Financial Sector Restructuring in 1999

Ⅰ. Foreword

Financial sector restructuring continued throughout 1999, as it had in 1998, as the central thrust of the government's drive to improve the soundness and the efficiency of the financial industry in the wake of the financial crisis. This involved not just the restructuring of financial institutions but also the revision of financial sector legislation and regulations. During the year under review, the government laid more emphasis on complementing the operational shortcomings of the new financial framework that had been shaped in the preceding year. In doing so, it sought to bring about a more rational pattern of financial behavior by participants.

This article deals with the details of financial sector restructuring that took place during 1999 including the resolution of unsound financial institutions, the injection into viable financial institutions of public funds, and details of the revision of legislation and regulations designed to facilitate the financial sector restructuring. The article concludes with some suggestion as to what the supervisory authority and the financial institutions themselves should do to reap the maximum benefits from the current restructuring.

Ⅱ. Restructuring of Financial Institutions

The government maintained its policy of closing down financial institutions no longer viable owing generally to their accumulation of non-performing loans(NPLs), while inducing an early normalization of those still viable through injection of public funds under the condition of their intensive self-rescue efforts.

1. Resolution of Non-Viable Financial Institutions

After 149 non-viable financial institutions had been closed down in 1998, 186 financial institutions were additionally closed clown through exit or merger in 1999. Starting with the banking sector, Chungbuk Bank and Kangwon Bank merged with Chohung Bank. Also, the government sold 50.99% of its shares in Korea First Bank, whose equity it had acquired in full, to an American company, KFB Newbridge Holdings Ltd., in December 1999.

As for merchant banking corporations, the government revoked the licence of Daehan Investment Banking in 1999, while Hyundai Merchant Bank was merged with Kangwon Bank, Korea International Merchant Bank with Korea Exchange Bank, and LG Merchant Bank with LG Securities. As a result, the number of merchant banking corporations had dwindled to ten as of the end of 1999, compared to thirty at the end of 1997. Thirty-one mutual savings and finance companies and 148 credit unions either exited the market or merged with other institutions in 1999.

2. Support for Financial Institutions from Public Funds

A total of 29.7 trillion won of public funds was injected into financial institu-

[Table 1] **Changes in the Number of Financial Institutions during 1998~99**

	Number of institutions at the end of 1997[1]	1998			1999			Number of institutions at the end of 1999[1]
		Exit[2]	Merger[3]	Newly established	Exit[2]	Merger[3]	Newly established	
Banks	33[4]	5	3	-	-	2	-	23
Merchant banking corporations	30	16	-	-	1	3	-	10
Securities companies	36	6	-	1	-	-	1	32
Investment trust companies	31	7	-	-	-	1	-	23
Insurance companies	45	4	1	-	-	-	-	40
Mutual savings and finance companies	231	22	2	4	21	10	6	186
Credit unions	1,666	69	14	9	103	45	-	1,444
Total	2,072	129	20	14	125	61	7	1,758

Notes : 1) Excluding bridge financial institutions and branches of foreign institutions.
2) Including revocation of licence, bankruptcy, liquidation.
3) The number of financial institutions that ceased to exist following a merger.
4) Commercial banks(26), specialized banks(7)

tions in 1999, bringing the accumulated total to around 94 trillion won since November 1997.

Categorizing the sources, the Korea Deposit Insurance Corporation(KDIC) provided a total of 23.8 trillion won. Of this amount, 13.7 trillion won was used for recapitalizing financial institutions, and 4.1 trillion won for compensating for the losses sustained by the financial institutions that had acquired troubled financial institutions at government request. In addition, 3.7 trillion won was used to purchase those assets of Korea First Bank rejected by Newbridge Capital, and those returned under a put-back options by the banks that had acguired troubled banks in 1998. A total of 2.3 trillion won was made available for the repayment of deposits at financial institutions that had exited the market.

