.8	0	6.1
Insurance	2.7	0.01	0	0	2.71
Merchant Banks	2.4	2.1	0	0	4.5
Investment Trust Companies	4.8	0	0	0	4.8
Others	0	1.34	0	0.4	1.74
Total	14.0	3.65	1.8	0.4	19.85

Note: the National Assembly approved W40 trillion in additional public funds in December 2000 to allocate to ailing financial companies.

Source: FSC, Financial Reform & Supervision in Korea 2001.

<Summary>

In 1998, Korea established the integrated financial supervisory organization, the FSC. As an independent government agency, the FSC has supervisory responsibilities, and is also expected to work closely with MOFE, BOK, KDIC and other authorities in carrying out its supervisory mission and formulating financial policies.

In the context of single vs. multiple supervisory body system, the FSC aimed to move away from multi-regulatory system and toward the single supervisory system.[20] Despite the structural change of supervisory system, the FSC seems to have many difficulties. That is, the MOFE and BOK still hold the supervision functions over financial institutions, and the FSC as the single regulator has not been realized. It can be argued that the MOFE should transfer an authority to write or revise financial laws to FSC, without organizational reshuffling. To enforce prudential regulations, MOFE and FSC should coordinate more closely in applying the prudential regulations to specialized and development banks. In that sense, FSC should have full responsibility for specialized, development and commercial banks.

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[20] In the case of United Kingdom, the supervisory activities were transferred from the Bank of England to the financial supervisory agency (FSA), and Germany is also aiming at the unified regulatory system. In case of Japan, main financial supervisory function was separated from the Ministry of Finance and moved to a newly created FSA.

The fact that the supervisory role alone was transferred from BOK while the experts on the subject at BOK did not move to FSC contributed to the ineffective supervisory function. The personnel structure, the FSC from KOEF and FSS from the private sector, also has produced friction between the FSC and FSS, which may weaken the body and thus undermines the authority of FSC.

7. KAMCO

The final stage and often most difficult part of financial sector restructuring is the disposal of NPLs. Disposal can be done directly by banks and the financial institutions. But sometimes, setting up a special agency in charge of collecting bad debts is a good idea. Collecting and disposing of NPLs require special talents, and consolidating NPLs in one organization is often more efficient than each bank trying to deal with NPLs. Moreover, failed banks must be taken over by the regulator (government) and their bad assets have to be managed anyway. Korea was no exception.

By the end of 1998, total NPLs of all financial institutions amounted to W60.2 trillion, and loans classified as substandard or below (SBA) were W71.0 trillion. As of March 2000, total NPLs of all financial institutions decreased to W54.6 trillion, consisting of W37.8 trillion NPLs of banks and W16.8 trillion NPLs for non-banks. On top of this, there was another W90 trillion SBAs.

The purchase of NPLs was led by Korean Asset Management Corporation (KAMCO) while the recapitalization of viable institutions was done by Korea Deposit Insurance Corporation (KDIC). The overall restructuring efforts were supervised by Financial Supervisory Commission and Financial Supervisory Service (FSC/FSS). KAMCO bonds were used and given to the bank in exchange for NPLs. KAMCO did not issue bonds to the market.

<Objective>

Korean Asset Management Corporation (KAMCO) was originally established based on Article 53, paragraph 3 of the Korea Development Bank (KDB) Act on April 6, 1962. Its primary role was to manage bad loans of the State-run Korean Development Bank under the control of Ministry of Finance and Economy (MOFE).

On November 24, 1997, KAMCO was reestablished to expand its role. New KAMCO was launched to set up NPL Management Fund. The Fund was created to acquire, manage and dispose of NPLs for the financial sector restructuring. One of the important functions of KAMCO was to purchase distressed assets from banks and other financial institutions with public fund. In November 2002, KAMCO stopped purchasing NPLs from financial institutions. The goal of public fund injection is to recover brokerage function in the financial sector as well as international credibility. In the long run, it aims to raise stability and efficiency of financial industry and to increase international competitiveness.

<Operations>

KAMCO's primary roles are: (1) management and operation of Non-Performing Loans management Fund, (2) acquisition and resolution of Non-performing assets from financial institutions, (3) implementation of work-out programs for acquired distressed companies, and (4) management of state-owned properties and resolution of tax arrears. KAMCO decides the time for acquisition, the size of assets, acquisition approach and purchase rate of NPLs according to the restructuring plan by the government. KAMCO purchases assets according to the fair market value.

The Non-performing Asset Management Fund (NPA Fund) was introduced on November 24, 1997. This Fund was organized to support financial restructuring by efficiently resolving NPLs of financial institution in the wake of the unprecedented financial crisis. The NPA Fund was used to purchase NPLs from financial institutions and helped financial institutions clean up operations by taking the burden of NPLs away from them. By December 2001, KAMCO had used a total of W21.6 trillion in funds raised. Of the initial Public Fund raised for financial restructuring (W64 trillion), W20.5 trillion was raised by issuing KAMCO bonds, and W0.5 trillion was borrowed from Korean Development Bank, and other 0.6 trillion was acquired through borrowings (contributions) from financial institutions.

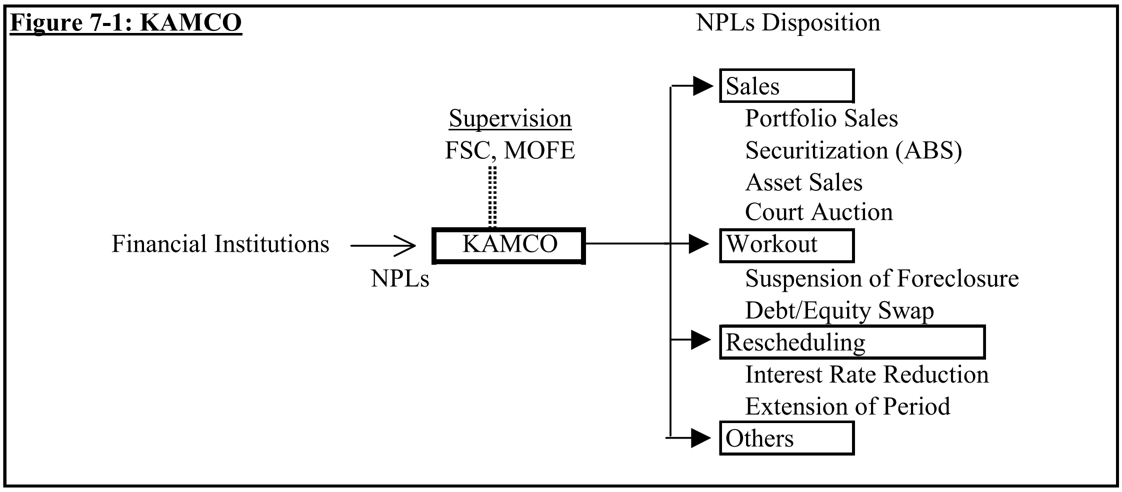

Figure 7-1: KAMCO

<KAMCO Bond>

The initial size of the NPA Fund was W10 trillion. KAMCO finances itself by issuing W32.5 trillion worth of its own bonds and by disposing purchased assets through direct sale of these assets or of asset-backed securities. According to the projected plan, KAMCO had to purchase NPLs amounting to over W50 trillion.[21] The Government had guaranteed the KAMCO bond without assuming responsibilities for interest payments until 2002. The cost of interest payment was expected to decrease greatly with a sharp drop in interest rates, and the Government would bear interest costs from 2003.

As one of the NPL resolution measures, KAMCO issued domestic ABS bond secures by restructured corporate loans purchased from selling institutions (insolvent companies). KAMCO bought them from creditor banks. KAMCO's ABS structure is as follows.[22]

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[21] KDIC issued W31.5 trillion worth of bonds for equity participation and for compensation of the differential between liabilities and assets

[22] We are grateful to Je-Chul Yoon, Executive Director/CPA at KAMCO, for a detailed explanation on KAMCO's ABS structure.

