3-7-2013

Resolution Experiences and DIF Management in Korea

Eunji Gwon

Resolution Experiences and DIF Management in Korea

Korea Deposit Insurance Corporation

Eunji Gwon(Research Fellow)

March 7, 2013

Table of Contents

I. Overview of the KDIC

1. Establishment of the KDIC ('96)

Dec. 29,'95	Enactment of the Depositor Protection Act
Jun. 1, '96	Establishment of the KDIC (and the Deposit Insurance Fund)
Jan. 1, '97	Started to Provide Depositor Protection (Banks)
Apr. 1, '98	**Integration of Deposit Insurance Funds (of 6 Financial Sectors)**
Jan. 1, '01	Transition from Full Coverage(Nov '97, financial crisis) to Limited Coverage (50 million won)
Jan. 1, '03	Establishment of the New Deposit Insurance Fund
Dec. 21, '07	Legal Basis for the Target Fund System (Launched in Jan.1,'09)
Feb. 3, '09	Legal Basis for the Differential Premium System (Scheduled for 2014)

I. Overview of KDIC

2. Integration of DI Schemes (Since Apr. '98)

☐ Integration of sector-specific schemes into the KDIC

Date	Protection Schemes				
	Banks	Insurers	Investment Firms	Merchant Banks	Savings Banks
Before Mar. 31, '98	Deposit Insurance Fund (KDIC)	Insurance Guaranty Fund (Insurance Supervisory Board)	Securities Investors Protection Fund (Securities Supervisory Board)	Credit Management Fund (Credit Management Fund)	Credit Management Fund (Credit Management Fund)
Since Apr. 1, '98	**Deposit Insurance Fund (KDIC)**				

☐ Member Institutions (as of the end of Sep.'12)

Category	Banks	Insurers		Investment Firms	Merchant Banks	Savings Banks
		Life	Non-life			
Number of Firms	56	24	22	114	1	98
Insurable Deposits(KRW tril.)	871	350	80	21	1	45

II. Resolution Process

1. Principles of Resolution

- **Least Cost** : The resolution process should be *least costly* to the Deposit Insurance Fund or other public funds.
  However, if it is deemed by the Deposit Insurance Committee that a liquidation or bankruptcy might *significantly compromise the stability of the financial system, an exception can be made.*

- **Equitable Loss-sharing** : There should a *fair sharing of loss* among parties responsible for the failure.

2. Resolution Process

Insolvency Determination (FSC, KDIC) → **Least Cost Test (FSC, KDIC)** → **Selection of the Resolution Method (FSC)*** → **Financial Assistance (KDIC)**

*Since Feb.'05, the KDIC has had the authority to choose the method of resolution in the case of savings bank failures.

II. Resolution Process

3. Resolution Methods

Type		Description	Advantages	Disadvantages
Non-open	Liquidation · Bankruptcy	Liquidation and bankruptcy after deposit payoffs	· The speediest deposit payoffs	· Highest costs
	P&A	Transfer of assets and liabilities from the failed bank to a healthier financial institution	· Lower likelihood of insolvency of the acquirer	· If a loss compensation agreement is signed, it will be hard to minimize costs.
	Bridge Bank	All quality assets and liabilities of the failed bank are passed to a bridge bank established by the KDIC. The bridge bank returns the bank to normal operations and then sells it.	· Lower likelihood of insolvency of the acquirer	· Since a bridge bank is a temporary arrangement, it faces challenges in sales activities, which might decrease its franchise value.
Open	M&A	The control of the failed bank is transferred to an acquirer (This may require financial assistance).	· The need for KDIC's assistance is minimized	It is hard to find appropriate investors.
	Open Bank Association	The failed bank directly receives money from the KDIC in the form of contributions to attempt a turnaround of business.	· Prevention of systemic risk	· In case of another insolvency after normalization, resolution costs increase.