Meanwhile, the Korea Asset Management Corporation(KAMCO) provided a total of 2.9 trillion won for purchasing the NPLs of financial institutions.

The government devoted a total of 2.4 trillion won from fiscal resources. Of this amount, 1.8 trillion won 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. Furthermore, it devoted 550 billion won to the purchase of subordinated debentures issued by banks to raise their BIS capital adequacy ratios.

The Bank of Korea similarly injected 700 billion won into the Export-Import Bank of Korea to improve its international credit standing and facilitate its trade financing activities through enlarging its equity capital.[1)]

[Table 2] **Public Funds Injected**
(November 1997 ~ December 1999)

Unit : billion won

Source	Support Type	November 1997 ~ December 1998	January 1999 ~ December 1999	Total
KDIC	recapitalization	6,338	13,693	20,031
	compensation of losses	6,932	4,075	11,008
	purchase of assets	-	3,724	3,724
	repayment of deposits	14,563	2,262	16,825
	subtotal	27,834	23,754	51,588
KAMCO	purchase of NPLs	19,907	2,869	22,776
Fiscal Resources	recapitalization	10,507	1,800	12,307
	purchase of subordinated debentures	5,821	550	6,371
	subtotal	16,328	2,350	18,678
Bank of Korea	recapitalization	-	700	700
Total		64,069	29,674	93,743

Source : The Ministry of Finance and Economy, KDIC, KAMCO

Ⅲ. Revision of Legislation and Regulations

The revision of legislation and regulations related to the financial sector during 1999 fell generally into four main areas, namely, facilitating financial sector restructuring, improving governance, realigning the prudential regulation system, and lowering entry barriers.

1. Facilitation of Financial Sector Restructuring

Seeking to facilitate financial sector restructuring, the government revised the Act Concerning Structural Improvement of the Financial Industry(effective from January 21, 2000). Financial institutions in the course of merger, under the revised Act, could engage in their pre-merger operations for a certain period upon approval of the Financial Supervisory Commission(FSC). Also, the government and the KDIC were allowed to support troubled financial institutions through purchase of their securities in addition to recapitalization support, which had been the only option.

Following revisions of the Act Concerning Efficient Disposal of Financial Institutions' Non-Performing Assets and Establishment of the Korea Asset Management Corporation(effective from April 30, and December 31, 1999), KAMCO's capital was increased from 200 billion won to 1 trillion won. And the revision expanded KAMCO's business scope to include the management of securitized assets entrusted by special purpose companies(SPCs), the acquisition of the shares resulting from debt-for-equity-swaps on loans bought by the corporation, the provision of payment guarantees for companies in which KAMCO took a stake or for those pursuing restructuring or improvement of their financial structure. Management, outright sale, and brokerage of assets for companies pursuing restructuring or improvement of their financial structure were also included in KAMCO's business scope. And, previously, the scope of the non-performing loans that KAMCO could acquire had been restricted to "loans whose redemption was not possible due to bankruptcy or such like and required special measures for recovery or administration." To this, the following was added, under the revised legislation : "loans which have been recognized by KAMCO's Management Supervisory Committee as posing a considerable risk of non-redemption or giving rise to con-

1) As a result, the BOK's share in the Export-Import Bank of Korea rose from 15.5% to 40.1%, and of this total amount, the Export-Import Bank of Korea used 336 billion won to take a capital participation in Korea Exchange Bank, in accordance with their cooperative financing contract to support domestic companies competing for large-scale foreign projects.

cern over such a risk in view of the debtor's management, financial status or expected cash flow."

The government also revised the Depositor Protection Act(effective from January 21, 2000), under which the KDIC was given the right to request those financial institutions which were unsound or highly likely to become so and were given financial support by KDIC to claim damages against their staff members. Moreover, where unsound financial institutions did not comply with such request, the KDIC was given the right to pursue its claims directly against members of staff responsible for a financial institution's unsoundness.