KAMCO transfered NPLs to SPC (Special Purpose Company), and SPC evaluated the assets. After credit enhancement, KAMCO issued the ABS. KAMCO originated 15 times of ABS, and out of 14 were backed-up by Special Loans (or Restructured Corporate Loans) which underwent the Civil Courts restructuring process. The repayment schedule was fixed and approved by the Court. KAMCO has once originated ABS backed-up by secured Ordinary Loans without putting back option.[23]

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[23] KAMCO web page, http://www.kamco.or.kr/eng/area/main2.htmd, describes the key features of KAMCO's ABS with put-back option as follows:

"One of the noticeable features of KAMCO's ABS is, despite the fact that they are backed by nonperforming loans, when borrowers of the nonperforming loans fail to make payments according to the payment schedule, the financial institutions which originally sold the loans to KAMCO buy back the loans. And if the SPC (Special Purpose Company) suffer temporary shortage of financial resources in making principal and interest payment, the National Housing and Commercial Bank, KAMCO's trustee for the MIRAE bond 99-2 extends credit line accordingly. "

According to one KAMCO official, "Even for the ABS backed by Special Loans with put back option, original lender bank do not buy back the NPLs merely when the interest on ABS is late or is not to be paid, they buy back only when the debtor company fails to repay the interest or principal as scheduled. When SPC encounters shortage of money to repay to ABS holder, regardless the debtor of NPLs defaults or not, the trustee bank subrogates according to the trustee agreement."

However, there still remain some unclear points. The structure of redemptive ABS issuance does not seem to lessen the financial institutions' NPL burden because, in case of default in payments, it's not only KAMCO, but the lender bank that have to buy back NPLs. Then, it is not obvious if the KAMCO's acquisition of NPLs and issuance of ABS does clear FI's balance sheets of NPLs and mitigates bad-loan risks.

Table 7-1: ABS Issuance*

(in billions of Won)

	Face Value	Purchasing I	Amount
June 15 1999	305.1	268	320
Aug 30 1999	384.9	299.6	360
Nov 9 1999	237.7	201.9	223
Dec 27 1999	291.5	221.7	265
Jan 19 2000	365.6	337	340
Apr 3 2000	320.7	342.5	330
Apr 27 2000	414	367	375
July 19 2000	495.2	194.4	257
July 22 2000	361.6	311.2	346
July 28 2000**	440.9	444.2	468.8
Sep 7 2000	402.1	337.2	378
Dec 12 2000	221.6	182	218
Dec 29 2000	395.5	344	404
Aug 17 2001	213.3	165.8	229.9
Dec 4 2001	264.4	193.6	284
Total	5114.1	4210.1	4798.7

Source: Korea Asset Management Corporation, Annual Report, 2001

* Set on the basis of contract amount.

** Foreign currency denominated ABS

<Asset type>

KAMCO had three types of assets in its inventory: Ordinary loans, Restructured corporate loans, and Workout loans.

Ordinary loans were currently in default for three months or longer, whether they were secured or unsecured (regardless of the existence of security (collateral)).

Restructured corporate loans were those that had obtained court approvals of restructuring as part of corporate re-organization or composition proceedings regardless of existence of security (collateral). The important distinction between Ordinary loans and Restructured corporate loans lied in the collection procedure of the loans. Most of the obligators of Restructured Loans were initially considered as viable with temporary liquidity problems. Therefore, when KAMCO initially purchased these loans, the original lenders were not entitled to declare default or execute their claims through the foreclosure. This was due to the current and existing repayments of the loans according to the rescheduled payment schedules. Thus, in valuing the Restructured Loans, more emphasis has been given to the credit standing of the borrower.

Workout corporate loans were Daewoo-related loans covering corporate bonds, CPs, and foreign loans issued by the Daewoo Group in line with its restructuring. They were restructured by each institution (out of court). KAMCO began to buy workout loans from companies in 2000.

Table 7-2: KAMCO loan classification

Court Approval \ Collateral	Secured	Unsecured
Ordinary Loans	Loans currently in default for 3 months or longer	Loans currently in default for 3 months or longer
Restructured Corporate Loans	Loans to companies under court reorganization	Loans to companies under court reorganization
Workout Corporate loans	Restructured out of court (under private workout programs) KAMCO began to buy these loans from conglomerates in 2000.	

Table7-3: Acquisition and Resolution of NPLs by type of Loans since November 1997

(as of June 30, 2002, in trillion won)

Classification	Purchased		Resolved		Balance	
	Face value	Purchase Price	Face value	Purchase Price	Face value	Purchase Price
Ordinary Loans	29.8	9.2	24	8.3	5.8	0.9
Restructured Corporate Loans	41.1	17.0	33.5	14.4	7.6	2.6
Workout Loans	34.5	13.2	2.3	1.6	32.2	11.6
TOTAL	105.4	39.4	59.8	24.3	45.6	15.1

Souce: KAMCO

<Purchase Price and Purchasing Process>
KAMCO acquires assets from financial sector with purchase price by estimating potential market price based on its past experience in dealing with similar assets transaction.[24] The purchase price of NPLs is based on price guideline, real property right, right of lease, and so on. When it is difficult to estimate the price in advance, the difference between purchasing price and sales price of NPLs can be settled later on. If the recent transaction prices reflect speculative factor rather than market condition, there is a high possibility that the estimated purchase price could be very different from the market price.

The basic criteria of purchase price assessment for NPL is as follows. Secured loans are priced by adding or subtracting price fluctuations of collateral assets, from the recent average foreclosure auction rate and appraisal value. Unsecured loan is priced at 3% of the face value. The purchase prices of corporate restructured loan are calculated based on debt payment by court decision.

KAMCO has the put-back options to the selling financial institutions for all loans (including Ordinary and Restructured) that KAMCO purchases from these institutions.

The purchase prices had been decided by the Government until 1999. From 2000, no instruction on purchase price was given by the Government. In the process of purchasing NPLs from financial institutions, KAMCO presented to financial institutions the purchase prices on a take-it-or-leave-it basis. Since the price is based on the criteria, as mentioned above, and publicly available for every institution, there is no room to bring the price up for selling

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[24] The reasonable purchasing price should be calculated with the expected future cash flow discounted at an appropriate rate. This net present value (NPV) is, however, difficult to evaluate since it depends on the future cash flow and a reasonable discount rate of each NPLs. Besides, there are limits in evaluating distressed loans on the basis of all kinds of market information since KAMCO does not acquire NPLs from public auction.

institutions. Financial institutions can sell their assets to foreign investors directly as well as to KAMCO.

There is no loss sharing agreement between KAMCO and the financial institutions that sold the loans. KAMCO is responsible for all and any loss that may be generated. As previously mentioned, however, KAMCO has the put-back option on all loans that it purchased from the financial institutions.

7.1 Purchase of NPLs

KAMCO started its acquisition of NPLs from financial institutions in November 1997. By the end of 2001, the total NPLs purchased by KAMCO amounted to W38.7 trillion. It was 27.8% of the accumulated public funds from 1997-2001 injected through KDIC, BOK, Government and KAMCO.

As of December 1997, the face value of NPLs bought by KAMCO amounted to W11.0 trillion, of which W8.4 billion from banks and W2.6 trillion from merchant banks. The total purchase amount was W7.1 trillion.

In 1998, KAMCO continued to purchase NPLs from financial institutions. KAMCO acquired the face value of W32.8 trillion of NPLs as of the end of 1998. The total purchase amount was W12.3 trillion. Most of these NPLs (92%, or W30 trillion in face value) purchased by KAMCO was from banks. The total face value of NPLs purchased by KAMCO from other financial institutions was about W3.0 trillion, whereas W27 trillion of NPLs remained in non-banks and other institutions as of December 1998. This means that the remaining NPLs, 9 times as much as those acquired by KAMCO, were managed by individual institutions.