III. History of Financial Institution Resolution

1. Financial Restructuring in Korea

Nov.'97 ~ Mar.'98	Apr.'98 ~ Aug.'00	Sep.'00 ~ Dec.'02	'11 ~ '12
Immediately after the Asian Financial Crisis	1st stage of Financial Restructuring	2nd stage of Financial Restructuring	Savings Bank Crisis
-Accepting IMF recommendations - Liquidation of the majority of insolvent merchant banks	- Easing of a credit crunch - Restoration of the financial system	-Additional public fund raising -Improvement of financial supervision and corporate governance	- Savings bank restructuring - Currently underway

III. History of Financial Institution Resolution

1. Financial Restructuring in Korea

As of June, 2012

Financial Sector	Number of Companies, Year-end 1997 (A)	Restructuring Status					Newly Opened	Current Total
		License Revocation	M&A	Liquidation, P&A, Suspension of Operation	Total (B)	Change (B/A, %)		
Banks	33	5	11	-	16	48.5	1	18
Merchant Banks	30	22	8	-	30	100	1	1
Securities Companies	36	6	8	2	16	44.4	31	51
Insurance Companies	50	10	7	6	23	46	28	55
ITCS	24	6	10	-	16	66.7	74	82
Savings Bank	231	130	28	1	159	68.8	25	97
Credit Unions	1,666	2	154	574	730	43.8	18	954
Lease Companies	25	3	13	-	16	64	18	27
Total	2,095	184	239	583	1,006	48	196	1,285

Source: Public Fund Oversight Committee

2. Features of Resolution in Korea

- From the Asian financial crisis in late 1997 to the early 2000's
  - Large-scale financial restructuring
  - The emergence of large banks
  - Liquidation of the majority of insolvent merchant banks

- To resolve failed **bank**s,
  - The government provided financial assistance from public funds to return the failed bank to normal operations.
  - The most common methods were P&A and M&A.
  - If it was impossible to arrange a P&A or an M&A, the government took over the ownership of the bank.
  - The efforts to privatize such government-owned banks are still under way.

- To resolve failed **insurance companies**,
  - Arranged P&A or M&A transactions in most of the cases
  - In consideration of social and economic impacts and the value of in-force policies

- In the case of **savings bank**, from Sep. '06, almost all failed savings banks were resolved through bridge bank transactions.

IV. Resolution of Recent Savings Bank Failures

1. Savings Bank Resolution in Korea

Year	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	Total
Liquidation·Bankruptcy	1	1	1	–	–	–	–	–	–	–	3
P&A	–	–	1	1	–	–	–	–	4	9	15
Bridge Bank	–	–	2	–	4	2	2	1	5	5	21
Open Bank Assistance	–	–	–	–	–	–	–	–	1	–	1
Total	1	1	4	1	4	2	2	1	10	14	40

◆ **Reasons for Recent Failures of Savings Banks**

- After financial restructuring in 1997~2002, competition in the banking industry has intensified.
- An increase in Real-estate PF loans (high-risk assets)
- The economy entered a recession after the global financial crisis in 2007.
- And as real estate prices started to fall, many of the PF loans began to default.

IV. Resolution of Recent Savings Bank Failures

2. Resolution Process

Prompt Corrective Action (FSC)	Prompt Corrective Action (FSC)	Resolution Phase (KDIC)
• **BIS ratio under 5%** : Business Improvement (BI) Recommendation • **BIS ratio under 3%** : BI Request	• **BIS ratio under 0%** : BI Order - Business suspension - Request to submit a BI plan • **Evaluation of the BI Plan** : If the plan is viable, → business resumes. : If the plan is not viable, → the FSC asks the KDIC to decide resolution method	• **Least cost test** • **Resolution method selection** - Purchase of assets & Assumption of liabilities (P&A) - Deposit Payoffs - Open Bank Assistance • **Implements the resolution method**

IV. Resolution of Recent Savings Bank Failures

3. Principles of Savings Banks Resolution

- In Feb. '05, the KDIC was given the authority to decide resolution methods for failed savings banks.

  - "Our principle is to sell failed banks in the market (though a P&A). The use of bridge banks should be kept to the minimum."