In addition, to facilitate the competitiveness of cooperatives, a new Agricultural Cooperatives Act was passed to replace the former Agricultural Cooperatives Act, Livestock Cooperatives Act, and Ginseng Cooperatives Act. As a result, the three federations serving the agricultural sector, namely, the National Agricultural Cooperative Federation(NACF), the National Livestock Cooperative Federation(NLCF) and Ginseng Cooperative Federation, are to be integrated as of July 1, 2000 when it comes into effect.

2. Improvement of Governance

Seeking to help improve the structure of the ownership of financial institutions, the government revised the Monopoly Regulation and Fair Trade Act to enable the establishment of financial holding companies(effective from April 1, 1999). Under the new Act, if an enterprise intends to establish or convert itself into a financial holding company, it is obliged to file a report with the Fair Trade Commission. Meanwhile, to preserve the segregation of the industrial and financial sectors, the Act stipulates that a financial holding company shall not own the shares of domestic corporations other than those engaging in financial or insurance business(or those closely related to financial or insurance business). Likewise, no holding company other than a financial holding company is allowed to own shares of domestic corporations engaging in financial or insurance business. In addition, a financial holding company's liabilities may not exceed its net assets, and it is obliged to hold more than fifty percent of the total stock issued by any of its subsidiaries(or more than thirty percent in the case of the subsidiaries listed on the Korea Stock Exchange). Subsidiaries of a holding company may not themselves own subsidiaries.

Next, in order to strengthen the corporate governance structure of financial institutions, a number of related acts were revised; the General Banking Act(effective from January 21, 2000), the Merchant Banking Corporation Act(effective from January 28, 2000), the Securities and Exchange Act(effective from January

21, 2000), the Securities Investment Trust Business Act(effective from January 21, 2000), and the Insurance Business Act(effective from January 21, 2000). Under the amended General Banking Act, banks are required to change the title of their non-executive directors to "outside directors" and establish an audit committee two-thirds of whose members should be outside directors. At least half of the membership of the boards of securities companies and insurance companies exceeding a certain size, and of merchant banking corporations should be made up of outside directors and audit committees should be established. Similar requirements were applied for investment trust companies above a certain size with the additional stipulation that at least three outside directors be appointed to their boards.

3. Realignment of the System of Prudential Regulation

The system of prudential regulation of financial institutions was realigned to heighten its transparency by setting out regulations prescribed under delegated authority directly in the relevant laws or enforcement decrees.

First, the government amended the General Banking Act(effective from April 22, 2000), so that management guidelines previously specified in the FSC's regulation, would be set out under the Act's Enforcement Decree. Also, the revised Act requires banks to establish internal control standards, as the basis for members of staff's conduct of their business, to comply with the law and regulations and to protect investors. And the banks should appoint at least one compliance officer, who should assume the responsibility of investigating and reporting incidences of violation of these internal control standards to the audit committee.

The revised Merchant Banking Corporation Act(effective from April 29, 2000) also requires merchant banking corporations to set up similar internal control standards and institute a system of compliance officers.

Under the revised Securities and Exchange Act(effective from April 1, 2000), a capital adequacy ratio was introduced as a standard for assessing the financial soundness of securities companies, with securities companies obliged to keep their ratios above the standard stipulated in the Enforcement Decree. And as with the legislative requirements imposed on commercial banks and merchant banking corporations, securities companies have to set up internal control standards and appoint compliance officers.

Under the revised Securities Investment Trust Business Act(effective from April 1, 2000), investment trust companies should establish internal control standards and institute a system of compliance officers.

The Insurance Business Act(effective from April 22, 2000) was amended, so that the management guidance standards formerly set by the FSC will be stipulated under the Enforcement Decree, while insurance companies will also be obliged to set up internal control standards and appoint compliance officers.