In 1999, KAMCO acquired W4.5 trillion of NPLs (the face value of W18.3 trillion) from banks and financial institutions. In 2000, the face value of NPLs acquired by KAMCO amounted to W33 trillion and their purchase amount was W12.9 trillion. In 2001, KAMCO purchased NPLs of W1.9 trillion, whose face value was W6.0 trillion. From 2002 to 2004, KAMCO purchased NPLs of more than W8.5 trillion.

The face value of NPLs bought by KAMCO from November 1997 to April 2005 was about W110 trillion, and the total purchase amount was about W40 trillion.

Table 7-4: Acquisition of NPLs by KAMCO

(billions of Won)

	Face Value	Purchase Amount
1997	11062.4	7136.2
1998	32831.9	12255.3
1999	18289.0	4464.4
2000	32974.9	12919.2
2001	6002.4	1963.8
2002	8961.6	1062.7
2003		7587.9
2004		
1997-2000	95158.2	36775.1
1997-2001	101160.6	38738.9
1997-April2005	110760	39730

Souce: KAMCO, Business Report

<Purchase Breakdown by type of institution>

Since the first acquisition of NPLs from financial institutions in November 1997, KAMCO had purchased NPLs amounting to W38.7 trillion by the end of 2001. Most of NPLs acquired by KAMCO was from banks: they were in relation to mergers and liquidation in banks. KAMCO also purchased NPLs from Non-banks, securities and Insurance companies, etc.

In November 26, 1997, KAMCO purchased W3.0 trillion (Face value of W4.4 trillion) of NPLs of Seoulbank and Korea First Bank, two of the big-five commercial banks in Korea. On November 28 and December 15, 1997, KAMCO acquired NPLs from commercial banks and merchant banks. The face value of NPLs acquired by KAMCO in 1997 was W11.1 trillion. As of December 1997, KAMCO had acquired W7.1 trillion of NPLs from financial institutions.

In 1998, NPLs acquired by KAMCO amounted to W12 trillion with face value of W33 trillion. On September 29, 1998, KAMCO acquired NPLs with their face value of W23 trillion from 23 banks and other 2 institutions, at the purchase value of W9.0 trillion. KAMCO also acquired NPLs from Seoulbank, KFB, 5 specialized banks, Kwangju and Jeonbuk Banks, and other financial institutions, amounting to face value of W10 trillion, with the purchase value of W3.2 trillion.

In 1999, KAMCO acquired the face value of W18.3 trillion of NPLs from financial institutions. The purchased amount of NPLs in 1999 was relatively small compared to that in the previous year of 1998 or the following year. The purchased amount of NPLs from KFB and Seoulbank was the largest: the face value of NPLs was W4.4 trillion from KFB and W 4.6 trillion from Seoulbank.

In 2000, KAMCO acquired NPLs of the face value amounting to W33 trillion from the financial system, of which W26.7 trillion was the loan rights of Daewoo Bank Group. The amount of removal of these NPLs from the Daewoo Group accounted for 81% of the total face value of NPLs removed from the banking sector in 2000. The purchase amount was W11.4 trillion, 88% of total NPLs acquired by KAMCO in that year. On December 29,KAMCO made a large purchase of NPLs with face value of W2.4 trillion (purchase amount of W84 billion) of financial institutions restructured by KDIC, in addition to NPLs related to KFB, PBK, Cheju Bank and Daewoo Secured CP bought by KAMCO amounted to W1.2 trillion (face value).

In 2001, KAMCO purchased NPLs from financial institutions amounting to W2.0 trillion with face value of 6.0 trillion. Most of NPLs purchased by KAMCO was from banks and the Daewoo Group.

The total purchase value of NPLs by KAMCO from 1997 to the end of 2001 was W38.7 trillion, about one third of the face value of W101.2 trillion. The NPLs of banking sector decreased to W15.5 trillion (2.8%) by the end of 2001. The acquisition by KMACO may be a potential cause for the large decline in NPL ratio in banks. However, the NPLs and NPL-ratio in the non-bank and other insurance and securities sector remained high, exceeding 23% and 50%, respectively.

Table 7-5: Purchase of NPLs by Type of Institutions, November 1997-April 2005

(in billions of US dollar)

	Loan Amount	Purchase Price	Purchase Price Ratio (%)
Commercial Banks	62.07	24.71	39.81
Merchant Banks	3.51	1.54	43.87
Investment Trust	7.06	1.75	24.79
Insurance companies	22.45	8.39	37.37
Foreign Financial Institutions	5.12	2.13	41.60
others	10.55	1.21	11.47
Total	110.76	39.73	35.87

Souce: KAMCO, Business Report

Table 7-6: KAMCO Purchase of NPLs by type of institution, 1997-2001

Year 1997 (billions of Won)

Date	Financial Institutions	Face Value	Purchase Amount
Nov 26 1997	KFB and Seoul Bank	4394.3	2910.3
Nov 28 1997	30 Merchant Banks	2698.8	1755.5
Dec 15 1997	30 Commercial Banks	3951.0	2474.3
Total		11062.4	7136.2

Year 1998 (billions of Won)

Date	Financial Institutions	Face Value	Purchase Amount
Feb 19 1998	2 Guarantee Insurance Companies(GIC)	2816.6	412.1
July 23 1997	Seoul Bank	1040.0	498.9
July 31 1998	KFB	1133.5	606.6
Sep 29 1998	23 Banks and 2 GIC	23031.6	9085.0
Nov 6 1998	Kwangju and jeonbuk Banks/Securities a	496.9	261.6
Dec 29 1998	5 Special Banks	4530.8	1903.0
Total		32831.9	12255.3

Year 1999 (billions of Won)

Date	Financial Institutions	Face Value	Purchase Amount
Feb 12 1999	Chohung Bank	87.6	42.8
March 31 1999	Chungbuk Bank	7.8	2.5
May 19 1999	5 Acquiring Banks	1751.4	280.4
June 30 1999	Koram Bank	23.7	8.3
June 30 1999	Mutual Finance and Savings	187.3	105.1
July 8 1999	KFB	4362.4	897.0
July 31 1999	Hugkook Life Insurance	1.0	-
Sep 17 1999	Seoul Bank	4559.3	1154.3
Oct 8 1999	Kangwon Bank	179.0	72.6
Oct 21 1999	5 Acquiring Banks	180.7	46.5
Oct 26 1999	6 Regional Banks	480.5	223.8
Dec 20 1999	5 Commercial Banks	114.9	35.8
Total		18289.0	4464.4

Year 2000 (billions of Won)

Date	Financial Institutions	Face Value	Purchase Amount
Jan 29 2000	DAEWOO Loans from 23 ITCs	18478.8	6407.4
March 18 2000	5 Acquiring Banks	99.0	37.0
June 20 2000	8 Mutual Finance & Savings	23.0	19.8
Aug 3 2000	Seoul Guarantee Insurance Company	1135.8	299.7
Oct 31 2000	Daewoo Secured CP	2431.3	1952.3
Oct 31 2000	Daewoo Foreign Debt	4302.1	1840.9
Nov 9 2000	Daewoo Foreign Debt	31.8	26.4
Nov 30 2000	Daewoo Secured CP	366.9	294.6
Dec 29 2000	KFB/PBK/Cheju Bank	130.1	54.2
Dec 29 2000	FIs restructured by KDIC	2396.4	84.0
Dec 29 2000	Daewoo Secured CP	1121.9	900.9
Dec 30 2000	NPLs related to Daewoo Motors Co.	399.9	170.1
Total		32974.9	12919.2

Table 7-6 (continued)

Year 2001 (billions of Won)

Date	Financial Institutions	Face Value	Purchase Amount
Jan 5 2001	Seoul Bank	750.8	364.8
Jan 5 2001	18 Mutual Finance & Savings	103.1	47.9
Jan 16 2001	Kwangju Bank	25.6	17.3
Feb 15 2001	NPLs related to Daewoo Mortors	1545.1	668.3
Feb 16 2001	6 Mutual Finance & Savings	11.5	5.3
March 29 2001	KEB, Hanvit, Daegu Bank	609.1	222.8
June 28 2001	Seoul Bank & 7 Banks	533.0	77.3
June 29 2001	Daewoo Foreign Debt	190.7	61.7
Sep 14 2001	KDB & 6 banks	497.5	197.1
Dec 24 2001	Hanvit Bank & 17 Banks	430.3	134.3
Total		6002.4	1963.8

Total (billions of Won)

	Face Value	Purchase Amount
1997-2000	95158.2	36775.1
1997-2001	101160.6	38738.9

Source : KAMCO, Business Report.