- Yet, in a P&A, depositors could not access their funds for a long time while the bank was suspended from business, which increased depositor complaints and sharply decreased the bank's franchise value.

- To resolve this problem, the KDIC decided in Sep. '06 that the preferred resolution method should be bridge bank P&As.
  - Reduction of depositor inconvenience by minimizing the business suspension period (within three months)
  - Reduction of resolution costs by protecting the banks' franchise value
  - Flexibility in failure resolution in the event of a future savings bank failure

➔ *From Sep. '06, most of the failed savings banks were resolved through bridge bank arrangements.*

4. Current Issues Related to Resolution

1) Improvements in the process for financial institution failure resolution

- Problem
  - ✓ Delays in resolution caused problems at failed banks to increase.
  - ✓ And depositors had to suffer inconvenience due to business suspension.

➔ Goal:

Prompt wind-down of failed banks that does not require business suspension

2) Stronger PCA restrictions

- Leaving little room for regulatory forbearance
- More rigorous PCA triggers to prevent failures

3) Stronger supervision of financial institutions

V. Deposit Insurance Fund Management

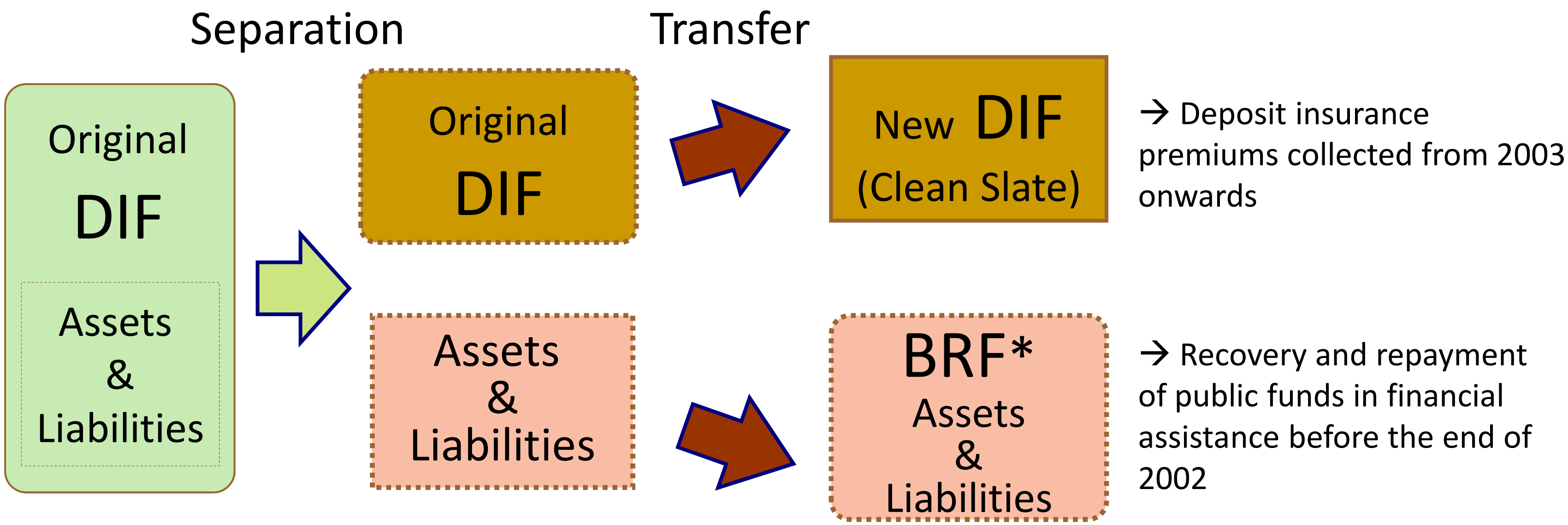
1. Overview of the Deposit Insurance Fund in Korea

- Apr. 1998 Integration of funds & separate accounting

- The KDIC incurred fund losses as it provided financial assistance to failed financial institutions during the Korean government's restructuring of the financial industry