Meanwhile, the FSC's regulations for individual areas of the financial business were revised several times during the year under review. For banks, the following additional stipulations were added to the conditions for complying with a management improvement order of the FSC: if a bank's BIS capital adequacy ratio falls below 2%, and if it is considered by the FSC that its normal business operation is not possible because it fails to carry out a management rehabilitation plan or faces difficulty in carrying out the plan. Secondly, for any bank considered likely to face a deterioration in its prudential management ratios or to have weak points in management after evaluation of its management status, the Governor of the Financial Supervisory Service(FSS) should require it to submit a rehabilitation plan or committment letter to the FSS, or order it to enter into a management improvement contract with the FSS.

Drawing upon the Core Principles for Effective Banking Supervision set out by the BIS, guidelines for banks' comprehensive risk management were also prepared. These call on banks to equip themselves with comprehensive systems that can precisely recognize, measure, and control risks arising from various types of transactions, and manage each type of risk. In addition, a bank should establish an executive organ responsible for risk management that operates independently from other parts of its business organization.

Also, asset soundness standards were made more comprehensive by incorporating not just the previous performance of borrowers in servicing and redemption but also their future repayment capacity.

In the case of merchant banking corporations whose management conditions are expected to worsen, the Governor of the FSS should request them to submit a rehabilitation plan or to enter into a management improvement contract. In addition, merchant banking corporations are now obliged to set up a risk management organization bringing together the board of directors, the risk management committee, and senior staff with responsibility for risk management. The criterion for evaluating a merchant banking corporation as unsound on the basis of its assets and liabilities was redefined as one having a ratio of capital to risk-weighted assets of below 4%(as against the previous 2%).

The Prompt Corrective Action system for securities companies was strengthened by adding the condition that action should be triggered when the supervisory authority deemed that a securities company fell short of meeting the minimum standards for soundness owing to a large-scale financial loss or an accumulation of non-performing assets. If the securities company did not carry out its rehabilitation plan or the authority did not approve the plan, the authority could move on to the next stage of corrective action. In addition, the risk-weighted balance of beneficiary certificates sold by securities companies should be included in their calculation of net operating asset ratios to prevent excessive exposure to the consequent liquidity or market risk.

The Prompt Corrective Action system for insurance companies was also strengthened. A negative opinion on its management evaluation was added to the criteria triggering prompt corrective actions. Management improvement recommendations or requirements could be made if the authority deemed that the insurance company fell short of meeting the minimum standards for soundness owing to a large-scale financial loss or an accumulation of non-performing assets. If the insurance company did not carry out its rehabilitation plan or the authority did not approve the plan, the authority could move on to the next stage of corrective action. The payment reserve system for insurance companies was also strengthened to bring it on a par with international standards. For life insurance companies, the payment reserve requirement was changed from "more than zero" to "above the required reserve level." For non-life insurance companies, the requirement for long-term insurance with a maturity of more than one year was raised from 1% to 4%.

4. Lowering of Entry Barriers

Entry barriers to the financial sector were lowered through revision of the relevant legislation.

First, under the revised Government Organization Act(effective from May 24, 1999), the right to authorize the establishment and business of financial institutions was transferred from the Minister of Finance and Economy to the FSC, which proceeded to establish appropriate guidelines. The main features of these guidelines were as follows.

Previously, securities companies had not been permitted to own subsidiaries which themselves engaged in securities business, but they were now allowed to hold securities companies specializing in brokerage business as subsidiaries. The establishment of investment trust companies was open to foreign financial institutions(including holding companies) engaging in investment trust business as well as to banks, securities companies, insurance companies, and individuals.

Also the top five *chaebol* which had formerly been able to enter the life insurance business either by taking over or merging two unsound life insurance companies or by establishing a new company and taking over or merging it with one unsound life insurance company, were limited to accessing the business using the former method. And, under the previous regulation, no major shareholder of a financial institution determined as unsound during the preceding five years was allowed to engage in new financial activity or to expand the business scope of the existing financial institution. However, a provision was added for an exception in the case of a major shareholder who assumed a share of the financial responsibility equivalent to half the shortfall in net assets multiplied by the ratio of his or its shares.