7.2 Disposition of NPLs

KAMCO disposed NPLs according to the basic principle of selling at the highest price possible. However, it was difficult for KAMCO to decide when to sell the acquired NPLs in order to maximize the gains, while it would be achieved without delay. Loans that could be sold in an early stage take only small parts of the whole NPLs that KAMCO had acquired. Most of NPLs were under legal supervision of the court or in the process of the settlement.

For the asset targeted for immediate sales, KAMCO used such measures as (1) Portfolio sales (international auction), (2) Securitization (ABS), (3) Public auction, (4) Court auction (foreclosure), and (5) Individual Loan sales. When an asset could not be sold at present condition, the agency tried to improve the asset value through a value adding process and sold later at a reasonable price. Besides, even if the assets could not be sold at a present condition and could not be improved either, the agency set a rule to dispose of them as early as possible even at a lower price.

For efficient disposition of NPLs, KAMCO set priority on selling its assets through international auction, then later by Securitization (ABS) in order.

KAMCO collected USD22.8 billion of the total face value of W58.5 trillion disposed NPLs through international auction, ABS Issuance, Court Auction and the others on September 30, 2002. The Purchase price of disposed NPLs was USD20.0 billion. The recovery rate of the NPLs disposition, the ratio of recovery value to the face value, was about 46%.

Excluding the Repurchase and Cancellation, the total face value of disposed NPLs amounted to USD34.6 billion. The purchase price of these disposed NPLs was USD12.3 billion and the sales amount was USD15 billion. The recovery rate, the ratio of the recovery value to the face amount (excluding repurchase and cancellation) of the disposed NPLs, was about 44.6%.

<Equity Partnership>

As one of the NPL disposition methods, the equity participation strategy was introduced as a joint venture partnership between KAMCO (the public) and the private sectors. The equity partnership strategy was designed to improve the expected amount of recovery from NPL sales, by covering the upside risk. When NPLs with uncertainty was sold, the method of sharing the upside risk would be better than outright sale.

The equity partnership involved three organizations: Asset Management Company (AMC), Corporate Restructuring Company (CRC), and Corporate restructuring vehicle (CRV).

I. Asset Management Company (AMC)

AMC aims at having a comprehensive asset management function. The details of its function include management and collection of loans that controls cash flow concerning the secured and unsecured debt, rental, sale and management of real estate, and enhancement of asset value including real estate. The major operation of AMC is to conduct workout programs (debt-to-equity swaps, debt rescheduling, and debt reduction) and to enhance asset value of real estate.

KAMCO pools assets for international bid and awards the bidder (investor) who has submitted the highest bid price through an open limited competitive international bidding. The winner of the bid purchases 50% share of the SPC by cash payment commensurate to 50% of NPLs (receive an investment certificate). The ownership between KAMCO and the investor of the SPC is 50:50 respectably. The pooled assets are turned over to the SPC whether it is established on or off shore as long as it is in conformity with the Asset Backed Securitization Law.

According to the percentage interest of the shareholder, the profit sharing and rights of the remaining property gets distributed pro rate in accordance to the percentage of shares in SPC, while the investor company has the managerial right to the SPC (General Partner)

KAMCO established 3 joint venture-AMCs with foreign investment companies. On December 21, 1999, Deutsche Bank and Samsung Life Insurance Consortium was selected as the first AMC partner. On May 9, 2000, Morgan-Stanley became the 2nd and 3rd AMC partner. KAMCO selected Colony Capital as the winning bidder of the 4th JV-AMC, international bid on June 20, 2001. Another JV-AMC was established with Colony Capital by October 25, 2001.

II. Joint Venture Corporate Restructuring Company (CRC)

The Korean government conformed the "CRC Act" under the Industry of Development Act of Korea. Ministry of Finance Economy (MOFE) had loan to Korea Asset Management Corporation (KAMCO) from the Asian Development Bank (ADB) Financial Sector Program Loan (FSPL), in the aggregated principal amount of USD$ 500million for the purpose of establishing one or more Corporate Restructuring Companies (CRCs).

The total Capital Commitment amounted to USD900 million, and USD 270 million for each CRC (KAMCO:Foreign Investor = 50:50). Equity Share between KAMCO (General partner) and foreign investor (Limited Partner) is 50:50. Investment Period is 3 years from signing the Investment Agreement.

CRCs focus on acquisition/disposition of non-performing loans, lending a loan to distressed company, securitization and restructuring the troubled companies. The major operation scope of a CRC is to acquire, normalize, and dispose a target company by taking over the management.

KAMCO established 3 Joint venture-CRCs with the foreign investment companies in 2000. On February 23, Joint Venture CRC Partnership with Lehman Brothers was established (KAMCO-LB). On March 23, Joint Venture CRC Partnership with Sonnenblick Goldman was established (KAMCO-SG). On September 28, Morgan Stanley Dean Witter was established. MSDW was selected as a 3rd JV-CRC partner.

On May 23, KAMCO auctioned off W610.3 billion (book value) of NPLs to KAMCO-LB and W946.7 billion (book value) of NPLs to KAMCO-SG Investor Inc. on September 28, respectively.

III. Corporate Restructuring Vehicle (CRV)

Following the introduction of vulture funds and corporate restructuring companies to the local market, the legal framework for Corporate Restructuring Vehicle (CRV) was set up. The corporate Restructuring Vehicle (CRV) is a paper company. CRVs are intended to help creditor banks and other lenders improve their capital position by enabling them to transfer non-performing loans to workout firms into the hands of specialized private sector asset management entities and remove them from their balance sheets.

A CRV collects NPLs held by creditor banks and workout companies and normalizes the operation of companies subject to reorganization by entrusting management of assets to a professional asset management company. Unlike the existing restructuring vehicles, a CRV gathers the loans of workout companies and dissolves conflicts among creditor banks.