  → Separation of the Deposit Insurance Fund (Jan.2003)

Separation of the Fund - Jan.2003



* Deposit Insurance Fund Bond Redemption Fund

V. Deposit Insurance Fund Management

2. Funding Sources

A. Premiums

B. Contributions

C. Borrowings (Between-Account Borrowing)

D. Bond Issuance

E. Recovery of previously injected funds

V. Deposit Insurance Fund Management

3. Between-Account Borrowing

- It is possible to make between-account transactions to finance resolution costs. Before resorting to outside financing, a DIF account in need of funds can *borrow money from another DIF account with a surplus (within a limit)*.

- If a certain account has accumulated so much loss that it cannot be expected to return to a surplus on its own, it can be *exempted from paying interest on between-account borrowings for a maximum of ten years*. If a certain account is experiencing a temporary liquidity crunch, it can be *given a grace period for the payment of interest on between-account borrowings*.

V. Deposit Insurance Fund Management

4. Creation of a Special Account for Restructuring

MSB Failures after launch of new DIF in 2003

(Unit : number of banks)

2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	Total
1	3	3	1	3	3	2	0	16	8	40

➢ In order to resolve 16 MSB failures from 2003 to 2010, a total of KRW 2.6 trillion was provided *through between-account borrowings*.

→ An accumulated deficit of KRW 2.1 trillion in the MSB Account of the DIF as of late 2010

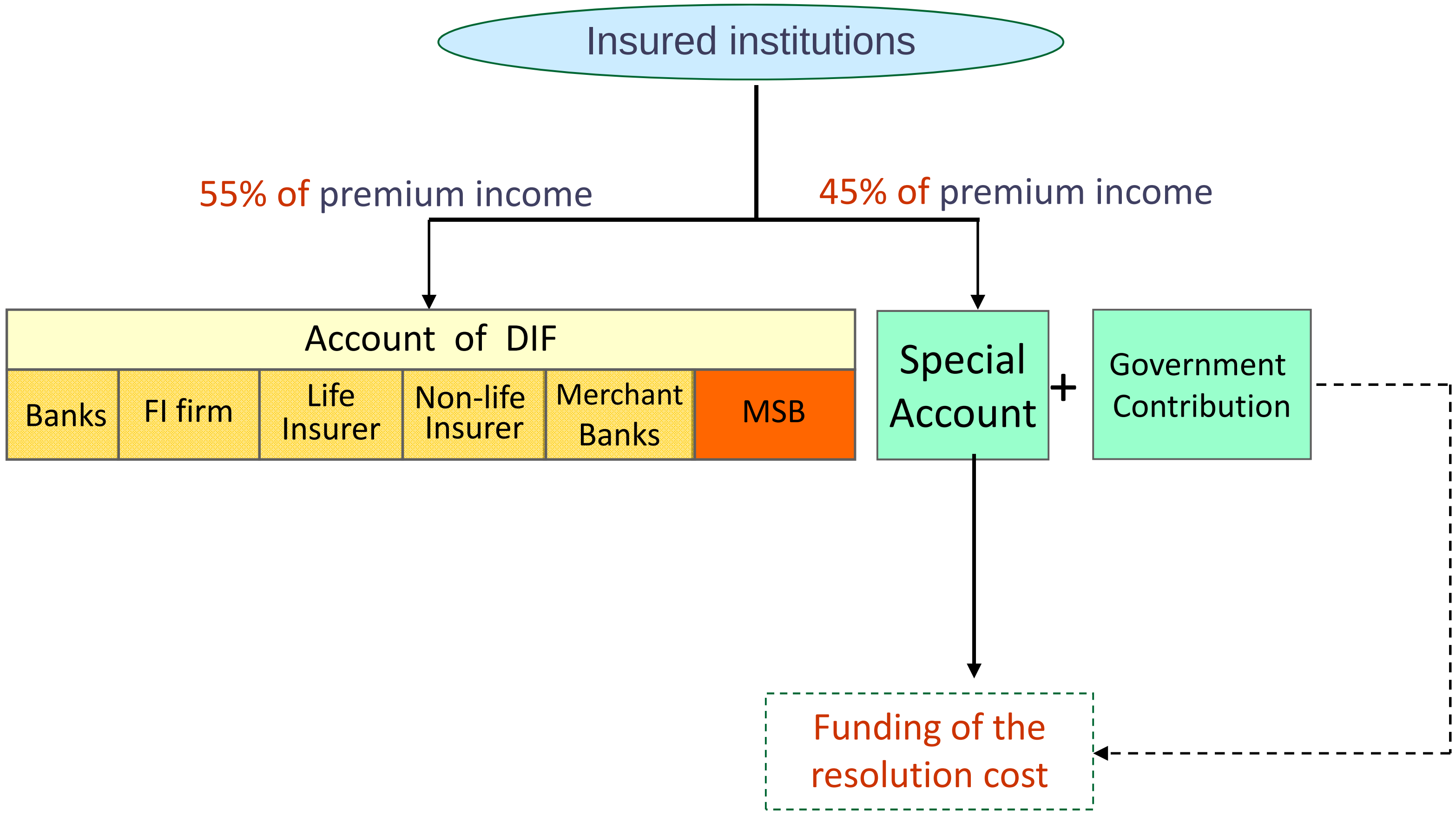
➢ On March 29, 2011, ***'the Special Account for the Restructuring of the MSB(Special Account)'*** was set up.