Under the revised Enforcement Decree of the Securities and Exchange Act(effective from May 27, 1999), the minimum equity capital for establishing a securities company specializing in brokerage business was reduced from 10 billion won to 3 billion won.

Under the revised Enforcement Decree of the Securities Investment Trust Business Act(effective from May 12, 1999), the minimum equity capital for establishing an investment trust company was reduced from 30 billion won to 10 billion won. The revised Decree also laid down stipulations as to the minimum in-country capital and management staff for a foreign investment trust company establishing a domestic branch of 3 billion won and at least 5 persons.

Insurance companies engaging in a full range of insurance business should have an equity capital or fund amounting to at least 30 billion won. Following the revision of the Insurance Business Act(effective from April 22, 2000), however, a company engaging only in certain sectors of the insurance business requires a minimum of 10 billion won in the form of equity capital or fund with the scale and range of its insurance business determining the excess required up to the full range.

5. Other Steps Taken

The government sought to protect investors, strengthen market discipline, and facilitate management autonomy in financial institutions through revision of relevant legislation including the General Banking Act(effective from January 21, 2000), the Trust Business Act(effective from April 22, 2000), the Merchant Banking Corporation Act(effective from April 29, 2000), the Securities and Exchange Act(effective from January 21, 2000), and the Insurance Business Act(effective from April 22, 2000).

The rights of minor shareholders in banks, merchant banking corporations, securities companies, and insurance companies were greatly improved in comparison to those stipulated in the Commercial Code. Specifically, anyone holding more than 0.005% of the total amount of shares issued by those financial institutions was given the right to take legal proceedings, while those holding more than 0.25% of the total shares were given the right to request dismissal of directors. Meanwhile, those holding more than 0.5% were given the right to make proposals to a general meeting of shareholders and to inspect account books. Those whose holdings exceed 1.5% of the total may request extraordinary general meetings and to inspect business of the financial institutions.

In order to curb attempts to evade prudential regulations by *chaebol*-owned financial institutions, those merchant banking corporations and insurance companies owned by *chaebol* were prohibited from taking part in collusive actions with financial institutions or companies owned by other *chaebol* and engaging in cross funding activities such as credit extension and stock purchase.

The amendment of a bank's articles of incorporation or a proposed reduction of its capital, which formerly needed approval of the FSC, now requires only the filing of notification. For trust companies, the amendment of their articles of incorporation or change in the type of business conducted, formerly subject to notification to the FSC, now requires only the filing of an *ex post facto* report.

Ⅳ. Remaining Tasks

Over the last two years of the twentieth century, thanks to financial restructuring efforts, the soundness of financial institutions improved a great deal and an infrastructure with the capacity to strengthen market discipline was put in place up to a certain degree. Nevertheless, the efforts by financial institutions to heighten the autonomy and efficiency of their management seem to be inadequate and comparatively weak.

Therefore, in order to pursue financial restructuring successfully, more emphasis should be laid on reshaping the superstructure, or the paradigm within which management systems operate, in order to encourage market discipline and the management efficiency of financial institutions.

In this context, the supervisory authority should tighten its prudential regulation of financial institutions, while creating an environment for financial institutions to define their business objectives themselves on the basis of commercial principles, as well as to establish an accountable management system. To this end, the supervisory authority should abstain from implicit regulations or management intervention and, instead, provide a level playing field for all market participants and remain as an impartial referee maintaining order in the market.

As for financial institutions, they should place foremost priority on maximizing their value by improved management performance. In addition, they should follow the trend toward universal banking by expanding their areas of business, but at the same time, they should not neglect their efforts to specialize in those areas where they have a comparative advantage. Meanwhile, it is equally important for shareholders, managers, and employees of financial institutions to break free of their established parameters of thinking so as to encourage large-scale mergers between financial institutions.