Table 7-7: Disposition(Resolution) of NPLs, As of December 31, 2000

(in billions of Won)

	Face value	Purchase price	Selling price
International Auction	6062.1	1311.7	1599.6
ABS	8016.4	4218.1	4140.6
Individual loan Sale	1266	279.0	394.1
AMC*	2566.6	655.1	919.2
CRC*	1841	364.4	673
Court Auction etc.	8085.1	2460.6	3006.5
Direct Recovery	6995.9	1812.4	2876.9
Repayment by the approved plan	2126.7	1274.9	1551.9
CRV	511.6	112.6	169.6
Daewoo debt-equity swap	1741	979.7	615.1
Recovery from Daewoo repayment	1396.2	1214.1	1396.2
Sub-Total	40608.8	14682.6	17342.5
Repurchase & Cancellation	17877.7	9556.6	9556.6
Total	58486.5	24239.2	26899.1

source: KAMCO, Annual Report 2001

* Equity partnership

Table 7-8: Disposition(Resolution) of NPLs, As of April 30, 2005

(in billions of U.S. Dollars)

	Face value	Purchase price	Recovery Value	Ratio* (%)
International Auction	6.1	1.3	1.6	8.39
ABS Issuance	8.4	4.4	4.7	11.55
Sale to AMC**	2.50	0.7	0.9	3.44
Sale to CRC**	1.90	0.4	0.7	2.61
Individual loan Sale	3.40	0.8	1.4	4.68
Court Auction etc.	8.60	2.8	3.5	11.83
Collection	15.1	4.8	6.8	20.77
Daewoo	6.9	4.3	5.9	9.49
Sub-Total	52.9	19.5	25.5	72.76
Recourse & Cancellation	19.8	10.3	10.3	27.24
Total	72.7	29.8	35.8	100.00

source: KAMCO, Business Report

*Face value /total disposed face value of NPLs

** Equity partnership

<Portfolio Sale>
As a portfolio sale, KAMCO conducted two types of international auction: International Bidding for Corporate Restructured Loans and International Bidding for Secured Loans. Loans offered by KAMCO was not only for the bulk purchase by one investor, but also for small transactions. Loans took the form of mixed asset pool type and each asset pool was sold by individual purchaser.

<International Bidding for Corporate Restructured Loans>
KAMCO conducted four international auctions for Corporate Restructured Loans from 1998 to 2000. The first international auction was held in September 1998. It completed its first sale of non-performing loans having a face value of approximately W207.5 billion to Goldman Sachs, the highest bidder in the auction. The sales price of the NPLs was W25.4 billion, while the purchase amount was W2.8 billion. The NPLs sold to Goldman Sachs were made by debtor-creditor contract. The upside profit sharing was: KAMCO: Goldman Sachs = 60 : 40.

In May 1999, KAMCO completed its international auction through the sale of a portfolio of non-performing restructured corporate loans to two major investors, Goldman Sachs Consortium and Morgan Stanley Consortium, which consisted of two local (Korean) investors, Hyundai Investment Trust & Securities Co. Ltd. This was the first sale in that the Korean investor participated to bid in a series of international auctions by KAMCO. The successful bidders agreed to purchase loans from KAMCO, offered in three separate pools, for prices ranging between 16 to 18% (average of 16.03%) of the outstanding principal value. The outstanding face value of the assets sold by KAMCO was W772 billion, which included loans to 120 corporate borrowers. The sale price of the assets was W124 billion, whereas KAMCO paid W72 billion of the purchasing price.

In November 1999, KAMCO completed its third auction through the sale of a portfolio of non-performing Restructured Corporate Loan to three different groups of investors. The successful bidders included Goldman Sachs-GE Capital Consortium, Morgan Stanley-Ceberus Tongyang, and Central Banking Corp. They agreed to purchase the loan from KAMCO, offered in seven separate pools, for prices ranging from 6.24% to 23.05% (average of 21.02%).

In July 2000, KAMCO completed the sale of non-performing restructured corporate loans to three foreign investors and one individual investment corporation. The winning bidders were Goldman Sachs Asia LLC, Morgan Stanley Asia Ltd, Lone Star.

Among four international biddings for corporate restructured loans since September 1998, only one (the first international bid in September 1998) was with upside profit sharing rules. The other three biddings were outright sales, sometimes accompanied by put-back options to entice investors occasionally. In the outright sales, purchaser received all rights and interests in the loans KAMCO had prior to sale, and KAMCO received the purchase price.

<International Bidding for Secured Loans>

KAMCO conducted international auction for Secured Loan three times from 1998 to 1999. In December 1998, KAMCO completed the first secured-NPLs sale in the international auction. The winning bidder was Lonestar Fund of US. The face value of the assets was W565 billion, and Lonestar Fund and KAMCO agreed to sell and purchase the portfolio for about 36% of the outstanding principal balance, W201 billion. The winning bidder Lonestar Fund agreed to pay KAMCO approximately W141 billion (70% of the purchasing price) in an offshore special purpose vehicle (SPV)--the transaction was structured as a sale of equity in an offshore special purpose vehicle (SPV). KAMCO retained 30% interest in the SPV allowing it to participate in the assets resolution upside.

Table 7-9: International Bidding for Corporate Restructured Loans*

(in billions of Won)

	Face Value	Purchase Price	Selling Price	Profit Sharing KAMCO: Investor	Investor
Sep 1 1998	207.5	2.8	25.4	60:40	Goldman Sachs
May 27 1999	772.4	71.7	123.8	outright sale	Goldman Sachs & others
Nov 10 1999	811.2	97.7	170.5	outright sale	Morgan Stanley Dean Witter & others
July 26 2000	1097.5	228.9	322.8	outright sale	Goldman Sachs & others
Total	2888.6	401.1	642.5		

Source: Korea Asset Management Corporation, Annual Report, 2001 and Business Report.

* Set on the basis of contract amount.

Table 7-10: International Bidding for Secured Loans*

(in billions of Won)

	Face Value	Purchase Price	Selling Price	Profit Sharing KAMCO: Investor	Investor
Dec 9 1998	564.6	238.8	201.2	40:60	Lonestar Fund
Jun 22 1999	1038.8	554.5	525.9	outright sale	Lonestar Fund
Dec 8 1999	1022.6	379.6	439.3	outright sale	Morgan Stanley Dean Witter
Total	2626.0	1172.9	1166.4		

Source: Korea Asset Management Corporation, Annual Report, 2001 and Business Report.

* Set on the basis of contract amount.

<Summary>

The size of NPLs was a soft, moving target. It changes according to the standard of loan classification and to the change in economic conditions. Under stricter standards, NPLs were estimated bigger. The international standard became effective on July 1, 1999. As of the end of June 1998, FSC estimated that NPLs, including precautionary and internationally-defined substandard loans, amounted to W197 trillion, of which precautionary credit was W79 trillion, and credit that was substandard and lower was W118 trilliion.

Given that NPLs amounted to W200 trillion roughly, by international standards, public funds of W32.5 trillion were insufficient to deal with all the NPLs of financial institutions. Although the acquisition of NPLs did help decrease NPLs in Banks and Merchant Banks, NPL ratio in other financial institutions remained very high. The Government should have either increased the funds or used the allotted funds in a different way for a more efficient resolution. However, the amount the government allotted was clearly large in proportion of the GDP.

KAMCO remained as the sole asset management company in the country. Although it has been very active in purchasing and reorganizing NPLs, it has not escaped criticism, especially with respect to the disposition of the NPL through international auction. Most of the biddings until 2000 were outright sale, not with upside profit sharing rules. But this problem was rectified when equity partnership was introduced in 1998.

The evolution of the methods of KAMCO sales offered a lesson to other asset management companies. It is preferable for an asset management company to devise a framework that is transparent and fair aution/bidding inviting various types of investors so that expected recovery of values from NPLs can be maximized. The details of KAMCO auctions described above show that having a method to share upside risk is important. Outright sales in the midst of a crisis often resutls in low sales prices, and they can be criticized domestically as fire sales. On the other hand, hanging on to assets with an expectation of better markets is most likely to end up in deteriorated asset values in months. This was the case in the earlier attempts of sales of KAMCO assets, especially restructured banks. Instead, securitized sales of NPLs is one way to achieve sharing upside risk with investors.

KAMCO stopped purchasing NPLs in November 2002, in view of improved condition of the overall banking sector. The role of New KAMCO will be shifted from the current NPL management of the crisis period to the consolidation of banking system during peacetime.