- To enhance the financial health of the MSB account in the DIF
- The Special Account is settled separately as well.
- Funded by 45% of yearly insurance premiums, issuance of DIF bonds, external borrowings, recovered funds, etc.
- Part or all of the assets and liabilities of a mutual savings bank that fails after January 1, 2011 may be transferred to the Special Account.
- Effective until December 31, 2026

V. Deposit Insurance Fund Management

4. Creation of a Special Account for Restructuring

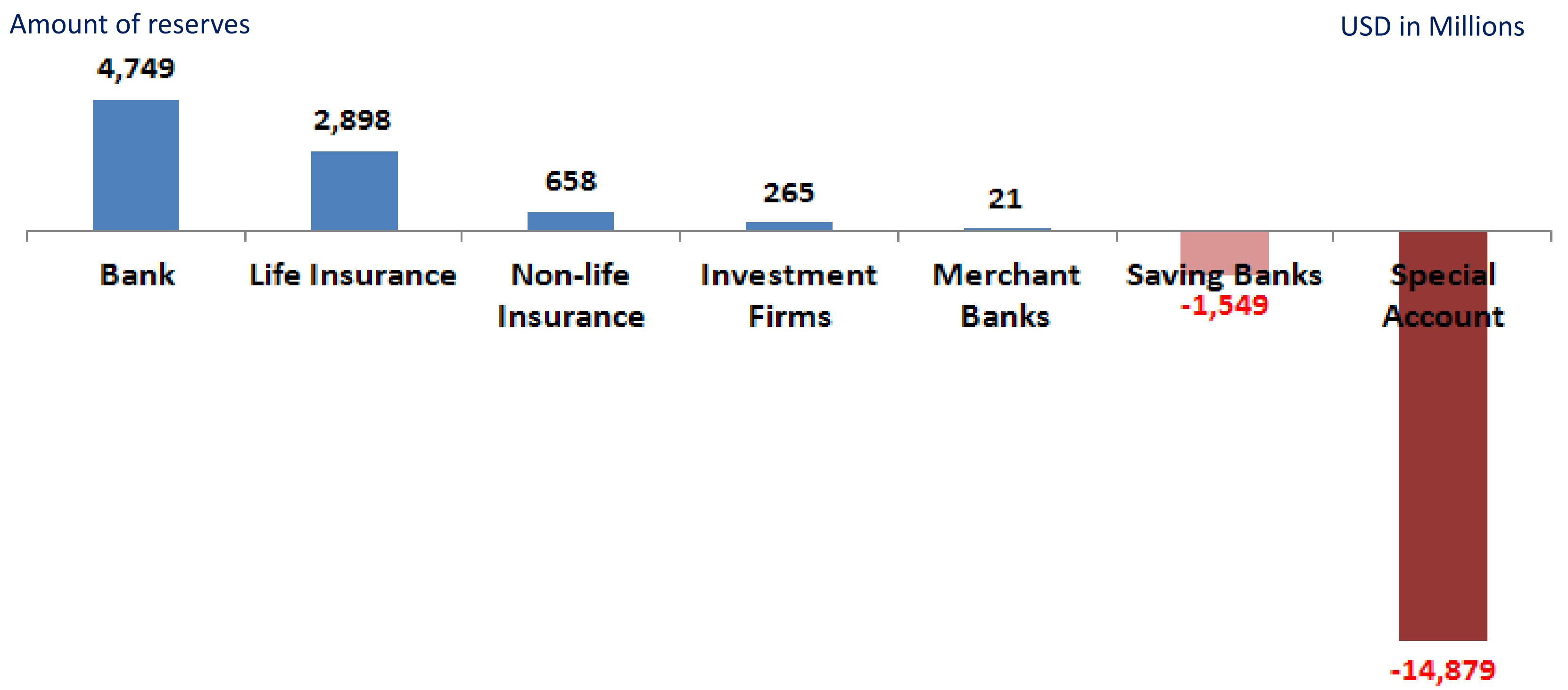
Structure of the Special Account



V. Deposit Insurance Fund Management

4. Creation of a Special Account for Restructuring

State of the DIF (As of 30 June 2012)



VI. Current Issues Related to the DIF

1. Controversy over the Special Account

Opposition from other sectors	Benefits of the Special Account
✓ Against the Principle ✓ Other Accounts Unstable ✓ Moral Hazard problems	✓Minimization of taxpayers' burden ✓ Smooth restructuring of insolvent MSBs ✓ Prevention of Systemic Risks

◆ **Measures to Deal with the Adverse Effects of the Special Account**

- Increased premium on MSB sector
- Harsher punishment after accountability investigation
- Regular reporting to National Assembly

VI. Current Issues Related to the DIF

2. How to Restore the Financial Health of the DIF?

▪ (Principles) A separate fund will be created to take over current losses from the MSB account. If another MSB failure occurs, it will be handled with money from the MSB account.

- If the resolution cost does not exceed the amount of reserves in the MSB account, it will be paid from the reserves.