Table 7-11: Recovery and Disposition of NPLs, at the end of 2003

(in billions of Won)

Acquired NPLs		110.5
Disposed NPLs	Purchased price	28.3
	Selling price	32.8
	Face value	68.6
recovery rate(%)		62.1
disposition rate(%)		29.7

Source: KAMCO, Annual Report 2004 and Business Report.

8. Korea Deposit Insurance corporation (KDIC)

The Korea Deposit Insurance Corporation (KDIC) was established on June 1, 1996. The primary aim of the KDIC is the protection of depositors: the KDIC initiated the deposit insurance operations for almost all the financial institutions on January 1, 1997. Its major functions include the operation of the Deposit Insurance Fund, collection of insurance premiums, payment of insurance claims, resolution of failed financial institutions and provision of financial assistance. The KDIC does not have supervisory power over the institutions, although it has limited joint inspection power with FSS.

8.1 Deposit Insurance System

<Deposit Insurance>

Prior to the establishment of KDIC in 1996, Korea lacked an explicit and formal deposit protection system for banking institutions. Instead, it was commonly believed that the government would guarantee bank deposits in some ways. In the event of failure or insolvency, the government intervened to resolve the problem and protect depositors. In fact, no Korean bank had ever been closed before 1997. For non-banking financial institutions, trust funds had deposit insurance function. Life and non-life insurance companies utilized the Insurance Guarantee Fund, and the Securities Investor Protection Fund served that role for securities companies. Mutual savings & finance companies, merchant banks and investment brokerage houses employed the Credit Management Fund.

Amid the advance in the liberalization of financial markets, the accessibility to become more pertinent, generating concerns about the possibility of prevalent bank failures. In considerations of these concerns, the government enacted the Depositor Protection Act on December 29, 1995 and established the KDIC in the following June.[25] The Depositor Protection Act was revised at the end of 1997 and, accordingly, the previously-separate deposit insurance funds for non-bank financial institutions were integrated under the management of the KDIC in April 1998. Consequentially, all industry-specific deposit insurance funds were consolidated into the Korea Deposit Insurance Corporation by April 1, 1999. Deposits to be protected by the KDIC included not only bank deposits, but also deposits held in securities companies, insurance companies, merchant banks, mutual savings and finance companies, and credit unions.

<Insured Financial Institutions>

The insured financial institutions are those required to subscribe to deposit insurance coverage from the KDIC and those remit deposit insurance premiums to the KDIC. In terms of banks, commercial banks, regional banks, domestic branches of foreign bank, specialized banks[26], and regional branches of the National Federations are under the protection scope of the KDIC. All domestic securities and stock brokerage companies and insurance companies, including domestic branches of foreign securities companies, are also protected by the KDIC. Merchant banks and mutual savings & finance

[25] Initially, the KDIC embarked upon the task of deposit insurance for banks in January 1997, while the separate funds for each respective non-bank financial institution remained in place.

[26] Excluding the Export-import Bank of Korea.

companies can obtain protection from the KDIC after being approved under the pertinent laws and acknowledged as KDIC insurable financial institutions. The number of insured financial institutions as of the end of 2003 is summarized below.

Table 8-1: Insured Financial Institutions, as of December 31, 2003

Financial Institutions		Domestic	Foreign	Others	Total
Banks		18	40	0	58
Non-Bank	Merchant Banks				2
	Mutual Ssavings				114
	Credit Unions				1086
Insurance Companies	Life Insurance				23
	Non-life Insurance				20
Securities	Securities Companies				58
Total					1361

Source: KDIC

8.2 Deposit Insurance Protection Limits

The insurance coverage was W20 million per individual depositor at the establishment of KDIC in 1996. Due to the instability of the financial market resulting from the Asian currency and financial crisis of 1997, the coverage was expanded to blanket guarantee, following the amendment to the Enforcement Decree in December 1997. This *de facto* removal of the protection limit was in part successful to stabilize the market for the extremely turbulent times. However, as the concerns of moral hazards became apparent, the Enforcement Decree was amended in July 1998 to limit coverage and subsequently, protection per individual depositor under the system of partial protection was re-adjusted up to W50 million through the amendment of the Enforcement Decree in October 2000.

Before January 1, 2001, the coverage of deposit protection was classified into two. For the accounts opened (purchased) before August 1, 1998, both the principal and interests was covered in full. Deposits and new accounts that were opened on or after August 1, 1998 were covered up to W20 million if the sum of principal and interests was less than or equal to W20 million. If the principal exceeded W20 million, only the principal was covered up to W20 million. From January 1, 2001, the deposit protection was expanded up to

W50 million for the sum of principal and interests. The coverage of deposit insurance is summarized in the table below.

Table 8-2: Deposit Insurance Claim Payment Limitations

	Until December 31, 2000			From January 1, 2001
Accounts opend or purchased	Until July 31, 1998	From August 1, 1998		
		Principal and Interests: up to W20 million	Principal exceeds W20 million	
Banks; Securities companies; Merchant Banks; Credit Unions	Principal & Interests: Fully Covered.	Sum of Principal & Interests: Covered up to W20 million.	Only Principal (up to W20million) Covered.	Sum of Principal & Interests: Covered up to W50 million.

Source: KDIC

8.3 Resolution of failed financial institutions

The KDIC was also in charge of the resolution of failed financial institutions and provision of financial assistance. Failed financial institutions can be liquidated by the KDIC, making deposits payoffs to depositors. Otherwise, they can be assisted in merging or being taken over by sound financial institutions. The KDIC is entitled to arrange mergers or assignment of business between insured financial institution and failed financial institutions or acquisitions of failed financial institutions by a third party.

In the case where a financial institution falls under a criteria, the KDIC may request the FSC to take necessary measures against the failed financial institution. And then the KDIC may provide financial assistance in accordance with a decision by the Policy Committee of the KDIC.

Table 8-3: KDIC financial support

Banks and Insurance Companies (100 million of Won)

	Equity Participation			Contribution			Asset Purchase		
	1998	1999	2000	1998	1999	2000	1998	1999	2000
Banks	58132	109394	41307	57790	42738	4539		32785	52536
Insurance Companies	-	51447	36750	11535	2474	2318	-	-	3447

Securities Companies and Merchant Banks (100 million of Won)

	Equity Participation			Insurance Claim Payment		
	1998	1999	2000	1998	1999	2000
Securities Companies	-	-	49000	140	4	-
Merchant Banks	421	-	14608	139738	-	13447

Source: KDIC

Table 8-3: KDIC financial support (cont'd)

Banks and Insurance Companies (100 million of Won)

	Equity Participation			Contribution			Asset Purchase		
	2001	2002	2003	2001	2002	2003	2001	2002	2003
Banks	12543	-	662	31190	547	942	5961	6654	4561
Insurance Companies	71000.5	0.5	0	9561	868	4052	0	0	48

Securities Companies and Merchant Banks (100 million of Won)

	Equity Participation			Insurance Claim Payment		
	2001	2002	2003	2001	2002	2003
Securities Companies	0	0	0	0	0	0
Merchant Banks	0	0	647	0	0	0

Source: KDIC

8.3.1 Financial Assistance to Banks

<1998>

On June 29, 1998, the FSC ordered the closure of five banks: Daedong, Donghwa, Dongnam, Kyunggi, and Chungchong banks. Five relatively healthier banks assumed the assets and liabilities of these exit-ordered banks and the KDIC provided financial support. Following the contract transfer decision, the Committee[27] laid down the criteria for the due diligence performed by the accounting firm. Taking the due diligence into consideration, the KDIC made a contribution up to W5.78 trillion to the five merger banks in September 1998.

There was also a put back option if additional losses on assets were to occur during a certain time frame following the merger. Furthermore, to account for the lowered BIS capital adequacy ratios arising from the assumption of the exit-ordered banks' assets, and to bring up the BIS ratio to levels at the end of June prior to the mergers, the KDIC made equity participation of W1.19 trillion in December 1998.

The KDIC also made equity participation in five other banks during the course of 1998. First, a total of W1.5 trillion was extended to Seoulbank and Korea First Bank to help raise their capital adequacy ratios. Second, in September 1998, the Commercial Bank of Korea and Hanil Bank, both ordered to reduce their capital stock according to the prompt corrective action put forward by the FSC, sought rehabilitation through merger and were recognized as failing financial institutions. Thus, the KDIC made a capital investment of W1.63 trillion to each bank respectively.

In addition, following a revised due diligence by the FSC, Boram Bank's low BIS capital adequacy ratio deemed it a failing financial institution. Therefore, Hana Bank's merger with Boram bank was achieved by KDIC's capital investment of W329 billion, preventing the deterioration of the merged bank's capital adequacy level.

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[27] Comprising members from the KDIC, related banks, accounting firms and the Bank Supervisory Board.

<1999>

In 1999, the KDIC made a capital investment of W10.9 trillion. It invested W2.1 trillion on February 18, 1999 in the CHB under the condition that the bank would consolidate with Kangwon Bank and Chungbuk Bank. Subsequently, the Kangwon Bank and the Chungbuk Bank invested W212.3 billion and W393.3 billion, respectively, during their consolidation with the CHB. In total, W2.72 trillion was contributed in the consolidation process.

In the case of Korea First Bank (KFB), a contract pertaining to its purchase by the Newbridge Capital took place on December 23, 1999 to achieve KFB's normal operation and international credit rating improvement. The KDIC made a total of W4.2 trillion equity participation in 1999.[28]

With respect to the Seoulbank, existing capital was written off to help facilitate a self-managed normalization as opposed to selling it to a foreign institution. To improve the BIS ratio, the KDIC contributed W3.32 trillion on September 18, 1999. Furthermore, the KDIC provided W4.3 trillion in the form of fund contribution and W3.2 trillion as asset purchase to banks in 1999.

<2000>

Capital injection made by the KDIC in 2000 amounted to W4.1 trillion: W2.76 trillion in Hanvit Bank, W610.8 billion in Seoulbank, W273 billion in Peace Bank, W259 billion in Kyungnam Bank, in the form of equity participation. In total, the KDIC provided fund contribution of W453.9 billion and purchased W5.25 trillion of assets in banks in 2000.

<2001-2003>

Although the financial support to Banks made by KDIC between 2001 and 2003 was relatively small compared to the amount from 1998 to 2000, a significant amount of capital was injected to banks. In total, more than W4.9

[28] The KFB had been acquired by the KDIC. As a result of a partial equity write off of KFB stocks the Corporation had already owned and W4.2 trillion in additional contributions, the KDIC ended up with 45.92% ownership of KFB as of December 31,1999.

trillion was injected as equity participation, W720 billion as fund contribution, and W616 billion as asset purchase.

8.3.2 Insurance Companies, Securities Companies and Merchant Banks

<1998>

At the end of 1998, resolution procedures were in progress for a total of 6 securities companies that were ordered to close down operations or voluntarily wind up operations. Money deposited in two securities companies were repaid through the Securities Investors Protection Fund and payoff procedures on two other securities companies

The KDIC provided a total of W925 billion in September 1998, to enable these merger companies to speed up their rehabilitation efforts. Following a complete due diligence, an additional W228.7 billion was extended as financial support.

Mainly due to liquidity problems, 19 merchant banks were ordered to cease operations following December 1997.[29] To make deposit payments, the KDIC provided a total of W12.7 trillion.

<1999>

On October 1, 1999, the KDIC provided W50 billion in the form of priority equity participation to Daehan Life Insurance Company. The KDIC additionally invested W2.0 trillion on November 25, 1999. With respect to Seoul Guarantee Insurance, which merged with Daehan and Korea Guarantee Insurance, the KDIC provided W1.25 trillion on June 24, 1999, in the form of equity participation. In total, the KDIC made equity participation of W5.14 trillion and contribution of W25 million in 1999 to insurance companies.

<2000>

In 2000, the KDIC provided W3.67 trillion to insurance companies in the form of equity participation. Of which, the KDIC injected additional funds of W3.4

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[29] Three merchant banks have been reopened while the remaining 16 have had their contracts transferred to Hanarum Merchant Bank.

trillion into Seoul Guarantee Insurance, which undertook vicarious payments on corporate bonds issued by the insolvent Daewoo Group.

The KDIC also made fund contribution of W231.8 billion to insurance companies. Within the amount, the KDIC provided W58.7 billion to Korea Life Insurance concerning the P&A of Doowon Life Insurance. The Corporation also acquired W344.7 billion worth of assets (real estate plus non-performing loans) through the resolution and finance corporation, a wholly owned subsidiary of the KDIC.

<2001-2003>
Capital injection made by the KDIC in the form of equity participation between 2001 to 2003 to insurance companies amounted to W80.6 trillion, among which W71 trillion was injected to Korea life and to Seoul Guarantee. In addition to that, the KDIC provided fund contribution of W868 billion and purchased W410 billion of assets.

As for Hans, Korea, Joongang, Youngnam Merchant Banks, whose operations were suspended in the second half of 2000, assets and liabilities were transferred to Hanaro Merchant Bank, a KDIC subsidiary that was solely established and capitalized by the KDIC in accordance with the Government's restructuring plan for merchant banks dated October 20, 2000. The KDIC made insurance claim payments through the Hanareum Banking Corporation, a Resolution Financial Institution subsidiary of the Cooperation in respect of resolution processes concerning insolvent merchant banks, the KDIC provided a total of W14268 billion to Hanareum Banking Corporation by the end of 2000 to enable Hanareum Banking Corporation to make subrogation deposit payoffs.

<Summary>
Deposit insurance system was initially introduced in anticipation of the growing need of regulatory framework in case of bankruptcies and failures of financial institutions in the process of financial liberalization. In the wake of Asian currency and financial crisis of 1997, however, the Government decided to provide a blanket guarantee on deposits in order to restore depositors'

confidence after the IMF program was implemented. A wide range of financial products of all institutions was protected by the deposit insurance system. In order to lessen moral hazard problem of troubled financial institutions, the Government modified the coverage of deposit insurance from full to limited, maximum at W20 million in August 1998, and the coverage raised to W50 million from January 2001. Considering the insurance coverage in US and European countries, the coverage in Korea is too wide.

It is obvious that the wide coverage by deposit insurance will end up in the implicit Government's guarantee that leads to unhealthy management by banking institutions and contributes to insolvency. Therefore, the Government should consider that the deposit insurance system meets global standards and decreases moral hazard by ensuring the following: the insurance should cover a limited range of financial products, and the operation of the system should be strict. This principle had been restored after the crisis management was over. By and large, the temporary adoption of blanket guarantee was best under the circumstances, and an early resumption of limited guarantee shows a speedy resolution of financial crisis.

Table 8-4: KDIC financial support to Banks (100 million of Won)

Names of Banks	Equity Participation			Contribution			Asset Purchase		
	1998	1999	2000	1998	1999	2000	1998	1999	2000
KFB	7500	42086	-	-	4459	3600	-	31197	33536
Hanvit	32642	-	27644	-	-	-	-	-	-
Seoul	7500	33201	6108	-	-	-	-	-	-
CHB	-	27179	-	-	-	-	-	-	-
Peace	-	2200	2730	-	-	-	-	-	-
Kyungnam	-	-	2590	-	-	-	-	-	-
Kwangju	-	-	1704	-	-	-	-	-	-
Cheju	-	-	531	-	-	-	-	-	-
Kookmin	2000	-	-	10651	7534	120	-	179	-
H&CB	2965	-	-	6812	11008	175	-	538	-
Shinhan	2925	-	-	15376	9226	589	-	591	-
Hana	-	4728	-	7739	3400	22	-	54	-
KorAm	2600	-	-	17212	4111	33	-	226	-
KDB	-	-	-	-	-	-	-	-	13000
IBK	-	-	-	-	-	-	-	-	6000
TOTAL	58132	109394	41307	57790	42738	4539		32785	52536

source: KDIC Annual Report, various issues.