- If the resolution cost exceeds the amount of reserves in the MSB account, it will be paid from money borrowed from the other DIF accounts as long as there is an assurance that the borrowings can be repaid with future premiums paid by MSBs.

▪ If the size of the failure is so big that it can not be handled with money from the DIF alone, the KDIC will get borrow money from the government and repay it with deposit insurance premiums paid by MSBs.

-To minimize the injection of public funds and prevent moral hazard

➔ *Need to restructure the MSB sector and enhance supervision*

VII. Lessons Learned

Summary

◆ *Effective resolution of financial crises*

✓ Unified Approach
✓ Having knowledge in all financial sectors
✓ Experience of resolving different types of financial institutions
✓ Highly efficient sales of failed financial institutions by finding the market timing that would fetch the most value for the company.

◆ *Efficient management of the Deposit Insurance Fund*

- Efficient restructuring of financial institutions through between-account borrowings
- Cost reduction through economies of scale and scope

VII. Lessons Learned

Some Considerations

1. Well-designed governance structure
   - Check and balance among financial safety-net players
   - Strengthening the deposit insurer's integrity, independence and accountability

2. Prevention of moral hazard
   - Cross-subsidy
   - It should be made sure that a loss in any one account would not affect the whole Deposit Insurance Fund.

3. Development of a prompt resolution process
   - Reduction of depositor inconvenience
   - Restoration of public confidence in the financial system

4. Keeping the DIF healthy

5. Enhancement of financial stability

Thank you

for kind attention!