Table 8-4 (cont'd): KDIC financial support to Banks (100 million of Won)

Names of Banks	Equity Participation 2001	2002	2003	Contribution 2001	2002	2003	Asset Purchase 2001	2002	2003
KFB			662	640	547	929	5961	6654	4561
Woori				18772					
Seoul				2216					
Chohung									
Peace				3386					
Kyungnam				938					
Kwangju				2714					
Jeju				1651					
Kookmin				3					
H&CB									
Shinhan						13			
Hana									
KorAm									
KDB									
IBK									
AC	962			870					
FC	11581								
Choongbuk									
RFC									
TOTAL	12543	-	662	31190	547	942	5961	6654	4561

source: KDIC Annual Report, various issues.

Table 8-5: KDIC financial support to Insurance Companies (100 million of Won)

Names of Institutions	Equity Participation 1998	1999	2000	Contribution 1998	1999	2000	Asset Purchase 1998	1999	2000
Korea life	-	20500	-	-	2368	587	-	-	-
Doowon	-	300	-	-	-	-	-	-	-
SK	-	-	-	-	-	506	-	-	279
Kookmin	-	2862	-	-	-	-	-	-	168
handuck	-	2327	1023	-	-	-	-	-	-
Hyundai	-	-	-	-	-	111	-	-	-
Chosun	-	993	173	-	-	-	-	-	-
Kumho	-	-	-	-	-	700	-	-	-
Dongah	-	10214	708	-	-	-	-	-	2711
Dongyang	-	-	-	-	-	414	-	-	-
Taepyongyang	-	1751	846	-	-	-	-	-	289
Samsung	-		-	4329	22	-	-	-	-
Kyobo	-	-	-	2399	12	-	-	-	-
Heungkook	-	-	-	2723	69	-	-	-	-
Jeil	-	-	-	2084	3	-	-	-	-
Seoul Guarantee	-	12500	34000	-	-	-	-	-	-
TOTAL	-	51447	36750	11535	2474	2318	-	-	3447

source: KDIC Annual Report, various issues.

Table 8-5 (cont'd): KDIC financial support to Insurance Companies (100 million of Won)

Names of Institutions	Equity Participation			Contribution			Asset Purchase		
	2001	2002	2003	2001	2002	2003	2001	2002	2003
Korea life	15000			7560		236			48
Daehan Cement	0.5			380	129				
KunWha Pharmaceutical		0.5							
Kumho Life				54	739				
SK Life				117					
Tongyang Life						37			
Hyundai Life									
Samsung Life									
Kyobo Life									
Heungkook Life									
Jeil Life									
Seoul Guarantee	56000								
Acq. Of Regent Fire						2386			
Green Cross Life						1393			
	71000.5	0.5	0	9561	868	4052	0	0	48

source: KDIC Annual Report, various issues.

Table 8-6: KDIC financial support to Securities Companies (100 million of Won)

Names of Institutions	Equity Participation			Insurance Claim Payment		
	1998	1999	2000	1998	1999	2000
Jangeun Securities	-	-	-	40	-	-
Dongbang Peregrine Sec.	-	-	-	100	-	-
Hannam I & S	-	-	-	-	1	-
Korea Industrial Sec.	-	-	-	-	3	-
Korea Investment Trust	-	-	30000	-	-	-
Daehan Investment Trust	-	-	19000	-	-	-
TOTAL	-	-	49000	140	4	-

source: KDIC Annual Report, various issues.

Table 8-7: KDIC financial support to Merchant Banks (100 million of Won)

Names of Institutions	Equity Participation 1998	1999	2000	Loan Prior to 1999	1999	2000
Chungsol	121	-	-	1275	-	-
Saehan	-	-	-	4238	-	-
Hangil	-	-	-	1139	-	-
Daegu	-	-	-	502	-	-
Asia	-	-	-	300	-	-
Kumho	-	-	-	375	-	-
Dongyang	-	-	-	1200	-	-
Soolsan	-	-	-	200	-	-
Hyundai	-	-	-	505	-	-
Hanwoi	-	-	-	531	-	-
Samyang	-	-	-	250	-	-
Jeil	-	-	-	1118	-	-
Youngnam	-	-	1717	370	-	-
Korea	-	-	0.5	914	-	-
Hans	-	-	0.5	-	-	-
Joongang	-	-	0.5	-	-	-
Hanaro	-	-	12889	-	-	-
HBC	300	-	-	126821	-	13447
TOTAL	421	-	14608	139738	-	13447

source: KDIC Annual Report, various issues.

Table 8-7 (cont'd): KDIC financial support to Merchant Banks (100 million of Won)

Names of Institutions	Equity Participation 2001	2002	2003	Loan 2001	2002	2003
Woori Investment Bank			647*			
Kumho Merchant Bank						
Hanbui Merchant Bank						
	0	0	647	0	0	0

source: KDIC Annual Report, various issues.

*Due to Woori Investment Bank's transferal of assets and liabilities to Woori Bank.

9. Summary and conclusion

As we have documented, the Korean financial sector did have problems even before the Asian currency crisis. Over-borrowing from foreign banks, over-extension of businesses by chaebols, and easy-lending to those chaebol projects, were all obvious from the data dated before July 1997, at least with benefits of hindsight. However, the downfall of the currency and the macroeconomy was more than what Korea and its financial sector deserved from careless lending before the crisis. This was the case that Korea was hit by a severe liquidity crisis in November and December 1997. The sharp depreciation of the currency shook the fragile financial sector badly. Many banks and financial institutions became insolvent and failed due to the currency depreciation, macroeconomy downturn, and nonperforming loans.

Bank restructuring in Korea, in response to the severe difficulties of the financial institutions worked out relatively successful. Although restructuring required a substantial amount of resources in fiscal fund injections, the banking sector recovered quickly, compared to that in other crisis-hit countries, such as Thailand, Indonesia, and Japan. Drastic measure of closing down banks, nationalization, and forcing privatization and mergers, did do the trick—making surviving banks stronger. KAMCO completed its role to purchase NPLs from financial institutions in November 2002 and entered the new phase, not only working out and auctioning off NPLs but also increasing international competitiveness and improving efficiency in the banking sector.

However, there are still some challenges. The consolidation of banks and merchant banks has dramatically progressed, but the number of Non-banks, such as mutual savings and credit unions, has not decreased significantly. The number of securities companies have even increased.

Similarly, NPL ratios of banks have decreased, NPL ratios of other financial institutions have remained rather high. Public assistance through KAMCO in purchasing NPLs and KDIC in capital injection has relied on banks, and surviving merchant banks and other non-banks have not benefited by the government restructuring program. The Non-bank sector is still vulnerable.

Institutional reform, creating and reinforcing KAMCO and KDIC, has worked well. The sales of assets from KAMCO had the initial problem, but did proceed smoothly afterwards. Inviting foreign capital as a partner did speed up the process of bank restructuring. KAMCO's outright sales of NPL resulted in lower prices than the fair value. Profit sharing was introduced in the form of equity partnership later.

The FSC's role can be strengthened as a unified supervisory agency. The division of roles among FSC, KAMCO, and KDIC should be clarified once the crisis management is over.

After all, bank restructuring in Korea in the aftermath of the Asian currency crisis is almost over. The focus of government-led bank restructuring will be shifted to create market-oriented reform, to ensure peace-time operation, and to strengthen Korean banks so that Korea will no longer have financial crisis.

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